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# STAKEHOLDER GOVERNANCE: A BAD IDEA GETTING WORSE

*George W. Dent, Jr.*<sup>†</sup>

## INTRODUCTION

Like Dracula, stakeholder participation in corporate governance is an ogre that has been repeatedly slain by prudent argument but invariably springs back to life. This ogre persists because capitalism does not create anyone's idea of heaven. Inevitably, some who cannot or will not accept reality float well-intended but misguided schemes intended to usher us into utopia. We are now suffering a renewed outbreak of these fantasies. Now, however, they are ill-advised not only for the reasons given in the past—although those reasons remain valid—but also because the globalization of capital markets has seriously exacerbated the costs of flaws in the law of corporate governance. This Article will review the traditional objections to stakeholder governance—with special attention to the proposals of the other participants on this panel, Professors Kent Greenfield and Timothy Glynn—and also discuss current trends that should influence our thinking on this topic.

## I. CORPORATE GOVERNANCE AND STAKEHOLDERS: WHERE ARE WE NOW?

### *A. The Current Welfare of Stakeholders*

An initial problem is simply defining “stakeholders” or, as Professor Greenfield calls them, “non-equity investors.”<sup>1</sup> “[S]takeholder theory can be many things to many people . . . .”<sup>2</sup> As

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<sup>1</sup> Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 HARV. L. & POL'Y REV. 1, 2 (2008) [hereinafter Greenfield, *Reclaiming*].

<sup>2</sup> R. Edward Freeman et al., *Stakeholder Theory and “The Corporate Objective Revisited,”* 15 ORG. SCI. 364, 365 (2004); see also Ronald K. Mitchell et al., *Toward a Theory*

for non-executive employees, I support much that Professor Greenfield and Professor Glynn say. In the last twenty-five years, too much of our economic gains have gone to the wealthiest Americans; income for most Americans has stagnated.<sup>3</sup> The resultant deepening of economic inequality is disturbing.

Most of this trend stems from changes in technology, the globalization of economic activity, unchecked immigration, American tax policies, and changing social mores (like the divergence of class attitudes toward marriage<sup>4</sup>) having nothing to do with corporate governance. There is some connection, though. Compensation for many CEOs has become obscenely excessive and economically indefensible.<sup>5</sup> Even if that excess comes entirely from the hides of investors, it breeds understandable resentment among employees. Also, many companies have a CEO autocracy that is inefficient and sometimes disastrous. Many workers have been devastated by the collapse of companies like Enron, Tyco, and WorldCom. These catastrophes also injure customers, suppliers, and the communities in which the companies operate.

It follows that I also agree with Professor Glynn and Professor Greenfield that employees and other stakeholders have an interest in the success of their company even if they do not own stock in it. Employees, creditors, and suppliers all benefit if a company grows and prospers. In that sense they, like the shareholders, have a residual interest in the firm. That is not to say, however, that the interests of each group are identical; their interests differ significantly.<sup>6</sup> Their interests should be considered in corporate governance—and indeed they are. How could it be otherwise? No company can succeed without attending to its employees, customers, suppliers, and the

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*of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts*, 22 ACAD. MGMT. REV. 853 (1997) (finding twenty-seven different definitions of “stakeholder”).

<sup>3</sup> See Kent Greenfield, *Defending Stakeholder Governance*, 58 CASE W. RES. L. REV. 1043, 1048–49 (2008) [hereinafter Greenfield, *Stakeholder Governance*].

<sup>4</sup> There is a growing “family gap” between the children of well-to-do parents, who are much more likely to live with both their biological parents (who are married to each other), and children of the poor, who as a result of illegitimacy or divorce are more likely to live with only one parent (usually the mother). The former reap huge benefits by virtually every measure of social welfare. See DAVID BLANKENHORN, *THE FUTURE OF MARRIAGE* (2007); KAY S. HYMOWITZ, *MARRIAGE AND CASTE IN AMERICA: SEPARATE AND UNEQUAL FAMILIES IN A POST-MARITAL AGE* (2006).

<sup>5</sup> CEO compensation has continued to rise despite public outcry and the protracted slump in stock prices. See Claudia H. Deutsch, *A Brighter Spotlight, Yet the Pay Rises*, N.Y. TIMES, Apr. 6, 2008 (Bus. Section), at 1 (citing report of a compensation research firm based on SEC filings in the first three months of 2008).

<sup>6</sup> See *infra* notes 34–49 and accompanying text.

communities in which it operates.<sup>7</sup> But is the degree of consideration now given optimal? That issue requires further discussion.

### *B. The Current State of Corporate Governance*

Stakeholder theorists hurl two types of criticism against current corporate governance practices. One is that it does not maximize share prices. The other is that it does. In this part I will discuss the charge that current practice does not maximize share value because investors are fixated on short-term performance and that current practice abuses employees, and the corollary claim that stakeholder governance would “grow the pie”—i.e., actually increase share values. I will then discuss whether maximizing share value is the proper goal of corporate governance.

#### *1. Short-termism*

In economic theory, rational common stockholders seek to maximize the net present value of the firm, which (in public companies) is gauged by its stock price.<sup>8</sup> Stakeholder theorists sometimes deny this. Professor Greenfield believes that “short-termism” is a serious problem for American corporations now, and that this problem stems from shareholder primacy.<sup>9</sup> I believe short-termism is not a serious problem and, to the extent that it is a problem at all, it stems not from excessive shareholder power but from excessive CEO power and shareholder weakness.

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<sup>7</sup> Firms that “contract with their stakeholders on the basis of mutual trust and cooperation . . . will have a competitive advantage.” Anant K. Sundaram & Andrew C. Inkpen, *The Corporate Objective Revisited*, 15 *ORG. SCI.* 350, 353 (2004). “In the long run, shareholders can’t systematically exploit other ‘stakeholders’ in the corporate enterprise” because doing so would damage the shareholders’ own interests. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 *UCLA L. REV.* 811, 863 (1992); see also Bradley Warren Benson & Wallace N. Davidson III, *The Relation between Stakeholder Management, Firm Value, and CEO Compensation: A Test of Enlightened Value Maximization* (Working Paper, Sept. 17, 2008), available at <http://ssrn.com/abstract=1208403> (empirical study concluding that “firms cannot mismanage relations with their stakeholders if they wish to maximize the value of the firm”).

Thus it is misleading to say, as Professor Greenfield does, that I believe “we need to worry only about the investment of one of the many investors, namely that of shareholders.” Greenfield, *Stakeholder Governance*, *supra* note 3, at 1043. Shareholders’ desire to maximize the value of the stock *requires* them to care about employees. However, I do not claim that “employees need not worry because shareholders have their back.” *Id.* at 1060. Pursuit of profit places a floor on the treatment of employees, but their interests are not identical and market forces alone may not produce an outcome that society does or should consider fair.

<sup>8</sup> “The public’s valuation of a company in the marketplace has unique value, because it is the only judgment that cannot be manipulated, at least not for long.” ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 67 (3d ed. 2004).

<sup>9</sup> “[P]art of the problem is the short-term focus of corporate management, which is a function of market, norm, and law.” Greenfield, *Stakeholder Governance*, *supra* note 3, at 1049.

First, “for all the anecdotal evidence of short-termism and its effects, there is not a lot of empirical data to back it up.”<sup>10</sup> “[N]o one has *demonstrated* that the long/short phenomenon exists . . . .”<sup>11</sup> Undoubtedly some investors trade on the basis of short-term performance, but this is no more important than that some investors trade on the basis of astrology. All that is needed for markets to be efficient is a critical mass of rational investors. “[C]ompetition among investors who do not suffer from a short-term bias will drive stock price toward an unbiased level.”<sup>12</sup>

If short-termism is common, its claimants should be able to identify numerous profitable opportunities that go unfunded in America, so that these opportunities are either taken abroad or are not exploited at all. I am not aware that anyone has produced such a bill of particulars. If anything, America seems quite receptive to long-term, risky projects because of our vibrant venture capital industry, an industry that barely exists even in many industrialized countries.

Perhaps a few firms are obsessed with the short-term, but does that stem from shareholder pressure? There is no evidence that institutional investors dislike long-term investment in research and development (“R&D”).<sup>13</sup> Share prices rise, not fall, when companies increase R&D.<sup>14</sup> Stock markets generally ignore accounting changes that alter reported earnings but not cash flow.<sup>15</sup> Many investors (including many institutional investors) do trade rapidly, but there is no evidence that this trading stems from obsession with short-term results.<sup>16</sup> Strong shareholder rights are associated with higher share and bond prices.<sup>17</sup>

<sup>10</sup> Joe Nocera, *A Defense of Short-Termism*, N.Y. TIMES, July 29, 2006, at C1. “Baruch Lev, the well-known accounting professor at New York University . . . scoffs at the notion that short-termism is even a problem.” *Id.*

<sup>11</sup> Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 13 (1991).

<sup>12</sup> Ronald J. Gilson, *Separation and the Function of Corporate Law*, 2 BERKELEY BUS. L.J. 141, 148 (2005).

<sup>13</sup> See OFFICE OF THE CHIEF ECONOMIST, SEC, INSTITUTIONAL OWNERSHIP, TENDER OFFERS, AND LONG-TERM INVESTMENTS 12–13 (1985) (finding that high institutional ownership is not associated with lower research and development).

<sup>14</sup> See J. Randall Woolridge, *Competitive Decline and Corporate Restructuring: Is a Myopic Stock Market to Blame?*, 1 J. APPLIED CORP. FIN. 26, 33–34 (1988). See generally John J. McConnell & Chris J. Muscarella, *Corporate Capital Expenditure Decisions and the Market Value of the Firm*, 14 J. FIN. ECON. 399, 415 (1985).

<sup>15</sup> See Robert S. Kaplan & Richard Roll, *Investor Evaluation of Accounting Information: Some Empirical Evidence*, 45 J. BUS. 225, 245 (1972).

<sup>16</sup> “If a governance provision does not serve long-term shareholder value, its adoption will likely reduce short-term prices (which reflect expectations about long-term value) . . . .” Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1802 (2006); see also Bernard Black & Reinier Kraakman, *Delaware’s Takeover Law: The Uncertain Search*

If short-termism exists in some firms, it is more likely the product of CEO domination—i.e., of too little shareholder power, not too much. CEOs entrenched behind antitakeover defenses actually reduce R&D.<sup>18</sup> Some executives pump up their firm's stock price (often to push it above the exercise price of their stock options) with misleading disclosures, then dump their stock before the truth gets out.<sup>19</sup> Outside investors cannot do that. Other cognitive malfunctions may prevent dominant managers from maximizing the value of the firm even if they want to do so.<sup>20</sup> Thus, some dismiss CEOs' claims that they manage for the long-term as "bogus."<sup>21</sup> If some shareholders unduly stress the short-term, perhaps it is because they have so little control over the long-term.

## 2. Abuse of Stakeholders

In addition to the charge of short-termism, some stakeholder theorists charge that current corporate governance practices sometimes fail to maximize share value because they mistreat stakeholders. They claim that firms make unenforceable promises to induce stakeholders (primarily employees, although they could

for *Hidden Value*, 96 NW. U. L. REV. 521, 532 (2002) ("Under elementary principles of finance, even short-term investors have an incentive to maximize the firm's long-term value . . ."); Roe, *supra* note 11, at 13 ("The long/short controversy posits a market failure. After all, institutions should know how to discount long-term value to present value.")

<sup>17</sup> See George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOUS. L. REV. 1213, 1261–63 (2008) [hereinafter Dent, *Academics in Wonderland*].

<sup>18</sup> See MICHAEL T. JACOBS, *SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA* 108, 249–50 n.4 (1991) (citing a study by the SEC's Office of Economic Analysis).

<sup>19</sup> See generally ROBERT H. TILLMAN & MICHAEL L. INDERGAARD, *PUMP AND DUMP: THE RANCID RULES OF THE NEW ECONOMY* (2005); Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667, 703–04 (2007); John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ* 6–8 (Ctr. for Law & Econ. Studies, Working Paper No. 274, 2005), available at <http://ssrn.com/abstract=694581>. Managers also time corporate disclosures to maximize their profits on stock options. See David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73 (2000); Keith W. Chauvin & Catherine Shenoy, *Stock Price Decreases Prior to Executive Stock Option Grants*, 7 J. CORP. FIN. 53 (2001); Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997).

<sup>20</sup> See Laurie Larwood & William Whittaker, *Managerial Myopia: Self-Serving Biases in Organizational Planning*, 62 J. APPLIED PSYCH. 194 (1977); James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 MGMT. SCI. 1404 (1987).

<sup>21</sup> Nocera, *supra* note 10; see also MATTEO TONELLO, *REVISITING STOCK MARKET SHORT-TERMISM* 8 (2006) (reporting that "most business managers stated that they would rather forgo an investment promising a positive return on capital than miss the quarterly earnings expectations of their analysts and financiers").

include independent contractors, customers, suppliers, and communities where the firm operates) to make commitments (in the case of employees, commitments of “human capital”) to the firm.<sup>22</sup> The firm’s promises are unenforceable because the understandings on both sides are too vague or complex (e.g., “if you do a good job we will treat you fairly”) to be specified in an enforceable contract. Thus the understandings are only “implicit” contracts. Shareholders, then, may make “opportunistic attempts to increase ‘shareholder value’ by changing the corporate rules in the middle of the game.”<sup>23</sup>

This scenario is not impossible, but its occurrence is probably rare. A company in trouble might lower the wages of or fire dedicated employees, but do such steps violate implicit contracts? One problem with implicit contracts is their terms are uncertain, and subject to misunderstandings, precisely because they are not explicit. It is not unreasonable to expect that the employees of a prosperous firm will share its success, while the employees of troubled companies may share their suffering.<sup>24</sup> Thus, although stakeholder participation in corporate governance might occasionally shelter employees from abusive breaches of implicit contracts, it could also shelter them from properly sharing the burdens of failing companies and impose other unacceptable costs.<sup>25</sup> By contrast, traditionally governed corporations cannot treat employees less well than their market value demands or the employees would quit and the company could not hire equally valuable substitutes. Indeed, shareholders have no incentive not to treat employees as well as possible so long as that treatment does not impair share value.<sup>26</sup> If because of market failure labor markets do not adequately protect, relief should come directly through changes in

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<sup>22</sup> See Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 685–86 (2003); see also Greenfield, *Stakeholder Governance*, *supra* note 3, at 1043 (stating that one problem of corporate governance is “how to induce investment from the various contributors to the firm”).

<sup>23</sup> Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 805 (2007); see also Kent Greenfield, *Proposition: Saving the World with Corporate Law*, 57 EMORY L.J. 948, 951 (2008) [hereinafter Greenfield, *Saving the World*] (alleging that corporations “fail to sustain implicit or explicit commitments to communities”).

<sup>24</sup> If there are net social benefits to cushioning employees from such harm, the cost of such cushioning should be borne socially—i.e., by the government—rather than by shareholders. In general, however, it is better for society if resources are directed to growing than to shrinking enterprises, so steps to insulate workers from such harm should generally be limited.

<sup>25</sup> For discussion of these costs, see *infra* notes 34–55 and accompanying text.

<sup>26</sup> See, e.g., D. Gordon Smith, *Response: The Dystopian Potential of Corporate Law*, 57 EMORY L.J. 985, 1008 (2008) (“When boards of directors are able to enhance employee welfare, make the environment cleaner, or improve human rights throughout the world without impairing shareholder value, they often do it.”); see also *supra* note 7.

employment laws rather than through tinkering with corporate governance.

### 3. *Would Stakeholder Governance "Grow the Pie"?*

Like many stakeholder theorists, Professor Greenfield believes that stakeholder governance has the potential to "grow the pie."<sup>27</sup> To weigh this claim we should first review the economic rationale for committing corporate control to shareholders to begin with.

"[S]hareholders, as residual claimants, have the greatest incentive to maximize the value of the firm."<sup>28</sup> Stakeholder theorists reply that stockholders are not the only residual claimants; stakeholders share in the success or hardship of the firm.<sup>29</sup> This is true.<sup>30</sup> However, control is still best allotted to shareholders because they are the *primary* residual claimants, and they are *only* residual claimants. The claims of other stakeholders are largely fixed and senior to those of the shareholders. Stakeholders may reap *additional* benefits if the company flourishes. Stockholders, however, have *no* fixed claims; they get their share *only* from the residue.

As a result, stakeholders do not necessarily benefit from maximizing the value of the firm. Employees may get raises if their firm prospers, but even if the firm falters they must be paid their agreed wage, even if that leaves nothing for shareholders. This is not a fanciful scenario; many firms pay their workers and creditors and perform their contractual duties to their customers but generate no profits for their stockholders. Because they are *just* residual claimants, only shareholders have "the perspective of the aggregate."<sup>31</sup>

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<sup>27</sup> See Greenfield, *Stakeholder Governance*, *supra* note 3, at 1044 ("[C]orporations themselves will be better managed in the long term when management is held to consider the interests of all key investors of the firm, not just a small subset of them."); see also Margaret M. Blair, *Directors' Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885, 900 (2003) (claiming that the team-production model of corporate governance works to maximize firm value).

<sup>28</sup> Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1267–68 (1999); see also Sundaram & Inkpen, *supra* note 7, at 353 ("Only residual cash flow claimants have the incentive to maximize the total value of the firm."); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 149 (2009) ("Shareholders are the appropriate group to monitor the board and correct errors because they are uniquely sensitive to the principal signal indicating a deviation of the board from its duty to the corporation: the market price of the corporation's stock.")

<sup>29</sup> See Greenfield, *Stakeholder Governance*, *supra* note 3, at 1044 ("[N]on-shareholder stakeholders are investors, too . . .").

<sup>30</sup> Thus it is not true that I "conflat[e] the term 'investor' with shareholder." *Id.* at 1051. However, the other stakeholders' investments differ from the stockholders' in ways that influence their attitudes toward corporate governance.

<sup>31</sup> Bayless Manning, *Thinking Straight About Corporate Law Reform*, LAW & CONTEMP. PROBS., Summer 1977, at 3, 20–23. See also STEPHEN M. BAINBRIDGE, CORPORATION LAW



The control rights of stockholders can be compared to the property rights of a homeowner. The value of a home depends in part on the condition of its neighborhood, so a homeowner's neighbors are to some extent residual claimants of the value of her house—they benefit if she improves her property, and their own homes depreciate if she lets her house deteriorate. Laws place some limits on the owner's use of her property. She may not, for instance, create a nuisance. Residents of a neighborhood may also agree by contract to covenants that limit their property rights for their collective benefit. With these exceptions, the owner may do as she pleases with her property.

Likewise, shareholders should control the firm. Their control is subject to some legal limitations (such as the law of torts) and to contracts with stakeholders (such as employment contracts), but within these limits they should be free to do as they think best.

Professor Greenfield nonetheless argues that stakeholder governance can increase corporate efficiency. He suggests that externalizing costs (in the vernacular, antisocial behavior) would be less common under stakeholder governance.<sup>32</sup> This is dubious. Stakeholder constituencies have no more motive than do shareholders to heed any interests but their own. Employees, for instance, have as much incentive as do stockholders to pollute the environment or to sell shoddy products to one-time purchasers.

Consider recent fiascos like Enron and Tyco. Employees of these companies were better positioned than public stockholders to know what was going on. They could have blown the whistle to law enforcement agencies and alerted fellow employees to dump their company's stock from their investment accounts. They did not do so. Why, then, should we assume that employee representatives on the board would have taken effective action? Employee participation in corporate governance might actually increase managerial discretion.<sup>33</sup>

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AND ECONOMICS 469 (2002), which states: “[S]hareholders are the only corporate constituent with a residual, unfixed, ex post claim on corporate assets and earnings.” Therefore, “shareholders have the strongest economic incentive to care about the size of the residual claim.” *Id.* at 470. Thus I do not just “assume[] that shareholders are best seen as owners of the corporation.” Greenfield, *Stakeholder Governance*, *supra* note 3, at 1050. Rather, economic theory and empirical evidence indicate that efficiency is maximized when control of corporations is allotted to shareholders.

<sup>32</sup> See Greenfield, *Stakeholder Governance*, *supra* note 3, at 1055 (stating that corporations can “profit by extracting economic rents from society by externalizing social costs”).

<sup>33</sup> See Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in *EMPLOYEES AND CORPORATE GOVERNANCE* 163, 192 (Margaret M. Blair & Mark J. Roe eds., 1999) (“[T]he net beneficiaries [of employee participation in corporate

Professor Greenfield says “employees are vitally interested in the success of their employers.”<sup>34</sup> But why wouldn’t employees prefer that there be no payouts to shareholders, none, ever? Even if that might eventually injure employees, the damage might not occur for a long time, after most current employees are gone. For the mayor’s political appointee serving as a corporate director, the relevant time-frame might be next month’s election. In other words, stakeholder governance might create a problem of short-termism, which is now minor or non-existent.<sup>35</sup>

Apart from economic theory, there is another and perhaps more telling problem with the stakeholder concept: If stakeholder governance can produce a bigger pie, and a larger piece for each constituency, why has it not happened through private arrangements? Sometimes pie-increasing solutions cannot be reached privately because the transaction costs of negotiation are too high. But at least for employees with collective bargaining that should not be so—they are negotiating with management already.

Professor Greenfield suggests that firms do not act voluntarily because they “simply do not see the potential long-term profitability of stakeholder governance.”<sup>36</sup> This explanation is unpersuasive. Businesses constantly seek new ways to increase profits. Stakeholder theory has been around for a long time; it is not so novel an idea that it simply has not occurred to investors and entrepreneurs. If it held any promise, some firms would try it. But even if we assumed that he is right about this, it would follow that after stakeholder governance was forced on investors, they would discover they liked it. He should, then, be willing to let shareholders of a company vote to end stakeholder governance and institute shareholder primacy after some period of time (one year?), since they would not do so unless experience showed that stakeholder governance materially injured them.

My students know that one of my favorite allusions is the story *Silver Blaze*, in which Sherlock Holmes solves a crime in part by noting the dog that did not bark.<sup>37</sup> The dog’s silence showed that the intruder was an insider; had it been an outsider, the dog would have

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governance] are those who ought to be controlled: the company’s management.”).

<sup>34</sup> Greenfield, *Stakeholder Governance*, *supra* note 3, at 1057.

<sup>35</sup> See *supra* notes 8–21 and accompanying text.

<sup>36</sup> Greenfield, *Reclaiming*, *supra* note 1, at 26.

<sup>37</sup> When Holmes refers to “the curious incident of the dog in the night-time,” Inspector Gregory says, “The dog did nothing in the night-time.” Holmes replies, “That was the curious incident.” Arthur Conan Doyle, *Silver Blaze*, in 1 THE COMPLETE SHERLOCK HOLMES 335, 347 (Doubleday & Co. 1930) (1893).

barked. It is interesting in this case to notice the dogs that are not barking. Professor Greenfield touts his proposal as beneficial to employees. If he were right, we should see groups of employees forming firms and hiring capital.

Actually, we *do* see this, but not at all in the way stakeholder advocates want. In fact, most companies *are* controlled by employees, but only by a small, elite group of employees. Law firms are run by their partners. Even in industrial, non-professional firms employee control, where it exists, tends to be concentrated in a homogeneous subset of workers, not shared among all.<sup>38</sup> The reason for this is that the interests of different groups of employees conflict.<sup>39</sup> In general, labor-controlled firms grow more slowly and create fewer new jobs than other public firms.<sup>40</sup> When outside equity capital is needed, venture capitalists provide it, but only on conditions that are not at all what stakeholder theorists envision.

American organized labor has also shown little interest in board representation.<sup>41</sup> And Europe is moving toward the shareholder model and may have passed the United States in protecting investors.<sup>42</sup>

In addition to this “negative” empirical evidence, there is positive empirical evidence that employee participation in corporate governance does not “grow the pie.” In France and Norway, law requires employee representation on certain boards. The conditions and exceptions permit a good comparison of firms with and without such representation. Recent studies in both countries found that employee representation significantly injured firm performance.<sup>43</sup> Other studies have made similar findings in other countries,<sup>44</sup> even when labor representation is granted voluntarily.<sup>45</sup>

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<sup>38</sup> See HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996).

<sup>39</sup> See Sundaram & Inkpen, *supra* note 7, at 354.

<sup>40</sup> See Olubunmi Faleye et al., *When Labor Has a Voice in Corporate Governance*, 41 J. FIN. & QUANTITATIVE ANALYSIS 489 (2006).

<sup>41</sup> The addition of Douglas Fraser, president of the United Auto Workers, to the board of Chrysler in 1979 was a first for a union leader, but in the eyes of some in the union it “tainted” Fraser. See ROBERT B. REICH & JOHN D. DONOHUE, *NEW DEALS: THE CHRYSLER REVIVAL AND THE AMERICAN SYSTEM* 126, 226 (1985).

<sup>42</sup> See *infra* notes 137–42 and accompanying text.

<sup>43</sup> R. Oystein Strom, *Better Firm Performance with Employees on the Board? Not in the Long Run* (University College of Ostfold, Paper No. 1757, 2007), available at <http://ssrn.com/abstract=967445> (study of Norwegian experience); Edith Ginglinger et al., *Employee Ownership, Board Representation, and Corporate Financial Policies* 4 (Jan. 10, 2009), available at <http://ssrn.com/abstract=1259609> (“Directors elected by employees by right [in France] significantly reduce payout ratios, increase overall staff costs, and increase board size, complexity, and meeting frequency—but do not significantly impact firm value or profitability.”).

<sup>44</sup> See Felix R. FitzRoy & Kornelius Kraft, *Economic Effects of Codetermination*, 95 SCANDINAVIAN J. ECON. 365 (1993) (study in Germany); Frank A. Schmid & Frank Seger, *Arbeitnehmermitbestimmung, Allokation von Entscheidungsrechten und Shareholder Value*, 68

Voluntary action may in fact be moving in the opposite direction. Employee stock ownership plans (“ESOP”) were originally adopted mostly in nonunionized firms, but by the 1990s they became just as prevalent in unionized firms.<sup>46</sup> The adoption of an ESOP in a unionized firm causes a reduction in strikes and of the proportion of labor disputes that lead to strikes.<sup>47</sup> Giving employees stock changes their incentives and brings their interests closer to those of the shareholders. This is a more promising path than stakeholder governance.

When other stakeholders are tossed into the recipe, the conflicts become glaring and overwhelming.<sup>48</sup> Employees want the highest compensation and job security and the easiest working conditions. Customers want the best products at the lowest prices. Creditors want the highest assurance of prompt payment of their claims. Suppliers want the largest orders at the highest prices. Environmentalists want to minimize pollution. These preferences make irreconcilable demands on corporate resources.<sup>49</sup>

ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT 453 (1998) (study in Germany); Mark J. Roe, *German Codetermination and German Securities Markets*, 5 COLUM. J. EUR. L. 199, 199–200 (1999) (arguing that codetermination has created problems for corporate boards and German securities markets); Gary Gorton & Frank Schmid, *Class Struggle Inside the Firm: A Study of German Codetermination* (Nat’l Bureau of Econ. Research, Working Paper No. 7945, 2000), available at <http://ssrn.com/abstract=245742> (finding that the higher the labor representation on corporate boards, the lower the company’s market to book value). *But see* Kent Greenfield, Remarks at the Case Western Reserve Law Review Symposium: Corporations and Their Communities 15 (Jan. 25, 2008) (transcript on file with the Case Western Reserve Law Review) [hereinafter Greenfield, Symposium Remarks] (praising co-determination in Europe).

To the extent that co-determination has succeeded in Germany, it may be a result of conditions unique to Germany. *See* Alberto Chilosì & Mirella Damiani, *Stakeholders vs. Shareholders in Corporate Governance* (Mar. 20, 2007), available at <http://ssrn.com/abstract=975293>. Professor Greenfield cites an unpublished study showing that countries with strong co-determination have lower income inequality, higher labor productivity, fewer days lost to strikes, and lower unemployment. Greenfield, *Reclaiming*, *supra* note 1, at 25. Apart from the possibility that this study is just wrong and that the studies reaching contrary conclusions are right, there is a question of which way causation runs. Perhaps nations with higher productivity and lower unemployment are more willing to sacrifice growth by instituting co-determination.

<sup>45</sup> *See* Faley et al., *supra* note 40, at 490 (study in Canada).

<sup>46</sup> *See* Peter Cramton et al., *ESOP Fables: The Impact of Employee Stock Ownership Plans on Labor Disputes* 1 (Fed. Reserve Bank of N.Y., Staff Report No. 347, 2008), available at <http://ssrn.com/abstract=1266717>.

<sup>47</sup> *See id.* at 2, 20; *see also* Ginglinger et al., *supra* note 43, at 25–26 (describing a French study finding that exercise of statutory right of employees to elect directors when they own over 3 percent of the employer’s stock did not impair firm value of financial policy).

<sup>48</sup> *See generally* Sundaram & Inkpen, *supra* note 7, at 354.

<sup>49</sup> Thus, for example, “lender control may generate suboptimal results due to the suboptimal investment incentives that parties not fully covered by explicit contracts may have.” Sergio A. Muro, *Lender Control Liability Functional Examination: The Firm and Heuristics 3* (2008) (Cornell Law School J.S.D./Doctoral Student Paper), available at <http://lsr.nellco.org/>

Professor Greenfield proposes that “the concerns of all the firm’s investors should be brought into the governance of the firm.”<sup>50</sup> He says the details for implementing this proposal “will be difficult, though not impossible.”<sup>51</sup> Difficult! Now there’s an understatement. Apart from its employees, what are the constituencies of General Electric that would be entitled to representation on its board? And how will they be chosen? How will “communities in which the company employs a significant percentage of the workforce . . . propose a representative for the board?”<sup>52</sup> Will that be done by the mayor of the city where the company has its headquarters? Its largest facility? Or will the governor choose a director for every company incorporated in the state? If consumers, the environment, and others are to be represented, the difficulties of selection get even tougher. The problem here is not Professor Greenfield’s imagination; the problem of implementation is inherent in stakeholder theory. Even Ralph Nader concedes: “It seems impossible to design a general ‘interest group’ formula which will assure that all affected constituencies of large industrial corporations will be represented and that all constituencies will be given appropriate weight.”<sup>53</sup> Indeed, he tacitly acknowledges this difficulty—no sooner does he take up the issue than he drops it for good.

Unfortunately, the idea of board representation for stakeholders resurfaces regularly, reviving the problem of its implementation. This is not a minor quibble. Appointment of directors for political rather than economic reasons could cause serious damage, even if the political appointees were only a minority of the board. They would at least obstruct the efficient operation of boards, and would appropriately be treated as spies and enemies by investor representatives on the board. Professor Greenfield claims that boards would benefit from greater viewpoint diversity.<sup>54</sup> Again, practice shows that he is right—but in a way that shows that he is fundamentally wrong. Boards do strive for diversity—by including representatives from various industries and professions. They also try to understand stakeholders by seeking advice from expert consultants.

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<sup>50</sup> Greenfield, *Stakeholder Governance*, *supra* note 3, at 1044.

<sup>51</sup> Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87, 115 (2005).

<sup>52</sup> Greenfield, *Saving the World*, *supra* note 23, at 980.

<sup>53</sup> RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* 124 (1976); *see also* ROBERT CHARLES CLARK, *CORPORATE LAW* 688–90 (1986) (stating that social responsibility proposals are vague about goals and inconsistent about means).

<sup>54</sup> Greenfield, *Reclaiming*, *supra* note 1, at 26–28.

However, they rarely include stakeholder representatives as directors. Obviously, they do not perceive that doing so would be beneficial.

If we mandate stakeholder governance, would we include or exempt non-public companies? Or would inclusion depend on the size of the company? If so, how measured? Assuming that there is some kind of cutoff line below which companies are exempt, that becomes a powerful incentive for companies to stay below that line.

For non-exempt companies, how would the antagonistic stakeholder interests be balanced? A best-case scenario is that corporate boards would embody America's pluralism as elected legislatures now do, with all the group conflicts that occur in politics.<sup>55</sup> Given that, however, why not just hand control of industry to government? It surely is more efficient to have industrial policy decided by a few democratic, pluralistic bodies than by many. Centralization would also permit the coordination of industrial policy, rather than the chaos that would result from having myriad firms following inconsistent policies. If this were done by the federal government, the coordination would be nationwide.

In other words, why not have socialism? The answer is that nearly everyone now agrees that socialism has proved unworkable; even most of the Left has lost faith in it.<sup>56</sup> Nonetheless, it is less problematic than having innumerable corporate boards, each supposedly democratic and pursuing the social good, but working at cross-purposes. For all its flaws, democracy (in its bourgeois, liberal form) is the best form of government. Societies are more economically prosperous, however, if industry is organized to maximize economic efficiency, not pluralist participation.

Although firm owners cannot generally abuse constituents with whom they contract,<sup>57</sup> shareholder governance does not invariably produce a fair exchange. Employers may, for example, take advantage of employees who have made commitments to the firm.<sup>58</sup>

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<sup>55</sup> See JEAN TIROLE, *FINANCIAL CRISES, LIQUIDITY, AND THE INTERNATIONAL MONETARY SYSTEM* 118 (2002) ("Conflicts of interest among the board generate endless haggling, vote-trading and log-rolling. They also focus managerial attention on the delicate search for compromises that are acceptable to everyone; managers thereby lose a clear sense of mission and become political virtuosos.").

<sup>56</sup> To his credit, Professor Greenfield does not suggest social ownership of the means of production. Indeed, after tossing out the idea of board representation for stakeholders other than employees, he then completely drops it. Thus my comments here are not intended as "name calling" or to conjure a "socialist menace," see Greenfield, *Stakeholder Governance*, *supra* note 3, at 1052–53, but to point out that representation of these constituencies seems inevitably to lead to government participation in corporate control, and that no one has figured out how to make this work well.

<sup>57</sup> See *supra* note 7 and accompanying text.

<sup>58</sup> See *supra* notes 22–23 and accompanying text.

We must, however, avoid the Nirvana fallacy of concluding that because shareholder control is not flawless, it is unacceptable.<sup>59</sup> The proper question is whether it works better than any other option. Stakeholder theorists have not come close to designing a superior alternative.

## II. IS SHAREHOLDER WELFARE (I.E., MAXIMUM SHARE PRICE) THE PROPER GOAL?

Professor Greenfield proposes changing the rules for the election and fiduciary duties of corporate directors. The corporate lodestar, he says, should not be maximization of shareholder wealth but "abundance for all."<sup>60</sup> Professor Glynn proposes changing the "internal affairs" doctrine and urges some specific changes for corporate law. I will respond first to Professor Greenfield's proposals and then to Professor Glynn's specific changes. I discuss changing the "internal affairs" doctrine below.

### A. *Changing the Selection and Duties of Corporate Directors*

Professor Greenfield says that "*corporations, and therefore corporate law, are created in the interest of society as a whole.*"<sup>61</sup> I agree. The questions, then, are how corporations can best serve society, and what corporate governance structure best enables corporations to accomplish this goal? Some commentators support stakeholder governance even though they concede, at least tacitly, that stakeholder governance would not enhance shareholder welfare. In effect, this is an attack on capitalism since shareholders are the suppliers of capital. It is not surprising that most people instinctively dislike capitalism. Who of us relishes competition from others? And the central phenomenon of capitalism, made famous by Adam Smith, that pursuit of private gain through competition with and exploitation of others results in public benefit, is completely counterintuitive.

So are many of its corollaries. For example, it seems logical that industrial policy should strive directly to maximize the quantity and quality of employment, yet we know from experience that this is

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<sup>59</sup> See Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1, 1 (1969) ("The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing 'imperfect' institutional arrangement. This *nirvana* approach differs considerably from a *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements. In practice, those who adopt the *nirvana* viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient.").

<sup>60</sup> Greenfield, *Reclaiming*, *supra* note 1, at 2.

<sup>61</sup> Greenfield, *Saving the World*, *supra* note 23, at 962.

self-defeating. To an enterprise an employee is a cost, and costs are to be reduced or eliminated whenever possible in order to increase gain.

Professor Greenfield asked why the cost of capital is not also a cost to be minimized.<sup>62</sup> Indeed it is. And once capital is committed to an enterprise, returns on that capital can be reduced or even eliminated, thereby reducing the cost of capital to zero. In other words, capital can be expropriated. However, any polity that expropriates capital or reduces returns on capital below the international market level will get no more of it. That is what we observe in Communist and other regimes that overtly expropriate capital, and also in nations where property rights are so weak that investors fear that they will not get a market rate of return, including countries where shareholder rights are weak or the rule of law is lacking.

At the least, feeble shareholder rights raise risks to investors. Since most investors are risk-averse,<sup>63</sup> countries with weak investor protections will actually have to pay a higher cost of capital. Like Professor Greenfield, I want to minimize the cost of capital in America, so we should both favor the strongest possible shareholder rights, which will reassure investors that America is the safest place to put their money.

I also share the desire of Professor Glynn and Professor Greenfield for the best possible treatment of American workers. Here, again, though, a direct approach would be counterproductive. Just as you do not lower someone's fever by putting her into a refrigerator, you do not benefit workers by mandating the highest wages, the best workplace conditions, and the greatest job security. In fact, job creation has been much better in economies that make it easier for employers to dismiss employees either for poor performance or because innovation has rendered the employee superfluous.<sup>64</sup> Thus

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<sup>62</sup> See Greenfield, Symposium Remarks, *supra* note 44, at 39 (stating as part of his rebuttal that "firm shareholders are costs, too," and, regarding the cost of capital, "it is not actually clear why one stakeholder, the shareholders, are to win and the other stakeholders are to lose within the corporate forum").

<sup>63</sup> See BAINBRIDGE, *supra* note 31, at 117 ("[M]ost people are risk averse most of the time.").

<sup>64</sup> See Arthur Foulkes, Ludwig von Mises Institute, In Defense of Employment-at-Will (May 23, 2005), <http://mises.org/story/1821> (stating that employers react to laws limiting dismissal of employees by switching to temporary employees who are not subject to the limitations); *id.* ("[C]ountries with more flexible labor markets enjoy greater benefits from technological change, have better records in job creation, and experience faster growing economies." (quoting a 1994 OECD Report)); Pietro Garibaldi & Paolo Mauro, *Job Creation: Why Some Countries Do Better*, in ECONOMIC ISSUES 12 (Int'l Monetary Fund, Econ. Issues Series No. 20, 2000), available at <http://www.imf.org/externals/pubs/ft/issues/issues20/index.htm> ("[E]xtensive employment protection appears to dampen job creation . . .").



shareholder control is probably the best arrangement for each firm's employees.<sup>65</sup>

Nonetheless, given that the benefits of capitalism are counterintuitive, it is not surprising that capitalism is never secure in a democracy. Everyone wants to be insulated from *some* effects of the market, and people do not notice any of its benefits that accrue only to others. Professor Greenfield touts a desire for stability, but capitalism, as Joseph Schumpeter said, is creative destruction.<sup>66</sup> Striving for stability can easily produce stagnation.

Professor Greenfield seems to find the shareholder-wealth-maximization principle *a priori* unacceptable: "The argument, as I understand it, is that corporate managers best advance society's interests by ignoring them. . . . Not even Adam Smith's invisible hand was assumed to be so powerful that people should be *prohibited* from taking the interests of others, or society in general, into account."<sup>67</sup> This is *not* a proper understanding of shareholder primacy. First, corporate law does allow directors some discretion to act for the benefit of non-shareholders. A board may, for instance, make reasonable charitable gifts that are not intended to maximize profits.<sup>68</sup> Second, far from being "*prohibited* from taking the interests of others

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<sup>65</sup> See BAINBRIDGE, *supra* note 31, at 420–21 (stating that "pursuit of shareholder wealth maximization often redounds to the benefit of non-shareholder constituencies" and that in a hypothetical bargain among all corporate stakeholders "we would expect a bargain to be struck in which shareholder wealth maximization is the chosen norm"). Professor Greenfield cites "something on Wall Street called the 7 percent rule" which says

the best way to bolster your stock price in the short term is to announce layoffs or wage cuts because Wall Street loves it when you cut employment, because it shows that you are tough on cutting costs, and it shows that you are dedicated to a focus on profit rather than long-term human resource development.

Greenfield, Symposium Remarks, *supra* note 44, at 11–12. As his source for this "rule" Professor Greenfield cites a *New Yorker* article. See Greenfield, *Reclaiming*, *supra* note 1, at 12 (citing James Surowiecki, *It's the Workforce, Stupid!*, *NEW YORKER*, Apr. 30, 2007, at 32). I had never previously heard of this "rule," and I doubt that it is taken seriously by intelligent investors and executives. In some cases it makes sense for a company to make layoffs and wage cuts. Professor Greenfield cites some cases where share prices have jumped following announcements of layoffs. *Id.* at 13 nn.48–51. But this hardly means that *any* company can raise its share price by laying off workers. Growing companies typically increase employment and compensation. Moreover, there is little support for the theory of short-termism implied in this "rule." See *supra* notes 8–21 and accompanying text.

<sup>66</sup> JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* 81–86 (1942) (Chapter VII, entitled "The Process of Creative Destruction").

<sup>67</sup> Greenfield, *Saving the World*, *supra* note 23, at 966.

<sup>68</sup> See BAINBRIDGE, *supra* note 31, at 435 (stating that charitable gifts are generally allowed "so long as the amount in question is reasonable and some plausible corporate purpose may be asserted"); *id.* at 436 ("Virtually all states have adopted statutes specifically granting corporations the power to make charitable donations . . ."). See generally Thomas W. Joo, *Race, Corporate Law, and Shareholder Value*, 54 *J. LEGAL. EDUC.* 351, 361 (2004) ("No courts actually require management to maximize shareholder wealth . . .").

. . . into account,” directors are *required* to do so—they are enjoined to pursue the shareholders’ interests, not their own.

It is true that in corporate governance shareholder wealth is elevated over the public interest, but this is common for fiduciaries or anyone who controls other people’s money. I doubt that Professor Greenfield would be pleased if his bank or investment company donated his life’s savings to a charity, however deserving the cause might be. Their job is to maximize his wealth, not the public interest. That is not to say that none of Professor Greenfield’s wealth should go to charities, but only that it is *he* who should make that decision. Likewise, corporate directors are fiduciaries for the shareholders’ money; the shareholders, not the directors, should decide how to use it in the public interest.

Stakeholder theorists also object that corporations can “profit by extracting economic rents from society by externalizing social costs.”<sup>69</sup> This is an exaggeration. Corporate directors are required to obey the law. If a corporation breaks the law and injures others, it can incur a variety of civil and criminal liabilities. If society believes that the negative externalities from some activity are still excessive, it can simply change the law to discourage or outlaw the activity.

In this regard corporations are just like individuals and non-corporate organizations that are deterred by legal sanctions from imposing costs on others. Professor Greenfield says individuals are different because we “have a conscience, and we are subject to certain reputational norms that corporations are not.”<sup>70</sup> First, the high level of criminal and other anti-social activity in our society shows that many individuals have an underdeveloped conscience. Second, although the corporation itself is a fictitious person and cannot have a conscience, corporate shareholders, directors and officers do have consciences.

Professor Greenfield suggests that private corporations are better than public in this respect because the owners of private corporations can act on their consciences while directors of public companies are required (by economic and social forces if not by law) to ignore their consciences in order to maximize share price. This is at best misleading. Public corporations can and do make charitable gifts, for example. Further, once their shareholders have reaped the (maximized) gains from their stock, they are free to apply these gains to altruistic ends. They often do so; the philanthropy of Bill Gates and Warren Buffett are two prominent current examples. It also surprises me that Professor Greenfield proclaims the moral superiority of

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<sup>69</sup> Greenfield, *Stakeholder Governance*, *supra* note 3, at 1055.

<sup>70</sup> Greenfield, *Symposium Remarks*, *supra* note 44, at 8.

private corporations.<sup>71</sup> Progressives tend to prefer public companies because their greater public visibility makes them more sensitive about the social consequences of their acts.

In other words, corporations (and especially public corporations) *are* affected by their reputations. That is why they not only tout their products, but also cultivate images as good citizens through charitable gifts and other public-spirited activities. If these forces are inadequate to the purpose for corporations, so that stakeholders should be inserted into their internal governance, is the same true for other organizations, like private universities, cultural institutions, and labor unions?

Reliance on external forces (i.e., the law) to deter anti-social corporate behavior is likely to produce a better result than simply instructing directors to act in the public interest. Even in liberal democracies the record of economic regulation is spotty, but unless we espouse total anarchy, some regulation is necessary to give effect to the public interest. The question, then, is whether this regulation should be implemented through legislatures or through corporate boards chosen in an as yet undetermined manner. The latter is hazardous. To allow corporate boards to deploy the vast assets of corporations in whatever way they consider socially optimal is to vest them with huge political power. That the power is fragmented among myriad firms lessens the dangers, but it also makes it more difficult for citizens to monitor what is being done (supposedly in their interest) and to hold those in power (i.e., the corporate directors) accountable than it is when this power is wielded by a legislature.

Professor Greenfield understands the reasons for shareholder primacy to be that: "(1) advancing shareholder wealth trickles down and advances social wealth; (2) requiring managers to look after responsibilities other than advancing shareholder interests actually releases them from any real responsibility; and (3) it is more efficient to regulate corporations from the outside than from the inside."<sup>72</sup> Here, again, he sets up a straw man. These are not the best arguments for shareholder primacy.

The "trickle down" metaphor is upside down. It suggests that wealth already exists and that, after shareholders grab it, some trickles

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<sup>71</sup> Greenfield, Symposium Remarks, *supra* note 44, at 10 ("If it had been a publicly held company, I strongly doubt that [paying workers during the period it took to rebuild the factory after a fire] would have been possible for him [the privately held corporation's CEO] to do because doing the right thing often costs money in the short term and sometimes in the long term, and that's impossible for a company that has to make sure that the next quarter targets are satisfied.").

<sup>72</sup> Greenfield, *Saving the World*, *supra* note 23, at 966-67 (footnotes omitted).

from them down to others. That's not how business works. Wealth is not pre-existing; it is created by enterprise. Shareholders realize profits *after* operations, not before. A firm first hires employees and purchases supplies and services in order to produce the products that it then sells.<sup>73</sup> That is why capital is needed at the outset. Stakeholders get paid before profits are generated, even if profits are *never* generated. Failure to generate profit—indeed, the loss of much or all the equity capital invested—is no chimera; most new businesses lose money.

Professor Greenfield sees as a corollary of the “trickle-down” thesis that the interests of shareholders and stakeholders coincide,<sup>74</sup> a proposition he rejects. His denial is valid but ironic since he himself argues that stakeholder governance will not harm investors since they all have the same incentive to “grow the pie.”<sup>75</sup> The interests of stakeholders and shareholders overlap to the extent that neither wants a quick failure. Beyond that, their interests diverge.

Professor Greenfield objects that ownership of capital is so concentrated that “a rule that says that shareholders win is a rule that says the very richest among us wins.”<sup>76</sup> This is true and regrettable, but what should we do about it? Again, stakeholders tend to benefit when corporations prosper, so lowering profits by reducing efficiency helps no one. Altering corporate governance to lower returns to shareholders is also dubious because capital is international and can move abroad.<sup>77</sup>

A better approach is to facilitate efficiency and the corollary of high profits, then mitigate economic inequality by subsidies for those who need help and by taxes that are progressive (more so, in my opinion, than we have now). I do not oppose putting “adjustments to

<sup>73</sup> Professor Greenfield argues that “shareholder profit could even result from a transfer of wealth *from* the company’s employees or from society in general *to* the shareholders.” *Id.* at 967. He gives the example that, “by some accounts, Wal-Mart’s employee wages are so low that its workers must subsist on a range of government assistance programs. In effect, government programs subsidize the profits of Wal-Mart shareholders.” *Id.* at 967 n.87 (citation omitted); see also Greenfield, Symposium Remarks, *supra* note 44, at 40.

Obviously Wal-Mart pays its employees *something*, so they make more money (and, since they take and keep the jobs, must consider themselves better off) with their jobs than they would make without them. It is not clear why Professor Greenfield says that government assistance programs subsidize Wal-Mart rather than the employees. Government assistance programs do not cause workers to take lower compensation from Wal-Mart; if anything, these programs enable workers to hold out for higher compensation. Moreover, if there were some benefit to Wal-Mart, it would extend equally to other employers, including Wal-Mart’s competitors, so that the ultimate beneficiary would presumably be their customers—i.e., in this case, the general public.

<sup>74</sup> Greenfield, *Saving the World*, *supra* note 23, at 967.

<sup>75</sup> See *supra* notes 27–29 and accompanying text.

<sup>76</sup> Greenfield, Symposium Remarks, *supra* note 44, at 11.

<sup>77</sup> See *infra* notes 138–41 and accompanying text.

corporate governance law . . . on the table."<sup>78</sup> This Symposium shows that they *are* on the table, and I accept that. However, in surveying the buffet of policy choices from which we can choose, I believe that other dishes are more healthful and tasty, even if they are less appealing to the eyes of some progressives.

We should also spread the ownership of capital. To some extent that is already occurring; pension funds are growing rapidly. Capital accumulation is still far too unequal, though, and is not changing fast enough to reach equity soon. We should enact policies (like tax breaks for saving by lower- and middle-income citizens) to hasten change.

Professor Greenfield claims that "a decisionmaking calculus that takes shareholder interests as its goal will sometimes result in decisions that are overly risky from the standpoint of society as a whole."<sup>79</sup> At least in theory this might be true. Because of limited liability and investment diversification, rational shareholders of a firm with substantial debt might prefer risky projects with negative net present value to safe projects with positive value. The reason for this is that if a risky project fails, creditors bear much of the loss, but if it succeeds the shareholders reap most of the profits.<sup>80</sup>

However, it should be remembered that corporations create positive as well as negative externalities. Again, when shareholders prosper through high profits, employees, customers, suppliers, and communities in which the firm operates generally also benefit. Thus the goal of corporate governance should be not to minimize the negative externalities from corporate activities, but to maximize their net positive externalities—i.e., the difference between the positive and negative externalities.

Stakeholder governance is not the way to achieve this goal. First, stakeholders contract with the firm and can either contract for limits on risk or demand compensation for the risk they assume. In practice, both approaches are used. Major lenders insist on restrictive covenants that curb the borrowing firm's discretion to increase risk.<sup>81</sup> Lenders also extract higher interest rates from risky borrowers.

The market alone does not entirely solve the problem, though, because it is difficult for some stakeholders to contract efficiently

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<sup>78</sup> Greenfield, *Stakeholder Governance*, *supra* note 3, at 1061.

<sup>79</sup> Greenfield, *Saving the World*, *supra* note 23, at 967.

<sup>80</sup> See RICHARD A. BOOTH, *FINANCING THE CORPORATION* § 3:12, at 31 (1993); RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 244–45 (2d ed. 1995) (discussing the conflict between debt and equity).

<sup>81</sup> See Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

with the firm. It is often hard for employees to identify and price the hazards (physical and economic) of their jobs. And for some, like passers-by who might be injured if a plant explodes, it is hard to contract with the firm at all, even if they know the risks posed.

Nonetheless, the problem may not be very great. Most companies are non-public and their shareholders' investments are not fully diversified, so they are often as risk-averse as the employees. In practice most public companies are dominated by their executive officers who, like most rational people, are also risk-averse.<sup>82</sup> Indeed, it is a little ironic that Professor Greenfield charges that corporate governance now generates too much risk. Although this is occasionally true, managers are generally cautious,<sup>83</sup> and excessive caution may be a bigger problem than excessive risk.

Professor Greenfield says "there is little reason to believe that society as a whole is risk neutral with regard to corporate decisions."<sup>84</sup> "Society" is a diversified investor.<sup>85</sup> It is risk averse about its entire portfolio. (At least it ought to be. Our nonchalance about environmental degradation and government debt make me wonder if it is.) However, it should be risk neutral about the conduct of individual corporations except in rare cases when one firm's risk to society cannot be diversified away. Like the diversified investor, society should seek to maximize the return from each investment, then use the winners to compensate for the losers.

To the extent that excessive risk-taking remains a problem, stakeholder governance is certainly not the best solution since it creates grave problems of its own.<sup>86</sup> Better solutions would include

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<sup>82</sup> See *supra* note 18 and accompanying text; see also *supra* text following note 5 (referring to CEO autocracy).

<sup>83</sup> "[L]ess monitoring by owners makes managers invest less rather than more in order to enjoy the quiet life." Øyvind Bøhren et al., *Corporate Governance and Real Investment Decisions 3* (Mar. 2, 2007) (unpublished EFA 2007 Ljubljana Meetings Paper), available at <http://ssrn.com/abstract=891060> (citing their own empirical findings and Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043, 1047 (2003)); see also Kose John et al., *Corporate Governance and Risk Taking 1* (Apr. 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=979413> ("When . . . private benefits are large, insiders may undertake sub-optimally conservative investment decisions to preserve them. Better investor protection reduces these private benefits and may therefore induce riskier but value enhancing investment policy.").

<sup>84</sup> Greenfield, *Stakeholder Governance*, *supra* note 3, at 1058. I agree with Professor Greenfield that "society as a whole . . . is not an absolute profit maximizer. There are other economic and non-economic 'goods' we value." *Id.* However, I see little reason to think that most people do or should consider stakeholder participation in corporate governance an intrinsic good (like love or freedom of religion) that should be promoted even if it is economically wasteful.

<sup>85</sup> See BAINBRIDGE, *supra* note 31, at 116–19 (explaining risk and diversification).

<sup>86</sup> See *supra* notes 34–56 and accompanying text.

giving employees and customers better access to information about physical hazards of the firm's facilities and products; direct regulation of hazardous activities (as by forbidding highly dangerous activities and requiring insurance for less risky behavior); and perhaps some broader exceptions to limited liability.<sup>87</sup>

In addition to stakeholder governance, Professor Greenfield favors altering the fiduciary duties of corporate officers to encompass all the firm's stakeholders. "Courts could simply hold directors and management to a duty to the firm as a whole, defined as the collection of interests imbedded in the firm, rather than a specific subset of it (the shareholders)."<sup>88</sup> His discussion of how much of a change this would be, however, is inconsistent. First he says that "some corporate law scholars . . . believe that this is even the best description of *current* corporate law. Indeed, some cases can be read to presume such a broad reading of fiduciary obligations. In any event, such a change in doctrine would not represent a huge transformation."<sup>89</sup> However, he then says "the benefits of this change would be significant."<sup>90</sup>

How can a change so minor that it may be no change at all generate significant benefits? As already noted, stockholders striving to maximize share value have significant incentives to treat employees decently.<sup>91</sup> Thus it is doubtful that there is any systemic problem of mistreatment of workers to begin with. Neither Professor Greenfield nor other stakeholder advocates have offered any firm evidence that there is a widespread problem.

Professor Greenfield denies the claim that "a broadening of corporate responsibilities is counterproductive because managers can use the additional responsibilities to avoid responsibility. If corporate managers have more than one 'master,' they can play masters off of one another . . . ."<sup>92</sup> He properly notes that "people routinely have

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<sup>87</sup> See Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991). Thus it is not true, as Professor Greenfield alleges, that I "urge[] . . . trust in the market . . . even if it is inefficient, defective, or slow in responding" to stakeholder suffering. Greenfield, *Stakeholder Governance*, *supra* note 3, at 1045. I only believe that different legal mechanisms would protect stakeholders better than the one Professor Greenfield favors.

<sup>88</sup> Greenfield, *Saving the World*, *supra* note 23, at 976. Along similar lines, it has been proposed that the fiduciary duty of care be expanded to require boards to consider the interests of all stakeholders. See Judd F. Sneirson, *Doing Well by Doing Good: Leveraging Due Care for Better, More Socially Responsible Corporate Decisionmaking*, 3 CORP. GOVERNANCE L. REV. 438, 468-81 (2007).

<sup>89</sup> Greenfield, *Saving the World*, *supra* note 23, at 976 (footnote omitted).

<sup>90</sup> *Id.*

<sup>91</sup> See *supra* note 7 and accompanying text.

<sup>92</sup> Greenfield, *Saving the World*, *supra* note 23, at 968 (footnote omitted).

more than one responsibility, some of them even conflicting, and we do not throw up our hands.”<sup>93</sup> Moreover,

corporate law duties are simply not enforced in a way that would allow managers to play one duty off the other. Both the duty of care and the duty of loyalty have been reduced in recent decades to essentially procedural obligations—to investigate various alternatives, to look at the various possible outcomes, to take the time necessary to make a good decision, to make decisions untainted by self-interest. These obligations would not be weakened if they were owed to more stakeholders.<sup>94</sup>

There is much truth in this claim. Corporate law is now remarkably indulgent of self-serving conduct by managers, especially regarding executive compensation.<sup>95</sup> It is hard to imagine that creating a new duty to stakeholders could make matters any worse. However, investors themselves have started to rein in selfish executives, and this trend is likely to continue.<sup>96</sup> Moreover, there are means by which managers could be made truly accountable to shareholders.<sup>97</sup> Creating a new duty to stakeholders would cut off the possibility of curbing CEO autocracy.<sup>98</sup>

What is most disturbing, then, about Professor Greenfield’s position is that, by supporting a position that would affect little or no change, he tacitly bolsters the status quo. The status quo is CEO domination, resulting in grossly excessive executive compensation, costly entrenchment of incumbents, wasteful empire building, and

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<sup>93</sup> *Id.* at 969.

<sup>94</sup> *Id.* at 969 (footnote omitted).

<sup>95</sup> Professor Greenfield acknowledges this. “[T]he business judgment rule gives executives large discretion in managing the firm. Senior management have used this flexibility to increase their compensation to unprecedented levels.” Greenfield, *Reclaiming*, *supra* note 1, at 14.

<sup>96</sup> See Dent, *Academics in Wonderland*, *supra* note 17, at 1264–69.

<sup>97</sup> See *infra* note 145 and accompanying text.

<sup>98</sup> In the United Kingdom a new law, Companies Act § 172 (2006), requires corporate boards to “promote the success of the company for the benefit of its members as a whole” and to consider several interests, including the effects of corporate actions on stakeholders, the community and the environment. See Jennifer Hill, *The Shifting Balance of Power Between Shareholders and the Board: News Corp’s Exodus to Delaware and Other Antipodean Tales* 25 (Vanderbilt Univ. Law Sch., Law & Econ. Research Paper No. 08-06, 2008), available at <http://ssrn.com/abstract=1086477> (discussing this law). It is too soon to know what effects this law will have and, in any case, it may be hard to separate those effects from many other influences, including some laws that give shareholders more protections in U.K. than in Delaware companies. See, e.g., *id.* at 39 (discussing the greater protection of U.K. shareholders in takeovers).



stock manipulation.<sup>99</sup> Professor Greenfield's proposal would shift a few corporate crumbs to non-shareholder constituencies while leaving this system essentially intact. We should strive for better.

Professor Greenfield, though, claims that "adding to the number of people who benefit from managers' fiduciary duties will make it *more* difficult for managers to get away with violating those duties. More corporate stakeholders will have an interest in monitoring and remedying managerial misconduct."<sup>100</sup> It is a mystery, though, how consumers or suppliers would curb management excesses. Without effective enforcement mechanisms, executives could simply flout stakeholders as they have been (and to a large extent still are) flouting investors.<sup>101</sup>

Finally, Professor Greenfield confronts the argument that "it is more efficient to regulate corporations from the 'outside' than from the 'inside.'"<sup>102</sup> He does not dismiss this claim lightly. He acknowledges that "[e]ven law professors do not believe that regulation is a good in and of itself. Regulation is a tool to address public policy ends, and the questions of what problems demand a public policy response and how best to mold that response should always be asked."<sup>103</sup> He says that the "'external' versus 'internal' dichotomy is too simple" because external regulations, like tax law, "often have as a goal the adjustment of behavior within the firm."<sup>104</sup> That observation is certainly true, but it does not demonstrate that stakeholder governance would improve corporate behavior. For reasons already discussed, stakeholder advocates have failed to make this case.

### *B. Professor Glynn's Proposals for Specific Changes in Corporate Law*

In addition to recommending abandonment of the "internal affairs" doctrine, Professor Glynn proposes some specific changes in corporate law. First, he proposes that we expand "corporate disclosure or information sharing requirements to protect nonshareholder

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<sup>99</sup> See Dent, *Academics in Wonderland*, *supra* note 17, at 1240–49; George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 42–48 (2005) [hereinafter Dent, *Corporate Governance*].

<sup>100</sup> Greenfield, *Saving the World*, *supra* note 23, at 968.

<sup>101</sup> See Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 610 (2006) (stating that instructing directors to serve multiple constituencies would produce mixed and possibly unstable signals, thus undermining their monitoring role).

<sup>102</sup> Greenfield, *Saving the World*, *supra* note 23, at 970.

<sup>103</sup> *Id.* at 973.

<sup>104</sup> *Id.* at 971.

stakeholder groups and other interests.”<sup>105</sup> Disclosure requirements seem so mild that it is easy to accept them. They do not compel or forbid any underlying behavior; they merely require telling others what you are doing. We tend to assume that people should not object to disclosure unless they are doing something wrong.

However, disclosure is not costless. Much of the information Professor Glynn mentions is not currently produced by most corporations, so there would be substantial costs just in finding or creating (as for forecasts) the requisite information. Even where information already exists, it will often be costly to compile it, as with audits of energy use, to meet regulatory specifications. Distributing the information as required will add further costs. Finally, there will be the costs of litigation and other disputes over whether the disclosure requirements have been met. How likely is it that these requirements will satisfy any reasonable cost-benefit analysis? Outsiders seeking corporate information have no reason to care about this because the corporation bears virtually all the costs.

Even if we ignore the monetary costs of disclosure, will all disclosures be beneficial? In general, the more public information the better, but there are exceptions. Professor Glynn mentions some areas where he prefers more disclosure. Are there some issues on which he and other progressives would not? For example, universities now generally resist requests for disclosure about how much preference they grant favored racial minorities in admissions and faculty hiring. Do progressives demand disclosures about racial preferences from either universities or corporations? What of corporate information about production of implements used in abortions?

State lawmakers would choose what corporate disclosures to require. The process would become politicized. In a pluralist, representative democracy like ours, special interest groups—small, tight-knit, committed minorities—often prevail over a disorganized, apathetic majority. That could happen already, but two factors

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<sup>105</sup> Timothy P. Glynn, *Communities and Their Corporations: Towards a Stakeholder Conception of the Production of Corporate Law*, 58 CASE W. RES. L. REV. 1067, 1091 (2008) [hereinafter Glynn, *Towards a Stakeholder Conception*]. He proposes

disclosure requirements on a vast array of subjects that would make firms more transparent and would give others the information they need to play a greater role in addressing what firms do, forecasts regarding economic activity, audits regarding energy use, discussions about downstream strategies with regard to physical plant, anticipated personnel changes and the like.

Timothy P. Glynn, Remarks at the Case Western Reserve Law Review Symposium: Corporations and Their Communities 27 (Jan. 25, 2008) (transcript on file with the Case Western Reserve Law Review) [hereinafter Glynn, *Symposium Remarks*]. These requirements “would also apply to private firms.” *Id.* at 28.

discourage it. First, if a state imposes burdensome, economically inefficient rules on its corporations, they can simply reincorporate elsewhere. Professor Glynn, however, would largely remove that escape hatch. Second, we now have a general policy at both the state and federal levels of requiring disclosure only for investment purposes (i.e., of financially material information). Again, however, Professor Glynn would change that. Once legislatures start requiring disclosure for other purposes, the door will be open for every well-connected interest group to compel the disclosures it seeks—regardless of overall costs and benefits.

Professor Glynn's second proposed change is "deputization." He would provide "various corporate actors with the tools or incentives to monitor firm activity, prevent or correct illegal conduct, or otherwise protect stakeholder interests."<sup>106</sup> Again, would the benefits of this measure exceed its costs? The Sarbanes-Oxley Act ("SOX") was intended in part to do this by imposing stricter requirements on corporate auditors, lawyers, and executives. Many (perhaps most) commentators have concluded that the costs of SOX exceed its benefits.<sup>107</sup>

This requirement, too, would become politicized as special interest groups sought to require monitors for illegal conduct, no matter how minor, or for conduct they deem "harmful," even if it is not illegal. Progressives should recall various government hunts for subversive or un-American activities and then ask themselves whether widespread deputization of corporate snoops would necessarily be wise. Again, would they welcome extension of this proposal to non-corporate organizations, like universities and labor unions?

Professor Glynn's third proposal is to "impose vicarious liability on high-ranking corporate officers for the firm's tort or tort-like statutory violations."<sup>108</sup> Unlike his first two ideas, which are mixed bags, this one is unambiguously bad. Corporate officers (or anyone else) are already subject to personal liability for participating in a tort

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<sup>106</sup> Glynn, *Towards a Stakeholder Conception*, *supra* note 105, at 1092.

<sup>107</sup> See Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125 (2003); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Daniel A. Cohen et al., *The Sarbanes Oxley Act of 2002: Implications for Compensation Contracts and Managerial Risk-Taking* 4 (New York Univ., Working Paper No. 2451/27546, 2007), available at <http://ssrn.com/abstract=1280709> (finding that SOX was associated with a decline in research and development and capital expenditures); Peter Iliev, *The Effect of SOX Section 404 Compliance on Audit Fees, Earnings Quality and Stock Prices* (Nov. 26, 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=983772>.

<sup>108</sup> Glynn, *Towards a Stakeholder Conception*, *supra* note 105, at 1092.

or statutory violation. Vicarious liability is liability imposed without any participation, without fault.<sup>109</sup> Liability without fault is unusual in our jurisprudence. It is premised largely on the superior ability of one person (the “controlling person”) to insure against, or to spread the liability for, the torts of another person who is unlikely to be able to respond in damages for his own torts.<sup>110</sup> Thus a corporation is generally liable for torts committed by its employees within the scope of employment.<sup>111</sup>

What is accomplished by imposing liability on an individual corporate officer who is without fault? She is not better able than the corporation to insure against or to spread the liability. Undoubtedly most firms would indemnify and insure their executives against this liability, so the main effect would be to add pointless complication to insurance policies and to add parties and complication to tort litigation.

To the extent that liability was not just shifted back to the firm by private arrangement—i.e., to the extent that Professor Glynn’s proposal actually threatened corporate executives with personal liability—it would make them unduly cautious. Executives of most large public companies own only an infinitesimal fraction of their company’s stock, and would therefore shun any activity that posed any perceptible threat of personal liability.

Once more, would Professor Glynn (or other progressives) favor this proposal for non-corporate executives, like university presidents, mayors, governors, presidents, and other “high-ranking . . . officers”? If it makes sense to hold corporate executives liable for torts “within the firm,” why not hold the president of the United States liable for torts committed by national park rangers? And if we are going to impose broader liability without fault, why stop with “high-ranking” officers? Why not impose liability on *all* corporate agents, down to the lowest employees? Employees on a given assembly line or other small unit are probably better able to influence their colleagues than is the CEO of a mega-corporation who is hundreds of miles away.

Professor Glynn’s fourth idea is to “impose an independent, generalized duty on the board of directors to establish and maintain reasonable monitoring and compliance systems to prevent and correct

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<sup>109</sup> See WILLIAM A. GREGORY, *THE LAW OF AGENCY AND PARTNERSHIP* 118 (3d ed. 2001) (“The liability thus imposed is a strict liability.”).

<sup>110</sup> See *id.* at 118–19 (“[T]he liability is frequently justified on the ground that the master may spread the risks attendant upon his doing business through insurance.” (citing *United States v. Romitti*, 363 F.2d 662 (9th Cir. 1966))).

<sup>111</sup> See *id.* at 117–18 (“Under the doctrine of respondeat superior, an employer is vicariously liable for the negligent or tortious act of its employees acting within the scope of employment.”).

unlawful or tortious conduct."<sup>112</sup> This is a good idea. Indeed, it would be desirable to expand generally the duty of care of corporate directors and officers. (Given that their duty of care is now virtually non-existent, it might be more appropriate to say "create a duty of care.") We would then ask what should reasonably be expected of business executives—in keeping with the objective of maximizing shareholder wealth.

Our goal would not be to compensate injured persons (as is the primary purpose of vicarious liability), but to foster responsibility in officers. We could, therefore, talk about limiting the amount of liability, but also limiting or forbidding insurance, so that the liability would not just be shunted onto an insurance company, leaving responsibility unaffected. And it *would* make sense to extend this liability to officers of non-corporate organizations.

Professor Glynn's fifth proposal is for "the creation of consultation or participation requirements that would give stakeholders a voice in firm decision making processes."<sup>113</sup> Such requirements could include "mandatory consultation with works councils or community representatives on decisions or planning that materially affect the relevant stakeholder groups."<sup>114</sup> In commenting on Professor Greenfield's proposals I have already indicated why this is unwise.<sup>115</sup> Likewise, Professor Glynn's last proposal—to "impose on board members duties to consider other interests besides shareholders in fulfilling obligations to enhance the wealth or success of the firm"<sup>116</sup>—tracks the proposals by Professor Greenfield on which I have already commented.

### III. DEMOCRACY AND BARGAINING POWER

Professor Glynn and other stakeholder theorists suggest that stakeholder representation in corporate governance is mandated by democratic principles.<sup>117</sup> Stakeholder advocates are clearly right that

<sup>112</sup> Glynn, *Towards a Stakeholder Conception*, *supra* note 105, at 1093.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> See *supra* notes 34–56 and accompanying text.

<sup>116</sup> Glynn, *Towards a Stakeholder Conception*, *supra* note 105, at 1093.

<sup>117</sup> *Id.* at 1100 ("Basic democratic principles suggest that those primarily affected by corporate activity ought to have a voice in how corporations behave.")

[W]e have to consider who ought to be involved in making democratic decisions. And the situation we have now is the worst of all possible worlds where we have a jurisdiction, which . . . has enormous influence on the most important economic actors in our society, and it is not democratically accountable to any of these other stakeholders.

stakeholders are affected, often profoundly so, by what corporations do. It does not follow, however, that they have to have a direct voice in corporate control. Even in democratic societies, most institutions outside of government are not democratic. Fans at a baseball game do not get to vote on whether a runner is safe or out; the decision is made by an unelected, autocratic umpire. I do not know of anyone who wants to change that. Even as to government activities, not all affected persons get to vote. We are all affected by the actions of the governments of nations, states, and localities of which we are not citizens, yet we do not get to vote for those governments.

Again, it seems anomalous that stakeholder advocates do not propose the same medicine for non-corporate institutions, like labor unions. The same considerations seem to apply there—actions by a union (e.g., to strike) affect many non-members, including the employer's stockholders, its employees who are not members of the union, and its customers and suppliers. (The ripple effects may be even greater for the acts of public employee unions.) One can argue that “[n]o constituency would have an incentive to hurt the [union] in order to gain a larger piece of the pie,” as Professor Greenfield has said of stakeholder participation in corporate governance.<sup>118</sup> After all, the ability of a union to exert pressure (often, to halt operations) by striking shows that it is a crucial part of the operation, and other constituents do not want to destroy a crucial part of the operation.

Further, unions can impair firm efficiency because, to a much greater degree than shareholders, they do not bear all the costs they generate—i.e., they create externalities. The costs of a strike to its members may also be mitigated by unemployment benefits paid for by taxpayers. Unions may be infected with short-termism because much of the damage they can inflict will be delayed until after many incumbent members have retired; they will be borne, *inter alia*, by future employees who are not now represented in the union.

The flaws in this argument are obvious, and they apply equally to stakeholder participation in corporate governance. Although the interests of union members and other constituencies overlap to some extent, they also diverge in many ways. Other constituents may not want to get rid of union members, but they probably do not agree about what “piece of the pie” they deserve. If they did agree, why is there a strike? The economic incentives of unions may not be perfect because of externalities, but it is most unlikely that adding other constituencies to union governance would improve efficiency.

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<sup>118</sup> Greenfield, *Saving the World*, *supra* note 23, at 982.

The lack of a direct voice does not render stakeholders helpless before corporate power. As is often the case, an alternative to voice is the right to exit.<sup>119</sup> Employees can quit their jobs and customers can take their business to other suppliers if they are dissatisfied. It is understandable that employees, especially, often feel that this right is inadequate. Many employees do make commitments of human capital to their employer that reduce their value to other employers in the labor market—i.e., reduce their ability to exit if they are treated unfairly by their employer.<sup>120</sup> Many employees also have personal commitments, like family ties to their community, that limit their ability to seek a job elsewhere. The employer may take advantage of these circumstances in a way that is arguably unfair.

However, it does not follow that corporations generally enjoy a bargaining advantage over employees, much less customers. Even the largest company employs only a tiny fraction of the total workforce, and most American workers in the private sector are employed by smaller companies that have little or no market power. In general, companies have strong incentives to treat employees and customers fairly in order to maximize their long-term profits.<sup>121</sup>

A comparison with unions is again instructive. Only a union's members vote for its officers, but that does not mean that the interests of other constituencies are flouted. Ultimately, a union must reach a mutually acceptable agreement with the employer. Like any party in contract negotiations, a union that is too aggressive will damage itself. A labor union must also consider its reputation. If it alienates the public, it can forfeit the sympathy and incur the hostility of the public and lose its economic support. It can also suffer political and legislative damage.

#### IV. A THOUGHT EXPERIMENT: INVESTORS WITH NO VOICE

A thought experiment: If the right of exit alone does not adequately protect employees and customers, would stakeholder advocates be willing to give that right to shareholders in exchange for their (theoretical) control of corporate governance? Stakeholders

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<sup>119</sup> The concepts of exit and voice were developed by Albert Hirschman. See ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1970).

<sup>120</sup> See Allen Kaufman et al., *A Team Production Model of Corporate Governance Revisited* 13 (Dep't of Strategic Mgmt. & Pub. Policy, George Washington Univ. Sch. of Bus. & Pub. Mgmt., Working Paper 03-03, 2003), available at <http://ssrn.com/abstract=410080> (noting that since "each member's skills remain valuable only within the context of the team (and the firm and industry), individuals cannot threaten to quit and join another effort").

<sup>121</sup> See *supra* note 7 and accompanying text.

could choose the entire board but, like employees and customers, shareholders would have the right to “quit” at any time. That is, each shareholder would have a “put” allowing her to recover the capital she invested in the corporation.

What contractual arrangements would develop under this regime? Actual practice is instructive. Many investors *do* provide capital without demanding a voice in governance, but they typically demand senior securities—either debt securities or preferred stock that promise a more or less fixed return. This is necessary because those who do exercise control have no motive to give voiceless investors anything unless they are contractually required to do so.<sup>122</sup> When does a company ever pay bondholders *more* than the stipulated principal and interest?

But these arrangements exist in businesses for profit only if they are controlled (at least in theory) by investors. A board controlled by stakeholders would have no motive to pay dividends on common stock (if there were any), or even to generate any profit. This is why non-profit organizations often issue debt securities (i.e., borrow money), but do not issue stock, common or preferred. Likewise, firms controlled by stakeholders could not issue securities with the features we associate with stock.

Puts do exist in some businesses for profit, but again actual practice does not confirm but refutes the economic rationality of stakeholder theory. Sometimes venture capitalists acquire stock with a put.<sup>123</sup> However, these venture capitalists also typically contract for a voice in control through representation on the board, and contractual limits on compensation to and self-dealing by the officers, who also own substantial common stock. In other words, they make sure that the officers who share control with them have primarily an equity interest, not just a stakeholder interest.

Further, the put is typically fictitious in that it is not expected that the company would actually repurchase the venture capitalist’s stock out of corporate funds. Rather, the officers must keep the venture capitalist happy so that it does not exercise the put; or attract another

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<sup>122</sup> Sometimes dividends on preferred stock are mandated if the company meets certain measures of profits. See BOOTH, *supra* note 80, § 2:14, at 41 (“Dividend rights may be made contingent on the company’s earning enough in the prior period to pay them.”). Even if preferred stock dividends are not mandated, dividends on common stock are typically forbidden unless the preferred stock dividends have been paid. See *id.* § 2:03, at 10 (“[P]referred stock is preferred precisely because its dividends must be paid before any distribution can be made to the common stockholders.”). Thus a board controlled by common stockholders has a strong motive not to cheat the preferreds.

<sup>123</sup> See 1 MICHAEL J. HALLORAN ET AL., VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION 348 (1991) (form of mandatory redemption).



outside investor (by credible promises of attractive returns) to finance the repurchase and take the place of the venture capitalist exercising the put; or default on the put and surrender control to the venture capitalist.<sup>124</sup> In other words, there is no such thing as a stockholder who has the same right to “exit” that all employees and customers enjoy.

In some industries (like hospitals), non-profit and for-profit entities compete. Even here, though, the governance of non-profit entities does not embody stakeholder theory. Most non-profit organizations are controlled by self-perpetuating boards of trustees that do not even vaguely approximate stakeholder theory.<sup>125</sup> No law bars stakeholders from forming non-profit entities and obtaining financing in any way they can to compete with for-profit firms in any industry. That we observe such non-profit entities only in a few industries demonstrates that only the shareholder model is efficient in other industries. And the fact that even non-profit entities eschew the stakeholder model shows that it is not efficient anywhere.

Ironically, the current practice that most resembles the stakeholder model is the large, CEO-dominated public company. Dominant CEOs wield their power to their own benefit at the expense of shareholders.<sup>126</sup> Stakeholder governance might enable other constituencies to join in the abuse of shareholders. However, CEO domination is now under siege. Because of the abuse of investors in public companies, more companies are being taken private. In companies that remain public, institutional investors are becoming more assertive.<sup>127</sup> Because of growing international competition for capital, these trends are likely to continue and may even accelerate. Mistreatment of investors is likely to wane. If stakeholder governance were instituted, this investor rebellion would undoubtedly spread.

In sum, economic theory and real-world practice indicate that the stakeholder model is not feasible.

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<sup>124</sup> See George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1048–49 (1992) (describing use of puts to force a change in favor of the holder).

<sup>125</sup> See MICHAEL J. WORTH, *NONPROFIT MANAGEMENT: PRINCIPLES AND PRACTICE* 64 (2009) (“Most charitable nonprofits have *self-perpetuating boards*.”); see also MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION* 159 (2004).

<sup>126</sup> See Dent, *Academics in Wonderland*, *supra* note 17, at 1240–49 (describing CEO domination and its costs).

<sup>127</sup> See *id.* at 1264–69.

## V. THE INTERNAL AFFAIRS DOCTRINE

Professor Glynn proposes an end to the “internal affairs doctrine” under which the internal affairs (or governance) of a corporation are subject to the law of the state of incorporation.<sup>128</sup> As with Professor Greenfield, I share many of Professor Glynn’s premises, and I cannot see that this change would be a disaster. However, I suspect that its net benefits, if any, would be trivial and that it would do little or nothing for stakeholders.

It certainly is anomalous that corporate internal affairs are governed by a state with which a corporation has no contact except the filing of a charter and the payment of franchise fees. The idea that the freedom of corporations to incorporate in any state has led to a race to the top, with states competing to offer the most efficient corporation laws, has been refuted.<sup>129</sup> To the extent that there is such a competition, it is probably competition to benefit managers, not shareholders or stakeholders.<sup>130</sup>

However, abandoning the internal affairs doctrine would not lead to dramatic improvement or, perhaps, any benefit at all. There would at least be a messy transition period as courts struggled to choose the criteria for determining with which state a corporation has its primary contacts. Which state would that be for a company with such scattered operations as General Electric? To resolve conflicting claims, standards would have to be laid down by Congress or the United States Supreme Court.

Congress or the federal courts would also have to police state governance under the dormant Commerce Clause to ensure that states did not abuse their jurisdiction to favor local economic activity at the expense of other states or to tamper with the law of other states.<sup>131</sup>

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<sup>128</sup> Glynn, *Towards a Stakeholder Conception*, *supra* note 105, at 1071, 1083–84; see FRANKLIN A. GEVURTZ, CORPORATION LAW § 1.2.1, at 35–39 (2000) (explaining the internal affairs doctrine). Professor Glynn does not propose a single alternative choice of law rule. In some cases regulation of a company might be limited to the state where it has its “primary operational or equity investor presence,” but in other cases each of the various operations of an interstate company might be regulated by the state in which that operation is located. Glynn, *Towards a Stakeholder Conception*, *supra* note 105, at 1086.

<sup>129</sup> See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 533 (2002); Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL’Y REV. 381 (2005) (questioning whether there is a race to either the top or the bottom); Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32 (2004) (finding that incorporation in Delaware is not generally associated with higher firm value).

<sup>130</sup> See Oren Bar-Gill et al., *The Market for Corporate Law*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 134 (2006).

<sup>131</sup> See JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW § 8.1, at 319–34 (7th ed. 2004) (describing the “dormant” commerce clause power).

These limits would shackle any attempt to help stakeholders. The “primary contact” state could not, for example, interfere with a domestic corporation’s shifting operations out of the state or regulate employment by the corporation outside the state. The state could regulate employment conditions within the state (subject to federal law), but states already have that power.

The state of incorporation could dictate corporate governance rules. It could, for example, require a corporation to include employee representatives and appointees of the governor on its board of directors. Like state taxation, though, a state could not get far out of line with other states without injuring itself.<sup>132</sup> If a state imposed inefficient rules, new and foreign corporations would hesitate to put or move their “primary contacts” there. Domestic corporations hampered by inefficient governance would grow more slowly, shrink or fail, or move their “primary contacts” elsewhere. State competition for jobs has already led states to pander to corporations with tax breaks and subsidies. Changing from the “internal affairs” doctrine to a “primary contacts” regime would reduce corporate mobility a little, but would not fundamentally alter the economic forces inducing interstate competition.

It is also doubtful that the “primary contacts” state of incorporation would be more solicitous of investor interests than is Delaware, the now-dominant state of incorporation for public companies.<sup>133</sup> The states have already widely embraced antitakeover laws that favor managers and (maybe) employees at the expense of shareholders.<sup>134</sup>

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<sup>132</sup> The practical restrictions on state regulatory discretion would probably be even greater than they are for taxation. States have wide flexibility in choosing what business activity to tax or exempt from taxation. By contrast, rules of incorporation would presumably be more general. A state can, for example, grant a tax abatement for a specific corporate project. Presumably it would not do so with corporate governance laws.

<sup>133</sup> Delaware is chosen by 95 percent of firms that incorporate outside their home state. Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1563 (2002).

<sup>134</sup> See John Pound, *On the Motives for Choosing a Corporate Governance Structure: A Study of Corporate Reaction to the Pennsylvania Takeover Law*, 8 J.L. ECON. & ORG. 656, 668–69 (1992) (study finding that companies that opted out of Pennsylvania’s extreme antitakeover law were more highly valued in the market than those that did not). Employees also tend to like antitakeover laws because they fear that a raider will reduce wages or fire workers, but most acquirers do not do that. See U.S. DEP’T OF LABOR BUREAU OF LABOR STATISTICS, ANNUAL REPORT ON MASS LAYOFFS IN 1988, at 2 (1989) (finding that fewer than 5 percent of major layoffs resulted from changes in firm ownership). The largest study to date of going private transactions recently found that they are followed by employment reductions of about 1 percent. See Andrew Ross Sorkin, *Study Says Private Equity Isn’t Big Job Killer*, N.Y. TIMES, Jan. 25, 2008, at C6. One recent study finds that “private-equity firms are net job creators.” David Haarmeyer, *Private Equity: Capitalism’s Misunderstood Entrepreneurs and Catalysts for Value Creation*, 13 INDEP. REV. 245, 278 (2008); see also Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, 43 U. TORONTO L.J. 315, 317–25 (1993) (concluding that takeovers do not harm stakeholders much, if at all); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 133–43

This is not surprising. Officers and employees of public companies are likely both to be more numerous in the “primary contacts” state than shareholders, who are scattered across the nation, and to care more about a “hostile” takeover of the company than the shareholders, whose investments are generally diversified and who therefore do not care much about the fate of a single company. If a “primary contacts” rule did injure public investors, one of its principal consequences would be to accelerate the trend toward going private.

In sum, it is likely that dumping the “internal affairs” doctrine in favor of a “primary contacts” rule would do little for stakeholders and might do some (albeit probably slight) damage to investors.

## VI. FEDERALIZING CORPORATE LAW

Progressives periodically urge that incorporation, at least of large public companies, be taken away from the states and taken over by the federal government. Professor Greenfield recently revived that argument,<sup>135</sup> and Professor Glynn alludes to it in this Symposium.<sup>136</sup> I have acknowledged the problems of the current regime dominated by Delaware,<sup>137</sup> but it does not follow that federalization would be better. Congress now routinely makes decisions based on the political interests of Congressmen—such as wasteful home district pork projects used to attract votes and provide favors to wealthy interests that attract campaign contributions.

Nonetheless, markets are not perfect; some regulation is necessary and desirable. The federal securities law, though flawed in many ways, is on the whole beneficial, so federalization should not be categorically rejected. Rather, we should be skeptical and entertain a pretty strong presumption against government intervention; proponents of regulation should bear a heavy burden of proof.

I do not accuse Professor Glynn and Professor Greenfield of being un-American, but I want to persuade them (and the reader) that corporate governance is not just an issue of distribution among domestic interest groups, but is rather a matter of national well being.

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(1992) (same).

<sup>135</sup> Kent Greenfield, *It's Time to Federalize Corporate Charters: Delaware and Other States Aren't Tough Enough*, July 26, 2002, available at [http://law.case.edu/lectures/files/2007-2008/20080125\\_Greenfield-TOMPAINÉ\\_com.pdf](http://law.case.edu/lectures/files/2007-2008/20080125_Greenfield-TOMPAINÉ_com.pdf).

<sup>136</sup> See Glynn, *Towards a Stakeholder Conception*, *supra* note 105, at 1104 (“[T]o the extent regulatory overreaching or interstate conflict becomes a problem that the states and firms cannot resolve themselves, federalization of corporate law . . . ought to be the primary remedy.”).

<sup>137</sup> See *supra* notes 5–6, 18–21 and 99 and accompanying text.

After World War II the United States was unique as a safe place for capital investment. Its dominance shrank a bit with the economic revival of Europe and Japan, but until recently competition for capital was limited.

Professor Greenfield is complacent about this: "Given the power and stability of U.S. markets, there are very few places likely to offer [investors] a better risk/return ratio."<sup>138</sup> That is now ceasing to be true. Capital is international and becoming as fluid as quicksilver. China, India, Brazil, and other countries have adopted capitalist ways and become more attractive to investors. Europe is increasingly embracing shareholder value as the proper norm for corporate governance.<sup>139</sup> One recent study using measures developed by the World Bank found the United States to be below average in investor protection.<sup>140</sup> Recently Rupert Murdoch's News Corporation shifted its incorporation from Australia to Delaware in an effort to *weaken* shareholder rights.<sup>141</sup> In 2006 the Paulson Committee Report declared that "[o]verall, shareholders of U.S. companies have fewer rights in a number of important areas than do their foreign competitors" and that lack of shareholder rights was affecting the level of investment in U.S. companies.<sup>142</sup>

If investors in American public companies continue to suffer the abuse and contempt of CEOs that are now common, investors will go elsewhere. To some extent they already have. The proliferation of private equity stems in large part from the benefits of avoiding the

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<sup>138</sup> Greenfield, *Reclaiming*, *supra* note 1, at 32. Professor Greenfield has also written that "there is little reason to worry that capital will abandon ship if the U.S. adopts a similar model" to Europe's "robust system of stakeholder protection." Kent Greenfield, *Corporate Ethics in a Devilish System*, 3 J. BUS. & TECH. L. 427, 434 (2008). Given the slow economic and employment growth in western Europe in recent years, this is not a good model to emulate. See *supra* notes 43–45 and accompanying text.

<sup>139</sup> See Greenfield, *Saving the World*, *supra* note 23, at 949 ("[A]s globalization intensifies, the narrow shareholder-executive focus of United States corporate law is increasingly exported . . ."); Lans Bovenburg & Coen Teulings, *Rhineland Exit?* 16 (Tinbergen Inst. Discussion Paper No. 2007-101/3, Dec. 2007), available at <http://ssrn.com/abstract=1082707>. It has been predicted that all countries with market economies will converge at a single model of corporate governance. See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001). There is debate about how far and how fast this trend will go. See CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon & Mark J. Roe eds., 2004).

<sup>140</sup> Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008); see also Bovenburg & Teulings, *supra* note 139, at 12–14 (study finding that Denmark adheres more closely to the norm of shareholder value in corporate governance than does the United States).

<sup>141</sup> See Hill, *supra* note 98, at 28–66 (discussing the battle between Murdoch and institutional shareholders and the various shareholder rights at stake).

<sup>142</sup> INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 93 (rev'd version Nov. 30, 2006), available at [http://www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf).

agency costs of the separation of ownership and control characteristic of public companies. But private equity is not a complete solution to the problem. Investors who need some liquidity, for example, will invest elsewhere. Indeed, they are already doing so. American investors are rapidly going abroad, and foreign investors are staying away.

If this continues, American firms will have to pay more for capital than foreign competitors.<sup>143</sup> Our economy will suffer.<sup>144</sup> And workers and communities will suffer most. If progressives care about these constituencies, this is the problem on which they will focus.

There are many proposals to strengthen shareholder protection. Many of them would be beneficial but trivial. That includes the proposals tabled by the SEC to allow shareholder nominees for the board.<sup>145</sup> I have a proposal that I think would produce real change: The nominees for the board on a company's proxy statement should not be chosen by the incumbent board, which is usually dominated by the CEO. Rather, they should be chosen by a committee of the ten to twenty largest shareholders. This would ensure the selection of directors who are truly committed to maximizing share value.<sup>146</sup>

And maximizing share value, I submit, should be a goal of progressives. Employees tend to be paid better, have better job security, and have better opportunities for promotion in firms that are profitable and growing than in firms that are stagnant or declining. More important, workers generally fare better in a growing economy; there is no better program for workers than a tight job market.

I realize that this is not a complete solution to the problems of workers, communities, the environment, etc. Even a vibrant economy does not prevent unreasonable inequality, cost externalities, and the

<sup>143</sup> See Mark J. Garmaise & Jun Liu, Corruption, Firm Governance, and the Cost of Capital (Feb. 28, 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=644017> (finding that firms in countries with weak shareholder rights face a higher cost of capital).

<sup>144</sup> See Rui Castro et al., *Investor Protection, Optimal Incentives, and Economic Growth*, 119 Q.J. ECON. 1131, 1131–35 (2004) (finding a positive correlation between investor protection and economic growth).

<sup>145</sup> Indeed, the SEC amended rule 14a-8(i)(8) to overturn the decision in *American Federation of State, County & Municipal Employees v. American International Group, Inc.*, 462 F.3d 121 (2d Cir. 2006), which required the company to include in its proxy statement a shareholder proposal to amend the company's bylaws to permit inclusion of shareholder nominees in the company's future proxy statements in certain circumstances. Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56,914, Investment Company Act Release No. 28,075, 72 Fed. Reg. 70,450 (Dec. 11, 2007).

<sup>146</sup> See Dent, *Corporate Governance*, *supra* note 99, at 67–75. It is not at all true that I believe that “[t]he government must step in . . . in order to protect shareholders from the vagaries of the market.” Greenfield, *Stakeholder Governance*, *supra* note 3, at 1045. I propose only that the default rule for choosing the company's official nominees for the board be changed to vest that power in those who have the greatest incentive to maximize wealth—i.e., the shareholders.

dislocations that stem from the “creative destruction” that is capitalism. However, those problems should be addressed by means other than corporate governance. Precisely what should be done is an interesting question, but that is the subject for another symposium.

#### CONCLUSION

I do not delude myself; nothing I say will drive a stake through the heart of stakeholder theory and finally put an end to this folly. I hope, however, I can persuade realists that, however appealing the specter of stakeholder participation in corporate governance, it is a mirage. It is also a distraction; it diverts attention from more promising initiatives. Shareholder primacy—real shareholder primacy, not the counterfeit version we have now—is the corporate governance system that holds the greatest promise for both investors and employees.<sup>147</sup> It will not achieve a desirable level of equality, but policies other than stakeholder governance are better suited for that purpose.

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<sup>147</sup> See Hansmann & Kraakman, *supra* note 139, at 441:

All thoughtful people believe that corporate enterprise should be organized and operated to serve the interest of society as a whole, and that the interests of shareholders deserve no greater weight in this social calculus than do the interests of any other members of society. The point is simply that now, as a consequence of both logic and experience, there is a convergence on a consensus that the best means to this end . . . is to make corporate managers strongly accountable to shareholder interests . . . .