

SHAREHOLDERS, NONSHAREHOLDERS AND CORPORATE LAW: COMMUNITARIANISM AND RESOURCE ALLOCATION

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I. INTRODUCTION

For years now, debates over the proper scope and content of corporate behavior and corporate law have exhibited one regularity: they almost always involve a clash between those who treat corporations as contractually-based, profit-maximizing entities, and those who wish corporations could be made to be something else. As David Millon, one of the most prolific recent authors in the latter camp, puts it, two visions animate such debate over corporate law, "a public law, regulatory concept of corporate law on the one hand, and a private law, internal perspective on the other."¹ Millon elaborates:

The abidingly crucial issue in corporate legal theory has been the public/private distinction. Whether corporate law is thought to be one or the other reflects a choice between a body of law concerned solely with the techniques of

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1. David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 202.

shareholder wealth-maximization or, instead, a body of law that embraces and seeks to promote a richer array of social and political values.²

Several other authors have recently sounded this theme. For example, Martin Lipton argues that current corporate law "places stockholder wishes [and] stockholder profit . . . on an undeserved pedestal."³ Lawrence Mitchell criticizes "the parochial and outmoded focus of corporate law on stockholder wealth maximization."⁴ Mitchell proposes instead that the law should recognize "the pluralistic nature of the corporation"⁵ and not "abdicate[] its function as a socializing tool [by leaving] the redressing of individual and societal wrongs to the forces of competition."⁶ Lyman Johnson attacks "a radically proshareholder vision of corporate endeavor [as] substantially out of line with prevailing social norms."⁷ Johnson proposes that judges recognize this deviation and define "the meaning of corporate endeavor"⁸ by referring to "norms with approval wider than the thin thread of shareholder primacy."⁹

This recent scholarship strongly resembles the work of Professor Merrick Dodd who, more than sixty years ago, argued that the corporation "has a social service as well as a profit-making function"¹⁰ According to Dodd, "[B]usiness is permitted and encouraged by the law primarily because it is of service to the *community* rather than because it is a source of profit to its owners."¹¹

2. *Id.*

3. Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 253 (1991).

4. Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 640 (1992).

5. *Id.* at 586.

6. *Id.* at 641.

7. Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 934 (1990).

8. *Id.* at 873.

9. *Id.* at 934.

10. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932) (responding to Adolf Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931)). The so-called "Berle-Dodd debate" continued, at intervals, over a 20 year period. Two interesting assessments of the debate are A.A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33 (1991), and Joseph L. Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964).

11. Dodd, *supra* note 10, at 1149 (emphasis added).

Because their work echoes Dodd's, we will refer to Johnson,¹² Lipton,¹³ Millon,¹⁴ Mitchell,¹⁵ and others who favor the "public law" conception of corporate law¹⁶ as "communitarians."¹⁷ In short, the communitarian approach to corporate law seeks to undermine the law's distinction between "public" and "private" spheres of activity.¹⁸ For example, Millon deplors "the emptiness of the public-

12. See Johnson, *supra* note 7; Lyman Johnson, *Corporate Takeovers and Corporations: Who Are They For?*, 43 WASH. & LEE L. REV. 781 (1986); Lyman Johnson, *State Takeover Statutes: Constitutionality, Community, and Heresy*, 45 WASH. & LEE L. REV. 1051 (1988). Johnson has coauthored several articles on this subject with David Millon, including: Lyman Johnson & David Millon, *The Case Beyond Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846 (1989) [hereinafter Johnson & Millon, *Missing*]; Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862 (1989).

13. See Lipton & Rosenblum, *supra* note 3; Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987).

14. See Millon, *supra* note 1; David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991) [hereinafter Millon, *Redefining*]; David Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 WASH. & LEE L. REV. 903 (1988) [hereinafter Millon, *Rebirth*]. Also see the articles Millon coauthored with Lyman Johnson, collected in *supra* note 12.

15. See Mitchell, *supra* note 4; Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263 (1992).

16. For example, Lucian Bebchuk's recent call for a "significant expansion" of the federal government's role in corporate law risks a communitarian result. Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1437 (1992). Bebchuk argues that the decision as to the scope of protection of nonshareholder interests should be made at the federal level, rather than by the states. *Id.*

17. A group of academics, led (in some sense) by sociologist Amitai Etzioni, has recently adopted the term "Communitarian" to refer to the social and political philosophy they espouse. These writers "share a belief that the liberal theories that have dominated English-speaking politics for centuries place too much emphasis on individual rights and not enough on community needs and civic obligations." Karen J. Winkler, *A Scholar Seeks the Multicultural Middle Ground*, CHRON. OF HIGHER EDUC., Dec. 9, 1992, at A8 (discussing the work of Canadian political scientist Charles Taylor). See generally *The Responsive Communitarian Platform: Rights and Responsibilities*, THE RESPONSIVE COMMUNITY, Winter 1991-92, at 4 (outlining the generally accepted principles of the communitarian perspective). This sort of communitarianism is currently fashionable in many academic circles and in some political circles as well, including the nascent Clinton Administration. William Galston, a communitarian academic and a member of the Clinton "transition team," sketched the current popularity of communitarian ideas in *Clinton and the Promise of Communitarianism*, CHRON. OF HIGHER EDUC., Dec. 2, 1992, at A52.

We do not know whether those people currently travelling under this particular communitarian banner would agree with the communitarian critics of corporate law. Accordingly, what we have to say about the latter should not necessarily be read as a criticism of the former.

18. The public/private distinction has been attacked by several writers iden-

private distinction that has so long structured our thinking about the appropriate goals and content of corporate law."¹⁹ He proceeds by defining away the existence of a sphere of private activity deserving of the law's benign neglect. "The decision to treat particular conduct as private and therefore immune from regulation in the public interest is, of course, a public policy determination. In any event, so-called private activity always takes place within a framework of legal rules justified by their social, public utility."²⁰

Presented in this light, the communitarian/public law view of corporate law invokes two familiar arguments in favor of government intervention in the marketplace. The first argument is that the existence of governmental power that can be called upon by a property owner, or a contracting party, to enforce property rights politicizes every private contract and all aspects of private property, thus exposing all property rights to justifiable political tinkering.²¹ The second argument is that "'private' corporations and other large organizations [are] governmental in nature [because they possess] sufficient power to be 'governmental' in [their] ability to dominate and control individuals"²² and that, as a result, corporations and

tified with the Critical Legal Studies school of thought. *See generally* Gerald Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1276 (1984) (criticizing corporate and administrative law as perpetuating bureaucratic power); Morton Horwitz, *The History of the Public/Private Distinction*, 130 U. PA. L. REV. 1423 (1982) (tracing the development of the public realm in various legal doctrines); Duncan Kennedy, *The Stages of the Decline of the Public/Private Distinction*, 130 U. PA. L. REV. 1349 (1982) (describing the life history of the public/private distinction); Joseph William Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611 (1988) (criticizing the decision in *Local 1330, United Steel Workers v. United States Steel Corp.*, 631 F.2d 1264 (6th Cir. 1980), and arguing that local communities should be recognized as having reliance interest in private property).

19. Millon, *supra* note 1, at 261.

20. *Id.*

21. William Bratton has described this form of argument, which he calls "sovereign coercion theory," in the following terms:

The private market represents an artifact of "public violence." Contractual arrangements always entail sovereign commands and, therefore, are never fully private. Stating the point more expansively, the necessity of public enforcement makes contract a "delegation" of "coercive power" to individuals. Contracting becomes "legislation"—a public event. As the public coloration of the particular contract becomes more intense, the argument that the delegated coercive power should be publicly accountable becomes more persuasive.

William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 438-39 (1989) (footnotes omitted).

22. Charles A. Reich, *The Individual Sector*, 100 YALE L.J. 1409, 1429 (1991).

other supposedly "private" organizations should be subjected to political controls.

The communitarian approach to corporate law can also be understood as an attempt to reinvigorate the "concession theory" of corporate law. Concession theorists argue that corporations exist at the sufferance of the government, which retains a legitimate role in conditioning its grant of a corporate charter (viewed as the concession of the government) on the receipt of some *quid pro quo*. Thus Lipton and Rosenblum argue:

The Anglo-American corporate form is a creation of the state, conceived originally as a privilege to be conferred on specified entities for the public good and welfare. While the corporate form became more widely available as the economy demanded it, and is now generally available to any business, it remains a legal creation. As with any legal construct, we must justify the rules governing it on the basis of economic and social utility, not intrinsic rights.²³

Proponents of the "contractual" view of the corporation have heavily criticized the concession theory. Contractual theorists minimize the importance of governmentally-granted corporate status, pointing out that most corporate attributes could be established by contract in the absence of the state.²⁴ In spite of contractual theorists' critiques,

Millon has framed this argument as follows:

[P]rivate ordering is an inequitable process for structuring relationships between parties of unequal wealth and information. These disparities can generate significant bargaining disadvantages, and substantially impede the ability of the less powerful to protect their interests adequately through contract. Where the conservative economist sees voluntariness, bargaining, and wealth-increasing exchange, the critic sees coercion and severely limited choice.

Millon, *Redefining*, *supra* note 14, at 274-75.

23. Lipton & Rosenblum, *supra* note 3, at 188. For an example of concession theory in Supreme Court decisional law, see *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) (quoting *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1819), for the proposition that the corporation is a "mere creature of law").

24. Ronald Coase, *The Nature of the Firm*, 4 *ECONOMICA* (n.s.) 386 (1937), provided the seminal insight of the business firm as a complex of contractual relations. The most comprehensive statement of the contractual approach to date is FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991). Henry N. Butler, *The Contractual Theory of the Corporation*, 11 *GEO. MASON U. L. REV.* 99 (1989), is a good, brief introduction. For contractarian discussions of the limited liability characteristic of the corporate form, see EASTER-

the concession theory has gained a new lease on life as a result of communitarian scholarship.

However, despite the flurry of law review articles extolling its value, the communitarian view of corporate law is not likely to meet with much success. In this article we explain why this is so, and offer reasons (which are often overlooked in corporate law debate) why the general public should be thankful that the communitarian/public law approach to corporate law is unlikely to prevail. We make these two points in the context of the ongoing debate over "non-shareholder constituency statutes" that permit corporate managers to consider the interests of nonshareholders such as employees, suppliers, customers, and others in determining whether and how to defend against a "hostile" takeover bid. The communitarians' enthusiasm for the direction taken by these statutes is likely to go unsatisfied, which is clearly beneficial for the largest nonshareholder constituency of all—consumers.

II. CONSTITUENCY STATUTES IN PERSPECTIVE

It has been the dominant American conception of the corporation for many years that a corporation's primary goal is, and should be, the maximization of shareholder welfare. This goal is usually operationalized as profit maximization, which should result in the maximization of the price of the corporation's shares. Of course, "Corporations owe many contractual, common law, and statutory duties to their customers, suppliers, creditors, employees, and to the environment, the general public, and numerous governmental entities."²⁵ However, a corporation's directors and officers' "duties to all [nonshareholder] groups need simply be satisfied—they function as constraints—but the duty to shareholders is open-ended: Profits should be made as large as possible, within the constraints."²⁶ Accordingly, corporate law, as traditionally conceived, provides that directors and officers are exclusively accountable to the shareholders for any breach of their duties to the corporation.

The alternative public law view objects to profit maximization as the corporation's *raison d'être*. Merrick Dodd's intellectual inheritors

BROOK & FISCHER, *supra*, at 40-62; Roger E. Meiners et al., *Piercing the Veil of Limited Liability*, 4 DEL. J. CORP. L. 351 (1979); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80 (1991).

25. ROBERT C. CLARK, CORPORATE LAW 678 (1986).

26. *Id.*

argue that corporate law should be redrawn to force corporations to serve broader "social" purposes in addition to, or instead of, maximizing the shareholders' return on investment. In this quest, several communitarian authors have joined the on-going debate over the statutes adopted by most states in the 1980s to deter "hostile" takeover bids for locally significant corporations. These statutes have had the effect of attenuating the duties owed shareholders by corporate directors and officers.²⁷ Why have so many states taken actions that lessen the residual claims of shareholders, and thus run counter to the dominant view of the proper goals of corporate activity?

The answer lies in the fact that state-level political actors have generally treated hostile takeovers as a threat to "local" prosperity based on the theory that successful hostile bidders would be likely to downsize or close local manufacturing and other operations, fire incumbent managers, and so on. Further, the costs of adopting statutes discouraging hostile takeovers are borne by geographically dispersed shareholders, while the benefits (if any) are felt locally. As a result of this arrangement of political incentives, two significant legislative responses developed in the 1980s, both aimed at making life difficult (or, indeed, impossible) for hostile bidders targeting local corporations.

First, a large majority of states, including Delaware, have adopted various forms of "antitakeover" statutes.²⁸ While some of these statutes were enacted under the guise of being shareholder protection measures, there is general agreement among commentators that antitakeover statutes were adopted "not to maximize share values for target company investors," but rather "to protect nonshareholders from the disruptive impact of the corporate restructurings that are thought typically to result from hostile takeovers."²⁹

27. See generally Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119 (1992) (analyzing literature on the negative effects of antitakeover regulation on shareholder wealth).

28. Virginia passed the first antitakeover statute in 1968, but this strategy faced a major setback in the Supreme Court's 1982 decision *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), which struck down a similar Illinois statute. The states' continued experimentation paid off in 1987 when the Supreme Court sanctioned Indiana's antitakeover statute in *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987). For analyses of *CTS*, see Daniel R. Fischel, *From MITE to CTS: State Anti-takeover Statutes, the Williams Act, the Commerce Clause, and Insider Trading*, 1987 SUP. CT. REV. 47, and Donald C. Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on CTS Corp. v. Dynamics Corp. of Am.*, 101 HARV. L. REV. 96 (1987).

29. Johnson & Millon, *Missing*, *supra* note 12, at 848. The most influential

In fact, it appears that the states' fears of hostile takeovers were, and are, economically baseless.³⁰ On the other hand, target managers' fears of personal loss as a result of a hostile takeover are quite valid.³¹ Thus, the antitakeover statutes' primary beneficiaries appear to have been incumbent managers. This "benefit" has come at a significant cost to shareholders, who have watched the value of their investments decline significantly because of the reduction in the likelihood of hostile bids.³² Interestingly, Delaware's statute is less harsh than most,³³ and appears to have had no significant negative effect on the share prices of Delaware corporations.³⁴

Later in the 1980s, states began to adopt "nonshareholder constituency" statutes, purporting to give nonshareholder constituencies

statement of this explanation is presented in Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

30. Romano, *supra* note 27, at 172 ("[T]he best available data consistently indicate that takeovers are *not* a mechanism for transferring wealth from labor to shareholders.').

31. *See id.* at 129-31 (describing studies of executive turnover after hostile takeovers).

32. Professor Romano states, "Policies intended to aid employees . . . simply extract wealth from shareholders and redistribute it to management because there is no evidence that takeovers systematically affect labor or the [governmental] treasury adversely, while there is evidence of managerial job loss accompanying takeovers." *Id.* at 177.

There are numerous case studies showing that the value of the shares of corporations covered by antitakeover statutes fell significantly upon passage of these statutes. *See* Michael Ryngaert & Jeffrey M. Netter, *Shareholder Wealth Effects of the Ohio Antitakeover Law*, 4 J.L. ECON. & ORG. 373 (1988); Laurence Schumann, *State Regulation of Takeovers and Shareholder Wealth: The Case of New York's 1985 Takeover Statutes*, 19 RAND J. ECON. 557 (1988); Jo Watson Hackl & Rosa Anna Testani, Note, *Second Generation State Takeover Statutes and Shareholder Wealth: An Empirical Study*, 97 YALE L.J. 1193 (1988) (analyzing the statutes of 19 states); W. Thomas Conner, Note, *Sword or Shield: The Impact of Third-Generation State Takeover Statutes on Shareholder Wealth*, 57 GEO. WASH. L. REV. 958, 976-84 (1989) (discussing the effects of the Massachusetts and Minnesota statutes on stock prices).

For a debate on the use of stock market data to gauge the effects of statutory changes, compare Donald G. Margotta et al., *An Analysis of the Stock Price Effect of the 1986 Ohio Takeover Legislation*, 6 J.L. ECON. & ORG. 235 (1990), with Michael Ryngaert & Jeffrey M. Netter, *Shareholders Wealth Effects of the 1986 Ohio Antitakeover Law Revisited: Its Real Effect*, 6 J.L. ECON. & ORG. 253 (1990).

33. *See* E. Norman Veasey et al., *The Delaware Takeover Law: Some Issues, Strategies and Comparison*, 43 BUS. LAW. 865, 885 (1988) (describing the Delaware law as "a very moderate statute which is quite balanced, particularly when compared to other state statutes"); Elliott J. Weiss, *A Proposal for a Federal Takeover Law*, 9 CARDOZO L. REV. 1699, 1723 (1988) (stating that the Delaware statute "does the best job of any state antitakeover law of maintaining a balance between allowing fair takeover bids to succeed and alleviating shareholder coercion").

34. John S. Jahera, Jr. & William Pugh, *State Takeover Legislation: The Case of Delaware*, 7 J.L. ECON. & ORG. 410 (1991).

some voice in corporate decisions, particularly decisions surrounding takeover offers.³⁵ To date, more than half of the states have enacted some form of constituency statute.³⁶ Generally speaking, these statutes permit the board of directors of a corporation to consider the likely effect of a given corporate decision on the corporation's employees, suppliers, customers, and, at the limit, the communities in which the corporation operates.³⁷

Pennsylvania adopted the first of these statutes, and its effort is representative of the majority of these laws:

In discharging the duties of their respective positions, the board of directors . . . may, in considering the best interests of the corporation, consider to the extent they deem appropriate:

(1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.

(2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

(3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.

35. See generally *Symposium: Defining the Corporate Constituency*, 59 U. CIN. L. REV. 319 (1990) (discussing the object of managers' fiduciary duties); *Symposium: Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 1 (1991) (addressing the benefits and disadvantages of nonshareholder constituency statutes).

36. For catalogues of these statutes, see John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1540-45 (1991) (appendices summarizing 29 statutes); Mitchell, *supra* note 4, at 579 n.1 (28 statutes); Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 194-96 (1991) (28 statutes).

37. For critical assessments, see James J. Hanks, Jr., *Playing with Fire: Non-shareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991); Committee on Corporate Laws, American Bar Ass'n, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990).

(4) All other pertinent factors.³⁸

The legislative history clearly shows that the Pennsylvania legislature designed the statute with takeovers in mind.³⁹ It is also significant that the Pennsylvania statute is permissive rather than mandatory, and that it clearly states that the nonshareholder constituencies cannot sue for any claimed breach of duty to them.⁴⁰ All of these characteristics—antitakeover animus, non-mandatory nature, and absence of enforcement through litigation—are typical of the constituency statutes.

Although Delaware has not enacted such a statute, the trend toward nonshareholder protection may find some support in the Delaware Supreme Court's decision in *Paramount Communications, Inc. v. Time Inc.*⁴¹ As Trevor Norwitz puts it, the decision

clearly distinguishes between *the corporate entity* and its *shareholders*, and suggests that the Board owes its fiduciary duties to the former (metaphysical) body, at least in the takeover context. On this reading of the *Time* decision, the case can be said to have fashioned a common law basis for the consideration of other constituencies⁴²

Both lines of empirical criticism levelled at antitakeover statutes appear equally applicable to the constituency statutes: the fear of disruption from takeovers is unwarranted, and the statutes benefit managers at the expense of shareholders. Indeed, with regard to the cost borne by shareholders, a recent study estimates that the decline in share values due to the passage of the Pennsylvania statute *alone* amounted to \$4 billion.⁴³

38. 15 PA. CONS. STAT. § 1715(a) (1990). The Pennsylvania code further provides that boards shall not "regard any corporate interest or the interests of any particular group . . . as a dominant or controlling interest or factor." *Id.* § 1715(b).

39. See generally Jeffrey L. Silberman, Note, *How Do Pennsylvania Directors Spell Relief? Act 36*, 17 DEL. J. CORP. L. 115 (1992) (discussing Pennsylvania's enactment of Act 36 and the factors leading to its promulgation).

40. The permissive language regarding nonshareholder interests contained in § 1715 does "not impose upon the board of directors . . . any legal or equitable duties, obligations or liabilities or create any right or cause of action against, or basis for standing to sue, the board" 15 PA. CONS. STAT. § 1717 (1990).

41. 571 A.2d 1140 (Del. 1990).

42. Trevor S. Norwitz, "*The Metaphysics of Time*": *A Radical Corporate Vision*, 46 BUS. LAW. 377, 378-79 (1991) (footnote omitted).

43. Samuel H. Szewczyk & George P. Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310*, 31 J. FIN. ECON. 3, 19 (1992) (describing this amount as "conservatively estimated").

Both the antitakeover statutes and the constituency statutes change the focus of directors' and managers' efforts and legal duties in hostile takeovers from the welfare of shareholder-owners to the welfare of both shareholder and nonshareholder constituencies. Notwithstanding the empirical objections to the operation of these statutes, the communitarians support this expansion in corporate solicitude for nonshareholder interests. For these observers, the antitakeover and constituency statutes are a salutary development in themselves, holding great potential for returning corporate law to the "public" side of the "public/private" divide.⁴⁴ In fact, these writers have argued that corporate law should develop much further in the direction staked out by the antitakeover and constituency statutes. These writers elaborate on the communitarian theme, arguing that corporate law should be used to further regulate corporate behavior, drawing on the antitakeover and constituency statutes for useful concepts and precedent in putting more regulatory flesh on what are now the largely contract-oriented bones of state corporate law.

The arguments put forth by these communitarian writers are an attack on the recent advance of the contractual view of the corporation, and the subsidiary idea that corporate law is essentially enabling, rather than regulatory. The contractual view of the corporation has proven to be controversial.⁴⁵ The articles supporting

44. Take, for example, Millon:

[B]y using corporation law to protect local nonshareholders from the consequences of incorporation, recent takeover legislation resembles the older approach of corporation law that was abandoned during the early decades of this century. It is this development that suggests a rebirth of corporation law.

Millon, *Rebirth*, *supra* note 14, at 926.

For another example of this line of thought, see Daniel W. Fessler, *Of Fishes, Frogs and Franchises and the Humble Suggestion of Misplaced Governmental Priorities*, 14 J. CORP. L. 111 (1988).

45. Significant critiques include William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989); Bratton, *supra* note 21; Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Thomas Lee Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273 (1991). See generally Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697 (1990) (arguing that contract law involves three normative dimensions: the validity and limits of consent, interpretation of obligations, and supplying terms).

For an extended defense of contractarianism against these critiques, see Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990).

antitakeover and constituency statutes are a challenge to the contractual view. The substance that these commentators attempt to write into corporate law would have a distinctly communitarian cast.

For example, Lawrence Mitchell applauds antitakeover and constituency statutes for "rais[ing] the normative question of whether the stockholder-owner model of corporate governance is appropriate for American society in the twenty-first century."⁴⁶ According to Mitchell:

The increasing recognition of the modern corporation's profound effect on the lives of a variety of groups not traditionally within the corporate law structure has the potential to lead corporate law into the next century in a manner more reflective of the role that this type of organization actually plays in our society.⁴⁷

Lyman Johnson simply concludes that "shareholder primacy does not ring true; therefore it must remain subdued."⁴⁸ In Trevor Norwitz's opinion, "the entire structure of American corporate governance" is at stake in the debate over the legal status of nonshareholders.⁴⁹ For Norwitz, the *Time* decision—and, by implication, the constituency statutes—may have "opened the door for a new, a more socialized, vision of the corporate entity."⁵⁰

However, for several reasons that are explored in Part III, corporate law cannot successfully be used for such ambitious schemes of social engineering. In Part IV, we show why it is a good thing that the communitarian project cannot be accommodated through corporate law. Two reasons stand out. The first is that an attempt to make businesses more community-minded would entail a substantial politicization of corporate decision making. Replicating governmental and political structures and processes within the business world would produce the same sort of interest group politics and incentive and information problems that plague government action.⁵¹

The second reason is that corporate law as now framed encourages profit maximization, an under-appreciated discipline that

46. Mitchell, *supra* note 4, at 587.

47. *Id.* at 584.

48. Johnson, *supra* note 7, at 934.

49. Norwitz, *supra* note 42, at 390.

50. *Id.*

51. For an overview, see Michael E. DeBow, *Markets, Government Intervention, and the Role of Information: An "Austrian School" Perspective, with an Application to Merger Regulation*, 14 GEO. MASON U.L. REV. 31 (1991).

benefits the public at large as well as the shareholder-owners. Thus, the largest nonshareholder constituency—the consuming public at large—finds its interests best served by corporate law rules that favor shareholders and profit maximization over employees, suppliers, and individual communities. As more fully developed in Part IV, protection of shareholders' central position in the corporate cosmos protects profit maximization and, by extension, the efficient allocation of resources through the workings of the market system.

III. THE UNLIKELIHOOD OF COMMUNITARIAN CORPORATE LAW

What would communitarian corporate law reform look like? This article considers this question first in terms of state corporate law, then in terms of a federal corporate chartering regime.

A. *State Law as a Vehicle for Communitarian Reform*

Assume, for purposes of discussion, that a state legislature is considering a bill modeled on the Pennsylvania statute but written in mandatory terms.⁵² The communitarian proponents of such a statutory approach envision its application to questions such as “whether or not to automate a production line, whether or not to close down a plant, [and] whether or not to locate a new plant in Mexico or Michigan?”⁵³

52. See *supra* text accompanying note 38. In other words, substitute the word “shall” for the word “may” and delete the last six words in the first sentence so that the hypothetical statute reads:

In discharging the duties of their respective positions, the board of directors [shall], in considering the best interests of the corporation, consider:

(1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.

(2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

(3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.

(4) All other pertinent factors.

53. Norwitz, *supra* note 42, at 390.

Given the problems inherent in the enforcement of existing fiduciary duties through shareholder litigation,⁵⁴ it is difficult to imagine an effective private remedial structure for enforcing the new statute. For the sake of argument, we will make the generous assumption that some sort of enforcement mechanism is included in the bill. Assume further that this mechanism will compel some form of compliance, perhaps through the workings of a state regulatory agency, that results in some perceptible change in corporate managers' decisions.

We should note at the outset that the need for such a statute has been called into serious question. Several commentators have noted that the nonshareholder groups most often mentioned by the communitarians—employees, customers, and local communities—can and do use private contracts to protect themselves to a significant degree from opportunistic corporate behavior.⁵⁵ Indeed, this fact helps explain the absence of any solid evidence that take-overs systematically harm these nonshareholder groups. Thus, it is not clear at all that these groups "need" any public law intervention on their behalf.

However, let us assume that a majority of the legislature is persuaded that some form of public law response is called for by "unequal bargaining power" arguments,⁵⁶ John Coffee's concern over opportunism,⁵⁷ Lucian Bebchuk's concern over externalities,⁵⁸ or perhaps by simple interest group politics. Should the legislators vote to adopt the new statute?

As corporate law is currently defined in the United States predominantly at the state level, the legislators' adoption of the new statute would be completely futile. This is because the political dynamics behind state corporate law, such as the interests of managers of large corporations and the interstate competition for chartering businesses, would render the statute virtually impotent as a regulatory device. As the chartering process works now, a state that tries to

54. Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991).

55. William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 394-417 (1990); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173; Romano, *supra* note 27.

56. Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45 (1991).

57. John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986).

58. Bebchuk, *supra* note 16, at 1485-96.

impose an onerous term for granting a corporate charter simply invites corporations to “migrate” to another state that does not insist on the objectionable term.⁵⁹ The ability of corporations to leave jurisdictions that adopt corporate law provisions that harm shareholders is illustrated by the choice of numerous Pennsylvania corporations to opt out of portions of that state’s nonshareholder constituency statute.⁶⁰ If the terms had been mandatory, presumably most (or all) of these firms would have incurred the relatively small costs of reincorporation in a state without such a statute in order to reap the market rewards of share price appreciation for opting out.⁶¹

After reviewing state competition in corporate law, Bernard Black concluded that the two central lessons of the last 100 years of American corporate law are that “writing flexible [corporate law] rules can increase franchise tax revenue and writing strict rules is pointless”⁶² From this position, Black argues that “state corporate law is trivial: it does not prevent companies—managers and investors together—from establishing any set of governance rules they want.”⁶³

59. This does not mean that the states are necessarily engaged in a “race to the bottom.” Instead, the competition must mainly be reflective of investor desires as well as the interests of corporate boards and managers. See generally RALPH WINTER, *GOVERNMENT AND THE CORPORATION* (1978) (addressing the “race to the bottom” accusation and concluding that the market forces driving profit maximization negate the arguments for a federal corporate law ending the “race”).

We recognize that antitakeover statutes and decisions do place a strain on the view that interstate competition protects shareholder interests. Judge Frank Easterbrook, a leading proponent of the contractual view of the corporation, notes this tension in his opinion in *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 507-09 (7th Cir.), cert. denied, 493 U.S. 955 (1989).

60. Szewczyk & Tsetsekos, *supra* note 43, at 19, report that at least 35 of the 56 Pennsylvania firms in their sample “chose to exempt themselves from one or more of the law’s three antitakeover provisions.” See also John Pound, *On the Motives for Choosing a Corporate Governance Structure: A Study of Corporate Reaction to the Pennsylvania Takeover Law*, 8 J.L. ECON. & ORG. 656 (1992) (presenting data on firms opting out of Pennsylvania’s antitakeover law and drawing conclusions therefrom); Silberman, *supra* note 39, at 152 (“[A]t least sixty-seven of the estimated 200 companies affected by the statute have exercised their right to opt out of at least one of its subchapters.”)

61. Szewczyk and Tsetsekos found that “[a] statistically significant positive average abnormal return [in stock prices] was recorded by firms electing to opt out of all three provisions” of the Pennsylvania statute. Szewczyk & Tsetsekos, *supra* note 43, at 19.

62. Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 Nw. U.L. REV. 542, 549 (1990).

63. *Id.* at 544.

Black's triviality hypothesis dovetails with our argument that the communitarian vision is not likely to be realized under the current format of corporate law. Neither managers (outside the hostile takeover context) nor investors wish to see the claims of shareholders compromised by nonshareholder interests.⁶⁴ Two pieces of evidence provide further support for our argument.

The first is the obvious point that most nonshareholder constituency statutes are permissive rather than mandatory, and many are limited to the takeover setting.⁶⁵ Perhaps most significantly, these statutes will not come into play with regard to "friendly" takeovers. Professor Mitchell is puzzled by the limited scope of these statutes.⁶⁶ The mystery clears if one understands that the legislatures were doing the bidding of the corporate managers in passing these constituency statutes. Although corporate managers want protection from hostile takeover bids, they have no reason whatsoever to want state legislatures to force corporate consideration of nonshareholder interests in more mundane situations. The political forces that led to the adoption of the antitakeover constituency statutes would vigorously oppose—not support—the extension of the idea of protecting nonshareholders to any area other than the takeover arena.

Second, at roughly the same time that many states were broadening the groups to which a "duty of care" was, arguably, owed, most states were also adopting changes in their corporation statutes to make the duty of care optional.⁶⁷ Thus, even as the states were moving to bring nonshareholders within the scope of directors' and officers' legally-defined duties, they were also acting in a way that

64. Obviously, in a hostile takeover the interests of the investors and the managers can diverge, which explains the adoption of nonshareholder constituency statutes applicable to takeover situations.

65. To date, the most significant exceptions to this statement are the statutes of Connecticut, Indiana, and Iowa. See Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1372-74 (1991).

66. "Curiously, the centerpiece of constituent recognition, the constituency statute, stops short of fulfilling its ultimate goal." Mitchell, *supra* note 4, at 631.

67. James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988), is a good survey of this development. Negative appraisals include Thomas Lee Hazen, *Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C. L. REV. 171 (1987); and Marc I. Steinberg, *The Evisceration of the Duty of Care*, 42 SW. L.J. 919 (1988). For a more sanguine view, see Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155 (1990) (concluding that these statutes are likely to benefit shareholders).

greatly undermined the legal enforceability of these duties, whether owed to shareholders or nonshareholders.

In short, state-generated corporate law cannot provide a workable vehicle for communitarian reforms. So long as corporate law is made primarily by the states, the communitarians' hopes are exceedingly unlikely to be realized. This is due to the responsiveness of state legislatures to the wishes of corporate managers⁶³ and those managers' strong incentive to offer attractive investment opportunities to potential investors.

The philosopher Arthur Danto has described philosophical debate in a way that is reminiscent of debates over state corporate law:

The ascetic Hindu who believes there is only the self has a body that must be fed and it is located in a world of sun and rain, amid animals and plants and beneath the stars, which are experienced by him the same as by the materialist or by the idealist, whose view is that everything is mental through and through. The fierce controversies between contending philosophies disturb not a single leaf and cast not a troubling shadow over the world as we live in it as cognitive beings. As we shall see over and over . . . philosophical differences seem at once momentous and negligible.⁶⁹

We argue that because of the states' competition for incorporation "business," philosophical debates over the proper content of state corporate law are similarly negligible.

B. Federal Chartering and Communitarian Goals

The communitarians' only hope of success rests in the adoption of a federal corporate law, preempting state law and eliminating the "problem" of interstate competition. Although a federal chartering statute has been a favorite suggestion of corporate law reformers for

68. The most recent example of this responsiveness is the adoption of "limited liability company" statutes that permit the creation of companies that combine limited liability with aspects of the partnership form of organization. See Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 *BUS. LAW.* 375 (1992) (describing statutes adopted in eight states as well as proposals being considered in other jurisdictions).

69. ARTHUR C. DANTO, *CONNECTIONS TO THE WORLD: THE BASIC CONCEPTS OF PHILOSOPHY* xv (1989).

many years,⁷⁰ it remains a political long shot and, more interestingly, its "promise" is largely an illusion.

It is illusory because the interstate competition under the current corporate law regime strongly suggests that, *at some level of regulatory costs imposed by a federal corporation statute written along communitarian lines*, investors would choose new forms of "migration" in response to the undesirable changes in corporate law achieved through federal preemption. This point deserves further explanation.

If a communitarian corporate code was adopted at the federal level, investors would be threatened with (partial) displacement as the residual claimants to the corporation, thus losing ground to other constituencies. That is, from the point of view of potential equity investors, the costs associated with operating in the corporate form would go up. Of course, investors would continue to want to invest in firms that are market driven and profit maximizing (read: private) rather than communitarian (read: public).

At every point along the continuum of increasing costs associated with communitarian regulations, some investors would conclude that better investment opportunities lie outside the corporate realm and would seek to invest elsewhere. The first obvious alternative for investors and for businesses seeking equity capital would be organizing as limited partnerships. Further, as firms responded to the huge incentive to design new, non-"corporate" investment instruments that would (as nearly as possible) meet investors' demand for equity-type investment opportunities, it is likely that other forms of business organization would arise to circumvent the federal corporate code. The remarkable growth of the leveraged buy out (LBO) form of organization in the 1980s is a testament to the speed with which the market for organizational forms can evolve in response to changes in the business environment.⁷¹

70. Ralph Nader, *The Case for Federal Chartering*, in *CORPORATE POWER IN AMERICA* 67 (Ralph Nader & Mark J. Green eds., 1973); RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* (1976) (proposing a detailed federal corporate statute); Bebchuk, *supra* note 16; William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L.J.* 663 (1974); Donald Schwartz, *A Case for Federal Chartering of Corporations*, 31 *BUS. LAW.* 1125 (1976); Donald Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 *GEO. L.J.* 71 (1972); Donald Schwartz, *Federal Chartering Revisited*, 22 *U. MICH. J.L. REF.* 7 (1988); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 *MD. L. REV.* 947 (1990). See Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 *YALE L.J.* 1, 37-45 (1980).

71. See generally Michael Jensen, *Eclipse of the Public Corporation*, *HARV. BUS.*

It follows that a communitarian federal corporate law would face stiff competition from state partnership (and other contract) laws. In a sense, this analysis goes a step further than Professor Black's assertion that state corporate law is trivial; it reminds us that *all* state business organization law is "trivial" in the sense that investors can use it to structure "any set of governance rules they want."⁷² For these reasons, if a communitarian federal corporate law were to be at all successful, it would require the preemption of all state laws regarding all forms of business organizations including partnerships, joint ventures, and so on. In sum, communitarianism would require a federal business organization statute rather than a federal corporation code.

Of course, this seems quite unlikely. But even if it came to pass, past experience in this area suggests that such a comprehensive approach to the regulation of investment in business organizations would be difficult and expensive to enforce. The rise of joint-stock companies in eighteenth century Britain following the enactment of the Bubble Act of 1720 is instructive.⁷³

From the passage of the Bubble Act in 1720 to 1844,⁷⁴ the organization of a legally enforceable corporation required Parliamentary action to confer a corporate charter; a course of action that was complicated and costly.⁷⁵ The Bubble Act prohibited the operation of unincorporated companies under the threat of severe penalties.⁷⁶ However, the Act proved to be unenforceable. This fact, coupled with the difficulties parties faced in procuring a Parliamentary charter, led to widespread use of unincorporated joint-stock companies, in spite of the law's attempt to suppress them.⁷⁷ A similar attempt in this country to outlaw noncommunitarian corporations would prompt a similar migration into a black (or gray) market existence for some businesses and investors.⁷⁸

REV., Sept.-Oct. 1989, at 61 (describing the growth of LBOs and asserting that, in some industries, the publicly held corporation "has outlived its usefulness").

72. Black, *supra* note 62, at 544.

73. The following paragraph is drawn from Gary M. Anderson & Robert D. Tollison, *The Myth of the Corporation as a Creation of the State*, 3 INT'L REV. L. & ECON. 107 (1983).

74. In 1844 and 1855, Parliament passed limited liability statutes. *Id.*

75. *Id.*

76. *Id.* at 109.

77. *Id.*

78. An instructive case might be Peru's economy, which contains a large "informal" (that is, partially underground) sector, largely as a result of extensive

Even if one assumes that enforcement by the United States could deter the growth of a significant number of gray market corporate entities, the "success" of a communitarian business organization statute within the borders of this country would increase the incentives faced by United States investors to invest more of their funds in foreign firms that are not as subject to such political forces. In response, United States firms could reincorporate (or create subsidiaries) in other countries with more efficient legal regimes. Thus, a communitarian corporate law in the United States would likely ignite a round of international competition for corporate chartering business—a form of competition which Lucian Bebchuk notes has been "largely disregarded" in the corporate law literature.⁷⁹ The fluidity of investors' capital in the increasingly interlinked world economy would thus act as a significant barrier to a successful communitarian regime in the United States alone.

This line of analysis indicates that a significant degree of international governmental "cooperation" would be necessary in order for any advanced economy to turn to communitarian corporate law.⁸⁰ This point may be implicitly recognized in Martin Lipton's call for joint United States-European Economic Community cooperation in adopting statutes to protect incumbent managers from hostile takeover bids.⁸¹ Because "communitarianism in one country" is not a workable proposition, the communitarian project would require not only a federal business organization code, but that the code be imbedded in a set of international agreements constraining capital movements and the like. Such a regime would be necessary to staunch the

government attempts to regulate businesses. See HERNANDO DE SOTO, *THE OTHER PATH* (1989).

79. Bebchuk, *supra* note 16, at 1508 n.212. Bebchuk briefly notes the possibility that foreign firms could be subjected to regulation by the United States if they have "a sufficiently substantial fraction of their shareholders in the United States." *Id.* at 1508. For an interesting discussion of U.S. securities law in international capital markets, see Larry E. Ribstein, *Efficiency, Regulation and Competition: A Comment on Easterbrook & Fischel's Economic Structure of Corporate Law*, 87 NW. U. L. REV. 254, 271-73, 281-83 (1992).

80. For a description of recent developments in this area, see RICHARD MCKENZIE & DWIGHT LEE, *QUICKSILVER CAPITAL: HOW THE RAPID MOVEMENT OF WEALTH HAS CHANGED THE WORLD* (1991).

81. Lipton & Rosenblum, *supra* note 3, at 248-52. Compare Lipton & Rosenblum's proposal with Ralph Nader's earlier suggestion to close the door on international chartering competition via intergovernmental "cooperation" coordinated by the United States, discussed in ROBERT HESSEN, *IN DEFENSE OF THE CORPORATION* 104-06 (1979).

transnational migration of investment capital in response to communitarian demands.

Such an international regulatory regime seems wildly improbable. For the sake of argument, assume its enactment. In this event, some capital would flow to countries that do not join the regime in a move akin to the registry of ocean-going vessels in less regulated jurisdictions such as Panama and Liberia. Beyond this, should United States investors' access to attractive foreign outlets for investment capital be blocked, many United States investors would choose either to attempt to evade the regulations or to invest less and consume more.

We should be clear that we are *not* predicting that United States' adoption of an enforceable communitarian business organizations law would have no effect. In fact, we think that the costs that such a development would entail would be enormous. Some United States firms would enter the gray market, some would migrate overseas. Both of these responses would entail substantial transaction costs to those firms. It is likely that some firms would comply rather than move abroad or attempt to evade the regulations. Simply put, *any* compliance would impair the efficiency with which compliant American firms are run. The overall result would be huge social costs associated with decreased economic efficiency. The reasons for this unpleasant result will be explored in Section IV.

The huge social costs of this sort of federal intervention, coupled with the slightly higher probability that the federal government would adopt communitarian policies as compared to the probability that the states would do so, lead us to reject Lucian Bebchuk's recent call for "a significant expansion of federal corporate law."⁸² Bebchuk argues for federal law on the grounds that state corporate law generates "significant externalities" in the regulation of "takeover bids, proxy contests, and corporate disclosure and the *protection accorded to creditors and other non-shareholder constituencies*."⁸³ While we agree that significant externalities are generated by state antitakeover regulations, we submit that the social costs of federalizing corporate law would greatly outweigh any gains from eliminating state interference in the takeover market.

For reasons that primarily have to do with the role of profit maximizing corporations in the allocation of scarce resources,⁸⁴ a

82. Bebchuk, *supra* note 16, at 1440.

83. *Id.* at 1441 (emphasis added).

84. *See infra* Section IV.

factor which Bebchuk and the communitarians ignore,⁸⁵ the central question regarding the choice between federal and state control of corporate law is whether the federal or state level of government is more likely to maintain corporate law as an area of "private" and "contractual" law, rather than converting it into "public" and "regulatory" law. Because states are not about to adopt a communitarian statute, the chance, however small, that such a policy might be adopted at the federal level strongly favors leaving the control of corporate law with the states.

How does one explain the possibility that "making a federal case" out of corporate law would lead to a highly regulatory, communitarian result? We believe that Americans have become too cavalier about the demands that government imposes on business. Indeed, for at least the last sixty years, the history of American law has been one of increasing governmental demands on businesses and, by extension, their owners. Many of these developments in the law have come at the expense of the concept of freedom of contract.⁸⁶ Further, the most significant of these developments have occurred at the federal level. There is, it seems, reason enough to worry that the federalization of corporate law would involve further substantial damage to the concept of freedom of contract through the adoption of a communitarian view of business firms. Since such an attenuation of this freedom in the area of corporate law would have disastrous effects on the efficiency of the United States economy, it is best to avoid the risk of bad federal policy by simply keeping corporate law as a matter for state regulation.

85. Bebchuk notes two objections to federal regulation of corporations through corporate law, the possibility of errors by federal regulators in drafting the corporate code due to either "lack of information or effort" or lobbying by interest groups. Bebchuk, *supra* note 16, at 1500-07. Neither of these points includes a consideration of the likelihood of damage to the resource allocation function discussed *infra*.

86. This process saw the growth of areas of law that "robbed contract [law] of its subject-matter[, such as] labor law, anti-trust law, insurance law, business regulation, and social welfare legislation. The growth of these specialized bodies of public policy removed from 'contract' (in the sense of abstract relationships) transactions and situations formerly governed by it" LAWRENCE FRIEDMAN, *CONTRACT LAW IN AMERICA* 24 (1965). One view of this process, expressed by the late Grant Gilmore, is that "the general law of contract" is merely "a residual category—what is left over after all the 'specialized' bodies of law have been added up" GRANT GILMORE, *THE DEATH OF CONTRACT* 7 (1974). The costs of this series of reforms, both to the United States economy and to our constitutional system, have been large. See generally RICHARD A. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* 280-82 (1985) (critique of New Deal reforms).

In summary, state legislatures, left to their own devices, will not enact mandatory, communitarian nonshareholder constituency statutes, nor will state legislatures allow to stand judicial decisions that seriously advance the communitarian nonshareholder constituency idea. The United States Congress might, at some point, be tempted to adopt a federal corporate chartering statute that includes mandatory nonshareholder constituency provisions. We have explored, however, the reasons why a *corporate* statute alone would be of limited effectiveness. Instead, Congress would be forced to preempt the entire field of business organizations law, including partnership and close corporation law, if the reform were to have any substantial bite. Even then, a federal statute would require huge enforcement costs and would almost certainly result in United States investors beginning to invest more heavily outside the country. Although the problems and costs inherent in a federal business organizations law are so great as to render passage of such a statute highly unlikely, we argue that it would be better not to run this risk.

We turn now to consider more fully the costs of communitarianism in the business world.

IV. PROFIT MAXIMIZATION AND RESOURCE ALLOCATION AS A "SOCIAL SERVICE"

In the preceding section, we argued that a communitarian corporate law is quite unlikely. In this section, we show why this conclusion should be reassuring to the reader. In so doing, we take up the challenge set forth by Professor Millon:

[A]nti-regulation commentators (like Milton Friedman and his cousins, the nexus-of-contracts theorists) continue to insist that the public-private distinction is meaningful and that important normative implications follow from it. If corporate law is to focus solely on the financial interests of shareholders, let the proponents of this point of view tell us why, without wasting energy on the ambiguous implications of the claim that corporations are aggregations of private contracts. Read generously, *Time* implies that all corporate law must take into account its public dimension, and thus corporate law is public law. Particular theories of the corporation should no longer provide a screen behind which to hide from this truth.⁸⁷

87. Millon, *supra* note 1, at 261 (footnotes omitted).

Our answer to Millon and the other communitarians involves two points. First, the economic definition of the principal-agent relationship is more fruitful than is the legal definition in analyzing corporate behavior and corporate law. Second, there is a close relationship between firm-level profit maximization and the efficient allocation of resources across the entire economy.

Consider the second point first. Certainly, we are not the first to notice that a relationship exists between profit maximization and economic efficiency. This is, of course, the essence of Adam Smith's "invisible hand."⁸⁸ Nor are we the first to argue that this fact should strongly influence corporate law. However, the relationship between profit maximization and economic efficiency is not as widely appreciated as it should be.⁸⁹

This relationship has been under-appreciated in part because defenders of profit maximization often stress the property rights of shareholders and the principal-agent relationship between a corporation's shareholders and its managers, and slight the connection between profit maximization (which directly benefits shareholders) and resource allocation (which indirectly benefits everyone in society by promoting the most efficient use of all available resources).⁹⁰ For example, in his writings Milton Friedman speaks repeatedly of "mak[ing] as much money for . . . stockholders as possible" and

88. ADAM SMITH, *THE WEALTH OF NATIONS* 423 (Modern Library ed. 1937).

89. Indeed, the importance and difficulty of firms' resource allocation decisions has been somewhat obscured in the traditional formulation of economic theory, which "assumes" perfect information, treats firms as "black boxes" that automatically make efficient choices, and analyzes markets as a series of constrained optimization problems. Influential critiques of this view are summarized in James M. Buchanan, *What Should Economists Do?*, 30 S. ECON. J. 213 (1964); R.H. Coase, *The Institutional Structure of Production*, 82 AM. ECON. REV. 713 (1992); Friedrich Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945). While this crabbed view of markets has been seriously challenged in the last three decades, it has influenced at least a generation of economists (and their students) in a way that depreciates the role of the entrepreneur in the economy.

90. One notable exception to this is Eugene Rostow's 1959 essay, *To Whom and For What Ends is Corporate Management Responsible?*, published in *THE CORPORATION IN MODERN SOCIETY* 46 (Edward S. Mason ed., 1959). Rostow reasoned that if corporations were to "seek less than maximum profits," it would "lead [] to [a] serious malfunctioning of the economy as a whole." *Id.* at 64. This malfunctioning would come in the form of "a serious distortion in the pattern of resource use." *Id.* at 65.

“making maximum profits for stockholders.”⁹¹ This emphasis on the “rightness” of the benefits received by property owners (investors) as a result of profit maximization is well-taken, but it is not the whole story. Too strict a focus on ownership rights of stockholders obscures the broad social benefits from profit maximization by businesses through the most efficient possible use of a nation’s resources.

Society’s interest in profit maximization can be better understood by using the economist’s concept of agency, which is broader than the legal definition of agency. The legal definition is relatively more formalistic, with the existence of an agency relation being dependent on the explicit or implicit consent of the parties to be bound by the relationship.⁹² For an economist, however, a principal-agent relationship can exist without legal formalities such as consent. For example, in an introduction to a collection of essays titled *Principals and Agents: The Structure of Business*, the editors (professors at Harvard’s Business School and Kennedy School, respectively) define agency relationships as arising “[w]henver one individual depends on the action of another”⁹³ Consider their illustration of this view of agency: “In writing this overview, we are acting as your agents. On behalf of our principal (you, the reader), we will try to offer an informative introduction to this volume.”⁹⁴

In the broader economic sense, society is the real principal of business decisions, since the primary objective of all economic activity is to serve the interests of consumers. The only way for managers to implement the idea of profit maximization is to seek out or create profit opportunities by satisfying consumer demand.⁹⁵ Once the im-

91. MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 133 (1962). Friedman took a similar stockholder-focused position in his famous essay, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32.

92. See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1045-47 (1991).

93. John W. Pratt & Richard J. Zeckhauser, *Principals and Agents: An Overview*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 2 (John W. Pratt & Richard J. Zeckhauser eds., 1985). For a slightly more formal definition, see Stephen A. Ross, *The Economic Theory of Agency: The Principal’s Problem* 63 AM. ECON. REV. PAPERS & PROC. 134, 134 (1973) (stating that an agency relationship exists whenever one party “designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal, in a particular domain of decision problems”).

94. Pratt & Zeckhauser, *supra* note 93, at 1.

95. The work of Israel Kirzner presents an elegant discussion of the entrepreneurial role of managers. See ISRAEL M. KIRZNER, *COMPETITION AND ENTREPRENEURSHIP* (1973); ISRAEL M. KIRZNER, *PERCEPTION, OPPORTUNITY, AND PROFIT* (1979).

portance of the relationship between profit maximization and efficient resource allocation is grasped, it is easy to see why profit maximization benefits people in addition to a corporation's shareholders. In fact, the largest "nonshareholder constituency" is the public at large. Once this point is understood, corporate law can then be analyzed in terms of creating the right set of incentives in order to promote the twin goals of profit maximization *and* efficient resource allocation. A communitarian corporate law would blunt managers' incentives to maximize profits, and the necessary corollary of this would be a reduction in the efficient use of resources and a decline in our material standard of living.

In effect, the current, modest form of corporate law can be seen as an attempt to lash ourselves to the mast of private decision making. To understand why such a policy is strongly advisable, consider that, when determined in a free marketplace, the fate of a firm ultimately depends on its ability, in competition with other firms, to serve the interests of consumers. An evolutionary process prevails in which those firms that organize in ways that best facilitate the cooperation of owners, managers, and workers for the purpose of creating consumer value have the best long-run prospects for survival. Corporate law's current focus on profit maximization plays an important role in this evolutionary process by promoting and disciplining organizational innovations in ways that, over time, increase economic productivity. Communitarian corporate law, however, would be driven by the near-term concerns of politically organized nonshareholder interests and would impede the efficient organization of production, imposing long-run costs on us all as consumers. In fact, any legal regime that promotes business decisions directed at anything other than profit maximization has a negative effect on economic efficiency and, by extension, on consumer and social welfare.

To envision how a communitarian corporate law would generate this negative result, consider first that managers in a capitalistic system make a fantastic number of hard and sometimes unpleasant decisions, such as to pay no more and charge no less than the market will bear, to close inefficient plants and other operations, and so on. Many of these decisions, by their very nature, displease certain groups such as employees, suppliers, customers, local residents, etc., who would be the supposed beneficiaries of a communitarian corporate law. Clearly, with any given corporation, its input suppliers would prefer to be paid higher prices, its customers would prefer to pay

lower prices, and the communities in which it operates would prefer larger corporate gifts to local charities. Nonshareholder constituency claims would regularly be in conflict with one another and, in principle, would be inexhaustible. We can foresee no principled way for our hypothetical enforcement agency, or the courts, to develop predictable rules for determining "who gets what" under this sort of regulatory regime.⁹⁶

To see this, recall the three issues presented earlier⁹⁷ as within the scope of a communitarian approach to corporate law: automation of a production line, a plant closure, and a choice between a United States and a foreign site for a new plant. Consider the range of objections that various constituencies might make against any given course of action in connection with any of these issues. A communitarian corporate law would make all these decisions more political and less bottom line oriented than they are now. In essence, the law would mandate the (partial) replication of the political process within each business firm. Business would become more like politics. The ability to plan business strategy, dependent in part on predictability in the legal realm, would be seriously compromised.

By making businesses less likely to adopt "unpopular" decisions, a communitarian statutory regime might maintain "local" jobs, charitable donations, tax revenues, and the like, at least temporarily. But a legal regime that holds existing business investment hostage to nonshareholder interests prevents resources from being reallocated to other locations in response to market forces and into other employments in which they would be more productive. By turning corporations into replicas of political institutions, communitarianism would substitute political pressures for market incentives as the guide for investment decisions. This course of action is guaranteed to adversely affect the long-run performance of the economy. Accordingly, the largest long-run costs of a communitarian corporate law would be imposed not just on stockholders, but on the general public through a less efficient allocation of resources and a less innovative and productive economy, as compared with the allocation of resources that now results from firms' profit seeking under the current legal regime.

96. Attempts to explain how nonshareholder constituency statutes should be interpreted include Mitchell, *supra* note 4, and Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992).

97. See *supra* text accompanying notes 53-58.

While some may question the importance of profit maximization (and, by extension, efficient resource allocation) when compared to the dislocations caused by job losses and plant closings, this view should change once one considers the sum of the entire society's valuation of efficiency. This point is magnified if one takes into account the effects of inefficiency across an entire economy and over time.⁹⁸

But are we not all resource owners (at least as sellers of labor) as well as consumers? Why are our interests as resource owners not as important as our interests as consumers? The evidence is overwhelming that, for a number of reasons, societies geared to consumer welfare are more productive than those geared to the welfare of resource owners. In short, capitalism works better than its alternatives. Consider the performance of the non-profit maximizing economies in the former Soviet bloc.⁹⁹ These societies quite simply went broke. As Gerhard Casper put it, what happened there "partook as much of Chapter 11 reorganization as of political change."¹⁰⁰ While a communitarian regime in the United States would probably not be as inefficient as Soviet-style economic planning, it would be terrifically costly nonetheless. In other words, if the law prevented "unpopular" business decisions from being made, the economic performance of the United States would suffer, even if it never reached the depths that socialist economies reached.

For examples confirming this hypothesis, one may turn to the considerable evidence from non-centrally-managed economies that the performance of state-owned and partially-state-owned industrial firms is substantially below that of privately-owned firms in competitive markets.¹⁰¹ There are storied examples of politically-generated

98. Economics texts often use the "production-possibilities curve" to illustrate the concept of an economy operating at less than capacity. The social costs of a legal regime that results in something less than profit maximization and, by extension, something less than optimum resource allocation, would be shown as a point "inside" the production possibility frontier. See FRED R. GLAHE & DWIGHT R. LEE, MICROECONOMICS: THEORY AND APPLICATIONS 439-41 (1981).

99. While our invocation of the failures of socialism may seem to the reader to involve beating a dead horse, we note that for some on the Left, hope springs eternal. See Pranab Bardhan & John E. Roemer, *Market Socialism: A Case for Rejuvenation*, J. ECON. PERSPECTIVES, Summer 1992, at 101; Paul Wallich & Elizabeth Corcoran, *The Analytical Economist: Don't Write Off Marx*, SCI. AM., Feb. 1991, at 135 (collecting comments of Marxian economists).

100. Gerhard Casper, *European Convergence*, 58 U. CHI. L. REV. 441, 444 (1991).

101. See Anthony E. Boardman & Aidan R. Vining, *Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed, and State-Owned Enterprises*, 32 J.L. & ECON. 1 (1989).

inefficiency in the operation of much of the subsidized industries of Western Europe, as well as the United States' experience with Amtrak, the Postal Service, the Corps of Engineers, and other agencies. It should come as no surprise that recent research confirms that a nation's choice of economic, legal, and political institutions has a substantial and systematic effect on national economic growth rates. Clearly, less government regulation correlates with higher rates of growth.¹⁰²

The magnitude of the combination of increased transaction costs and decreased efficiency that would be generated by a communitarian corporate law is impossible to estimate with any high degree of precision. Some hint of this cost is given by the magnitude of the stock market's negative reaction to passage of the *permissive* Pennsylvania constituency statute: a \$4 billion decline in the value of Pennsylvania corporations' stock.¹⁰³ We submit that this figure would be dwarfed by the costs attendant to the passage of a *mandatory* national constituency statute, particularly in terms of less efficient resource allocation. In our opinion, the potential costs of such corporate law reform is a decisive argument against communitarianism.

In summary, the success of corporate structures, as they have evolved over time, is not fully measured in terms of the benefits corporations have conferred on stockholders, per se. The overriding advantage of corporate arrangements that make corporate managers responsible agents to stockholders is that by serving the interests of stockholders, corporate managers are also serving as responsible agents to consumers as well. Increasing political influence over corporate decisions through a communitarian corporate law would reduce the benefits we all realize as consumers, since shifting control over management away from the stockholders and towards nonshareholders would result in a dramatic departure from the optimal use of the society's resources.

Once one sees that society as a whole is the real principal of business activity, Merrick Dodd's rhetoric takes on a new and more

102. GERALD W. SCULLY, CONSTITUTIONAL ENVIRONMENTS AND ECONOMIC GROWTH (1992); Gerald W. Scully, *The Institutional Framework and Economic Development*, 96 J. POL. ECON. 652 (1988).

On a related point, we note that Mark Roe has recently explored the possibility that federal regulation of certain aspects of corporate existence—particularly the federal limitations on bank ownership of equity and the activity of large institutional investors—systematically disadvantages the United States economy. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

103. See *supra* note 43 and accompanying text.

tangible meaning: the "profit-making function" served by corporations and other investor-owned businesses is also their primary "social service."¹⁰⁴

V. CONCLUSION

Legal reform interferes with freedom of contract at the risk of being short-circuited by individuals "contracting around" the reform. It turns out that the incentives that lead individuals to trade with one another, which Adam Smith described as the human "propensity to truck, barter, and exchange one thing for another,"¹⁰⁵ are remarkably strong and can be only partially attenuated by even the most hostile governmental regimes.¹⁰⁶ The existence of voluntary, private, market exchanges in the Soviet Union and in other countries with authoritarian regimes is eloquent testimony to the resilience of markets and contracts. Thus, contractual *behavior* has a much larger domain than that of contract *law*.

Whether communitarian legal scholars like it or not, the corporate entity is a contractual entity. Accordingly, corporate law reform cannot succeed if it violates the essentially "private" nature of the contractual relations at the corporate entity's core. We hope that we have demonstrated that communitarian advocates of non-shareholder constituency statutes run afoul of this rule.

Our position does not equate "convention and necessity"; a charge that Millon levels at "conservatives."¹⁰⁷ Such a characterization of our argument would miss the point entirely. The best argument for the corporate law status quo is not that it is inevitable,

104. See *supra* notes 10-11 and accompanying text.

105. SMITH, *supra* note 88, at 13.

106. Critical legal studies to the contrary notwithstanding, all law is not politics. This is particularly true of contract law. It is not necessary for the state to exist in order for (some) voluntary exchanges to be realized through contract. While the potential for government enforcement of contracts (through the judiciary) in all likelihood expands the scope of contracting behavior, contracts exist and are enforced privately even in the absence of government. See generally Bruce L. Benson, *The Spontaneous Evolution of Commercial Law*, 55 S. ECON. J. 644 (1989) (establishing that the genesis of commercial law was a private response to the needs of contracting parties); Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5 (1985) (stating that the elements of bargain have their basis in natural instincts). Thus, while all law can be at least partially transformed into politics (albeit at a significant cost), at least some privately-generated law can exist apart from politics.

107. Millon, *supra* note 1, at 262.

but that it has survived as the status quo!¹⁰³ The survival and prosperity of the corporate form is closely related to the astonishing efficiency and productivity of the economies of the United States and other largely capitalist countries, and should not be dismissed as mere "convention." Certainly, a substantial departure from traditional corporate law norms should not be seriously proposed without a thorough assessment of the costs and benefits of such a "reform."

The communitarians have failed to provide such an assessment. Having made the rhetorical move of denying an identity between the status quo and "necessity," the communitarians come close to confusing the *possibility* of government intervention through corporate law with its *advisability*. While the communitarians' critique may appeal to some on a first hearing, we hope this article sets out a compelling case against the communitarians' false equation of possibility with advisability in the corporate law realm. It is true that the government can make any demands it wishes of corporate investors. It could, to borrow an idea from Woody Allen, require that all corporate shareholders wear their underwear on the outside of their clothes.¹⁰⁹ But just because government *can* make any demands it wishes of investors does not mean that it *should*. Compliance with ambitious government edicts comes at a price. At the limit, it involves a price that investors could simply refuse to pay.

In sum, the communitarian vision will not prevail for the simple reason that investors will not cooperate. In their affinity for public law "solutions" to perceived social problems, the communitarians have overlooked investors as well as the key difference between the actions of individuals as investors and their actions as taxpayers. The difference, of course, is that it is much easier for a disgruntled investor to "exit" an investment situation by simply selling the investment than it is for a disgruntled citizen to "exit" a political jurisdiction. By overlooking investors' ability to exit or avoid investment in corporations, the communitarians implicitly, and mistakenly, treat them as captives.

108. It should be clear that the private property/capitalist status quo is not a static, rigid thing. Rather, it is a status quo that continually responds to competitive forces reflecting changing circumstances, including changing consumer desires.

109. In Allen's 1971 film *Bananas*, a Latin American revolutionary leader addresses his public for the first time after a successful coup. Drunk with his new power, he declares, *inter alia*, that "[a]ll citizens will be required to change their underwear every half hour. Underwear will be worn on the outside, so we can check." *BANANAS* (Metro-Goldwyn-Mayer 1971).

More broadly, then, our critique of communitarianism constitutes a "proof" of the existence of a public/private distinction in corporate law: *It is a line that investors will pay money not to be dragged across.* Whether or not legal theorists can agree on a definition of the difference between public and private, other individuals in the society seem perfectly capable of making the distinction and acting on it. As it happens, all members of society benefit from investor insistence on firm profit maximization, which can only be effected through a market process that promotes efficiency in the allocation of productive resources and improvements in the standard of living of the society as a whole.