

## Boston College Law School Digital Commons @ Boston College Law School

---

Boston College Law School Faculty Papers

---

3-10-2008

# Reclaiming Corporate Law in a New Gilded Age

Kent Greenfield

*Boston College Law School*, [kent.greenfield@bc.edu](mailto:kent.greenfield@bc.edu)

Follow this and additional works at: <http://lawdigitalcommons.bc.edu/lspf>

 Part of the [Corporation and Enterprise Law Commons](#)

---

### Recommended Citation

Kent Greenfield. "Reclaiming Corporate Law in a New Gilded Age." *Harvard Law & Policy Review* 2, (2008): 1-32.

This Article is brought to you for free and open access by Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Law School Faculty Papers by an authorized administrator of Digital Commons @ Boston College Law School. For more information, please contact [nick.szydowski@bc.edu](mailto:nick.szydowski@bc.edu).

# Reclaiming Corporate Law in a New Gilded Age

---

*Kent Greenfield\**

Corporate law matters. Traditionally seen as the narrow study of the relationship between managers and shareholders, corporate law has frequently been relegated to the margins of legal discussion and political debate. The marginalization of corporate law has been especially prevalent among those who count themselves as progressives. While this has not always been true, in the last generation or so progressives have focused on constitutional law and other areas of so-called public law, and have left corporate law to adherents of neoclassical law and economics. To the extent that the behavior of businesses has been a matter of concern, that concern has been aimed at adjusting the rules of environmental law, administrative law, employment law, and the like.

The time has come to reclaim corporate law as a topic of wide debate and progressive concern. Instead of being a narrow discipline with limited implications, corporate law determines the rules governing the organization, purposes, and limitations of some of the largest and most powerful institutions in the world. By establishing the obligations and priorities of companies and their management, corporate law affects everything from employees' wage rates (whether in Bakersfield or Bangalore), to whether companies will try to skirt environmental laws, to whether they will tend to look the other way when doing business with governments that violate human rights. Corporate law also determines whether corporations will look at the long term or the short term, whether they will see themselves as owing any responsibilities to stakeholders other than shareholders, and indeed whether they consider themselves to be constrained by law at all.

There are reasons to challenge the dominant vision of corporate law in the United States. Adjustments in corporate law not only could stifle the worst impulses of the corporation but also could create room for businesses to be a more positive social force, primarily by creating and more broadly distributing financial surplus.

---

\* Professor of Law and Law Fund Scholar, Boston College Law School; Distinguished Faculty Fellow, Center on Corporations, Law & Society, Seattle University School of Law. The author benefited from insightful substantive comments from Lawrence Cunningham, Dana Gold, Daniel Greenwood, Renee Jones, Gordon Smith, Adam Winkler, and participants at workshops or lectures at: the University of Mississippi School of Law; the Seattle University School of Law; the University of California at Berkeley Department of Political Science; the Center on Poverty, Work, and Opportunity at the University of North Carolina at Chapel Hill; American Constitution Society student chapter events at Northwestern Law School, University of Chicago Law School, and Boston College Law School; and ACS lawyers' chapter events in Detroit, Seattle, Los Angeles, Nashville, Phoenix, Hartford (Connecticut) and Lexington (Kentucky). Angela Arroyo, Liam Davis Crane, Kyle McClain, and Thomas Noonan provided excellent research assistance. The author also gratefully acknowledges the support of Dean John Garvey and the Boston College Law School Fund.

Indeed, the main thesis of this article is that corporate law is much more important than most progressives realize. Corporate law can be part of the wider task of regulating corporations in particular and business in general. The rules that govern corporations should more expressly take into account the fact that corporations are collective enterprises that demand investment from a number of different sources. These investments come in various forms: inflows of capital from shareholders and creditors; cash inflows from customers; infrastructural support from governments and communities; and effort, intelligence, and direction from employees. Whereas corporate law presently focuses on the financial investments of shareholders only, it could, and should, be adjusted to take into account the contributions of “non-equity investors.” Adjusted in this way, corporate law will make it more possible for corporations to serve their purpose of facilitating the creation of wealth, broadly defined and distributed. Instead of shareholder primacy being the lodestar for corporate decisionmaking, corporations should be governed by the maxim of “abundance for all.”

This Article makes this argument in several steps. Part I catalogs some serious economic ills that exist in the United States today. Part II draws a link between those ills and corporate governance, arguing that the way corporations allocate their resources has helped create some of the ills outlined in Part I. Part III is more optimistic, arguing that adjustments in corporate law and governance can be part of a helpful response to the problems cataloged in Part I. The final Part of the article draws on regulatory theory to explain in more detail how corporate governance could be adjusted to achieve these benefits. Not only is corporate law an underutilized public policy tool, it in fact may be able to achieve certain public policy goals more efficiently than other forms of regulation.

## I. ECONOMIC ILLS

If progressives were to claim a guiding statement on economic policy, an excellent candidate would be President Franklin Roosevelt’s famous declaration that “[t]he test of our progress is not whether we add more to the abundance of those who have much; it is whether we provide enough for those who have too little.”<sup>1</sup> FDR’s charge guided a significant part of the nation’s economic policy for a generation. From 1947 to 1973, the economy grew at an average annual rate of about 4% “and became more equal in the process.”<sup>2</sup> During that period, the poorest fifth of Americans saw their family income grow faster than any other group of Americans.<sup>3</sup>

---

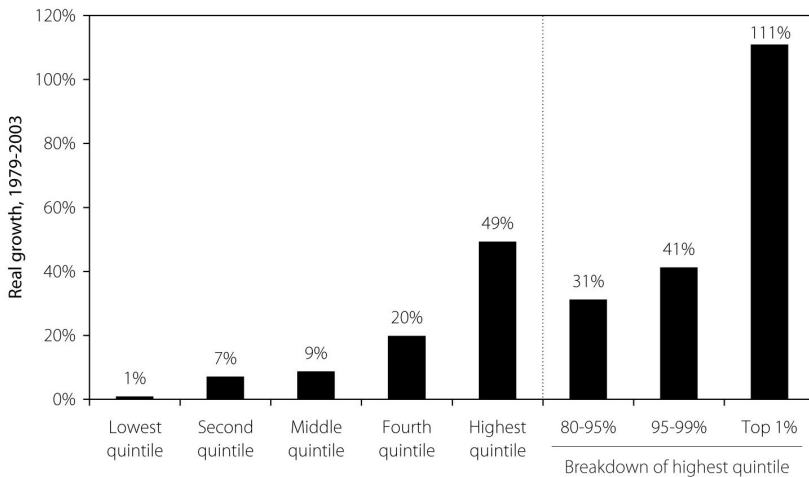
<sup>1</sup> President Franklin Roosevelt, Second Inaugural Address (Jan. 20, 1937).

<sup>2</sup> ROBERT KUTTNER, *THE SQUANDERING OF AMERICA: HOW THE FAILURE OF OUR POLITICS UNDERMINES OUR PROSPERITY* 16 (2007).

<sup>3</sup> LAWRENCE MISHEL ET AL., *THE STATE OF WORKING AMERICA 2004/2005* 71 (2004). See also Claudia Goldin & Robert A. Margo, *The Great Compression: The Wage Structure in the United States at Mid-Century* (Nat’l Bureau of Econ. Research, Working Paper No. 3817, 1991).

This progressive emphasis eroded during the 1970s and 1980s and has not been a meaningful touchstone for public policy for a generation. If this era's economic policy were reduced to a mantra, nothing would fit better than Ronald Reagan's pronouncement that "[w]hat I want to see above all is that this remains a country where someone can always get rich."<sup>4</sup> The emphasis on the rich and well-heeled has had an impact: since 1979 the richest 20% of Americans have seen their income grow the most, by almost 50%.<sup>5</sup> As the following chart shows, the richest 1% of Americans have had their household income more than double in the same period.<sup>6</sup>

Growth in real household income, 1979-2003



Source: Authors' analysis of CBO data.

Figure 10 from: Mishel, Lawrence, Jared Bernstein, and Sylvia Allegretto, *The State of Working America 2006/2007*. An Economic Policy Institute Book. Ithaca, N.Y.: ILR Press, an imprint of Cornell University Press, 2007.



These trends are worsening, not improving. For the first time since just before the stock market crash of 1929, “the richest of the rich”—the wealthiest one one-hundredth of 1% of Americans—claim 5% of all reported personal income.<sup>7</sup> In fact, the richest 10% of Americans, those Americans making roughly \$100,000 or more per year, now claim almost half of all

<sup>4</sup> KEVIN PHILLIPS, *WEALTH AND DEMOCRACY* 91 (2002).

<sup>5</sup> LAWRENCE MISHEL ET AL., *THE STATE OF WORKING AMERICA 2006/2007*, 254 (2007).

<sup>6</sup> *Id.* at 64 fig.10.

<sup>7</sup> Louis Uchitelle, *The Richest of the Rich, Proud of a New Gilded Age*, N.Y. TIMES, July 15, 2007, at A1 (chart). These data may in fact underreport the inequality, because a greater percentage of income for the wealthiest individuals comes from investment income, which is typically underreported in income tax returns. See also David Cay Johnson, *Income Gap is Widening, Data Shows*, N.Y. TIMES, Mar. 29, 2007, at C1.

reported personal income.<sup>8</sup> The richest 300,000 Americans together make as much as the bottom 150 million Americans.<sup>9</sup>

The economic inequality is not merely a function of boom times at the top. It is also an outcome of low and stagnant wages at the bottom. The most recent economic data show that while the total reported income in the United States grew 9% in 2005, average income fell for nine out of ten Americans.<sup>10</sup> Unfortunately, this stagnation is not a new phenomenon. The income for Americans at the bottom of the pay scale has stayed essentially flat for thirty years, and real household income for the typical American family has declined over the last seven years.<sup>11</sup>

The stark inequality in income is dwarfed by the nation's inequality in wealth. Whereas the bottom 90% of American income earners account for 57.5% of the nation's personal income, they control less than 30% of the nation's personal net worth and less than 20% of net financial assets owned by individuals.<sup>12</sup> By comparison, the top 1% of income earners bring in 17% of the nation's personal income—which is striking in its own right—and own over 40% of net individual financial assets. See the following table:<sup>13</sup>

DISTRIBUTION OF INCOME AND WEALTH, 2004

	Distribution of:		
	Household income	Net worth	Net financial assets
All	100.0%	100.0%	100.0%
Top 1%	16.9	34.3	42.2
Next 9%	25.6	36.9	38.7
Bottom 90%	57.5	28.7	19.1

For detailed information on table sources, see Table Notes.

Source: Wolff (2006).

Table 5.1 taken from the Economic Policy Institute's *State of Working America 2006/2007*, available at [www.epi.org](http://www.epi.org)

<sup>8</sup> Johnson, *supra* note 7.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> John Irons, *Typical Families See Income and Earnings Decline, Economic Snapshot for September 5, 2007*, [http://www.epi.org/content.cfm/webfeatures\\_snapshots\\_20070905](http://www.epi.org/content.cfm/webfeatures_snapshots_20070905). These declines are especially troubling when compared to the growth in labor productivity in the United States, which has increased 32% over the past fifteen years. See EPI, *Productivity and Median and Average Compensation, 1973–2004*, [http://www.epi.org/datazone/06/prody\\_comp.pdf](http://www.epi.org/datazone/06/prody_comp.pdf).

Poverty data are also relevant. The wages for about one out of four American workers are so low that they fall below the poverty line, and this proportion has increased over the last few years. See EPI, *Share of All Workers Earning Poverty-Level Hourly Wages, 1973–2005*, [http://www.epi.org/datazone/06/poverty\\_wages.pdf](http://www.epi.org/datazone/06/poverty_wages.pdf). The data are worse for women and people of color—nearly 30% of working women earn poverty wages, as do a third of African American workers and almost four in ten Hispanic workers. *Id.*

<sup>12</sup> MISHEL ET AL., *supra* note 5, at 249 tbl.5.1.

<sup>13</sup> *Id.*

Of course, statistics vary over time, but the trends are sufficiently clear and stable that the *New York Times* remarked that the concentrated wealth of the “new tycoons . . . has made the early years of the 21st century truly another Gilded Age.”<sup>14</sup>

For those whose public policy imperatives correlate more with Franklin Roosevelt’s than Ronald Reagan’s, these data are quite troubling. While it is still premature to say that economic fairness is an issue of mainstream concern, it is indeed slowly re-emerging as an issue of focus among progressive scholars, thinkers, activists, and at least a few politicians.<sup>15</sup> The public policy options that are increasingly touted include additional increases in the minimum wage,<sup>16</sup> greater legal protection for unions and union organizers,<sup>17</sup> income tax credits,<sup>18</sup> and even a constitutional amendment guaranteeing the right to a job.<sup>19</sup>

There is something missing in this debate: the role of corporations, corporate governance, and corporate law. This is a crucial topic because it is both part of the problem and a very important part of a potential solution. It is hardly earth shattering to point out that, in an age when wages for most Americans are stagnating and the wealth and income of the richest Americans are rocketing skyward, something must be wrong with how we regulate and govern business. Most American wealth is produced by business,<sup>20</sup> so it would be shocking if the trends were unrelated. It is perhaps more surprising to think of corporate governance law as a mechanism to address some of the economic problems the nation faces. But the case can be made that reforms in corporate governance offer a significant set of untapped public policy tools that could be used to improve the fortunes of many Americans.

---

<sup>14</sup> Uchitelle, *supra* note 7.

<sup>15</sup> See, e.g., JOHN EDWARDS ET AL., *ENDING POVERTY IN AMERICA: HOW TO RESTORE THE AMERICAN DREAM* (2007).

<sup>16</sup> See, e.g., Jonathan Barry Forman, *Making America Work: Alfred P. Murrah Professorship Inaugural Lecture*, 60 OKLA. L. REV. 53, 69–72 (2007); see also MISHEL ET AL., *supra* note 5 at 109–70.

<sup>17</sup> One of the current legal initiatives being pursued by U.S. unions is the Employee Free Choice Act, proposed legislation that would ensure workers have a fair chance to form a union by, among other things, strengthening penalties against employers who retaliate against employees who organize and permitting workers to form a union through a “majority sign-up.” See *Why We Need the Employee Free Choice Act*, <http://www.americanrightsatwork.org/employee-free-choice-act/resource-library/why-workers-need-the-employee-free-choice-act.html>. The Employee Free Choice Act was defeated in the Senate on June 26, 2007. The Senate voted 51–48 in favor of cloture, nine votes short of the sixty needed to end the filibuster.

<sup>18</sup> See, e.g., Forman, *supra* note 16, at 65–69; Edmund L. Andrews, *A Tax Plan as Trial Run for '09 Law*, N.Y. TIMES, Oct. 25, 2007, at C1.

<sup>19</sup> See, e.g., WILLIAM QUIGLEY, *ENDING POVERTY AS WE KNOW IT* 93–163 (2003).

<sup>20</sup> Approximately 60% of the nation’s income comes from the corporate sector. MISHEL ET AL., *supra* note 5, at 82.

## II. CORPORATIONS, AND CORPORATE LAW, AS PART OF THE PROBLEM

Traditionally, large corporations were seen as quasi-public institutions with social responsibilities that came as a condition of their charter.<sup>21</sup> But beginning just over a century ago, states began to bestow increasing power on corporations and to remove many of the previous limits on their size and authority. Corporations came to be seen as supremely private entities, whose primary purpose was making money. Corporations now enjoy legal benefits—including limited liability of shareholders, a perpetual existence separate from their creators and investors, and legal and constitutional personhood—that help ensure their power and maximize the likelihood of their success. Corporations are also the beneficiaries of a huge array of public resources, including the very fabric of the securities markets, infrastructural support ranging from sewers to educational facilities, and regulatory and judicial protection of their intellectual property. Various public sources also contribute billions of dollars in “corporate welfare” for a variety of purposes, including state and local tax incentives to affect factory location decisions and federal government subsidies to support international marketing.<sup>22</sup>

These public supports of corporations are important and valuable, and not just to the corporations themselves. Corporations provide one of society’s most powerful engines of wealth creation, and the nation as a whole enjoys more abundance because of them.<sup>23</sup>

---

<sup>21</sup> See KUTTNER, *supra* note 2, at 145 (“As late as the 1890s, many states demanded that corporations serve public purposes and strictly regulated their internal governance in exchange for the limited liability granted to general corporations in their charters”); see also MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1870–1960* 77 (1992).

<sup>22</sup> See, e.g., Marilyn W. Thompson & Ron Nixon, *Even Cut 50%, Earmarks Clog a Military Bill*, N.Y. TIMES, Nov. 4, 2007, at A1 (cataloging \$1.8 billion in federal payments to private companies added to military bill for projects the Pentagon did not request); Stephen Slivinski, *The Corporate Welfare State: How the Federal Government Subsidizes U.S. Businesses*, 592 POL’Y ANALYSIS 1 (May 14, 2007) (detailing “\$92 billion in direct and indirect subsidies to businesses and private-sector corporate entities” in the fiscal year 2006).

<sup>23</sup> The business form that we call the corporation is an immensely successful mechanism for organizing business endeavors and has been so since the late 1800s. See JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, *THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA* (2003). Compared to the other kinds of business entities available—partnerships, trusts, limited liability companies, sole proprietorships—the corporate form is the dominant method of organizing large (and even small) business enterprises. This is true in the United States and increasingly true throughout the industrialized world. The 2002 tax returns of enterprises in the United States show \$18.8 billion in receipts for corporations, as compared to \$2.6 billion for partnerships and \$1 billion for non-farm proprietorships. U.S. CENSUS BUREAU, *STATISTICAL ABSTRACT OF THE UNITED STATES* 503 tbl.727 (2006). According to Eurostat, in the European Union during 2001, 77,861 more corporations were born than died, as compared to 9,335 enterprises organized under all other legal forms. See Eurostat, *Business Demography Indicators Presented by Legal Form*, <http://epp.eurostat.ec.europa.eu>. For a longer treatment of the comparative advantages of the corporate form, see Kent Greenfield, *Saving the World With Corporate Law?*, 58 EMORY L. J. \_\_\_\_ (forthcoming 2008).

### A. Externalities

But corporations have their pathologies as well, and these pathologies are partially a function of their advantages. We endow the corporation with the authority and ability to create wealth; but without constraints, it can be overly single-minded in the pursuit of profit. As an artificial entity, it has no conscience of its own. Because corporate investors are separated from managerial decisionmakers, their consciences are not easily brought to bear. The company has every incentive to externalize costs onto those whose interests are not included in the firm's financial calculus. The firm can do this in many ways. It can refuse to provide health benefits to its employees, leaving Medicare or Medicaid to pick up the tab.<sup>24</sup> It can save on production costs by skirting environmental laws.<sup>25</sup> It can sell shoddy products to one-time purchasers, produce goods in sweatshops, or underfund employees' pension funds.<sup>26</sup> In fact, because of the corporation's tendency to create benefits for itself by pushing costs onto others, the corporation could aptly be called an "externality machine."<sup>27</sup>

Of course not all corporations engage in such shady behavior, but those who refuse to do so often suffer competitive disadvantages vis-à-vis companies that do. Society has long understood that the corporation's penchant for overlooking the negative impacts of its drive for profit means that, while corporations should be appreciated for their special ability to create wealth, they should also be treated warily, given the form and power bestowed on them.<sup>28</sup>

---

<sup>24</sup> See, e.g., WAL-MART: THE HIGH COST OF LOW PRICES (Brave New Films 2005).

<sup>25</sup> See Joseph Kahn & Jim Yardley, *As China Roars, Pollution Reaches Deadly Extremes*, N.Y. TIMES, Aug. 26, 2007, at A1; Jane Perlez & Raymond Bonner, *Below a Mountain of Wealth, a River of Waste*, N.Y. TIMES, Dec. 27, 2005, at A1.

<sup>26</sup> See Roger Lowenstein, *The End of Pensions?*, N.Y. TIMES, Oct. 30, 2005, §6 (Magazine), at 56; Steven Greenhouse & Michael Barbaro, *An Ugly Side of Free Trade: Sweatshops in Jordan*, N.Y. TIMES, May 3, 2006, at C1; "Wake Up Wal-Mart" Information Sheet, available at [www.wakeupwalmart.com](http://www.wakeupwalmart.com). For a related (and more provocative) example, see Kent Greenfield, *September 11 and the End of History for Corporate Law*, 76 TUL. L. REV. 1409 (2002).

<sup>27</sup> See LAWRENCE MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 49-65 (2001) (calling the corporation an "externalizing machine").

<sup>28</sup> Justice Brandeis explained this best: "The prevalence of the corporation in America has led men of this generation . . . to accept the evils attendant upon the free and unrestricted use of the corporate mechanism as if these evils were the inescapable price of civilized life and, hence, to be borne with resignation. Throughout the greater part of our history a different view prevailed. Although the value of this instrumentality in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, educational and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils . . . . There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations." *Liggett v. Lee*, 288 U.S. 517, 548 (1933) (Brandeis, J., dissenting).



### B. Shareholder Primacy

The pathologies of the corporate form are not limited to the creation of externalities. In a sense, the corporation's core pathology is its core mission: to advance the interests of shareholders first and foremost. In Milton Friedman's famous explanation, the responsibility of directors is to conduct the business in accordance with the "desires" of the shareholders, "which generally will be to make as much money as possible."<sup>29</sup> This means that the corporation looks after the interests of other contributors to the firm (employees, communities, creditors, etc.) only to the extent that doing so advances shareholder interest, or to the extent those other contributors have sufficient market power to prompt the corporation to consider their interests.

To be sure, not all corporate law scholars (not even all "progressive" corporate law scholars) believe that it is a correct statement of the law that shareholders are supreme.<sup>30</sup> Those who contest shareholder primacy usually argue that the business judgment rule gives management so much flexibility and power that in fact it owes no enforceable duty to shareholders. Some see this flexibility as a good thing, a way to allow executives to manage for the long term and with a view toward a broader range of responsibilities.<sup>31</sup> Others see this flexibility but argue that it is a significant malady—one of a number of indications of the triumph of managerial prerogative over shareholder interests.<sup>32</sup>

The fact remains, however, that because of a mix of law, norms, and market dynamics, the touchstone of corporate success is the maximization of shareholder return. There are exceptions, both in terms of companies that in fact are able to look beyond shareholder interests and in terms of companies whose management has used the business judgment rule to aggrandize power and wealth at the expense of the firm (more on this below). But these exceptions are just that, and are unsustainable in the long term. On the

<sup>29</sup> Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, (Magazine), at 32.

<sup>30</sup> See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 287–88, 298–300, 320–21 (1999). For responses to Blair and Stout on this point, see Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L. J. 89, 115–17 (2005); Thomas Wuil Joo, *A Trip Through the Maze of 'Corporate Democracy': Shareholder Voice and Management Composition*, 77 ST. JOHN'S L. REV. 735 (2003).

<sup>31</sup> See Blair & Stout, *supra* note 30, at 298–300, 320–21. Blair and Stout assert that the business judgment rule allows the board to balance the needs of the various stakeholders, because they are protected from shareholder suits except in the most egregious situations.

<sup>32</sup> See, e.g., LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 45–46 (2004) (the business judgment rule is one reason stockholders are not able adequately to challenge compensation agreements in court); Note, *Corporate Law - Fiduciary Duties of Directors - Delaware Court of Chancery Finds Disney Directors Not Liable for Approval of an Employment Agreement Providing \$140 Million in Termination Payments - In re Walt Disney Co. Derivative Litigation*, 119 HARV. L. REV. 923 (2006) (arguing that the business judgment rule allowed executives in the Disney case to avoid liability); J. Robert Brown, Jr., *Disloyalty Without Limits: 'Independent' Directors and the Elimination of the Duty of Loyalty*, 95 KY. L. J. 53, 56 (2006–2007) (the business judgment rule protects executives' compensation)..

whole, shareholder primacy is a fact of life in the United States in the early twenty-first century.

The costs of shareholder primacy are immense. Shareholder primacy means that corporations not only will—but should—take care of the environment, workers, community, or ethics only when doing so serves the shareholders in the end. In the words of the Delaware Supreme Court, a corporate “board may have regard for various constituencies in discharging its responsibilities, *provided there are rationally related benefits accruing to the stockholders.*”<sup>33</sup>

Consider the situation in which a board of directors of a public company makes a decision that benefits its employees financially but imposes real, long-term costs on shareholders. Also assume that the board makes that decision because it has determined that benefits to the employees would far outweigh the costs to shareholders. Even though such a decision would maximize the return to the firm’s stakeholders as a whole and thus would maximize the social welfare resulting from such a decision, such a decision would violate existing law. The directors might be able to protect themselves from suit through the elasticity of the business judgment rule, but only if they lie about their motivation and suggest that they are really acting in the long-term interests of the shareholders. While that might be a plausible argument some of the time, it will clearly be a reach in other situations. The shareholder plaintiff law firms, and eventually the courts, will catch on. Moreover, the market will punish the managers severely. The stock price will fall, making the company a target for takeover. Companies whose managers act as if they have duties to stakeholders other than shareholders are squeezed out of the market.

Shareholder primacy not only narrows management’s view of their responsibilities, it also squeezes that view temporally, incentivizing a focus on the short term. Shareholders increasingly expect high returns quarter to quarter, and if they do not get such returns they punish the companies that fail to provide them. Shareholders do not have loyalty to the companies whose stock they hold. Indeed, other than through initial public offerings, few shareholders actually invest their money in the companies whose stock they own; the vast majority of shareholders buy their stock on the secondary market, from another stockholder who at some earlier point (months or minutes before) had also purchased shares in the secondary market. If a stock is not performing in the short term, there will always be a more appealing company. Not surprisingly, the average stock turnover for Fortune 500 companies is over 100% a year, and is even greater for smaller companies.<sup>34</sup> Short-termism is made worse by the size and power of institutional shareholders such as mutual funds, pension funds, hedge funds, banks, and insurance companies, which now own more than 60% of all public corporate

---

<sup>33</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (emphasis added).

<sup>34</sup> LAWRENCE E. MITCHELL, *THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY* 277–78 (2007).

equities and have their own incentive to maximize the value of their portfolio in the short term.<sup>35</sup>

Shareholder primacy restricts management, keeping it focused on the short term and on shareholder interest. Any company that wants to take the long-term view—or thinks it important to take into account the interests of other firm stakeholders—will be punished in the securities markets. Shareholder primacy thus guarantees that any talk from management about social responsibility will likely be for show; it will mean that legal requirements intended to protect other stakeholders will be seen as costs rather than commands;<sup>36</sup> it will mean that any externality that does not translate into a corporate cost will be disregarded. Non-shareholder stakeholders are left to depend on mechanisms outside corporate law to protect their interests. These mechanisms primarily appear in the form of express contracts or government regulation, both seriously imperfect.

### C. Corporations and Economic Inequality

The costs of shareholder primacy also have a negative influence on the trends mentioned early in this essay: stagnant wages for many if not most American workers and a growing disparity between the rich and poor. These negative effects are not inherent in the corporate form, nor in business in general. Americans benefit, individually and collectively, from a robust, privately-run economy that motivates people and institutions to discover ways to create wealth. However, corporate law has established as a touchstone for corporate decision making an extremely narrow and at times counterproductive measure of success.

Shareholder primacy is relevant to the discussion on inequality because the requirement that managers look to maximize shareholder wealth provides disproportionate benefits to those who are already financially well-off. The capital wealth in the United States is controlled by a tiny fraction of the American population, so a rule requiring corporations to be managed to the benefit of shareholders amounts to a rule that corporations should be managed to benefit the rich. The significance of this rule is hard to overstate.

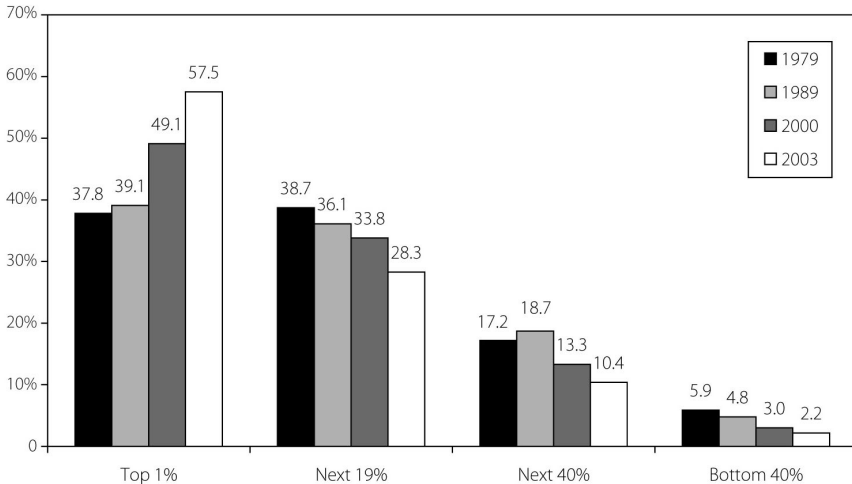
---

<sup>35</sup> KUTTNER, *supra* note 2, at 144 (arguing that these institutional investors “do not behave like owners. They act more as traders, seeking short-term gain.”). See also LAWRENCE E. MITCHELL & DALIA TSUK MITCHELL, *CORPORATIONS CASES AND MATERIALS* 77 (2006)(citing statistics on block ownership by institutional investors).

<sup>36</sup> See, e.g., James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 765 (1984) (stating that corporate fiduciary duties may not have a place in enforcing general law compliance if the illegality is profitable to the corporation because the derivative suit is incapable of being a mechanism of enforcing general law compliance); Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1177 n.57 (1982) (“[M]anagers not only may but also should violate the rules when it is profitable to do so.”). For responses, see Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279 (2001); Cynthia A. Williams, *Corporate Compliance with the Law in the Era of Efficiency*, 76 N.C. L. REV. 1265 (1998).

The richest one-tenth of 1% of Americans receive over a third of the nation's total capital income,<sup>37</sup> while the bottom 80% of Americans control less than 13%.<sup>38</sup> Consider the following chart:

#### Share of capital income, 1979-2003



Source: Authors' analysis of CBO data.

Figure 15 from: Mishel, Lawrence, Jared Bernstein, and Sylvia Allegretto, *The State of Working America 2006/2007*. An Economic Policy Institute Book. Ithaca, N.Y.: ILR Press, an imprint of Cornell University Press, 2007.



Such a disproportionate benefit obviously leads to wealth and income disparity—the rich are seizing an increasing percentage of corporate profits. But the situation vis-à-vis inequality is even worse than this one set of statistics can show, because the *source* of these profits is in part a transfer from labor. This of course is exactly what one would expect to find in an economy where the largest income-producing sector of the economy—the corporate business sector<sup>39</sup>—operates under a duty to shift as much of its profit as possible toward its shareholders. The statistics bear this out. In 2005, the share of all corporate income that went to labor had fallen to its lowest levels since the late 1960s, and capital's share of corporate income (that is, profits earned by shareholders or retained as earnings) had risen to levels not seen in nearly forty years.<sup>40</sup> Moreover, capital investors have seen their return per dollar of investment improve. In 2005, return to capital was at its highest level in thirty-six years, except for the year 1997. And because of the lower-

<sup>37</sup> MISHEL ET AL., *supra* note 5, at 78–79.

<sup>38</sup> *Id.* at 82 fig.1S. This chart represents 2003 data; for 2006, the estimate is that the bottom 80% received 15.2% of capital income. See *id.* at 79 tbl.

<sup>39</sup> *Id.* at 84.

<sup>40</sup> *Id.*

ing of taxes on corporate profits, the after-tax return on capital was even higher and more historically dramatic.<sup>41</sup> This expansion of capital's share in corporate income has apparently had real effects on wages. The Economic Policy Institute estimated that if the return to capital was the same in 2005 as it had been in 1979, then wages in the corporate sector would be 5% higher. In other words, in comparison to a generation ago, employees are transferring \$235 billion more per year to capital than they were in the late 1970s.<sup>42</sup>

On the national level, these trends result in a greater percentage of total personal income going to owners of capital and a lower percentage going to those who earn income through wages. Not only have the rich seized a greater proportion of capital income, capital income itself is a greater percentage of personal income than it was a generation ago.<sup>43</sup> If the economy is a pie, the rich are getting a larger and larger percentage of the capital income piece, which is itself growing. The disparity effect is thus worsened. As economists Lawrence Mishel, Jared Bernstein, and Sylvia Allegretto suggest, "[s]ince the rich are the primary owners of income-producing property, the fact that the assets they own have commanded an increasing share of total income automatically leads to income growth that is concentrated at the top."<sup>44</sup>

These economic data reflect real operative norms within the workplace. Shareholders' desires for short-term returns often directly conflict with the interests of others of the firm's stakeholders, who are more interested in long-term success and stability. When such a conflict occurs, one side or the other has to give, and in the United States it is clear which side that will be.

Even when the interests of various stakeholders do not conflict, decisionmakers within the firm often assume that they do. Executives have long assumed, for example, that cutting employment will reduce costs, making the company more profitable. During the 1990s, "downsizing" became the rage among executives who wanted to show Wall Street that they were committed to cutting costs. Wall Street's positive response became so predictable that analysts would talk about the "seven-percent rule": whenever a company would announce a major layoff, its share price would jump 7%.<sup>45</sup> This share-price increase represented a shoddy assumption about the underlying fundamentals of the companies in question, and recent research shows that the long-term effect of downsizing on share prices is at least unclear and may even be negative.<sup>46</sup>

---

<sup>41</sup> *Id.* at 86.

<sup>42</sup> *Id.* at 88.

<sup>43</sup> *Id.* at 80–81.

<sup>44</sup> *Id.* at 81.

<sup>45</sup> James Surowiecki, *It's the Workforce, Stupid!*, *NEW YORKER*, Apr. 30, 2007, at 32.

<sup>46</sup> *Id.* For a scholarly analysis, see Gunther Capelle-Blancard & Nicolas Couderc, *How Do Shareholders Respond to Downsizing? A Meta-Analysis*, Helsinki Center of Economic Research, Seminar (Feb. 2007), [http://www.hecer.fi/Seminars/documents/labor\\_turnover/Capelle-Blancard\\_Couderc.pdf](http://www.hecer.fi/Seminars/documents/labor_turnover/Capelle-Blancard_Couderc.pdf); Greg Filbeck & Shelly E. Webb, *Information Asymmetries, Managerial Ownership, and the Impact of Layoff Announcements on Shareholder Wealth*, 40(2) *Q.J. BUS. & ECON.* 31 (2001) (finding "statistically significant negative share price response associated with layoff announcements"); Henry S. Farber & Kevin F. Hallock, *The Changing Rela-*

Many executives nevertheless acted as if the “seven-percent rule” was a fact and continue to do so. They read the *Wall Street Journal* more often than economists’ working papers, and notwithstanding scholarly demonstrations that the assumption is dubious, the “seven-percent rule” matches with reality often enough that executives have their beliefs reinforced.<sup>47</sup> When Earthlink announced layoffs in 2007, its stock price rose 7% in a day.<sup>48</sup> Alcoa announced in 2006 that it was going to close plants and cut jobs, and its stock price went up almost 6.5% over two days.<sup>49</sup> Computer software company CA announced in 2006 it was cutting 11% of its workforce, and its share price went up nearly 7% in a day.<sup>50</sup> And on and on.<sup>51</sup>

The assumption that cutting employees helps a company’s financials is simply too facile, salient, and powerful for executives looking for a quick fix to ignore. “Downsizing has become less a response to disaster than a default business strategy, part of an inexorable drive to cut costs.”<sup>52</sup> This is especially true if the executives are looking at the short term. The average CEO stays in his or her job for only six years—“long enough to see the benefits of downsizing (like a lower payroll) but not long enough to suffer costs that may appear in the long term.”<sup>53</sup>

Downsizing is just a subset of short-term business strategies that emphasize making profit for shareholders in the short term at the expense of other firm stakeholders and the firm as a whole in the long term. In addition,

---

*tionship Between Job Loss Announcements and Stock Prices: 1970–1999* (Princeton Univ., Univ. Ill. & Nat’l Bureau of Econ. Research, Working Paper, 2004) (finding that the overall stock price reaction to job loss announcements, on average, was negative but that this negative reaction was getting smaller over time).

<sup>47</sup> See DANIEL GILBERT, *STUMBLING ON HAPPINESS* 163–70 (2006) (Discussing the idea that people generally seek only facts and knowledge that confirm conclusions they have already reached).

<sup>48</sup> See *Earthlink to Trim Work Force and Close Offices*, N.Y. TIMES, Aug. 29, 2007, at C9.

<sup>49</sup> See *Plant Closings Are Set at Alcoa*, N.Y. TIMES, Nov. 22, 2006, at C8. Alcoa, the world’s largest aluminum producer, announced on November 21, 2006, that it was going to close plants and cut as many as 6,700 jobs. See *id.* Its stock price rose from \$28.58 at the start of November 21, to \$30.43 at the close on November 22, an increase of almost 6.5%. See Yahoo! Finance Historical Prices, <http://finance.yahoo.com>.

<sup>50</sup> *Software Maker, Struggling with Turnaround, to Cut 1,700 Jobs*, N.Y. TIMES, Aug. 15, 2006, at C8. CA announced these job cuts on August 14, 2006. Its stock price opened that day at \$21.71 and closed on August 15 at \$23.24, an increase of approximately 7%. See Yahoo! Finance Historical Prices, <http://finance.yahoo.com>.

<sup>51</sup> See *Countrywide to Cut Jobs*, N.Y. TIMES, Oct. 25, 2006, at C12. On October 24, 2006, Countrywide Financial announced it was cutting its workforce by 2,500, or 5%. Its stock price opened October 24 at \$35 and closed the day at \$37.33, an increase of almost 7%. See Yahoo! Finance Historical Prices, <http://finance.yahoo.com>. On June 14, 2006, United Airlines announced cuts to its salaried workforce of 11%, a total workforce reduction of 2%. See *United Airlines Plans to Lay Off 11% of Its Salaried Workers*, N.Y. TIMES, June 15, 2006, at C12. The stock of the UAL corporation, which owns United, rose from \$27 at the start of June 14, to \$30.42 by the time of closing on June 15, 2006, a rise of almost 13%. See Yahoo! Finance Historical Prices, <http://finance.yahoo.com>. On January 24, 2006, Daimler Chrysler announced elimination of 6,000 jobs. See Carter Dougherty, *Cost-Cutting at Daimler to Eliminate 6,000 Jobs*, N.Y. TIMES, Jan. 25, 2006, at C3. The stock price rose \$2.60 that day to \$54.84, a 5% increase. See Yahoo! Finance Historical Prices, <http://finance.yahoo.com>.

<sup>52</sup> Surowiecki, *supra* note 45.

<sup>53</sup> *Id.*

corporations achieve the same effect by keeping wages low, limiting or cutting medical benefits or pension contributions, or ignoring environmental regulations. These strategies do not even need to work; executives simply need to believe they will work, at least in the short term.

There is a final way in which corporate law creates economic inequality. As discussed above, the business judgment rule gives executives large discretion in managing the firm. Senior management have used this flexibility to increase their compensation to unprecedented levels.<sup>54</sup> There are a number of notable examples, the most prominent being the Disney case, where Michael Eisner hired his friend Michael Ovitz as second-in-command. After only eighteen months, Ovitz was forced out, but left with nearly \$140 million in total compensation. After protracted, multi-year litigation, the Delaware courts held that the company's management had not violated their fiduciary duties in compensating Ovitz so richly.<sup>55</sup>

The data bear out the anecdotal evidence of enormous increases in executive compensation. In 1965, the CEOs of major U.S. companies earned 24 times that of an average worker. By 2005, this ratio had ballooned to 262 times the average worker.<sup>56</sup> "In other words, in 2005 a CEO earned more in one workday (there are 260 in a year) than what the average worker earned in 52 weeks."<sup>57</sup> The median CEO saw his total compensation increase 186% between 1992 and 2005, while the median worker saw wages rise by only 7%.<sup>58</sup> The average CEO of a Fortune 500 company now makes nearly \$10 million per year,<sup>59</sup> and CEO compensation now amounts to roughly 10% of corporate profits.<sup>60</sup>

One might consider such outrageous executive compensation as undermining the story of shareholder primacy and as evidence of the ascendancy of managerial power exercised to the *detriment* of shareholders. Scholars who oppose giving managers more authority to look after the interests of non-equity stakeholders point to the rise in executive compensation as indicating the risk that managers will use this new authority simply to feather their own nests.<sup>61</sup> In this view, necessary corporate law reforms include mechanisms to give shareholders more power within the firm.<sup>62</sup>

There are certainly examples of executives disregarding shareholder interests in order to aggrandize power and accumulate financial wealth. Rob-

---

<sup>54</sup> See sources cited *supra* note 32.

<sup>55</sup> *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 728–40 (Del. Ch. 2005); *Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.)*, 906 A.2d 27 (Del. 2006).

<sup>56</sup> MISHEL ET AL., *supra* note 5, at 202. According to a study published by the Institute for Policy Studies and United for a fair economy, this ratio is now at 364 to 1. SARAH ANDERSON ET AL., *Executive Excess 2007: The Staggering Social Cost of U.S. Business Leadership 5* (2007), available at <http://www.faireconomy.org/reports/2007/ExecutiveExcess2007.pdf>.

<sup>57</sup> MISHEL ET AL., *supra* note 5, at 202.

<sup>58</sup> *Id.* at 202–03.

<sup>59</sup> *Id.* at 204 tbl.

<sup>60</sup> *Id.* at 86.

<sup>61</sup> See sources cited *supra* note 32.

<sup>62</sup> See ROBERT MONKS & NELL MINOW, *WATCHING THE WATCHERS: CORPORATE GOVERNANCE FOR THE 21ST CENTURY* 261–88 (1996).

ert Nardelli of Home Depot is a popular recent example. While he was head of Home Depot, his annual compensation grew as high as \$38 million, but the company's share price was stagnant and outperformed by competitors.<sup>63</sup> Nardelli's compensation caused a revolt among Home Depot shareholders and he was eventually forced to leave. His high compensation was not the problem (there were at least fifty-five CEOs who made more than he did in 2005).<sup>64</sup> The problem, rather, was his high compensation compared to the languid stock performance. In fact, the dispute that was the ultimate cause of his "resignation" reportedly was his refusal to tie his compensation more closely to share price. He claimed, with good cause, that most of the company's financials during his tenure were quite good, and that the stock price was one measure of company performance that he could not control.<sup>65</sup> But the company's shareholders would not stand for it, and the board listened, forcing him out. Nardelli's story is not a story of how shareholders have no power. It is precisely the opposite.<sup>66</sup>

If executives were, on the whole, aligned against shareholder power, then one would have expected to see lower executive compensation correlate with the rise in the power of institutional shareholders over the past decade. But instead, the dominance of institutional shareholders has, for the most part, gone hand in hand with high executive compensation. Executive compensation has become the carrot that shareholders use to entice management to focus primarily on shareholder value (and consequently to disregard other stakeholders). In this view, high executive compensation is evidence of shareholder primacy. When executives are called on to justify their high salaries, they point not to the value of the company in creating jobs or providing useful goods and services, but to shareholder gain.<sup>67</sup>

---

<sup>63</sup> Brian Grow, *Nardelli: Out at Home Depot*, MSNBC ONLINE, Jan. 9, 2007, <http://www.msnbc.msn.com/id/16469224> (last visited November 13, 2007); see also Peter Cohen, *Best & Worst: Nardelli Builds Himself a Fat Pay Plan*, BLOGGINGSTOCKS, Dec. 5, 2006, <http://www.bloggingstocks.com/2006/12/05/best-and-worst-bob-nardelli-builds-himself-a-fat-pay-plan-at-home> (last visited Nov. 13, 2007).

<sup>64</sup> Del Jones & Matt Krantz, *Home Depot Boots CEO Nardelli*, USA TODAY ONLINE, Jan. 4, 2007, tbl., [http://www.usatoday.com/money/industries/retail/2007-01-03-hd-nardelli\\_x.htm](http://www.usatoday.com/money/industries/retail/2007-01-03-hd-nardelli_x.htm).

<sup>65</sup> Grow, *supra* note 63; Julie Creswell & Michael Barbaro, *Home Depot Board Ousts Chief, Saying Goodbye With Big Check*, N.Y. TIMES, Jan. 4, 2007, at A1; Richard Beales, *Nardelli's Forced Departure Reveals Some Home Truths*, FIN. TIMES (London), Jan. 5, 2007 (Markets), at 29.

<sup>66</sup> Indeed, his sins must not have been unforgivable. The private equity investors who recently purchased Chrysler from Daimler hired Nardelli as Chrysler's new CEO. Micheline Maynard & Nick Bunkley, *Ex-Home Depot Chief Taking Reins at Chrysler*, N.Y. TIMES, Aug. 6, 2007, at A1.

<sup>67</sup> See Uchitelle, *supra* note 7 ("Some chief executives of publicly traded companies acknowledge that their fortunes are indeed large—but that it reflects only a small share of the corporate value created on their watch"). Lew Frankfort, CEO of Coach, justified his \$44 million compensation in 2006 by pointing to shareholder gain, saying "I don't think it is unreasonable . . . for a CEO of a company to realize 3 to 5 percent of the wealth accumulation that shareholders realize." *Id.* Sanford Weill, the former chairman of Citigroup, defended his compensation by saying, "I think that the results our company had, which is where the great majority of my wealth came from, justified what I got." *Id.* See also Robert B. Reich, *CEOs Deserve Their Pay*, WALL ST. J., Sept. 12, 2007, at A13.



While the increase in CEO and executive salaries by itself adds to economic inequality, the collusion between executives and Wall Street creates a snowball effect. Neither has an incentive to slow the push for more and more income for themselves—shareholders keep getting theirs, managers keep getting theirs, and those who gain their livelihood from wage work are left further and further behind. Managers are not compensated for how they benefit their employees or the communities where they do business. Money spent for those things is regarded as costs, not profits, and those mere accounting conventions reveal the underlying assumption within corporate law that shareholders are the only owners and it is their fortunes that count.

### III. CORPORATIONS, AND CORPORATE LAW, AS PART OF A SOLUTION

The costs of the current framework of corporate law are significant. The framework entices corporations to spin off externalities, and the law has tried in various ways to react to those costs by regulating corporations. But what has not been recognized or emphasized is that the framework of corporate law has worsened certain macroeconomic trends, such as the stagnation of wages for working Americans and the increasing levels of economic inequality in our country.

Some might argue that even if these costs are real, there is no reason for any additional public policy response. One might think that the inequality is itself a good thing, since it motivates individuals to work hard and strive for success within the market. Others might see these economic effects as inherent in a corporate system that otherwise does an excellent job of creating wealth for the economy as a whole. If the costs of the framework are justified by its benefits, then any change in the framework will put those benefits at risk.

A rigorous empirical analysis of the costs and benefits of various corporate governance regimes is certainly beyond the scope of this article, if not impossible. But the existing legal framework is itself not based on an empirical justification. For some, it is based on notions about the nature of the firm—i.e., that shareholders own the firm and the managers owe them duties because of the nature of that ownership.<sup>68</sup> For others, it is based on judgments, which are themselves unproven, about how existing corporate law benefits the nation as a whole.<sup>69</sup> The status quo cannot claim a presumption of superiority over other possibilities other than through its position as the status quo. Those who are not disciples of Edmund Burke need more.<sup>70</sup>

---

<sup>68</sup> *But see* KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW* (2006) 43–47 (rebutting notion of shareholder ownership).

<sup>69</sup> *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 *GEO. L.J.* 439 (2001) (arguing that shareholder primacy maximizes social welfare). For a response, see GREENFIELD, *supra* note 68, at 21–26.

<sup>70</sup> *See* EDMUND BURKE, *REFLECTIONS ON THE FRENCH REVOLUTION*. (Charles W. Eliot ed., *The Harvard Classics* 2001) (1790) (arguing for the value of tradition and the status quo).

For those who would use Roosevelt rather than Burke as a guide, the question is this: If the present economic status quo contains conditions that fall short of what we aspire to achieve as a nation, are there tools at our disposal that are underutilized and potentially efficacious in addressing these shortfalls? There is a case to be made that corporate law is such a tool, and that adjustments in the way corporations govern themselves could bring about meaningful improvements in the lives of many Americans. Moreover, using corporate governance to help achieve these ends may be more efficient and less costly than other forms of regulation.

### A. *Starting Premises and Principles*

In arguing that adjustments to corporate law could be an important regulatory tool in addressing issues of stagnant wages and economic inequality, the underlying assumptions must be clear.<sup>71</sup> First, and perhaps the most fundamental, is that *corporate law is not an area of law governed by rights of ownership in the traditional sense*.<sup>72</sup> The view of shareholders as owners was once championed by a few traditionalists who derived shareholder rights from a rights-based view of the private nature of corporations.<sup>73</sup> Under this view, shareholders are seen as the owners of the firm, and the corporation is their individual property. Their control is to be respected. Managers are agents, and the correct law to apply is the law of property and trusts. Managers are to serve their principals. The proper stance of government is one of deference, with minimal or no governmental regulation.

The defects with this model are numerous and pervasive. Despite its residual popular appeal,<sup>74</sup> the model does not find legitimacy in the reality of the corporate world today. Shareholders do not have a complete bundle of rights to make them owners in the traditional sense: they do not have the right to gain access to the company's place of business, the right to exclude others from the property, the right to decide upon the use of the property on a day-to-day basis, or practically any other right usually associated with the ownership of a piece of property. Moreover, little distinguishes the contri-

---

<sup>71</sup> For a different iteration of these arguments, with a response, see Kent Greenfield & Gordon Smith, *Debate: Can Corporate Law Save the World?*, 58 EMORY L. J. \_\_\_\_ (forthcoming 2008).

<sup>72</sup> See 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, 591–601 (2002) (arguing that corporate law should be seen as public law rather than private law); Thomas W. Joo, *Contract, Property and the Role of Metaphor in Corporations Law*, 35 U.C. DAVIS L. REV. 779 (2002).

<sup>73</sup> The leading advocate of this view remains Milton Friedman, and the most famous statement of this view is his essay in the *New York Times* over thirty-five years ago. See Friedman, *supra* note 29, at 32 (“In a free-enterprise, private-property system a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible. . . .”).

<sup>74</sup> See, e.g., Gretchen Morgenson, *The Owners Who Can't Hire or Fire*, N.Y. TIMES, Oct. 14, 2007, at C1.

butions shareholders make to the firm from those of other stakeholders. To say that shareholders are the only “owners” is to say that there is something inherent in the act of contributing money to buy shares—or in the definition of “ownership” of shares—that distinguishes that act from the contribution of money to buy bonds issued by the company, the supply of raw materials to be refined by the company, or the investment of human labor to be used by the company. For these reasons, an argument that corporate governance operates in the realm of ownership rights is a difficult, unpersuasive, and increasingly undefended contention. Even among those scholars who defend shareholder primacy, very few continue to make the ownership argument. Instead, they argue that shareholder primacy is justified by other rationales, not a rights-based “ownership” claim.<sup>75</sup>

This leads to this article’s second major premise: *corporations, and therefore corporate law, are created in the interest of society as a whole.* Corporations are state creations, and no rational state would willfully allow for the creation of institutions as powerful as corporations unless there was a belief that, on balance, society would be better off. To be clear, this does not necessarily mean that the internal rule of decisionmaking within the corporation should be that the managers always act to maximize the benefit to society. But it does mean that whatever rule society constructs for corporate decisionmaking—whether one of shareholder primacy, stakeholder balance, or societal protection—the ultimate goal is to create social welfare, broadly defined.

Even though it would seem obvious that corporations should be created only if they, on balance, create more benefit than harm, this principle is largely absent in corporate law doctrine, judicial opinions, corporations casebooks, and business courses in both law and business schools. Occasionally one will come across a source that does consider the corporation’s responsibility to society,<sup>76</sup> but for the most part, judges and mainstream corporate law scholars take shareholder primacy as the guiding principle and ignore the interests of the public, unless those interests are something the company should take into account in an instrumental way to maximize shareholder value.

Of course, “social welfare” is an elastic term that is difficult to define with precision. What is crucial, however, is the importance of defining social benefits and costs broadly. Benefits include not only profit to the shareholders but also workers’ earnings, the stability a company brings to communities in which it does business, the quality and importance of the company’s products or services, and more. Costs include pollution, depletion of scarce resources, harmful effects of the company’s products or services, and mistreatment of employees. Ultimately, the social value of a company is not measurable by looking at shareholder return alone, which is

---

<sup>75</sup> For a comprehensive review of the arguments in favor of shareholder primacy, including the notion of ownership, and responses to each, see GREENFIELD, *supra* note 68, at 41–47.

<sup>76</sup> See Hansmann & Kraakman, *supra* note 69, at 441 (saying that “all thoughtful people” agree that business should be organized to increase social welfare).

hardly the best proxy for broader measures. Shareholder return may at times be consistent with social welfare, but it is often uncorrelated with social welfare and may at times be negatively correlated with social welfare.

The argument that corporations are intended to benefit society does not depend on an expectation of benevolence from corporations. It relies rather on another premise: *corporations are distinctively able to contribute to social welfare by creating financial prosperity*. Public corporations bring together a number of characteristics that distinguish them from other kinds of businesses and that make them particularly successful in making money. These traits include easy transferability of shares, limited liability, specialized and centralized management, and a perpetual existence separate from their shareholders. These and other characteristics create a potentially powerful money-making institution, which occupies a special place in our society. The corporation should not be expected to act altruistically in the same way as churches, families, schools, or social service organizations do. Corporations are institutions with a distinctive purpose, which is to create wealth. If they stop creating wealth, they are failures.

It follows, then, that a corporation that does nothing more than create wealth for its shareholders, employees, and communities is providing an important social service. Even if the corporation does nothing else to advance social welfare, assuming its benefits to society outweigh the cost of the externalities it casts upon the society, the corporation has satisfied its purpose for existence. It may be a good thing if a business provides meaning for people who work there, finds a cure for cancer, or funds the local symphony. These things all add to the positive side of the social benefit "ledger," but these benefits are extras. A company that is otherwise a neutral, lukewarm actor in society can still be counted as a success *if* it creates wealth for society. Indeed, care should be taken that over-regulation of corporations does not destroy their ability to contribute to society by building its wealth.

Importantly, the wealth that matters includes not only monetary gain by shareholders but also gains to other stakeholders. We must include the value to employees of their jobs and the social worth of the goods or services sold, as well as the multiplier effect on other businesses that provide raw materials, transport the end product to market, or sell sandwiches to the employees at lunchtime.

All this is to say that corporations should be appreciated for their special ability to create wealth but, as described in Part I, should be treated warily because of their inability (absent regulation) to take into account values far more important than wealth. We should be persistent in our monitoring of corporations to make sure they are moving us in a positive direction, given the form and powers we have bestowed upon them. The ability to create wealth is a very important power of corporations. As any powerful force, it must be constrained and regulated to ensure it does not careen out of control.

In this light, the next underlying premise becomes clear: *the socially optimal amount of regulation of corporations is not zero*. The free market is

a figment of imaginations, and only of outlandish ones at that. Even the most shareholder-centric scholars acknowledge that public policy demands regulation of the corporation; they just believe that it should come in the form of external, rather than internal, regulation.<sup>77</sup> Corporations will not, through their own generosity, internalize the external costs of their decisions or keep an eye on the social harms they produce. We use law to grant corporations the characteristics that make them capable of generating great wealth, but we also need to constrain them with law. Whether corporate law should be adjusted to take into account the interests of non-equity investors—those other than shareholders who contribute to the firm—should therefore turn on whether such an adjustment would tend to create more social welfare, broadly defined, not on whether it is inconsistent with the so-called free market.

Finally, the use of the term “non-equity investor” as a way to characterize stakeholders embodies the last premise of this article: *corporations are collective entities, demanding a variety of investments from a variety of sources*. This last premise is simply a statement of one of the important implications of the first—that corporations are not an entity wherein “ownership” makes much sense. Shareholders own their shares, of course, but as Margaret Blair and Lynn Stout write, “shareholders are not the only group that provides essential, specialized inputs into public corporations.”<sup>78</sup> Bondholders own their bonds, suppliers own their inventory, governments “own” their infrastructure, and workers “own” their labor. All of these contribute something essential to the firm, and none does so altruistically. They all contribute to the firm because they believe they will gain more by allowing the corporation to collect and use their inputs than if they keep them to themselves.<sup>79</sup> Indeed, the notion that corporations depend on multiple stakeholders is implicit in most theories of the firm.<sup>80</sup>

---

<sup>77</sup> See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Daniel R. Fischel, *The Corporate Governance Movement*, 35 *VAND. L. REV.* 1259, 1271 (1982) (Arguing that those who are concerned with corporate misdeeds should “seek redress through the political process and [should] not . . . attempt to disrupt the voluntary arrangements that private parties have entered into in forming corporations.”); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 *STETSON L. REV.* 23, 42 (1991) (expanding the scope of a firm’s fiduciary duties to include local communities is unnecessary because such communities “can appeal to their elected representatives in state and local government for redress”).

<sup>78</sup> Blair & Stout, *supra* note 30, at 250.

<sup>79</sup> For a more detailed argument, see GREENFIELD, *supra* note 68, at 47–53 (noting that workers have agency costs of their own).

<sup>80</sup> The modern theory of the corporation owes much to Ronald Coase, who theorized that the firm exists when it is more efficient to engage in intra-firm transactions (organized by direct authority) rather than market transactions. See R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 33–55 (1988). Thus the theory of the firm much depends on insights about when it is most efficient for people to work together within a firm rather than through individually negotiated contracts. Other writings on the economics of the firm turn on arguments about the consolidation of productive work. See, e.g., Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972) (arguing that the firm exists to decrease the monitoring costs inherent in team production);

### B. *Corporate Law as Public Policy*

With these underlying premises, it is straightforward to recognize corporate law as a subset of the broad range of business regulation used in this country and elsewhere to channel corporate power toward socially beneficial ends. Corporate law's imposition of the duties of care and loyalty help ensure that managers perform their tasks dutifully and without acting on the basis of self-interest. The duties to disclose certain kinds of information to shareholders and not to commit fraud on shareholders (mostly arising from federal law but still best seen as "corporate law," as this article uses the term) are other ways that corporations' internal affairs are regulated in furtherance of public policy goals. The question is whether corporate law should be put into use in furtherance of those public policy goals that extend beyond creating money and protecting shareholders from managerial negligence, theft, or mendacity.

This question—whether corporate governance should be adjusted to take into account the interests of non-shareholder stakeholders—depends primarily on the answer to another question: whether it is more efficient to regulate corporations from the "outside" or from the "inside." In other words, since the corporation is a creature of law and is already pervasively regulated, the question is simply whether it would be more efficient to use *corporate* law to oblige businesses to consider the interests of non-equity investors or to continue to use the existing regulatory structure, which leaves their interests to be protected through costly, ad hoc regulatory initiatives external to the corporate form.

Perhaps it is useful to begin with the acknowledgement that this "external" versus "internal" dichotomy is too simple. Regulations of corporations come in a multitude of forms. Even ones that are seen as external—tax law, for example—often have as a goal the adjustment of behavior within the firm. It is more correct, as a matter of regulatory theory, to characterize the regulation of the corporation as falling into three categories: (1) regulation requiring or encouraging certain results (e.g., pollution laws that prohibit the discharge of certain effluents); (2) regulation requiring or encouraging certain processes or actions (e.g., disclosure laws, nondiscrimination laws); and (3) regulation requiring or encouraging certain internal structures (e.g., a board that is elected by shareholders). When characterized this way, it becomes clear that the non-equity investors in corporations typically are forced to depend on regulatory initiatives that focus on results and on procedures. The only stakeholder that has any significant structural protection within the corporate form is the shareholder. It is this reality that best reveals the norm of shareholder primacy. Consider the following chart:

---

Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310–11 (1976) ("Contractual relations are the essence of the firm, not only with employees" but with others as well; the firm is a legal fiction that "serves as a focus for the complex process in which the conflicting objectives of individuals . . . are brought into equilibrium. . . .").

ILLUSTRATIVE EXAMPLES OF REGULATORY EFFORTS TO CONSTRAIN AND HARNESS CORPORATE POWER<sup>81</sup>

Stakeholders	Regulatory Focus		
	Results	Actions/Process	Structure
<b>Shareholders</b>	Limited liability Profit-maximization “norm” Capital markets (Quasi-legal)	Duty of care Duty of loyalty Disclosure law Anti-fraud law (10b-5) Insider trading law	Shareholder voting for directors Right to sue derivatively Right to vote on major corporate changes
<b>Employees</b>	Minimum wage OSHA	ERISA (regulates retirement benefits; limited protection only) Tort/workers’ comp law Anti-discrimination law Federal plant closing notification requirements Labor law (limited)	
<b>Community/Environment</b>	“Command and control” environmental statutes; Superfund, Clean Air/Water Acts, etc.	Tort law Environmental Impact Statements Planning/permitting/zoning processes	
<b>Customers</b>	Contract law Consumer Safety law Regulatory protections (food & drug, consumer protection, air safety, etc.)	Anti-fraud law Tort law Antitrust law	
<b>Creditors</b>	Contract Law	Good faith in Contract/Uniform Commercial Code Anti-fraud law Bankruptcy law	

One might think that this chart shows the extent of the regulatory efforts aimed at protecting stakeholders of various kinds, and that nothing else needs to be done. This response would be apt if the interests of stakeholders were in fact being adequately protected by these efforts. Another response to this chart is to question why regulation of the corporate structure—the stuff of corporate law—is not being utilized to its full potential. The empty boxes in the rightmost column represent regulatory gaps and opportunities—presently ignored—to address employee, community, and environmental concerns. Taking advantage of these opportunities is a question of whether the corporation’s structure can be adjusted so that its distinctive abilities can be put to greater use in protecting non-shareholder stakeholders.

There is reason to be optimistic in this regard. It is often cheaper to avoid a problem than to rectify it later, and it is often better to give the responsibility to avoid a problem to the person who knows most about it and can avoid it at the least expense. As such, corporate law may have comparative advantages over other kinds of law in addressing the concerns of its stakeholders.

---

<sup>81</sup> Another version of this chart appears in Greenfield & Smith, *supra* note 71.

For example, because the central purpose of the corporation is to create wealth, broadly defined, it is likely to be more efficient to have the corporation distribute this wealth among those who contribute to its creation rather than having government redistribute wealth after the fact through tax and welfare laws. A fair distribution of corporate profit to employees, for example, will likely have significant positive multiplier effects (such as workers being more productive because they feel they are being fairly treated) that would not likely occur with later governmental redistribution initiatives.

Moreover, in dealing with issues such as economic well-being or environmental sustainability, corporate managers may have expertise that government bureaucrats do not, and there may be efficiencies in a corporate setting that do not exist in a governmental setting. Broadening corporate responsibilities would allow corporations and their management to be proactive in addressing issues of social concern, which in turn might be more efficient than relying on the mostly reactive power of government regulation.

In the end, if non-shareholder stakeholders need more regulatory protection than they now receive, it is foolish and inefficient as a matter of public policy to leave corporate law as an untapped resource. Using corporate law to adjust the composition or duties of the board to force the consideration of stakeholder interests could be a powerful tool, not only to rein in the worst excesses of the corporation, but also to take advantage of the unique capabilities of the corporation to achieve important gains in social welfare.

### *C. The Benefits of Stakeholder Governance*

To bolster this argument with a concrete example, examine how adjustments in corporate governance could efficiently bring about gains in societal wealth. The corporation is immensely successful in creating wealth, but because of the narrow fixation on shareholder benefit embedded in the market, social norms, and corporate law, non-equity investors (employees, communities, etc.) are often shortchanged in the distribution of the wealth they help create. Even though the corporation is a collective enterprise when it comes to inputs, the distribution of outputs is determined by a body—the board—dominated by representatives of only two stakeholders: the shareholders and the senior management. Changing this arrangement has the potential not only to improve the corporation's ability to create wealth, but also to address serious and enduring social and economic ills. Almost certainly, if senior managers were required to consider the interests of the firm more broadly—to include the well-being of all investors, equity or non-equity—in their decisionmaking calculus, the firm would be more successful in satisfying the social goal of creating wealth, broadly defined.

Stakeholder concerns could be added to the firm's decisionmaking calculus in a couple of ways. First, the fiduciary duties of management could simply be expanded to include a requirement that the management



owe a fiduciary duty to the firm as a whole, rather than to the shareholders alone. Once the fiduciary duties extend to the entire firm, and the firm is seen as a collective enterprise, then managers cannot meet their duties by fixating solely on the interests of shareholders.<sup>82</sup>

A more powerful change would come through acknowledging that a duty to the firm as a whole—which includes a duty to a range of stakeholders—would be best effected by providing some mechanism for non-shareholder stakeholders to elect their own representatives to the board. While the duties of care and loyalty are crucial, they have little connection to the problem of fair allocation of the corporate surplus. The best way for the board to make such decisions is to have all important stakeholders represented. The specifics will be difficult but not impossible: employees could elect a proportion of the board, communities in which the company employs a significant percentage of the workforce could propose a representative for the board, and long-term business partners and creditors could be represented as well.<sup>83</sup> For specific ideas as to mechanisms for choosing stakeholder directors, one could look at the procedures used in various European countries that have boards with non-shareholder representatives.<sup>84</sup>

The specific mechanisms of election do not matter as much as does the notion that the board itself should hear more than a shareholder perspective only. As they participate on the board, all stakeholder representatives will have the incentive to build and maintain profitability in order to sustain the company over time. Moreover, the board will be the locus of the real negotiations among the various stakeholders about the allocation of the corporate surplus. Even though board members might be selected for their positions in different ways and from different constituencies, each would be held to fiduciary duties to the firm as a whole. Decisions that affect major stakeholders would no longer be made cavalierly, without someone on the board being able to anticipate and articulate the likely impact such a decision would have on the workers, creditors, and other interested stakeholders.

The benefits of stakeholder representation on corporate boards could be significant. First, this change would likely benefit society broadly by distributing corporate wealth more fairly. It is reasonable to expect stakeholder boards to behave differently from shareholder boards. The market will be a

---

<sup>82</sup> Some scholars believe that this is in fact the best statement of current law, and there are cases that seem to stand for that proposition. See generally Blair & Stout, *supra* note 30. Even if one disagrees with their descriptive claim that current corporate law protects all stakeholders, the fact that discussion exists at all means that this adjustment would be less stark than one might suppose at first glance.

<sup>83</sup> “Co-determination,” the practice of having employee representatives on company boards, is widespread in Europe. “Employees in 18 of the 25 European member states have the right to have their interests represented in their company’s top administrative and management bodies.” REBECCA PAGE, CO-DETERMINATION IN GERMANY—A BEGINNER’S GUIDE 31 (2006). For an excellent overview, see THE EUROPEAN COMPANY—PROSPECTS FOR WORKER BOARD-LEVEL PARTICIPATION IN THE ENLARGED EU 64–65 (Norbert Kluge & Michael Stollt, eds., 2006)(chart of co-determination forms around Europe).

<sup>84</sup> See THE EUROPEAN COMPANY, *supra* note 83, at 36–39, 93–95 (summarizing methods of election for employee representatives).

constraint, to be sure, but one of the goals of the board will be to allocate the surplus so as to maintain the firm as a going concern. Shareholders will get their proportion, but so will others. In a sense, this conception would use the corporation not only as a mechanism for creation of wealth but for its distribution as well.

There may be a comparative advantage to using stakeholder governance over other kinds of regulatory efforts. Current public policy tools that redistribute wealth and income tend to either take effect after the initial distribution of financial wealth (e.g., taxes, welfare policy) or benefit only those at the lowest rung of the economic ladder (e.g., the minimum wage). These mechanisms are notoriously inefficient. A stakeholder-oriented corporate governance system would operate at the initial distribution of the corporate surplus and would benefit stakeholders up and down the economic hierarchy and earlier in the wealth creation process.

This is not as jarring as it might seem at first. In the United States, and indeed in most industrialized countries, one of the most important tasks of the state is to redistribute a portion of private wealth and income. Mechanisms include the tax and welfare system, the minimum wage, and Social Security. At base, this article proposes simply that the structure of corporate law be adjusted to better serve this purpose as well.

Evidence from other nations bolsters this argument. The majority of European Union countries require representation of employee interests in their company's top administrative and management bodies.<sup>85</sup> This insistence on taking employees' interests into account has beneficial effects. In a recent study, Sigurt Vitols measured the macroeconomic implications of worker participation in corporate management throughout Europe. On a countrywide level, European countries with strong "co-determination" (i.e., worker participation on boards) had lower income inequality than countries that have no or weak worker participation. Moreover, strong co-determination countries had higher labor productivity, fewer days lost to strikes, and lower unemployment.<sup>86</sup>

Not only will adjustments in corporate governance create beneficial effects, but these benefits may be achieved at a much lower cost than through other regulatory initiatives, because stakeholder governance will *benefit* corporations themselves over time. Because corporations are a collective effort, the key to sustainability is for those who contribute to the firm to believe that the firm can be trusted. Broadening stakeholder representation will help build this trust, ensuring that *all* stakeholders will be willing to invest in the firm whether by way of financial investments, or investments in terms of labor or expertise. For example, workers who believe they are treated fairly tend to work harder, be more productive, obey firm rules more often, and be

---

<sup>85</sup> PAGE, *supra* note 83, at 31; THE EUROPEAN COMPANY, *supra* note 83, at 64–65.

<sup>86</sup> Sigurt Vitols, Prospects for Trade Unions in the Evolving European System of Corporate Governance, Final Report for European Trade Union Institute, Nov. 2005 (on file with author).

more loyal to their employers. This, in turn, is likely to make those firms more profitable than they would have been absent such fair treatment.<sup>87</sup>

If stakeholder governance would help firms be more profitable, why do so few firms voluntarily adopt it? One answer is that some firms already try to share wealth created by the collective action of their stakeholders, and some firms even recognize that they owe an obligation to treat all their stakeholders fairly. The more general answer is that, in all likelihood, firms simply do not see the potential long-term profitability of stakeholder governance. Boards are elected by shareholders, and the law makes shareholders supreme. Few directors or managers have the incentive to push their firms to take what must seem like a huge short-term risk—reallocating a greater portion of the corporate surplus to non-shareholder stakeholders—for gains that seem abstract. Moreover, since many shareholders are interested only in the short term (as described earlier), the likelihood of long-term benefits is immaterial. No one has the incentive to make the first move. The law must overcome this “stickiness” of the status quo.

Another reason why stakeholder governance would be beneficial to the firm is that it would improve managerial decisionmaking. The success of corporations comes about in part because of the abilities of a highly talented group decisionmaker, the board, at the top of the hierarchy.<sup>88</sup> The benefits of group decisionmaking, however, are drastically diminished, and sometimes undermined completely, when the group is too homogeneous. In fact, more and more studies show that good decisionmaking requires a diversity of viewpoints. As Cass Sunstein detailed in his book *Why Societies Need Dissent*, conformity among people in a decisionmaking group inevitably breeds error. Dissent is essential, and sometimes “social bonds and affection” can suppress dissent.<sup>89</sup> Sunstein notes, “if strong bonds make even a single dissent less likely, the performance of groups and institutions will be impaired.” He extends the point to corporate boards: “The highest performing companies tend to have extremely contentious boards that regard dissent as a duty and that ‘have a good fight now and then.’”<sup>90</sup>

If homogeneity is a flaw, then corporate boards are indeed suboptimally constituted. At present, corporate boards are among the least diverse institutions in America. A 2002 survey found that 82% of the director positions on Fortune 1000 companies were held by white men while only 14% were held by women, 3% by African-Americans, 2% by Asian-Americans, and 2% by Hispanics.<sup>91</sup>

These statistics reference only racial and gender diversity, but the point is likely even stronger when it comes to diversity of perspective and back-

---

<sup>87</sup> For a more developed argument on this point, see Greenfield, *supra* note 72, at 611–27.

<sup>88</sup> For a more detailed analysis, see Greenfield & Smith, *supra* note 71.

<sup>89</sup> CASS R. SUNSTEIN, *WHY SOCIETIES NEED DISSENT* 27 (2003).

<sup>90</sup> *Id.* at 28 (quoting Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, 80 HARV. BUS. REV. 106, 111 (2002)).

<sup>91</sup> See Gary Strauss, *Good Old Boys' Network Still Rules Corporate Boards*, USA TODAY, Nov. 1, 2002, at 1B.

ground. This homogeneity is a function of legal decisions—giving the right to elect board members to shareholders and the right to nominate to the board itself. But this could be changed through law as well. Adding perspectives other than those of rich, white men will almost certainly improve the quality of business decisions made by the board.

Adding diversity of perspectives to the board is hardly as radical as it might at first seem. Even mainstream scholars are sometimes found to recognize the benefits of board pluralism. For example, Steven Bainbridge has said in the context of suggesting that larger boards are better than smaller boards that “[m]ore directors will usually translate into more interlocking relationships with other organizations that may be useful in providing resources such as customers, clients, credit, and supplies.”<sup>92</sup> Note that Bainbridge sees the benefits of including persons on the board who can speak for and offer insight from various non-equity investors, even though he notably does not include employees in his list. He describes the benefits of this kind of board pluralism as including the ability to address information asymmetries and thus aiding in the creation of strategic alliances.<sup>93</sup> This insight, which seems right, would be true not only for business partners but for all non-equity investors, including employees. Employees, too, are in effect entering into a strategic alliance with a firm when they invest their time, energy, and futures with the company. They “need credible information about the competencies and reliability of prospective partners,” just as the firm needs credible information about their “competencies and reliability.”<sup>94</sup>

Making the board less homogeneous may make decisions less tidy, since the board will have to take more views into account. The board will be forced to compromise so that decisions are acceptable to a majority or plurality of stakeholders. Decisionmaking will thus be more deliberative and perhaps slower, but that is not in itself a reason to refuse to improve boards by introducing a range of views and perspectives. The real question is whether additional diversity results in decisions that are worth the extra effort.

The notion that decisions produced by a finely wrought process of dialogue and compromise are better than decisions made unilaterally by a uni-

---

<sup>92</sup> Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 43 (2002).

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* Bainbridge also suggests that boards perform better when a larger board includes a greater number of “specialists” who would aid in both the board’s monitoring and service functions. As he says, “complex business decisions require knowledge in such areas as accounting, finance, management, and law. Providing access to such knowledge can be seen as a part of the board’s resource gathering function.” *Id.* Boards cannot expect to be, and probably should not be particularly specialized, but they benefit from having specialists among them. While Bainbridge’s examples are of investment bankers and attorneys, his reasoning would extend to those having specialized insight about other non-equity investors. As Bainbridge argues, “larger, *more diverse* boards likely contain more specialists, and therefore should get the benefit of specialization.” *Id.* (emphasis added). Bainbridge’s focus is more on the *size* of boards, but he—perhaps inadvertently—makes the point about the diversity of boards as well.

form group of individuals is widely accepted by institutions other than corporate boards. Legislative bodies, administrative agencies, school faculties, and nonprofit boards recognize that a diversity of viewpoints increases the likelihood of groups welcoming dissent, hearing important perspectives, and vetting decisions more fully. In fact, greater diversity in perspectives and backgrounds within the boardroom will lessen the risk over time that the board will engage in the defects and systematic mistakes of “groupthink.”<sup>95</sup> Notwithstanding the unique attributes of the corporation and the intense competitive environment in which it operates, perhaps the same is true in corporate governance.

The worries often expressed about stakeholder governance are overstated. No constituency would have an incentive to hurt the company in order to gain a larger piece of the pie. Even if they did, they would be violating their fiduciary duties to the firm as a whole and could be held to account for their behavior. Second, the possibility of strategic, “rent-seeking” behavior already exists in the firm. Currently only shareholders are allowed to elect directors, and shareholders already have incentives to put their interests ahead of the interests of the firm as a whole. A pluralistic board could actually stifle those selfish impulses, because any behavior that benefits one stakeholder at the expense of the firm would be done in full view of the others.

#### *D. Answering Objections*

There are two additional objections that the article has not yet addressed directly.

##### *The “Two Masters” Argument*

One worry about stakeholder governance is that a broadening of corporate responsibilities would actually make it easier for managers to avoid responsibility altogether.<sup>96</sup> The argument goes something like this: if corporate managers have more than one “master” (that is, not just shareholders), they can avoid real responsibility to any stakeholder by claiming their actions are to further the interests of another stakeholder. Economists would call this an “agency costs” argument: enlarging the duties of management will increase the agency costs inherent in managing the firm, since it will be more difficult to monitor whether the managers are in fact doing their jobs carefully and in good faith.

First, this concern is inconsistent with another objection to stakeholder governance that one often hears, namely that corporate law need not worry

---

<sup>95</sup> See, e.g., SUNSTEIN, *supra* note 89, at 143 (“defective decisionmaking” is “strongly correlated” with structural flaws such as “insulation and homogeneity”); Bainbridge, *supra* note 92, at 32 (discussing groupthink).

<sup>96</sup> For a more developed argument on this point, see GREENFIELD, *supra* note 68; Greenfield & Smith, *supra* note 71.

about stakeholder interests since looking after shareholders will inevitably help other stakeholders as well. Of course, shareholder advocates cannot have it both ways. If the interests of shareholders and other stakeholders are not in conflict, then agency costs will not increase much if the law requires managers to take into account the interests of other stakeholders.

A more accurate view is that there is indeed conflict between the interests of shareholders and other stakeholders in a range of cases, especially in the short term. Such conflict, however, is not a reason to fear that managers are unable to handle increased responsibility or that it would be impossible to know whether managers are doing their jobs well. It is true, in a mundane way, that someone who has two responsibilities may have more difficulty meeting both than she would if she had only one. But people routinely have more than one responsibility, some of them even conflicting. Humans are quite accustomed to having a range of obligations.

Many business managers are asked to balance a multitude of obligations, some arising from corporate law, some from other areas of law, and some from the market. For example, corporations regularly issue different classes of stock that afford different rights, but directors still owe fiduciary duties to holders of all classes of stock even when the interests of the various classes are in conflict. It is not impossible for courts to analyze whether the managers satisfied their fiduciary duties to be careful, act in good faith, and not act in their own self-interest.

The only way in which having more and broader responsibilities would make it easier for managers to avoid responsibility is that it would allow them to use one obligation as a defense to a claim that they failed to satisfy another. This, however, is not a function of the number and scope of responsibilities, but how they are enforced, and corporate law duties are simply not enforced in a way that would allow managers to play one duty off the other.

Consider the duty of care. When courts enforce that duty they reduce it essentially to a procedural obligation, namely to investigate various alternatives, to consider various possible outcomes, to take the time necessary to deliberate effectively, and to erect certain monitoring systems to ensure the smooth flow of information from throughout the company to the centralized management.<sup>97</sup> If managers were required to take account of, for example, employees' interests, the duty of care would be enforced in the same way it is now. No manager would be able to erect a defense to a shareholder claim by saying she was unable to pay attention to the impact of the decision on

---

<sup>97</sup> See *Smith v. Van Gorkom*, 488 A.2d 858, 891 (Del. 1985) (finding that Director-defendants breached the duty of care because of their failure to inform themselves of all information reasonably available to them and relevant to their decision, and by their failure to disclose all material information to the stockholders); *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, 968 (Del.Ch. 1996) (finding that Director-defendants upheld the duty of care by meeting and being informed by experts on the relevant issues and having monitoring information systems in place); *Francis v. United Jersey Bank*, 87 N.J. 15, 31 (N.J. 1981) (finding that Director-defendant had breached the duty of care by nonfeasance because a director has a duty to act, including acquiring at least a rudimentary understanding of the business of the corporation).

shareholders because she was thinking at the time about employees. *The managers would have to do both.* Yes, this may be more difficult. But it is not impossible, and it is certainly not the kind of difficulty that throws up such dust that one cannot discern if the management is doing their jobs.

Similarly, the duty of loyalty would not be loosened if managers were required to look after non-equity investors. In corporate law, loyalty requires managers not to engage in self-dealing. Such an obligation would not be undermined by including employees among the beneficiaries of managers' fiduciary duties. Rather, adding to the number of people who benefit from managers' fiduciary duties will make it less likely that managers will be able to get away with self-dealing. More corporate stakeholders will have an interest in monitoring managerial conflict of interest.

Beneath the surface of the agency cost argument, one finds that the real worry of the mainstream theorists is that adding to the responsibilities of management will make it less likely that management will act like agents of the shareholders. Managers may indeed change their behavior in that way, but asserting that such a change is a problem simply begs the question of whether managers should serve only the interests of the shareholders.

Moreover, the existence of shareholder agency costs is not itself a persuasive argument, since other stakeholders also have agency costs. Other stakeholders make important contributions to the firm, and all stakeholders depend on management to use those contributions to create wealth. All stakeholders depend on managers and therefore have an incentive to monitor them. A shareholder primacy rule makes it more difficult for these other stakeholders to rely on management, which raises the stakeholders' agency costs. A relaxation of the shareholder primacy model might increase the agency costs of shareholders, but it will decrease the agency costs of non-shareholder stakeholders, which are just as important as shareholders' agency costs.

To say that only shareholders should have a rule that lowers their agency costs assumes shareholder primacy. But we cannot justify the rule of shareholder primacy by pointing to shareholder agency costs, unless the agency costs of other stakeholders are discounted. Those costs can only be discounted if shareholders are supreme.

### *Competitiveness*

Another objection to a stakeholder model is that such a brand of corporate governance might kill the golden goose of American competitiveness. Forcing corporate managers to take into account the interests of employees and other stakeholders, the argument goes, will deaden companies' ability to make tough allocation decisions, to produce products at a low price, and to succeed over time.

This worry is overblown. As mentioned earlier, no stakeholder in the firm benefits when a company fails, and no one is hurt more from the failure of a publicly-traded company than its employees. Shareholders, on the other

hand, typically hold a diversified portfolio of stocks, and the failure of one firm or another is not usually debilitating to a shareholder's overall financial situation.

In fact, a focus on shareholders will mean that companies will be more, not less, likely to fail. Because of their diversified portfolios and the fact that they enjoy the protection of limited liability, shareholders actually tend to prefer that companies whose stock they hold make risky decisions that create an above-average return for their entire portfolio, but that risk bankruptcy for individual firms. Shareholders do not care much whether any given firm fails, as long as their portfolio as a whole maximizes their expected returns.<sup>98</sup>

Employees, on the other hand, are not diversified in their labor investment—they typically work for one employer at a time and may have invested much time and effort to develop firm-specific human capital. They are not risk neutral, but as to their employment, risk averse. Rather than being indifferent as to the risk of failure for the company for which they work, employees care deeply about their firm's financial health because they stand to lose a great deal if their firm suffers.

What this means is that *a company required to take into account employee interests will fail less often than a shareholder-dominated firm*. Because shareholders are relatively indifferent as to the possibility of any single firm failing, managers who make decisions according to what is good for the shareholders will bring about the failure of their companies more often than managers who make decisions based on what is good for a broader mix of stakeholders.

There is nothing incompatible with employee (and stakeholder) involvement in management and business success. As discussed above, as employees feel more “ownership” in their firm, they will work harder, contribute more ideas, improve their productivity, mangle less, and obey company rules more. This will tend to improve company profitability over time.

The more difficult competitiveness critique to answer is not that individual firms will fail if they take into account the interests of stakeholders, but that capital (i.e., shareholders) will flee U.S. markets if a stakeholder governance framework is established. That is, if corporations are required to take into account the interests of non-equity investors, then equity investors will take their capital elsewhere.

It is true that recognizing a stakeholder framework might bring about a reallocation of the corporate surplus away from shareholders and toward other stakeholders. That is part of the objective of such a framework. But as the stakeholder model creates gains for the corporation as a whole, then the slice of the pie going to shareholders may grow in an absolute sense, even if it is not as large in a comparative sense.

The judgment of capital is always a relative one—“will I make more if I invest here or elsewhere?”—so a stakeholder corporate governance regime

---

<sup>98</sup> For a more detailed analysis, see GREENFIELD, *supra* note 68, at 54–59.



will only cause capital to flee if it can find a better risk/return mix elsewhere. Given the power and stability of U.S. markets, there are very few places likely to offer a better risk/return ratio. Europe's current corporate governance framework is more protective of stakeholders than any regime the U.S. is likely to enact, making it unlikely that capital will flee to Europe. Indeed, the fact that Europe has such a robust system of stakeholder protection while maintaining healthy and competitive capital markets is an indication that there is little reason to worry that capital will abandon ship if the U.S. adopts a similar model.

Of course, an argument that capital will punish efforts to impose a stakeholder governance regime is analogous to an objection to *any* regulatory effort that imposes costs on capital, whether it be a minimum wage, additional environmental protection, or a ban on child labor. In those settings, a range of factors determines regulatory choices, including whether the regulatory effort will be worth the various costs that might arise. In some cases, a public policy initiative (for example, limiting carbon emissions from factories) would impose costs on capital, and those costs might have an effect on whether capital will flow to U.S. securities markets or markets overseas. But an analysis of the costs must include a look at the potential benefits as well (for example, a lessening of the rate of climate change), and it would be unwise simply to succumb to the pressures from those who threaten to take their capital and go home.

The same should be true with regard to stakeholder governance. The question is not simply whether there might be some short-term costs to capital, but whether benefits can be gained from the initiative that would balance out those costs. There is reason to be optimistic that they would, since these benefits are of the kind that will build on themselves.

#### CONCLUSION

Corporations are creatures of law, and they are regulated pervasively by various aspects of the legal system. Law is essential to make the corporation successful as an institution that collects various inputs and uses them to create wealth. At present, corporate law takes a very narrow view of the obligations of corporate management, and this legal choice has resulted in a number of social costs, including stagnant wages and increasing economic inequality.

Corporate law reform thus represents an area of significant promise in addressing issues of social concern. If corporate management owed fiduciary duties to the firm as whole, or if corporate decisionmaking bodies included representatives of various stakeholders, the unique and powerful capabilities of the corporation could be put to use to create wealth and to distribute it broadly, and to do so more efficiently than through existing regulatory options.