EFFICIENCY AND ETHICS IN THE DEBATE ABOUT SHAREHOLDER PRIMACY

BY IAN B. LEE*

ABSTRACT

With the rise to dominance of the economic analysis of corporate law, a nearly overwhelming chorus of academic voices has endorsed "shareholder primacy," the view that managers' fiduciary duties require them to maximize the shareholders' wealth and preclude them from giving independent consideration to the interests of other constituencies. This article examines two recent theoretical contributions that have called into doubt the normative consensus around shareholder primacy, specifically Margaret Blair and Lynn Stout's "team production" model, which conceives of the board as a "mediating hierarch," and Einer Elhauge's argument that managers must have discretion to "sacrifice profits in the public interest." Although Blair, Stout and Elhauge are far from the first scholars to argue against shareholder primacy, their contributions break new ground because they argue within the dominant normative framework, namely economic efficiency.

This article argues that neither of these efficiency-based attacks on shareholder primacy is successful. In the author's view, the efficiency debate remains a draw.

This article also examines the relevance of morality to the debate about shareholder primacy. Blair, Stout, and Elhauge introduce, in different ways, conceptions of moral behavior, even though they remain committed to the efficiency framework. The author claims that morality may be relevant to the debate about shareholder primacy in two ways overlooked by Blair, Stout, and Elhauge because of their commitment to efficiency. First, morality may be relevant to the evaluative standard. Second, ethical commitments may be a more complicated concept than efficiency theorists typically acknowledge. These observations may help to explain why corporate law does not and should not unqualifiedly endorse shareholder primacy and, in particular, why it does not and should

---

*Faculty of Law, University of Toronto. The author thanks Heidi Libesman, Bruce Chapman, Andrew Green, Ed Iacobucci, Larry Mitchell, Lynn Stout, and participants in the 2005 annual meetings of the Canadian Association of Law Teachers and the Canadian Law and Economics Association for their comments and Huw Evans for his able research assistance. Comments can be sent to ian.lee@utoronto.ca.

not obligate corporate managers to analyze ethical questions arising in the course of business from the standpoint of profit alone.

TABLE OF CONTENTS

Page

I. INTRODUCTION 535
II. EFFICIENCY ANALYSIS AND SHAREHOLDER PRIMACY 537
A. *The Claim that Shareholder Primacy is Efficient* 537
B. *Blair and Stout's "Team Production" Theory* 539
1. Presentation of the Theory 539
a. *Mediating Hierarchy as a Solution to the Problem of Team Production* 539
b. *Who Monitors the Hierarch?* 541
2. Analysis and Criticism of the Theory 542
a. *Markets and Rules Constrain, but They Don't* 543
b. *The Hierarch Is Not a Team Member, but it Produces Value* 545
c. *The Role of Trustworthiness* 546
d. *The Importance of Implicit Contracts* .. 548
3. Synthesis 550
C. *Elhauge's Argument for "Profit-Sacrificing Discretion"* 551
1. Presentation of the Argument 551
a. *Latent Discretion* 552
b. *Patent Discretion* 552
2. Evaluation of the Argument 554
a. *Latent Discretion: "Not Eradicable" Does Not Mean "Desirable"* 555
b. *Patent Discretion and Delaware Law: A One-Sided Interpretation* 557
c. *Patent, Loyal Profit Sacrificing: Aggregate Shareholder Welfare versus the Welfare of "Most Shareholders"* 558
d. *Patent Profit Sacrificing and Social and Moral Sanctions* 561
3. Synthesis 567
D. *The Efficiency Debate Is a Draw* 568
III. THE RELEVANCE OF MORALITY TO THE DEBATE ABOUT SHAREHOLDER PRIMACY 571
A. *Economic Man (Modified)* 571

1. Behavioral Foundations of Efficiency Analysis 571
2. The Market for Social Responsibility 573
B. *Justice and Commitments* 575
1. Some Business Decisions Raise Questions of Justice 576
a. *Deontological Argument* 576
b. *Consequentialist Argument* 577
2. Individuals Have Commitments 579
3. Deliberation in the Corporation? 582
IV. CONCLUSION 585

I. INTRODUCTION

The debate about "for whom corporate managers are trustees" just does not seem to want to go away. To some, it might have seemed that the debate that began in the 1930s with Adolf Berle and Merrick Dodd's exchange of arguments in the *Harvard Law Review*[1] had finally been resolved a few years ago. With the rise to dominance of the economic analysis of corporate law, a nearly overwhelming chorus of academic voices endorsed "shareholder primacy," the view that managers' fiduciary duties require them to maximize the shareholders' wealth and preclude them from giving independent consideration to the interests of other constituencies.[2] In 2001, two prominent corporate law scholars proclaimed the "end of history for corporate law."[3] The debate was over, and shareholder primacy had prevailed.

The announcement of the end of history, however, may have been premature. On the positive-law side, the question whether managers are obligated to maximize shareholder profits remains as ambiguous as ever. The 1919 case of *Dodge v. Ford Motor Co.* remains the high-water mark for shareholder primacy in important U.S. corporate law jurisdictions.[4] The

---

[1]A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

[2]Other scholars sometimes use different terms for this notion. For example, Stephen Bainbridge uses the term "shareholder wealth maximization" to describe this concept. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 549 (2003). In Bainbridge's usage, "shareholder primacy" refers to the notion, which he rejects, that shareholders ultimately control the corporation. *Id.* at 563.

[3]Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001).

[4]Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

persistence of the ambiguity amounts in practice to a judicial toleration of deviations from shareholder primacy.

Moreover, within the corporate law academy, recent theoretical contributions also call into doubt the claimed normative consensus around shareholder primacy. For instance, Margaret Blair and Lynn Stout argue that the board of directors should be conceived, not as agents of the shareholders charged with the maximization of their profits, but as a "mediating hierarch" responsible for allocating the surplus produced by the corporate enterprise to the various team members (investors, managers, employees and so on) who participated in its production.[5] More recently, Einer Elhauge has argued for managerial discretion to "sacrifice profits in the public interest."[6] Although Blair, Stout, and Elhauge are far from the first scholars to argue against shareholder primacy, their contributions break new ground in that they argue within the dominant normative framework, namely economic efficiency. These authors "speak the same language" as the economically-minded proponents of shareholder primacy. Consequently, their writing has attracted a degree of respectful attention from the proponents of shareholder primacy.

This article analyzes these contributions to the debate about shareholder primacy with two principal aims. The first aim is to argue that Blair, Stout, and Elhauge do not succeed in demonstrating the superiority of their alternative approaches from an efficiency perspective. Part II of the article sets forth these arguments.

The second aim is to analyze the relevance of morality in the debate about shareholder primacy. The argument, set forth in Part III, is that although Blair, Stout, and Elhauge ostensibly reject *homo economicus*, their reliance on the normative criterion of efficiency commits them to an impoverished conception of ethics. Morality is relevant to the debate about shareholder primacy in two additional ways that are overlooked by Blair,

---

[5]Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 404-05 (2001) [hereinafter Blair & Stout, *Director Accountability*]; Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250-51 (1999) [hereinafter Blair & Stout, *Team Production*].

[6]Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 739 (2005). Other noteworthy contributions include LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT (2001); and Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999). Although Mitchell and Williams' contributions are not the focus of this article, the author has commented on them elsewhere. *See* Ian B. Lee, *Corporate Law, Profit Maximization and the "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31 (2005) [hereinafter Lee, *Responsible Shareholder*]; Ian B. Lee, *Is There a Cure for Corporate "Psychopathy"?*, 42 AM. BUS. L.J. 65 (2005).

Stout, and Elhauge because of their commitment to the efficiency framework. First, morality is relevant to the evaluative standard for judging shareholder primacy and, in particular, may provide a reason for qualifying shareholder primacy where questions of justice arise in the course of business. Second, as a behavioral matter, individuals' ethical commitments may be more complicated than efficiency theorists typically acknowledge. In relation to the latter point, Elhauge's conceptualization of individuals' morality as an ingredient of their utility leaves his argument vulnerable to the objection that we should rely on market forces, rather than managerial discretion, to register individuals' relative preferences for morality and other things they value, such as wealth. An alternative understanding of morality as a commitment, or higher-order preference, may help to explain why, in the design of corporate institutions and rules, we might not wish to rely solely on market mechanisms for the ascertainment and reconciliation of the participating individuals' preferences.

II. EFFICIENCY ANALYSIS AND SHAREHOLDER PRIMACY

A. *The Claim that Shareholder Primacy is Efficient*

From the standpoint of economic efficiency, the orthodox argument for shareholder primacy rests on the proposition that the more amorphous the managers' mandate is, the more difficult it is to determine whether the managers are faithfully and diligently accomplishing their mandate. "Agency costs"—the costs associated with underzealous or disloyal managerial conduct and the monitoring costs incurred by the corporation in trying to ensure diligence and loyalty—are a drag on the corporation's performance. It follows that a venture is worth more if managers are tasked with a clear mission, such as the maximization of the stock price, than with a more amorphous mission involving the balancing of competing interests. Although the former arrangement may appear, at first glance, to be detrimental to non-shareholders, this appearance is misleading. In fact, the increased value of the venture means that whatever non-shareholders forgo in accepting shareholder primacy is more than compensable out of the enhanced value of the arrangement for the shareholders. Defenders of shareholder primacy believe that non-shareholders receive better terms

(higher wages, higher interest, and so on) for having accepted shareholder primacy than they would under its alternative.[7]

The argument may also be articulated in terms of the designation of shareholders as sole "residual claimants." Shareholders are "residual claimants" in the sense that they are entitled to whatever corporate assets are left once the "fixed claims"—contractual obligations to creditors, employees, customers, and other participants in the corporation—have been met. In corporate law, this idea is captured in the rules governing the distribution to shareholders of net liquidation proceeds and prohibiting the payment of dividends by an insolvent corporation. Defenders of shareholder primacy argue that this structure is in the interests of all participants in the corporation. A venture is worth more in the aggregate if there is a single group of residual claimants because of lower agency costs compared to a venture in which there are multiple residual claimants. It follows that if all of the participants are acting rationally and with a view to their respective interests, they will agree that (1) one of the groups (let us call them shareholders) will enjoy the status of sole residual claimant; (2) management's powers should be exercised towards the end of maximizing the value of the shareholders' investment; and (3) the other participants will receive fixed terms that compensate them prospectively for agreeing to (1) and (2).

Lying just beneath the surface of these arguments is the notion that the corporation is a voluntary arrangement among the participants—a "nexus of contracts." Because creditors, employees, and consumers are in voluntary relationships with the corporation, it must be that the terms of the relationship are, all things considered, beneficial to them.[8] Shareholder primacy is, according to its defenders, one of these terms.

Not all of those who are affected by corporate activity are, of course, in a voluntary relationship with the corporation. For instance, the victims of corporate torts or environmental damage cannot typically be said to have

---

[7]Market forces determine the overall balance of advantage in the arrangements between shareholders and non-shareholders—to use a familiar metaphor, market forces determine the relative size of each participant's "slice of the pie." Keeping market forces constant, if shareholder primacy results in a "bigger pie," the absolute size of each participant's slice will be larger. This translates, for example, into higher interest rates for creditors and higher wages for employees.

[8]Indeed, the arrangement is the *most* beneficial arrangement possible. If it had been more beneficial to a creditor or employee to obtain a waiver of shareholder primacy in exchange for a lower interest rate or wage, they could have concluded that bargain instead. If they did not, it is because they are willing to accept shareholder primacy in exchange for a higher interest rate or wage.

implicitly consented to shareholder primacy.[9] Nonetheless, the proponents of shareholder primacy argue that the possibility of negative externalities—harm to persons having no contractual relationship with the corporation—does not call for a departure from shareholder primacy. Such a departure would needlessly increase agency costs and, therefore, diminish "social wealth." Instead, society should use regulatory laws backed by fines to "chang[e] the prices [the corporation] confronts" and thereby "conscript the firm's strength (its tendency to maximize wealth)."[10] The conclusion: participants in the corporation are better off, and the rest of us are at least no worse off, when social interests are protected through regulatory laws rather than by tampering with shareholder primacy.

Although the view just outlined has attained the status of orthodoxy within the corporate law academy, three authors have recently articulated dissenting arguments. As noted in the introduction, what is significant about the contributions of Margaret Blair, Lynn Stout, and Einer Elhauge, is that they argue within the dominant normative framework, economic efficiency. The next two subparts examine, in turn, Blair and Stout's "team production" theory and Elhauge's argument for "profit-sacrificing discretion."

B. *Blair and Stout's "Team Production" Theory*

1. Presentation of the Theory

a. *Mediating Hierarchy as a Solution to the Problem of Team Production*

Blair and Stout draw on Armen Alchian and Harold Demsetz's famous characterization of activity within firms as "team production," a type of production that requires investments of resources by several contributors in circumstances where the value created by the team as a whole is observable, but it is difficult to measure the contribution of each to this value.[11] A difficulty arises in designing a scheme for rewarding the members of the team as to how to counteract the incentives of team

---

[9]Significant possible exceptions are purchasers of defective products and employees injured in workplace accidents.

[10]FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (Harvard University Press 1991).

[11]Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779 (1972).

members to shirk.[12] Alchian and Demsetz argued that the optimal arrangement would involve one of the team members selecting the other team members and monitoring their contributions.[13] The monitor would be entitled to retain all of the value produced by the team, after compensating the other team members for their contributions by the payment of fixed rewards determined by input markets.[14] The residual claim supplies the monitor with appropriate incentives to assemble a productive team and to keep an eye on the other team members' contributions.[15] Applied to the corporation, of course, shareholders occupy the position of monitor and residual claimant.

One difficulty with Alchian and Demsetz's model, as numerous commentators have pointed out, is that shareholders in a widely held corporation do not, in fact, play the active role that the model predicts. It seems more realistic to describe shareholders as the suppliers of a factor of production rather than as the team's coordinator and monitor.

According to Blair and Stout, there is another problem with Alchian and Demsetz's model: it does not take into account the problems associated with "firm-specific investment."[16] The participants in a venture make available to it resources that cannot easily be retrieved and redeployed elsewhere. A supplier's investment in customized machinery and an employee's investment in specialized knowledge come readily to mind as examples of firm-specific investments.[17] In fact, the concept also encompasses more generic investments such as labor and capital because, once made, "they effectively become sunk in the firm."[18] It is essential for team production that the members make firm-specific investments. These investments, however, reduce the contributing team member's mobility[19] and

---

[12]*Id.* at 779-81.

[13]*Id.* at 781-83.

[14]*Id.*

[15]Alchian & Demsetz, *supra* note 11, at 779-81.

[16]Blair & Stout, *Team Production*, *supra* note 5, at 275. Again, this is not a concept that originates with Blair and Stout, but is familiar in the economic literature on industrial organization. *See, e.g.*, Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387 (1998); Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J.L. & ECON. 453 (1993).

[17]*See, e.g.*, Blair & Stout, *Team Production*, *supra* note 5, at 276 (mentioning an employee's acquisition of "specialized knowledge" as a firm-specific investment).

[18]Blair & Stout, *Team Production*, *supra* note 5, at 276. *See infra* text accompanying notes 56-61.

[19]Blair & Stout, *Team Production*, *supra* note 5, at 277-79 (describing participants having made firm-specific investments as "'stuck' in the firm").

therefore make the contributor "vulnerable to opportunistic exploitation by other team members."[20]

The sensible arrangement from the standpoint of all of the team members is to designate an independent body—the board of directors—to wield control over the team's assets and to allocate the value produced by the team among the various members. This body is not a team member, which implies, most importantly, that it has no expectation of sharing in the value created by the team. It must also be independent of any of the team members.[21] For example, if the board were beholden to the shareholders, the other team members would fear that the board would allocate to the shareholders a disproportionately large share of the value produced by the team, and they would be deterred from making firm-specific investments.

Blair and Stout's theory is both descriptive and normative. They argue that corporate law reflects this arrangement, vesting the directors with the exclusive power to manage the corporation and insulating them from interference by the shareholders or any other team member.[22] Although the shareholders have the right to elect the directors, this does not impair the board's independence because the very large number of shareholders means that voting in most public corporations is a "meaningless rite."[23]

b. *Who Monitors the Hierarch?*

No one monitors the board of directors. Indeed, in order to function as a mediating hierarch the board must be independent of the other team members. Blair and Stout anticipate the obvious question raised by their model: if the board is independent, what guarantee is there that the directors will diligently and faithfully accomplish their mission?

According to Blair and Stout, there are several sources of assurance. First, directors are constrained by "economic pressures," essentially the pressure exerted by the markets for the firm's outputs and inputs.[24] Second, the board needs to keep the team members happy to ensure that they continue to make their contributions to the team, and to avoid the "coalition . . . fall[ing] apart."[25] Third, by prohibiting self-dealing, corporate law

---

[20] *Id.* at 276.

[21] Blair & Stout, *Director Accountability*, *supra* note 5, at 421 ("[I]t is essential that the hierarch remain free from the command and control of any of the team members.").

[22] *Id.* at 423-24.

[23] *Id.* at 434.

[24] *Id.* at 438.

[25] Blair & Stout, *Team Production*, *supra* note 5, at 315.

makes it more likely that directors will faithfully carry out their mission by decreasing the opportunity cost to them of doing so.[26]

The fourth and most important constraint is trust or, more precisely, an internalized norm of trustworthiness.[27] Blair and Stout argue that the experimental literature about cooperative behavior supports the proposition (which they suggest may be surprising to many economists) that trustworthy behavior occurs.[28] The literature further indicates that the prevalence of such behavior is determined in part by four variables: instructions from authority, group identification, herd behavior, and the personal cost of trustworthiness.[29] Blair and Stout argue that some of these factors may be at work in encouraging trustworthiness on the part of corporate directors, for example through judicial dicta exhorting directors to act diligently and loyally and the cultivation of a perception among directors that they share "in-group status" with the corporation's investors, employees, and managers.[30]

2. Analysis and Criticism of the Theory

The team production theory has attracted considerable scholarly criticism,[31] directed both at its descriptive claim that corporate law establishes the board of directors as a mediating hierarch and at its normative claim that mediating hierarchy is an efficient arrangement on which all corporate participants can be expected to agree in advance.

---

[26]*Id.* Blair and Stout draw an analogy to the "non-distribution constraint" applicable to non-profit enterprises and that provides some assurance to donors and clients of such enterprises that funds will be applied to the purposes for which they were donated. *See id.* at 316 (citing Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838, 847 (1980)).

[27]Blair & Stout, *Director Accountability*, *supra* note 5, at 438 ("directors' internalized belief that they ought to behave in a careful, loyal, and trustworthy fashion"); Blair & Stout, *Team Production*, *supra* note 5, at 316 ("corporate cultural norms of fairness and trust").

[28]Blair & Stout, *Director Accountability*, *supra* note 5, at 438.

[29]*Id.* at 440-41.

[30]*Id.* at 442.

[31]*See, e.g.*, John C. Coates, IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?*, 24 J. CORP. L. 837 (1999); Jeffrey G. MacIntosh, *The End of Corporate Existence: Should Boards Act as Mediating Hierarchs?: A Comment on Yalden*, *in* THE CORPORATION IN THE 21ST CENTURY: NINTH QUEEN'S ANNUAL BUSINESS LAW SYMPOSIUM (2002); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002); David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000). Blair and Stout's theory has also attracted supporters: *see, e.g.*, Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667 (2002); Robert M. Yalden, *Competing Theories of the Corporation and Their Role in Canadian Business Law*, *in* THE CORPORATION IN THE 21ST CENTURY: NINTH QUEEN'S ANNUAL BUSINESS LAW SYMPOSIUM (2002).

In relation to the descriptive claim, Blair and Stout's critics point out that boards of directors are not in fact independent. In reality they are often dominated by one of the team members—management—through, among other things, management's monopoly over the directorial nomination process.[32] Moreover, Blair and Stout have been criticized for overlooking the impact of the market for corporate control,[33] which for decades contractarians and progressives alike have argued focuses management's attention (and that of the board) on the stock price and, indirectly, on shareholder value.[34]

In relation to the normative claim, Blair and Stout's critics take issue with the efficiency effects of the board's independence. On the one hand, the critics are unpersuaded that the constraints described by Blair and Stout provide the board with any incentive to perform its duties conscientiously.[35] On the other hand, the model appears to invite socially wasteful efforts by team members to influence the board's discretionary allocation of the surplus.[36] In addition, the model seems ill-designed to induce firm-specific investments because team members' expectation of a share of the surplus appears to depend more on their rent-seeking skill than on the value of their firm-specific investments.

Although the normative criticisms of Blair and Stout's theory are often framed in terms of the consequences of adopting the team production model, they also highlight some conceptual problems with the theory. The discussion that follows identifies two especially important such problems, concerning the constraining force of markets and rules, and the ambiguous role of the hierarch. We shall also examine the role that the concepts of trustworthiness and implicit contract play in Blair and Stout's argument.

a. *Markets and Rules Constrain, but They Don't*

A first difficulty is a conceptual tension regarding the role of the legal and market factors cited by Blair and Stout as constraints on boards of directors. Blair and Stout argue that "economic pressures," the desire to avoid the team's disintegration, and legal rules against self-dealing all serve

---

[32]Coates, *supra* note 31, at 845-47.

[33]*Id.* at 849.

[34]The argument is that boards and managers have an incentive to maximize the stock price, independently of any legal duty to do so, because a depressed stock price makes the corporation a potential takeover target and thereby jeopardizes the incumbent directors and managers' positions. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

[35]Meese, *supra* note 31, at 1665-66.

[36]Millon, *supra* note 31, at 1031.

to constrain directors' otherwise considerable discretion.[37] These are, undeniably, weak constraints. More importantly, for present purposes, Blair and Stout *need* them to be weak because to the extent that market and legal constraints reduce directors' discretion, they also reduce the domain of Blair and Stout's project, which is, after all, an attempt to rationalize directorial discretion.

Thus, for example, Blair and Stout make no effort to explain how market pressures are supposed to operate. In fact, the market is dangerous for Blair and Stout's project because if it operates too well, the hierarch's independence will be compromised and Blair and Stout's model will collapse into shareholder primacy. Put another way, Blair and Stout's project is to explain how the surplus accommodated by the slack in markets is distributed. If markets are perfectly competitive, there is no surplus to distribute[38] and Blair and Stout's project has no *raison d'être*.

Similarly, the need to keep the team from disintegrating seems to require only that the team members have an expectation of being compensated for the opportunity cost of their contributions. Accordingly, it is not a constraint on the distribution of the surplus generated by team production because by definition the surplus is the value in excess of the cost of the inputs.

As for the legal rules against self-dealing, they are not so much a constraint as part of what makes the board a mediating hierarch. It is intrinsic to the concept of a mediating hierarch—a device used by team members to allocate neutrally the gains from team production—that the hierarch is not itself a team member and, accordingly, is not entitled to allocate to itself a share of the value produced by the team.

Moreover, while rules against self-dealing may discourage a board from allocating gains to itself, they do not constrain the board's allocation of the surplus among the team members. Again, the board's allocative discretion is essential to the concept of a mediating hierarch. To the extent that it is possible to reduce this discretion by formulating rules in advance concerning the allocation of surplus, the need for the independent, external body that Blair and Stout imagine the board to be is correspondingly reduced.

---

[37] *See* Blair & Stout, *Director Accountability*, *supra* note 5, at 438.

[38] Although "team production" may still generate a surplus, in the sense that the market value of the product may exceed the cost of the inputs (including opportunity costs), this surplus will be enjoyed exclusively by consumers if product markets are competitive. There will be no surplus to distribute to the team. This is simply a restatement of the microeconomic truism that in a perfectly competitive market firms make zero economic profit.

b. *The Hierarch Is Not a Team Member, but it Produces Value*

A second difficulty concerns the ambiguous role of the hierarch. Blair and Stout waver between two conceptualizations of the hierarch. Sometimes, the hierarch is described as a mediator, responsible only for allocating value among those who have produced it; on other occasions, the hierarch appears to be a coordinator whose decisions have a bearing on the amount of value that is produced by the team.[39] These are very different roles, and to some extent they are in conflict. In particular, the choice between them has implications for whether the hierarch should be expected to maximize anything and whether it is a serious concern that the hierarch's discretion is only weakly constrained.

Consider first the hierarch's role as a mediator. Recall that Blair and Stout propose a hierarch as a solution to the problem said to be associated with team production and firm-specific investment. In order to protect themselves from the risk of strategic behavior that would act as an obstacle to firm-specific investments, the team members delegate to a hierarch the task of allocating the surplus from the team's production. In order to be acceptable to the team, the hierarch must not itself be a team member and must not have any claim to a share of the value produced by the team.

Because the mediating hierarch is not a member of the productive team, it matters little that the hierarch lacks incentives to maximize the value of the firm—by the time the hierarch enters the scene, the value has already been produced through the efforts of the team members, and all that remains is to divide it up. The hierarch is akin to a judge, or a referee in a sports match.[40] Independence, honesty, and fair-mindedness are needed, while skill at maximizing value and motivation to do so are not.

The hierarch in Blair and Stout's model, however, plays a second role in addition to that of mediator. The board also "runs" the firm,[41] which means that it wields "control over . . . the team's assets"[42] and "coordinate[s] the activities of the team members."[43] Thus, the mandate given by the team members to the board is not simply that of allocating the value produced by the team, but extends to orienting its productive activities. Because of the hierarch's control over the firm's assets and its

---

[39]Blair & Stout, *Team Production*, *supra* note 5, at 251 (stating that the hierarch's function is to "coordinate the activities of the team members, allocate the resulting production, and mediate disputes among team members over that allocation").

[40]*Id.* at 284 (comparing the hierarch to a referee or a judge).

[41]*Id.* at 288.

[42]*Id.* at 271.

[43]Blair & Stout, *Team Production*, *supra* note 5, at 251.

coordinating role in relation to the team members, its decisions have a significant impact on the team's success. In this respect, Blair and Stout's hierarch seems less like a referee and more like a coach. Indeed, Blair and Stout suggest that the hierarch's "primary function" is not allocation, but maximization, specifically that the team members expect the hierarch to "exercise [its] control in a fashion that maximizes the joint welfare of the team as a whole."[44]

The problem, of course, is that Blair and Stout have not designed their hierarch to be a maximizer. Blair and Stout's hierarch, by design, has no expectation of sharing in the value produced by the team. Accordingly, it has no stake in the success of the team, other than not wanting the team to disintegrate completely.[45] This design choice makes sense if the hierarch's role is merely to allocate the fruits of others' labor. It does not make sense if the hierarch's role is to lead the team to success.

c. *The Role of Trustworthiness*

Trustworthiness appears to play a crucial role in Blair and Stout's model of corporate governance. Within the unconfining bounds imposed by "economic pressures," the potential disintegration of the team and rules against self-dealing, directors are said to be constrained above all by their "internalized belief that they ought to behave in a careful, loyal, and trustworthy fashion."[46]

---

[44]*Id.* at 271 (emphasis omitted). *See also* Blair & Stout, *Director Accountability*, *supra* note 5, at 404 (directors' role is to "maximize the sum of all the interests held by all the groups that bear residual risks and hold residual claims").

[45]Stout's discussion of directors' incentives in Lynn Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 688 (2003), is telling. She writes:

> [T]he mediating model of board governance does not assume or require that directors have a particularly robust incentive to maximize returns on the firm's investments once they have been made.... The mediating model simply assumes that directors want to get, and keep, their positions as directors.... [The] board ... has an incentive not to let the firm fall apart. As a result, the board will want to ensure that each essential team member receives enough of a return on its investment to induce it to remain on the team instead of seeking outside opportunities. Beyond this minimum standard, however, the board does not have a particularly strong motive to maximize returns to shareholders, managers, or other residual claimants. Although directors probably want their firms to grow in order to expand their own "empires," they do not have an especially keen drive to maximize returns on firm assets.

[46]Blair & Stout, *Director Accountability*, *supra* note 5, at 438; *see also* Blair & Stout, *Team Production*, *supra* note 5, at 316 ("corporate cultural norms of fairness and trust").

What do Blair and Stout mean by "trustworthiness"? In their articulations of the team production theory, Blair and Stout do not define the term and, indeed, they frequently use it interchangeably with nonsynonymous expressions such as "altruism,"[47] "careful and loyal" behavior,[48] and "cooperation."[49] In other writing, however, Blair and Stout have defined trustworthiness as non-exploitation of vulnerability. To "trust," according to Blair and Stout, is to "deliberately make [oneself] vulnerable to [another] in circumstances in which the trusted actor could benefit from taking advantage of the trusting actor's vulnerability[,] . . . [i]n the belief or expectation that the trusted actor will in fact behave 'trustworthily'—that is, refrain from exploiting the trusting actor's vulnerability."[50]

As previously stated, the adequacy of Blair and Stout's reliance on trustworthiness depends on what function they expect the board to fulfill. An internalized norm of trustworthiness will contribute to discouraging directorial self-dealing and, more generally, it may contribute to ensuring honest refereeing, but it will not provide directors with a strong drive to maximize the team's wealth.

In fact, in their emphasis on trustworthiness as a source of directorial accountability, Blair and Stout leave unstated a different way in which trustworthiness may be relevant to their theory, specifically, its role in the inducement of firm-specific investment. Recall the problem that mediating hierarchy is intended to solve. Team production requires members of the team to make irrevocable investments in the venture, such as the placing of capital at risk by subscribing for stock or extending credit, or the investment by employees in specialized knowledge or by suppliers in single-purpose technology. Once the team members have made these investments, they "will each find themselves at the [others'] mercy"[51] because they cannot withdraw from the team without leaving behind the value of these investments.[52] In particular, if the team is structured so that

---

[47]*See, e.g.*, Blair & Stout, *Director Accountability*, *supra* note 5, at 440-41.

[48]*Id.* at 442.

[49]*See, e.g. id.* at 440-41.

[50]Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1746 (2001). *See also* Lawrence E. Mitchell, *Trust and Team Production in Post-Capitalist Society*, 24 J. CORP. L. 869 (1999) (exploring the role that trust plays in interfirm corporation, the governance of a single corporation, and the management of production within a single corporation).

[51]Blair & Stout, *Team Production*, *supra* note 5, at 272.

[52]Holders of tradeable securities, such as shares, might appear to be the least vulnerable members of the team. A conventional argument in response is that a shareholder's investment is quintessentially firm-specific because it cannot be withdrawn from the firm: shares are not redeemable. Thus, the shareholder cannot recoup his or her money except by finding a willing

one of the team members (say, the shareholders) has control over the enterprise, the member with control has an incentive to allocate to itself a disproportionate share of the value produced by the team.[53] If this problem cannot be solved, the team members who do not have control "will be discouraged from making necessary firm-specific investments."[54]

It should be apparent that the problem of firm-specific investments is essentially a problem of trust and trustworthiness (or the lack thereof) within the team.[55] Team members will be discouraged from making themselves vulnerable by making firm-specific investments to the extent that they do not trust one another—that is, to the extent that they do not expect one another to act trustworthily. The solution Blair and Stout offer is the appointment of a disinterested outsider—a hierarch—to run the firm and divide up the value produced by the team. The hierarch's disinterestedness provides a structural substitute for trust and trustworthiness among the team members themselves.

d. *The Importance of Implicit Contracts*

The language of "firm-specific investments" summons images of employees investing effort in acquiring non-portable skills, or of the firm's suppliers investing in acquiring manufacturing equipment that is only useful for parts used by the firm, or of a municipality building a road to the firm's factory.[56] One may legitimately question, however, the claim that there is any particular "problem" in relation to investments in specialized skills, equipment and infrastructure. Although one can understand the supplier's unwillingness to make such investments, one way to induce such

---

buyer for the shares in the market. *See, e.g.*, Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984); Meese, *supra* note 31, at 1657-58 (referring to Williamson's argument).

[53]Blair & Stout, *Team Production*, *supra* note 5, at 272.

[54]*Id.*

[55]Blair and Stout's argument joins arguments previously made by Bruce Chapman, Andrei Shleifer, and Lawrence Summers in the hostile takeover context. *See* Bruce Chapman, *Trust, Economic Rationality and the Corporate Fiduciary Obligation*, 43 U. TORONTO L.J. 547 (1993) (discussing the concept of trust and its importance in economic relations); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (Alan J. Auerbach ed., 1988) (conceptualizing hostile takeovers as breaches of implicit contracts founded on trust, on the basis of which employees made firm-specific investments).

[56]*See, e.g.*, Rajan & Zingales, *supra* note 16, at 387 ("investments that have little or no value outside a relationship but great value inside it"). *See also* Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70 J. POL. ECON. 9 (1962) (discussing the empirical implications of investing in human capital).

investments is for the firm to pay for them.[57] The single-purpose nature of the investment can either be priced into the transaction between the firm and its supplier, or else the firm can make the investment itself, for example, by paying for its employees' specialized training or buying the land that the road will sit on and building the road itself. While transaction costs are, as always, an issue, it is far from clear that there is any need for the device of an external hierarch to prevent the parties from exploiting one another.

In fact, the image of specialized human capital and technology may be misleading because even many investments that appear to be generic are irrevocable, and are therefore "firm-specific" in the sense in which Blair and Stout use the term. Thus, for example, many economic analysts emphasize that shareholders make firm-specific investments simply by supplying capital without any entitlement to withdraw it and thereby placing their entire investment at risk.[58] Other superficially generic contributions are similarly irrevocable, and therefore "firm-specific," for example, the effort an employee puts into carrying out his or her duties. Once the employee has made the effort, it is sunk in the firm, in the same way as the shareholder's investment.

The real problem, therefore, is not how to induce investments in specialized human capital and technology, but the more general and more mundane problem of how to motivate team members to make any irrevocable contribution, including ordinary effort and transfers of material resources, to the venture.[59] Such contributions may be induced through contractual means, including contractual devices intended to align the members' incentives with the success of the team (e.g., profit-sharing formulas) and formal legal obligations accompanied by sanctions (e.g., performance standards). In addition, team members may induce contributions from one another through informal understandings, which some

---

[57]*See, e.g.*, Becker, *supra* note 56, at 18 (suggesting that firms would pay for their employees' firm-specific training).

[58]*See also* Blair & Stout, *Team Production*, *supra* note 5, at 276 ("cash contributions . . . effectively become sunk in the firm"). However, Blair and Stout's presentation is not always attentive to the distinction between "firm-specific" and "specialized." *See, e.g.*, *id.* (describing the "develop[ment] of specialized knowledge" by employees as a firm-specific investment, and noting that the above-described cash contributions cease to be generic once they have been "used to purchase specialized assets or pay wages").

[59]*See* Chapman, *supra* note 55, at 573 (discussing the notion that any contribution of effort by an employee with the expectation of future compensation is a firm-specific investment).

economists label "implicit contracts," but which one might also describe as extra-contractual.[60]

Extra-contractual understandings may be at work not only in relation to the team members' expectations from the other members, but also in relation to each team member's own contributions. In other words, it is helpful for the team if team members (say, employees) devote more than the bare minimum of effort that will prevent their incurring contractual penalties or dismissal from the team. A combination of contractual promises, such as profit-sharing, and extra-contractual mechanisms, such as the cultivation of a sense of mutual loyalty, may induce investments of this kind.[61]

The limitations of formal contracting and the resulting need for informal understandings create a role for a mediating hierarch. The board of directors acts both as a monitor of the team members' contributions and as a commitment mechanism that ensures that implicit understandings are not reneged.

3. Synthesis

Thus, the argument for mediating hierarchy amounts to the following. Extra-contractual understandings are sometimes necessary to optimize team production. Specifically, it is helpful if team members contribute more than the bare minimum that will prevent their dismissal, and a combination of contractual promises and implicit understandings may induce them to make their contributions. The team members appoint a trustworthy board as the guardian of one another's commitments.

The main difficulty with the model is that the board's function is not only to broker disputes between the members of the team and to allocate the value of the team's production to the members. The board is also expected to coordinate the team's efforts and, therefore, to contribute to the team's productive activity. Because the board is not simply a mediator, but also coordinates the production of value, it is problematic that the board lacks incentives to maximize the value produced by the team. In another writing, Stout has acknowledged this difficulty, conceding that "we can expect boards to run [firms] in a satisficing, but suboptimal, fashion."[62]

---

[60] *Id.* at 572 (observing that implicit understandings have advantages over explicit contracts in some cases because of the difficulty in predicting and specifying future contingencies).

[61] This might be conceptualized as an expectation that all team members will share, in an unspecified way, in the fruits of the team's success.

[62] Stout, *supra* note 45, at 688.

From the standpoint of efficiency, the case for the team production theory appears to rest on an assumption concerning the relative costs and benefits of the model compared to its alternative. Specifically, Blair and Stout assume that the costs of mediating hierarchy—the profits forgone by the team members by appointing a leader who is indifferent to their success—are less than the costs of adopting a principal-agent structure—the costs associated with searching for and adopting the next-best solution to the problem of mutual vulnerability in team production. As this assumption is controversial, Blair and Stout have not succeeded in demonstrating the superiority of the team production theory as a matter of efficiency.

C. *Elhauge's Argument for "Profit-Sacrificing Discretion"*

1. Presentation of the Argument

We now turn to Elhauge's argument that managers have, and ought to have, discretion under corporate law to sacrifice profits in the public interest. By the term "public interest," Elhauge means the interests of non-shareholders other than the managers themselves (or their families and friends).[63] Elhauge's five principal claims can be summarized as follows. First, extensive managerial discretion to sacrifice profits in the public interest exists as an inevitable consequence of the business judgment rule.[64] Second, this "latent" discretion cannot be eliminated without eliminating the business judgment rule, a reform that would harm shareholders even on the assumption that the latter are interested only in maximizing their profits.[65] Third, corporate law explicitly authorizes managers to sacrifice a reasonable amount of profits in the public interest even where the business judgment rule does not apply.[66] Fourth, this "patent" discretion is efficient because, without it, social and moral norms would not be available as a means of regulation of corporate behavior, and alternate means of regulation may be less effective or more costly.[67] Fifth, "patent" profit-sacrificing is consistent with the maximization of shareholders' welfare to the extent that the managers' actions faithfully translate the preferences of most shareholders.[68]

---

[63]Elhauge, *supra* note 6, at 744.

[64]*Id.* at 738.

[65]*Id.*

[66]*Id.*

[67]Elhauge, *supra* note 6, at 738-40.

[68]*Id.*

a. *Latent Discretion*

Elhauge's first two claims concern what he terms "latent" managerial discretion to sacrifice corporate profits in the public interest. According to Elhauge, the courts' reluctance to second-guess managers' business judgment and, in particular, their reluctance to interfere with a business decision that appears to sacrifice short-run profits if it "may conceivably maximize [long-run] profits" implies this discretion.[69] Because "just about any decision to sacrifice profits has a conceivable link to long-term profits, this suffices to give managers substantial de facto discretion to sacrifice profits in the public interest."[70]

According to Elhauge, the existence of managerial discretion to sacrifice profits in the public interest is socially desirable.[71] Indeed, such discretion would be desirable even if the objective of corporate law were the maximization of shareholder profits because it is inevitably entailed by the business judgment rule.[72] This rule recognizes that scrutinizing managerial decisions is not costless, and that at some point the costs associated with judicial scrutiny of managerial decisions will exceed the managerial inefficiencies that might be avoided through such scrutiny.[73] According to Elhauge, the business judgment rule represents a profit-maximizing compromise between these two costs, and the business judgment rule, as shown above, in effect leaves managers with "latent" discretion to sacrifice profits in the public interest.[74]

b. *Patent Discretion*

Elhauge is not content to argue simply that corporate law tolerates profit-sacrificing as a necessary consequence of the business judgment rule. In addition, he tries to demonstrate that corporate law explicitly authorizes managers to sacrifice profits in the public interest, and that this "patent" discretion is socially desirable.[75]

In support of the descriptive claim, Elhauge notes the provisions in state corporations statutes explicitly authorizing corporate donations; the so-called "constituency" statutes enacted by many states authorizing

---

[69] *Id.* at 770-71.

[70] *Id.* at 771.

[71] *See* Elhauge, *supra* note 6, at 738-40.

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] Elhauge, *supra* note 6, at 738-40.

managers explicitly to take into account the interests of other constituencies; and the American Law Institute's (ALI) Principles of Corporate Governance, which authorize boards of directors to devote a "reasonable amount of resources" to "public welfare, humanitarian, educational, and philanthropic purposes," even if "the conduct either yields no economic return or entails a net economic loss."[76] Further, Elhauge refers to Delaware case law on takeovers, especially *Unocal Corp v. Mesa Petroleum Co.*,[77] and argues that this case law has confirmed explicitly that the stockholders' interests "are not a controlling factor"[78] and that directors may take non-shareholder interests into account in responding to a takeover bid. From the standpoint of Elhauge's argument, what is significant about these statutes and legal authorities is that they do not require managers to concoct a profit-oriented justification for taking into account the interests of non-shareholders. Therefore, in addition to the "latent" discretion created by the business judgment rule, corporate law also explicitly permits managers to sacrifice a reasonable amount of profits in the public interest.

Elhauge makes two normative claims in relation to "patent" profit-sacrificing. His first and more important claim is that the discretion to sacrifice profits in the public interest is "socially efficient" because it is necessary in order for "social and moral sanctions" to be available as a means of regulating corporate conduct.[79] As imagined by Elhauge, society regulates conduct through the use of three types of sanctions: "legal sanctions" (definition and punishment of illegal behavior), "economic sanctions" (commercial incentives to refrain from excessive selfishness), and "social and moral sanctions" (social reprobation, feelings of guilt, and internalized "private values").[80] All three types of sanction are necessary in order to "optimize behavior."[81]

Within public corporations, a difficulty arises because the structure of the corporation insulates the owners of the business from moral and social sanctions. Shareholders are anonymous to critics of the corporation's antisocial activities and, because of their lack of information about

---

[76]*Id.* at 763-66; ALI PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(b)(3) (1992).

[77]493 A.2d 946 (Del. 1985).

[78]Elhauge, *supra* note 6, at 764-65; *see also Unocal*, 493 A.2d at 955-56 (stating that when analyzing a takeover bid, directors may consider "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders . . . the risk of nonconsummation, and the quality of securities being offered in the exchange").

[79]Elhauge, *supra* note 6, at 796-805.

[80]*Id.* at 751-52.

[81]*Id.*

corporate operations, they are unlikely to feel "moral guilt" about these operations.[82] Moreover, even if "social moral impulses" do manage to penetrate the corporate structure and make themselves felt by shareholders, collective action problems make it difficult for shareholders of public corporations to respond to these impulses.[83] In particular, because a shareholder's decision to sell her shares or to vote them in a particular way has no impact on the corporation's conduct, such actions are pointless sacrifices that even conscientious shareholders cannot be expected to make.[84]

Consequently, if social and moral sanctions are to have any impact in regulating public corporations, it must be through their effect on managers. Preventing managers from sacrificing profits in response to social and moral sanctions would deprive society of a useful means of regulation, requiring society to rely exclusively on legal and economic sanctions even though in some circumstances they may be less effective or more costly.

Elhauge's second claim is that when managers sacrifice profits in the public interest, they are often maximizing the shareholders' welfare.[85] After all, shareholders have non-financial interests in addition to desiring profits. Consequently, "maximizing shareholder welfare is not the same thing as maximizing shareholder profits" and, when non-financial preferences held by a majority of the shareholders outweigh those shareholders' desire for profits, the managers may maximize the shareholders' welfare even if they choose a course of action that does not maximize their profits.[86] As Elhauge puts it, managers maximize shareholders' welfare when, in departing from profit-maximization, they are acting as "loyal agents for the majority of shareholders."[87]

2. Evaluation of the Argument

Elhauge's ambitious attack on the "canonical law and economics account"[88] is unsuccessful. In particular, four criticisms of his argument may be offered. First, while Elhauge is surely justified in his claims that latent discretion exists and that devoting infinite resources to eliminating

---

[82] *Id.* at 798-99.

[83] Elhauge, *supra* note 6, at 799.

[84] *Id.* at 799-800.

[85] *Id.* at 785.

[86] Elhauge, *supra* note 6, at 783.

[87] *Id.*

[88] *Id.* at 736.

this discretion would do more harm than good, these claims suggest only that latent discretion is not feasibly eradicable, which is not the same thing as saying that it is desirable. Second, at least in relation to Delaware law, Elhauge's claim that "patent" or overt sacrificing of profits in the public interest is permitted is overstated. Third, Elhauge's claim that managers maximize shareholder welfare when, in sacrificing profits in the public interest they are giving effect to the non-financial preferences of "most shareholders" incorrectly identifies an increase in the welfare of "most shareholders" as the maximization of the aggregate welfare of all shareholders.

A fourth criticism goes to Elhauge's important argument that patent managerial discretion to sacrifice profits in the public interest is "efficient" because it enables social and moral sanctions to function. Elhauge does not define efficiency but he appears to believe that patent profit sacrificing discretion confers substantial benefits upon non-shareholders at no cost to shareholders. In my opinion, Elhauge mischaracterizes the benefit of discretion in a way that overstates its magnitude and he fails to demonstrate that there would be no cost to shareholders. As a result, he does not succeed in avoiding the question whether the social costs of profit maximization are greater or less than the agency costs associated with managerial discretion to sacrifice profits in the public interest.

Each criticism will be discussed in turn.

a. *Latent Discretion: "Not Eradicable" Does Not Mean "Desirable"*

There is a sense in which Elhauge's descriptive and normative arguments about the latent discretion created by the business judgment rule are uncontroversial. Even commentators who in an ideal world might prefer a stronger commitment to shareholder profit maximization typically agree that the business judgment rule makes it very difficult for a shareholder to succeed in challenging a managerial decision on the ground that it favored the public interest over the maximization of profits.[89] Similarly, few would disagree with the claim that latent profit-sacrificing discretion cannot be eliminated without eliminating the business judgment

---

[89]Bainbridge, *supra* note 2, at 582; Larry E. Ribstein, *Partnership Social Responsibility* 24-25, *available at* http://home.law.uiuc.edu/~ribstein/partnershipsocialresponsibility130.doc (last visited July 21, 2005). Even in *Dodge*, which after nine decades is still the high-water mark for judicial recognition of a shareholder wealth maximization requirement, the court declined to interfere with Henry Ford's plans to expand production despite criticizing his avowed desire to benefit society rather than generate maximum profits. The court's reason was that "judges are not business experts," and the court was not persuaded that the plan would not ultimately result in greater profits for the corporation. *Dodge*, 170 N.W. at 684.

rule, or with the claim that eliminating such discretion would be counterproductive even from the standpoint of shareholder profit-maximization. Even the proponents of profit maximization do not argue for its enforcement at all costs.[90]

For two reasons, however, it is inapt to characterize Elhauge's argument as an argument in support of "sacrificing corporate profits in the public interest." First, the freedom created by the business judgment rule is not limited to "sacrificing profits in the public interest," but includes every type of departure from the zealous pursuit of profits, from laziness to excessive consumption of perquisites. In defending the business judgment rule, one is not so much defending a discretion to sacrifice profits in the public interest, as a discretion to sacrifice profits *tout court*. In other words, Elhauge's argument is no more accurately described as an argument for the desirability of managerial discretion to advance the public interest than as an argument for the desirability of managerial discretion to be lazy or to consume excessive perquisites.

Second, Elhauge ignores the distinction between the desirability of sacrificing profits in the public interest and the undesirability of legislating against such sacrifices. The latter does not entail the former. Even if it is true that shareholders' interests would be ill-served by attempts to stamp out profit-sacrificing through judicial enforcement of a profit-maximization rule, this does not establish that managerial discretion to sacrifice profits in the public interest is desirable.[91] As Butler and McChesney observe in relation to corporate philanthropy, "Tolerance of inevitable costs is not the same as applause."[92] In short, Elhauge's argument about latent discretion is not an argument for the desirability of managerial discretion to sacrifice profits in the public interest. It is, at best, an argument that such discretion is a necessary evil.

---

[90]Elhauge's argument that profit-seeking shareholders would favor a rule leaving managers with "discretion" to sacrifice profits can be seen as a generalized version of an argument previously made by Henry Butler and Fred McChesney in relation to corporate philanthropy. *See* Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195 (1999).

[91]Indeed, drawing on Elhauge's own analysis of norms as supplementary regulation, one might acknowledge the legal ineradicability of profit-sacrificing discretion while advocating the cultivation of a norm against sacrificing profits. *See* Bainbridge, *supra* note 2, at 579-80; Elhauge, *supra* note 6, at 814.

[92]Butler & McChesney, *supra* note 90, at 1226.

b. *Patent Discretion and Delaware Law: A One-Sided Interpretation*

Elhauge's claim that corporate law explicitly authorizes managers to sacrifice profits in the public interest is overstated. Elhauge's interpretation of the relevant materials is not implausible, but it is ultimately uncompelling because Elhauge does not establish the superiority of his reading over a contrary interpretation that, at least in relation to Delaware, is also plausible.

Opponents of Elhauge's position might point out, for example, that the message to be drawn from a statutory provision authorizing donations is not that profit-sacrificing, in general, is authorized, but that donations are authorized as an exception to a general rule against the use of corporate funds for purposes not motivated by profit. Moreover, the fact that donations are within the corporation's powers does not preclude a managerial duty to exercise corporate powers, including the power to make donations, with a view to the maximization of shareholder wealth. Indeed, the leading Delaware case, *Theodora Holding Corp. v. Henderson*,[93] is famously ambiguous as to whether a connection is necessary between the donation and some benefit, however remote, to the shareholders.[94]

Elhauge's interpretation of Delaware case law on takeovers is similarly one-sided. As the defenders of shareholder wealth maximization have pointed out, the Delaware Supreme Court qualified its position in the years following *Unocal* by stating that consideration of non-stockholder interests was conditioned on the presence of "rationally related benefits accruing to the stockholders" and that a focus on obtaining the best price for the stockholders must prevail over other considerations once the directors have decided to abandon their "long-term strategy" or have decided to sell the business.[95] While this case law falls short of unequivocally mandating shareholder wealth maximization, it also falls

---

[93]257 A.2d 398 (Del. Ch. 1969).

[94]It will be recalled that the court's opinion states both that it is per se appropriate for corporations to make contributions to public causes, and that the shareholders benefited from the contributions, in the long run. *Id.* at 404 ("[t]he recognized obligation of corporations towards philanthropic, educational and artistic causes is reflected in the statutory law of all [but two] of the states"); *id.* at 405 ("the relatively small loss of immediate income otherwise payable to [the shareholders because of the donation] is far out-weighed by the overall benefits flowing from [the donation, which in providing] justification for large private holdings, thereby [benefits the shareholders] in the long run").

[95]Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 47 (Del. 1994); Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

short of unambiguously authorizing the pursuit of non-shareholder interests other than instrumentally for the benefit of the shareholders.[96]

In fact, an enduring feature of Delaware law is that it is ambiguous with respect to whether the interests of non-shareholders may receive independent consideration by boards of directors, or whether they may be considered only as a means to the end of maximizing profits. The ambiguity persists, in part, because—as Elhauge himself observes—it is virtually always possible to identify a long-term profit-oriented rationale for an act that, superficially, involves a sacrifice of profits.[97] Moreover, courts typically frame their opinions in terms that preserve the ambiguity of the legal standard, a phenomenon which may reflect the absence of a social consensus on the underlying normative issue.[98]

Elhauge is not the first scholar to attempt to demonstrate that, as a matter of positive law, one side or the other has the better part of the argument. His demonstration is no more conclusive than previous attempts have been.

c. *Patent, Loyal Profit Sacrificing: Aggregate Shareholder Welfare versus the Welfare of "Most Shareholders"*

There is an important insight underlying Elhauge's argument that managers do not necessarily reduce shareholders' welfare in deviating from profit maximization, namely that shareholders need not be assumed to be interested only in profits.[99] Elhauge suggests that "some shareholders derive nonfinancial benefit from having corporate activities further their social and moral views, or . . . suffer social or moral sanctions from corporate violations of social or moral norms."[100] For socially conscious shareholders, "their welfare reflects a combination of their financial returns and their social or moral satisfaction with corporate activities."[101]

---

[96]A better example might have been a case not mentioned by Elhauge, specifically Crédit Lyonnais Bank Nederland N.V. v. Pathé Communications Corp., No. 12,150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1155 (1992) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.").

[97]Elhauge, *supra* note 6, at 771.

[98]*See* William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 280 (1992).

[99]*See also* Lee, *Responsible Shareholder*, *supra* note 6, at 55-56.

[100]Elhauge, *supra* note 6, at 783.

[101]*Id.* at 784.

Rational-choice purists may object to Elhauge's suggestion that shareholders have social and moral preferences[102] because such preferences are at odds with the assumption of self-regarding preferences that underlies the traditional concept of *homo economicus*. Increasingly, however, economists have been prepared to relax the traditional assumption in the face of evidence that real people are not purely self-interested.[103] A good example of this development is Louis Kaplow and Steven Shavell's conceptualization of welfare as encompassing, among other things, "tastes for fairness."[104] The admission of social and moral preferences is a significant development, but its implications for economic analysis should not be overstated. As Richard Posner commented in relation to seemingly irrational preferences, "[a] preference can be taken as a given, and economic analysis proceed as usual, even if the preference is irrational."[105] Elhauge's description of "social and moral satisfaction" as an ingredient of shareholders' welfare is consistent with this approach, as is his argument that aggregate shareholders' welfare may be maximized even if their profits are not.

This article discusses the economic analysis of morality in Part III, focusing on the conclusion that Elhauge draws from the fact that shareholders have non-financial preferences. In the author's view, Elhauge's conclusion—that managers increase shareholder welfare when they are "acting as loyal agents for most shareholders"—is problematic. Elhauge is suggesting, in effect, that the welfare of shareholders as a group is increased if management increases the welfare of the majority shareholders. The problem, of course, is that the proposition takes no account of the magnitude of the advantage or disadvantage to the majority and minority shareholders.

This is an obvious problem, and one of which Elhauge is evidently aware although he does not address it directly.[106] Elhauge does, however, anticipate and attempt to deal with two similar objections. He

---

[102]*See, e.g.*, George J. Stigler, *Economics or Ethics?*, *in* 2 THE TANNER LECTURES ON HUMAN VALUES 143, 145 (Sterling M. McMurrin ed., 1981).

[103]*See* Christine Jolls et al, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1473 (1998).

[104]Louis Kaplow & Steven Shavell, *Fairness Versus Welfare: Notes on the Pareto Principle, Preferences, and Distributive Justice*, 32 J. LEGAL STUD. 331, 333 (2003) [hereinafter Kaplow & Shavell, *Notes on the Pareto Principle*]. Kaplow and Shavell previously used the expression "taste for a notion of fairness." *See* LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 21 (2002) [hereinafter KAPLOW & SHAVELL, FAIRNESS VERSUS WELFARE].

[105]Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1554 (1998).

[106]Elhauge, *supra* note 6, at 785 ("Most is not all . . . .").

acknowledges, for example, Milton Friedman's argument that sacrificing profits to suit the majority stockholders is a "tax"—a reallocation of wealth from the minority to the majority.[107] Elhauge's response to this objection is to challenge the "baseline" of profit-maximization that underlies the characterization of profit-sacrificing as a tax.[108] In substance, he argues that someone has to be disappointed, and it is no less arbitrary to disappoint the majority in their non-financial expectation than to disappoint the dissenters in their profit expectation.[109]

Elhauge also anticipates the possible objection that the costs imposed on the minority are an externality and the related suggestion that the majority should be obliged to internalize these costs by compensating the minority for the latter's forgone profits.[110] Elhauge's response to the objection is a variation on his "baseline" argument. He asserts, after Coase,[111] that it is arbitrary to label the sacrificing of profits as the imposition of a cost by the majority on the minority.[112] The pursuit of maximum profits despite the contrary wishes of the majority could just as easily be described as the imposition of a cost by the minority on the majority. Moreover, shareholders supportive of profit-sacrificing face a collective action problem: if the majority shareholders were compelled to compensate the minority, shareholders supportive of profit-sacrificing would hide their real preferences so as to free-ride on the other members of the majority. In Elhauge's words, "[S]hareholders who, in their heart of hearts, prefer to sacrifice profits to advance the public interest, would have an incentive to dissent, hoping the majority would still further the public-spirited activity, but without their contribution."[113]

These responses, however, do not go to the proposition that Elhauge set out to defend, which is that managers increase aggregate shareholder welfare whenever they increase the welfare of "most shareholders." They appear instead to be building blocks of a different, unarticulated argument based on the relative severity of the collective action problems faced by shareholders who favor profit-sacrificing in a given instance compared to shareholders who favor profit-maximization. One could imagine a Coasean argument in support of a default rule permissive of profit-sacrificing; the premise of the argument would be that it is easier for profit-preferring

---

[107] *Id.*

[108] *Id.* at 787.

[109] *Id.* at 785.

[110] Elhauge, *supra* note 6, at 788.

[111] *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2-8 (1960).

[112] Elhauge, *supra* note 6, at 789.

[113] *Id.* at 792.

shareholders to bargain for a waiver of a profit-sacrificing decision than for profit-sacrificing shareholders to bargain for a waiver of profit maximization. This, however, is not the argument Elhauge makes and there is no reason to believe that the empirical premise is true.[114]

Ultimately, Elhauge seems to believe that these majority-minority problems are temporary because, in the long run, shareholders of the minority persuasion will drift to other corporations where their interests are more aligned with those of the majority.[115] But Elhauge cannot succeed in his argument by assuming "ethical cleansing" of corporations, that is, by imagining a future day when shareholders are unanimous about how zealously to pursue profit and under what circumstances forbearance is warranted. Elhauge's self-imposed burden is to show that, when there is a majority and minority, maximizing the welfare of the majority maximizes the welfare of all. He must at least demonstrate that if shareholders do not agree on the non-financial aspect of their investment, it maximizes their total welfare for management to sacrifice profits in the public interest on the basis of the preferences of the majority shareholders as opposed to maximizing the profits of all shareholders. This is a difficult, perhaps impossible burden, and Elhauge's arguments do not meet it.

d. *Patent Profit Sacrificing and Social and Moral Sanctions*

Let us now consider Elhauge's most important claim, namely that "efficiency" requires that managers have discretion to sacrifice profits to a reasonable extent because without such discretion, social and moral sanctions would be unavailable as a means of regulating corporate behavior.

Elhauge's argument is evocative of arguments made by other prominent critics of corporate profit maximization, not least Merrick Dodd's argument that it is "hardly thinkable" that "stockholders who have no contact with business other than to derive dividends from it" should

---

[114]On the contrary, there is reason to believe that the premise is false. Profit-preferring shareholders face the same collective action problem as profit-sacrificing shareholders—perhaps worse, if one believes that a person is more likely to free-ride when motivated by selfish considerations than when motivated by principle. In addition, profit-preferring shareholders would face the problem of how to calculate the amount required to compensate the profit-sacrificing shareholders for the defeat of the latter's social and moral preferences. This strikes me as a much more difficult calculation than that faced by profit-sacrificing shareholders in bargaining for a waiver of profit maximization; in the latter case, the measure of compensation would be the profits forgone.

[115]Elhauge, *supra* note 6, at 794 ("[O]ver time one would think that the dissenting shareholders would sell their shares to shareholders who do share the public interest views of the majority shareholders.").

fulfill the social responsibilities of business owners, and that we must look instead to managers.[116] Like Dodd, Elhauge links his argument for managerial discretion to the situation of shareholders in the public corporation. The shareholders' anonymity and dispersion "insulates" them from the "social and moral sanctions and processes" that generate responsible conduct.[117] Accordingly, if those sanctions and processes are to operate at all, they must be permitted to operate upon managers.

What distinguishes Elhauge from authors such as Dodd is his invocation of the behavioral economic understanding of norms. Like Blair and Stout, Elhauge draws on concepts from the economic literature in an effort to bridge the gap between the proponents and critics of shareholder primacy. In Elhauge's case, the argument is that the economic literature on norms demonstrates that the imposition of shareholder wealth maximization as an exclusive mandate for managers would be inefficient.

In this author's view, Elhauge's argument is unsuccessful due to three problems. First, Elhauge misdescribes the relationship between law and norms. As a result, he misstates the social choice involved when he describes it as an all-or-nothing proposition in which law must either authorize managers to sacrifice profits or else render social and moral sanctions unavailable as a means of regulation. In reality, the alternatives are more subtly different from one another, and the choice between them is less clear. Second, Elhauge demands too much of norms as the sole guiding force for managers' discretion to transfer wealth to non-shareholders. A third problem concerns Elhauge's unsuccessful argument that when managers sacrifice profits in the public interest it comes at no cost to the shareholders. In the remainder of this section, each of these problems will be briefly elaborated.

1. Law Does Not Trump Norms

According to Elhauge, the problem with a legal duty to maximize profits is that it would "override" the social and moral sanctions that serve as the enforcement mechanism for non-legal norms.[118] It would result in "the sort of suboptimal conduct we would get with *zero* social and moral sanctions."[119] By contrast, "assuming that our society's social and moral norms do, as a group, improve behaviour . . . [,] managerial discretion to

---

[116]Dodd, *supra* note 1, at 1153. This is also the tenor of Mitchell's argument. *See* MITCHELL, *supra* note 6.

[117]Elhauge, *supra* note 6, at 798.

[118]*Id.* at 733.

[119]*Id.* at 800.

respond to social and moral sanctions will move corporate behavior in the right direction."[120]

If Elhauge were correct in his suggestion that with a shareholder primacy rule, we would find ourselves in a world of "zero social and moral sanctions,"[121] there might, indeed, be an efficiency-grounded reason for questioning shareholder primacy. The behavioral economic literature on which Elhauge relies, however, does not support his account of the effect of a shareholder primacy rule.

How do norms arise? Three types of processes are mentioned in the behavioral economic literature. One process is evolution, which some argue may account both for the human capacity to acquire the moral notions necessary to generate social and moral sanctions, and for the wide acceptance of certain specific norms.[122] A second process is internalization and inculcation. Some scholars theorize that individuals internalize norms, in effect investing in the acquisition of moral preferences and becoming susceptible to social and moral sanctions, in order to increase their opportunities for cooperation with others.[123] Similarly, parents who love their children inculcate norms in them in order to increase the children's opportunities. A third process is self-conscious compliance. An individual may conduct himself or herself in accordance with a norm, not because the individual has internalized it, but because of a simple belief that the conduct will attract the esteem of others[124] or because the individual wants to signal desirable innate characteristics associated with the conduct.[125]

---

[120]*Id.* at 804.

[121]Elhauge, *supra* note 6, at 800 (emphasis omitted).

[122]*See, e.g.*, STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 606-07 (2004) (arguing that the capacity to learn moral notions and the inherited predisposition to obeying such notions is "highly functional and should have been favored in an evolutionary sense").

[123]*See* ROBERT H. FRANK, PASSIONS WITH REASONS: THE STRATEGIC ROLE OF THE EMOTIONS 16-19 (1988); Robert Cooter, *Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 VA. L. REV. 1577, 1593 (2000); Robert H. Frank, *If* Homo Economicus *Could Choose His Own Utility Function, Would He Want One with a Conscience?*, 77 AM. ECON. REV. 593, 595 (1987).

[124]Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 355 (1997).

[125]Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1787-89 (2000). The differences between Posner's signaling account and the internalization position are subtle. First, Posner takes preferences as exogenous. The individual complies with norms in order to signal these preferences. She does not attempt to acquire the preferences if she does not already have them. Second, the preferences are not norm-like. The individual does not have preferences for fairness, for example. The preferences are more selfish (e.g., discount rate for future consumption) and go to the relative likelihood of cooperation and defection in multi-period prisoners' dilemmas. In addition, on this third view, since norms are not internalized, the individual is motivated by social sanctions alone, and not also by moral sanctions, to use Elhauge's

Law and norms are interdependent. For example, law derives its regulatory power not only from compulsion but also from the social and moral sanctions that attend the norm of obedience to law.[126] And while law's power thus depends on a norm, so too are norms influenced by law. Laws may seek to coerce individuals into acting in accordance with norms, or to prevent them from doing so, or they may signal the desirability or undesirability of particular types of conduct and thereby modify the opinions that generate social and moral sanctions in relation to that conduct.[127] In addition, if a substantial proportion of the laws are at variance with prevailing social and moral norms, it will weaken the norm of obedience to law.[128]

It should be apparent from the foregoing that law does not trump norms. It is an exaggeration to claim, as Elhauge does, that a legal duty to maximize profits would entail "the sort of suboptimal conduct we would get with *zero* social and moral sanctions."[129] Where, in relation to a particular business decision, a legal duty to maximize profits cuts against particular substantive norms, the effect of the legal duty may more accurately be described as follows. Liability risk and the norm of obedience to law pull the manager in the direction of choosing the profit-maximizing course of conduct, while the substantive norms pull in the other direction. From a longer-term perspective, the legal duty may eventually alter the substantive norms, or the latter may weaken the norm of obedience to law, or both. The result of this interplay of legal, moral and social sanctions cannot be determined in the abstract but will, of course, depend on the circumstances.

Elhauge is incorrect, therefore, to suggest that we are presented with an all-or-nothing choice: either the law must authorize managers to sacrifice profits in the public interest, or else "social and moral sanctions" are totally excluded as a means of regulation of corporate behavior. In reality, the enactment of a legal duty to maximize profits would produce a

---

terms.

[126]A staple problem of the law-and-norms literature is to explain, using norms, why tax compliance reaches a level that would not be achieved if taxpayers were concerned only with penalties and the probability of enforcement. *See* Cooter, *supra* note 123, at 1578-79; Posner, *supra* note 125, at 1789.

[127]For example, laws that prohibit smoking in public may attempt to prevent people from acting in accordance with social norms favorable to smoking but they may also attempt to alter those norms.

[128]*See, e.g.*, Janice Nadler, *Flouting the Law*, 83 TEX. L. REV. 1399, 1403-06 (2005) (discussing the idea that gaps between particular laws and individuals' sense of justice makes individuals less likely to comply with laws more generally).

[129]Elhauge, *supra* note 6, at 800.

more subtle effect. It would adjust managerial behavior by introducing liability risk and the social and moral sanctions that attach to the norm of obedience to law. Both of these forces would tend to shift managerial behavior towards the pursuit of profit and away from other goals.

Whether such a shift would be desirable is an open question. It is, in fact, a restatement of the basic normative issue in relation to shareholder primacy: is it desirable for managers to focus on profits? The argument that a legal duty to maximize profits would render moral and social sanctions unavailable as a means of regulation thus turns out to be a red herring. From an efficiency perspective, we cannot escape the question whether the agency cost advantages of encouraging managers to focus on a narrow goal (the pursuit of profit) outweigh the social costs entailed by corporate neglect of considerations other than profit.

2. A Nebulous Discretion to Transfer Wealth to Non-Shareholders

A second problem with Elhauge's argument is that it offers no theory about how the discretion it advocates is supposed to be exercised, other than that it is guided by "moral and social sanctions." As a result, we cannot be confident that the discretion will result in efficient resource allocations.

A discretion to sacrifice profits in the public interest is, in essence, a freedom to transfer wealth from shareholders to non-shareholders.[130] Elhauge recommends that this freedom be limited in amount to 10% of profits where the wealth transfer results from "altering corporate operations," and that it be unlimited where the managers merely forgo a profitable opportunity.[131] Elhauge also acknowledges that the scope of managers' freedom would be limited to the degree of slack left by market mechanisms, including the market for corporate control.[132] Within these essentially quantitative bounds, Elhauge's basic point is that it is beneficial for society if managers are free to transfer some wealth from shareholders to non-shareholders, as they see fit.[133] The discretion Elhauge advocates is not unbounded, but within the specified bounds it is absolute.

The point of the discretion is, of course, to enable social and moral sanctions to do their beneficial work. The expectation seems therefore to

---

[130]In deference to Elhauge's "baseline" argument, the discretion might alternatively be characterized as a discretion to allocate wealth between shareholders and non-shareholders, without affecting the analysis.

[131]Elhauge, *supra* note 6, at 845-46.

[132]*Id.* at 852.

[133]*See id.* at 868.

be that the interplay of social and moral sanctions will lead managers to make wealth transfers that are, on balance, socially beneficial. But Elhauge does not explain why this should be so. It is far from obvious why a centralized decision maker acting on feelings of guilt and virtue, valuing praise, wanting to avoid criticism, and otherwise simply serving his or her own ends, should produce superior resource allocation decisions than, say, the market.

In addition, one would expect that non-shareholders would engage in rent-seeking, which in Elhauge's terminology might translate into the production of social and moral sanctions in an effort to obtain "profit-sacrificing" decisions for their benefit. Shareholders might attempt to defend their interests by investing in the production of countervailing social and moral sanctions. The costs associated with these efforts cast further doubt on the claim that managerial discretion would be socially efficient.

3. When Managers Sacrifice Profits in the Public Interest, Is it Cost-free to the Shareholders?

As noted above, Elhauge does not specify his concept of efficiency. In much of his analysis, he appears to have in mind the maximization of an unspecified aggregative function of individual welfare.[134] However, Elhauge also appears to believe that patent profit-sacrificing discretion is Pareto-superior to shareholder primacy: it makes the non-shareholder beneficiaries of managerial largesse better off without harming shareholders. In Elhauge's words:

> [I]f agency slack is constant, any decisions managers made to sacrifice profits in the public interest would leave shareholders financially indifferent while still advancing the public interest views reflected in the social and moral norms to which managers are responding. . . . It is hard to see how [this] choice could possibly be undesirable.[135]

Although Elhauge's statement is expressed subject to the condition that "agency slack is constant," he adds that "there is little reason to think" that patent profit sacrificing discretion would increase agency slack.[136]

---

[134]*See, e.g.*, *id.* at 805 ("increase the satisfaction of societal preferences").

[135]Elhauge, *supra* note 6, at 806-07. *See also id.* at 807 ("Public interest causes benefit from such discretion, but shareholders do not suffer . . . .").

[136]*Id.* at 807.

By "agency slack," Elhauge means the amount of freedom that a manager has to deviate from the pursuit of corporate profits. In Elhauge's view, in light of the business judgment rule, the amount of "slack" is determined largely by market forces. A rule explicitly permitting managers to sacrifice profits in the public interest does not increase slack because "most" of the profit-sacrificing that occurs under an explicit rule could in any event be sustained under the business judgment rule. Indeed, given that an explicitly permissive rule frees managers of the need to pretend they are maximizing profits, they are more open in their decisions to exercise profit-sacrificing discretion in the public interest. This increased transparency actually reduces agency costs. It follows that a rule authorizing patent profit-sacrificing discretion in the public interest does not increase agency slack. Its only effect is that managers exercise some of their slack "in a socially responsible way" rather than to benefit themselves.[137]

The problem with this argument is that to the extent that its premise is valid, Elhauge's overall argument for the necessity of patent profit-sacrificing discretion is undermined. Elhauge's claim that it makes little difference to managers' freedom to sacrifice profits whether or not profit-sacrificing is prohibited undercuts his argument that a prohibition would impede managers from sacrificing profits in response to social and moral sanctions. Patent profit-sacrificing discretion is useful only to the extent that the managerial actions it authorizes would not otherwise be possible—in other words, only to the extent that it increases agency slack.

The argument also highlights an inconsistency in Elhauge's understanding of the relationship between law and norms. Elhauge predicts that a legal rule against sacrificing profits in the public interest would cause managers to desist from public-spirited profit-sacrificing and to engage instead in an equal amount of self-serving profit-sacrificing.[138] This prediction imagines that managers have no scruples about disregarding rules against self-dealing. But if managers attach so little weight to the norm of obedience to law, it is implausible that the mere existence of a rule prohibiting the sacrificing of profits in the public interest would suffice to divert managers from the profit-sacrificing course of action dictated by moral and social sanctions.

3. Synthesis

The most convincing branch of Elhauge's argument is that dealing with "latent" profit-sacrificing discretion. One can readily agree with the

---

[137] *Id.*

[138] *Id.* at 810-11.

notion that some degree of managerial discretion is inevitably entailed by the business judgment rule, and that the rule itself is desirable. This article has suggested, however, that Elhauge mischaracterizes his argument as an argument in favor of discretion to sacrifice profits in the public interest. Indeed, Elhauge's argument about the desirability of the business judgment rule and the resulting inevitability of latent discretion is arguably irrelevant to the debate about shareholder primacy. It does not speak to the question whether managers should be under a legal duty to maximize profits, but argues only against the devotion of infinite judicial and other public resources to the enforcement of such a duty, assuming there is one.[139]

More pertinent to the debate about shareholder primacy are the branches of Elhauge's argument dealing with "patent" profit sacrificing. Elhauge, however, does not succeed in his attempt to demonstrate that "social efficiency" and shareholder welfare favor explicitly authorizing managers to sacrifice profits in the public interest.

In relation to the efficiency argument, Elhauge fails to show that the aggregate welfare of all shareholders is maximized whenever the non-financial preferences of the majority are satisfied. He also mischaracterizes the social choice involved in relation to shareholder primacy as a choice whether to permit moral and social sanctions to operate or banish them from the set of regulatory tools at society's disposal. In fact, the choice we face is whether or not to encourage managers to pursue profit as opposed to other goals. This question has no uncontroversial answer. Elhauge's proposal is, in essence, that managers be empowered to allocate a "reasonable" amount of wealth between shareholders and non-shareholders as they see fit. The assumption that "society's social and moral norms . . . , as a group, improve behavior"[140] is a very thin reed on which to hang the claim that the resulting allocation will be efficient.

Finally, Elhauge's argument that patent profit-sacrificing discretion benefits non-shareholders at no cost to shareholders is implausible.

D. *The Efficiency Debate Is a Draw*

The conclusion of the foregoing analysis is that Blair, Stout, and Elhauge's respective attempts to refute shareholder primacy on efficiency grounds are unsuccessful. Blair and Stout's theory assumes, in essence, that the value to the team members of the mediating hierarch as a structural

---

[139]Elhauge finesses this point by formulating the question of latent discretion in terms of whether there should be an "enforceable" duty to maximize profits. *See* Elhauge, *supra* note 6, at 738.

[140]*Id.* at 804.

substitute for intra-team trust outweighs the cost to them of entrusting the coordination of their efforts to a leader who has no stake in their success. This is a questionable assumption.

Elhauge, on the other hand, fails to show that the aggregate welfare of all shareholders is maximized when the non-financial preferences of the majority are satisfied. He also does not succeed in demonstrating that a managerial decision to sacrifice profits in the public interest is costless to shareholders and he misstates the nature of the social benefit from relaxing shareholder primacy in a way that overstates the benefit. Accordingly, he fails to show that the cost of relaxing shareholder primacy in the way he proposes is outweighed by the benefits.

Readers should not conclude, however, that shareholder primacy is efficient. Rather, the efficiency debate is a draw.[141]

Shareholder primacy produces costs and benefits. Because the costs and benefits fall on different groups, any assessment of the net social welfare impact is *prima facie* impossible without an interpersonal utility comparison, and such comparisons are impermissible within welfare economics.[142]

Many proponents of shareholder primacy believe that this difficulty can be circumvented through an analysis of the corporation as a voluntary arrangement among the participants in the corporation. Since creditors, employees, and so on participate willingly, it must be that the terms of their participation are beneficial to them *ex ante*, i.e., when entered into. Shareholder primacy is said to be one of these terms because it reduces agency costs and, therefore, increases the overall expected profitability of the venture. From an *ex ante* perspective, at least, shareholder primacy is claimed to satisfy the Pareto criterion because it is part of an arrangement that when entered into is beneficial to all.[143]

There are, however, at least two difficulties with the contractarian defense of shareholder primacy. The first is that shareholder primacy is not unambiguously beneficial for the venture. Although it reduces agency costs, it imposes other costs on the venture. For instance, as Blair and Stout's analysis shows, shareholder primacy makes it more difficult for the venturers to induce irrevocable commitments of resources to the firm. In

---

[141]Stout, writing separately, has acknoweldged that the debate is inconclusive. *See* Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1200-01 (2002).

[142]DANIEL M. HAUSMAN & MICHAEL S. MCPHERSON, ECONOMIC ANALYSIS AND MORAL PHILOSOPHY 84 (1996).

[143]*But see* Chapman, *supra* note 55, at 561-71 (demonstrating that in light of the sequential nature of the contracts among the participants in the corporation—i.e., they are all not entered into simultaneously—it is possible to obtain a Pareto-inferior outcome in practice).

addition, it may be uneconomical to compensate non-shareholders *ex ante* for damage to their interests that might arise as a result of profit-maximizing activity to the extent that the damage relates to unlikely, but high-stakes events or to other risks that are difficult to estimate. Risk-averse non-shareholders may require a level of fixed compensation for exposure to high-stakes losses such that it would make more sense for the parties simply to agree that the profit maximization norm will not be applied if it exposes non-shareholders to such losses.[144] Because of these considerations, the claim that shareholder primacy is unambiguously advantageous to the participants, even *ex ante*, is doubtful.[145]

The second difficulty concerns persons adversely affected by corporate activities, who are not voluntary participants in the corporation. Even if shareholder primacy were beneficial to the participants in the corporation, this would not establish its efficiency if it led the corporation to cause harm to unwilling third parties, for example by committing torts or causing environmental damage. Proponents argue that shareholder primacy's superiority from the standpoint of agency costs implies that the interests of third parties should be protected through external regulation rather than by increasing managers' discretion within corporate law. As Elhauge observes, however, external regulation inevitably leaves gaps in the protection of third parties.[146] These gaps are a social cost of shareholder primacy. Whether the agency cost advantages of shareholder primacy outweigh these costs is a question that cannot be answered without interpersonal utility comparisons.[147]

In short, even from an *ex ante* perspective, efficiency cannot resolve the debate about shareholder primacy because the maximizing choice for the team is uncertain, and the maximizing choice for the team may not be the maximizing choice for society.

---

[144]Lee, *Responsible Shareholder*, *supra* note 6, at 51. There is also a worry that the non-shareholders have underestimated the risks.

[145]This discussion assumes, of course, that the participants have not explicitly provided for shareholder primacy, either by the inclusion of appropriate language in the corporation's constitutional documents or by incorporating in a jurisdiction in which shareholder primacy is unambiguously the law. It is because corporate charters never explicitly exclude consideration of non-shareholder interests, and because state law remains ambiguous, that the question arises whether shareholder primacy should be presumed on the ground that it is unambiguously advantageous to all of the participants.

[146]Elhauge, *supra* note 6, at 748.

[147]Because the third parties are, by definition, unconsenting, the need for interpersonal utility comparisons cannot be avoided by positing *ex ante* consent.

III. THE RELEVANCE OF MORALITY TO THE DEBATE ABOUT SHAREHOLDER PRIMACY

We will now consider the relevance of morality to the debate about shareholder primacy. Both Blair and Stout (timidly) and Elhauge (less timidly) introduce the idea of morality into the debate about shareholder primacy, but in each case an attempt is made to interfere as little as possible with the behavioral assumptions necessary to apply efficiency analysis.

In the discussion that follows, we shall primarily examine Elhauge's strategy of incorporating "moral and social sanctions" as a component of individuals' utility. It will be seen that Elhauge's strategy leaves him vulnerable to the argument often made by proponents of shareholder primacy that the market mechanism, rather than managerial discretion, is a better device for reconciling individuals' competing social, moral, and financial preferences.

Blair, Stout, and Elhauge overlook two other ways of thinking about morality which, although less obviously compatible with the efficiency framework, may provide more persuasive reasons for questioning the desirability of shareholder primacy.

A. *Economic Man (Modified)*

1. Behavioral Foundations of Efficiency Analysis

"The very logic of economic theory," according to George Stigler, requires the assumption that individuals maximize the satisfaction of their own interests.[148] This assumption underlies the traditional argument for shareholder primacy: if managers were unselfish, there might be less cause to worry about agency costs,[149] and if shareholders were unselfish, they might not insist upon the maximization of profits as the price of having only a residual claim on the firm's assets.

It is by challenging the assumption of individual selfishness, albeit in different ways, that both Blair and Stout and Elhauge construct arguments against shareholder primacy.

Consider first the team production theory. From one perspective, the theory departs radically from conventional behavioral assumptions. As its proponents themselves acknowledge, the trustworthiness required of

---

[148]Stigler, *supra* note 102, at 150.

[149]We might still worry, however, that without shareholder primacy they would lack a strong drive to maximize the value of the firm. *See supra* notes 41-45 and accompanying text (discussing the team production model).

directors "appears to clash with an economic analysis premised on calculations of rational self-interest."[150] Curiously, however, Blair and Stout's behavioral assumptions are perfectly orthodox when it comes to the members of the team, a much larger segment of society. Team members (investors, managers, employees, suppliers, and so on) are modeled as traditional *homines economici*, that is, as unqualifiedly self-interested. Indeed, the team members' self-interest is crucial in Blair and Stout's argument, which amounts to the claim that corporate participants, mistrustful of one another, best serve their own interests when they transfer control over the corporation's assets to the board of directors, a trustworthy hierarch. Blair and Stout's emphasis on managers' "trustworthiness" contrasts awkwardly with the mistrustful self-interestedness that they assume characterizes the team members.

At first glance, Elhauge's behavioral assumptions represent a more extensive departure from the orthodox economic view of human behavior. Elhauge writes that most individuals "comply with social promises, hold doors open for strangers, and refrain from lying and abusing each other's trust, even when doing otherwise is legal and personally beneficial."[151] Unlike Blair and Stout, Elhauge does not differentiate with respect to this basic amenability to decent behavior on the basis of the role played by the individual within the corporation. When, for example, Elhauge argues that shareholders are "insulated" from "social and moral sanctions,"[152] he is describing an attribute of the structure of corporations rather than an ethical incapacity inherent in the type of person who becomes a shareholder.

Yet, the individuals depicted by Elhauge remain utility maximizers. People act morally because their utility responds to "social and moral sanctions." In other words, in addition to the utility they derive from the satisfaction of their own interests, individuals derive positive utility from praise and feelings of virtue and they experience disutility from criticism and feelings of guilt.[153] Since they maximize their utility, moral individuals can still be the subject of "proper economic analysis," to use Elhauge's term.[154]

In particular, Elhauge's revised Economic Man, as well as Blair and Stout's more traditional version (the self-interested team members), are

---

[150]Blair & Stout, *Team Production*, *supra* note 5, at 316.

[151]Elhauge, *supra* note 6, at 753.

[152]*Id.* at 740, 798.

[153]For a critique of the utilitarian conception of individuals' felt obligation to comply with moral norms, see Lawrence E. Mitchell, *Understanding Norms*, 49 U. TORONTO L.J. 177, 226-33 (1999).

[154]Elhauge, *supra* note 6, at 738.

compatible with normative arguments sounding in efficiency. For example, Blair and Stout's argument is, in essence, that mediating hierarchy is *ex ante* Pareto-superior to shareholder primacy from the standpoint of the participants in the corporation. For his part, Elhauge argues that managers maximize shareholders' utility, even if they do not maximize their profits, if the corporation's activities generate social or moral satisfaction for the shareholders.[155] He also argues that social and moral sanctions lead managers to act in socially desirable ways—ways that increase some aggregation of individuals' utility—even when they depart from the interests of the shareholders.[156]

The shortcomings of Blair, Stout, and Elhauge's arguments have already been discussed and will not be repeated here. Instead, an important implication of Elhauge's strategy of incorporating moral sentiments within utility while retaining efficiency as the normative criterion will be highlighted. Specifically, the notion that individuals' utility includes social and moral satisfaction invites the question whether markets, rather than managerial discretion, are the appropriate mechanism for reconciling the competing preferences.

2. The Market for Social Responsibility

The argument for market-based social responsibility has been most recently articulated by Larry Ribstein. According to Ribstein, "[M]arkets now are much better able to reflect all political and social tastes . . . than they were in early corporate history."[157] Shareholders reveal their social and moral preferences by investing in corporations of whose practices they approve and avoiding corporations of whose practices they disapprove.[158] Shareholders may, of course, choose to focus on risk and return and ignore morally dubious conduct by corporations in which they invest, but this, too, reveals a preference—for profits. Similarly, consumers may reveal their social and moral preferences through their choices in product markets. If they wish, "[c]onsumers can demand not only better designed and

---

[155] *Id.* at 784.

[156] *Id.* at 785.

[157] Ribstein, *supra* note 89, at 3. *See also* Larry Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. ____ (2005 - forthcoming), *available at* http://ssrn.com/abstract=746844 (last visited Apr. 10, 2006); Arthur A. Small & Joshua Graff Zivin, *A Modigliani-Miller Theory of Corporate Social Responsibility* (Aug. 2002), *available at* http://ssrn.com/abstract=325921 (last visited Feb. 11, 2006) (developing a theory of corporate social responsibility as involving a market in which firms compete to provide "charity-related 'warm glow'" utility to customers, employees, investors and others).

[158] Ribstein, *supra* note 89, at 15.

manufactured products and lower prices, but also that the product be made in a socially responsible way."[159] In all of the markets in which the corporation is active, each individual's choices may be expected to reflect utility-maximizing tradeoffs among his or her material, social and moral preferences.

Within the efficiency framework, the case against markets typically rests on a market failure, such as problems of inadequate information or collective action. Elhauge in fact offers arguments along these lines. He argues, for instance, that socially conscious consumers may not be able to obtain the information necessary to determine what particular corporations have done and "whether that conduct was desirable given all the facts."[160] In addition, Elhauge argues that even informed, socially conscious consumers and shareholders face collective action problems.[161] The argument is that a rational, albeit socially conscious consumer or shareholder has an incentive to free-ride on the efforts of other socially conscious consumers or shareholders. In concrete terms, even a consumer who values a clean environment will, if rational, not pay more for an "environmentally friendly" product, because (1) if other consumers purchase environmentally friendly products, "she knows that the [environmental] harm will be stopped regardless of what she does, so she might as well take the [lower-priced product]"; and (2) if other consumers do not purchase environmentally friendly products, her own purchase of environmentally friendly products will not "stop the . . . harm from occurring but will cost her" money.[162]

But these arguments about market failure have limitations of their own. For example, there is a market for information about corporate behavior. An argument is needed (and Elhauge does not provide one) as to why if consumers do not possess information about corporate behavior it is because the information is not available, as opposed to their not being willing to pay for it.[163] As for Elhauge's argument about free-riding by environmentally conscious consumers, it assumes that the satisfaction of

---

[159] *Id.* at 16.

[160] Elhauge, *supra* note 6, at 750.

[161] *Id.*

[162] *Id.* at 750-51.

[163] Such an argument might draw on the "public good" character of information. The argument is that information is underproduced because people are reluctant to pay for information that, once produced, can be used even by people who have not paid for it. This argument has been discussed elsewhere in this article, suggesting that it applies only to information obtained from third parties and not to information that would be produced by the corporation itself, which can recover the cost of information desired by consumers through the price of its products. *See* Lee, *Responsible Shareholder*, *supra* note 6, at 68.

social and moral preferences is a public good. This may be the case in relation to preferences for states of the world (e.g., a clean environment), but it is not the case insofar as individual utility responds to "social and moral sanctions," as Elhauge conceives of them. Criticism, praise, and feelings of guilt and virtue attach to a person's own acts and omissions. A person does not receive praise or derive feelings of virtue as a result of other consumers' purchase of environmentally friendly products. Since the avoidance of criticism and guilt and the enjoyment of praise and feelings of virtue are private goods, there can be no argument that a collective action problem makes the market an unreliable indicator of people's tradeoffs between these and other sources of utility.

If, as Ribstein argues, the maximization of aggregate utility—even expanded to include individuals' social and moral preferences—is more likely to be achieved through the market mechanism than by "trusting autocratic corporate managers,"[164] then it follows that managers should focus on maximizing corporate profits and leave the allocation of resources to the public interest to others who are spending their own money.

It is possible to argue against market-based social responsibility and its corollary, shareholder primacy, but the most persuasive arguments seem to lie outside the framework of efficiency.

B. *Justice and Commitments*

In their commitment to efficiency, Blair, Stout, and Elhauge overlook two other ways in which morality is relevant to the normative debate about shareholder primacy. First, to the extent that some business decisions raise questions of justice,[165] it is inappropriate to leave such questions to be determined by the interplay of markets. While governmental regulation is, of course, often concerned with justice, it is not the case that what the law does not prohibit and market forces do not prevent is, therefore, just. It may be argued that shareholder primacy, if it is otherwise socially desirable, should at least be qualified so as not to require managers to perpetrate injustice.

The terms "morality" and "justice" may raise red flags for readers skeptical of deontology and inclined toward consequentialism. It can be argued, however, that even from a consequentialist perspective, moral

---

[164]Ribstein, *supra* note 89, at 19.

[165]The term "justice" is used rather than "morality" because the former term is more familiar in this context. In doing so, this does not mean to suggest a distinct concept. It is taken for granted that questions of justice are moral questions.

judgments are inevitable and, in particular, are relevant to the assessment of the desirability of shareholder primacy.

Second, individuals' preferences may be more complicated than efficiency theorists typically assume. Choices in the market are not the only evidence of what individuals believe contributes to their welfare and, in particular, the information markets convey may be incomplete in relation to individuals' moral commitments. This observation undermines the suggestion many proponents of shareholder primacy make for exclusive reliance on the market mechanism as a clearinghouse for the "social and moral preferences" of consumers, investors, and others. This consideration provides a justification for corporate institutions in which both market and deliberative mechanisms are present.

1. Some Business Decisions Raise Questions of Justice

Virtually no analysts claim that efficiency is a comprehensive normative framework.[166] It is uncontroversial, for instance, that we may form normative judgments about policy alternatives on grounds other than efficiency when efficiency is silent as between them—e.g., neither is Pareto-superior to the other. There may even be good reasons to reject a policy that efficiency analysis, especially the Kaldor-Hicks variety, would recommend. It should not be surprising, therefore, that considerations other than efficiency are relevant to the assessment of the desirability of shareholder primacy. Considerations of justice, in particular, may be relevant.

a. *Deontological Argument*

For anyone who believes in the special importance of rights, the foregoing claim should be easy to accept. To be sure, the maximization of profits will sometimes be consistent with respect for rights. This may be true, for example, to the extent that the corporation's profitability depends on the rightsholders' cooperation or on the cooperation of others with sympathy for the rightsholders. In other words, people may have sufficient marketplace power, or attract the sympathy of others with power, to ensure that their rights are respected. In addition, governments may enact laws, backed by fines or other sanctions, to protect the rights of those without

---

[166]To the contrary, *see, e.g.*, RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 374-387 (1990); Daniel A. Farber, *Economic Efficiency and the Ex Ante Perspective*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 54, 56 (Jody S. Kraus & Steven D. Walt eds., 2000); KAPLOW & SHAVELL, FAIRNESS VERSUS WELFARE, *supra* note 104, at 37; Richard A. Posner, *The Ethics of Wealth Maximization: Reply to Malloy*, 36 KAN. L. REV. 261, 263 (1988).

power, further aligning the maximization of profits and respect for rights. However, on the inevitable occasions when profit-maximization and rights do not coincide, shareholder primacy would place managers under a legal obligation always to choose profits.

Shareholder primacy is morally problematic to the extent that it places managers under an obligation to subordinate rights to profits whenever the two collide. Let us consider the following concrete example. Should a manager supply a genocidal regime with equipment that he or she has reason to believe is being used in carrying out a slave labor program? Is supplying the equipment profitable, taking into account public relations issues and liability risk? It is submitted that these questions are not equivalent—in fact, the first question is a moral question, while the second is an empirical question. Shareholder primacy's conflation of the two questions should give us pause.

One need not be an absolutist about rights in order to have qualms about shareholder primacy. Shareholder primacy is inconsistent with any belief that rights have special value, even if they may be overridden in exigent circumstances.[167] Under shareholder primacy, managers must attach no special normative weight to rights, but, rather, take rights into account only to the extent that regulatory law or the corporation's most important investors (customers, suppliers, and so on) compel them to.

b. *Consequentialist Argument*

It may appear that in making the foregoing claims this article is taking sides in the debate about consequentialism and deontology. Even consequentialism's defenders, however, do not deny that policy analysts must make value judgments.[168] Such judgments are inevitable because of the need to weigh consequences—costs and benefits—falling upon different individuals.

Consider again the question whether a corporation should supply equipment useful to an oppressive regime's slave labor program. Any comparison between the respective utilities and disutilities experienced by the individuals affected will necessarily involve a moral judgment about, for example, the value of some people's freedom from enslavement

---

[167]These are the "mixed normative views" criticized by Kaplow and Shavell. *See* Kaplow & Shavell, *Notes on the Pareto Principle*, *supra* note 104, at 333-35.

[168]*See, e.g.*, *id.* at 340-41. *See also* Daniel A. Farber, *What (If Anything) Can Economics Say About Equity?*, 101 MICH. L. REV. 1791 (2003) (reviewing LOUIS KAPLOW AND STEVEN SHAVELL, FAIRNESS VERSUS WELFARE) (discussing the ways in which "fairness" creeps into Kaplow and Shavell's purportedly non-deontological model of social choice).

compared to the benefit other people would obtain from the transaction. Through such judgments, morality enters into the debate about shareholder primacy even for consequentialists. Even a consequentialist can have misgivings about the fact that under shareholder primacy, in the decision whether to sell equipment to an oppressive regime, the interests of the regime's victims count for less than the disutility the corporation's customers in wealthy countries experience from knowing that people are being oppressed. It is not disputed here that managers should not generally be in the business of maximizing social welfare. It may well be that in pursuing a narrower goal (profits) managers are usually more likely to maximize social welfare than in pursuing the latter goal directly.[169] But just as Louis Kaplow and Steven Shavell observe that social norms, despite being "useful . . . rules of thumb that promote individuals' welfare," may sometimes "lead us astray,"[170] so too may profit maximization sometimes lead managers astray. To be sure, one purpose of governmental regulation is to identify and attach sanctions to social welfare-reducing acts. Through markets, persons adversely affected by corporate activities may also be able to compel profit-focused managers to internalize the social costs of those activities.[171] It cannot be ruled out, however, that, in some circumstances, an act, although not legally prohibited and not punished by markets, may be so obviously social welfare-reducing that despite managers' general lack of expertise at social welfare maximization it does not make sense to hold them to profit maximization.[172] This may be especially likely to happen where the profit-maximizing course of action would severely impair or destroy important interests of third parties lacking in economic or political power. The term "justice" may be a suitable label to distinguish these cases from mere matters of public policy.

---

[169]Allen, *supra* note 98, at 269-70; Hansmann & Kraakman, *supra* note 3, at 441.

[170]KAPLOW & SHAVELL, FAIRNESS VERSUS WELFARE, *supra* note 104, at 68, 73. *See also* Cass R. Sunstein, *Fast, Frugal, and (Sometimes) Wrong* (University of Chicago Public Law and Legal Theory Working Paper No. 110, Nov. 2005).

[171]*See* Coase, *supra* note 111, at 10-11. Coase illustrated this point using the example of pollution. If there are no transactions costs, the "victims" of pollution can offer to pay a polluter to discontinue it, and if the harm to the affected persons exceeds the polluters' profits from the activity, the offer is likely to be accepted.

[172]Presumably, this intuition underlies the suggestion made by some critics of shareholder primacy that a line should be drawn at the "infliction of serious harm" on non-shareholders. *See* Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1420-21 (1993).

2. Individuals Have Commitments

As a behavioral concept, morality may be more complicated than the "moral and social sanctions" approach recognizes. The argument that follows takes issue with the claim made by defenders of shareholder primacy that markets are the most appropriate mechanism for making tradeoffs among the social, moral and financial preferences of investors, consumers and other corporate participants. The basis for the argument developed below is that choices in the marketplace are not the only, and may not be the best source of information in relation to an individual's ethical commitments.

Several authors—notably Amartya Sen—have suggested a conceptual distinction between self-interested and sympathetic motivations, and between those motivations and commitments.[173] Thus, for example, while traditionalists assume that individuals are generally self-interested,[174] meaning that their utility is independent of the utility of others, most economists accept that, to varying degrees, individuals are motivated by sympathy, meaning that they also derive positive utility from the utility of other individuals.[175] In addition to self-interest and sympathy, a distinct concept—commitment—may be useful in describing motivations that conflict with self-interest and sympathy. It may be helpful to think of commitment in understanding, for example, why some otherwise rational citizens trouble themselves to vote in elections, an act which is very difficult to understand in terms of self-interest or sympathy in light of the well-known problem of non-pivotality.[176]

---

[173]HAUSMAN & MCPHERSON, *supra* note 142, at 62-64; Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 326-27 (1977).

[174]Stigler, *supra* note 102, at 179.

[175]*See, e.g.*, Posner, *supra* note 105, at 1557; Sen, *supra* note 173. Even Stigler accepts a limited degree of sympathy in acknowledging that individuals' utility depends on the welfare of their family and close associates. Stigler, *supra* note 102, at 189.

[176]Given the extreme rarity with which an election result is so close that it can be said to have turned upon a single vote, the individual as modeled by rational choice theorists has little reason to cast a vote even if he or she is not indifferent to the outcome, because the vote will have no impact on the outcome. For attempts to explain why many individuals nevertheless do vote, see John H. Aldrich, *Rational Choice and Turnout*, 37 AM. J. POL. SCI. 246, 273 (1993) (discussing rational choice models of voter turnout and suggesting that voting may be based on "long-term political considerations" rather than based on a desire to influence an immediate electoral outcome); Arthur J. Jacobson & John P. McCormick, *The Business of Democracy Is Democracy*, 3 INT'L J. CONST. L. 706, 720 (2005) (suggesting that individuals vote, even though "rational calculation counsels against it," because not voting "contradicts the premise of [their] life in a democracy.").

Sen models commitments as "meta-rankings."[177] The ranking of actions reflected in a person's actual choices is only one possible such ranking for that person; another ranking might be drawn up based solely upon self-interest, a third based on both self-interest and sympathy. There is, of course, no limit to the number of possible rankings. Sen conceptualizes commitment as a ranking on these rankings. That is, one of the three examples of rankings provided above, or some completely different ranking, is the highest-ranked ranking according to a particular commitment.

The point of conceptualizing commitments as meta-rankings rather than folding them into a single, undifferentiated concept of utility is to drive a conceptual wedge between choice and welfare.[178] What a person actually does is the highest-ranked action according to one of his or her rankings, but it may not be the highest-ranked action according to his or her highest-ranked ranking.

The foregoing discussion has been rather abstract, but the difference between a framework that includes commitment and the more conventional single-utility framework may be illustrated in more concrete terms by considering the phenomenon of weakness of will.[179] If a person gives in each day to the temptation not to exercise, the traditional understanding is that the person has "revealed a preference" for passive leisure over fitness, but an alternative interpretation is that the choice may be at odds with his or her higher-order preferences.

For defenders of the conventional approach, defeated higher-order preferences are a distraction, and only a person's actual choices are of significance in terms of describing the person's welfare. In other words, what a person chooses is what she *actually* prefers, all things considered, regardless of what in more reflective moments she may say that she prefers. But it is important to understand that the economists' definition of welfare in terms of choice is a methodological device, rather than a provable

---

[177]Sen, *supra* note 173, at 337-39.

[178]Timothy J. Brennan, *A Methodological Assessment of Multiple Utility Frameworks*, 5 ECON. & PHIL. 189, 202-03 (1989); Jules L. Coleman, *The Grounds of Welfare*, 112 YALE L.J. 1511, 1540-41 (2003). Commentators writing about meta-rankings often take pains to point out that "higher-order preferences" need not be particularly virtuous, see Sen, *supra* note 173, at 335, 344; Brennan, *supra*, at 203-04—for example, ethnic nationalism can be the basis for a meta-ranking. The notion of commitments as meta-rankings or higher-order preferences provides only a structure for articulating the gap between choice and welfare. There is no claim that human beings, for having and acting on commitments, are "excessively noble." Sen, *supra* note 173, at 344.

[179]Sen, *supra* note 173, at 340.

hypothesis about either welfare or choice. The identity of choice and welfare is certainly not intrinsic to the notion of welfare.

The contrary position, defended by Sen, is that we underdescribe an individual's welfare if we define it by reference solely to the way in which the individual acts and ignore the way in which he or she would like to act (i.e., his or her preferences about preferences). Sen is in effect inviting us to diversify our sources of information about individuals' welfare and to consider, in addition to the information that is revealed by actual choices, the information that may be revealed by "introspection and communication."[180]

By being willing to conceptualize welfare as a broader notion than choice, to envisage that individuals do not on every occasion for choice take the action that maximizes their welfare, and to consider that "revealed preference" is only one (albeit an important one) source of information about an individual's welfare, we gain insight into the otherwise difficult-to-understand suggestion by some commentators that individuals behave differently as consumers than as citizens.[181] Whereas Elhauge searches for the explanation for consumer social apathy in informational or collective action problems,[182] an additional explanation for the observed discrepancy may be that the introspection, deliberation, and discussion characteristic of political participation provide different welfare information compared to markets, which reveal only individuals' choices.[183]

Moreover, we may question whether the ascertainment and reconciliation of individuals' ethical commitments are best left to markets for social responsibility, as some defenders of shareholder primacy contend. There may also be a role for mechanisms of discussion and deliberation, which will provide additional information about this aspect of individuals' welfare beyond that which can be obtained by observing their choices in the market.

There is, of course, a risk involved in questioning the identity of individuals' choices and their welfare that an analyst will project onto others the analyst's own conception of the good life. Nevertheless, it should not be a matter of indifference to a welfarist that individuals' welfare may not always be maximized by their choices and that in relation to ethical

---

[180] *Id.* at 399-40.

[181] *See, e.g.*, JOEL BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER 146 (2004); Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEG. STUD. 1059, 1090 (2000). Public choice theorists dispute this suggestion. *See, e.g.*, JAMES M. BUCHANAN & G. TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962).

[182] Elhauge, *supra* note 6, at 749-51.

[183] *See* Sen, *supra* note 173, at 342.

and other commitments, other sources of information, such as discussing the matter with them, may also be revealing.

3. Deliberation in the Corporation?

Proponents of shareholder primacy might concede that deliberation should have a role in social decision making but nevertheless defend shareholder primacy on the theory that deliberation should be confined to the governmental sphere and the corporate sphere preserved as a space for market-based interactions. Within ministries, administrative agencies, and legislatures, policymakers may inquire as to the preferences that individuals may hold even if those preferences do not register in individuals' marketplace choices. By contrast, in the private sphere (including corporate decision making), while the laws emanating from the public sphere should be complied with, the market mechanism should otherwise prevail. The aggregated preferences of customers, employees, suppliers, and so on, as revealed in the corporation's markets, should determine what products a corporation makes, how it makes them, and to whom it sells them.

It is not clear, however, that there is a good reason why either the government or the corporate sphere must be the exclusive domain of one type of mechanism. As a descriptive matter, of course, the governmental sphere is not a purely deliberative system: for example, federalism ensures that "revealed preference" plays a role in determining who is subject to what law. In this connection, we may recall Roberta Romano's characterization of law as a product in which, in a federal system, there is a competitive market.[184]

Similarly, deliberative and market mechanisms co-exist within corporate governance. Economic analysts of the corporation typically focus almost exclusively on market mechanisms, especially the market for corporate control. But the deliberative mechanism is also present in corporate governance. The mechanism is most strikingly reflected in the organization of the two principal decision-making organs within the corporation: the board of directors and the shareholders' meeting. The board and the shareholders are collective bodies for the taking of collective decisions. They are empowered to act only as a group, and their

---

[184]Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 225 (1985). *See also* Larry E. Ribstein, *A Standard Form Approach to Same-Sex Marriage*, 38 CREIGHTON L. REV. 309, 334 (2005) (describing jurisdictional competition as creating a "market for marriage laws").

paradigmatic method of acting is by decisions taken at a "meeting."[185] Corporate law lays down default rules and minimum procedural standards for meetings of boards and shareholders,[186] and federal law gives shareholders the right to require corporations to circulate in advance of the meeting, at corporate expense, the text of a proposed resolution and a statement in support of the resolution.[187]

Also contributing to preserving a role for the deliberative mechanism within corporate governance are the Delaware courts' persistent refusal to resolve the controversy as to whether non-shareholders' interests may receive independent consideration,[188] and the courts' tolerance, in practice, of directorial decisions taking non-shareholders' interests into account or adopting a "long-term" perspective on the interests of shareholders. As a result, Delaware law does not, for example, require directors to approach their decisions as an exercise in maximizing the stock price,[189] and in practice directors have the flexibility to make their decisions with due regard for ethical considerations. With respect to shareholder deliberation, of course, the legal situation is clearer still: there is no doubt that shareholder proposals on social responsibility grounds are permissible.[190]

The descriptive claim here is not that the deliberative mechanism predominates in corporate governance. The claim defended here is, more modestly, that the structure of the corporation accommodates the use of argument and exchanges of reasons—and not only the aggregation of interests revealed by market actors—in the decision-making processes of its two most important organs. There is thus a hybrid system in practice.

---

[185]DEL. CODE ANN. tit. 8, § 141(f) (2001) (permitting the directors to act without meeting only if the directors consent unanimously to the decision to be taken); *id.* § 228(a) (permitting shareholders to act without meeting only if an absolute majority of the shareholders consent to the decision to be taken).

[186]*Id.* § 211 (default rules for shareholders' meetings); *id.* § 222 (notice requirements for shareholders' meetings); §141(g) (directors may meet in- or out-of-state); *id.* § 141(i) (directors may "meet" through the use of telecommunications equipment). Corporations typically flesh out these rules slightly in their bylaws.

[187]17 C.F.R. § 240.14a-8 (2005).

[188]*See supra* text accompanying note 97.

[189]An exception arises when a corporation undertakes a transaction which will cause a change in corporate control or a break up of the corporate entity. *See Paramount Commc'ns*, 637 A.2d at 48.

[190]*See* Final Rule: Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 34-40018 (May 21, 1998) (stating that proposals raising "social policy issues" will not be found automatically excludable under the Rule 14a-8(i)(7) "ordinary business" exclusion, but rather will be determined on a case-by-case basis). *See also* Med. Comm. for Human Rights v. SEC, 432 F.2d 659, 681 (D.C. Cir. 1970) (vacating SEC decision granting no-action relief to corporation seeking to exclude a shareholder social responsibility proposal).

To many proponents of shareholder primacy, the coexistence of market and deliberative mechanisms within the corporation seems internally contradictory. They hope that a perfectly robust market for corporate control will render directorial authority and the specification of directors' duties irrelevant,[191] and they dismiss shareholder voice as anachronistic[192] or demote it to a role in support of the market for corporate control.[193]

This article's normative suggestion is that the deliberative elements in the system are not irrelevant, anachronistic, or ancillary. Rather they are part of an arrangement that can be understood, in contractarian terms, as one to which reasonable shareholders adhere because in addition to seeking protection for their financial interests, shareholders also have ethical commitments. The deliberative structure of corporate organs combined with the flexibility afforded by an ambiguous fiduciary duty standard make it possible for corporate actors—including directors, managers and shareholders—to deal appropriately[194] with ethical questions arising in the course of the corporation's business. On the other hand, the shareholders' liquidity and the market for corporate control provide shareholders with protection from "excessively responsible" corporate policies and from ethical judgments with which they disagree.[195]

---

[191]Henry G. Manne, *A Free Market Model of a Large Corporation System*, 52 EMORY L.J. 1381, 1392 (2003).

[192]*See* Stephen Bainbridge, *Can Shareholders Use the Bylaws to Limit Director Compensation*, ProfessorBainbridge.com, *available at* http://www.professorbainbridge.com/2004/05/can_shareholder.html (last visited July 22, 2005) (describing shareholders' right to initiate bylaw amendment by way of a shareholder proposal as a "historical anachronism").

[193]Thus, for example, they conceptualize shareholder voting not as an opportunity for shareholders to participate in deliberative governance, but as an element of the "market for corporate control." *See* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?*, 24 J. CORP. L. 837, 850-51 (1999) (arguing that although stockholder voice is "radically limited," voting is nonetheless important because of its role in the market for corporate control); *see also* Bainbridge, *supra* note 2, at 568-70 (arguing that stockholder voting rights do not provide stockholders with any decision-making power within the corporation or control over the board of directors; they support the takeover market, a mechanism of "market-based accountability").

[194]By "appropriately," it is not meant that all or even most of the shareholders will necessarily agree with the decision, but that the directors will be able to approach the choice appropriately, as raising an ethical question.

[195]Shareholders may derive additional protection from the fiduciary duty which, as ambiguous as it is, nevertheless provides managers with additional reasons to be attentive to the shareholders' interests. The risk that a manager will be held liable for preferring non-shareholders' interests over the interests of shareholders may be very small, but it is presumably not zero.

IV. CONCLUSION

Blair and Stout, and Elhauge's respective attempts to defend alternatives to shareholder primacy on efficiency grounds foundered because they seemed to demand too much of those who control corporations. In the case of Blair and Stout, we were asked to believe, implausibly, that the selfish interests of a team of co-venturers are best served when control over the venture is vested in an outsider designed to be unaccountable to the co-venturers and to have no stake in the success of the venture. Elhauge, on the other hand, failed to persuade us that discretionary wealth transfers by managers wishing to attract praise rather than criticism and to feel virtuous rather than guilty, and otherwise simply serving their own ends, are an efficient resource allocation mechanism.

This article has suggested, moreover, that the efficiency framework obscures moral considerations that are relevant to the debate, and that some of the more persuasive reasons for questioning the desirability of shareholder primacy sound in morality, rather than efficiency. Especially troubling is the fact that shareholder primacy substitutes questions of profitability for all questions of justice that may arise in the conduct of business.

Nevertheless, there are at least three important insights in Blair and Stout and Elhauge's respective analyses. First, Blair and Stout's analysis highlights the idea that a corporation is a "nonmarket institution embedded within the market economy."[196] This idea originates, of course, with Ronald Coase, who famously argued that firms arise where the transactions costs of repeated market interactions justify a structure in which allocative decisions are made by fiat.[197] The conceptualization of managerial decision making as a form of non-market allocation was implicitly criticized in early literature on the nexus of contracts,[198] but today many contractarians acknowledge its descriptive salience.[199]

---

[196]Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 307 (1993) (describing a characterization implicit within Ronald Coase's theory of the firm). *See also* Kostant, *supra* note 31, at 695-96 (praising the team production model for recognizing the importance of political mechanisms as complements to market mechanisms).

[197]R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390-93 (1937).

[198]*See* Alchian & Demsetz, *supra* note 11, at 777; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

[199]*See* Bainbridge, *supra* note 2, at 573; Ribstein, *supra* note 89, at 3.

Second, Blair and Stout conceptualize the corporate form as a structural commitment device.[200] Under the team production theory, members of the corporate "team" place their contributed resources under the control of an independent board in order to protect one another from mutual exploitation.[201] Writing separately, Stout has analogized shareholders to Ulysses, and described their investment in director-controlled corporations as akin to "tying their own hands."[202]

Third, Elhauge recognizes that corporate law should accommodate non-self-interested individual behavior, for example by investors. This author has written elsewhere of the regrettable tendency of some defenders of shareholder primacy either to dismiss investors' ethical commitments as extraneous to an investment decision or else to disparage their exercise of shareholder voice as presumptively pernicious rent-seeking.[203] The healthy suspicion that individuals' self-interest often prevails over their sympathy and ethical commitments risks becoming pathological if we become unable to comprehend and accommodate the exercise by individuals of their ethical and empathetic faculties when it occurs.

The foregoing insights reveal the corporation to be an organization in which both deliberative and market mechanisms co-exist. People might conceptualize the usefulness of deliberative mechanisms within the corporation in terms of transaction costs, as Coase did, but they may alternatively think of it in ethical terms, given the importance of deliberation as a means of eliciting, challenging, and reconciling individuals' ethical commitments and resolving questions of justice arising in the course of the corporation's business.

No claim is made that a corporation with both market and deliberative features is "more efficient" than shareholder primacy. Some people are made better off, but others are undoubtedly made worse off by such a structure—especially people with great economic power. Also, no claim is made that "rational utility maximizers" would choose this structure. It

---

[200]*Compare* Blair & Stout, *Team Production*, *supra* note 5, *with* Henry Hansmann & Reinier Kraakman, *Organizational Law as Asset Partitioning*, 44 EUR. ECON. REV. 807 (2000). *See also supra* text accompanying note 61 (promoting a sense of loyalty by having all members share in the team's success).

[201]*See also* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003) (arguing that the corporate form became popular in the late nineteenth century because of its utility as a device for committing resources to a venture).

[202]Stout, *supra* note 45, at 670. Mitchell has also used the Ulysses analogy, proposing that we "tie ourselves to the mast," by which he means reducing board accountability to shareholders, as a way of reducing profit-seeking incentives that he believes to be the root of irresponsible corporate behavior. *See* MITCHELL, *supra* note 6, at 11.

[203]Lee, *Responsible Shareholder*, *supra* note 6, at 58-60.

is, however, a structure that we can reasonably believe that people with commitments, valuing justice, and understanding that ethical questions can sometimes arise in the course of business, but not wanting to leave themselves excessively vulnerable to exploitation, might choose for themselves.