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Redefining Corporate Law

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A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent.[1]

INTRODUCTION: A REVOLUTION IN CORPORATE LAW?

Shareholders have long enjoyed a privileged position at the center of the corporate law universe. For much of this century, corporate law's principal function has been to render management accountable to them. Toward this end, state corporate statutes (supplemented by federal proxy regulation) provide shareholders with the right to elect directors. In addition, fiduciary principles specify duties of care and loyalty owed by management to the shareholders. In contrast, the various nonshareholder constituencies involved in the corporate enterprise (such as employees, creditors, suppliers, and customers) are of little concern to corporate law. Contracts (supplemented by regulatory statutes), rather than fiduciary duty or other accountability mechanisms, determine management's obligations to these groups. Under this conception of management's role in the corporation, management must accord primacy to shareholder interests in exercising its discretion to manage the corporation's business affairs. Management discharges this responsibility by

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1. IND. CODE ANN. § 23-1-35-1(d) (West Supp. 1990). So far, 27 other states have adopted similar statutes. *See* statutes cited *infra* note 76.

attempting to maximize the company's profits in order to enhance share values.[2]

Recent developments challenge the conventional framework. The catalyst has been the hostile takeover boom of the 1980s. Despite their undoubted value to target company shareholders,[3] highly leveraged "bust-up" acquisitions[4] by means of tender offer are widely perceived to threaten jobs, the security of creditors, established customer and supplier relationships, tax revenues, charitable contributions, and other economic and social benefits provided by resident companies to local communities.[5] Concerns about adverse effects on nonshareholders have resulted in various judicial and legislative efforts to curb hostile takeovers. State courts have been increasingly hospitable toward efforts by target company management to fend off unwelcome takeover bids. This attitude is illustrated most graphically by the Delaware judiciary's recent blessing of Time's rejection of Paramount's attempted acquisition, despite its obvious attractiveness to Time's shareholders.[6] At the same time, state

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2. I use the term "shareholder primacy" to refer to this conception of management's responsibility and also to corporate law's commitment to shareholder welfare as the primary objective of corporate activity. While it is possible to distinguish between them, these two ideas are inextricably linked in traditional doctrine. Management's duty to privilege shareholder interests is based on an underlying assumption about the purpose of corporate activity; and our system of corporate law assigns to corporate management the task of pursuing the underlying shareholder welfare objective. There is nothing inevitable about this linkage: one could imagine a legal system in which some other person or group (*e.g.*, a state agency; the shareholders themselves) was responsible for maximizing shareholder welfare.

3. Premiums paid to shareholders in hostile tender offers have averaged 50% over market price. Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 Colum. L. Rev. 891, 892 (1988).

4. So-called "bust-up takeovers" are motivated by an intention to earn profits by breaking up the acquired corporation and selling off some or all of the constituent parts. This objective, rather than a desire to continue existing operations under new management, has been identified as the dominant reason for hostile takeovers during the 1980s. *See* Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich. L. Rev. 1, 2-7 (1986).

5. *See, e.g.*, Chairman of the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess., Report: Corporate Takeovers: Public Policy Implications for the Economy and Corporate Governance (Comm. Print 1987), *reprinted in* L. Solomon, D. Schwartz & J. Bauman, Corporations: Law and Policy 1149, 1162-63 (2d ed. 1988); Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct*, 14 J. Corp. L. 35, 67 (1988); Proxmire, *What's Right and Wrong About Hostile Takeovers?*, 1988 Wis. L. Rev. 353; *see also* Edgar v. MITE Corp., 457 U.S. 624, 646 (1982) (Powell, J., concurring).

6. *See* Paramount Communications, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1989), *aff'd*, 571 A.2d 1140 (Del. 1990)

legislatures have adopted a potent array of statutory measures designed to slow the pace of hostile takeover activity.[7]

By empowering target company management to prevent shareholders from enjoying the benefits of a robust takeover market, these developments indicate a willingness to subordinate shareholder financial interests to other values. In this respect, they conflict with corporate law's traditional commitment to shareholder primacy. Even more dramatic, however, is the recent wave of statutes expressly redefining corporate management's duty. Though they differ in detail, in form these new directors' duty statutes[8] authorize management to consider the interests of various nonshareholder constituencies (typically including employees, creditors, suppliers, consumers, and local communities) in making business decisions. If a particular decision would harm the interests of one or more of these groups, management need not adopt it, no matter how beneficial that course of action might be to shareholders. These statutes abrogate the long-standing shareholder primacy requirement, and most are not confined to the hostile takeover setting.

The new directors' duty statutes confront corporate law's most basic premises. If the traditional conception viewed the corporation as an engine for shareholder wealth maximization and shaped legal doctrine accordingly, the new statutes suggest a more complex notion of the corporation's role in society. At the core of this new conception — vague and tentative as yet — is the recognition that a number of nonshareholder constituencies depend upon the corporation for their welfare and are therefore affected directly by the manner in which management conducts the corporation's affairs. Relentless pursuit of

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(refusing to enjoin preliminarily Time's defensive acquisition of Warner despite Paramount's offer of premium substantially over market price). For discussion of this decision's broad implications, see Johnson & Millon, *The Case Beyond* Time, 45 Bus. Law. 2105 (1990) [hereinafter Johnson & Millon, *Case Beyond* Time].

7. *See generally* Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87 Mich. L. Rev. 846 (1989) (discussing motivations behind various forms of antitakeover statutes) [hereinafter Johnson & Millon, *Missing the Point*].

8. Because in form they define the manner in which directors should discharge their duties to the corporation, I term these statutes "directors' duty statutes." Others have referred to them as nonshareholder (or nonstockholder) constituency statutes or stakeholder statutes. *See* Hanks, *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Come*, 3 Insights 20 (1989); Karmel, *The Duty of Directors to Non-Shareholder Constituencies in Control Transactions—A Comparison of U.S. and U.K. Law*, 25 Wake Forest L. Rev. 61, 66-68 (1990) (referring to stakeholder statutes); Note, *A Framework for Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. Pa. L. Rev. 1451 (1990); *see also A.B.A. Section of Business Law, Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion*, 45 Bus. Law. 2253 (1990) [hereinafter ABA Report].

profit maximization for their sake can impose substantial costs on nonshareholders. Corporations are more than just investment vehicles for owners of financial capital. The new statutes reflect a desire to redefine management's responsibilities in light of this fact.

Nearly thirty states have adopted various versions of the directors' duty statutes,[9] and more can be expected to do so in the months to come. Although the new statutes' general thrust is clear enough to have attracted some critical commentary,[10] they have not yet been subjected to judicial scrutiny[11] or sustained academic analysis.[12] As a result, the full implications of these terse and, in some ways, distressingly vague enactments are far from clear. This Essay begins, in Part I, with a sketch of the background from which the new statutes emerged. This is intended to furnish the context necessary to appreciate the statutes' apparently sharp break with the past, as well as the circumstances that led to their passage. An understanding of the statutes' background is necessary if we are to make sense of their mandate. Part II offers a description of the statutes' content, drawing attention to what is new as well as to what is not. Part III then considers, in detail, doctrinal implications with respect to shareholder primacy. By analyzing the statutes' abrogation of the shareholders' right to hold management accountable for deviations from profit maximizing strategies, this section deals with what might be termed the negative aspect of the statutory agenda. Part IV then takes up the separate question of the extent to which the directors' duty statutes affirmatively oblige management to protect nonshareholder interests. Initially, two interpretations of non-

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9. *See* statutes cited *infra* note 76.

10. An American Bar Association committee has published its analysis of the directors' duty statutes, undertaken to determine whether the Revised Model Business Corporation Act should be amended. ABA Report, *supra* note 8. The report is critical of the statutes and recommends against amendment, but the committee's conclusion apparently was not unanimous. *Id.* at 2254. For a briefer and sharper critique written by a respected lawyer for an audience of practicing lawyers and business executives, see Hanks, *supra* note 8.

11. Directors' duty statutes have been referred to in two decisions, but in neither did the court explain the relation between statute and outcome, if any. *See* Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984 (E.D. Wis.) (citing Wisconsin statute), *aff'd*, 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989); Baron v. Strawbridge & Clothier, 646 F. Supp. 690 (E.D. Pa. 1986) (citing Pennsylvania statute).

12. Paul Cox considers the Indiana directors' duty statute in the context of an insightful analysis of that state's broad array of antitakeover legislation. *See* Cox, *The Indiana Experiment in Corporate Law: A Critique*, 24 VAL. U.L. REV. 185 (1990). A student author offers useful suggestions about strategies available to management for satisfaction of its responsibilities to nonshareholders under the new statutes, but only briefly discusses the statutes themselves. Note, *supra* note 8.

shareholder rights under the new statutes (the "no new rights" and "minimal protection" interpretations) are suggested. Under either of these, protection of nonshareholders would depend on management's willingness to use its discretionary power for nonshareholders' benefit. However, it turns out that various incentives make it highly unlikely that this will occur. Accordingly, if the statutes are to have any meaningful effect, a stronger interpretation is needed. This is also presented in Part IV, and consideration of some objections then follows.

Corporate law is in a state of conceptual turmoil. Fundamental questions that seemed firmly settled a generation ago — about the appropriate aims of corporate law and about corporate purpose itself — no longer command consensus. This is nowhere more apparent than in the directors' duty statutes. One commentator has referred to them as a "revolution in corporate law."[13] Whether this judgment is accurate must await more judicial and academic attention than the statutes have yet received. Their language is in fact quite malleable. Nevertheless, there is little doubt that the directors' duty statutes present a serious challenge to fundamental assumptions. As a response to broadly shared concerns about the role of the business corporation in our society, they demand to be taken seriously. At the very least, these statutes invite us all — as lawyers, academics, judges, and concerned citizens — to engage in the dialogic process that will determine the direction of corporate law in the years to come.

I. The Shareholder Primacy Principle

The directors' duty statutes are the boldest in a series of recent efforts to reconsider management's role in the corporation. They announce that management, previously accountable to the shareholders by the fiduciary principle, may weigh a broad range of shareholder and nonshareholder interests in making decisions about deployment of the corporation's resources. Before considering these statutes in detail,[14] this section sketches their context, including a discussion of the conventional understanding of the shareholders' position in the corporation,[15] and then of developments that initially signalled a willingness to revise that understanding.[16]

A. *The Conventional Understanding*

1. Shareholder Primacy.—Corporate management's responsibility typically has been stated in terms of a duty owed to the corporation. Thus,

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13. Hanks, *supra* note 8, at 22.
14. *See infra* pts. II-IV.
15. *See infra* pt. I(A).
16. *See infra* pt. I(B).

for example, the American Law Institute's restatement of the common law duty of care identifies "the best interests of the corporation" as the objective of managerial decision-making.[17] If one thinks of the corporation as an entity embracing a variety of nonshareholder, as well as shareholder, interests, to designate the corporation as the beneficiary of management's activities is potentially vague. How is management supposed to promote a wide variety of possibly conflicting interests? Which is (or are) to have priority?

Corporate law has avoided such puzzles by, for the most part, equating the duty to the corporation with a duty to act in the best interests of its shareholders.[18] Delaware jurisprudence makes this identity explicit by describing management's duty as a duty owed simultaneously "to the corporation and its shareholders."[19] In practice, the view that management is supposed to act in the shareholders' best interests means that it should pursue maximization of the entity's profits in all but exceptional situations; shareholders will benefit in the form of enhanced share values.[20] Thus, under the conventional view, management's duty to act in "the best interests of the corporation" actually means a duty to promote shareholder welfare through profit maximization.[21]

2. Historical Background.—Corporate management's responsibility has not always been defined in terms of shareholder primacy. During much of the nineteenth century, various statutory and common law rules limited management's powers to accumulate wealth for the benefit of the shareholders.[22] The modern view of the corporation as an engine

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17. Principles of Corporate Governance: Analysis and Recommendations § 4.01(a) (Tent. Draft No. 4, 1985) [hereinafter ALI Principles]; *see also* Revised Model Business Corporation Act § 8.30(a) (1984).

18. "[The] phrase ['best interests of the corporation'] is an expression of that component of the duty of loyalty involving the corporate director's primary allegiance. As the shareholders' designee, the corporate director is in a position of stewardship for the owners of the enterprise, whose interests are interchangeably merged with the interests of the corporate entity." *A.B.A. Section of Corporation, Banking and Business Law, Corporate Director's Guidebook*, 33 Bus. Law. 1591, 1601 (1978) [hereinafter *Corporate Director's Guidebook*]; *see also* ALI Principles, *supra* note 17, § 2.01 (corporate objective stated as "enhancing corporate profit and shareholder gain"); ABA Report, *supra* note 8, at 2255 ("With few exceptions, courts have consistently avowed the legal primacy of shareholder interests when management and directors make decisions.").

19. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (1939), *aff'd*, 25 Del. Ch. 363, 19 A.2d 721 (Del. 1941).

20. This is because the corporation's shareholders, whose claims against corporate assets are residual, are entitled to whatever is left after the fixed claims of the corporation's various creditors have been paid.

21. *See* R. Clark, Corporate Law 17-19 (1986).

22. *See* Millon, *Theories of the Corporation*, 1990 Duke L.J. 201, 205-11 [hereinafter Millon, *Theories of the Corporation*].

for shareholder wealth maximization is of relatively recent vintage, connected with changes in thinking about the role of corporations in American society. These changes occurred around the turn of this century, as traditional hostility to corporate accumulation of wealth rapidly eroded.[23] This development was most graphically apparent in the statutory revisions — heralded by New Jersey in 1888[24] — that facilitated the creation of vast holding companies. Thus, it was only during the early years of the twentieth century that the gigantic business corporation assumed its place as a welcome fixture in the American commercial landscape.

As corporations grew in size and share ownership became much more widely dispersed than it had been in the days of smaller, closely-held companies, a class of professional managers emerged who were hired for their special expertise and who typically held minimal stock positions in the firms they managed. Realization of a growing distance between the owners of the corporation and those who managed it first prompted serious attention to the question of management's relation to the corporation's shareholders. This separation of ownership and control raised the danger that corporations might not be managed in the best interests of those who had contributed their capital and were likened to its "owners." The threat was exacerbated by changes in practice that effectively enlarged managerial discretion.[25] In addition, the courts vitiated doctrinal barriers that traditionally had been relied upon to limit corporations to narrow, defined ranges of profit-seeking activity.[26]

Adolf Berle and Gardner Means articulated these concerns with striking force in their classic work published in 1932.[27] They argued that shareholders were owners of property that deserved legal protection. Because of the lack of identity between managerial and shareholder

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23. For discussion of Americans' traditional hostility to concentrations of economic power, see Millon, *The Sherman Act and the Balance of Power*, 61 S. Cal. L. Rev. 1219 (1988). For fuller consideration of changes in thinking about corporations and corporate law that occurred around the turn of this century, see Millon, *Theories of the Corporation*, *supra* note 22, at 211-16; Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 Wash. & Lee L. Rev. 903, 905-18 (1988).

24. Act of Apr. 4, 1888, ch. 269, 1888 N.J. Laws 385; Act of Apr. 7, 1888, ch. 295, 1888 N.J. Laws 445 (allowing corporations to hold stock in other corporations). Removal of traditional statutory limits on capitalization also played an important part in these changes. *See* Millon, *Theories of the Corporation*, *supra* note 22, at 212.

25. Corporate statutes increasingly allowed incorporators to describe corporate purposes and powers in unlimited terms, rather than by means of specific definition. *See* Millon, *Theories of the Corporation*, *supra* note 22, at 208-09, 219.

26. *See id.* at 212 (demise of *ultra vires* doctrine).

27. A. Berle & G. Means, The Modern Corporation and Private Property (1932 & reprint 1948).

interests, such protection depended on effective legal mechanisms for constraining management's use of its discretion in ways that harmed shareholders.[28]

Berle and Means' analysis took for granted that shareholders, as property owners, were entitled to management's undivided loyalty. By 1932, corporate law had already endorsed the view that shareholder financial interests should guide managerial decision-making without regard to competing, nonshareholder claims. As early as 1919, in the oft-quoted *Dodge v. Ford Motor Co.* case,[29] the Michigan Supreme Court repudiated Henry Ford's desire to benefit employees and consumers by sacrificing corporate profits. The court stated a general principle:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.[30]

It was this idea — shareholder primacy in managerial decision-making — that lay at the heart of Berle and Means' influential book.

The history of corporate law since Berle and Means' elaboration of the shareholder primacy idea has consisted largely of efforts to fashion doctrinal solutions to the accountability problem they articulated so forcefully. Such efforts have vacillated between relatively strict and loose responses. Apparent laxity has been the product of judicial and legislative reluctance to second-guess management's expertise[31] and, more recently, to put faith in market forces as more effective policing mechanisms than legal rules.[32] Nevertheless, the underlying premise of the central importance of shareholder welfare has remained unchallenged within mainstream thinking about corporate law.

3. Justifications.—There have been two primary theoretical foundations for the shareholder primacy principle. Traditionally, as Berle and Means contended,[33] notions of property suggested that shareholders,

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28. *Id.*

29. 204 Mich. 459, 170 N.W. 668 (1919) (assessing management policy to use corporate revenues to improve wages and working conditions and to offer the company's product to the public at a lower than profit-maximizing price).

30. *Id.* at 507, 170 N.W. at 684.

31. For discussion of this justification for managerial discretion, see Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1277 (1984).

32. *See infra* text accompanying notes 35-41.

33. A. BERLE & G. MEANS, *supra* note 27.

as the corporation's owners, were entitled to certain legal protections. Along the same line, Berle had earlier described the relation between shareholders and management as a trust relationship, with management holding the shareholders' property in trust for their benefit.[34] The property idea provided a conceptual basis for articulation of rules focusing management's attention on shareholder welfare. The trust analogy was especially apt because, while it referred to the trustee's common law obligation to guard the interests of the beneficiary, it implied broad discretionary powers toward achievement of that objective.

More recently, scholars influenced by neoclassical economic analysis have offered a different explanation for corporate law's requirement that management maximize shareholder financial interests. These scholars have discarded the property notions on which the trust analogy was grounded, finding the ownership idea unhelpful in analyzing the relations among the various participants in the corporate enterprise. Instead, they see the elaborate web of relations that constitutes the large corporation as essentially similar to the relations among actors in a market.[35] Accordingly, the rights of the various participants, including shareholders, managers, and nonshareholders, are better thought of as governed by contractual ordering.[36]

In pursuing their interests through complex arrangements with other suppliers of "inputs," shareholders of large corporations have no choice but to act through professional managers. However, shareholders face the ever-present danger that managers, as agents, will fail to act as diligently as a principal would if acting on his or her own behalf. For shareholders to maximize returns on their investments under these circumstances, the costs of managerial shirking and other forms of misbehavior must be minimized. These costs, together with the costs involved

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34. Berle, *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931).

35. For an overview, see Butler, *The Contractual Theory of the Corporation*, 11 Geo. Mason U.L. Rev. 99 (1989). The seminal economic analyses include Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972) and Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976). Examples from the legal literature include Baysinger & Butler, *Anti-Takeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 Va. L. Rev. 1257 (1985); Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259 (1982); Ribstein, *Takeover Defenses and the Corporate Contract*, 78 Geo. L.J. 71 (1989); *Symposium: Contractual Freedom in Corporate Law*, 89 Colum. L. Rev. 1395 (1989). For critical commentary, see Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 Cornell L. Rev. 407 (1989); Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 Colum. L. Rev. 1403 (1985); Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 58 Tex. L. Rev. 865 (1990).

36. For this reason, this approach to corporate law is often referred to as "the contractual theory of the corporation." *See, e.g.*, Butler, *supra* note 35.

in reducing inefficient behavior, are termed "agency costs."[37] Market forces will tend to reduce agency costs to an efficient level by aligning the interests of shareholders and management,[38] but legal rules also have a role to play because market mechanisms may be insufficient. Thus, various legal doctrines, including the fiduciary duties of care and loyalty,[39] form part of the "standard form contract" between shareholders and management that is supplied by corporate law.[40] From this perspective, management's legal duty to prefer shareholder over other interests is

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37. *See* Jensen & Meckling, *supra* note 35.

38. According to the contractual theory, various market phenomena will have this effect. For example, product market competition will tend to discipline inefficient management. Further, inefficiency will increase capital costs and, because inefficiency will be reflected in share prices, it will invite hostile takeovers in order to install new management that will maximize asset value. *See generally* Butler, *supra* note 35, at 110-20 (discussing these and other market factors). For a vigorous argument against the efficacy of market forces in reducing agency costs, see Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1488-1514 (1989).

39. *See* Butler, *supra* note 35, at 119-20.

40. *Id.* at 119. Several prominent scholars are engaged in a lively debate over the appropriate character of corporate law rules. Some contractualists argue that corporate law rules should represent a standard-form contract governing management's conduct. Shareholders may choose to adopt these rules as a low cost alternative to negotiating and drafting a contract from scratch; however, it is argued, they should also be free to override these rules when they find it in their interest to do so. In other words, corporate law rules should be default or suppletory provisions. *See, e.g.*, Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701, 736 (1987); McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 Colum. L. Rev. 1530, 1535-37 (1989). In contrast, others argue that mandatory rules (*i.e.*, rules that shareholders may not contract around) are necessary to protect shareholders from agency costs. *See* Eisenberg, *supra* note 38.

To the extent this debate is interesting, its appeal is purely academic. First, no one denies that corporate law has always contained mandatory rules (as well as default rules) and there is no sign of any inclination among state legislators to reject the view that mandatory rules are an appropriate part of corporate law. Second, the argument over the desirability of mandatory rules is an argument between camps that share an underlying commitment to shareholder welfare as corporate law's primary objective. The argument is over which approach to corporate law better serves that goal. The mandatory-suppletory debate has nothing to say about why maximization of shareholder welfare (as opposed to some other norm that tempers commitment to that objective in order to accommodate other values) ought to be management's function. The adoption of the new directors' duty statutes indicates the extent to which state legislators are unimpressed with these academic disputations. In most cases, the statutes are mandatory, in the sense that shareholders lack the freedom to avoid their coverage. *But cf. infra* note 103 (discussing "opt-in" statutes). In this regard, corporate law retains the mandatory character it has always had and has never shown any signs of discarding. However, the new statutes' objective is not unalloyed shareholder welfare, but instead some measure of protection for nonshareholder interests in situations in which those interests conflict with shareholders'. In this regard, the new statutes reject the underlying premise on which the proponents of mandatory and suppletory approaches are in accord.

obviously a central element in this implicit bargain. Thus, the new economic theory of the firm replaces older trust and property law ideas as a theoretical explanation for shareholders' legal right to insist on management's exclusive fidelity to their interests.[41]

B. Initial Inroads

1. Hostile Takeovers.—Although it appeared to be firmly established, recent events have generated misgivings about shareholder primacy as the fundamental postulate of corporate law. The catalyst has been the immense public policy controversy generated by the proliferation of hostile takeovers during the 1980s. In a typical hostile takeover, the aggressor (or bidder) appeals directly to the target company's shareholders, offering to buy a controlling block of the target's stock at a premium substantially over market price.[42] The great attraction of the hostile takeover by means of tender offer is the bidder's ability to do an "end run" around target company management, who would be expected to resist the bid in order to keep their jobs. An offer's success does not require management approval because the target shareholders possess the power to decide a takeover bid's fate simply by virtue of their right to decide whether to tender their stock to the bidder.

The well-publicized hostile takeovers of the 1980s were, of course, a boon for target company shareholders, who found themselves the beneficiaries of the bidders' remarkable largesse. Takeover premiums, often paid for by readily available junk bond financing, were substantial. Averaging as high as fifty percent,[43] premiums in excess of one hundred

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41. As a normative assertion about the appropriate content of corporate law, the contractualist theory of the corporation rests on a belief in efficiency as the criterion by which legal rules should be evaluated. According to the proponents of the efficiency norm, self-interested bargaining will maximize aggregate wealth in the absence of impediments (market failures or legal rules) to freedom of contract. *See generally* R. Posner, Economic Analysis of Law 11-15 (3d ed. 1986) (discussing efficiency in terms of bargained-for exchange). In the context of corporate law, nonshareholders and shareholders (acting through management, which operates under the shareholder primacy mandate) should pursue their respective interests through private ordering. Unless shareholders agree, legal rules that allow management to temper its commitment to profit maximization with other considerations will threaten efficiency. The directors' duty statutes' apparent rejection of this normative vision and the assumptions on which it is based is discussed *infra* pt. IV(D)(2).

42. For general discussions of the mechanics of hostile takeovers, relevant law, and the attendant policy controversies, see R. Hamilton, Fundamentals of Modern Business 381-414 (1989); L. Solomon & A. Palmiter, Corporations: Examples and Explanations 533-44, 551-89 (1990).

43. *See supra* note 3.

percent were not uncommon.[44] Moreover, economic theorists argued that all shareholders — even those whose corporations were never pursued by hostile bidders — benefitted in another less dramatic, but no less significant, way from a robust market for corporate control. The looming threat of a hostile takeover spurs corporate managers to eliminate slack and otherwise increase corporate profitability: Management's failure to maximize the value of the firm's assets will be reflected in depressed stock prices, which will invite a takeover by someone eager to install a more efficient management team.[45]

In the public's eyes, the dark side of these impressive gains for shareholders has been the adverse effects on nonshareholders. The use of enormous amounts of credit to finance these acquisitions creates strong pressures to cut costs, and, in some cases, prompts asset liquidations and plant closings. Particularly with regard to bust-up takeovers,[46] it is often assumed that dramatic employee layoffs will follow. Given the usual unavailability of a right to compensation, layoffs of employees, who have invested years of their lives in their jobs, are widely perceived to frustrate legitimate expectations of employment security.[47]

The economic theory of implicit labor contract provides a useful perspective on this problem. According to this theory, entry-level employees starting a new job typically agree to work for less than the full value of their contribution to the firm in exchange for an implicit promise of job security and increased compensation in the future. In return for undertaking to reduce the risk of unemployment facing the employee, the employer can better encourage the employee to make firm-specific investments of human capital (such as acquisition of specialized skills) that he or she otherwise would be reluctant to make because they are not readily transferrable to a new job in the event of layoff. The deferred aspect of the compensation arrangement also motivates the junior employee to work diligently in the expectation of future pay-offs. These mutual undertakings are implicit elements of the contractual bargains struck between employees and employers, but they are not explicitly articulated and therefore not legally enforceable. Accordingly, the value

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44. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 Yale L.J. 1235, 1259 n.126 (1990).

45. *See* Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 Tex. L. Rev. 1 (1978); Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965).

46. *See supra* note 4.

47. For discussion of the problem of plant closings and an extended argument in favor of legal protection from job losses, see Singer, *The Reliance Interest in Property*, 40 Stan. L. Rev. 611 (1988). Singer argues for recognition of rights growing out of reliance on relationships, as opposed to the traditional limitation of reliance-based recovery to reliance on promises. *See id.* at 663-701.

of these expectations to the employee depends on the employer's willingness to honor them. Although employers may generally be disinclined to breach this trust (for reputational and employee morale reasons), shareholders whose corporation is the subject of a hostile tender offer are able to behave opportunistically toward the firm's employees by selling the firm to a bidder that will cut costs by reneging on implicit contracts. Thus, layoffs in the wake of a takeover may represent repudiation of legitimately relied upon expectations of continued employment for which no compensation is available.[48]

Employees are not the only nonshareholder constituency believed to suffer unfairly from hostile takeovers. Customers and suppliers may have made investments whose value depends on the continuation of legitimately expected long-term relationships, and increased indebtedness places preexisting creditors in a more precarious position than they were in before the takeover. Local communities in which corporate divisions have operated for years may lose tax revenues and charitable contributions on which they have come to depend, and find themselves saddled with costly public works projects (like roads, schools, or hospitals) undertaken in the expectation of the corporation's continued presence in the community. Even when companies avoid being taken over by resorting to radical financial restructuring, the increased debt burden may result in all of these various nonshareholder groups sustaining losses similar to those that follow successful takeovers.

2. Judicial and Legislative Responses.—Public perceptions about the harmful effects of hostile takeovers on nonshareholders have encouraged a series of assaults on the shareholder primacy principle in the takeover context. State courts have been increasingly willing to allow target company management to block unwelcome takeover bids, even when the bid might be lucrative enough to appeal to target shareholders. In some cases, courts have allowed target management to justify such measures by claiming to protect shareholder interests. Even though this sort of paternalism prevented shareholders from deciding for themselves whether

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48. Though senior executives may enjoy "golden parachute" arrangements, rights to severance payments are uncommon for lower-level employees. For discussions of the implicit contract idea and its relevance to the issues discussed here, as well as citations to the economic literature, see Coffee, *supra* note 4; Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173; O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, forthcoming in N.C.L. REV. (1991). It has been argued that takeover premiums paid to target company shareholders derive at least in part from bidders' ability to renege on implicit promises of long-term job security. *See* A. Schliefer & L. Summers, *Breach of Trust in Hostile Takeovers*, Nat'l Bureau of Economic Research Working Paper No. 2342 (August 1987).

to tender their stock,[49] courts at least paid lip service to shareholder primacy. In the important *Unocal* case,[50] however, the Delaware Supreme Court suggested that shareholder primacy may not be the rule in the hostile takeover setting. In that case, the court stated that a board of directors deciding whether to block a hostile bid might justify defensive measures by taking into account "the impact [of the takeover] on 'constituencies' other than shareholders (*i.e.*, creditors, customers, employees, and perhaps even the community generally)."[51] Delaware's judiciary has since reiterated this idea,[52] and courts in other jurisdictions have made similar pronouncements.[53] Nevertheless, the extent to which courts in Delaware and elsewhere are willing to allow target management explicitly to subordinate shareholder to nonshareholder interests has been unclear. In the only case squarely presenting the issue, the Delaware Supreme Court held that under the circumstances, management's sole responsibility was to maximize share value.[54]

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49. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (allowing management's deployment of poison pill designed to protect shareholders from unfair tender offer bids). Although it purports to rest on an underlying commitment to shareholder welfare, the shareholder protection rationale for management defensive action differs from a shareholder autonomy interpretation of shareholder welfare because an autonomy approach would leave shareholders with the power to define their welfare for themselves. For discussion of shareholder protection and shareholder autonomy as alternative and potentially conflicting interpretations of shareholder welfare in the context of target management defensive measures, see Johnson & Millon, *Misreading the Williams Act*, 87 Mich. L. Rev. 1862, 1882-86 (1989) [hereinafter Johnson & Millon, *Misreading the Williams Act*].

50. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

51. *Id.* at 955.

52. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), the court referred to the board's prerogative to consider nonshareholder interests, but added that "there must be some rationally related benefits accruing to the stockholders." *Id.* at 176; *see also* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1987). However, in Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341-42 (Del. 1987), the court reiterated *Unocal*'s declaration of the relevance of nonshareholder considerations in hostile takeovers, without *Revlon*'s qualification. More recently, Chancellor William Allen has written that "directors in pursuit of long run corporate (and shareholder) value may be sensitive to the claims of other 'corporate constituencies.'" TW Services, Inc. v. SWT Acquisition Corp., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,178 (Del. Ch. 1989).

53. For statements endorsing management consideration of nonshareholder interests, see Herald Co. v. Seawell, 472 F.2d 1081, 1091 (10th Cir. 1972); Baron v. Strawbridge & Clothier, 646 F. Supp. 690, 697 (E.D. Pa. 1986); GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985); Enterra Corp. v. SGS Assoc., 600 F. Supp. 678, 689 (E.D. Pa. 1985).

54. *See Revlon*, 506 A.2d 173 (holding that situation required target company management to auction the company to the highest bidder in order to maximize share value); *cf.* City Capital Assocs. v. Interco, 551 A.2d 787 (Del. Ch. 1988) (requiring

Although state courts have exhibited ambivalence about the legitimacy of explicitly decentering shareholder interests in takeover contests, the Delaware judiciary seemed particularly sympathetic to that objective in the recent widely publicized *Paramount Communications, Inc. v. Time, Inc.* case[55] — though, ironically, the supreme court's opinion purported to endorse shareholder primacy. The judgments in *Time* approved Time management's efforts to fend off Paramount's unwelcome bid by restructuring a negotiated merger with Warner in a manner that denied Time shareholders a right to vote.[56] The object of this tactic was to foreclose the likely possibility that Time's shareholders would vote against the merger in order to accept Paramount's tender offer premium, which started high and soon exceeded one hundred percent.[57] Time's projections for the value to its shareholders of the Time-Warner combination were strong, though necessarily vague and highly speculative.[58] In addition, Time management emphasized the importance of a distinctive "Time culture" of editorial independence and journalistic integrity,[59] said to be crucial to the magazine's role in the cultivation of an informed, politically astute citizenry. An acquisition by Paramount would have placed "Time culture" in jeopardy.[60]

The Delaware Supreme Court affirmed the trial court's refusal to enjoin preliminarily the Time-Warner combination, purportedly on the

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management redemption of poison pill to allow shareholders to choose whether to accept noncoercive tender offer; no reference to possible harm to nonshareholder constituencies). For a thoughtful commentary on the Delaware judiciary's vacillating commitment to shareholder primacy in the takeover setting, see Johnson, *supra* note 35, at 910-33.

55. Paramount Communications, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1989), *aff'd*, 571 A.2d 1140 (Del. 1990).

56. *Id.*

57. Paramount's initial offer, to buy all outstanding shares at $175, was later increased to $200. At the time of the first announcement, Time stock was trading at $126. *Time*, 571 A.2d at 1147-49.

58. Time's advisers offered the following ranges: between $106-$188 for 1990, $159-$247 for 1991, $230-$332 for 1992, and $208-$402 for 1993. In Chancellor Allen's words, the last range in particular was one "that a Texan might feel at home on." *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,273.

59. *See Time*, 571 A.2d at 1143 n.4; *see also Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,267-69.

60. Time director Matina S. Horner, then president of Radcliffe College, described the public interest aspect of "Time culture" in these terms:

> I am very concerned about the need to preserve Time's editorial freedom. I believe that editorial freedom free from political or other kinds of intervention is absolutely essential if members of our society are to be enlightened enough to form wise judgments and fulfill their responsibilities as citizens. I believe that the need to foster a literate citizenry is the *sine qua non* of this nation's and the company's future.

Time, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,269.

ground that Time's management was legitimately seeking to serve shareholder interests.[61] However, because the long-term financial benefits of the Warner agreement were uncertain and the shareholders could be presumed to have preferred the short-term alternative of a Paramount acquisition, the facts did not present a strong instance of blocking tactics undertaken to protect shareholder welfare. The court did refer to Time management's duty to protect its shareholders from harmful tender offer bids, but the asserted threats to shareholder welfare were so inconsequential that it is hard to take seriously shareholder protection as the dominant justification for the court's holding.[62]

Although purporting to rely on conventional shareholder primacy rhetoric, the broad power to block unwelcome takeovers that *Time* endorses instead suggests a very different justification for the result. Shareholders effectively lose the benefits of an active takeover market in exchange for the Delaware Supreme Court's authorization of broad managerial prerogative to chart the corporation's course. Thus, the court spoke approvingly of management's discretion to prefer long-term corporate strategies over short-term shareholder gains.[63] Because the court is silent, we are left to speculate about what underlying values legitimate management's authority to pursue such long-range strategies. Shareholder welfare itself would not seem to be among those values because the premise underlying the case was Time shareholders' preference for the short-term gains offered by Paramount. The references to corporate benefit and denigration of short-term shareholder gains suggest instead that the beneficiary of the court's decision is supposed to be the corporate enterprise as a whole, distinct from its shareholders. Beneath this conception may be a continued adherence to the importance of profit maximization, but only so long as it is pursued through preservation of stable relations among the firm's various constituencies.[64] Further, the "Time culture" idea may suggest the legitimacy of the public's interest in the preservation of corporate independence when necessary to protect legitimately valued business policies.[65]

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61. *Time*, 571 A.2d at 1142.

62. Because Paramount's bid was an all-cash, all-shares offer, the threat of shareholder coercion presented by a two-tier bid was not present. Nor was the bid obviously too low. Instead, the court referred to the danger that Time shareholders might be ignorant or confused about the respective merits of the alternatives before them and that the conditions attached to the offer would make it hard to evaluate. *See id.* at 1153. Needless to say, the same might be said about most hostile tender offers.

63. *Id.* at 1150.

64. For a reading of the *Time* opinions that analyzes their destabilizing effects on existing legal doctrine, see Johnson & Millon, *Case Beyond* Time, *supra* note 6.

65. For a reading of *Time* that discusses the nonshareholder considerations —

Alongside these common law developments, most states have enacted statutes that restrict hostile takeovers in various ways.[66] After the United States Supreme Court struck down Illinois's takeover regulation statute on commerce clause grounds in 1982,[67] state legislatures returned to the drawing board in order to develop new strategies. The result has been various forms of antitakeover statutes that are packaged as instances of the states' traditional jurisdiction over corporate internal affairs.[68] One such statute, the control share acquisition statute, passed constitutional muster in *CTS v. Dynamics Corp. of America*[69] and has been widely adopted.[70] The more potent business combination statute also has survived constitutional challenge.[71] The aim of these and other legislative efforts is to protect the interests of those nonshareholders who must bear the costs of unrestricted takeover activity.[72] While the judiciary has exhibited an ambivalent stance toward restriction of shareholder rights in hostile takeovers, the state legislatures have acted much more forthrightly.

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particularly a public interest idea — that may lie beneath its conventional rhetoric, see Millon, *Theories of the Corporation*, *supra* note 22, at 251-61. Professor Johnson argues that judges confronting important corporate law questions inescapably do so from a public policy perspective. *See* Johnson, *supra* note 35.

66. For a general discussion of the various species of antitakeover legislation, see Johnson, *supra* note 5, at 61-88. The Investor Responsibility Research Center Inc. publishes an up-to-date record of state antitakeover legislation. P. McGurn, S. Pamepinto & A. Spector, State Takeover Laws (1989 & Supp. June 30, 1990) [hereinafter IRCC, State Takeover Laws].

67. Edgar v. MITE Corp., 457 U.S. 624 (1982).

68. For discussion of this "corporatization" strategy, see Johnson & Millon, *Misreading the Williams Act*, *supra* note 49, at 1873-82.

69. 481 U.S. 69 (1987).

70. Control share acquisition statutes condition a hostile bidder's voting rights on approval by the target company shareholders. For an up-to-date listing, with citations, see IRCC, State Takeover Laws, *supra* note 66.

71. Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th Cir. 1989) (upholding Wisconsin's business combination statute), *cert. denied*, 110 S. Ct. 367 (1989); RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476 (D. Del. 1988) (Delaware's statute); Vernitron Corp. v. Kollmorgen Corp., No. 89 Civ. 241 (S.D.N.Y. 1989) (New York's statute). Several states besides Delaware, New York, and Wisconsin have adopted business combination statutes. *See* IRCC, State Takeover Laws, *supra* note 66. Business combination statutes restrict a hostile bidder's rights to engage in certain significant post-takeover transactions unless target company management previously approved the acquisition or the transaction.

72. For a discussion of the motivations behind state takeover legislation, see Johnson & Millon, *Missing the Point*, *supra* note 7. *But see* Booth, *The Promise of State Takeover Statutes*, 86 Mich. L. Rev. 1635 (1988) (analyzing benefits to shareholders of control share acquisition statutes); Romano, *The Political Economy of Takeover Statutes*, 73 Va. L. Rev. 111 (1987) (arguing that management interests are primary motive force behind antitakeover legislation).

The effectiveness of judicial and legislative efforts to halt the takeover boom is still uncertain. Other factors, such as the withering junk bond market, may bring about that result on their own.[73] Nevertheless, these efforts are significant for what they tell us about the security of the shareholder primacy principle. They indicate a willingness to subordinate shareholder financial interests to the interests of nonshareholders and of the corporate entity's longer-term viability, at least in the hostile takeover context. Explicit rhetoric, implicit motivation, and actual results make this interpretation unmistakable. Though these efforts are thus far limited to the specific context of hostile takeovers, it is important to see that the takeover market is perhaps the single area in which shareholder primacy is most important. After all, that is where shareholders stand to reap the rewards of windfall premiums, as well as the less dramatic benefits to be derived from enhanced managerial diligence. Thus, the states' judicial and legislative willingness to place restrictions on the market for corporate control represents an important prelude to the frontal assault on shareholder primacy apparent in the directors' duty statutes.

II. The Directors' Duty Statutes

A. The Statutes

Although recent judicial and legislative restrictions on hostile takeovers suggest at least a partial willingness to subordinate shareholder to nonshareholder interests, the proliferation of state statutes redefining management's duties reveals this policy much more graphically. In various forms, these statutes authorize management[74] to consider shareholder as well as nonshareholder interests in formulating corporate policies. On their face, the statutes appear to deny shareholders the right to insist on management's undivided devotion to their financial welfare, and may also acknowledge nonshareholders' right to management's attention.[75]

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73. A respected commentator has stressed the importance of junk bond financing to the takeover boom. *See* Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. Pa. L. Rev. 1, 11-13 (1987).

74. Most of the statutes refer to directors' duties. As such, they apply to senior officers who sit on the board as well as to outside directors. A few also apply to officers who are not directors. *See, e.g.*, Ill. Ann. Stat. ch. 32, ¶ 8.85 (1989), *as amended by* Pub. Act 86-126, 1989 Ill. Legis. Serv. 1314 (West); Me. Rev. Stat. Ann. tit. 13-A, § 716 (Supp. 1989); Wis. Stat. Ann. § 180.305 (West Supp. 1989).

75. These questions are considered in detail *infra* pts. III & IV.

Nearly thirty states have adopted some form of this new directors' duty statute.[76]

As discussed previously, management's duty to the corporation has been defined in terms of a duty to maximize corporate profits for the benefit of the shareholders.[77] Until the hostile takeover boom, it was rarely necessary to consider situations in which the interests of the corporate entity (including the various participants in the corporate enterprise) and those of the shareholders alone might diverge.[78] For the most part, one could safely assume that corporate profitability would benefit nonshareholders as well as shareholders. Especially in times of general prosperity, larger pies imply larger servings for all. Accordingly, there have been very few cases in which courts have been called upon to consider whether, if profit maximization threatens nonshareholder interests, management might lawfully choose to temper its devotion to shareholder welfare.[79]

Yet the legal description of management's duty as a duty owed to the corporation[80] contains a potential ambiguity. Although this duty has been interpreted as synonymous with a duty to maximize share values,[81]

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76. Ariz. Rev. Stat. Ann. § 10-1202(A) (1990); Conn. Gen. Stat. Ann. § 33-313(e) (West Supp. 1990); Fla. Stat. Ann. § 607.111(9) (West Supp. 1990); Ga. Code Ann. § 14-2-202(5) (1989); Haw. Rev. Stat. § 415-35(b) (Supp. 1990); Idaho Code § 30-1602 (Supp. 1990); Ill. Ann. Stat. ch. 32, ¶ 8.85 (Smith-Hurd Supp. 1990), *as amended by* Pub. Act 86-126, 1989 Ill. Legis. Serv. 1314 (West); Ind. Code Ann. § 23-1-35-1(d)(f)(g) (West Supp. 1990), *as amended by* Pub. Law 227-1989 (approved Feb. 23, 1989); Iowa Code Ann. § 490.1108 (West 1990); Ky. Rev. Stat. Ann. § 271B.12-210(4) (Michie/Bobbs-Merrill Supp. 1990); La. Rev. Stat. Ann. § 12:92(G) (West Supp. 1991); Me. Rev. Stat. Ann. tit. 13-A, § 716 (Supp. 1990); Mass. Gen. Laws Ann. ch. 156B, § 65 (West Supp. 1990); Minn. Stat. Ann. § 302A.251(5) (West Supp. 1991); Miss. Code Ann. § 79-4-8.30 (Supp. 1990); Mo. Ann. Stat. § 351.347 (Vernon Supp. 1991); Neb. Rev. Stat. § 21-2035(1) (Supp. 1988); N.J. Stat. Ann. § 14A:6-14(4) (West Supp. 1990); N.M. Stat. Ann. § 53-11-35(D) (Supp. 1989); N.Y. Bus. Corp. Law § 717(b) (McKinney Supp. 1991); Ohio Rev. Code Ann. § 1701.59 (Anderson Supp. 1989); Or. Rev. Stat. § 60.357(5) (1989); Pa. Cons. Stat. Ann. §§ 511(d),(e),(g) & 1721(e),(f),(g) (Purdon Supp. 1990); R.I. Gen. Laws § 7-5.2-8 (Supp. 1990); S.D. Codified Laws Ann. § 47-33-4 (Supp. 1990); Tenn. Code Ann. § 48-35-204 (Supp. 1988); Wis. Stat. Ann. § 180.305 (West Supp. 1990); Wyo. Stat. § 17-16-830 (1989). Notable among the states that have not adopted directors' duty statutes are Delaware and California. IRCC, State Takeover Laws, *supra* note 66, continuously monitors legislative activity and is a good source for locating additional statutes enacted since this Essay went to press.

77. *See supra* pt. I(A)(1).

78. *See generally* Johnson, *Corporate Takeovers and Corporations: Who Are They For?*, 43 Wash. & Lee L. Rev. 781 (1986).

79. For notable exceptions, see *supra* text accompanying notes 29-30 (discussing *Ford* case) and *infra* note 119 (discussing *Wrigley* case).

80. *See supra* text accompanying note 17.

81. *See supra* text accompanying notes 18-21.

there has always been the latent possibility that the duty to the corporation might be interpreted as a duty to consider the welfare of the enterprise as a whole, including all of its constituent participants, rather than as a sharply focused duty to promote shareholder welfare to the exclusion of other considerations. The hostile takeover explosion fractured the complacently assumed unity of interest between the corporate entity and shareholders. As shareholders reaped unprecedented returns, lost jobs and other costly, highly publicized side effects focused attention on the fact that shareholder welfare did not necessarily imply corresponding benefits for nonshareholders. Indeed, the opposite might be the case. Accordingly, state courts and legislatures have been forced to define management's duty with more precision.[82] This process began with the judicial[83] and legislative[84] developments traced above and finds its most direct expression in the new directors' duty statutes.

In form, the directors' duty statutes specify the interests that directors may legitimately weigh in performing their managerial functions. Ironically, they do this while, for the most part, clinging to the traditional formulation of management's duty as owing to the corporation or even to the corporation and its shareholders. Nevertheless, the new statutes clearly reject shareholder primacy as the guiding principle. For example, Maine's statute refers to the responsibility to make business decisions according to "the best interests of the corporation and of its shareholders"[85] but then specifies that directors may "consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors."[86] Other statutes similarly refer to the standard duty to the corporate entity and its shareholders, but add that "long-term" considerations as well as nonshareholder interests are also relevant:

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82. Recently, Delaware Chancellor William Allen lucidly stated the ambiguity latent in the board's duty to "the corporation and its shareholders":

> The knowledgeable reader will recognize that this particular phrase masks the most fundamental issue: to what interest does the board look in resolving conflicts between interests in the corporation that may be characterized as "shareholder long-term interests" or "corporate entity interests" or "multi-constituency interests" on the one hand, and interests that may be characterized as "shareholder short-term interests" or "current share value interests" on the other?

TW Services, Inc. Shareholders Litigation, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,178 n.5 (Del. Ch. 1989).

83. *See supra* text accompanying notes 49-65.

84. *See supra* text accompanying notes 66-72.

85. Me. Rev. Stat. Ann. tit. 13-A, § 716 (Supp. 1990).

86. *Id.* For a similar formulation, which is limited to hostile or friendly corporate combinations, see La. Rev. Stat. Ann. § 12:92(G) (West Supp. 1991).

> In discharging his [or her] duties, a director may consider such factors as the director deems relevant, including the long-term prospects and interests of the corporation and its shareholders, and the social, economic, legal, or other effects of any action on the employees, suppliers, customers of the corporation or its subsidiaries, the communities and society in which the corporation or its subsidiaries operate, and the economy of the state and nation.[87]

According to statutes like this one, directors are not only free to consider the listed nonshareholder interests, they may also decline to take action that would be immediately profitable to shareholders in order to pursue possible longer-term benefits.[88] Presumably, shareholders need not be the primary beneficiaries of these longer-term strategies. Yet another statutory approach characterizes management's duty simply as a duty owed to the corporation as an entity, but includes shareholder interests as only one among a longer list of relevant considerations.[89]

All directors' duty statutes share the apparent objective of allowing management to consider nonshareholder interests in running the corporation. In this respect, they reject the traditional principle that management's attention should focus solely on shareholder financial welfare. However, the statutes typically offer little, if any, guidance about how management is to exercise this new power. This feature raises important questions: Is there any duty to consider shareholder interests at all? Can management make decisions bearing on nonshareholder interests with complete disregard for shareholder welfare? Or, alternatively, can management choose to ignore nonshareholder interests in order to promote the traditional objective of shareholder welfare? If management chooses to weigh both shareholder and nonshareholder interests, what weight is each to receive in cases of conflict?

Ohio's statute is one of the few that expressly makes consideration of shareholder interests mandatory:

> [A] director, in determining what he [or she] reasonably believes to be in the best interests of the corporation, shall consider the

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87. FLA. STAT. ANN. § 607.111(9) (West Supp. 1990).

88. *See* CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1990); HAW. REV. STAT. § 415-35(b) (Supp. 1990); IDAHO CODE § 30-1602 (1989); IOWA CODE ANN. § 490.1108 (West 1990); KY. REV. STAT. ANN. § 271B.12-210(4) (Michie/Bobbs-Merrill 1990); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West Supp. 1990); MINN. STAT. ANN. § 302A.251(5) (West Supp. 1989); N.M. STAT. ANN. 53-11-35(D) (Supp. 1989); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1991); OR. REV. STAT. § 60.357(5) (1989).

89. IND. CODE ANN. § 23-1-35-1(d),(f),(g) (West Supp. 1990), *as amended by* Pub. Law 227-1989 (approved Feb. 23, 1989); WIS. STAT. ANN. § 180.305 (West Supp. 1990).

> interests of the corporation's shareholders and, in his [or her] discretion, may consider any of the following:
>
> (1) The interests of the corporation's employees, suppliers, creditors, and customers;
>
> (2) The economy of the state and nation;
>
> (3) Community and societal considerations.[90]

In most other cases, there is no explicit requirement that management assign any significance to shareholder interests. Thus, most of the directors' duty statutes apparently confer broad discretion on management to decide whether to take shareholder interests into consideration at all.[91]

In contrast, Connecticut's statute is the only one that makes consideration of nonshareholder interests mandatory:

> [A] director . . . shall consider, in determining what he [or she] reasonably believes to be in the best interests of the corporation, (1) the long-term as well as the short-term interests of the corporation, (2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation, (3) the interests of the corporation's employees, customers, creditors and suppliers, and (4) community and societal considerations including those of any community in which any office or other facility of the corporation is located. A director may also in his [or her] discretion consider any other factors he [or she] reasonably considers appropriate in determining what he [or she] reasonably believes to be in the best interests of the corporation.[92]

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90. OHIO REV. CODE ANN. § 1701.59 (Baldwin Supp. 1989); *see also* CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1990); N.M. STAT. ANN. § 53-11-35(D) (Supp. 1989).

91. A few statutes refer to the interests of the corporation as an entity and of various nonshareholder constituencies, but actually omit any direct reference to shareholders in specifying management's responsibility. *See* ILL. ANN. STAT. ch. 32, ¶ 8.85 (Smith-Hurd Supp. 1990), *as amended by* Pub. Act 86-126; MO. ANN. STAT. § 351.347 (Vernon Supp. 1990). Tennessee's law is phrased as an exemption from liability for good faith consideration of enumerated nonshareholder interests and therefore says nothing about shareholder interests. TENN. CODE ANN. § 48-35-204 (1988). Despite the absence of direct references, however, it seems highly unlikely that these legislatures intended actually to exclude shareholder interests from the realm of legitimate management discretion; these would no doubt be included among unspecified "pertinent factors" or be subsumed within the reference to the interests of the corporate entity.

92. CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1990). Arizona's statute, ARIZ. REV. STAT. ANN. § 10-1202(A) (1990), does not explicitly refer to nonshareholder constituencies but does require directors to consider the "long-term as well as short-term interests of the corporation and its shareholders." This reference might be interpreted as a requirement that management consider effects on nonshareholders as well as shareholder interests in short-term gains.

The rest would appear to leave management free to give no weight to nonshareholder interests and instead attend solely to shareholders.

Questions concerning what the directors' duty statutes allow or require of management are complicated and will be discussed below in detail.[93] For now, it is enough to note that, on their face, the statutes appear to confer extremely broad discretion. Most of them seem to allow management to decide which among the array of potentially relevant shareholder and nonshareholder interests should guide decision-making. There is no express requirement that either shareholder or nonshareholder considerations be taken into account in any particular case. This suggests that management may legitimately choose to focus its attention on one or the other. Likewise, management may be free to concern itself with only one or a few nonshareholder constituencies, to the exclusion of other conflicting nonshareholder interests. The statutes' only apparent substantive limitation on management's freedom to choose the beneficiaries of its decision-making is an implicit one, and would require that management seek to further some statutorily enumerated shareholder or nonshareholder interest, as opposed to the interest of some nonshareholder constituency (such as management's self-interest) beyond the range of interests articulated by the statute.

Superficially, at least, this broad freedom (to decide which interests to consider) seems to imply further that management also has the discretion to decide the respective weight to be accorded the various shareholder or nonshareholder interests it chooses to consider. If a statute implies that no constituency can insist on being considered at all, it may also imply that none may demand that it receive priority should management choose to consider it. Two statutes appear to contain clear language to this effect. Indiana's statute expressly provides that in considering the best interests of the corporation, directors are free to take into account effects on enumerated nonshareholder constituencies as well as on shareholders.[94] It goes on to state that "directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor."[95] Pennsylvania recently has amended its directors' duty statute to include similar language.[96] Though lacking express provision to this

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93. *See infra* pts. III & IV.

94. IND. CODE ANN. § 23-1-35-1(d) (West Supp. 1990), quoted *supra* in text accompanying note 1.

95. *Id.* § 23-1-35-1(f).

96. "[T]he board of directors . . . shall not be required . . . to regard any corporate interest or the interest of any corporate group as a dominant or controlling interest or factor." PA. CONS. STAT. ANN. § 511(b) (Purdon Supp. 1991); *cf.* N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1990) ("Nothing in this paragraph shall create any duties owed

effect, it may be possible to read most of the directors' duty statutes[97] as implying the same idea.

The broad powers granted to management by the directors' duty statutes extend, in most cases, across the entire spectrum of managerial decision-making.[98] A few apply only to takeovers or other change of control transactions,[99] reflecting the background against which they were adopted. Others, however, include references to the takeover context, but clearly indicate that they apply generally to director decision-making. Illinois's statute, for example, authorizes directors to consider the effects on nonshareholders "of any action (including without limitation, action which may involve or relate to a change or potential change of control of the corporation)."[100] Similarly, Indiana's statute, while speaking in general terms about the directors' authority to consider shareholder as well as nonshareholder interests,[101] also includes an explicit statement disaffirming any duty to act or decline to act in the interest of any shareholder or nonshareholder constituency "solely because of the effect such action might have on a proposed acquisition of control of the corporation or the amounts that might be paid to shareholders under such an acquisition."[102] Most of the remaining statutes say nothing about takeovers or any other specific contexts to which they might apply.[103]

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by any director to any person or entity to consider or afford any particular weight to any of the foregoing [specified nonshareholder constituencies.]").

97. That is, all but those that expressly make consideration of either shareholder or nonshareholder interests mandatory. *See supra* notes 90 & 92 and accompanying text.

98. In a few cases, coverage is limited to publicly held corporations, defined according to stated criteria. *See* Conn. Gen. Stat. Ann. § 33-313(e) (West Supp. 1990); Idaho Code § 30-1602 (Supp. 1990).

99. *See* Conn. Gen. Stat. Ann. § 33-313(e) (West Supp. 1990); Iowa Code Ann. § 490.1108 (West Special Pamphlet 1990); La. Rev. Stat. Ann. § 12:92(G) (West Supp. 1990); Mo. Ann. Stat. § 351.347 (Vernon Supp. 1990); Or. Rev. Stat. § 60.357(5) (1989 & Supp. 1990); Tenn. Code Ann. § 48-35-204 (Supp. 1990).

100. Ill. Ann. Stat. ch. 32, ¶ 8.85 (Smith-Hurd Supp. 1990); *see also* Ky. Rev. Stat. Ann. § 271B.12-210(4) (Michie/Bobbs-Merrill Supp. 1989 & Supp. 1990); Mo. Ann. Stat. § 351.347 (Vernon Supp. 1990); N.J. Stat. Ann. § 14A:6-14(4) (West Supp. 1990); N.Y. Bus. Corp. Law § 717(b) (McKinney Supp. 1991).

101. Ind. Code Ann. § 23-1-35-1(f) (West Supp. 1990).

102. *Id.*

103. *See* Fla. Stat. Ann. § 607.111(9) (West Supp. 1990); Haw. Rev. Stat. § 415-35(b) (Supp. 1990); Me. Rev. Stat. Ann. tit. 13-A, § 716 (1981 & Supp. 1990); Mass. Gen. Laws Ann. ch. 156B, § 65 (West Supp. 1990); Minn. Stat. Ann. § 302A.251(5) (West Supp. 1991); Neb. Rev. Stat. § 21-2035(1) (Supp. 1988); Ohio Rev. Code Ann. § 1701.59 (Anderson Supp. 1989); Pa. Cons. Stat. Ann. § 511(b) (Purdon Supp. 1990).

All but a few of the statutes apply automatically. None allows shareholders (or nonshareholders for that matter) to agree to waive (or "opt out" of) the statutory authorization to consider nonshareholder interests and substitute a shareholder primacy rule instead. In this sense, although most do not require management to protect non-

B. *The Structure Of Corporate Governance*

Despite their apparent iconoclastic ambitions, the statutes leave untouched some basic features of existing corporate legal structure. Most obviously, management remains at the top of the corporation's decision-making hierarchy. If state legislatures were motivated by solicitude for nonshareholders, they conceivably might have established a quite different governance structure. For example, nonshareholders might be given the right to participate directly in high level decision-making, at least with respect to matters in which they have an immediate interest. Toward this end, corporations might be required to set aside particular seats on the board of directors for representatives of various nonshareholder constituencies.[104] Or, more radically, one might revise the customary decision-making hierarchy by diffusing power downward from management into the hands of particular nonshareholder constituencies most likely to be affected by particular decisions. The statutes do not seek to promote nonshareholder interests in these ways.

Furthermore, the directors' duty statutes do nothing to alter the existing electoral system. In this respect, management remains accountable only to the shareholders. This may seem surprising: If the legislatures expected management to look after nonshareholder interests, one might have thought the statutes would attempt to achieve accountability by providing nonshareholders with the right to participate in the annual election of the board of directors.[105] This, of course, is the rationale behind shareholder voting rights. Yet the directors' duty statutes say nothing about voting rights for nonshareholders.[106]

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shareholders, the new statutes are "mandatory." *See supra* note 40. A few, however, merely allow corporations to "opt in" by including a new directors' duty provision in the articles of incorporation. *See* GA. CODE ANN. § 14-2-202(5) (1989); TENN. CODE ANN. § 48-35-204 (1988). Because articles amendments typically require shareholder approval, "opt-in" directors' duty statutes seem odd: Would rational shareholders ever agree to such provisions if given the chance to vote against them? In fact, at least two such proposals, both involving Georgia corporations, have been adopted. ABA Report, *supra* note 8, at 2263 n.35. While these events may be explained by management's control of the proxy machinery, it would be wrong simply to assume that management seeks to further its own self-interest in such situations. It is conceivable that management desires the broader powers conferred by the directors' duty provisions because they better comport with management's views about responsible conduct of corporate operations.

104. *See, e.g.*, R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976).

105. Compare German corporate law, which mandates employee participation (with shareholders) in election of the board of directors. *See generally* Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. & SEC. REG. 155 (1982).

106. *See infra* pt. IV(B) for further discussion of this and related issues.

To the extent the statutes do attempt to protect nonshareholder interests, they rely on a traditional conception of the role of corporate management. That is, just as management has been the vehicle for achievement of the goal of shareholder welfare, now, as the objective apparently changes to embrace nonshareholder welfare as well, management takes on that responsibility. Facially, the statutes leave open the question of management's status as fiduciary. Is it still appropriate to conceive of management as owing a fiduciary duty, albeit qualified, to the corporation's shareholders? Is management's new responsibility to nonshareholders fiduciary in nature? Before these questions can be addressed, it is necessary to consider in more detail how the new statutes alter existing shareholder and nonshareholder rights.

III. Decentering Shareholders

The new directors' duty statutes appear to allow management to consider the impact of its decisions on nonshareholder interests and, if deemed appropriate, to choose courses of action that are inconsistent with traditional notions of shareholder primacy. Decentering the shareholder in this manner might be termed the negative aspect of the statutory agenda: The directors' duty statutes take away a basic right — shareholder primacy in managerial decision-making — previously provided by corporate law.[107] But what sort of legal regime do the statutes contemplate instead? What new rights do nonshareholders gain? What is management supposed to do with its newly minted discretion? Postponing for the moment consideration of such questions, which we might call the affirmative side of the new directors' duty statutes,[108] this section analyzes their negative aspect.

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107. In referring to the statutes' "negative" aspect, I do not mean to imply an evaluative judgment. Rather, my point is to distinguish between, on the one hand, the way in which they diminish or reduce existing legal protection for shareholders and, on the other, enhance or increase the status of nonshareholders. The latter is what I mean by the statutes' "affirmative" agenda, considered in Part IV below. Professor Johnson has analyzed both the negative and the positive aspects of judicially imposed restrictions on shareholders' right of access to tender offers in terms of redefinition of the attributes of corporate stock. That is, protection for nonshareholders has been achieved by cutting back existing shareholder "property" rights rather than by articulating new rights (based on property, contract, or tort, for example) on behalf of nonshareholders. *See* Johnson, *supra* note 35, at 888 n.86; *see generally* Johnson, *Sovereignty Over Corporate Stock*, forthcoming in Del. J. Corp. L. (1991). Considering the question beyond the specific context of hostile takeovers, I argue below that adequate protection for nonshareholders cannot be achieved solely through restriction of shareholder rights; instead, affirmative responsibilities must be imposed on management to protect nonshareholder interests. *See infra* pts. IV(B), (C). For discussion of the property-based critique of the directors' duty statutes, see *infra* pt. IV(D)(1).

108. *See infra* pt. IV.

In order to assess the negative impact of the directors' duty statutes, it is necessary to understand how the new statutes alter shareholders' rights to challenge objectionable management decisions. Under traditional doctrine, management is subject to common law fiduciary duties of loyalty and care. The duty of loyalty mandates that a director "should not use his [or her] corporate position to make a personal profit or gain other personal advantage."[109] The idea is that, as fiduciaries, directors (and senior officers too) owe a duty of undivided loyalty to their principal, the corporation. Most of the legal doctrine in this area is concerned with various species of conflict of interest transactions.[110]

According to a typical formulation of the duty of care, a director should "perform his [or her] functions in good faith, in a manner that he [or she] reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[111] The duty covers both negligent failure to act and decisions taken without appropriate care, including decisions reached without sufficient information regarding the matter at issue. In addition, director action may be challenged on the ground that, from an objective standpoint, it could not rationally have been deemed to be in the corporation's best interests. Thus, for example, a decision that amounts to waste of corporate assets cannot be justified on the ground that it was disinterested and the result of a reasoned decision process.[112]

Shareholders have traditionally enjoyed the right to enforce the fiduciary duties of care and loyalty through litigation.[113] However, the practical significance of this right has always depended in large part on the so-called "business judgment rule," which insulates managerial decision-making from shareholder (and judicial) scrutiny. Thus, before it is possible to determine how the directors' duty statutes affect the common law duties of care and loyalty, it is first necessary to consider the business judgment rule in light of the new statutes.

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109. *Corporate Director's Guidebook*, *supra* note 18, at 1599.

110. *See generally* R. Clark, *supra* note 21, at 141-89.

111. ALI Principles, *supra* note 17, § 4.01(a).

112. In this respect, the duty of care can be said to require substantive as well as procedural due care. W. Cary & M. Eisenberg, Cases and Materials on Corporations 541 (6th ed. 1989).

113. In form, the challenge is usually by means of the shareholders' derivative action, in which particular shareholders sue on behalf of the corporation to obtain a remedy for past or threatened financial harm to the corporation. The typical case is one in which managerial negligence or self-dealing has resulted in a financial loss to the corporation. In contrast to derivative suits are direct actions, in which a shareholder (or a class of shareholders) asserts a claim based on an injury suffered by the shareholder as such. Examples include efforts to enforce voting rights or to compel payment of dividends. *See generally* R. Clark, *supra* note 21, at 639-74.

The business judgment rule has been expressed in different ways in different jurisdictions, but the basic idea is the same.[114] Courts will not allow shareholders to challenge exercises of managerial business judgment if, at the time of the decision, three prerequisites were satisfied. The decision in question must have been the product of (i) disinterested and (ii) informed judgment, and (iii) an objectively rational effort to further the corporation's best interests.[115] Accordingly, the business judgment rule requires a shareholder seeking to challenge a board decision to show that the directors were subject to a conflict of interest with respect to the matter at issue,[116] failed adequately to inform themselves prior to reaching the decision,[117] or, from an objective point of view, could not rationally have believed that the decision was in the corporation's best interests.[118] An allegation of irrationality requires a court to evaluate the substantive merits of the decision in question. Here, under traditional doctrine, the shareholder primacy principle comes into play. Absent some demonstration of likely long-term financial gain to the corporation, a decision to sacrifice profits solely to benefit employees or other non-shareholders would not enjoy the protection of the business judgment rule. Even if the directors were fully informed and had nothing to gain personally from the decision, it would fail the rationality test because of its inconsistency with shareholder financial interest.[119]

Only if the disgruntled shareholder can demonstrate that at least one of these three conditions (conflict of interest, inadequate information, irrationality) is present will he or she be allowed to proceed with a

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114. For extended analysis of the variations, see ALI Principles, *supra* note 17, at 58-76 (comment and reporter's note to § 4.01(c)).

115. One area in which formulations of the business judgment rule differ is with respect to the rationality element. Some jurisdictions have used a reasonableness standard instead. *See* ALI Principles, *supra* note 17, at 67-68. Some jurisdictions also add a requirement of good faith.

116. *See* R. Clark, *supra* note 21, at 138.

117. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

118. *See, e.g.*, ALI Principles, *supra* note 17, § 4.01(c)(3).

119. For example, in Shlensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968), a shareholder sought to challenge a corporate policy (no lights at Wrigley Field) alleged to be inconsistent with profit maximization. According to the plaintiff, management was motivated by a conviction that baseball is a "daytime sport" and concerns that night baseball would lead to deterioration of the neighborhood surrounding the ballpark, rather than by "interest in the welfare of the corporation." The appellate court affirmed dismissal of the complaint not because such a policy was entitled to the protection of the business judgment rule but rather because the plaintiff had failed to allege adequately that management's motives "are contrary to the best interests of the corporation and its stockholders" and that the policy might not in fact be related to legitimate financial objectives. As a decision about proper pleading, the opinion is hyper-technical and thoroughly disingenuous.

lawsuit alleging management misconduct. Thus, the business judgment rule is designed to shield directors from judicial scrutiny if they acted properly at the time of the conduct at issue — even though their decision later proves harmful to the corporation.[120] In addition, because the shareholder bears the burden of proving that at least one of the prerequisites to business judgment rule protection was not satisfied, the business judgment rule also furnishes a presumption that directors act in a disinterested, informed, and rational manner when they make management decisions.[121] Only if a shareholder can overcome this presumption will he or she be able to challenge the merits of management's conduct. Thus, whether the business judgment rule blocks a particular shareholder claim and the merits of the claim itself are actually two distinct questions.

To appreciate the impact of the new statutes on shareholders' ability to challenge management decision-making, it is necessary first to consider how the statutes alter traditional business judgment rule analysis. There does not seem to be any change with respect to the requirement of disinterest. Although the new statutes allow management to deviate from relentless pursuit of profit maximization, they offer no basis for an argument that management's own self-interest is an acceptable justification for such deviations. Some statutes include a residual catch-all category among the listing of specified nonshareholder considerations that justify management's subordination of shareholder welfare (such as "other pertinent factors"[122]). However, even if this category were interpreted to extend beyond the listing of specific nonshareholder constituencies that appear to be the statutes' intended beneficiaries, there is no warrant for adding management's own interests to the list of legitimate considerations. The directors' duty statutes authorize management to use its discretion to protect nonshareholders at the expense of shareholders, but do not allow management to transfer corporate wealth to itself. So, a shareholder seeking to challenge a management decision still should be able to avoid the business judgment rule by arguing that the decision in question was tainted by conflict of interest.

In addition to cases of conflict of interest, it still should be possible to challenge a decision on the ground that management failed adequately to inform itself beforehand. For example, in cases of decisions that relinquish profit maximization out of solicitude for nonshareholders, a

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120. The reason for this is the belief that, on the one hand, managers are chosen for their business expertise and require a fair measure of discretion if they are to do their jobs effectively, while, on the other, courts are poorly qualified to second guess business decisions after the fact. *See Corporate Director's Guidebook*, *supra* note 18, at 1603-04.

121. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

122. *See, e.g.*, *supra* note 86 and accompanying text.

shareholder might claim that the board failed adequately to evaluate the respective costs and benefits to all affected constituencies (shareholders as well as nonshareholders) of the options before it. Absent such an evaluation, the business judgment rule's presumption of prudent, deliberate decision-making should not apply. Additionally, it might be argued that the board had no informed basis for believing, on the one hand, that a profit-maximizing option would harm identifiable nonshareholder constituencies and, on the other, that the decision actually taken would benefit those nonshareholders or at least avoid harming them. Thus, acting on inadequate information should remain a basis on which a shareholder seeking to challenge a management decision can overcome management's invocation of the business judgment rule.

Because they expressly authorize management to make decisions that take nonshareholder interests into account, the new statutes presumably have the effect of revising what counts as a rational decision under the business judgment rule. A decision that trades off shareholder gain against nonshareholder benefits may now be construed as rational. For example, the owners of a professional baseball franchise need not attempt to justify their refusal to install lights for night games on the ground that doing so will actually enhance the club's profitability by preventing deterioration of the surrounding community; they could simply rely on their desire to be good neighbors.[123] Iowa's statute attempts to address this issue expressly. After specifying the nonshareholder interests that a director may consider, the statute goes on to state the following:

> Consideration of any or all of the community interest factors is not a violation of the business judgment rule or of any duty of the director to the shareholders, or a group of shareholders, even if the director reasonably determines that a community interest factor or factors outweigh the financial or other benefits to the corporation or a shareholder or group of shareholders.[124]

Even in the absence of such language, however, the logic of the directors' duty statutes should preclude a shareholder from arguing against business

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123. *Cf. Shlensky*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (affirming dismissal of shareholder complaint because of failure to establish harmful financial impact of management's refusal to install lights to facilitate night baseball).

124. Iowa Code Ann. § 490.1108(2) (West Special Pamphlet 1990) (coverage restricted to "acquisition proposals"). Though the passage's meaning is clear, its reference to "violation of the business judgment rule" is an unfortunate malapropism. The business judgment rule is both an exemption from liability and a rebuttable presumption that directors exercise proper business judgment in making decisions. *See supra* notes 120-21 and accompanying text. It is not a substantive liability norm that can be violated. What the legislature meant was that consideration of nonshareholder interests does not provide a sufficient basis for denial of business judgment rule protection.

judgment rule protection simply on the ground that a management decision prefers nonshareholder over shareholder interests.

If this is so, under what circumstances might a shareholder argue against invocation of the business judgment rule on the ground that a particular decision was objectively irrational? Although it seems sensible to assume that the statutes are not designed to eliminate entirely the distinction between objectively rational and irrational managerial decision-making, the content of the distinction is no longer clear. An obvious example of objectively irrational behavior not entitled to business judgment rule protection would be a decision that, at the expense of the corporation's shareholders, conferred a benefit on some third party not legitimately entitled to management's largesse. An example might be a gratuitous cash payment to the surviving spouse of a recently deceased senior officer of the corporation. Another less obvious possibility might be a case in which management chose to forego a certain and very substantial benefit to shareholders in order to achieve a much more speculative and less substantial benefit for nonshareholders. The argument would not be that management acted irrationally by preferring nonshareholders over shareholders (the statute allows this), but rather that under the circumstances the balancing judgment was so sharply skewed against the shareholders and of so little benefit to nonshareholders as to be objectively irrational.

To sum up the analysis thus far, the directors' duty statutes alter the grounds available to shareholders for overcoming the business judgment rule's presumption in favor of management. Shareholders should retain the right to challenge management decisions tainted by self-interest. In cases of decisions that benefit nonshareholders at the shareholders' expense, shareholders should be able to argue in appropriate cases that such decisions were based on inadequate information, but should no longer be allowed to argue that any decision sacrificing profit maximization for the sake of nonshareholder interests is objectively irrational for that reason alone. In this respect, the new statutes significantly restrict shareholders' rights to hold management accountable.

If a complaining shareholder is able to overcome the business judgment rule's hurdle to judicial scrutiny of managerial decision-making, he or she must still prevail on the merits of the underlying claim. In this regard, the duties of care and loyalty should be much the same as under traditional doctrine.[125] One important difference must be noted,

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125. As already noted, the duty of loyalty proscribes management decision-making on the basis of self-interest. *See supra* text accompanying notes 109-110. The new statutes authorize deviation from shareholder primacy only for the sake of specified nonshareholder

however. A management decision to sacrifice shareholder interests in order to benefit nonshareholders no longer amounts to a per se violation (such as waste of corporate assets).[126] For example, even a clearly stated management policy to use corporate revenues to improve wages and working conditions and to offer the company's product to the public at a lower than profit-maximizing price would not, without more, appear to be a basis for liability or injunction.[127] In this regard, several directors' duty statutes provide expressly that management shall be exempt from personal liability for decisions taken pursuant to the statutory authorization to consider nonshareholder interests.[128]

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interests; they do not allow managerial self-dealing.

The duty of care requires management to act "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." ALI PRINCIPLES, *supra* note 17, § 4.01(a). This implies a requirement that management be adequately informed before deciding to protect nonshareholders at the shareholders' expense. Indiana's statute makes this clear: A disinterested decision, reached after consideration of nonshareholder interests, "shall conclusively be presumed to be valid *unless* it can be demonstrated that the determination was not made in good faith after reasonable investigation." IND. CODE ANN. § 23-1-35-1(g) (West Supp. 1990) (emphasis added). This relevant information should include evaluations of the likely costs and benefits of a particular decision to all affected constituencies, including shareholders and nonshareholders.

It should be apparent that the evidence bearing on liability in such cases (lack of adequate information) is the same as the evidence that a shareholder would cite in order to overcome the business judgment rule's presumption. This will not always be the case, however. For example, if the claim is conflict of interest, the plaintiff must first establish the existence of a legally sufficient conflict to rebut the business judgment rule's presumption and, if successful, will then have to litigate a different issue, the substantive fairness of the transaction at issue. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a) (1989).

126. A disgruntled shareholder might try to characterize such a decision as a violation of the duty of loyalty (on the ground that management acts disloyally when it favors the interests of some particular constituency), but the duty of loyalty has traditionally been interpreted in terms of illegitimate managerial efforts to promote self-interest rather than the interests of third parties.

Alternatively, a plaintiff might attempt to frame such a challenge in terms of the duty of care, on the theory that the duty of care includes a substantive element recognizing that certain decisions (however prudent they may appear to be from a procedural point of view) are objectively irrational. *See supra* text accompanying note 118. However, the mere fact that management has chosen to prefer nonshareholder interests over those of shareholders would be insufficient to demonstrate irrationality because the statutes allow management to act in this way.

There may still be something left to the rationality requirement, but it is unclear how helpful it would be to shareholders who object to policies favoring nonshareholders. One possible example of irrationality might be a decision that sacrificed very substantial shareholder gains for trivial nonshareholder benefits.

127. *Cf.* Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) (ordering payment of dividend when management sought to retain earnings to pursue policies contrary to shareholder financial interests).

128. *See* CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1990); HAW. REV. STAT.

From the shareholders' viewpoint, the principal doctrinal effect of the directors' duty statutes is to deny them the right to hold management accountable for decisions that renounce their interest in profit maximization in order to protect nonshareholders. The fact that a management decision has that objective no longer provides a sufficient basis for overcoming the business judgment rule's presumption of propriety or for proving a substantive violation. By revising traditional doctrine in this way, the directors' duty statutes allow management to protect nonshareholder interests without fearing liability to shareholders for their decisions. The effect is to decenter shareholders by abrogating the traditional shareholder primacy principle. It should be stressed, however, that the changes discussed here are purely doctrinal. Whether they will be of any practical importance to shareholders depends on the extent to which management actually chooses to exercise its authority to disregard shareholder welfare. In other words, as long as management pursues shareholder welfare, the loss of a right to challenge deviations from that norm will be unimportant. Thus, the practical significance of the changes discussed in this section will depend on how management behaves. That, in turn, will depend on whether the new statutes are interpreted as imposing affirmative responsibility on management to protect nonshareholders, as discussed in the next section.

IV. The Rights of Nonshareholders

We have seen that, in their negative aspect, the directors' duty statutes sharply curtail shareholder opportunities to challenge management decisions that sacrifice their interests to those of nonshareholders.[129] Yet, because the statutes are mostly phrased in permissive rather than mandatory terms, the extent to which management will exercise its new powers — and therefore the extent to which shareholders will suffer and nonshareholders benefit — is unclear. To approach the question of whether the new statutes incorporate an affirmative agenda entitling nonshareholders to management's solicitude, it is necessary to determine the circumstances under which nonshareholders can hold management accountable for decisions nonshareholders deem harmful to their interests. The first part of this section addresses that question, suggesting two possible interpretations. One would leave nonshareholders entirely reliant on management's discretion, while the other would acknowledge some

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§ 415-35(b) (Supp. 1990); Idaho Code § 30-1602 (1989); Ind. Code Ann. § 23-1-35-1(d) (West Supp. 1990); Mass. Gen. Laws Ann. ch. 156B, § 65 (West Supp. 1990); N.M. Stat. Ann. § 53-11-35(D) (Supp. 1989); Or. Rev. Stat. § 60.357(5) (1989); Pa. Cons. Stat. Ann. § 511(b) (Purdon Supp. 1990).

129. *See supra* pt. III.

minimal rights with respect to management's consideration of nonshareholder interests.[130] It will then be suggested that either of these readings would likely be of slight value to nonshareholders.[131] Accordingly, if the directors' duty statutes are to be taken seriously, a stronger interpretation of nonshareholder rights is needed.[132] After presentation of such an interpretation, some objections to it will be addressed.[133]

A. Defining Management's Responsibility To Nonshareholders

1. No New Rights.—A superficially appealing answer to the question of nonshareholder rights under the new statutes is to deny that they provide anything. We might term this the "no new rights" interpretation. This answer stresses that virtually all statutes make consideration of nonshareholder interests optional but not mandatory. That being the case, nonshareholders gain nothing from these statutes beyond what directors choose to give. This interpretation appears to be all the more forceful when the statute expressly states that no single group's interests shall be deemed controlling by the board.[134]

If courts were to interpret the directors' duty statutes in this manner, the effect would be to expand management discretion substantially. Management would enjoy the freedom to decide whether shareholder or nonshareholder interests should receive priority in particular situations. Decisions to favor nonshareholders could not be challenged by shareholders;[135] and nonshareholders could not challenge management decisions designed to promote shareholder interests at substantial cost to affected nonshareholder constituencies. In other words, the manner in which management chose to exercise its broad powers would be largely immune from judicial review.

It would be a mistake to adopt the no new rights interpretation of the new statutes. Courts should be reluctant to read them in a manner

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130. *See infra* pt. IV(A).

131. *See infra* pt. IV(B).

132. *See infra* pt. IV(C).

133. *See infra* pt. IV(D).

134. *See supra* notes 95 & 96 and accompanying text. Even when consideration of nonshareholder interests is required by the directors' duty statute (*i.e.*, Connecticut), nothing is said about how shareholder and nonshareholder interests are to be weighed against each other. Accordingly, once the board has assessed the relevant nonshareholder interests, it apparently is free to accord them whatever weight (including none) it wishes. Here, at least, a nonshareholder could sue management for simply ignoring his or her interest in the decision in question. But determining the remedy might be problematic, because it would be difficult, if not impossible, to show that compliance with the duty to consider might have resulted in a different management decision. *Cf. infra* note 137.

135. At least not as long as they were disinterested, adequately informed, and rational. *See supra* pt. III.

that creates such expansive and unaccountable power, while at the same time denying any meaningful role for the judiciary in policing the manner in which that power is exercised. Furthermore, if the statutes are read as leaving nonshareholder protection entirely to management's discretion, a variety of incentives will discourage management from using its powers to protect nonshareholder interests, a point discussed more fully below. This interpretation would therefore result in the statutes having virtually no effect at all. If that is so, the no new rights interpretation would amount either to judicial nullification of the directors' duty statutes or to imputation to the legislatures of empty intentions. However, before considering these incentives and the need for a stronger interpretation of nonshareholder rights under the new statutes, it is first necessary to examine how the no new rights interpretation conflicts with basic notions of management's responsibility to act with due care and should be rejected for that reason alone.

2. Minimal Protection.—An alternative to the no new rights interpretation of the directors' duty statutes would recognize limited opportunities for nonshareholders to challenge management decision-making. This reading — a "minimal protection" interpretation — is based on the traditional requirement of managerial due care. We have seen that directors are now empowered to sacrifice (or at least temper) devotion to shareholder wealth maximization when they decide that other values so merit. Decisions about *how* to weigh shareholder financial interest against nonshareholder considerations may now qualify as proper exercises of business judgment. Even here, however, the usual requirement that management exercise due care — with its attendant requirement of adequate information — would seem to apply.[136]

At the very least, nonshareholders should be able to challenge a decision adversely affecting them on the ground that it was uninformed. In this context, nonshareholders might contend that the board failed accurately to assess the impact of the decision in question on an affected nonshareholder constituency. As a result, its decision to adopt a policy harmful to that constituency was not the product of careful, reasoned deliberation. In other words, the statutes should be interpreted to require management to give adequate consideration to possible adverse effects on particular nonshareholder constituencies before deciding on a course of action designed to benefit shareholders. This implies that management needs to be both aware of possible adverse effects and adequately informed about their likely magnitude. Only then will management be in a position to deliberate about the significance of these costs in relation to expected shareholder benefits. Thus, this interpretation would ac-

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136. *See supra* pt. III.

knowledge that management has the discretion to pursue profitable transactions despite harmful effects on nonshareholders, but would allow it to do so only after having assembled and considered relevant information about such effects.

This does not seem too much to ask. As a general matter, the law's willingness to delegate power to make substantive choices need not imply lack of concern for the manner in which choices are made. To the contrary, the very act of delegation ordinarily implies an expectation that the power conferred will be exercised with reasonable care. This principle is reflected in corporate law's traditional requirement that management exercise its discretion to manage the corporation on the basis of adequate information and with appropriate deliberation. Under the directors' duty statutes, these discretionary powers are enlarged to include an authorization to take into account harmful effects on nonshareholders. It seems only reasonable to continue to require management to exercise its powers of choice in light of adequate consideration of the relevant options. Thus, delegating to management the power to protect nonshareholder interests implies a duty to ascertain whether and to what extent those interests are likely to be affected by particular decisions.

If so, a nonshareholder's claim that a decision was not based on adequate information should be sufficient to avoid management immunity based on the business judgment rule, just as it would be if a shareholder were attempting to challenge a decision on the same ground. In addition, if proved, lack of due care ought to be grounds for relief in suits by nonshareholders and shareholders alike. This interpretation would therefore acknowledge management's discretionary powers to choose between shareholder and nonshareholder interests, requiring only that those powers be exercised with knowledge and circumspection.

If the analysis offered here is sound, the new statutes should at least be interpreted to confer certain limited rights on nonshareholders, allowing them to formulate challenges to harmful management decisions on the ground that management's decision was uninformed.[137] However,

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137. Even if this interpretation is accepted, there is a potentially vexing question of causation in such cases. When the claim is that management failed adequately to inform itself about effects on nonshareholders (or failed to consider nonshareholder interests at all), aggrieved nonshareholders would presumably have to show that, had management acted with adequate information, it would not have taken the objectionable decision. This may be extremely difficult to prove. Nevertheless, perhaps a court should not be too hesitant about granting prospective injunctive relief in appropriate cases. Such a judgment would amount to an order to reconsider the matter at issue, paying adequate attention to relevant nonshareholder interests, and would not involve personal liability for money damages. As such, it would be an endorsement of the value of the deliberative process,

the question still remains whether nonshareholders have standing to bring suit under the new statutes. The statutes themselves are silent on this question, but courts should not deny rights of action to nonshareholders. One obvious reason is the standard one for implying private rights of action under statutes that neither confer nor deny such rights. As the statutes' intended beneficiaries, nonshareholders ought to be able to enforce whatever rights they gain under them. This argument is all the more forceful in situations, like this one, in which there is no reason to expect public authorities (or others) to vindicate the beneficiaries' interests by suing on their behalf.

There is a further reason for allowing nonshareholders to bring suit. The apparent goal of the statutes is to encourage, or at least allow, managerial attention to nonshareholder interests in cases in which exclusive devotion to profit maximization would be harmful. Under the minimal protection interpretation, management would be permitted, but not required, to exercise this power. It is therefore especially important to minimize significant disincentives for management to do so.[138] From the nonshareholders' perspective, there is concern that management will fail adequately to consider nonshareholder as well as shareholder welfare. Shareholders will have an incentive to challenge decisions that sacrifice their interests for the sake of assertedly offsetting benefits to nonshareholders. Thus, if management chooses a course of action that sacrifices shareholder interests for the sake of nonshareholders, there is at least some likelihood that it will be sued by a disgruntled shareholder. However, if management chooses to promote shareholder welfare instead, and adversely affected nonshareholders have no right of action, there

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rather than an assertion that management would necessarily have reached a different conclusion under hypothetically altered circumstances. However, when the harmful effects of a decision have already occurred, it may be harder to make a compelling case for monetary relief. Perhaps it should be enough to say that, if the relatively mild prohibition on management decisions that harm nonshareholders inadvertently or carelessly is to mean anything, courts will need to avoid overly scrupulous insistence on proof of causation.

Two further grounds for relief should also be mentioned, though these may be relatively unimportant. First, nonshareholders should be able to challenge decisions to benefit shareholders that are tainted by management's self-interest, as, for example, if a majority of the board members owns substantial blocks of stock. Second, even if a decision to benefit shareholders at a cost to nonshareholders is disinterested and adequately informed, it should be possible to claim that the decision is objectively irrational. However, as in the case of shareholder suits, the rationality requirement is likely to be relevant only in a relatively small range of cases. One category might include decisions designed to benefit shareholders that will result only in slight gains even if things work out as hoped, but will produce substantial detriment to a particular class of nonshareholders. Another would be cases of waste, in which management confers a benefit on some person or group having no legitimate claim.

138. *See infra* pt. IV(B) for further discussion of related issues.

is little if any reason to fear litigation challenging adverse impact on nonshareholders. Surely shareholders would not be expected to sue management because a financially beneficial decision also happens to impose costs on nonshareholders. So, unless nonshareholders can assert their rights under the statutes, the threat of suits by shareholders may encourage management to disregard nonshareholder considerations, and choose the safer course of preferring shareholder wealth maximization over competing nonshareholder interests. Such a result would, of course, render the statutes meaningless as a device for protecting nonshareholders. Thus, the availability of a right of action for shareholders suggests a reason for a corresponding right for nonshareholders.[139]

Even with a right of action, the interpretation of nonshareholders' rights under the new statutes offered in this section is far from generous. It only establishes a right to relief in cases in which management either entirely ignored affected nonshareholder interests or chose to subordinate such interests to shareholder welfare without first having adequately informed itself of relevant costs and benefits. If management is disinterested and adequately informed prior to making a decision, there is virtually no basis on which nonshareholders might sue management for choosing to pursue shareholder interests despite significant costs to nonshareholders.[140] Thus, although this interpretation is more generous than the no new rights interpretation discussed above,[141] it is still quite minimal. Whether it is at all adequate to the statutes' apparent objective of protecting nonshareholder welfare is considered next.

B. Incentives

Of the two interpretations of the new statutes discussed in the previous section, the minimal protection interpretation would at least require informed, disinterested evaluation of the impact of particular decisions on nonshareholder constituencies. Assuming a right of action were available, nonshareholders would be entitled to challenge management decisions on grounds that the decisions are based on inadequate information, tainted by conflict of interest, or substantively irrational.

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139. In form, nonshareholder challenges of the type discussed above might be deemed direct actions (as opposed to derivative, *see supra* note 113), because the injury complained of is a harm to a particular nonshareholder constituency, rather than to the corporation as a whole. Alternatively, however, if a decision to protect a particular nonshareholder group is conceived of as an effort by management to discharge a duty owed to the corporation, the action could be characterized as derivative, even though the beneficiaries of a judgment are only a single nonshareholder constituency.

140. The sole exception would be those odd-ball cases in which management's decision could be construed to be substantively irrational. *See supra* note 126.

141. *See supra* pt. IV(A)(1).

This is a more generous interpretation than the no new rights reading, but it does not require that management protect nonshareholder interests under any defined circumstances. As long as management collects and digests the necessary information, it would be free to pursue profit maximization without regard to adverse effects on nonshareholders.

If protection is limited to that provided by either the no new rights or minimal protection interpretations, and even assuming that nonshareholders enjoy a right of action, the statutes will have little if any beneficial effects for nonshareholders. Instead, various incentives will encourage management to focus its energies on shareholder welfare, for the most part leaving its newly minted discretionary powers on the shelf.[142] This is so for several reasons.

First, as noted previously, the new statutes do not extend voting rights to nonshareholders. The power to elect the corporation's board of directors therefore remains in the hands of the shareholders. However weak this power may be (because of management's control over the proxy machinery[143]), voting rights still represent a potentially meaningful check on the way in which management exercises its powers. Especially as large institutional shareholders take on an increasingly vocal monitoring role, managers who wish to retain their jobs and avoid controversy must be wary of disappointing the corporation's shareholders. In contrast, there would be little reason to fear the nonshareholders, at least as long as management does its homework well enough to minimize the likelihood of a successful lawsuit. This means that in cases in which management must choose between promoting shareholder welfare at a cost to nonshareholders or protecting nonshareholders at the shareholders' expense, the existence of shareholder voting rights encourages management to prefer the former option.

Existing executive compensation schemes that discourage management from tempering a commitment to profit maximization are another disincentive to regard for nonshareholders. This is obvious when bonus payments are tied to profitability. In addition, if grants of stock or of stock options are an important part of the compensation package, management will have an incentive to maximize share values. The long-term security of executive pension plans may also be perceived to depend in part on the corporation's financial performance.

Besides the voting rights disparity and the character of existing executive compensation schemes, several market-based incentives constitute a third factor discouraging regard for nonshareholders. These in-

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142. The argument is not that management will be more attentive to shareholder welfare if the new statutes are interpreted minimally than it would be if there were no statutes at all. Rather, it will not be any less so.

143. *See* M. Eisenberg, The Structure of the Corporation 97-136 (1976).

centives are based on management's interest in ensuring that the corporation compete effectively with the other firms in its markets. Failure to do so would result in declining market shares and, ultimately, bankruptcy. As with voting rights and executive compensation, management's financial welfare, job security, professional reputation, and self-esteem are at stake. Even if such considerations do not guarantee that management will do everything in its power to pursue profit maximization, they still generate systemic pressures that lead management away from costly policies beneficial to nonshareholders.

One such market-based incentive is the existence of product (or service) market competition. Competition from other sellers in the same market will encourage management to trim costs. This objective can translate into losses for nonshareholders. For example, in a case in which maintaining operations at an older facility constitutes a productively inefficient use of the corporation's assets, management will feel pressured to close the plant. Failure to do so may disadvantage the corporation *vis-a-vis* its competitors. Thus, the need to minimize production costs creates an incentive for management to pursue efficiency rather than nonshareholder welfare.

Competition among corporations for debt financing may also have that effect. To the extent that lenders perceive an uncertain commitment to profit maximization as a threat to the corporation's financial stability, borrowing costs should be higher. These will be out-of-pocket costs in the form of higher interest rates, and may therefore impair the corporation's ability to compete. Accordingly, there is an incentive to pursue strategies that will facilitate lower-cost borrowing.

Capital market pressures may also be relevant. Sub-optimal performance is likely to increase the cost of raising capital through sale of equity; investors in newly issued stock who are asked to settle for a lower rate of return can be expected to demand a larger quantity of stock in return for their capital contribution. The higher cost of such stock offerings is not an additional out-of-pocket expense affecting the corporation's ability to compete in the product market.[144] Nevertheless, the greater the amount of stock to be issued, the greater the likelihood that existing shareholders will object that the percentage share of the corporation's total equity to be held by the new investors is too great in relation to the amount of their capital contribution. The result may be lawsuits by existing shareholders or dissatisfaction registered at the annual meeting.[145] Thus, the fact that corporations must compete with

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144. Eisenberg, *supra* note 38, at 1500-01.

145. Nevertheless, the significance of the higher capital cost factor should not be overstated. Most publicly held corporations do not depend on public offerings of stock

each other to obtain equity financing may also encourage profit maximization, despite negative effects on nonshareholders.

Finally, it should be recalled that only some corporations are subject to the new directors' duty statutes. Some states — notably Delaware and California — have not enacted them; presumably shareholder primacy (however diluted) will continue to be the governing norm for firms incorporated in these states. Thus, management of a corporation subject to a directors' duty statute may have to compete against companies for which adoption of policies designed to favor nonshareholders would be illegal. This factor could therefore compound the significance of the various market forces discouraging deviation from profit maximization.[146]

All these reasons taken together suggest that there will be substantial incentives for management to pursue profit maximizing options even when it is aware of foreseeable, substantial negative effects on particular nonshareholder constituencies.[147] If the statutes are interpreted as requiring nothing more than disinterest, adequately informed decision-making, and rationality, they can be expected to be of little benefit to nonshareholders. Critics of the directors' duty statutes have focused on management's broad discretion to choose between shareholder and nonshareholder interests, apparently unconstrained by guidelines about how this discretion is to be exercised.[148] Under this view, managers wield unprecedented power not only over questions of business policy but over the question of corporate purpose itself. However, the analysis offered above suggests that these critics may have little to fear. If there is no

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to generate needed capital, relying on retained earnings instead. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 648 (1988).

146. This discussion raises the possibility that states adopting directors' duty statutes could put their domestic corporations at a competitive disadvantage (*vis-a-vis* firms incorporated in other states) if the statutes were interpreted as requiring management to take nonshareholder interests into account. If the disadvantage were severe enough, the result might be reincorporation in a state (such as Delaware) that lacks such a statute. Before that possibility is taken too seriously, however, one would want to see some empirical evidence that the detrimental effect of management's conduct is sufficient to make a difference in the corporation's competitive position. Even if there is a noticeable effect, there may be other considerations (taxes or convenience, for example) that militate against reincorporation.

147. One market factor that may be of relatively limited significance is the market for corporate control. Such a market encourages management to maximize returns on corporate assets in order to deter potential hostile acquirers. *See generally* Manne, *supra* note 45. However, the combination of judicial decisions and antitakeover legislation, discussed in Part I(B)(2) above, have sapped the takeover market of much of its vigor. Another cause has been the withering of the junk bond market on which the takeover market depended in large part.

148. *See* Hanks, *supra* note 8, at 24-25; ABA Report, *supra* note 8, at 2269.

legal requirement that management protect nonshareholders, it is unlikely that it will do so.

One response to this analysis is to point out that management's dedication to profit maximization depends on its perception that such a course of action is in its self-interest. There may be situations in which self-interest will dictate use of the statutory power to disregard shareholder welfare. In other words, the interests of management and nonshareholders may be aligned under certain circumstances, and the incentives ordinarily encouraging promotion of shareholder welfare may not apply. In those cases, even a weak interpretation of the statutes will be sufficient to protect nonshareholders.

This observation may be accurate in the relatively isolated situations in which promotion of shareholder interests threatens management's job security. The obvious example is the hostile takeover. When nonshareholder interests are also threatened, management can use its authority under the directors' duty statutes to take whatever defensive actions are needed. In such cases, the statutes may work in the nonshareholders' favor even if management's responsibility to them is wholly discretionary. However, even in the hostile takeover situation, management and shareholder interests may be aligned, as for example, if generous golden parachute provisions apply. In any event, hostile takeovers are increasingly rare and represent only one among the many possible situations in which nonshareholders may be adversely affected by pursuit of shareholder welfare. They are also unique in presenting the likelihood that management will lose its job. Most other situations involving a choice between shareholder and nonshareholder interests (plant closings unrelated to changes in control, for example) involve no such threat. Thus, the cases in which management and nonshareholder interests will coincide will be relatively rare, and are not nearly frequent enough to justify confidence that management will use its statutory powers to protect nonshareholders on more than an occasional basis.

Under either the no new rights or minimal protection interpretations, the directors' duty statutes do not present as serious a threat to shareholder primacy as their critics fear. From a doctrinal viewpoint, the statutes would prevent shareholders from challenging management decisions that sacrifice shareholder interests for the sake of nonshareholder welfare. However, it is likely that they will fail to benefit nonshareholders because management will be reluctant to exercise its powers on nonshareholders' behalf. If the statutes are interpreted to impose only minimal requirements on management, they will have only minimal effect. Therefore, the need is to decide whether to read the statutes in a manner that trivializes and effectively nullifies them or, instead, to try to understand them as meaningful legislative efforts to protect nonshareholders from the harmful side-effects of overly zealous commitment to profit maximization.

C. *Taking the Directors' Duty Statutes Seriously*

If the directors' duty statutes are to have any significant effect, they must impose requirements on management that extend beyond minimal requirements of disinterest, adequate knowledge, and rationality. As part of a larger effort by the states to protect vulnerable nonshareholders from the excesses of exclusive devotion to shareholder welfare, the directors' duty statutes should be read in light of their political context. An interpretation that in effect renders the statutes vacuous ignores the magnitude of the problem they address and vitiates the legislatures' attempt at a solution. It also leaves corporate management with greatly expanded discretionary power, without any likelihood of meaningful benefits to the statutes' intended beneficiaries. The statutes therefore need to be interpreted in a way that mandates protection for nonshareholder interests under defined circumstances.[149]

This section suggests three broad principles governing management's exercise of its powers under the new statutes. These principles apply both within and outside of the hostile takeover context and are based on an understanding of the context out of which the statutes emerged. Before outlining the principles, it is necessary to revisit a few key points about that context. As discussed above,[150] the immediate occasion for the directors' duty statutes was the hostile takeover explosion. Before then, management's duty to the corporation could be interpreted as a duty to the shareholders because the interests of shareholder and nonshareholder participants in the corporate enterprise were assumed to be largely congruent.[151] So long as management pursued long-term strategies, all participants stood to gain. Profits would flow from investment in research and development and gradual expansion and adjustment of production in response to market conditions. Management promoted the firm's interest by supervising employee, supplier, creditor, and customer

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149. Statutory language apparently disclaiming the right of any corporate constituency to insist that its interests receive priority should present no obstacle to such an interpretation. *See supra* text accompanying note 95 (quoting Indiana's statute); *see also* Pa. Cons. Stat. Ann. § 511(b) (Supp. 1990) (quoted *supra* note 96); *cf.* N.Y. Bus. Corp. Law § 717(b) (McKinney Supp. 1990). The purpose of this language is not to deny rights to nonshareholders, but rather to state explicitly that shareholders are no longer entitled to the primacy they enjoyed under traditional corporate law principles. The Indiana statute seems to make this clear. Immediately following the sentence denying priority, the statute addresses shareholders' rights to tender offer premiums, explaining in effect that Indiana law does not require directors to promote shareholder interests in hostile takeover situations. *See* Ind. Code Ann. § 23-1-35-1(f) (West Supp. 1990). Thus, it would be a mistake to read such provisions as precluding efforts to interpret management's obligations to nonshareholders in a meaningful manner.

150. *See supra* pt. I(B)(1).

151. *See supra* text accompanying notes 78-79.

relationships in ways that minimized unexpected, uncompensated disruption.

Hostile takeovers presented a highly visible and dramatic instance in which shareholder interests and those of the other participants in the corporate enterprise diverged. Target company shareholders possessed the power to decide unilaterally whether particular hostile bids would succeed by virtue of their power to decide whether to tender their stock to the bidder. They could and did wield this power without regard to how changes in management and in corporate policy might affect nonshareholders. As a result, shareholders' desires for immediate gains often brought immediate costs to nonshareholders. Despite the absence of express contractual commitments by the corporation, many of these nonshareholders had legitimate expectations of long-term relationships with the corporation, built on implicit understandings and reliance.[152] By allowing shareholders to sell the company to the highest bidder, tender offers interfered with target company management's ability to pursue longer-term strategies in accordance with nonshareholder expectations, even when these might be to the ultimate benefit of target shareholders as well. Takeovers therefore focused attention on the distinction between short-term shareholder gain and attendant nonshareholder losses, on the one hand, and, on the other, the possible longer-term benefits to both shareholders and nonshareholders of the continued independence of the corporation.

The new directors' duty statutes, as a part of the broader judicial and legislative response to the harmful effects of hostile takeovers,[153] should be read as an effort to deny shareholders the power to realize short-term profits at the expense of management's discretion to pursue longer-term strategies from which both shareholders and nonshareholders might benefit. Because most of these statutes apply beyond the hostile takeover context, it seems entirely reasonable to conclude that they seek a similar goal beyond that context. Accordingly, the first principle that should guide interpretation of the directors' duty statutes is this: Management should not seek or allow short-term shareholder gains if frustration of legitimate nonshareholder expectations will result.

For example, it would be presumptively improper for management to adopt a policy that would result in the swift, unexpected layoff of large numbers of workers or the closing of a plant in a community in which that facility is an important citizen, even if the immediate financial benefit to the corporation would be significant. (This decision would only be presumptively improper because it might be justified under certain

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152. *See supra* text accompanying notes 47-48.
153. *See supra* pt. I(B)(2).

circumstances by reference to the third principle, discussed below.) The first principle would also embrace situations in which management must intervene to prevent shareholder profit-taking from harming nonshareholders. The most salient example would be a threatened bust-up takeover that would result in a large premium for shareholders but a substantial disruption of existing nonshareholder relationships. In other words, this principle is an explicit rejection of the view that management's duty is to promote short-term shareholder financial interests when significant harm to nonshareholder constituencies would follow.

Although the first principle would interpret the statutes as empowering management to disregard short-term shareholder gains in order to avoid nonshareholder losses, there is no basis for interpreting the statutes as authorizing management to disregard the profit motive altogether. It would be surprising to read so radical a message into these terse enactments, and there is no need to do so. Accordingly, the second principle requires management to pursue profit-seeking strategies that aim to harmonize the shareholders' financial interest and nonshareholder interests in stable relationships with the corporation.

This objective implies that management should run the corporation with an eye toward a longer horizon. That suggests a policy of patient attention to profit maximization through gradual, prudent adjustment to market circumstances, rather than radical, disruptive reactions motivated by a desire to shore up current profits. Some statutes refer expressly to the relevance of "long-term" considerations to managerial decision-making.[154] The decline of a robust takeover market, together with the empowerment to block destructive bids that the directors' duty statutes themselves provide, should give management the freedom needed to pursue such strategies.

As long as management adheres to the first and second principles, sharp conflicts of interest between shareholders and nonshareholders may be relatively infrequent. Long-term strategies can be formulated that minimize disruption of nonshareholder relationships. However, there will be times when preservation of existing relationships appears to be either impossible or so costly as to threaten the well-being of the enterprise as a whole. Plants will have to be replaced; suppliers may prove unable to trade at competitive prices. Under such circumstances, management's duty to respect existing nonshareholder relationships implies a larger duty to promote the welfare of the enterprise as a whole; after all, if the corporation collapses, all fall with it. Accordingly, the statutes should not be read as entitling nonshareholders to permanent relationships with the corporation under all circumstances. However, in cases of conflict

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154. *See supra* text accompanying note 87 and statutes cited *supra* note 88.

between the interests of the enterprise in maintaining profitable operations and those of a particular nonshareholder constituency in continuing a valuable relationship, the latter need not be sacrificed with impunity. Keeping their context in mind, the directors' duty statutes clearly reveal a concern about abrupt, unfair disruption of relations between the corporation and vulnerable nonshareholder constituencies. Accordingly, a third principle seems appropriate: In managing the company in a manner that pays due regard to profit maximization over the long-term, management should honor the legitimate expectations of nonshareholder constituencies if abrogation of existing relationships is necessary to serve the larger interests of the corporate enterprise as a whole.

A duty to consider the interests of particular nonshareholder constituencies therefore does not mean that plants can never be closed or supplier relationships terminated. It does mean, however, that management should conduct such transitions in a manner that minimizes losses to the affected parties. Substantial advance notice would seem to be a basic entitlement. In the case of employees, job transfer and retraining opportunities may also be appropriate. If losses resulting from disruption of legitimate expectations cannot be avoided, the objective should be full compensation for losses resulting from breach of commitments implicitly undertaken by management. If computation of such awards proves to be too difficult, it may be desirable to spell out these rights ahead of time by contract as, for example, through adoption of so-called "tin parachute" severance payment provisions.[155]

The interpretive principles offered here are admittedly very general. Even those who are sympathetic may find them too vague to be helpful. Terms like "legitimate expectations" and distinctions like "long-term" versus "short-term" are notoriously manipulable. If this is all that can be made of the statutes, some will conclude that it is not enough. (And those who are implacably hostile to the entire enterprise will find another reason to object.) In its defense, this approach relies on necessarily loose normative guidelines and, in effect, invites courts to develop a new body of common law in this area. The virtue of the common law method has always been its adaptability to new information and changing circumstances. This seems all the more suitable in a situation that involves factually and conceptually difficult issues, troubling political questions, and a sharp break with traditional legal doctrine. Perhaps the meaning of the general principles sketched here is best worked out in the context of concrete cases.[156]

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155. Protection might also include successorship requirements binding subsequent acquirers. For discussion of the use of tin parachutes and successorship requirements in these contexts, see Note, *supra* note 8, at 1473-84.

156. For example, what counts as legitimate nonshareholder expectations entitled to

Surely a comparatively more cautious, less ambitious approach is preferable to an effort to specify a large number of detailed, narrow rules. It would be an act of foolish hubris to reject nearly a century of accumulated legal development and, simultaneously, offer what purports to be a fully articulated replacement. Whatever wisdom and clarity such a project might appear to offer would be largely illusory because it is sure to require adjustment and creative interpretation in light of future problems now only dimly perceived. In any event, the statutes themselves speak in such general terms that a more finely textured interpretation seems inappropriate.

The interpretation suggested above implies a new conception of management's responsibilities to shareholders and nonshareholders. One might ask whether under this interpretation the new statutes extend the fiduciary principle from the management-shareholder nexus to the relations between management, on the one hand, and all the various corporate constituencies (shareholder as well as nonshareholder), on the other.[157] The problem with this conceptualization is that it implies that management owes fiduciary obligations to a wide range of beneficiaries whose interests will inevitably conflict from time to time. Used in this manner, the fiduciary idea, with its implication of undivided loyalty, does not seem very helpful.

One alternative is to continue to think of the shareholders as the beneficiary of management's fiduciary obligation, but to appreciate that the obligation is hemmed in by statutory responsibilities to nonshare-

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protection is best decided on a case-by-case basis. Even if legitimate expectations are defined more precisely (such as those growing out of relied upon, implicit understandings of long-term employment, as evidenced by firm-specific investments made in anticipation of long-term returns), the justice of a nonshareholder group's claim will depend on the factual circumstances, including the nature and history of the relationship with the corporation, the extent and character of the nonshareholders' reliance, the reasonableness of their expectations under the circumstances, the amount of compensation, and other factors. The difficulty of such evaluations would not be eliminated by expressing legal principles in the language of economic theory. For example, to state management's responsibility as a requirement that significant policy decisions be Pareto efficient with respect to nonshareholders as well as shareholders (*i.e.*, no one should be made worse off) would simply raise a new set of interpretive difficulties. General economic concepts are no more determinate than ordinary legal ones.

157. For an extended argument in favor of recognition of a fiduciary duty owed by management to the corporation's employees, see O'Connor, *supra* note 48. Though the existence of the new directors' duty statutes is one element on which O'Connor draws in support of her position, her argument is not presented as an interpretation of these statutes. Rather, she advocates creation of a common law fiduciary duty analogous to the nonstatutory fiduciary obligations traditionally owed by management to shareholders. *See also* McDaniel, *Bondholders and Stockholders*, 13 J. Corp. L. 205 (1988) (advocating fiduciary protection of bondholders).

holders. After all, there have always been limits on the shareholders' right to demand that management promote their interests. Most obvious is the traditional requirement that management act within the bounds of the law.[158] In addition, fraudulent conveyance principles restrict management's freedom to benefit shareholders at the expense of creditors.[159] Interpreted in the manner suggested above, the directors' duty statutes simply supplement existing restrictions on over-zealous pursuit of shareholder primacy.

Perhaps, however, it is preferable to think about management's fiduciary obligation as a duty to the corporation as such, rather than to any particular constituency. The directors' duty statutes invite us to jettison the traditional conflation of management's duty to the corporation with a duty to the shareholders. Doctrinally this was never accurate; management is an agent of the reified corporate entity rather than of its shareholders. Nevertheless, the conflation was long acceptable because both descriptively and normatively, it didn't seem to make much difference. Corporate and shareholder interests were perceived to be congruent and generally unthreatening to the various nonshareholder constituencies. How we conceptualize the nature of the corporation may have limited practical significance in any large sense, but it can nevertheless help us to clarify our thinking about particular normative questions.[160] By formulating management's duty as a duty to the corporate enterprise, we emphasize that management's responsibility to look after nonshareholders arises in the context of a more general duty to further the success of the corporation as a whole, conceived as a complex network of shareholders and nonshareholders. This idea rests on a normative perspective that rejects the notion that corporations exist solely to serve as investment vehicles for shareholders. This is only one of their functions. They also play a vital role in our society as employers, customers, suppliers of goods and services, and valued members of local communities. By redefining management's responsibility as a duty to the corporate entity, comprising nonshareholders as well as shareholders, corporate law acknowledges this fact.

D. Objections

The stronger interpretation of the directors' duty statutes offered above defines limitations on management's discretion that are designed to require protection of nonshareholder interests under certain circum-

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158. *See, e.g.*, ALI Principles, *supra* note 17, § 2.01.

159. *See generally* R. Clark, *supra* note 21, at 40-52.

160. For discussion of the role of theories of the corporation in legal and political discourse, see Millon, *Theories of the Corporation*, *supra* note 22, at 240-51.

stances. This interpretation would confer enforceable rights on nonshareholders to challenge particular management decisions. Definition and enforceability are necessary to overcome the incentives that will discourage management from exercising its powers to protect nonshareholders. The result will be restriction on management's ability to pursue shareholder welfare through profit maximization. This fact suggests one objection to the stronger interpretation: its damaging impact on shareholder property rights. If interpreted in the manner suggested here, the statutes will also interfere with shareholders' ability to structure their relations with nonshareholders through private ordering. In that respect, the statutes threaten efficiency. Both these objections are considered below.

1. Shareholder Property Rights.—By restricting management's ability to pursue shareholder welfare, the strong interpretation would have an adverse effect on shareholder property rights. Ownership of a share of stock would no longer imply a right to have management exercise its stewardship of the corporation in order to maximize the share's value. Of course, the new statutes do not authorize managerial self-dealing, sloth, or other forms of deliberate or negligent injury to shareholder financial interest.[161] Nevertheless, under certain circumstances, management would be required to put shareholder interests to one side in order to protect the interests of nonshareholders.[162] Because shareholders would have to settle for less than optimal financial performance, stock in corporations subject to the new statutes would presumably be worth less than before.[163]

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161. *See supra* pt. III.

162. Because nonshareholders would realize corresponding benefits, the statutes have been characterized as authorizing transfers of wealth from shareholders to nonshareholders and have been criticized on that account. *See* Hanks, *supra* note 8, at 24 (referring to management's power to allocate "stockholders' wealth" to other groups). However, what counts as shareholders' wealth depends in part upon how the shareholders' entitlements are defined by corporate law. While the enactment of the statutes may be said to have a negative impact on shareholder wealth, management decisions pursuant to the statutes would not involve wealth transfers unless there was a pre-existing entitlement involved. However, the new statutes redefine the shareholders' status in a way that redefines their entitlements. Thus, it is inaccurate to characterize management's power in terms of the power to transfer wealth.

163. It is possible that the stock market would assign a relatively small negative value to the new statutes. The magnitude of the effect would depend in large part upon their practical effects. It may be that these will be only occasional; if management is still able effectively to pursue profit maximization most of the time, the impact on share values may be insubstantial. In any event, the extent to which stock prices respond to apparently significant changes in the law is not clear. *See* Weiss & White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 Calif. L. Rev. 551 (1987) (analyzing effect of seven important judicial decisions on stock prices and finding no significant correlation).

As a legal argument, this objection is weak. Legal transitions do not present serious legal difficulties simply because they cause incidental, uncompensated diminution of share values. Shareholders have always been on notice that states can change the law governing their corporations. Taking the lead from Justice Story's opinion in *Trustees of Dartmouth College v. Woodward*,[164] state general incorporation laws routinely include provisions reserving the right of amendment and announcing their potentially retroactive force.[165] It might even be said that shareholders tacitly consent to such changes in advance by buying stock under these circumstances.

Shareholders cannot fruitfully respond that the shareholder primacy principle is somehow embedded or inherent in the essence of corporate stock. State legislatures define the content of these property rights. By redefining them, the legislatures are simply exercising a prerogative that has always been theirs.[166] For example, the one-share, one-vote principle, which may seem so fundamental as to be timeless, was by no means a universal feature of nineteenth-century corporate law.[167] So too, it has not been long since state legislatures eliminated the individual shareholder's veto power over fundamental corporate changes by doing away with the requirement of unanimous shareholder approval.[168] In short, there is no "ideal type" that defines the transcendental essence of stock.

One can respond that, however legally justified the state's redefinition of stock ownership rights might be, the change would be bad policy. Investors will find stock in corporations subject to the new directors' duty statutes less attractive relative to other investment opportunities, including stock in corporations not subject to the statutes. As a result, it will be more costly for some companies to raise needed capital, and potentially disastrous economic consequences will follow.[169] It might even come to pass that the very nonshareholders the state legislatures seek to protect will find themselves victims of bankruptcies and resultant plant closings.

Why might it make sense to interpret the statutes in a way that could lead to such results? For one thing, the empirical validity of these claims is unknown; the dire consequences may be overstated.[170] Even if

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164. 4 Wheat. 518 (1819).

165. *See, e.g.*, DEL. CODE ANN. tit. 8, § 394 (1989).

166. *See generally* Johnson, *supra* note 107.

167. *See* E. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 WITH SPECIAL REFERENCES TO MASSACHUSSETS 326 (1954).

168. *See* Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, in CORPORATIONS AND SOCIETY: POWER AND RESPONSIBILITY 13, 35-37 (W. Samuels & A. Miller eds. 1987).

169. *See* Hanks, *supra* note 8, at 25.

170. *See supra* note 163.

the effect on share prices were significant, however, offsetting considerations might justify it. Courts and state legislatures first placed new obstacles in the way of alienability (restricting shareholder opportunities in the hostile takeover context) in response to public policy concerns about the adverse effects of takeovers on nonshareholders. Then, in the directors' duty statutes, the states have taken the potentially much bolder step of effecting a general redefinition of management's responsibilities. The justification for statutes that are likely to impose costs on shareholders (and perhaps some nonshareholders too) is the political judgment that the intended benefits to nonshareholders are worth that price.

The manner in which shareholder property rights are defined is a manifestation of the states' general power to specify the content of property rights in order to promote justice or utility. So-called private property rights always exist in order to give expression to public values; the survival of a given property law regime depends ultimately on its social utility.[171] Once a particular legal doctrine is thought of as obsolete, it can and will be replaced with a new one. The directors' duty statutes are an example of this process at work.

2. *Efficiency*.—An interpretation of the directors' duty statutes that qualifies management's responsibility to maximize profits could also be criticized on efficiency grounds.[172] Instead of a firm structured as a network of bargained-for relationships among shareholders (acting through management) and nonshareholders, management would find itself obliged to make decisions that are designed to benefit nonshareholders at the shareholders' expense. To the extent that management acts in this way, one result may be less productive utilization of corporate assets. Corporations would be less efficient in the sense that fewer goods and services would be produced than would have been had management pursued profit maximization without regard to nonshareholder considerations. According to the proponents of economic efficiency, society as a whole will suffer if assets are not put to optimally productive uses.

From this perspective, the directors' duty statutes impede efficiency because the manner in which corporate assets are deployed and wealth is shared among the participants in the corporate enterprise would cease to be determined through private ordering according to economic self-

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171. The legal realists made this point forcefully. *See* Cohen, *Property and Sovereignty*, 13 CORNELL L.Q. 8 (1927); Hale, *Bargaining, Duress, and Economic Liberty*, 43 COLUM. L. REV. 603 (1943). For a more recent analysis of this and related aspects of legal realism, see Singer, *Legal Realism Now*, 76 CALIF. L. REV. 465 (1988).

172. *See* ABA Report, *supra* note 8, at 2268 (deviation from corporate law's traditional commitment to shareholder primacy "could undermine the effectiveness of the system that has made the corporation an efficient device for creation of jobs and wealth").

interest.[173] Nonshareholders would no longer be left to their own devices to identify and protect their interests through the bargaining process, while shareholders would lose the right to insist on profit maximizing strategies. Management interventions on behalf of nonshareholders are therefore likely to leave shareholders worse off than they would have been under the traditional corporate law regime. Additionally, nonshareholders might find themselves parties to relationships with the corporation that they themselves would have chosen to structure differently. For example, instead of protection through the directors' duty statutes, some employees might prefer that management relentlessly pursue corporate profit maximization as long as they receive higher wages and contractually tailored job security provisions in return. Thus, the new statutes might result in wealth sharing arrangements that nonshareholders as well as shareholders regard as less than optimal.

It is possible to take the efficiency critique a step further. In place of a regime based on private ordering, the new statutes would establish an "oligarchy" in which corporate management decides how resources will be allocated and corporate wealth distributed within the relatively loose constraints of the directors' duty statutes.[174] "Public" or "political" questions of wealth distribution would thus be committed to the discretion of private individuals rather than the impersonal workings of the market.[175]

While the strong interpretation of the directors' duty statutes would redefine the parties' ability to use private ordering to structure their relationships, that fact alone does not render the interpretation indefensible. It can be justified on grounds that reject the basic premises on which the efficiency critique rests. As interpreted here, the directors' duty statutes reflect a deep distrust of the efficiency model's bargain paradigm. According to this perspective, private 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 con-

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173. Note that this criticism implies that, but for the directors' duty statutes, corporate relationships are a product of private ordering. In fact, of course, private ordering takes place within an environment that includes many mandatory legal elements. One might say that, even if the directors' duty statutes are interpreted as suggested here, private ordering will still predominate. The rules of the game will be different, and therefore outcomes will be too, but it is incorrect to contrast a state of pure bargain with a state of pure regulation. At most, these are questions of more or less.

174. *See* Cox, *supra* note 12, at 209-12.

175. *See* ABA Report, *supra* note 8, at 2270.

servative economist sees voluntariness, bargaining, and wealth-increasing exchange, the critic sees coercion and severely limited choice.[176]

Seen in this light, a commitment to private ordering in the context of corporate law is itself "oligarchical."[177] Rather than an impersonal mechanism for wealth allocation through individual activity (to be contrasted with the arbitrary private power of corporate management), the market represents an opportunity for shareholders to impose their will on workers and others who lack the ability to protect themselves fully through contract. These nonshareholders find themselves dependent on management's good will for their well-being, but management must respond to the wholly self-interested hunger for short-term profits that drives an increasingly small number of arbitrageurs and institutional investors.[178] Under these circumstances, nonshareholders' inability to obtain fully specified contractual protection leaves them victim to opportunistic disregard of their interests. Market decision-making is thus no less oligarchical than the regime that would be inaugurated by the strong interpretation of the directors' duty statutes. The difference is in who will decide and, more importantly, in whose interest.

Distrust of the fairness of private ordering as a process is not the only reason for rejection of the efficiency norm. Commitment to efficiency as the central value in a normative system presupposes the justice of the existing distribution of wealth. If one views that distribution as unfair, individual pursuit of wealth maximization through bargaining will not correct the unfairness, however fair one might consider the bargaining process to be. Instead, existing disparities are likely to be replicated and perhaps intensified through the market.[179] This perspective on efficiency as a normative criterion therefore provides a further justification for legal intervention.[180]

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176. *See supra* note 171 and sources cited therein.

177. *Cf. supra* text accompanying note 174.

178. *See* Lipton, *supra* note 73, at 7-9.

179. *See* J. Coleman, Markets, Morals and the Law 319-20 (1988).

180. Though I prefer to read the statutes as a rejection of the efficiency norm and its premises, it is still possible to construct a defense of the new statutes on efficiency grounds. One might view the statutes as grounded on a belief that the traditional shareholder-management relationship, with its requirement that management maximize shareholder wealth, imposes significant externalities on identifiable nonshareholder constituencies. These nonshareholders are unable to protect themselves adequately through contract because transaction costs, such as severe informational disparities, stand in the way of effective contracting strategies. For example, the traditional legal duty to maximize shareholder interests threatens to cause lost jobs, disruption of other valuable economic relationships, and imposition of costs (such as unemployment benefits) on the general public. However, because employees often lack access to information about the likelihood of future layoffs and other plans to improve productive efficiency, employees are unable to insist on contract

The difference between this justification for nonshareholder protection and the views of the efficiency proponents is thus quite a bit wider than a disagreement about how to apply economic analysis to corporate law. A strong interpretation of the directors' duty statutes would reflect a rejection of basic positive and normative premises of neoclassical economic orthodoxy. It would reflect a willingness to interfere with efficiency in order to promote a program that restructures the power relationships within the corporation. Corporate law has always shaped those relationships. The new structure proposed here would redistribute power (and therefore wealth) from shareholders to nonshareholders through the mechanism of managerial supervision of the relations among shareholders and nonshareholders. If that is to be the statutes' meaning, it makes little sense for conservatives to criticize them on efficiency grounds. They should instead focus their efforts on the much more difficult task of persuading the public that theirs is a normative vision worthy of broad appeal.

Conclusion: Toward A New Definition Of Corporate Law

It is not enough simply to analyze the new statutes' negative doctrinal implications for the shareholder primacy principle. Even if shareholders lose the right to insist that management privilege their interests, it is by no means clear that management will use its statutory powers to protect nonshareholders at the expense of shareholders. Unless the statutes are interpreted as imposing affirmative obligations on management, there are good reasons to believe that nonshareholders will derive little benefit. So, if the directors' duty statutes are to have any significant meaning, it is necessary to make something constructive out of them. That has been the principal focus of this Essay.

The directors' duty statutes are not intended to provide a blueprint for a new vision of the corporation. Their thrust is as yet largely negative: The states wish to curb existing management tendencies to prefer the

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terms that are well-tailored to their interests. Difficulties may be even greater in situations in which actors (such as local governments) make firm-specific investments in the expectation of a long-term corporate presence but are not in contractual privity with the corporation. Accordingly, statutory protection may be necessary in order to give nonshareholders the rights they would have bargained for in the absence of transaction costs. However, as a justification for the strong interpretation of the new statutes, the suggestion that it aims to mimic the outcomes of private ordering is probably of limited utility. For one thing, the statutes themselves offer no obvious suggestion that they are designed to correct market failure. Further, defenders of protection for nonshareholders would probably make a serious strategic mistake if they limited themselves to defending intervention solely on grounds of efficiency. It probably makes more descriptive and strategic sense to interpret the new statutes as rejecting, for political reasons, the efficiency perspective.

short-term financial interests of shareholders despite the often substantial costs to nonshareholders. In so doing, they reject the orthodox shareholder primacy principle. Yet this negative aspect inevitably implies an affirmative one. By decentering the shareholder, the statutes also reject corporate law's traditional fixation with the shareholder-manager relationship and thrust nonshareholders into the limelight as legitimate objects for corporate law's attention. This in turn seems to be based on a conception of corporate purpose that is much more complex than profit maximization and shareholder welfare. Although these changes imply a fundamental reorientation of corporate law, the statutes speak tentatively and the contours of the new order are as yet uncertain.

It is conceivable that the directors' duty statutes herald the beginnings of a radically different understanding of corporate law and corporate purpose. If they are manifestations of a deeper design to enhance the status of nonshareholders within the corporate enterprise, several lines of development are possible. One could imagine greater nonshareholder involvement in the decision-making process, through voting rights, for example. More radically, we might revise our notion of corporate governance so as to replace the present hierarchical structure with one in which significant decision-making authority spreads downwards, from management into the hands of those most directly affected. And if nonshareholders are to have powers of control, perhaps new ownership structures should be considered as well.

The directors' duty statutes will not provide the vehicle for such developments. Nevertheless, these statutes raise fundamental normative questions about the appropriate aims of corporate law and about corporate purpose itself. In defining management's responsibilities to shareholders and nonshareholders, courts will face choices. As we have seen, it is possible to interpret the directors' duty statutes in ways that effectively trivialize them. To do so would be a mistaken attempt to shore up a crumbling status quo that no longer rests on a firm foundation of societal consensus. Alternatively, the courts can participate in the dialogic process — involving concerned citizens, legislators, and academics, as well as judges — by which society redefines corporate law and the meaning of the corporation itself. The directors' duty statutes challenge the courts to engage in this conversation. Whether these statutes prove to be as revolutionary as their critics suggest will depend on what we make of them.