AGAINST FIDUCIARY DUTIES TO CORPORATE STAKEHOLDERS

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I. INTRODUCTION

Philosophers of ethics have struggled for millennia with the question of how human beings ought to live. Some philosophers have propounded a teleological ethic, declaring that a man should take those actions the consequences of which will achieve the greatest good.[1] Other philosophers have advanced a deontological ethic, asserting that man should strive to conform his conduct to a specified set of moral principles, regardless of whether such conduct achieves any good.[2] Similarly, economists and law professors have struggled for decades with the question of how a corporation should conduct itself. The dichotomy between teleological and deontological ethics, so important in the domain of moral philosophy, has not informed the latter debate. Scholars have almost uniformly analyzed the corporation from a teleological perspective; they have assessed the behavior of a corporation based on how well it achieves some goal. This article will neither challenge nor vindicate this common assumption, nor will it address the second-order assumption of most corporate law scholars: that corporations should operate according to rules that maximize social wealth. Instead, this article seeks to champion those corporate law scholars who further assume that, in order to maximize social wealth, corporations should act to maximize shareholder wealth.

The teleology of the American public corporation has perhaps never been so murky. Disputes over how a corporation can best maximize social wealth have peppered the legal literature in the 1980s and 1990s.[3] State corporation statutes and case law compel directors to pursue the best interests of the corporation and its shareholders.[4] Statutes

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[1]*See, e.g.*, ARISTOTLE, NICOMACHEAN ETHICS 3-32 (Martin Ostwald trans., 1962); ST. THOMAS AQUINAS, TREATISE ON HAPPINESS 3-14 (John A. Oesterle trans., Univ. of Notre Dame Press 1983) (1964).

[2]*See, e.g.*, IMMANUEL KANT, FOUNDATIONS OF THE METAPHYSICS OF MORALS 9-22 (Lewis White Beck trans., 1959).

[3]The dispute has now begun to rage on the national political stage. *See Civics 101*, THE ECONOMIST 61 (May 11, 1996); *Shareholder Values*, THE ECONOMIST 15-16 (Feb. 10, 1996).

[4]*See, e.g.*, ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 1995) ("The directors and officers of a corporation shall exercise their powers and discharge their duties in good faith with a view to the interests of the corporation and of the shareholders . . . ."); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 1992) ("A director . . . of a corporation shall perform his duties . . . in a manner he reasonably believes to be in the best interests of the

and case law are silent or at least unhelpful, however, on the question of what it means for a manager to act in the best interests of the corporation.[5] If we dispense with the discredited, holistic notion that a corporation is an entity with interests of its own, independent of the interests of its stakeholders, then managers must decide whose interests the corporation ought to serve.[6] Answering this question is an essential prerequisite to defining the scope of management's fiduciary duty.

While the tradition is not unambiguous, history generally teaches that managers are to maximize shareholder profits, "subject to the constraint that the corporation must meet all its legal obligations to others."[7] I shall call this traditional view the shareholder model of the

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corporation . . . ."); Brown v. North Ventura Road Dev. Co., 30 Cal. Rptr. 568, 571 (Cal. Dist. Ct. App. 1963) (holding that directors have a "duty to promote the best interests of the stockholders and the corporation"); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("[D]irectors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders."); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949, 954 (Del. 1985) (holding that "the board had both the power and duty to oppose a bid it perceived to be harmful to the corporate enterprise" and asserting that the board had a "fundamental duty and obligation to protect the corporate enterprise, which includes stockholders"); Dankoff v. Bowling Proprietors Ass'n of Am., Inc., 331 N.Y.S.2d 109, 112 (N.Y. Sup. Ct. 1972) ("A director has a duty to act in what he believes to be the best interests of the corporation and its stockholders (members)."); *see also* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 6.02(b)(1) (1994) (stating that, in the context of responding to a tender offer, a "board may take into account all factors relevant to the best interests of the corporation and shareholders," including whether a successful offer "would threaten the corporation's essential economic prospects").

[5]I shall use the term "manager" to refer to both the directors and officers of a corporation.

[6]I shall use the terms "stakeholder," "constituency," and "patron" interchangeably to refer to all of the entities that transact with a firm.

[7]ROBERT CLARK, CORPORATE LAW 17-18 (1986); *see* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919). In *Dodge*, the court stated that:

> [a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself . . . .

Id. at 684. *But see* Sylvia Martin Found., Inc. v. Swearingen, 260 F. Supp. 231, 235 (S.D.N.Y. 1966) (noting in dicta that absent allegations of fraud, the directors' decision to authorize a foreign bond issue to the detriment of corporate profit was a matter of business judgment and not subject to judicial review); Shlensky v. Wrigley, 237 N.E.2d 776, 780-81 (Ill. App. Ct. 1968) (upholding the directors' decision not to install lights at Wrigley Field despite the loss of potential profits); A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 586 (N.J. 1953) (justifying the corporation's charitable contribution on the grounds of aid to the public welfare); Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121, 151 (1991) (rebutting opposition to constituency legislation with the argument that such legislation is actually concordant with the early nineteenth-century corporate model which was concerned with

corporation. In contrast to this narrow vision of the corporation's goal, more expansive visions have arisen. In the 1930s, Professor E. Merrick Dodd proposed that managers of a corporation should serve as trustees for the interests of all the corporate constituencies.[8] In the 1970s, Ralph Nader and others of his ideological bent carried on a corporate social responsibility crusade.[9] The law largely resisted these expansive visions until corporate America was hit by the 1980s wave of hostile takeovers.[10] In the mid to late 1980s, most state legislatures passed "other constituency" statutes, permitting or requiring directors to consider the interests of other corporate constituencies, such as employees, creditors, consumers, suppliers, and communities, in their decision-making process.[11] The Delaware courts also sanctioned multiconstituency decision making, at least in the hostile takeover context.[12] Moreover,

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nonshareholder constituencies); Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 166 (1991) ("The corporate constituency statutes reflect the early and traditional jurisprudence relating to director obligations, which made it clear that a director's sole duty was to the corporation and not the shareholders."). Notwithstanding this scattered evidence, no case law antedating the 1980s takeover wave required directors to consider nonshareholder interests, and certainly nothing permitted directors to subordinate shareholder interests to the interests of other stakeholders. *See* ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2254-55, 2257-61 (1990); *see also* James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 99 (1991) (acknowledging the historic view of "directors' duties as requiring directors to maximize the profits of the corporation"); *infra* note 24 (listing cases with explicit holdings that managers do not owe a fiduciary duty to nonshareholders).

[8]*See* E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1160 (1932).

[9]*See, e.g.*, RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976); ROBERT A. DAHL, AFTER THE REVOLUTION? AUTHORITY IN A GOOD SOCIETY 96-115 (rev. ed. 1990); CHRISTOPHER D. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR (1975).

[10]*See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 2-7 (1986) (tracing the development of hostile takeovers in the early 1980s); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119 (1992) (analyzing the various regulatory regimes instituted in response to the storm of takeovers in the 1980s).

[11]*See infra* notes 26-28 (listing state corporate constituency statutes).

[12]*See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989) ("[D]irectors may consider, when evaluating the threat posed by a takeover bid, . . . the impact on 'constituencies' other than shareholders . . . ."); *Unocal*, 493 A.2d at 955 (stating that, in assessing the reasonableness of a takeover defense, directors may consider "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees and perhaps even the community generally)").

many commentators, acting in the spirit of the "other constituency" statutes, advanced a new paradigm for corporate law.[13]

This new paradigm, which I shall refer to as the stakeholder model of the corporation, would impose a fiduciary duty on managers to act in the best interests of all the corporate constituencies.[14] While the shareholder model of the corporation is not exactly inexpugnable, this burgeoning legal and academic preference for making managers into guardians of the interests of all corporate stakeholders is unfortunate. The stakeholder model of the corporation will not particularly benefit the nonshareholder constituencies of a corporation, but it will decrease social wealth. It is the purpose of this article to combat the stakeholder model of the corporation.[15]

Most large U.S. firms are owned by stockholders. Ownership of a corporation by stockholders, however, does not resemble a single individual's ownership of an asset. The shareholders in a widely-held firm generally do not have the time, ability, or incentive to manage the firm's day-to-day affairs. Consequently, they elect directors who, in turn, appoint officers to operate the firm on behalf of the shareholders.[16] Regulating this separation of ownership from control is the central task of corporate law.[17] Theoretically, the relationship between managers and shareholders could be governed completely by contract. Because of the uncertainties and contingencies of the business world, however, shareholders and managers choose to leave the contract between them

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[13]Some academics have argued that corporate law should facilitate the board's role as a mediator between shareholders and stakeholders and protect the expectations of all firm patrons. For commentary advocating multilateral cooperation as the corporate governance paradigm, see William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 208-15 (1992); John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, 1988 WIS. L. REV. 435, 448; John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1443-47 (1994) [hereinafter Matheson & Olson, *Trialogical Imperative*]; John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1382 (1992) [hereinafter Matheson & Olson, *Longterm Shareholder Model*].

[14]*See* Matheson & Olson, *Longterm Shareholder Model*, *supra* note 13, at 1382; *see also* McDaniel, *supra* note 7, at 126 (noting that constituency statutes enable courts to expand the already existing common law of corporations to encompass stakeholder interests).

[15]As will become evident in the pages that follow, I am not alone in my quest to stem the rising tide of stakeholder advocacy. The contribution of this article, I hope, is a more comprehensive and less cavalier treatment of the subject than it has received previously.

[16]*See* DEL. CODE ANN. tit. 8, § 141(a) (1991).

[17]*See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 112-16 (rev. ed. 1968).

incomplete.[18] State corporation statutes provide a standard-form relational contract for the parties that details the rights of shareholders and the responsibilities of managers.[19] State law charges directors with a set of fiduciary duties in order to conform their behavior to the interests of shareholders.[20] Directors have a fiduciary duty of care to adequately inform themselves before making decisions and to act deliberately and carefully,[21] and a duty of loyalty to place the interest of the corporation and its shareholders above any interest possessed by the director alone.[22]

Although statutes and case law are often ambiguous as to the intended beneficiaries of managers' fiduciary duties,[23] absent special circumstances, shareholders traditionally have been the only parties capable of enforcing the duties.[24] In the past decade, however, Delaware case law[25] and most states' corporation statutes have set forth a new paradigm for managerial decision making by expressly permitting directors to take into account the interests of other corporate constituencies.[26] The Indiana "other constituency" statute, for example,

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[18]*See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444-45 (1989).

[19]*Id.*

[20]Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Guth v. Loth, Inc., 5 A.2d 503, 510 (Del. 1939).

[21]Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also Van Gorkom*, 488 A.2d at 872 (quoting *Aronson*).

[22]*Technicolor*, 634 A.2d at 361 (citing Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); *Aronson*, 473 A.2d at 812).

[23]*See supra* note 7.

[24]Many courts have explicitly held that managers do not owe a fiduciary duty to nonshareholder stakeholders. *See, e.g.*, Local 1330, United Steel Workers of Am. v. United States Steel Corp., 631 F.2d 1264, 1279-82 (6th Cir. 1980) (holding that a corporation had no common law or contractual obligation to consider the effects of plant closures on employees or communities in which the plants were located); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989) (holding that a corporation did not owe fiduciary duties to bondholders); Simons v. Cogan, 549 A.2d 300, 303 (Del. 1988) (holding that a corporate bond does not represent an interest in a corporation necessary for imposition of fiduciary duties); Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("[T]he relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature . . . .The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.").

[25]*See supra* note 12.

[26]*See, e.g.*, FLA. STAT. ANN. § 607.0830(3) (West 1993); GA. CODE ANN. § 14-2-202(b)(5) (1994); ILL. COMP. STAT. ANN. ch. 805, § 5/8.85 (West 1993); IOWA CODE ANN. § 491.101B (West 1991); ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 1995); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 1992); MINN. STAT. ANN. § 302A.251(5) (West Supp. 1995); NEB. REV. STAT. § 21-2035(1)(c) (1991); N.J. STAT. ANN. § 14A:6-1(2) (West Supp. 1995); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1996); OR. REV. STAT. ANN. § 60.357(5) (Supp. 1994); 15 PA. CONS. STAT. ANN. §§ 1715-1716 (1995); TENN. CODE ANN.

states that directors, while considering the best interests of the corporation, "are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor."[27] Connecticut has even passed legislation *requiring* directors to consider interests other than those of the firm's shareholders before deciding on a fundamental corporate change.[28] I shall argue in the remainder of this article that the efforts by commentators, state courts, and state legislatures to broaden the class of beneficiaries of managers' fiduciary duties are misdirected.[29]

The shareholder model of the corporation, which dominated state corporation law until the 1980s, is a more efficient paradigm than the stakeholder model. The shareholder model has its weaknesses, but its weaknesses are slight in comparison to the flaws of the stakeholder model. This article explains why the shareholder model of the corporation promises to create greater social wealth than the stakeholder model. I present the principal arguments on behalf of the shareholder model in Parts II-IV. Part II demonstrates that the shareholder model appropriately reflects the fact that, of all the corporate constituencies, equity holders have the highest potential costs of contracting with the firm in the market and incur the lowest costs of owning the firm. Part III shows that shareholders, as residual claimants, generally have the best incentive to maximize the profits of the firm. Part IV explains how the shareholder model increases corporate productivity by preserving management's accountability to the firm. Part V shows how the

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§ 48-103-204 (1995); WYO. STAT. § 17-16-830(e) (1995); *see also* AMERICAN LAW INSTITUTE, *supra* note 4, § 6.02(b)(2) ("The board may . . . have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders."). These other corporate constituencies include groups such as employees, suppliers, customers, creditors, and the community.

While the New York and Pennsylvania statutes explicitly state that they create no new fiduciary duties towards any stakeholder, the vast majority of the statutes do not expressly state whether nonshareholder constituencies have standing to seek judicial review of a director's decisions.

[27]*See* IND. STAT. ANN. § 23-1-35-1(f) (1995). *See also* 15 PA. CONS. STAT. ANN. §§ 1715-1716 (1995).

[28]*See* CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1995) (applying in the context of a corporate merger, consolidation, or a sale of all or substantially all of the corporation's assets).

[29]Throughout the article, I argue that the law ought not impose a fiduciary duty on managers to advance the interests of any nonshareholder corporate constituencies. Although my argument will always be phrased in terms of *managers'* fiduciary duties, I also mean to argue that the law ought not impose a fiduciary duty on *corporations* to protect the interests of any nonshareholder constituencies.

stakeholder model would reduce the amount of equity investment in the United States, interfere with efficient private ordering, and infringe upon stockholders' property rights. Part VI examines the takeover phenomenon and proves that in the takeover context, where shareholders have the greatest ability to take advantage of the other stakeholders, they do not do so. Part VII concludes the article.

II. FIRM PATRONS, MARKET CONTRACTING, AND THE COSTS OF OWNERSHIP

A firm transacts with several classes of patrons — namely, shareholders, creditors, employees, customers, and suppliers.[30] Theoretically, any one of these classes of patrons could own the firm, all classes of patrons could jointly own the firm, or persons who do not in any way transact with the firm could own the firm. Professor Henry Hansmann has argued persuasively that, all other things equal, ownership should be assigned to that class of patrons whose market contracting costs are highest.[31] Moreover, all other things equal, ownership should be assigned to that class of patrons for whom the costs of ownership are lowest.[32] Accordingly, the most efficient owner of a particular firm is that class of patrons whose ownership "minimizes the sum of (1) the costs of market contracting for those classes of patrons that are not owners and (2) the costs of ownership for the class of patrons who own the firm."[33] In his study of investor-owned firms, employee-owned firms, consumer cooperatives, supplier cooperatives, nonprofit firms, and variants on these organizational forms, Hansmann demonstrated that the controlling factor in the above calculus is the costs of ownership;[34] the class of patrons most likely to own a firm is the class of patrons who can most efficiently exercise ownership.[35] In particular, because homogeneous ownership

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[30]*See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976); Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267, 270 (1988).

[31]Henry Hansmann, The Ownership of Enterprise 18 (July 1995) (unpublished manuscript, on file with *The Delaware Journal of Corporate Law*) [hereinafter Hansmann, Ownership of Enterprise].

[32]*See id.* at 18-19.

[33]*Id.*

[34]*See id.* at 45-157.

[35]*See* Hansmann, Ownership of Enterprise, *supra* note 31, at 106 (noting that "successful instances of employee ownership will remain largely confined to firms with highly homogenous classes of employee-owners"); *id.* at 119 (finding that "much of the explanation [for farm marketing cooperatives] is to be found in unusually low costs of ownership"); *id.* at 128 (observing that "where the costs of ownership are low . . . producer cooperatives can

greatly reduces costs associated with collective decision making,[36] the most homogeneous class of patrons usually owns a firm.[37]

A. *Shareholder Market Contracting*

Contributors of equity capital, commonly known as shareholders, own U.S. public corporations. In short, shareholders own corporations because their costs of contracting with a firm in the market are high and their costs of owning a firm are low. Investors of equity capital without ownership privileges would face severe market contracting difficulties.[38] Because of the problem of asymmetric information, the firm's owners would have powerful incentives to appropriate for themselves much of the value of the invested capital, either by self-dealing or by more subtle forms of mismanagement.[39] Shareholders are widely dispersed and thus unable to monitor a firm's management effectively — unlike a supplier, a bank, an indenture trustee, or a union.[40]

The problem of lock-in exacerbates the problem of asymmetric information.[41] Most firms invest in long-lived, firm-specific assets.[42] Because continuous refinancing creates high transaction costs and opportunism risks, firms require long-term commitments from investors of capital.[43] The nature of business operations dictates that shareholders leave their funds at the corporation's disposal indefinitely. Although individual stockholders can exit a corporation at will, stockholders in the aggregate "are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal."[44]

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succeed even in the absence of serious market imperfections"); *id.* at 145 ("[H]igh costs of market contracting do not seem to be critical to the success of customer-owned enterprise, . . . [nor do they seem] sufficient in themselves to foster consumer ownership. Rather, the costs of ownership, and particularly the costs of [control,] seem to be decisive.").

[36]*See id.* at 79-87; Hansmann, *Ownership of the Firm*, *supra* note 30, at 278-79.

[37]One of the most cogent pieces of evidence for the relative importance of the costs of ownership is the "nearly . . . complete absence of large firms in which ownership is shared among two or more different types of patrons." Hansmann, Ownership of Enterprise, *supra* note 31, at 39.

[38]*See id.* at 46-49.

[39]*Id.* at 46-47.

[40]*Id.* at 49.

[41]Hansmann, Ownership of Enterprise, *supra* note 31, at 48.

[42]*Id.*

[43]*See id.* at 24, 48.

[44]Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984). Hansmann notes that another risk faced by market contracting equity investors is the inflation risk created by a long-term loan of capital. Hansmann, Ownership of Enterprise, *supra* note 31, at 49. In the 1990s derivatives markets, however, this risk is a small one. It would be easy

Equity investments are more vulnerable than the investments of other stakeholders for several additional reasons. First, the investments of stockholders are completely at risk, unlike those of employees (a fired worker retains his mental and physical abilities and some relevant job skills) and suppliers (an abandoned supplier retains his plant and equipment).[45] Second, because equity investments are not tied to specific firm assets, shareholders would find it very difficult to devise contractual safeguards to protect their investments.[46] While a firm can contract to protect a supplier's small and certain set of transaction-specific assets, a firm cannot adequately protect the shareholders' innumerable and amorphous set of firm-specific assets.[47] In order for creditors and employees to safeguard their investment in a corporation, they only need to maintain negative control over certain corporate decisions;[48] that is, to safeguard their investment in a firm, creditors and employees need only be able to prevent the firm from taking certain actions, such as incurring additional unsubordinated debt, closing a plant, or laying off workers. On the other hand, in order for shareholders to safeguard their investment, they must maintain positive control over a panoply of corporate decisions. The vast number of relevant contingencies renders contracting impossible.

B. *Shareholder Ownership*

Despite their high costs of market contracting, the costs of ownership for equity investors are low. Equity investors are good risk-bearers because of their comparative wealth and ability to diversify their stockholdings.[49] Stockholders also enjoy low costs of collective decision making because they "share a single well-defined objective: to maximize the net present value of the firm's earnings."[50] While the large number of shareholders in a widely-held public corporation makes effective monitoring of managers difficult, the homogeneity of shareholder interests

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for such investors to hedge this risk by entering into a swap transaction, exchanging its fixed-interest payments for floating-rate payments. *See* DON M. CHANCE, AN INTRODUCTION TO DERIVATIVES 499-506, 514 (3d ed. 1994).

[45]*See* Williamson, *supra* note 44, at 1209.

[46]*Id.* at 1210.

[47]*See id.*; 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, 36 (1991).

[48]Macey, *supra* note 47, at 36.

[49]Hansmann, Ownership of Enterprise, *supra* note 31, at 49.

[50]*Id.* at 53.

makes indirect monitoring of managers very easy.[51] Professor Hansmann points out that equity investors in widely-held corporations are protected from opportunism in large part by the *absence* of a "class of owners with interests contrary to that of the investors . . . . [T]his is in fact meaningful protection whose value often outweighs the costs of managerial opportunism that result from weak owner control."[52]

Although the interests of shareholders are relatively homogeneous, they do diverge in several ways. Shareholders come in many different flavors: long-term versus short-term; diversified versus non-diversified; individual versus institutional; common versus preferred; stripped versus unstripped;[53] dividend-income preferring versus capital-appreciation preferring. Shareholders on opposite sides of the above dichotomies often have different desires regarding their corporation's investment policies. For example, diversified common shareholders will have a much greater risk preference than will non-diversified preferred shareholders, and dividend preferring shareholders will want less retention of earnings than will capital-gain preferring shareholders.

While the shareholder interest is not monolithic, three reasons explain why shareholders are the least-cost owners of the firm. First, for all their differences, shareholders have fewer intra-class differences than employees or creditors.[54] Employees have conflicting interests on relative wages, on the apportionment of earnings between capital and labor, and on many of the "firm's investment decisions, such as which plants to keep open, which processes to automate, or where to improve safety."[55] Creditors, depending upon their seniority, will have starkly conflicting interests about the riskiness of the firm's investment decisions. Second, shareholders eliminate many of the potential conflicts among themselves by only investing in those firms with policies closely tailored to their interests.[56] For example, tax-exempt institutional investors will gravitate toward firms that pay a high annual dividend.[57] Third, the separation theorem teaches that the value of an investment to an individual investor does not depend on that investor's particular consumption preferences or other personal characteristics: "the individual's utility preferences are

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[51] *See id.* at 49-53.

[52] *Id.* at 52.

[53] Holders of stripped securities are debtholders who simultaneously acquire an amount of voting equity along with their newly-purchased debt instruments.

[54] *See* Hansmann, Ownership of Enterprise, *supra* note 31, at 53.

[55] *Id.* at 79-80.

[56] *Id.*

[57] This phenomenon is called the clientele effect. *See* STEPHEN ROSS ET AL., CORPORATE FINANCE 542-43 (3d ed. 1993).

independent or separate from the optimal portfolio of risky assets . . . . The separation theorem . . . allows the management of a corporation to make decisions without reference to the utility preferences of individual owners."[58]

The most unresolvable intrashareholder disputes are those between common and preferred stockholders. Neither the separation theorem nor the clientele effect will explain away their divergent interests. Although preferred stock resembles common stock to the extent that it does not have a right to dividends and that its claims upon liquidation follow the claims of debtholders,[59] preferred shareholders have a strikingly different relation to a corporation than do common shareholders. Preferred stock has a preference over common stock in the payment of dividends and the distribution of the corporation's assets upon liquidation."[60] Preferred shareholders have many interests that are more similar to those of fixed claimants than to those of common shareholders. For example, the quarterly return to preferred shareholders is capped at a stated dividend level, and if the corporation is liquidated, the preferred shareholders receive a predetermined lump sum.[61] Preferred shareholders may also prefer less-risky capital expenditures than common shareholders.[62]

Revealingly, corporate law and investment contracts control the divergent interests of common and preferred shareholders by strictly limiting the ownership privileges of preferred shareholders. Preferred shares are usually made nonvoting in order to reduce the costs of ownership. Preferred shareholders also enjoy limited fiduciary protection against the corporation. Their fiduciary protection is generally restricted to enforcement of the terms of the state's corporation statute, the corporation's charter, and the certificate of determination under which the preferred stock was issued.[63] While shareholders are not perfectly

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[58]JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 64-65 (7th ed. 1986); *see also* ROSS ET AL., *supra* note 57, at 298-300 (discussing the separation theorem).

[59]*See* ROSS ET AL., *supra* note 57, at 402-03.

[60]*Id.* at 402.

[61]*See id.* at 403.

[62]Macey, *supra* note 47, at 33.

[63]*See, e.g.*, Kirschner Bros. Oil v. Natomas Co., 229 Cal. Rptr. 899, 906 (Cal. Ct. App. 1986) ("[T]he articles of incorporation and the certificate of determination define the rights, preferences, and privileges granted to preferred shareholders."); Rothschild Int'l Corp. v. Liggett Group, Inc., 463 A.2d 642, 646 (Del. Ch. 1983) ("The preferential rights attaching to shares of preferred stock are contractual in nature and are governed by the express provisions of a corporation's charter."); Wood v. Coastal States Gas Corp., 401 A.2d 932, 937 (Del. 1979) ("For most purposes, the rights of the preferred shareholders as against the common shareholders are fixed by the contractual terms agreed upon when the class of preferred stock is created."); 12 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE

homogeneous, nor are they a motley crew. This section has shown that shareholders are the class of patrons who can most cheaply exercise ownership of a business corporation because of their inherent homogeneity of interests.

C. *Market Contracting by Other Stakeholders*

A linchpin of the argument on behalf of the shareholder model is the proposition that other stakeholders in the corporation are capable of protecting their interests by statute or contract.[64] Many of the stakeholder advocates, however, argue that other stakeholders cannot contract effectively with a corporation.[65] While some commentators claim that this issue can be dispatched with respect to all stakeholders without distinguishing between the various classes of stakeholders,[66] each

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CORPORATIONS § 5443 (perm. ed. rev. vol. 1985) ("Since the relation between the holders of preferred stock and the corporation is contractual, the extent of their right to share in the corporate profits and of their preference over the common stockholders depends upon the terms of their contract.") (citations omitted); *see also* 11 FLETCHER, *supra*, § 5305 (perm. ed. rev. vol. 1995) ("Common shareholders can object to and prevent any arrangement or transaction entered into or threatened by the company for the purpose of putting the preferred shareholders on a more favorable footing than is secured to them by their contract."); AMERICAN LAW INSTITUTE, *supra* note 4, at 412 (discussing the lack of any obligation on directors to consider the interests of preferred shareholders).

Instructive on this issue is the case of Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584 (Del. Ch. 1986). Chancellor Allen wrote:

> [W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards.

Id. at 594. This standard for determining the fiduciary duties of managers to preferred shareholders comports perfectly with the analysis laid out in this part of the article. Where the preferred shareholders have a divergent interest from the common, preferred shareholders have no fiduciary protection; where the preferred and common shareholders have the same rights and interests, a fiduciary duty applies.

[64]*See* William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 389-90 (1990); Hanks, *supra* note 7, at 115-16; Macey, *supra* note 47, at 36-43.

[65]*See, e.g.*, Bratton, *supra* note 13, at 197; Coffee, *supra* note 10, at 12, 45-50, 75-76; McDaniel, *supra* note 7, at 156-57; Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 48-66 (1991); Wallman, *supra* note 7, at 189-91.

[66]*See, e.g.*, Bratton, *supra* note 13, at 197-98 (asserting that contractual corporate governance is simply impossible because relational contracts with omitted terms are

stakeholder in the firm confronts the firm differently. This section examines the contracting problems faced by other stakeholders — employees, creditors, customers, suppliers, and communities — when transacting with the corporation in the market.

1. Employees

Besides shareholders, employees are probably the class of patrons that is least able to contract with the corporation.[67] According to the life-cycle model of employment compensation, employees and firms enter into efficiency-enhancing implicit employment contracts in which employees agree to receive less in wages than their then-current marginal product in exchange for extra compensation later in their career.[68] Employers implement deferred compensation programs to encourage employees to acquire firm-specific skills, to motivate employees to stay with the firm over the long haul, and to discourage employees from shirking.[69] Employees accede to deferred compensation programs as a bonding mechanism.[70] According to the theory, deferred compensation employment contracts are implicit but efficiency-enhancing; consequently, the law should police them to prevent employer opportunism and facilitate their formation.[71]

Shareholder advocates often argue that minimum wage, safety, plant-closing and other labor laws, combined with unions and collective bargaining laws, are sufficient to protect workers from exploitation by corporations.[72] Stakeholder advocates respond by pointing out that, while the law does provide substantial protection, unions do not adequately

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unavoidable and because the market cannot price all risks).

[67]Employees are included among the constituents whom directors may consider when making fundamental corporate decisions in all of the states listed in *supra* note 26.

[68]*See* Coffee, *supra* note 10, at 9; David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 234 (1991); Stone, *supra* note 65, at 48-53. "This model has been called a theory of life cycle earnings because it posits a relationship between wages and marginal productivity over a worker's life cycle rather than at each moment in time." *Id.* at 49 n.12.

[69]Millon, *supra* note 68, at 234.

[70]*See id.*

[71]*See* Coffee, *supra* note 10, at 75 (arguing that deferred wages are best awarded through implicit contracts); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33-34 (Alan J. Auerbach ed., 1988) (arguing that a large source of wealth for shareholders in hostile takeovers lies in the breach of implicit contracts with employees of the target firm).

[72]*See, e.g.*, ABA, *supra* note 7, at 2268; Gregory R. Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865, 884 (1987); Hanks, *supra* note 7, at 116.

protect employees during restructurings, and courts are reluctant to enforce specific provisions in contracts that guarantee employee job security.[73] While unions and life-time employment guarantees may not serve as the aegis that workers need, shareholder advocates have marshalled compelling evidence indicating that employees can contract effectively with corporations in most instances.[74]

Implicit contracts are contracts whose terms are observable to the contracting parties but are not observable to third parties like courts.[75] Most terms of employment contracts (e.g., wage compensation, pension benefits, other fringe benefits, and employment levels) are easily observable and verifiable.[76] Consequently, these terms can feasibly be incorporated by a court into explicit contracts. Investment in firm-specific skills, however, resembles a proper subject of implicit contracting.[77]

There are good reasons, however, to believe that workers are not subject to significant expropriation of their firm-specific capital. First, firms generally realize the efficiency of safeguarding employees' firm-specific assets.[78] Failure to safeguard these assets will lead to higher costs of labor.[79] Second, firms do in fact adopt safeguards such as mandatory severance pay, grievance machinery, and explicit promotion ladders in order to preserve workers' firm-specific capital.[80] Third, in most situations of employment at will, employees are protected by not only a competitive market containing many employers who are reasonably good substitutes for each other, but also the consequent reputational incentives for employers in such a market.[81] Employers realize that developing good will in their dealings with employees can garner significant benefits.[82] Fourth, employees should not fear

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[73]Stone, *supra* note 65, at 54-55, 66-67; *see also* McDaniel, *supra* note 7, at 157 ("[W]ith organized labor in decline in most industries, collective bargaining agreements will not be a source of protection for most employees.").

[74]*See* Alan E. Garfield, *Contractarians, Communitarians and Agnostics*, 43 AM. J. COMP. L. 150, 153-57 (1995).

[75]Romano, *supra* note 10, at 139.

[76]*Id.*

[77]*Id.* at 139-40; *see also* Williamson, *supra* note 44, at 1202, 1206-07 (arguing that workers with general purpose skills and knowledge "can quit and be replaced without productive loss to either worker or firm"). Williamson assumes easy re-employment and ignores the transition costs of re-employment. *Id.* at 1207 n.31.

[78]Williamson, *supra* note 44, at 1208.

[79]*Id.*

[80]*See id.*

[81]*See* Carney, *supra* note 64, at 405-06.

[82]*See id.* Employment at-will does not necessarily constitute employer overreaching;

opportunistic layoffs and plant closings. While an employer violating an implicit deferred compensation employment contract saves on wages, the employer loses workers' firm-specific skills and the costs of sunk investments in plant.[83] The symmetry of loss should deter corporate opportunism.[84] If these employer concerns did not sufficiently protect workers from exploitation, firms and their employees would devise other mechanisms for protecting workers' firm-specific capital.[85]

Although employees may not have the contracting power to protect their wages and working conditions, it is at least technologically possible for workers, unlike shareholders, to protect themselves through contract.[86] In contexts of roughly equal bargaining power, employees will be compensated for the risks of layoff and plant closing by a higher wage or a golden or tin parachute.[87] Failure to contract to prevent certain layoffs or plant closings would indicate employees' unwillingness to pay for such protection with a lower wage.[88] Indeed, workers capable of bargaining on roughly equal ground with their employer may not want a legal or contractual guarantee of permanent employment — if a corporation cannot layoff workers, it will often operate inefficiently and will face an increased risk of bankruptcy. Workers at different firms may want the freedom to decide whether or not to pursue special protections at the risk of decreased corporate efficiency and bankruptcy.

The bargaining power question remains. Collective bargaining and unions, albeit imperfect solutions, can ameliorate employees' collective action problem and provide an agent to monitor employers' compliance with labor contracts.[89] Although many industries are not protected by unions and collective bargaining, these protective devices exist in situations where employees are most vulnerable: in uncompetitive labor markets in which employees cannot easily obtain substitute employment.[90] Moreover, imposing new fiduciary duties on corporations will not solve

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many highly-paid professionals serve at-will, and many at-will employment agreements provide large salaries and fringe benefit packages. *Id.* at 406.

[83] *Id.* at 408-09.

[84] *Id.* Carney's admonition that "[i]n most cases employees would have had a lengthy period of employment over which to amortize their firm-specific investments" seems dubious. *Id.* at 411.

[85] *See generally* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985) (discussing contracting difficulties in the terms of transaction-cost economics).

[86] Macey, *supra* note 47, at 37.

[87] *Id.* The "tin parachute" is the lower level employee analogue to the "golden parachute." *See* Carney, *supra* note 64, at 406 n.83.

[88] *See* Macey, *supra* note 47, at 36.

[89] *See* Carney, *supra* note 64, at 406-07.

[90] *See id.* at 406.

any residual bargaining power disparities. Protecting employees with fiduciary duties will make those employees less valuable to their employer; consequently, their employer will be less willing to pay wages equivalent to the status quo ante.[91] According employees fiduciary protection without addressing the imbalance in bargaining power will not help employees at all.[92] Employers with unfair bargaining power will still have that unfair bargaining power and will force employees to bear the costs of their new fiduciary shield by extracting wage concessions or firing some workers.[93]

2. Creditors

Creditors are the next most likely corporate constituency to deserve fiduciary protection because of their inability to contract with the firm.[94]

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[91]Macey, *supra* note 47, at 37.

[92]*Id.* at 38.

[93]*See id.* Some commentators have advocated placing worker representatives on corporations' boards of directors. *See, e.g.*, Klaus J. Hopt, *New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 MICH. L. REV. 1338, 1343 (1984); Detlev F. Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 76 (1966). *But see* Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-managed Firms and Codetermination*, 52 J. BUS. 469, 473-74 (1979) (arguing that programs in which noninvestors have claims to a firm's income will make all claimants worse off).

[94]*See generally* Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165 (1990) (advocating the imposition of a fiduciary duty of fairness on boards of directors to ensure that fixed claimants receive their entitlements); *see also* Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 142 n.394 (1989) (citing cases in support of extending fiduciary duties to bondholders and preferred shareholders). States recognizing the interests of creditors in nonshareholder constituency statutes include Georgia, Iowa, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Pennsylvania, and Wyoming. *See supra* note 26.

The relative vulnerability of creditors should not be exaggerated. "Creditors seldom have firm-specific capital at risk" and most creditors are generally diversified investors. Coffee, *supra* note 10, at 51. Professor Coffee argues that many creditors do not protect themselves against firm opportunism because they have no market incentives to do so. *Id.* at 45. He gives as examples banks whose depositors have Federal Deposit Insurance Corporation (FDIC) insurance and mutual funds whose investors can observe the fund's return but cannot monitor the fund's risk. *See id.* at 45-47. I am inclined to think that depositors would care about debtor opportunism. Although FDIC insurance can act as a safety net, depositors want to receive a return on their investment, not just their principal minus the transaction costs of government insurance. Even if bank depositors did not care about debtor opportunism, bank managers would care. Most individual loans do not impose an insolvency risk upon a bank; hence, if a bank debtor acted opportunistically, depositors would earn a lower return but would not risk their principal. The perverse incentives created by FDIC insurance would not come into play. Furthermore, even when a bank extends a dangerous amount of credit to one

The agency costs of debt are indubitably high. Creditors always face the risk that a corporation's post-contractual behavior will increase the expected risk of default on a loan.[95] Because of shareholders' limited liability, a leveraged company acting in the shareholders' interests will sometimes pursue more risky projects than are in the debtholders' interests.[96]

As an illustration, suppose corporation Hercules has $1 million of debt in its capital structure and faces two investment possibilities: Project Alpha, providing a fifty percent probability of a $2 million return and a fifty percent probability of a $1 million return; and Project Beta, providing a fifty percent probability of a $3 million return and a fifty percent probability of a $500,000 return. While bondholders would prefer that their debtor pursue Project Alpha, because Alpha guarantees repayment of the debt, shareholders would prefer Project Beta, because Beta maximizes the expected value of shareholder gains.[97] Because the shareholders control the corporation, the corporation will likely pursue Project Beta. Although Project Beta is the socially efficient endeavor,[98] if corporations often face these sorts of investment opportunity sets, and

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particular borrower, bank managers have powerful reputational incentives to keep their bank out of receivership; these incentives should motivate banks to obtain protective covenants in their credit agreements. To the minimal extent that the availability of FDIC insurance perverts bank incentives, the problem is with the concept of federal bank insurance, and not with corporations' fiduciary duties.

Mutual fund investors are even more sophisticated than bank depositors in that they, or their yet more sophisticated representatives, will examine risks. Mutual fund managers are also subject to the same powerful reputational incentives as bank managers. The best way of solving any residual incentive problem would be to impose disclosure requirements on mutual funds.

[95]*See* William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1561 (1982); *see also* Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 457-60 (1986) (outlining the restrictive covenants in the indentures of America's 100 largest industrial corporations); Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 117-19 (1979) (examining how debt contracts are used to manage the bondholder-stockholder conflict).

[96]*See* Jensen & Meckling, *supra* note 30, at 334-40.

[97]The expected return to shareholders of Project Alpha is $500,000. This represents a 50% possibility of a $2 million return less the $1 million of debt plus a 50% possibility of a $1 million return less the $1 million of debt. The expected return to shareholders of Project Beta is $1 million. This represents a 50% possibility of a $3 million return less the $1 million of debt. Because shareholders enjoy limited liability, the 50% possibility of a negative return is valued at zero.

[98]The expected return to society of Project Alpha is $1,500,000. This is comprised of a 50% possibility of a $2 million return and a 50% possibility of a $1 million return. The expected return of Project Beta to society is $1,750,000. This is comprised of a 50% possibility of a $3 million return and a 50% possibility of a $500,000 return.

if creditors are unable to contract to prevent corporations from engaging in risky projects, then creditors will be much less willing to lend to firms and corporations' borrowing costs will rise. As a consequence, overall corporate investment and productivity will fall.

The agency costs of debt manifest themselves in ways other than excessive corporate risk-taking. Corporate debtors can also expropriate wealth from creditors by selling a substantial amount of the firm's assets, distributing money to shareholders, forgoing new investments, or increasing the firm's debt level.[99]

Although market contracting creditors face a theoretical risk of shareholder opportunism, shareholders will seldom be able to change a firm's policies in order to successfully expropriate the wealth of creditors. First, shareholders will seldom want to take advantage of creditors. Creditors avoid firms with a reputation for abusing debtholders.[100] Second, the potential for exploitation generally arises only when a firm faces a material probability of bankruptcy or is in financial distress.[101] Third, even when the potential for exploitation exists, it is difficult for shareholders to realize that potential.[102] Although Jensen and Meckling showed that conglomerate firms are able to increase the riskiness of their projects,[103] it is not obvious that the investment portfolios of non-conglomerate firms are so malleable. While a conglomerate firm can quickly shift capital expenditures from its low-risk businesses to its high-risk businesses, a firm with only one business will have to make serious adjustments to increase its riskiness. Because conglomerate firms are becoming more scarce,[104] risk level exploitation of creditors may become

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[99]*See* Coffee, *supra* note 10, at 43-44; *see also* Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1832-35 (1992) (showing how a debtor corporation can coerce public bondholders into amending bond indentures to their disadvantage); John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1211 (1991) (explaining how a debtor corporation can exploit public bondholders through recapitalizations and other exchanges of securities).

[100]*See* Ribstein, *supra* note 94, at 145 ("Management conduct that reduces bond prices also increases future borrowing costs and demands for more restrictive covenants, which, in turn, reduce stock prices.").

[101]*See* ROSS ET AL., *supra* note 57, at 456.

[102]*See id.* at 458.

[103]*See* Jensen & Meckling, *supra* note 30, at 334-40.

[104]*See* Frank R. Lichtenberg, *Industrial De-diversification and its Consequences for Productivity*, 18 J. ECON. BEHAVIOR & ORGANIZATION 427, 434-36 (1992) (showing that the level of diversification declined significantly between 1985 and 1989 for a sample of 6,505 U.S. firms); Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745, 745 (Aug. 1990) ("The evidence suggests that takeovers in the 1980s represent a comeback to specialized, focused firms after years of diversification. . . . To a significant

an increasingly uncommon occurrence. Powerful reputational incentives also discourage corporate managers from altering the size of corporate distributions to shareholders (in either direction).[105] Similarly, managers have strong incentives that discourage them from selling off most of the firm's assets.

There are also a host of good reasons to think that creditors can contract effectively with corporations.[106] Long-term creditors rely on contractual provisions to protect against debtor opportunism. Creditors can require that the debtor maintain reserves, periodically amortize the debt, maintain shareholders' equity, and/or submit to acceleration of the debt upon the occurrence of any one of a set of dangerous transactions.[107] Bond indentures routinely "limit the ability of an issuer to borrow, merge, pay dividends, repurchase stock, issue preferred stock, sell assets, or engage in transactions with affiliate companies."[108] Bondholders also have the capacity to insert "poison put" provisions into bond indentures.[109] Puts give bondholders the right, but not the obligation, to sell their bonds back to the issuer "at a predetermined price upon the occurrence of certain contingencies."[110]

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extent, takeovers in the 1980s reflect the deconglomeration of American business."). *But see* Cynthia A. Montgomery, *Corporate Diversification*, 8 J. ECON. PERSP. 163, 163-64 (1994) (showing that diversification increased from 1985-1992 for the 500 largest U.S. firms and noting that "multiple-line businesses are here to stay and will remain a dominant feature in the economic landscape").

[105]Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 314, 322 (John C. Coffee, Jr. et al. eds., 1988) ("[The] capital markets punish dividend cuts with large stock price reductions . . . ."). Managers tend to pursue a stable dividend policy and take great pains to avoid any drastic change in dividend payment levels. *See* Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881, 889-91 (1995); *see also* John Lintner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, Papers & Proceedings, 46 AM. ECON. REV. 97, 99 (1956) (examining the reasons why managers of corporations pursue stable dividend policies).

[106]*See Metropolitan Life Ins.*, 716 F. Supp. at 1521. *See also* Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 981 (1993) ("We find, however, that bondholders did obtain substantial contractual protection in the wake of the RJR buyout."); Kenneth Lehn & Annette Poulsen, *Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts*, 34 J.L. & ECON. 645, 647 (1991) (showing how bondholders protect themselves in leveraged acquisitions by event-risk indenture provisions); *cf.* Smith & Warner, *supra* note 95, at 121-24 (examining the various types of bond covenants used to control conflicts between stockholders and bondholders).

[107]Richard B. Tyler, *Other Constituency Statutes*, 59 MO. L. REV. 373, 412 (1994).

[108]Macey, *supra* note 47, at 38.

[109]*See* Carney, *supra* note 64, at 403; Macey, *supra* note 47, at 39.

[110]Macey, *supra* note 47, at 39; *see also* Kahan & Klausner, *supra* note 106, at 960-66

Creditors have additional contractual powers beyond that of obtaining negative covenants. They can charge higher interest rates to the extent that the debt contract fails to protect them. They can choose to lend on a short-term basis if long-term loans would generate excessive (unpriceable or undesirable) risk of exploitation. They can take security in some or all of the debtor's assets. Creditors also have available strip financing, whereby they can simultaneously acquire voting stock and debt instruments.

Bondholders have more difficulty contracting with firms than do sole lenders such as banks. Commentators have detected possible failures in the market for corporate debt securities.[111] Some commentators claim that corporate bonds do not trade in competitive markets; that is, corporate bond issuers have market power and the resultant ability to dictate prices and terms to debt investors.[112] If this were an accurate representation of the market for corporate debt securities, corporate debtors would have little incentive to accept covenants desired by creditors.[113] To prevail, this market failure argument must show either that purchasers of corporate bonds are naive or that some investors must purchase corporate bonds to obtain their desired portfolio.[114] The demonstration of either of these two propositions is difficult. The vast majority of holders of corporate bonds are sophisticated institutional investors.[115] At the end of 1992, households held only seven percent of outstanding corporate bonds.[116] Banks, savings and loans (S&Ls), insurance companies, and mutual funds owned nearly eighty percent of corporate bonds.[117] Moreover, few investors need to hold corporate bonds in their portfolios. If bonds proved to be a bad investment because of recurrent debtor opportunism, then most investors would build portfolios

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(comparing and contrasting two special remedies used in traditional bond covenants: puts and interest rate adjustments).

[111]*See, e.g.*, Coffee, *supra* note 10, at 68-69; Mitchell, *supra* note 94, at 1182-84.

[112]*See* Carney, *supra* note 64, at 402.

[113]*See id.*; *see also* McDaniel, *supra* note 95, at 424-26 (showing a decline in the number of restrictive covenants in the bond contracts of America's largest corporations).

[114]Carney, *supra* note 64, at 402.

[115]*Id.* at 403; *see also id.* at 404 n.74 (citing RICHARD S. WILSON, CORPORATE SENIOR SECURITIES 5-7 (1987) (providing statistical data on the percentage of U.S. corporate debt held by insurance companies, pension funds, and private households)); Coffee & Klein, *supra* note 99, at 1252 (noting that "debt these days is sold mostly to large institutions with sophisticated staffs" and that issuers routinely accede to bond purchasers' covenant requests).

[116]Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 583 (1995).

[117]*Id.*

with a combination of equity securities and risk-free U.S. Treasury securities in order to achieve their desired risk/return packages.[118]

Other commentators argue that the market for corporate bonds is plagued by asymmetric information inefficiencies.[119] Empirical studies have shown, to the contrary, that many legal terms in bond indentures are priced by the market.[120] Studies have also shown that "there is no evidence pointing to particular informational inefficiencies in the market for newly issued bonds. To the contrary, the primary market for newly issued bonds is more informationally efficient than the secondary bond market."[121] The market for corporate debt is highly liquid; the daily trading volume of bonds is more than double that of common stock.[122] Moreover, the institutional setting for the corporate bond market strongly suggests its efficiency. Corporate bondholders are highly sophisticated entities.[123] Legal terms comprising bond indentures are highly standardized.[124] Courts do not creatively interpret bond indentures; they only fill in implicit loopholes.[125] Information intermediaries (underwriters and bond rating agencies) vouch for the existence and effectiveness of terms in bond indentures.[126] Additional evidence of the informational efficiency of the market for corporate bonds is that bonds issued by firms

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[118]*But see* Kahan & Klausner, *supra* note 106, at 943 (arguing that investors' special preferences and the transaction costs of portfolio synthesis create a unique demand for low-risk corporate bonds).

[119]*See, e.g.*, Brudney, *supra* note 99, at 1830, 1851-52 (1992) (questioning the efficiency of the corporate bond market and arguing that dispersed bondholders are unable to give genuine informed consent to the terms of a bond indenture); Coffee & Klein, *supra* note 99, at 1218-20 (arguing that inefficiency in the high-yield debt market "follows from both the absence of regular trading and the scarcity of information"); Mitchell, *supra* note 94, at 1181-82; Martin Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 J. CORP. L. 211, 219 (1991) (demonstrating that public bondholders obtain lower interest rates and fewer protective covenants than sole lenders of capital).

[120]*See* Kahan, *supra* note 116, at 579.

[121]*Id. But see* Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1, 34-46 (arguing that the Efficient Capital Markets Hypothesis (ECMH) is not necessarily applicable in the bond markets).

[122]*See* Coffee & Klein, *supra* note 99, at 1218 n.31 (citing J. Edmund Colloton, *Bondholder Communications — The Missing Link in High-Yield Debt* 18 (Report for Hill & Knowlton, Inc., 1990)).

[123]*See supra* notes 115-16 and accompanying text.

[124]Kahan, *supra* note 116, at 586.

[125]*Id.* at 587-88.

[126]*Id.* at 590; *see also* Tauke, *supra* note 121, at 12 (stating that less sophisticated investors rely on professional market intermediaries such as underwriters and rating agencies to explain the terms of their bond contracts). *But see* Mitchell, *supra* note 94, at 1183 (arguing that underwriters and indenture trustees have insufficient incentives to protect bondholders).

that stand to gain the most from restrictive covenants are much more likely to include such covenants.[127]

Another form of market failure exists if the risks of debtor opportunism are simply not anticipatable by creditors, even by sophisticated investors in debt securities.[128] A related form of market failure would exist if the relationships between corporations and lenders of capital were subject to so many contingencies that the parties could not adequately address all of them in a contract. While these difficulties in market contracting between creditors and firms remain, they should not be allowed to obscure the fact that unprotected shareholders are more at risk from firm opportunism than are unprotected debtholders. Debtholders need only obtain negative protection against certain forms of shareholder behavior to protect their investment; shareholders need to obtain more comprehensive protection against any managerial behavior that reduces the value of the firm. Many things that reduce the value of the firm will not reduce the value of the firm's debt.

Ordinary trade creditors are in a different situation than commercial banks and bondholders. They often do not have the bargaining power to extract contractual concessions from a firm.[129] The market for short-term trade credit is reasonably competitive, and any attempt by a trade creditor to manipulate the contract terms to her advantage will be rebuffed and might induce the debtor to find a new trading partner.[130] Furthermore, transaction costs prevent the articulation of elaborate contractual provisions preventing debtor opportunism.[131] Notwithstanding the preceding considerations, trade creditors do not need and would not want fiduciary protection against debtors.[132] Trade creditors are short-term creditors who can quickly respond to bad firm behavior by taking their business elsewhere.[133] Hence, firms have an important reputational incentive not to mistreat trade creditors. Additionally, a variety of legal

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[127]Kahan, *supra* note 116, at 593-95. Professor Kahan points out that bond indentures of highly leveraged firms are more likely to have restrictive covenants while bond indentures of firms with a reputation for treating bondholders fairly are more likely to have fewer restrictive covenants. *Id.* at 593-94.

[128]For example, the early stages of the 1980s leveraged buyout (LBO) phenomenon found many creditors unprepared, and those creditors did lose wealth to shareholders. Carney, *supra* note 64, at 402 n.68; Tyler, *supra* note 107, at 412.

[129]Tyler, *supra* note 107, at 412.

[130]*See id.*

[131]*See* Carney, *supra* note 64, at 400.

[132]*But see* Tyler, *supra* note 107, at 412 (noting that "ordinary trade creditors are one of the prime candidates for protection by a nonshareholder constituency statute").

[133]Carney, *supra* note 64, at 400-01; Tyler, *supra* note 107, at 412.

devices protect trade creditors and obviate the need for expensive and elaborate negative covenants.[134]

State law imposes some specific duties on corporate managers to creditors precisely in those situations where creditors need positive protection from the firm — when the firm is insolvent or near insolvency. Each state requires that corporate managers obey certain rules designed to safeguard creditor interests. These rules include the legal doctrines of fraudulent conveyance, equitable subordination, piercing the corporate veil, as well as dividend statutes. The law of fraudulent conveyance prevents a debtor near insolvency from lying to creditors, hindering creditors in the enforcement of their claims,[135] transferring property to a non-creditor for less than adequate consideration,[136] or transferring property to one of many creditors.[137] The law of equitable subordination allows a court, in its discretion, to subordinate the claims in bankruptcy of a corporate insider to the claims of all other creditors if the insider committed fraud, mismanaged the insolvent corporation, or inadequately capitalized the insolvent corporation.[138] The doctrine of "piercing the corporate veil" allows a court to look through the corporate form and hold shareholders liable in situations where a fraudulent conveyance occurred or where the initial capitalization of the corporation was inadequate.[139] Finally, dividend statutes restrict a corporation's ability to pay out dividends or make other distributions of assets to its shareholders.[140]

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[134]Such legal devices include fraudulent conveyance and preference law, a seller's right of reclamation, and other Uniform Commercial Code provisions. *See, e.g.*, UNIF. FRAUDULENT CONVEYANCE ACT §§ 4-7, 7A U.L.A. 474-509 (1918) [hereinafter UFCA]; UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 643 (1984); 11 U.S.C. §§ 547-548 (1994); U.C.C. § 2-702 (1966).

[135]*See* UFCA § 7, 7A U.L.A. 509 ("Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.").

[136]*See* UFCA § 4, 7A U.L.A. 474 ("[E]very conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration."); UFCA § 6, 7A U.L.A. 507 ("Every conveyance made and every obligation incurred without fair consideration when the person making the conveyance or entering into the obligation intends or believes that he will incur debts beyond his ability to pay as they mature, is fraudulent as to both present and future creditors.").

[137]*See* 11 U.S.C. § 547(b) (providing that a trustee in bankruptcy may avoid transfer of the debtor's interest in property to or for the benefit of a creditor on account of an antecedent debt made within 90 days of the filing of a bankruptcy petition, if the transfer enabled a creditor to obtain more than his legal share of a debtor's estate).

[138]*See* 11 U.S.C. § 510(c).

[139]CLARK, *supra* note 7, at 81.

[140]*See, e.g.*, DEL. CODE ANN. tit. 8, § 170(a) (1994).

While it is true that a creditor could insist on contractual terms that would provide him with protections equivalent to the above legal doctrines, the law imposes these duties on corporate debtors anyway. It is important to note, however, that all four of these doctrines apply in only a small subset of situations and that two of the four doctrines impose very mechanical duties. The law of fraudulent conveyances only applies to certain specific transfers of property or incurrences of obligation near bankruptcy. Furthermore, this doctrine only applies to formal creditors and is highly mechanical in its approach.[141] The law of equitable subordination has a rather open-ended approach, but it only applies in the rarest of situations: federal bankruptcy proceedings involving debtors owned or controlled by persons who are also creditors of the debtor.[142] "Piercing the corporate veil" also has an open-ended approach, but it too applies in few situations, and never in the context of a large, publicly-held corporation. The dividend statutes have a perfectly algorithmic approach and, of course, apply only when a corporation distributes assets to its shareholders. Any corporate duties to creditors should be as carefully nuanced and limited in scope as these doctrines.

3. Customers

"Other constituency" statutes uniformly include a firm's customers on the list of constituencies whose interests directors are entitled to consider.[143] Only certain kinds of customers, however, need special protection from exploitation at the hands of corporate vendors.[144] Some consumers purchase products that have delayed malevolent health effects.[145] Other consumers must transact with firms possessing market power.[146] Some consumers purchase durable assets, and some are especially dependent on one corporation's product.[147] Finally, some consumers are faced with an informational asymmetry: producers have

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[141]*See* CLARK, *supra* note 7, at 91 ("The principles of [fraudulent conveyance] are specified by fraudulent conveyance law in rather precisely conceived tests, and their violation calls for equally precisely conceived, nonpunitive remedial action.").

[142]*Id.* at 62-63.

[143]All of the state statutes listed *supra* note 26 include customers in their nonshareholder constituency statutes.

[144]Tyler, *supra* note 107, at 413.

[145]*See, e.g.*, Carney, *supra* note 64, at 398 (discussing consumer dealings with tobacco companies).

[146]*Id.* at 394.

[147]*See* Tyler, *supra* note 107, at 413.

more information about the quality of their goods than they are willing to reveal to consumers.[148]

Despite their occasional vulnerability, customers would not benefit from broad-brush fiduciary protection. First, in many industries where the consumer exploitation problem is severe, firms have taken the form of consumer cooperatives rather than business corporations.[149] Second, most product markets in this country are quite competitive.[150] Third, to the extent that product markets are not competitive, federal antitrust laws are designed to seek and destroy repositories of market power.[151] Fourth, the problem of asymmetric information is largely solved by firms through the use of product sampling, warranties, and investments in brand names.[152] Fifth, in most cases, sellers have strong reputational incentives to tell the truth about their own products and the products of their competitors.[153] Finally, regulatory agencies like the Food and Drug Administration (FDA) and the Consumer Product Safety Commission (CPSC) protect consumers from harmful products.

4. Suppliers

"Other constituency" statutes also frequently include a firm's suppliers on the list of protectible constituencies to whom fiduciary duties should be extended.[154] As is the case with customers, most suppliers will be protected by the competitive U.S. product markets.[155] The only suppliers in need of extra-contractual protection are those who are induced by vendee firms to make firm-specific investments;[156] that is,

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[148]*See* Carney, *supra* note 64, at 396-97; Hansmann, Ownership of Enterprise, *supra* note 31, at 131.

[149]*See* Hansmann, Ownership of Enterprise, *supra* note 31, at 130-45.

[150]Carney, *supra* note 64, at 394-95 (citing sources).

[151]Admittedly, the courts have not uniformly construed U.S. antitrust laws to maximize consumer welfare. *See* ROBERT H. BORK, THE ANTITRUST PARADOX (1978) (demonstrating how antitrust suits have adversely affected consumers by promoting a costly form of protection for inefficient and uncompetitive small businesses).

[152]Carney, *supra* note 64, at 397. This should not be overstated. Many firms construct a reputation for quality, cheapen their product, and then take advantage of customers until the new information reaches the consumer product market. *See* Williamson, *supra* note 44, at 1214.

[153]Carney, *supra* note 64, at 398.

[154]Of the states listed *supra* note 26, all but New York include suppliers in their nonshareholder constituency statutes.

[155]Carney, *supra* note 64, at 412.

[156]Tyler, *supra* note 107, at 413; Williamson, *supra* note 44, at 1212. An example of such firm-specific investment by a supplier would be a supplier's construction of a plant that is only capable of producing certain electronic devices that are used by a particular operating

those suppliers who make investments in specialized capital assets that have little value except in producing particular goods for a particular purchaser.[157] The investments of these suppliers are susceptible to expropriation by an opportunistic buyer.[158]

There are several reasons why suppliers do not need fiduciary protection. First, in those industries where suppliers face a high risk of exploitation, suppliers will insist upon a price premium or special governance safeguards, such as hostages[159] or arbitration clauses.[160] Second, suppliers can and do form supplier cooperatives to protect themselves.[161] Third, those sellers who choose not to form a cooperative frequently have the opportunity to integrate into the vendee firm in order to prevent expropriation of firm-specific investments.[162] The fact that sellers choose not to form a cooperative or integrate suggests that they deem special protection unnecessary for the enforcement of their contracts. Fourth, most suppliers deal with vendee firms on a repeat basis.[163] In this circumstance, no fiduciary duties or complex governance arrangements are necessary; the expectation of repeated dealings is a strong enough motive for appropriate behavior.[164]

5. Communities

Many "other constituency" statutes also permit directors to consider the interests of communities.[165] The case for granting fiduciary protections to local communities is implausible but not ridiculous. Communities often make large "investments in infrastructure — schools, roads, sewers and other public utilities, not to mention tax relief — in

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company. If the operating company that uses the electronic devices threatens to hire another supplier to make the necessary devices, the supplier has no choice but to grant huge concessions to the operating company in order to preserve the value of its plant.

[157]Tyler, *supra* note 107, at 413.

[158]*See* Carney, *supra* note 64, at 412-13; *see also* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979) (analyzing the transaction costs associated with opportunism in transaction-specific investments).

[159]Hostages are credible commitments given by a corporation when dealing with a supplier who makes substantial firm-specific investments. Williamson, *supra* note 44, at 1212.

[160]*See id.*

[161]*See* Hansmann, Ownership of Enterprise, *supra* note 31, at 107-28.

[162]*See* Oliver E. Williamson, *Contract Analysis: The Transaction Cost Approach*, *in* THE ECONOMIC APPROACH TO LAW 39, 54 (Paul Burrows & Cento Veljanovski eds., 1981).

[163]*See* Carney, *supra* note 64, at 413.

[164]*See id. But see* Williamson, *supra* note 162, at 52-54.

[165]All of the state statutes listed *supra* note 26 include communities in their nonshareholder constituency statutes.

consideration for getting a major corporate facility to locate or remain within its boundaries."[166] The community could lose much of the value of its investment if the corporation picks up and leaves.[167] Although states and communities can and do contract with corporations, they have little bargaining power because the geographical market for corporate plants is not competitive.[168]

Despite these market failures, managers' fiduciary duties should not extend to cover states or their political subdivisions. Government always retains the power to alter many of the terms of its contracts with a firm.[169] Most forms of corporate opportunism are thus constrained by government's ability to rewrite contracts at whim.[170] If a firm acts in ways detrimental to a community, members of that community can obtain redress from state and local government.[171]

Of course, communities cannot control corporate opportunism in the form of a plant closing or relocation.[172] Nevertheless, communities are protected by the fact that corporations incur substantial sunk costs when they construct a new facility.[173] "[T]he employer invests in fixed plant and equipment that are specific to the particular location . . . . The employer's investment is a bond that the employer will not arbitrarily close down the plant and leave the community."[174] To relocate, the firm will have to squander part of its investment and pay the heavy transaction costs of switching operations to a new locality — hiring new employees, paying a reputational cost for displacing old employees, or constructing or modifying a new plant. To the extent that a community is concerned with a firm expropriating the community's investment in infrastructure, the community can compel the firm to make special-purpose

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[166]Tyler, *supra* note 107, at 414.

[167]*Id.*

[168]*See id.* at 414-15; *see also* Charter Township of Ypsilanti v. General Motors Corp., 506 N.W.2d 556 (Mich. Ct. App. 1993) (denying a claim for injunctive relief brought by a township to prevent General Motors from closing its facility near Ypsilanti, Michigan). *But see* Arthur S. Hayes, *Companies are Finding it Harder to Move Out of Town*, WALL ST. J., Mar. 1, 1993, at B8 (noting that states and communities "are demanding long-term commitments [from companies] in return for tax abatements, low-interest loans and other financial inducements").

[169]Carney, *supra* note 64, at 416.

[170]*Id.*

[171]Macey, *supra* note 47, at 42-43.

[172]Carney, *supra* note 64, at 416.

[173]Sunk costs are irrecoverable expenditures. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 97 (4th ed. 1991).

[174]Carney, *supra* note 64, at 415.

investments.[175] Second, if a corporation abandons a plant in a community because of increased regulation and increased taxes, it is not clear who has exploited whom.[176] Third, asking corporate managers to consider the interests of communities transforms managers from private sector businessmen into public sector bureaucrats. Corporate managers' ability to redistribute wealth between different social groups is doubtful, and even if managers were talented at redistributing wealth, we may not want such unelected individuals making such political decisions.[177]

The purpose of this section has not been to demonstrate that stakeholders enjoy a variety of contractual mechanisms for eliminating the worst potential abuses by corporations. Rather, its purpose has been to show that nonshareholder constituencies are in a better position to dictate corporate behavior to their advantage through explicit contracting than are shareholders. Other stakeholders who do not contract to prevent the firm from restructuring, relocating, or downsizing to their detriment generally have chosen to accept the risks of restructuring, relocating, or downsizing in exchange for higher returns on their investment. Given an adequate risk premium, most stakeholders are willing to grant corporations the freedom to restructure, relocate, and downsize.[178] Although shareholders are better bearers of risk than other stakeholders,[179] and therefore might not be willing to pay a sizable risk premium to other stakeholders, shareholders will pay a premium in exchange for the great efficiency gains that flexibility promises.

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[175]*See* Williamson, *supra* note 44, at 1215.

[176]Carney, *supra* note 64, at 416. Professor Carney argues that the decisions of a board of directors considering community impact would not differ from the decisions of a board ignoring community impact. *See id.* at 417. He argues that the loss to one community from a plant closing would be roughly offset by the gains to another community from a plant opening. *Id.* Carney's argument misconstrues the nature of a fiduciary duty. Just as managers have traditionally been fiduciaries only to the shareholders of their firm (and not to the shareholders of an acquiring firm or all investors in U.S. stock markets), so a community fiduciary duty would run only to the communities in which the firm's plants currently reside (and not to all communities in which the firm is considering constructing a plant).

[177]It is likely that government by corporate managers or shareholders would systematically favor social policies in the interests of the upper classes.

[178]*But see* McDaniel, *supra* note 7, at 147 (claiming that "[s]takeholders are unlikely to agree to being made worse off").

[179]*See* Hansmann, Ownership of Enterprise, *supra* note 31, at 48.

D. *Ownership by Other Stakeholders*

Firms could be structured as jointly owned by their shareholders, creditors, employees, customers, and suppliers. The patrons' costs of market contracting in such firms would be low; the patrons' costs of collective decision making in such firms would be very high. Although some commentators assert that the interests of shareholders and other stakeholders are not dissimilar,[180] the realities of bond indenture and employment contract negotiations indicate otherwise.[181] The heterogeneity of stakeholder interests taken together, suggests that ownership by all the stakeholders would not be feasible.[182]

This Part has demonstrated that shareholders can own and operate firms more economically than any other class of firm patrons, and certainly more economically than all classes of firm patrons combined. This Part has also established that shareholders have grave difficulties in contracting with firms, whereas other stakeholders contract with firms relatively easily. These empirical corporate realities strongly advise that the law should accord the privileges of ownership, including fiduciary protection, strictly to shareholders.[183] The succeeding three Parts will further demonstrate that the addition of a fiduciary duty to nonshareholder constituencies will impose high costs rather than improvements.

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[180] *See* Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STETSON L. REV. 197, 237 (1991) (asserting that shareholders recognize that stakeholder interests and "long-term value are inextricably intertwined"); A.A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 53 (1991). *See also* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1000-01 (1992) (agreeing that shareholder and stakeholder interests converge for operational decisions, but denying that the interests converge for structural decisions).

[181] *See* Simons v. Cogan, 542 A.2d 785, 786 (Del. Ch. 1987), *aff'd*, Simons v. Cogan, 549 A.2d 300 (Del. 1988) (recognizing that debt indentures "are typically carefully negotiated at arms-length"); *Katz*, 508 A.2d at 879 ("Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented."); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 68 (1991) (stating that creditors seek to control shareholders' ability to transfer wealth to themselves by negotiating "exquisitely detailed contracts").

[182] *See supra* notes 30-36 and accompanying text.

[183] As the least-cost owners of the firm, shareholders are also the least-cost beneficiaries of the fiduciary duties of management.

III. INCENTIVES AND RESIDUAL OWNERSHIP

Part II demonstrated that shareholders are the least-cost owners of a corporation. Shareholders also have the best incentives for maximizing the productivity of a corporation.[184] Shareholders have every incentive to encourage maximum corporate achievement, because they will earn almost all of the rewards from peak performance. In contrast, employees and creditors have little incentive to encourage a stagnant but stable corporation to increase its productivity; as long as the corporation is healthy enough to pay its debts as they come due and maintain the size of its work force, employees and creditors are satisfied.[185]

Exclusive fiduciary duties for shareholders make sense because shareholders are the residual claimants and therefore value undiluted fiduciary protection more highly than the other stakeholders.[186] A corporation's shareholders would be willing to pay the other stakeholders for exclusive fiduciary protection.[187] Indeed, assuming a reasonably healthy contracting market for employees, creditors, suppliers, and customers, shareholders do pay the other stakeholders for their status as the exclusive beneficiaries of management's fiduciary duties.[188]

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[184]*See, e.g.*, Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 788 (1972); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983); Matheson & Olson, *Longterm Shareholder Model*, *supra* note 13, at 1327.

[185]This is not exactly true. Stakeholders recognize that more profitable companies are less likely to layoff workers or have their debt securities downgraded. More profitable companies are also more likely to pay higher wages than less profitable companies. Moreover, where stakeholders can be assured of receiving their fixed claim, they often have incentives to select the most profitable project. Wallman, *supra* note 7, at 182-83. Of course, the decisional context is important. *See infra* part III.A.

[186]*But see* Coffee, *supra* note 10, at 12 (arguing that shareholders are not the only residual riskbearer in the firm). Coffee claims that "managers and others" play an "entrepreneurial role" and do not have a fixed claim on the corporation. *Id.* Coffee's argument rings true for managers, but he fails to show how the other stakeholders in the corporation bear any significant amount of *residual* risk. McDaniel also contends that shareholders are not the only residual risk-bearers: creditors, employees, and managers also bear residual risk. *See* McDaniel, *supra* note 7, at 150. If we understand residual status to mean the right to receive whatever remains after a corporation's fixed claimants have been paid, shareholders are the only residual risk-bearer in the public corporation.

[187]Macey, *supra* note 47, at 26.

[188]*See id.* at 26-27.

A. *The Marginal Incentives of Fixed Claimants*

Although shareholders usually have the best incentives to maximize corporate productivity, this is not always the case. Fixed claimants have salient incentives in two decisional contexts. Consider the following example. Suppose Ajax Corporation has $1 million of outstanding debt claims and an investment opportunity set that includes Project Gamma and Project Delta. Project Gamma provides a fifty percent probability of a $5 million return and a fifty percent probability of a $1 million return. Project Delta provides a fifty percent probability of a $11.5 million return and a fifty percent probability of a $500,000 return. Diversified shareholders (and society in general) would prefer Project Delta and its expected return to shareholders of $5 million over Project Gamma and its expected return to shareholders of $2 million.[189] Bondholders would prefer Project Gamma, however, because Project Gamma guarantees their repayment, while Project Delta leaves a fifty percent chance that they will not be fully repaid. Although bondholders certainly have incentives here, since Project Delta maximizes shareholder wealth and social wealth, bondholders have the wrong incentives.[190] For purposes of allocative efficiency, the important question is which class of patrons values the decision-making power more. In the Ajax Corporation example above, the shareholders most highly value the decision-making power. In other conceivable examples, however, such as the following, the bondholders might more highly value the decision-making power.[191]

In the second decisional context, fixed claimants have better incentives than shareholders for maximizing corporate productivity. Suppose that Diomedes, Inc. has $1 million of outstanding debt and must choose between the following two projects: (Epsilon) providing a fifty percent probability of a $1 million return and a fifty percent probability of a $1.5 million return; and (Zeta) providing a fifty percent probability

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[189]The expected return to society is $6 million for Project Delta and $3 million for Project Gamma. The expected return to shareholders for Project Delta is $5.25 million and $2 million for Project Gamma.

[190]Professor Macey contends that since fixed claimants "would be willing to pay for the right to block [a project like Project Delta] . . . it is simply incorrect to say that the shareholders are the only group with the correct incentives" to make this type of decision. Macey, *supra* note 47, at 30. Because the bondholders in this example prefer the socially less efficient project, I am not nearly as confident as Professor Macey that this is a situation where fixed claimants have "correct" incentives.

[191]Diversified shareholders would value the decision-making power at $3.25 million, the difference between the expected value to shareholders of Projects Gamma and Delta. Diversified bondholders would value the decision-making power at $250,000, the difference between the expected value to bondholders of Projects Gamma and Delta.

of a $0 return and a fifty percent probability of a $2 million return. Shareholders would prefer Project Zeta because it yields them an expected return of $500,000, while Project Epsilon yields them an expected return of $250,000. Creditors would prefer Project Epsilon because it guarantees them repayment, while Project Zeta leaves them with a fifty percent probability of default. Society would also prefer Project Epsilon because it promises an expected return of $1.25 million, while Project Zeta has an expected return of only $1 million. In this situation, creditors do indeed have better incentives than shareholders.[192]

The stylized example above ignores some compelling real world complications that cut in favor of giving shareholders the exclusive right to have corporate decisions made on their behalf. First, the interests of creditors and managers are generally aligned; managers, especially those with firm-specific skills, are afraid to allow their firm to go bankrupt. The real-world directors of Diomedes, Inc. will naturally seek to protect their personal investments in reputation capital by avoiding risky projects like Zeta that might render their corporation insolvent. Second, a corporation needs to maintain a good reputation with its lenders of capital. A corporation that frequently restructures its debt obligations will have a difficult time obtaining additional debt financing.[193]

There is good reason to think that this second type of decisional context will primarily arise when a firm is in financial distress.[194] Consequently, it seems beyond doubt that situations where shareholders have the right incentives are more common than situations where creditors have the right incentives. Moreover, when shareholders do not have the best incentives because the firm is near insolvency or insolvent, the law provides special protection to creditors and preferred shareholders. Creditors of a firm near insolvency are protected by fraudulent conveyance, equitable subordination, and other carefully articulated laws.[195] Preferred shareholders often obtain voting rights in

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[192]For another example, see Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12,150, 1991 Del. Ch. LEXIS 215, at *108 n.55 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1155-56 n.55 (1992).

We can also hypothesize situations where option holders or warrant holders of the firm have the best incentives, but courts have repeatedly held that a firm owes no fiduciary duty to the holders of its options and warrants. *See, e.g.*, Laventhall v. General Dynamics Corp., 704 F.2d 407, 409 (8th Cir. 1983); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1185-86 (S.D.N.Y. 1981).

[193]*See supra* note 100 and accompanying text.

[194]*See* EASTERBROOK & FISCHEL, *supra* note 181, at 69; *see also* ROSS ET AL., *supra* note 57, at 458 (recognizing that certain incentive "distortions only occur when there is a probability of bankruptcy or financial distress").

[195]*See supra* notes 135-39 and accompanying text.

a financially troubled firm. In addition, the Bankruptcy Code generally gives creditors complete control of an insolvent firm.[196]

For the foregoing reasons, it makes little sense to give fiduciary protection to fixed claimants. Notwithstanding these arguments, the Delaware Chancery Court has determined that directors assume some sort of fiduciary duty to creditors, and perhaps all nonshareholder constituencies, when a corporation becomes insolvent, whether or not bankruptcy proceedings have been initiated.[197]

The Delaware Chancery Court has gone even farther down this perilous road. In a complicated case where a corporation had recently emerged from bankruptcy with a 98.5% controlling shareholder and a governing executive committee composed of the corporation's creditors, Chancellor Allen opined: "At least where a corporation is operating in the *vicinity of insolvency*, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise."[198] The chancellor went on to specify the duty as "an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[199] While creditors do have somewhat better incentives than stockholders when a corporation is insolvent, several policy considerations militate against shifting managers' fiduciary duty prior to the initiation of bankruptcy proceedings. First, the class of creditors is usually not as homogeneous as the class of shareholders, and in or near insolvency, the interests of senior fixed claimants and junior fixed claimants diverge greatly. Ownership on behalf of creditors will produce internecine decision-making conflicts. Second, without the bright line of a bankruptcy petition, managers can never be sure when their fiduciary duty shifts to creditors. Third, corporate managers will not fully understand the interests of creditors, because their usual entrepreneurial skills and tendencies will be useless or counterproductive for fixed claimants. Transforming the fiduciary duty will at least create cognitive dissonance for managers. Finally, as discussed above, the law already comprehensively protects creditors of firms near insolvency.[200]

While the vast majority of states have resisted granting creditors fiduciary protection prior to a corporation's insolvency, most states do

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[196]EASTERBROOK & FISCHEL, *supra* note 181, at 69.

[197]Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787-90 (Del. Ch. 1992).

[198]*Credit Lyonnais Bank Nederland*, No. 12,150, 1991 Del. Ch. LEXIS 215, at *108 *reprinted in* 17 DEL. J. CORP. L. at 1155 (emphasis added).

[199]*Id.* at *109, *reprinted in* 17 DEL. J. CORP. L. at 1157.

[200]*See supra* notes 135-39 and accompanying text.

grant creditors fiduciary protection when a corporation becomes insolvent.[201] The case law is ambivalent, however, regarding whether the directors of an insolvent corporation owe their duties solely to creditors or to the entire community of interests in the corporation.[202] For the reasons set forth above, creditors ought to be the sole beneficiaries of management's fiduciary duty when a corporation becomes insolvent. A bilateral fiduciary shield would entail prohibitively high costs of collective decision making, and managers should never be made trustees for the entire community of interests in a corporation.

B. *Time Horizons*

Commentators have argued that the overall productivity of corporate America will increase faster if directors pursue broad stakeholder interests rather than an unalloyed shareholder interest.[203] They have argued that shareholders, especially institutional shareholders, have a short-term focus, and that advancement of shareholder purpose will therefore cause corporate America to overemphasize short-term earnings performance.[204] They further argue that since maximizing wealth requires a long-term focus, advancing shareholder purpose alone will not maximize social wealth.[205] For this argument to prevail, its proponents must establish three propositions: (1) that shareholders are more interested in the short-term than are other stakeholders; (2) that managers pursuing purely shareholder interests must conduct the affairs of the corporation in accordance with particular shareholders' time horizons; and (3) that a focus on short-term earnings is bad, from a social efficiency perspective. There are powerful reasons to think that the first two propositions are false, and that the third is not as certain as it might seem.

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[201] *See* Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239, 243-44 (1992) (stating that the majority view is that, upon insolvency, "corporate assets become impressed with a constructive trust for the benefit of corporate creditors").

[202] *See id.* at 244.

[203] A host of commentators offer a version of this argument. *See, e.g.*, Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. REV. 137, 207 (1991); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 202-15 (1991); McDaniel, *supra* note 7, at 141; Wallman, *supra* note 7, at 170, 176-77.

[204] *See* Hazen, *supra* note 203, at 178-80, 183-84; Lipton & Rosenblum, *supra* note 203, at 203; Wallman, *supra* note 7, at 176-77.

[205] *See supra* note 204.

Regarding the first proposition, all shareholders *qua* shareholders aspire to maximize current share value. In one sense, this is an incredibly short-term perspective: shareholders seek to maximize *current* share value. In a more important sense, however, this is an appropriately long-term strategy. The present value of common stock is equal to the discounted present value of all future distributions on that stock.[206] The discounted present value of all future distributions is directly related to the discounted present value of the corporation's future earnings.[207] Therefore, maximizing the present value of the corporation's earnings stream maximizes the total value of the corporation and, thus, maximizes the corporation's contribution to social wealth.[208] Shareholders, like stakeholders, have a long-term wealth-maximizing perspective.

Whether employees and creditors or shareholders care more about the long-term prosperity of a corporation depends upon the average tenure of employees, bond or loan maturities of creditors, and discount rates of shareholders. Employees and creditors, the most prominent of the nonshareholder constituencies, have temporary relationships with the firm. Most employees work with a firm for several years and then move on to a new job. These employees usually focus on preserving their job at the firm, not on preserving employment for future generations at the firm. Creditors make five-year loans or hold ten-year or thirty-year bonds, and after repayment of principal upon maturity, they care nothing about the fate of the corporation. These creditors are concerned only about the fate of their principal and interest, not about the fate of the corporation's creditors who will come after them. Shareholders care about the corporation's profitability throughout the life of the corporation. Granted, the effects of discounting render the shareholder interest minimal after a few dozen years, but the interest is present nonetheless. Moreover, the

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[206] *See* ROSS ET AL., *supra* note 57, at 133.

[207] *See* Hazen, *supra* note 203, at 184 n.210 (citing OFFICE OF THE CHIEF ECONOMIST, SEC, INSTITUTIONAL OWNERSHIP, TENDER OFFERS, AND LONG-TERM INVESTMENTS 1 (1985) (citing studies showing that stock prices reflect time-discounted cash flows rather than *current* reported earnings)). *But see* Robert D. Buzzell & Mark J. Chussil, *Managing for Tomorrow*, SLOAN MGMT. REV., Summer 1985, at 3, 10 (conducting a case study and arguing that corporate managers concentrate too much on short-term earnings).

Discounting earnings and discounting dividends are not equivalents. A firm distributes to shareholders only some portion of its earnings; the remainder is reinvested in the firm in order to generate future dividends. ROSS ET AL., *supra* note 57, at 133.

[208] Although there will be some discrepancy between a firm's opportunity cost of capital and the appropriate social rate of discount, as a rough estimate, valuing a firm's cash flows at its own opportunity cost of capital is socially efficient. *See* EDITH STOKEY & RICHARD ZECKHAUSER, A PRIMER FOR POLICY ANALYSIS 170-71, 174 (1978).

shareholder incentive in each year is to maximize profits, while the incentives of other stakeholders have more of a satisficing nature.[209]

The Delaware courts have spoken occasionally, and somewhat incoherently, about the appropriate time horizon of corporate managers.[210] In *Paramount Communications, Inc. v. Time Inc.*,[211] the Delaware Supreme Court declared that "a board of directors . . . is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[212] If the court meant by this statement that managers have the freedom not to maximize current share price, this is an unwise doctrine. If the court meant by this statement that managers have discretion in how to structure the corporation's cash flows so as to achieve maximum net present value for shareholders, this is sensible doctrine. Managers should not have a duty to maximize current cash flows to existing shareholders, because this might be detrimental to corporate profitability. For example, suppose Cassandra Corporation is projected to earn profits of $100 per year in perpetuity. Suppose further that Cassandra's managers have devised a restructuring that would give shareholders $500 in the current year, but would decrease corporate earnings in all subsequent years to $50 per year. Whether or not

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[209]Thomas Hazen argues that the recent proliferation of short-term investment vehicles like options and futures have severely narrowed investors' and managers' time horizons. Hazen, *supra* note 203, at 163-78. Others argue that the rise of the frequently-trading institutional investor has shrunk managers' time horizons. *See* Lipton & Rosenblum, *supra* note 203, at 206-07, 210-11. *But see id.* at 210 n.72 (citing PAUL MARSH, SHORT-TERMISM ON TRIAL 50-53 (Institutional Fund Managers' Association, 1990) (arguing that institutional investors do not have a short-term perspective)). These arguments are all beside the point. The length of time that equity investors hold shares of stock is not germane to the question of what are stockholders' time horizons. Virtually all common stockholders seek maximization of current share price. If the price of common stock is proportional to the discounted present value of a corporation's earnings stream from now until dissolution, an investor holding the stock for one year will have the same long-term focus as an investor who plans to hold the stock forever.

[210]*See* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1386 (Del. 1995) (reiterating that "distinctions among types of shareholders are neither inappropriate nor irrelevant for a board of directors to make, *e.g.*, distinctions between long-term shareholders and short-term profit-takers, such as arbitrageurs, and their stockholding objectives"); *Time Inc.*, 571 A.2d at 1150 ("Thus, the question of 'long-term' versus 'short-term' values is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon."); *Unocal*, 493 A.2d at 955-56 (stating that when assessing the reasonableness of takeover defenses, "a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long-term investor").

[211]571 A.2d 1140 (Del. 1989).

[212]*Id.* at 1150.

Cassandra's managers should implement this strategy depends upon the appropriate discount rate. If the firm's discount rate is higher than 12.5%, the restructuring would be a wealth-maximizing decision for Cassandra Corporation. If the firm's discount rate is lower than 12.5%, the restructuring would not be a wealth-maximizing decision for the corporation. Because a firm's opportunity cost of capital varies over time, managers ought to have discretion to structure the timing of corporate cash flows, but only in order to maximize current share value.

Regarding the second proposition, the decisions of managers pursuing only shareholder wealth maximization need not comport with individual shareholders' time horizons and consumption preferences. Lipton and Rosenblum have argued that "[i]nstitutional stockholders have little incentive or inclination to behave like traditional owners in the classical economic model — that is, to work actively towards the long-term operating success of the corporation. They tend to focus instead on the current market price of the corporation's stock."[213] Two elementary propositions from finance theory discredit this argument. The efficient capital markets hypothesis (ECMH) and the separation theorem counsel respectively that the current price of a stock is an unbiased reflection of the present value of the corporation's long-term outcomes (that there is no short-term bias in the stock market) and that the management of a corporation should make decisions without regard for the consumption preferences of individual stockholders.[214]

Some commentators suggest that investors suffer from myopia and are willing to forgo long-term benefits for immediate profits. These commentators argue, derivatively, that managers have a short time horizon and avoid making long-term investments, because such investments reduce current share price and leave the corporation vulnerable to a hostile takeover.[215] While individual managers may behave myopically at times, empirical evidence persuasively establishes that securities markets do not. Professor Jensen has presented the following probative pieces of data: (1) price-to-earnings ratios vary widely among different securities; (2) start-up companies with little current earnings but strong growth prospects are highly marketable; (3) except in the oil industry, stock prices respond positively to

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[213]Lipton & Rosenblum, *supra* note 203, at 205-06.

[214]For a description of the ECMH, see ROSS ET AL., *supra* note 57, at 362-65; Hazen, *supra* note 203, at 153-58. For a description of the separation theorem, see VAN HORNE, *supra* note 58, at 64-65.

[215]*See* Lipton & Rosenblum, *supra* note 203, at 208; Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61, 61-64 (1988).

announcements of increased research and development (R&D) and other capital investment and negatively to reductions in investment; (4) capital markets are reasonably efficient; (5) R&D expenditures do not decrease with increased institutional holdings; and (6) R&D spending levels set records in 1984 and 1985, two of the biggest acquisition years in the nation's history.[216] Other evidence exists that is inconsistent with the market myopia hypothesis. Manufacturing concerns involved in mergers from 1977 to 1986 did not change their R&D expenditure levels after the merger.[217] Also, firms that adopt defensive charter amendments, presumably to immunize themselves from market myopia, subsequently decrease R&D expenditures.[218] Lipton and Rosenblum provide some anecdotal evidence of short-term bias in the capital markets,[219] but such evidence pales in comparison to the vast amounts of contrary empirical evidence.

One of the most popular exhibits of the believers in market myopia is the economic health of Japan and Germany, countries that ostensibly have robust corporate worlds with a long-term focus.[220] Even if Japanese and German corporations were more far-sighted than U.S. corporations, it is not clear that: (1) Japan and Germany have substantially more successful economies than the United States, or (2) that any relative success of the Japanese and German economies is due to the long-term focus of their corporations. Professor Romano has issued several important caveats relevant to assessing these kinds of international competitiveness claims.[221] First, the United States maintains world-wide leadership in absolute productivity (measured by gross domestic product

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[216]*See* Jensen, *supra* note 105, at 319-21; *see also* Su Han Chan et al., *Corporate Research and Development Expenditures and Share Value*, 26 J. FIN. ECON. 255 (1990) (agreeing with Jensen on the role of R&D expenditures). *But see* Lipton & Rosenblum, *supra* note 203, at 210 n.73 (explaining that from 1980 to 1985, American corporate R&D increased 8.2% annually, while from 1986 to 1990, American corporate R&D increased less than 2% annually).

[217]*See* Gregg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 55 (1988) (citing Bronwyn H. Hall, *The Effect of Takeover Activity on Corporate Research and Development* (National Bureau of Economic Research Working Paper No. 2191, 1987)).

[218]*See* Lisa K. Muelbroek et al., *Shark Repellents and Managerial Myopia: An Empirical Test*, 98 J. POL. ECON. 1108, 1115 (1990). Professor Romano cites several studies by Bronwyn Hall to demonstrate that managers are not myopic, but I find the studies' conclusions unhelpful. *See* Romano, *supra* note 10, at 145.

[219]*See* Lipton & Rosenblum, *supra* note 203, at 209.

[220]*See, e.g.*, *id.* at 218-22.

[221]Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2023-26 (1993).

per capita).[222] Second, despite the recent decline in U.S. productivity growth relative to the post-war period, the current growth rate of the U.S. economy is similar to its normal historic growth rate.[223] Third, the recent decline in U.S. productivity growth is completely explainable by the phenomenon of international convergence: the economic performance levels of Japan and Germany have converged upon that of the United States as those countries have incorporated American technology.[224]

C. *Social Wealth Maximization*

A favorite refrain of stakeholder advocates is that shareholder wealth maximization does not equal social wealth maximization.[225] They offer hypotheticals like the Diomedes, Inc. example in Section III.A. — where shareholders prefer one project, and fixed claimants and society prefer another project.[226] These sorts of hypotheticals should not bother shareholder advocates for at least two reasons. First, as shown above, investment decision contexts where shareholders' incentives diverge significantly from social incentives are uncommon.[227] Second, and more important, any argument for fiduciary duties to nonshareholder patrons based on Diomedes, Inc.-type hypotheticals suffers from the inadequacies of an ex post perspective.[228] Viewed ex post, some corporate transactions cause harm to nonshareholder patrons. Transactions that cause harm to any group fail the Pareto criterion of efficiency; protecting nonshareholder patrons with fiduciary duties will block these Pareto inefficient moves.[229] Taking a more appropriate Kaldor-Hicks, or ex ante

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[222] *Id.* at 2023.

[223] *Id.* at 2024.

[224] *Id.*

[225] *See, e.g.*, Coffee, *supra* note 10, at 104; McDaniel, *supra* note 7, at 124.

[226] *See* Macey, *supra* note 47, at 30; Wallman, *supra* note 7, at 178-79. Moreover, when shareholders confiscate the wealth of employees, wealth is transferred in an inegalitarian direction. *See* McDaniel, *supra* note 7, at 124. Because of the declining marginal utility of wealth, this decreases efficiency. *See id.* While this claim is technically true, its importance should not be exaggerated. Over 50% of U.S. equities are held by institutional investors like pension funds. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 827 (1992). "[A]t the end of 1990, institutions owned 53% of the equity in U.S. public companies, up from 45% in 1986 and 38% in 1981." *Id.*

[227] *See supra* notes 101 & 194 and accompanying text.

[228] McDaniel makes this mistake in his analysis of Pareto and Kaldor-Hicks efficiency. McDaniel, *supra* note 7, at 126-30. He assumes that stakeholders lose in takeovers, an untenable position given the evidence presented in Part VI of this article, and then jumps to the conclusion that such losses are unfair and violate the Pareto definition of efficiency. *See id.*

[229] "A transaction is Pareto efficient if it makes some better off and none worse off."

Pareto perspective avoids these inadequacies.[230] The question then becomes whether there exists an arrangement, viewed ex ante, involving fiduciary duties to nonshareholder patrons that would be Pareto and Kaldor-Hicks superior to the present exclusive fiduciary duty system. For all the reasons that have been set forth and will be set forth in Parts II-V of this article, the shareholder model of the corporation will produce more social wealth than its competitor, the stakeholder model. Stakeholder advocates have the burden of showing first, that a sizable set of corporate transactions really does, as a matter of empirical fact, cause loss to nonshareholder patrons. Second, they must show that these losses are *unfair* transfers from nonshareholder patrons to shareholders. Finally, they must show that, from an ex ante perspective, a corporate law regime that allowed managers to invoke fiduciary duties to other stakeholders and block these transfers would be more efficient than the current regime. This is a burden they cannot carry.

IV. ACCOUNTABILITY

A. *Preserving a Measuring Stick*

A multilateral fiduciary duty would certainly decrease management's accountability to the corporation: to shareholders and to other stakeholders. If managers have a fiduciary duty to act in the best interests of shareholders, creditors, and employees collectively, they have a method for rationalizing the most egregious forms of self-dealing.[231] Faced with a challenge from shareholders that the adoption of certain defensive measures in response to a hostile tender offer constitutes entrenchment, managers could always aver that they were acting in the interests of employees or creditors to prevent a raider from laying off workers or overleveraging the company. Faced with a charge by employees that the recommendation of a merger constitutes self-dealing,

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Id. at 127.

[230] "A transaction is Kaldor-Hicks efficient if the winners win more than the losers lose, when total gains exceed total losses." *Id.*

[231] *See* Bainbridge, *supra* note 180, at 1012; Kahan, *supra* note 116, at 615; Matheson & Olsen, *Longterm Shareholder Model*, *supra* note 13, at 1353; Marleen A. O'Connor, *Corporate Malaise — Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 3, 15 (1991); Romano, *supra* note 10, at 171; Tyler, *supra* note 107, at 404, 424. *But see* Bainbridge, *supra* note 180, at 998-99 (claiming that "the defendant board normally will prevail regardless of whether the state has a nonshareholder constituency statute" and concluding that "the probability of holding directors liable for operational decisions was so low before nonshareholder constituency statutes came along that the statutes could not further lower it").

managers could always aver that they were acting in the interests of shareholders to raise the stock price.[232] Prohibiting managers from harming stakeholders in certain ways, or penalizing the firm for harming stakeholders in certain ways but otherwise allowing managers to pursue profit maximization is an approach that makes more economic sense. Although managers subject to an all-stakeholder fiduciary duty will still have to act on an informed basis and although courts have some ability to pierce through the business judgment rule when managers' rationalizations seem specious, these are slim reeds upon which to base shareholder protection.

While the stakeholder model of the corporation is largely standardless, a fiduciary duty exclusively for the benefit of shareholders is relatively certain and easy to administer.[233] Managers are relatively easy to monitor when their performance can be measured, at least

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[232]The ABA Report evinces a fear that "other constituency" statutes might cause an increase in litigation against directors and thus lead to a decrease in the number of qualified candidates willing to serve as directors. *See* ABA, *supra* note 7, at 2270. While granting other stakeholders fiduciary protection will indeed contribute to the proliferation of lawsuits against corporate directors — increasing entitlements means increasing lawsuits — multilateral fiduciary obligations also make it much easier for a board to defend itself against a breach of fiduciary duty lawsuit. *See* Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1371-72 n.76 (1991). Any increase in the amount of litigation will impose substantial costs on society though, "with no assurance of greater director accountability or effectiveness or profit to the business corporation." Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156, 1173 (1993).

A strong argument can be made that managers will not change their behavior if the law imposes fiduciary duties to stakeholders upon them. Managers will still be elected by shareholders, will still receive incentive-based competition, and will still face interfirm competition. Multilateral fiduciary duties will bring about some change in managerial conduct, however, because such duties will facilitate managerial self-dealing. Any resultant behavioral change will be socially inefficient, whether the new behavior is in the interests of managers or stakeholders.

[233]*See* CLARK, *supra* note 7, at 20; ABA, *supra* note 7, at 2270; Hanks, *supra* note 7, at 112.

McDaniel presents a possible methodology for managers subject to a multilateral fiduciary duty. He proposes that directors seek to maximize shareholder gain and minimize stakeholder loss. McDaniel, *supra* note 7, at 137-39. While McDaniel insists that his proposal does not require directors to balance the interests of the various corporate constituencies, this simply cannot be true. Any scheme that requires directors to maximize one variable and minimize another variable is nothing other than a balancing mechanism. When contemplating whether or not to close a plant — which will cause shareholder weal and stakeholder woe — directors will have to weigh profitability gains accruing to shareholders against losses suffered by employees and the local community. While directors can maximize one variable (profits) against a set of fixed background requirements (labor contracts, debt indentures, etc.), maximizing one variable and minimizing another variable is tantamount to maximizing overall stakeholder wealth, a standard that suffers from the defects laid out in this Part.

roughly, by an inspection of the firm's share price. Easy monitoring of management by firm patrons will lead to reduced agency costs and improved corporate efficiency. A clear profit-maximizing standard allows courts to review managerial conduct with some rationality and is necessary for the capital markets to allocate resources efficiently and thereby to maximize social welfare.[234] It is not surprising that when Pennsylvania adopted its anti-takeover and "other constituency" statute, those firms completely opting out of the statute experienced positive abnormal returns.[235] Although it is not an easy task to determine whether managerial conduct was motivated by profit maximization, it is an even more daunting task to assess whether managers adequately balanced the interests of all corporate constituencies.

B. *Intracorporate Conflicts*

One commentator has argued that corporate law rules designed to reduce the conflict between shareholders and management impose costs on stakeholders.[236] "Other constituency" statutes (and presumably fiduciary duties to stakeholders) allow managers to reallocate these costs to stockholders, the group chiefly benefitted by the general proscription against managerial self-dealing.[237]

This argument is wrongheaded. When a corporation acts in a way that benefits shareholders and harms other stakeholders, such actions should not be deemed externalities of the relationship between managers and shareholders. Other stakeholders generally have the ability to contract to preclude this type of behavior or to receive a compensatory premium for permitting such behavior.[238] For example, a prospective creditor of a firm can lend to the firm at a higher interest rate because of managers' exclusive fiduciary duty to the firm's shareholders. More importantly, a corporation's protection from managerial self-interest would dissolve if the law allowed managers to reallocate the costs of the

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[234]Walter M. Cabot, *The Free Market Promotes Long-Term Efficiency that Benefits all Stakeholders*, 21 STETSON L. REV. 245, 246-49 (1991); Romano, *supra* note 10, at 172 & n.208.

[235]*See* Romano, *supra* note 10, at 172-73 & n.212; *see also* Samuel H. Szewczyk & George P. Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310*, 31 J. FIN. ECON. 3 (1992) (estimating that the statute caused shareholders of Pennsylvania corporations losses of $4 billion).

[236]*See* Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 594, 606-07 (1992).

[237]*See id.* at 607, 610.

[238]*See supra* part II.C.

duty of loyalty among stakeholder groups. As noted above, allowing managers to reallocate firm wealth allows managers to avoid the duty of loyalty and reduce their accountability to the firm.[239]

Some stakeholder advocates downplay the loss of accountability that a multilateral fiduciary duty would create because they think that the conflict between shareholders and other stakeholders is more pernicious than the conflict between managers and shareholders.[240] They assume that external markets — the market for corporate control, the market for managerial services, product markets, and capital markets — will constrain managers from engaging in non-profit-maximizing activity. They assume that managers will be constrained by state law prohibitions and charter or bylaw prohibitions. Additionally, they contend that managers will be constrained by internal controls,[241] outside directors, incentive compensation, and stock ownership.[242] In light of this plethora of constraints on managers' misconduct, an exclusive shareholder fiduciary duty seems superfluous.[243]

While managers are subject to all the aforementioned constraints, the set of them taken together still leaves a great deal of room for self-dealing and more insidious forms of shareholder neglect. Market mechanisms for aligning management and shareholder incentives are not very effective. The market for corporate control currently provides little check on managerial misbehavior. State legislatures have passed a multitude of antitakeover statutes.[244] State courts have generally upheld potent poison pill defensive tactics.[245] Furthermore, takeovers are an

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[239] *See supra* part IV.A.

[240] *See* Brudney, *supra* note 99, at 1836-38; Coffee, *supra* note 13, at 459; Lipton & Rosenblum, *supra* note 203, at 195-97.

[241] *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293 (1980).

[242] *See, e.g.*, Clifford W. Smith, Jr. & Ross L. Watts, *Incentive and Tax Effects of Executive Compensation Plans*, 7 AUSTRALIAN J. MGMT. 139, 140, 142 (1982).

[243] *See* Carney, *supra* note 64, at 422. Some empirical evidence weakly supports this claim. Romano's analysis of a set of breach of fiduciary duty lawsuits brought against a random sample of publicly traded firms between the late 1960s and 1987 led her to the conclusion that "shareholder litigation is a weak, if not ineffective, instrument of corporate governance." Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORGANIZATION 55, 84 (1991). Romano admits, however, that her data are consistent with the possibility that "managers are so deterred by the prospect of shareholder litigation that suits involve only trivial violations." *Id.* at 85. While shareholder litigation may not provide specific deterrence of managerial misbehavior, the case for general deterrence is untestable.

[244] *See, e.g.*, DEL. CODE ANN. tit. 8, § 203 (1991) (business combination statute); IND. STAT. ANN. § 23-1-42-1 (1995) (control share acquisition statute); MD. CODE ANN. § 3-601 (Supp. 1995) (fair price statute); 15 PA. CONS. STAT. § 2571 (1995) (disgorgement statute).

[245] *See, e.g.*, Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 229-31 (S.D. Ohio),

expensive endeavor.[246] Managers can underperform with impunity until the cost to the firm of the manager's slouching becomes greater than the cost of a takeover. The capital markets also do not provide much discipline to managers. Most managers can and do avoid the scrutiny of the capital markets by financing projects from internally generated cash flow.[247] Product markets are not always effective either. They provide little constraint on very profitable firms or on firms in new industries.[248]

Internal mechanisms for incentive alignment are also not particularly effective.[249] Outside directors are far from shareholder representatives. Incentive compensation is an imperfect solution to the problem of agency costs.[250] The shareholder voting mechanism is a poor monitoring or punishing device: "Managers . . . are rarely displaced by voters; managers' recommendations on fundamental corporate changes, amendments of bylaws, or other matters are routinely followed; shareholders' proposals do well if they receive 5 percent of the vote."[251]

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aff'd, 815 F.2d 76 (6th Cir. 1987) (upholding the directors' decision to adopt a poison pill as reasonable in relation to the threat posed, but ultimately enjoining the poison pill because the directors failed to adequately inform themselves of all material information reasonably available regarding the trigger prices of the poison pill); Gelco Corp. v. Coniston Partners, 652 F. Supp. 829, 848-50 (D. Minn. 1986) (concluding that Delaware precedent is controlling and upholding the adoption of a poison pill as a valid defensive tactic); Turner Broadcasting Sys., Inc. v. CBS, Inc., 627 F. Supp. 901, 909 (N.D. Ga. 1985) (denying a motion for preliminary injunction and upholding defensive measures adopted by the CBS board of directors in response to Turner Broadcasting System's tender offer); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (upholding the adoption of a rights plan as a valid exercise of business judgment intended to ward off future bidders). The Delaware courts have determined, however, that directors have an obligation to redeem the rights at some appropriate time when shareholders are faced with a noncoercive tender offer. *See* Grand Metro. Pub. Ltd. Co. v. Pillsbury Co., 558 A.2d 1049, 1058 (Del. Ch. 1988); City Capital Assocs. Ltd. Partnership v. Interco, Inc., 551 A.2d 787, 797-800 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988).

[246]*See* Goshen, *supra* note 105, at 893. A bidder's costs include the value of the bid, bidding expenses, and search expenses. *Id.* A successful bidder must also incur the sizable cost of achieving effective control or integration of the acquired firm. *Id.*

[247]*See* WILLIAM J. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY 69-70 (1965). *See also* GORDON DONALDSON, MANAGING CORPORATE WEALTH 45-46 (1984) (discussing corporations' use of the public debt market to obtain funds necessary for investment). From 1981 to 1991, U.S. corporations financed almost 75% of their new investments from internally generated cash flow. ROSS ET AL., *supra* note 57, at 406.

[248]*See* Goshen, *supra* note 105, at 894 n.59 (citing Jensen, *supra* note 105, at 322).

[249]*See* Romano, *supra* note 10, at 129.

[250]*See* Goshen, *supra* note 105, at 892 n.51 (citing sources).

[251]EASTERBROOK & FISCHEL, *supra* note 181, at 83. This should not be read to imply that shareholders' voting rights are meaningless. Voting rights possess some value: (1) corporations continue to offer voting rights to their shareholders; (2) voting rights facilitate takeovers; (3) stock prices rise during proxy contests; (4) stock with voting rights trades at a two to four percent premium over identical stock without voting rights. *See id.* at 70-71.

While it is true that few corporate managers literally embezzle money from their firm,[252] this is beside the point. The managerialist conception of the corporation does not presume the existence of selfish, embezzling managers; rather, it relies primarily on managers' misuse of free cash flow.[253]

Another important body of evidence regarding the comparative conflict between shareholders and other stakeholders and the conflict between managers and shareholders is Kahan and Klausner's study of bond indenture event-risk provisions. Kahan and Klausner first note that "[m]anagers have substantial control over the terms of [event-risk] covenants. They do not need to obtain shareholder approval, and the complexity of the covenants may make it difficult for shareholders to assess the degree to which the covenants serve management's parochial interests."[254] They then conclude that nine out of ten covenants reflect some degree of management interest at shareholders' expense: "The terms of these covenants demonstrate that management has in fact frequently allowed its own interests to displace the interests of shareholders in designing these covenants."[255] Managers increase their firm's agency cost of debt by seldom including covenants that prohibit the firm from participating in a management buyout (MBO), a friendly acquisition, or a recapitalization.[256] Managers entrench themselves by frequently including covenants that overprotect bondholders from the risk of a hostile takeover.[257] In this highly revealing context, managers pursue their self-interest in a fashion that collaterally benefits bondholders but works to the detriment of shareholders.[258]

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[252]Lipton & Rosenblum, *supra* note 203, at 195. Lipton and Rosenblum provide anecdotal evidence that "most managers and directors act diligently and in good faith to develop and maintain the business success of the corporations they manage or direct." *Id.*

[253]*See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 66.

[254]Kahan & Klausner, *supra* note 106, at 947.

[255]*Id.* at 967-69.

[256]*Id.* at 980.

[257]*Id.* at 969.

[258]*See* Kahan & Klausner, *supra* note 106, at 969, 980-82.

V. SECONDARY ARGUMENTS ON BEHALF OF THE SHAREHOLDER MODEL

A. *Encouraging Equity Investment*

1. The Argument

The stakeholder model has additional flaws. If potential equity investors knew that part of their return might be diverted by the board of directors to other corporate stakeholders, such investors would be less willing to place their capital at the disposal of that corporation. Likewise, equity investors might be less willing to invest in firms incorporated in states whose corporation statutes allowed boards of directors to divert shareholder returns to other stakeholders. Moreover, because of the vagueness and uncertain application of any multilateral fiduciary duty, investors would be unable to calculate the size of the risk that the board would distribute the traditional equity return to other patrons of the corporation. Investors might accordingly hesitate in making their capital available to such firms. Multilateral fiduciary duties would ultimately reduce equity investment in the United States and would increase the cost of raising equity capital for U.S. firms.[259] The inevitable result of such a trend would be a decline in corporate growth and productivity.

McDaniel contends that "[m]ost investors do not buy stock with the expectation of realizing gains by exploiting stakeholders."[260] If, by this contention, McDaniel means merely that most corporations do not allow shareholders to transfer wealth from other stakeholders to themselves, he may be right. If, on the other hand, he means that the market does not increase stock prices based on its expectation that a corporation will transfer wealth from other stakeholders to stockholders, he is surely wrong. Even a casual believer in the ECMH believes that the price of a company's stock impounds the potential gains from a takeover or appropriation of the wealth of other stakeholders.[261]

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[259]Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1192 (1981). Many of the new financial products that attract investors and increase the liquidity and efficiency of capital markets exist only because of the exclusive fiduciary protections accorded by law to corporate stockholders. Tyler, *supra* note 107, at 397.

[260]McDaniel, *supra* note 7, at 158.

[261]For sources discussing the ECMH, *see supra* note 214 and accompanying text; *see also* Thomas A. Smith, *A Capital Markets Approach to Mass Tort Bankruptcy*, 104 YALE L.J. 367, 411 nn.136-37 (1994) (citing finance and law review articles critical of ECMH).

2. The Relative Importance of Debt and Equity

In contrast to the rosy picture of cheap equity financing and copious equity investment brought into existence by exclusive shareholder fiduciary duties, such exclusive duties might raise the cost of debt financing if creditors could suffer at the hands of stockholders during a takeover or any other frequent or prodigious corporate transaction. Stakeholder advocates must establish two propositions in order to make this argument credible: first, that creditors suffer from a systematic risk of shareholder opportunism such that debt financing is more expensive in a world of exclusive shareholder fiduciary duties, and second, that if exclusive shareholder duties do make debt financing less attractive, then the benefits of cheaper equity financing under the shareholder model do not outweigh the costs of more expensive debt financing under the shareholder model.

Concerning the first proposition, evidence demonstrates that creditors do not face a sizable risk of wealth loss from shareholder opportunism during takeovers.[262] Also, to the extent that debtholders face the risk of shareholder opportunism, the corporation and its prospective debtholders can negotiate a fair premium to compensate debtholders for bearing the risk of such contingencies.[263]

Concerning the second proposition, the importance of debt financing to corporations cannot be gainsaid. From 1983 to 1991, U.S. corporations have used debt to finance twenty-five percent of their new capital expenditures.[264] Over the same period, they have used a negative amount of equity.[265] Notwithstanding current trends, most U.S. corporations have less debt than equity in their capital structures.[266] Although equity financing has no theoretical superiority to debt,[267] equity

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[262]*See infra* part VI.

[263]*See supra* part II.C.2. Admittedly, inefficiency can result even if creditors receive a premium for bearing the endogenous risk of certain kinds of abuse at the hands of corporate managers. Certain corporate actions that exploit the investments of creditors are socially inefficient, even if they do not decrease the wealth of particular creditors. Fortunately, most of these inefficient actions either also harm the interests of shareholders (who can sue to enforce managers' fiduciary duties) or occur when the corporation is near insolvency (when creditors are protected by other bodies of law).

[264]*See* ROSS ET AL., *supra* note 57, at 406.

[265]*Id.* at 406-07 (Table 14.1). The use of a negative amount of equity means that firms repurchased more shares than they issued. *Id.* at 406.

[266]*See id.* at 472-73 fig. 16.5 (showing that in 1990, the ratio of debt to total value for U.S. firms was 45%).

[267]*See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 268 (1958).

markets are more important for U.S. corporations than debt markets. Maintaining the health and efficiency of equity markets is, therefore, also more important.

B. *The Benefits of Private Ordering*

1. The Argument

Broadening the fiduciary duty owed by managers to shareholders also would have the deleterious effect of displacing efficiency-enhancing private ordering with mandatory rules. There may indeed be situations where employees, creditors, or other stakeholders face contracting problems as severe as those normally faced by shareholders. Even without an inclusive fiduciary duty imposed by law, however, these exploitable patrons of the firm have several methods of protecting themselves: integration with the potentially exploitative firm; formation of a worker cooperative, supplier cooperative, or consumer cooperative; or contracting with the firm for explicit fiduciary-like protections. Virtually everything that state legislatures have accomplished with "other constituency" statutes can be accomplished through charter amendments.[268] Extending managers' fiduciary duties to cover all stakeholders imposes an unnecessary, one-size-fits-all remedy upon

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Firms determine their optimal capital structure by balancing the tax benefits of debt and the agency costs of equity against the financial distress costs (including agency costs) of debt. *See* ROSS ET AL., *supra* note 57, at 466.

[268]WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 194 (5th ed. 1993). Some corporate charters authorize directors facing a corporate control issue to consider "the social and economic effects of the acquisition on the Target's employees, suppliers, customers, and others." ROBERT H. WINTER ET AL., SHARK REPELLENTS AND GOLDEN PARACHUTES (State Takeover Statutes and Poison Pills Supp. 1991). Several corporations have adopted charter amendments that authorize consideration of stakeholder and shareholder interests, but their legal validity has apparently not yet been litigated. *See* Sommer, *supra* note 180, at 39.

Professor Bainbridge suggests that state law does not permit corporations to reconceptualize their directors' fiduciary duties through charter amendment. Bainbridge, *supra* note 180, at 985 (citing Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952)). A strict reading of section 102(b)(1) of Delaware's corporation code arguably supports his claim.

> [A corporation's charter] may also contain any or all of the following matters: (1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . *if such provisions are not contrary to the laws of this State.*

DEL. CODE ANN., tit. 8, § 102(b)(1) (1991) (emphasis added).

corporations, few of which actually need it. Efficiency would not be served by such an extension of the law. Stakeholders should bear those risks that they can hedge against or otherwise bear more cheaply than the corporation. The rarity of any attempt by individual corporations to make their managers fiduciaries of stakeholders is good evidence of the inefficiency of such an endeavor.

2. Starting Point Unfairness

Private ordering may generally maximize social wealth, but private ordering between a corporation and its nonshareholder patrons might generate unfairness because of unequal wealth, information, and bargaining power between a corporation and its nonshareholder patrons.[269] Some stakeholders may be unable to protect their interests adequately through contract. I have argued to the contrary above.[270]

Strong arguments have been made that a society can only justly pursue efficiency if the initial wealth distribution is fair.[271] Yet, a society's ethical duty to provide rough equality of initial endowment to its citizens could and should be fulfilled in a manner other than reforming the state corporation codes. Carefully designed redistributive taxation is a better method of guaranteeing equal starts. Interfering with private ordering in each individual legal arena in order to promote equality is not effective public policy.

C. *Property Rights*

1. The Uncertain Argument

Conceptualizing corporations as "owned" by their shareholders supports the shareholder model.[272] Although shares of corporate stock are different in important ways from normal property,[273] treating shareholders

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[269]Millon, *supra* note 68, at 275.

[270]*See supra* part II.C.

[271]Millon, *supra* note 68, at 275.

[272]*See* Cabot, *supra* note 234, at 250-51; Millon, *supra* note 68, at 230-31, 271-73. Even Lipton and Rosenblum acknowledge that "the premise that stockholders own the corporation in the same manner as they own any other private property" entails the conclusion that shareholders' interest "must be paramount." Lipton & Rosenblum, *supra* note 203, at 191-92.

[273]*See* Lipton & Rosenblum, *supra* note 203, at 191-94; Matheson & Olsen, *Longterm Shareholder Model*, *supra* note 13, at 1346. Lipton and Rosenblum offer several unconvincing reasons for distinguishing between corporate stock and other forms of private property. First,

as "owners" of corporations seems warranted.[274] We should worry, nevertheless, about the fact that the shareholder model of the corporation emerged at a time when shareholders were actively involved with corporate affairs.[275] While "invisible hand" arguments work well for sole owners who directly control their assets, incentive structures change when ownership and control are separated.[276] Laws regulating the ownership of corporate stock affect many more interests than laws regulating less complex forms of property. Corporations have constituencies that can number in the hundreds of thousands. Moreover, the state grants stockholders the benefit of limited liability — a benefit not possessed by owners of other property. In exchange for this benefit, shareholders should expect some additional regulation of their property in the public interest.

2. Transition Costs

If state legislatures adopted the stakeholder model of the corporation, shareholders would suffer a one-time abnormal negative return.[277] After an "other constituency" statute is enacted, however, all

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they contend that shares of stock are not normal property because corporations are "the central productive element" of the U.S. economy. Lipton & Rosenblum, *supra* note 203, at 192. While corporations are a central productive element, so was land in pre-industrial contexts, and land is usually best left in the hands of individual owners. *See* Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315, 1322-32 (1993). Second, they argue that "the nation and the economy as a whole have a direct interest in ensuring an environment that will allow the private corporation to maintain its long-term health and stability." Lipton & Rosenblum, *supra* note 203, at 192. While this statement is indubitably true, shareholders have the same interest in long-term productivity. *See supra* part III.B. Consequently, regulation of property rights is unnecessary to promote social wealth.

[274]Lipton and Rosenblum argue unpersuasively that shareholders should not be treated as "owners" of corporations. Lipton & Rosenblum, *supra* note 203, at 193-94. They first assert that shareholders have a mere financial interest in a corporation, entitling them to the expectation of dividends and capital gain, and that shares of stock are not subject to a "use and enjoyment" interest. *Id.* While this statement is largely true, it creates a distinction without a difference. The economic reasons for assigning absolute property rights do not generally include whether or not the property is subject to "use and enjoyment" by its holder. *See* Ellickson, *supra* note 273, at 1322-32. Lipton and Rosenblum also argue that, unlike a normal property owner, a shareholder "does not really care about the fate of the corporation as long as the stock generates a profit." Lipton & Rosenblum, *supra* note 203, at 194. Given all of the market forces which can affect stock prices and a firm's decision to issue dividends, shareholders most certainly do have an abiding interest in the "fate of the corporation."

[275]Matheson & Olsen, *Trialogical Imperative*, *supra* note 13, at 1462.

[276]Lipton & Rosenblum, *supra* note 203, at 204.

[277]Wallman, *supra* note 7, at 191; *cf.* Minow, *supra* note 180, at 220-21 (citing studies that demonstrate the negative stock market reaction to shares of firms incorporated in

shareholders would be treated fairly because stock prices would already be discounted to reflect the new allocation of profits among the corporate constituencies.[278] Accordingly, shareholders are not treated unfairly if they know from the outset that the firm's residual earnings might be divided among all the constituencies. The shareholder unfairness problem is only transitional; it is a one-time wealth transfer away from shareholders as stock prices drop in reaction to managers' new ability to redistribute wealth among stakeholders.

This argument ignores the fact that the more serious problem with the stakeholder model is not the unfairness served upon shareholders: in addition to the one-time wealth transfer, firms' operating efficiencies will be lower and their costs of capital will be higher under the stakeholder model.[279]

VI. TAKEOVERS AND STAKEHOLDERS

The takeover is the most common context in which multilateral fiduciary duties are alleged to help other corporate constituencies. Many scholars have claimed that shareholders are able to transfer bondholder, employee, and community wealth to themselves during takeovers.[280] This Part will show that takeovers increase social welfare and do not seriously harm any of the corporate constituencies. Unfortunately, a principal effect of a multilateral fiduciary duty will be to reduce the number of takeovers. This Part will not argue that different classes of stakeholders always have similar interests, even in the end-game context of the hostile takeover. Rather, this Part will show that where shareholders have the greatest capacity to exploit the other stakeholders in a corporation, they simply do not.

Many commentators argue that takeovers harm communities and employees and that takeovers mostly serve to transfer wealth from other stakeholders to shareholders.[281] Some argue that the social loss attending

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Pennsylvania due to the enactment of Pennsylvania's antitakeover/"other constituency" statute).

[278]Wallman, *supra* note 7, at 191.

[279]*See supra* parts II-IV.

[280]*See, e.g.*, Charles Brown & James L. Medoff, *The Impact of Firm Acquisitions on Labor*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 9 (Alan J. Auerbach ed., 1988) (discussing the impact of takeovers on labor); Coffee, *supra* note 13, at 447 (discussing the impact of takeovers on nonshareholder constituencies). While most people are indifferent toward takeovers, public opinion polls uniformly demonstrate that a large segment of the public believes takeovers harm nonshareholder constituencies. *See* Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 490-97 (1987).

[281]*See* McDaniel, *supra* note 7, at 125-26 (citing Shleifer & Summers, *supra* note 71,

takeovers often exceeds private shareholder gain.[282] Others argue that shareholders breach trust relationships with other stakeholders during takeovers.[283] Some contend that the debt produced by takeovers is socially harmful.[284] Still others contend that takeovers actually produce a loss for shareholders.[285]

Empirical research verifies that "shareholders of target companies in successful takeovers achieve large abnormal returns. When the takeover is done by merger the gains are 20 percent, and when the takeover is done by tender offer the gains are 30 percent."[286] Successful bidders, on the other hand, do not fare as well; they experience abnormal returns of four percent in tender offers and approximately zero percent in mergers.[287] From 1962 until 1985, "bidders on average realized small, but statistically significant gains . . . in the immediate period around the public announcement" of their bid.[288] Both shareholders of the target firm and shareholders of the bidder firm experience small abnormal negative returns in the wake of an unsuccessful takeover bid.[289] When a target company fends off a hostile bid, the value of the target company's stock returns to approximately its pre-bid level.[290] When a firm adopts a poison

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at 34); *see also* Coffee, *supra* note 13, at 447 (recognizing that "in theory, the gains accruing to shareholders in takeovers could simply be wealth transfers from other stakeholders").

[282]*See* Coffee, *supra* note 13, at 447-48. Even if takeovers produce more wealth than they destroy, it still might be the case that a utilitarian ought to denounce takeovers. Shareholders have a transitory relationship with a corporation, while employees and communities have a more permanent relationship with a corporation. *See* ABA, *supra* note 7, at 2268. A takeover could devastate a community or a supplier. A blocked takeover will have a much less vivid and much less disastrous effect on a shareholder. McDaniel, *supra* note 7, at 124-25. Plus, unlike many other stakeholders, most shareholders are diversified. Coffee, *supra* note 10, at 17. People, however, are risk averse: a loss of X utiles causes more pain than a gain of X utiles causes pleasure. *See* Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193, 203 (1991). Therefore, the larger gains to shareholders in the takeover context may not really outweigh the smaller but more concentrated losses to other stakeholders.

[283]*See* Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 125-26 (1992).

[284]*See, e.g.*, Lipton & Rosenblum, *supra* note 203, at 211-12; Orts, *supra* note 283, at 126-27.

[285]*See, e.g.*, Orts, *supra* note 283, at 124-25.

[286]ROSS ET AL., *supra* note 57, at 854.

[287]*Id.* at 854; *see id.* at 855, Table 29.9 (summarizing a study by Michael C. Jensen and Richard S. Ruback).

[288]Jarrell et al., *supra* note 217, at 53 (presenting research that indicates excess returns to bidders of 5% in the 1960s, 2.2% in the 1970s, and statistically insignificant losses in the 1980s).

[289]*See* ROSS ET AL., *supra* note 57, at 854; *see id.* at 855, Table 29.10.

[290]Jarrell et al., *supra* note 217, at 55 (collecting studies).

pill or other anti-takeover tactic, the firm's stock price generally falls in value.[291]

Empirical evidence illustrates rather convincingly that bondholders' losses do not finance takeovers. An early study by Asquith and Kim showed that "mergers generate no noticeable impact on bondholders and no noticeable wealth transfers between bondholders and stockholders."[292] Denis and McConnell examined a sample of 132 mergers that took place between 1962 and 1980.[293] They found gains to stockholders and no losses to bondholders in these mergers.[294] Lehn and Poulsen examined 108 LBOs that occurred between 1980 and 1984, and reached the same conclusion.[295] Although the Lehn and Poulsen study found that bondholders lost wealth in some leveraged buyouts, "[t]he data refute[d] the hypothesis that leveraged buyouts result in significant redistribution of wealth from bondholders . . . to common stockholders."[296] In a 1990 study, Asquith and Wizman discovered that bonds unprotected by restrictive covenants experienced negative abnormal returns of five percent in the wake of an LBO, while protected bonds had positive abnormal returns of two percent.[297] Moreover, because shareholder gains and the amount of debt in the target firm's capital structure are not correlated in the takeover context, bondholder expropriation cannot be an incentive for acquisitions.[298]

Empirical evidence also demonstrates that shareholder gains do not come at the expense of labor.[299] Although Shleifer and Summers contended that raiders' exploitation of target firm employment contracts "can be socially inefficient by ruining the market for these implicit long-run labor contracts and forcing labor and management to use less efficient

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[291]*See id.* at 58-65 (collecting studies); Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377 (1988).

[292]*See* Paul Asquith & E. Han Kim, *The Impact of Merger Bids on the Participating Firms' Security Holders*, 37 J. FIN. 1209, 1227 (1982).

[293]*See* Debra K. Dennis & John J. McConnell, *Corporate Mergers and Security Returns*, 16 J. FIN. ECON. 143, 146 (1986).

[294]*See id.* at 185.

[295]*See* Kenneth Lehn & Annette Poulsen, *Leveraged Buyouts: Wealth Created or Wealth Redistributed?*, *in* PUBLIC POLICY TOWARDS CORPORATE TAKEOVERS 46-47 (Murray L. Weidenbaum & Kenneth W. Chilton eds., 1988).

[296]*Id.* at 56-57.

[297]Paul Asquith & Thierry A. Wizman, *Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts*, 27 J. FIN. ECON. 195, 202-03 (1990). Asquith and Wizman found average bondholder losses of 2.8% associated with successful LBOs and noted that "total abnormal losses from preexisting public debt are 3.2% of the total abnormal shareholder gains." *Id.* at 211.

[298]*See* Romano, *supra* note 10, at 137.

[299]*See* Jarrell et al., *supra* note 217, at 57.

contracting devices,"[300] their breach of trust theory has received little empirical corroboration.[301] Brown and Medoff analyzed takeovers in the state of Michigan, where, admittedly, there are few large mergers and hostile takeovers, and found that wages for firms involved in acquisitions remained constant while employment for those same firms rose.[302] Other studies have shown that pension fund asset reversions occur in only twelve to fourteen percent of takeovers, and average only ten to twenty-three percent of the premiums.[303] Studies have also demonstrated that middle and top management, not blue-collar workers, are more likely to lose their jobs in the wake of takeovers.[304] Since white collar workers are less likely to have acquired firm-specific human capital, takeover gains are less likely to cause appropriation of employee quasi-rents. Other studies have shown that "firms experiencing ownership changes have higher employment and wage levels and increased productivity compared to firms that do not change control."[305] Rosett has shown that union wealth levels also experience an increase in the wake of hostile takeovers.[306]

Notwithstanding the large premiums garnered by target shareholders in hostile acquisitions, a body of early literature argued that takeovers do not increase the operating efficiency of firms.[307] These studies are obsolete, however, because they used an inappropriate benchmark for estimating how firms would have performed in the absence of an acquisition.[308] More recent studies have concluded that target firms' post-acquisition performance is better than their pre-acquisition performance.[309]

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[300]*See* Shleifer & Summers, *supra* note 71, at 52-53.

[301]*See, e.g.*, Jarrell et al., *supra* note 217, at 57; Romano, *supra* note 10, at 140.

[302]*See* Brown & Medoff, *supra* note 280, at 10-11, 23.

[303]*See* Romano, *supra* note 10, at 140-41 (collecting studies).

[304]*See, e.g.*, Frank R. Lichtenberg & Donald Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior*, 27 J. FIN. ECON. 165, 184-87 (1990) (noting that employment and compensation of white-collar workers decline following LBOs, but those of blue-collar workers are unchanged); Romano, *supra* note 10, at 141-42 (citing studies).

[305]Romano, *supra* note 10, at 141 (citing studies by Brown & Medoff and Lichtenberg & Siegel).

[305]*See* Joshua G. Rosett, *Do Union Wealth Concessions Explain Takeover Premiums? The Evidence on Contract Wages*, 27 J. FIN. ECON. 263, 263-65 (1990).

[307]*See* Coffee, *supra* note 13, at 442 nn.27-28, 448.

[308]*See* Romano, *supra* note 10, at 124-25.

[309]*See id.* at 124-25 & n.17 (citing sources); *see also* Steven N. Kaplan & Jeremy C. Stein, *The Evolution of Buyout Pricing and Financial Structure in the 1980s*, 108 Q.J. ECON. 313, 350-52 (1993) (detailing post-buyout increases in operating margins and cash flow margins in firms experiencing LBOs in the 1980s); Lichtenberg & Siegel, *supra* note 304, at

Although some employees may suffer in the wake of a takeover when viewed from an *ex post* perspective, certain facts should not be ignored. First, employees benefit collectively from takeovers when viewed from an *ex ante* perspective, because takeovers improve the efficiency of the economy as a whole.[310] Most takeovers are economically efficient because they move a corporation's assets to a more highly valued use. Moreover, the mere existence of a market for corporate control will discipline managers, prevent shirking, and encourage managers to maximize share value.[311] Second, if the recent, more sophisticated studies regarding post-acquisition operating efficiency are correct, target companies improve after most takeovers, and consequently, their employees will have better job security and higher wages.[312] Third, the employees who lose their jobs in takeovers are probably employees who should have experienced termination under

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165 (finding that productivity in manufacturing plants increases significantly in the three years following an LBO); Tim C. Opler, *Operating Performance in Leveraged Buyouts: Evidence from 1985-1989*, FIN. MGMT., Spring 1992, at 27, 28 (finding that operating profits/sales ratio, operating profits per employee, and cash flow net of investment rise following an LBO in absolute terms and after adjustment for industry trends). For evidence on management buyouts, see Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217, 218 (1989) (reporting increases in operating income, operating margins, and net cash flow for a sample of 48 firms that completed MBOs); Abbie J. Smith, *Corporate Ownership Structure and Performance: The Case of Management Buyouts*, 27 J. FIN. ECON. 143, 162 (1990) (showing that operating cash flow per employee and per dollar of operating assets increase significantly after MBOs in absolute terms and in comparison with industry).

[310]*See* Coffee, *supra* note 10, at 71; O'Connor, *supra* note 231, at 19 (citing sources). Although Coffee thinks that nonshareholder patrons are hurt by takeovers, he admits that bidder premiums are too high to be fully explained by transfers from nonshareholder patrons. Coffee, *supra* note 13, at 450-51.

The "vividness effect" may explain much of the cogency of the stakeholder model of the corporation. *See* RICHARD NISBETT & LEE ROSS, HUMAN INFERENCE: STRATEGIES AND SHORTCOMINGS OF SOCIAL JUDGMENT 43-62 (1980) (explaining that human decision makers give inordinate weight to concrete and vivid information and improperly discount the significance of abstract information). Takeovers do sometimes result in employee layoffs. Despite the poignancy of these losses, public policymakers must avoid falling prey to the vividness effect and related cognitive biases. The focus should not be on the employees who lost their jobs; the focus should be on overall industry welfare and the overall welfare of all employees in the country. *See* Cabot, *supra* note 234, at 248.

[311]*But see* Goshen, *supra* note 105, at 893-94 (arguing that the threat of a hostile takeover in the contemporary takeover environment will not discipline managers much); Lipton & Rosenblum, supra note 203, at 197-202 (arguing that hostile takeovers will not discipline managers); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 685 n.316, 691 (1988) (same).

[312]*See* Bainbridge, *supra* note 180, at 1009.

incumbent management: "new owners cannot improve the firm's performance by discarding valuable employees."[313]

Unlike other employees, incumbent managers are incontrovertibly harmed by takeovers.[314] They lose deferred compensation and their investments in firm-specific capital. In most takeovers, however, the managers who are fired are the very cause of the takeover.[315] In synergy acquisitions, if the incumbent managers have performed well, the acquirer will not replace them because the transaction costs of changing management are high.[316]

Allowing or requiring managers to consider the interests of all the stakeholders will reduce the number of takeovers by affording management new-fangled justifications for defending against a hostile bid.[317] The new justifications for defensive tactics created by a multilateral fiduciary duty will decrease the prospects for success of attempted takeovers and increase friction in the market for corporate control.[318]

VII. CONCLUSION

Few corporate governance disputes can be resolved with certainty by resort to something like mathematical proofs or divine revelation. The issue of who should benefit from management's fiduciary obligations is no exception. The soldiers marching on this field of argument are not juggernauts; they are hesitant and shambling men-at-arms. Notwithstanding the chronic uncertainty, the preponderance of the evidence suggests that state corporation statutes ought to confine the fiduciary duties of corporate managers to shareholders.

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[313]Easterbrook & Fischel, *supra* note 259, at 1190.

[314]*See* Bainbridge, *supra* note 180, at 1010.

[315]*See* Romano, *supra* note 10, at 129-31.

[316]*See id.* at 125-27.

[317]Some commentators have advocated complete managerial passivity in the face of a hostile takeover that takes place at a premium above the pre-bid market price. *See* Easterbrook & Fischel, *supra* note 259, at 1194-95, 1201. *See also* Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. LEGAL STUD. 165, 169, 186 (1988) (noting that while such an approach will often be inconsistent with target management's fiduciary duty to its shareholders, there is a strong utilitarian argument for legally compelling target management to maximize social wealth rather than target shareholder gain in the takeover context).

[318]For target managers to perform a genuine "all stakeholder" interests calculation in reaction to a takeover bid, they must know what the bidder plans to do with the target company. This might not be clear to the bidder at the time of the bid, and the bidder may want to keep his goals secret to prevent other bidders from taking this information and using it in an auction.

Admittedly, shareholders have several other defensive tools besides the fiduciary duties of managers, such as corporate election machinery and the ability to quickly and cheaply abandon an inauspicious investment by selling their stock.[319] While it cannot be denied that shareholders enjoy these privileges of ownership, their relevance should not be overstated. Although the proxy mechanism has become somewhat more useful in the age of the institutional investor, the corporate election machinery generally provides feeble protection to shareholders.[320] The "Wall Street Walk" only helps investors who have discovered better investment opportunities;[321] a multilateral fiduciary duty will make all equity investment opportunities less enticing. The "Wall Street Walk" will be no protection to an equity investor in a world where corporate managers owe a fiduciary duty to all the corporate constituencies.

Stakeholder advocates offer a host of arguments that do not withstand close analysis. Many of them argue that "other constituency" statutes and multilateral fiduciary duties will enrich shareholders in the long-run. They argue that solicitation of input from all the stakeholders will lead to better informed decisions: if corporate decision makers must consider all competing interests, their decisions will more likely produce optimally efficient outcomes consistent with every constituency's objectives.[322] A variation on this argument asserts that "other constituency" statutes promise the development of integrated relationships within and among various groups and interests of the corporation.[323]

The weight of the evidence presented in this article indicates that subjecting managers to a universal stakeholder fiduciary duty is not the most efficient form of corporate governance. Arguing that a multilateral fiduciary duty will benefit shareholders in the long-run assumes that shareholders are naive. After all, shareholders can always modify management's fiduciary duties by charter amendment.[324] If corporations

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[319]*See* EASTERBROOK & FISCHEL, *supra* note 181, at 25; McDaniel, *supra* note 7, at 157 & n.127; Wallman, *supra* note 7, at 191. Although shareholders can transfer their investments relatively cheaply, transaction costs in the stock market are not negligible and capital gains taxation on stock appreciation can be very significant.

[320]*See supra* note 251 and accompanying text.

[321]"The 'Wall Street Walk' refers to the well-known tendencies of investors who are dissatisfied with a company's management to 'walk away' from it by selling their shares." Orts, *supra* note 283, at 100 n.567. *But see* Tyler, *supra* note 107, at 399 (noting that "because of the size of their holdings, institutions can no longer avail themselves of the 'Wall Street Walk' — selling their shares and reinvesting in other securities — when they become dissatisfied; their sales would probably have a pronounced negative impact on the market").

[322]Matheson & Olson, *Trialogical Imperative*, *supra* note 13, at 1480-84.

[323]*See* Orts, *supra* note 283, at 128.

[324]*See supra* note 268 and accompanying text.

could efficiently make managers fiduciaries for all stakeholders, presumably corporations would do so in exchange for cheaper labor, supplies, and debt.

Another stakeholder advocate has suggested that "other constituency" statutes are important for their symbolic value.[325] This commentator presumably means that managers naturally, as a matter of cognitive psychology or the decision-making hierarchies of corporations, tend to discount excessively the interests of other stakeholders when making decisions. That is, managers blindly focus on narrow shareholder interests when it would actually benefit shareholders to make concessions to other stakeholders. This is a credible claim, but it is bolstered by no empirical evidence. While it is true that shareholders possess the election machinery and the ability to bring derivative litigation, if nonshareholder patrons regularly faced exploitation of their firm-specific investments, they would take corrective action. Creditors would become stockholders (or holders of convertible debt), employees would go to work for partnerships and sole proprietorships, and suppliers and customers would transfer their patronage elsewhere.[326] Moreover, the symbolic value of the stakeholder model of the corporation is clearly outstripped by its inefficiencies.[327]

Other stakeholder advocates make the opposite argument. They contend that the stakeholder model of the corporation will do no harm because directors and officers already view themselves as acting in all the stakeholders' interests.[328] If corporate managers do in fact act as trustees for all corporate constituencies, this is a happy phenomenon, and it in no way contradicts the premises of the shareholder model. Directors and officers should consider the interests of all stakeholders as they maximize share value. Maintaining good relations with creditors, suppliers, customers, and workers are all important parts of maximizing firm profitability. Imposing a multilateral fiduciary duty, however, is not the way to achieve corporate harmony.

Similarly, the oft-proffered concession argument for corporate social responsibility — that a corporation must pay society for the privilege of doing business in the corporate form — must fail. Society should not impose on its corporations a fiduciary duty toward local

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[325]Stone, *supra* note 65, at 71-72.

[326]*See supra* part II.C.

[327]*See supra* parts II-V.

[328]*See* Orts, *supra* note 283, at 42 (citing JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 39-49 (1989)).

employees, creditors, customers, suppliers, and communities.[329] This article has demonstrated that no self-interested state should ask its corporations to pay for the privilege of doing business in this fashion. Restricting the scope of managers' fiduciary duties to shareholders alone will increase social wealth.

A corporation cannot function without contributions of capital from shareholders and creditors, contributions of labor from employees, contributions of raw materials from suppliers, contributions of social infrastructure from state and local governments, and the patronage of customers. The committed participation of each class of patrons is essential to maintaining a corporation's viability. In the joint venture that is corporate enterprise, shareholders are the class of patrons most vulnerable and yet most capable of exercising control over the firm's operations. Their claim to govern the corporation is irresistible.

The hearts of stakeholder advocates are in the right place. Power corrupts, and nonshareholder patrons face some material risk of exploitation at the hands of shareholders and shareholder representatives. Remedying the occasional inequities between the firm and nonshareholder patrons, however, would be better accomplished if states protected vulnerable stakeholders with more highly articulated shields in the spirit of fraudulent conveyance laws, minimum wage laws, and plant closing laws.[330] Courts should also continue carefully to interpret bond contracts and employment contracts to fulfill stakeholders' reasonable expectations. This kind of approach will advance the interests of stakeholders without vitiating corporate decision making, decreasing the accountability of corporate management, or reducing equity investment in American public corporations.

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[329]*See* Coffee, *supra* note 10, at 72.

[330]As another example, Pennsylvania has adopted a Labor Contracts Subchapter to its Corporation Code that forbids takeovers from causing the termination or impairment of certain labor contracts. 1990 Pa. Laws, Act 36, §§ 2585-88.