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CONFRONTING THE ETHICAL CASE AGAINST THE ETHICAL CASE FOR CONSTITUENCY RIGHTS

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INTRODUCTION

Professor Ronald Green challenges the legal model of the firm on behalf of its nonstockholder constituents. Green centers his challenge on the model's principal-agent component. In his view, the fiduciary ideology bound up in the agency concept erects a false ethical barrier to a redefined firm.

This Comment makes two points in response. First, it asserts that the principal-agent concept carries insufficient normative force to determine the legal disposition of the constituency problem. Professor Green certainly has good reasons for pointing our attention to the agency notion. Even minimal suggestions of law reform to empower constituencies traverse deeply held values, and the principal-agent concept appears prominently in the articulation of objections.[1] Agency thinking still prompts questions about the legitimacy of the recently enacted constituency statutes and impedes the case for their expansive interpretation.[2] But the law itself does not generate the ethically-charged agency metaphor that Professor Green describes. Although the agency model has its ethical presuppositions, it does not import a strong, ethically-generated norm of absolute respect for beneficiary welfare and subordination of fiduciary self-interest. Appearances deceive here—agency plays a larger role in policy-laden academic descriptions of the doctrinal structure than it plays in the underlying doctrine itself.

Second, this Commentary asserts that as we describe corporate law's agency concept more fully, ethical and political barriers start to impede the case for constituency rights. Corporate law's agency component does have ethical implications for the constituency debate. It looms large because it

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1. *See, e.g.*, William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 421-24 (1990) (discussing importance of agency for management accountability); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 175 (arguing that shareholders retain ultimate right to control corporations because they value that right more highly than do other groups).

2. For a survey of the range of interpretative possibilities with a plausibly middle-of-the-road approach, see Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 71-90 (1992).

figures instrumentally in a wealth maximization story.[3] The agency concept may be only a metaphor at bottom, but theory of the firm discussants treat it as if it were a component in a production model. Shareholder wealth maximization by managers who play the role of agent is a norm because it is assumed to be the means to the end of maximum wealth for the society as a whole. It is not itself the end in view. Its ethical power derives from the fact that, in a world of scarcity, more is better than less.

Thus, to join Professor Green in considering the ethical problems of constituency injury is to restart an old debate over the desireablility of redistributive regulation within the framework of corporate law. On the side against mandated redistribution there come to bear factors such as wealth production incentives, free market ideology, the legal inheritance, and the agency model. On the side favoring redistributive intervention we see disrupted relationships, dashed expectations, pecuniary injuries, and disempowerment. In between the two sides lies a fragile, time- and incentive- dependent pot of wealth. Corporate law's historical structure permits redistribution in management's discretion but forecloses redistributive intervention. This Comment predicts that the inherited structure will control in the immediate future.

Part I of this Comment summarizes Professor Green's paper. Part II discusses the methodological problem that arises when an ethical perspective such as Professor Green's is advanced in legal academic contexts. It explains why this Comment joins Professor Green in treating the problem in ethical terms despite the legal academy's aversion to such discussions. Part III looks at the doctrine and shows that its agency component does not bear the ethical weight ascribed by Professor Green. Part IV describes ethical problems that constituency rights advocates must confront. It suggests, first, that in practice the problem of constituency rights should be conceived more narrowly as the problem of employee empowerment, and, second, that corporate law, viewed as an institution, offers a substandard framework in which to make the employees' case.

I. The Principal-Agent Barrier to the Case for Constituents

Professor Green focuses on the role that the principal-agent model of shareholder-management relationships plays in doctrinal and theoretical models of the corporation. The principal-agent model is, in Professor Green's view, a barrier that blocks the path to a constituency-based corporate governance model. In his description, this principal-agent barrier is more apparent than real—a metaphorical device rather than an essential cog in a machine of production. Once right-minded people who want to

3. Professor Green does note that the private enterprise system has "virtues of efficiency and productivity" and that concern for the system figures into defenses of the existing system. Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 Wash. & Lee L. Rev. 1409, 1417 (1993). Green does not explore the independent normative implications of wealth maximization.

expand the operative model of the firm clearly see the barrier's outline and character, they more effectively can direct a policy discourse toward its removal.

Professor Green tells us that the principal-agent metaphor's preemptive power derives from its ethical content. It is not just a descriptive concept; it is also a moral stumbling block. Agency relationships are fiduciary relationships. The characterization of the manager as the agent of a shareholder-principal therefore lends ethical force to the shareholder maximization model of the corporation.[4] If the shareholder is seen as a beneficiary, an ethical case arises for the shareholder's protection. That ethic dissipates concern about injuries to other corporate constituents. Stakeholder injury comes to be seen as injury inflicted in the course of performance of a moral imperative. Discussion of implicit moral questions of shareholder benefit versus stakeholder injury is preempted.[5]

In Professor Green's view, the agency metaphor's force diminishes if we bring to bear an accurate description of the firm.[6] He refers to both the separation of ownership and control and the absence of an institutional framework allowing for negotiated contracts between shareholders and managers. Together, these institutional realities undercut the factual case for applying the fiduciary principle. Shareholders, furthermore, do not resemble the beneficiaries of other fiduciary relationships. They are less vulnerable because they can sell on the market—less vulnerable, in fact, than the archetypical stakeholder, the at-will employee.[7] Finally, the shareholders' easy exit route denudes them of moral commitment to the firm.[8]

Professor Green also dispatches other standard arguments in favor of shareholder primacy. First comes Berle's warning to Dodd[9] of the dangerous power that would flow to the managers of a firm endowed with social responsibilities. Second comes the warning of Easterbrook and Fischel,[10] repeated often in the last decade,[11] that fiduciaries cannot coherently serve two beneficiaries with conflicting interests. Professor Green responds that analytical tools can be devised for dealing with the complex demands that a multibeneficiary model would impose on managers. If they set their minds to it, those in authority can develop frameworks of reasonable and defensible priorities[12] without causing either super-empowerment of managers or an outbreak of chaos.

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4. *Id.* at 1410.

5. *Id.*

6. *Id.* at 1413.

7. *Id.* at 1418.

8. *Id.* at 1414.

9. A.A. Berle, Jr., *For Whom Corporate Managers* Are *Trustees: A Note*, 45 HARV. L. REV. 1365, 1367-69, 1372 (1932).

10. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1192 (1981).

11. *See, e.g.*, William W. Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 735.

12. Green, *supra* note 3, at 1418. I agree that reasonable and defensible priorities can

Professor Green does not assert that the "constituency statutes" added to the corporate law of twenty-eight states during the 1980s[13] mandate that management articulate a multibeneficiary model along the lines he describes. He makes reference to some very restrictive readings of these provisions,[14] and opines that they do not dislodge the principal-agent metaphor.[15] But he takes care to leave a door open to more expansive readings. He would like to see a new body of corporate law that sets out "varied priorities" for corporate management. Shareholders would be *primus inter pares*, to be considered first in day-to-day business decisions, but to be subordinated when their interests threaten serious injuries to others.[16] Corporate actions not in the shareholders' immediate interests would not necessarily have to be justified in terms of long-term shareholder gain; shareholder detriment, short- or long-term, could be justified in the service of constituent protection.[17]

This last point—Professor Green's insistence that moral concerns require occasional disregard of long-term shareholder gain—takes us a step farther down the road of constituency empowerment than do Professors David Millon and Lawrence Mitchell, two of the constituents' more aggressive and effective legal academic advocates. Both Millon and Mitchell offer interpretations of the constituency statutes that provide for constituent rights. Under Professor Millon's reading, first, management should not seek short-term shareholder gains that frustrate legitimate constituent interests, and, second, management's business strategies should harmonize the shareholders' financial interest with the stakeholders' interest in stable relationships with the corporation.[18] But the constituents' interest in stability should not, says Millon, be confused with a constituent right to permanent relationships. His mediation of the conflict protects constituents only against "abrupt, unfair disruption of relations" in the course of management toward the end of long-term profit maximization.[19] The principal-agent model is relaxed, but its outlines are left in place for the long-term. Professor Mitchell's

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be developed to support a multibeneficiary model. *See* Patrick J. Ryan, *Calculating the "Stakes" for Corporate Stakeholders as Part of Business Decisionmaking*, 44 RUTGERS L. REV. 555, 562-66 (1992).

13. For cumulations of the states with constituency statutes, see John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1540-45 (1991); Orts, *supra* note 2, at 26-31.

14. Green, *supra* note 3, at 1411-12; *see also* The Committee on Corp. Laws, Am. Bar Ass'n, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2269 (1990) (interpreting statutes as confirming common-law duty to take other constituency interests into account only to extent board acts in best interests, short-term and long-term, of corporation and its shareholders); Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1375 (1991) (arguing that constituency statutes should be read as codifications of common law).

15. Green, *supra* note 3, at 1412.

16. *Id.* at 1419.

17. *Id.*

18. David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 266, 267 (1991).

19. *Id.* at 268.

reading also preserves a degree of shareholder primacy. He would leave in place the instruction to maximize shareholder wealth, but require the board to take constituent injury into account. Such injury could be justified in the interests of the shareholders or the corporate entity, but, drawing on the close corporation formulation of majority-to-minority shareholder fiduciary duties, Mitchell would hold open a door to a constituent showing of the availability of a less injurious alternative.[20] Both Millon and Mitchell thus carve out constituent rights at the expense of the shareholder primacy norm, but, unlike Green, would not allow its total eclipse.

II. The Ethical Presuppositions of Corporate Law

Professor Green speaks of the constituency problem in ethical terms. He implicitly invites us to join him in discussing the characteristics of an ethically defensible firm. At first glance, such talk might seem to be as appropriate in this venue as it is in the business school where Professor Green teaches. Business students get ethical education because they are on a track to positions of power in corporations. Corporate legal academics aspire to shape the law and thus shape the exercise of that corporate power. So legal academics also should take time out to think about the ideal firm, or so it would seem.

But Professor Green's invitation to ethical discussion is not so easily accepted. It gives rise to an important question of legal academic methodology: Should (or may) a legal academic respondent also speak in ethical terms, or should the legal respondent speak in the ordinary terms of legal policy talk?

Ethical discussions occur in the ordinary course in business schools, where business ethics are part of the curriculum.[21] In contrast, the legal academy tends to avoid direct mention of business ethics, even though the subject matter overlaps. The legal custom is to talk ethics freely in two contexts. One is demarked as jurisprudence, the other professional responsibility. Consider the latter. When we freely talk ethics in dealing with ourselves in our professional roles as lawyers, we do the same thing that

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20. Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 Tex. L. Rev. 579, 635-36 (1992).

It should be noted that Professor Green articulates his case for action that would not be in the long-term interests of the shareholders by reference to the Bhopal disaster. A substantial body of scholarship in favor of constraints on limited liability in respect of tort claimants supports Professor Green's treatment. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L.J. 1879 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 Colum. L. Rev. 1565 (1991). The articulation of a clear-cut distinction between Green's notion of constituency empowerment and that of Millon and Mitchell may require the articulation of a hypothetical case focused on employee tenure rights.

21. Professor Green is not the only scholar of business ethics to take up the constituency issue. *See, e.g.*, R. Edward Freeman & Daniel R. Gilbert, Jr., Corporate Strategy and the Search for Ethics (1988); Kenneth E. Goodpaster, *Business Ethics and Stakeholder Analysis*, 1 Bus. Ethics Q. 53 (1991).

business people do when discussing the ethical implications of their own conduct. Both of these theoretical discussions impact on internal, self-regulatory practices. Legal discussions of external regulation work differently. There the topic is application of the state mandate to others in their working roles. The possibility of regulatory overreaching makes the subject matter risky, and we avoid open consideration of the ethical implications of the behavior discussed.

It thus is easier to project the characteristics of an ethically ideal firm in a business school than in a law school. Legal scholarship is rarely deontological, at least in terms. Some exercise of sovereign mandate always shows up at the bottom line. Even so, occasional open recognition of the ethical aspects of business law can benefit the discourse. But we should still proceed with caution. Instead of working from the top down, and discussing an abstract and universalized ideal firm, we should work from the bottom up, and come to agreement on the ethical presuppositions that activate the law on the books. Such talk may herald no immediate prospect of a new legal mandate. But it does confer the singular benefit of making the operative description of the law more accurate.

Business law, like all private law, is shaped by ethical presuppositions. It has been noted that markets cannot function on self-interest only; they require in addition a substratum of moral conventions.[22] Legal decision-makers, when they impose standards of conduct on business actors, evaluate conduct by reference to a "should be." They draw on legal texts that set out past statements of norms and reconstruct the norms for present application. In so doing, they synchronize values expressed in the law for application against the unfolding background of business practice. This process is recollective and interpretive, but also ethical.[23] The "is" of the "law is" results from an imaginative reconstruction of what the law "might have been." The decision becomes informed by aspirations about how things "should be" in the process. Read this way, the fiduciary rules that we have in corporate law come down to us as artifacts of ethical judgments rendered in the past.

Does a more accurate description of the law's dynamics justify the risks that arise if we relax the norm against ethical discussions in policy contexts? The custom of restraint addresses valid concerns. It stems from a healthy philosophical skepticism. It serves the ends of cost reduction. And it protects individual autonomy, particularly in normative policy contexts. None of these concerns is preemptive, however.

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22. *See* Robert W. Gordon, *The Independence of Lawyers*, 68 B.U. L. REV. 1, 18 (1988) (citing A. FOX, BEYOND CONTRACT 1 (1980)).

23. Drucilla L. Cornell, *Institutionalization of Meaning, Recollective Imagination and the Potential for Transformative Legal Interpretation*, 136 U. PA. L. REV. 1135, 1145 (1988) (viewing law as "recollective imagination through the retrieval of the embodied ideals of law, a retrieval that releases the power of the 'might have been' through an appeal to the 'should be'").

First consider philosophical skepticism. Many observers make rational tools available for the solution of descriptive, but not ethical, debates. Ethics tend to be kept out of law to keep law under rational control. But we can recognize the play of ethical presuppositions in our description of corporate law without an outbreak of uncontrolled irrationality. Substantial rational controls operate along with ethical aspirations in the practice of corporate lawmaking.[24]

As to cost, the problem is that ethics may be expensive. But we can acknowledge ethical issues at stake in corporate law without causing undue suppression of cost considerations. Indeed, this Comment will argue that the ethics which inform corporate law include cost considerations.

As to individual autonomy, the problem is that state-imposed ethics impair freedom. But, in the context of corporate law duties, ethical presuppositions can be recognized without cognizable injury to freedom. This is because corporate legal decisionmakers perform a function that is mediative and relational as well as directive. They recollect the law not for abstract application, but for present contexts shaped by present actors. They take the actors' relationships into account. And they make adequate recognition of the actors' relational roles an aspect of responsible lawmaking. This respect for the actors becomes a constituent part of the ethic that motivates the legal decision. Since the actors shape their roles for themselves over time, they strongly influence the ethical context in which the lawmaker interprets the law. As a result, the decisionmaker operates subject to a significant constraint. Since the practice restricts the available ethical referents, a decisionmaker in this relational situation is unlikely to oppress an actor by imposing an alien morality. Indeed, corporate lawmakers are so respectful of the integrity of business actors that they contribute to the problem addressed in the constituency discussion.

Academic discussion has a rôle to play in the evolution of the ethic that informs business regulation. The ethic, as thus described, has a contingent, socially constructed character. It resists a discourse of universalization. It is derived not from first principles, but from a process by which individuals reflect on their past conduct and respond to present choices.[25] On this theory, individuals interacting in social contexts participate in the making of their own moral rules. This process is dynamic—the individual subjects are capable of growth, and the social context is capable of change.[26] Academic articulations of prevailing conflicts contribute to the process.

III. The Principal-Agent Model and the Legal Structure of the Corporation

Shareholder primacy is not absolute in the legal model. The principal-agent model does not apply to corporations so as to impose an absolutely

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24. Corporate law results from applications of communicative rationality as well as instrumental rationality. *See* William W. Bratton, *Public Values and Corporate Fiduciary Law*, 44 Rutgers L. Rev. 675, 698-92 (1992).

25. Alan Wolfe, Whose Keeper? 216 (1989).

26. *Id.* at 218, 222.

stated management duty to protect shareholder interests. Instead, the legal model mediates between the shareholders' interest and other interests in the corporation, particularly that of management. The more closely we inspect the principal-agent model's actual appearances in the legal corporation, the less structural significance it carries.

A. *The Principal-Agent Model, the Corporate Entity and the Business Judgment Rule*

Consider the legal theory of the firm at its most general. The shareholders elect the directors and an agency relationship arises. But this agency model of management rights and duties coexists in the law with an entity model bearing some of the earmarks of a trust relationship. Under the entity model, management is not the shareholders' agent, but the corporate entity's agent. Corporate powers are original and undelegated; management acquires them not from the shareholders, but from the charter, read in connection with the statute.[27] These agency and entity models share a place in the law without a precise statement of their relationship. For an example of this practice, we need look no farther than the ambiguous statement of corporate purpose included in the American Law Institute's recently adopted *Principles of Corporate Governance*. According to the *Principles*, management should conduct business "with a view to enhancing corporate profit and shareholder gain."[28] Here an undefined, but obviously capacious concept of a corporate entity, is conjoined with the shareholder and the agency notion. Maximization language is eschewed in favor of an equivocal directive to "enhance."

The legal model, then, includes the agency idea, but mediates between management for the shareholders' benefit and a variety of concerns bundled up in the opaque notion of the "firm." Both *Dodge v. Ford Motor Co.*,[29] the leading precedent for shareholder primacy, and *A.P. Smith Manufacturing Co. v. Barlow*,[30] a leading precedent for a management privilege to make charitable contributions, are good law. Under *Barlow*, the firm is personified and considered as a separate actor in society. Social exigencies come into the picture. The result is that management, far from acting solely under the direction of and for the benefit of the shareholders, has the power to give money away in "reasonable" quantities. Expanding on this, the ALI *Principles* allow management to take cognizance of "ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business."[31] The constituency statutes take this a step farther and confirm that constituency injury is one of the "ethical considerations" encompassed.

27. *See* People *ex rel.* Manice v. Powell, 94 N.E. 634, 637 (N.Y. 1911).

28. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (Proposed Final Draft 1992) [hereinafter ALI PRINCIPLES].

29. 170 N.W. 668 (Mich. 1919).

30. 98 A.2d 581 (N.J. 1953).

31. ALI PRINCIPLES, *supra* note 28, § 2.01(b)(2).

Corporate law, as it moves from the general to the particular, couples the entity concept of the firm with the business judgment rule.[32] As a result, management gets considerable latitude to derogate from the shareholder primacy norm as it makes decisions respecting investment, financing, and operations.[33] The door to close scrutiny of management decisions opens as a practical matter only for the plaintiff who makes out a case of self-dealing. There, under the rubric of the duty of loyalty, the agency concept makes its purest corporate law appearance. The duty is directed to the immediate interests of a shareholder beneficiary. But entity concerns still cloud the picture. The shareholders themselves are accorded enforcement power, but as a practical matter they have to employ the retarding device of an action taken in the name of the corporation. The corporate duty of loyalty's treatment of garden variety self-interested transactions does closely resemble the agency law treatment,[34] but in other situations its form and application differ materially. The range of pertinent concerns becomes particularly broad with corporate control transactions. The major corporate law issue of the 1980s was whether these cases called for a strong application of the principal-agent model. The back-and-forth responses of the Delaware courts,[35] together with antitakeover legislation enacted across the country, made it clear that the agency model does not determine the shape of this branch of corporate law. Shareholder gain certainly figures in. But it comes to absolute primacy only on the *Revlon* auction fact pattern,[36] and it still seems unlikely that the auction duty will come to bear in a large proportion of future control transfer situations.[37]

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32. *Id.* § 4.01(c). The coupling of the entity concept with the business judgment rule explains why charitable contributions and other ethically driven decisions figure into a small body of caselaw. Public interest concerns have only one generally accepted zone of outcome determination outside the charitable contribution privilege—the duty to obey the law. *See* Patrick J. Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's* Principles of Corporate Governance, 66 WASH. L. REV. 413 (1991). This is a supplemental strain in the doctrine.

33. For an excellent description of management's latitude in making investment, financial, and operational decisions, see Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 995-96 (1992).

34. *Compare* ALI PRINCIPLES, *supra* note 28, §§ 5.01-5.16 *with* RESTATEMENT (SECOND) OF AGENCY §§ 387-390 (1958).

35. *Compare* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), *and* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) *with* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989).

36. *See Revlon*, 506 A.2d at 173. The leading case scrutinizing an auction is Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988).

37. *Revlon* would have been at the center of future takeover litigation had it been later interpreted to instantiate a shareholder choice norm, as some commentators suggested. *See* Ronald J. Gilson & Reiner Kraakman, *What Triggers* Revlon?, 25 WAKE FOREST L. REV. 37 (1990). But, under *Paramount*, 571 A.2d 1140, the auction duty is triggered only if management abandons the entity and the values associated with it. *See also* Arnold v. Society for Sav. Bancorp, Inc., No. CIV.A. 12883, 1993 WL 526781 (Del. Ch. Dec. 17, 1993).

Enhanced scrutiny of boardroom processes under the duty of care rubric, motivated by the shareholder value norm, is suggested by *QVC Network, Inc. v. Paramount Communications Inc.*, 62 U.S.L.W. 2370 (Del. Ch. 1993).

B. *Self-Dealing Transactions*

The principal-agent model's ethical presuppositions lack preclusive structural force even in the core area of ordinary management self-dealing transactions. Corporate fiduciary duties follow the general pattern of fiduciary law. Generally, the fiduciary is not to take action that conflicts with the beneficiary's interest; nor may the fiduciary take profits from its position.[38] The keystone corporate duty tracks the general model and restricts self-dealing transactions by officers and directors. But, drawing from agency law, corporate law relaxes the prohibition to permit self-dealing based on informed consent.[39] The agency permission, reconstructed to fit the corporation's governance structure, is conditioned on full disclosure along with ratification by disinterested directors or shareholders. A substantive requirement of fair price also is imposed,[40] also in accordance with the general pattern.[41]

Corporate fiduciary law, thus articulated, equivocates as it imposes a norm of self-abnegation in the service of the interests of the shareholder-beneficiary. It announces a strong fiduciary principle. But then, in a synchronizing mode, it carves out endless exceptions, case by case. This rule-and-exceptions approach lets it pursue economic goals while respecting ethical concerns, and follows a general pattern of the law[42] toward limited toleration of self-interested conduct by the fiduciary.

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38. Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 16 (1975).

39. *See* ALI PRINCIPLES, *supra* note 28, Pt. V introductory note a (distinguishing corporate duty of loyalty from duty owed by trustee); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1433-34 (1985).

40. The requirements of informed consent and fair price are thought to back up one another's shortcomings. Fair price, taken alone, removes decisionmaking from corporate actors to legal decisionmakers. *See* Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 998-99 (1988). But without a fairness standard in addition to a disclosure rule, the scope of judicial review would be substantially constrained.

41. This familiar corporate rule requiring a fair price and informed consent in self-dealing transactions applies to trusts in general. According to Scott, a self-interested transaction may stand if the trustee makes full disclosure and takes no advantage of its position, and the transaction is in all respects fair and reasonable. If done without the beneficiary's consent, the transaction can be set aside even if fair and reasonable. *See* Austin W. Scott, *The Trustee's Duty of Loyalty*, 49 HARV. L. REV. 521, 564-65 (1936); *see also* 1 AUSTIN W. SCOTT, THE LAW OF TRUSTS § 2 (4th ed. 1987); RESTATEMENT (SECOND) OF TRUSTS § 170 (1959); RESTATEMENT OF TRUSTS § 170(2) (1935); RESTATEMENT (SECOND) OF AGENCY § 13 cmt. a (1958); RESTATEMENT OF AGENCY § 13 cmt. a (1933).

The corporate law constraint has undergone a gradual relaxation. Before 1880 corporate law strictly prohibited self-interested transactions. Around the turn-of-the-century, it took an approach close to the trust rule described by Scott. Then in the mid-twentieth century it underwent a further relaxation, permitting ex post judicial fairness confirmation even without disclosure and disinterested board ratification. *See* Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36-40, 43 (1966).

42. Recent law reform attempts to constrain the imposition of fairness scrutiny on director self-dealing transactions do, however, herald a break with the wider fiduciary pattern. *See* ALI PRINCIPLES, *supra* note 28, § 5.02.

Fiduciary law's tendency to equivocate stems from the presupposition that fiduciary relationships in business contexts would not exist in the first place without wealth pursuit on both sides. Consider the subjective motivations of the actors in a classic trustee/beneficiary relationship. The fiduciary acts for another, yet collects a fee and enters into the relationship in connection with a wider program of personal wealth pursuit. The beneficiaries, however dependent on the fiduciary's loyal and diligent performance of the trust, themselves pursue self-interest in the relationship. Ethical commitment and self-interested maximization jointly motivate both the fiduciary and the beneficiary.

Ethical sacrifice and self-interested maximization also combine when people produce in groups. We should not expect to see ethical commitments show up in cooperative production situations absent individual welfare pursuit. After all, actors work together in businesses in pursuit of their own welfare. But, at the same time, individual welfare pursuit through cooperative endeavor entails commitments among the members of the group. Motives of loyalty to other participants and group purposes influence the actors. The cohabitation of these values and incentives creates tensions. Corporate doctrine, again following the general pattern of fiduciary law, mediates this tension.

When commentators justify fiduciary law in terms of a need to protect the "integrity" of fiduciary relationships,[43] it thus turns out that fiduciary "integrity" is comprised of a complex of values, some ethical and some economic, to be "balanced" in the law. Theories of the fiduciary, says one commentator, have to be congruent with the basic approaches of morality and justice, and at the same time must adjust to the commercial realities of the situation.[44] Fiduciary integrity, then, is mediative: It encompasses both ethical and welfarist concerns and strives to maintain a balance between them.

C. *Summary*

Once we look through the legal concept of the fiduciary to its complex of ethical presuppositions, the legal concept of agency loses some of its appearance of ethical power. Corporate law's fiduciary ideology operates gently against self-dealing corporate managers in even the easier cases. So equivocal is its place in the law of management control that commentators unsuccessfully have been trying to infuse power into it for decades. This commentary insists over and over that the fact that agency lies at the legal

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43. Robert Flannigan, *The Fiduciary Obligation*, 9 OXFORD J. LEGAL STUD. 285, 297 (1989); Weinrib, *supra* note 38, at 15-16.

44. J.C. Shepherd, *Towards a Unified Concept of Fiduciary Relationships*, 97 L.Q. REV. 51, 74 (1981); *see also* Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 830 (1983); Weinrib, *supra* note 38, at 2.

model's core means that shareholder primacy should be the activating principle when the law is applied.[45] Unfortunately, the management interest has proved endlessly adept at maintaining its capture of the agencies that make corporate law. The law, accordingly, never fully conforms to the agency model. The concept does not sustain a central role in the constituency debate.

IV. THE PRINCIPAL-AGENT MODEL AND THE ETHICAL IMPLICATIONS OF THE CONSTITUENCY DEBATE

A. *The Constituency Problem as Ethical Conflict*

1. Constituent Dependence and Injury

We can widen and deepen our discussions of the constituency problem if we accept Professor Green's invitation to relax the positivist constraint that usually obtains in legal discussions and admit ethical considerations. Reference to ethics, like reference to economics, takes us outside of the inherited legal framework for a new look at a problem. We get a thicker description in either case. Of course, with constituencies, reference to economics thickens the description only substantially to ratify the law's exclusion of constituencies. The economic commentaries do take the relational ties that bind stakeholders to firms into account. They tell a story that recognizes that stakeholders such as employees and bondholders may have reasonable expectations of institutional stability based on past relational patterns. Abrupt changes in the patterns very well may frustrate those expectations and justifiably be experienced as an injury. But the prevailing conclusion is that these relationships amount only to "implicit contracts,"[46] and therefore give rise to no rights. This results partly from a reference to the legal inheritance and partly from application of an implicit norm.[47]

Reference to ethics adds an element of urgency to the story of stakeholder injury. Moral intuitions instruct us on how best to behave in situations in which it is in our power to counteract the extreme vulnerability of others by being considerate. Ethics function as a safety device, compen-

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45. *See* Lyman Johnson & David Millon, *Corporate Takeovers and Corporate Law: Who's in Control?*, 61 GEO. WASH. L. REV. 1177, 1178-79 (1993).

46. *Compare* Macey, *supra* note 1, at 181-95 *with* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 23-24 (1986). Since the contract is implicit, it imparts enforcement through nonlegal sanctions. *See generally* David Charney, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373 (1990).

47. *But cf.* Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, 43 U. TORONTO L.J. 315, 340-44, 345-49 (1993) (rejecting possibility of direct enforcement of employee implicit contract but holding open possibility of protective gapfilling on mutual mistake theory).

sating for the vulnerability built into life in society.[48] Thus described, ethics have a tie to the satisfaction of social needs, a tie not dissimilar from those of economics and law.[49]

Recognition of these moral intuitions diminishes the strength of the legal and economic presumptions against protection for stakeholders. Stakeholders, like shareholders, are vulnerable because they depend on the corporation for their welfare.[50] All but a few individual constituents of public corporations, whether stockholders, bondholders, or employees, come to hold or develop their corporate ties without a meaningful opportunity to negotiate a contract and make a considered trade off of short-term payment for long-term security. Once we look past the existing system of rights and compare the various firm relationships, distinguishing the shareholders from the other constituents potentially fitted to self-protect through contract becomes extremely difficult.[51] It becomes plausible to ask whether the existing system should be retained. Perhaps employee distress and windfall gain to shareholders need not be concomitants when corporations adjust to changing markets and new technologies. Perhaps some other, more equitable, arrangement could be concluded.

The ethical case becomes stronger still if we step outside of the legal framework and focus on the various constituents' contributions to the collective profit-making endeavor. Successful collective production depends on an extension of good will by each participant. That good will presupposes reciprocity—each actor must be receiving his or her due from the organization for good will to arise. Reciprocal treatment accordingly becomes an organizational norm that gets its content from past relational patterns. The takeovers of the 1980s violated the norm for the unilateral benefit of one interest group, the shareholders. Actors in the capital markets, in effect, betrayed other interest holders in the firm. Those most betrayed were the employees, the constituents who most actively participate in the firm's

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48. Jurgen Habermas, *Morality and Ethical Life: Does Hegel's Critique of Kant Apply to Discourse Ethics?*, 83 Nw. U.L. Rev. 38, 42 (1989). Habermas views the autonomous individual as dependent on interpersonal relationships. The more the individual becomes individuated, the more he or she becomes entangled in a fabric of "mutual recognition," causing exposure and vulnerability. *Id.*

49. Says Habermas:

> Moral philosophies of sympathy and compassion have discovered that this profound vulnerability calls for some guarantee of mutual consideration. This considerateness has the twofold objective of defending the integrity of the individual and of preserving the vital fabric of ties of mutual recognition through which individuals *reciprocally* stabilize their fragile identities.

Id. at 42-43 (footnote omitted). With this, ethics is associated not merely with the individual's economic well being, but with the stability of the individual's personality.

50. Millon, *supra* note 18, at 225.

51. This point has been articulated from various other points of view. *See* Daniels, *supra* note 47, at 326-29 (criticizing "narrow contractarian" approach to constituent claims); Katherine Van Wezel Stone, *Policing Employment Contracts Within the Nexus-of-Contracts Firm*, 43 U. Toronto L.J. 353, 357-59 (1993) (arguing that outcomes of bargains between labor and firm are shaped by existing legal regime).

mission.[52] Recognition of this disruption of the relational pattern, like recognition of constituent vulnerability, diminishes the force of the standing presumption against stakeholder inclusion in the legal definition of the firm.

2. Agency and Wealth Maximization

Descriptions of constituent dependency and injury and capital market betrayal only state the ethical problem that arises from the application of the traditional legal definition of the firm in restructuring situations. Thus to articulate the constituents' ethical case does not resolve the matter in their favor. Professor Green suggests that resolutions in the constituents' favor might follow if we take the additional step of reworking corporate law's principal-agent story so as to denude it of its ethical implications. This strategy is unlikely to succeed, however, for reasons both ethical and practical.

As noted above, corporate law's agency component and fiduciary ideology are as mediative as they are morally prescriptive and allow much latitude for self-interested pursuits by corporate managers.[53] But, nevertheless, the agency concept does have significant ethical implications in the constituency debate. These stem not from fiduciary ideology, but from the principal-agent concept's structural position in the prevailing economic model of corporate governance.

Economic models of the firm have the stated purpose of facilitating the creation of maximum wealth. The models impose the principal-agent concept on the shareholder-manager relationship as a means to this end. In economic governance stories, managers, like all rational economic actors, have incentives to perform suboptimally when acting as agents. Exacting optimal performance in the teeth of those incentives is the ongoing, unsolved problem of corporate governance. The shareholders, as residual risk holders, have financial incentives to use what weapons they have to prod the managers to perform productively.[54] Corporate law assists them in various ways with indifferent success—by regulating the voting process, maintaining a free market in shares, and imposing the duties of care and loyalty.

The principal-agent metaphor looms large as a conceptual tool in the ongoing struggle to get management under control. Shareholder primacy in an agency framework thus is not the end being served, but a means to the end of maximizing the general wealth. The mainstream of contemporary legal theory takes a significant additional step and limits discussion to the

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52. *See, e.g.*, Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 48-53 (1991).

53. *See supra* text accompanying notes 27-44.

54. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302-11 (1983). *But cf.* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 26-31, 36-39 (1991) (preferring shareholder vulnerability to shareholder position as residual risk holder as justification for exclusive status as beneficiary of corporate fiduciary duty).

confines of this instrumental picture. It views corporate law as an instrument shaped and constrained by the end of wealth maximization, to be appraised and justified only in terms of its consequences on a dollars-and-cents conception of human welfare.[55] The constituencies do not lose out in this discourse because corporate law presupposes a moral commitment to the shareholders; rather, they lose out because the discourse follows the advice of Berle in his discussion with Dodd[56] and defers distributional questions for reasons of economics rather than politics.

This economic welfarism may prevail in corporate law only by default. People tend to come to the field presuming that we should think about corporations in utilitarian terms. Economic welfare, although not necessarily the ideal definition of utility, turns out to be the only workable definition available. This follows even though the social sciences offer other, more expansive concepts of welfare. These concepts look to well-being rather than wealth[57] and often come to bear in legal contexts. But these expanded welfare concepts come to bear on corporate law only tangentially. Serious pursuit of an expanded notion of welfare, like serious pursuit of constituency rights, implies a radical, context breaking move toward a social corporation.[58] It also may be that many observers would support this move as an

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55. Of course, in some contexts the description of corporate law opens opens up to encompass the pursuit of power and leisure. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECONS. 305 (1976). However, the norm stays with dollars and cents.

The term "welfarist" is employed in preference to the term "consequentialist." *Compare* Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1713 n.30 (1989) *with* Anthony T. Kronman, *A Comment on Dean Clark*, 89 COLUM. L. REV. 1748, 1751 (1989). Clark defines consequentialism as assessing things in terms of how much they increase or decrease the welfare of individuals. Kronman finds this term unhelpful; he defines welfarism as making the welfare of those who live under a normative regime the only basis for assessing its desirability. *Id.* This is utilitarianism under either term. *Compare* David Lyons, *Utility and Rights*, *in* ETHICS, ECONOMICS AND THE LAW 107 (J. Roland Pennock & John W. Chapman eds., 1982) (defining utilitarianism as "the theory that the only sound, fundamental basis for normative (or moral) appraisal is the promotion of human welfare") *with* KENT GREENAWALT, CONFLICTS OF LAW AND MORALITY 94-95 (1987) (defining utilitarianism as theory that "the morality of any kind of act will depend on whether or not it will promote consequences more favorable than those produced by some alternative").

56. Berle, *supra* note 9, at 1372.

Distributively speaking, of course, shareholder wealth is left to trickle down from shareholder pockets, whether by means of consumption or investment.

57. *See* Herbert Hovenkamp, *Positivism in Law & Economics*, 78 CAL. L. REV. 815 (1990). Hovenkamp criticizes "Chicago-style law & economics [for] trad[ing] away a broad concept of 'well-being' based in the social sciences for a narrow concept—wealth maximization—based on market preferences." *Id.* at 835. Significantly, he notes that law and economics assumptions seem "more plausible when the relevant actors are business firms and we *assume* profit maximization." *Id.* at 846.

58. For an attempt to project a reformulated conceptual foundation for corporate law that would break the context in the service of an expanded concept of welfare, see Elliott J. Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System*

ideal proposition. But in the world of practice, and corporate legal theory always keeps practice in mind, the wealth creation ethic blocks its recommendation absent a showing of a productivity advantage.

It was easier to hold to ethical and social ideals and make the economic welfare assumption in the corporate law discourse of a quarter century ago. In those days such discourse carried no apparent political costs. Nor did it call for discomfiting ethical sacrifices. The policy sciences plotted various routes, statist and social as well as free market, to the destination of maximum wealth. One could make any of the antimanagerial assertions usual in corporate policy discussions and stay within the welfarist framework. Law reform in the form of strengthened fiduciary constraints on management was an everyday welfarist tool. Those advocating a social corporation found a place in the discourse. The assumption was that wealth enhancement no longer presented much of a problem. Given America's apparently unassailable competitive position and expected technological improvements, welfarists thought that attention safely could be diverted to matters of participation and distribution.

Today, however, intervening and continuing economic vicissitudes keep attention focused on the bottom line. The upshot for constituent interests is a widely accepted presumption in favor of the status quo. In this discourse, the Chicago story about the efficiency of the inherited legal scheme[59] holds much more strongly than elsewhere in corporate law. And, since wealth creation is a community value and, indeed, a long-run priority for its weaker and more vulnerable members, the presumption has ethical force. The prevailing vision of the corporation as a wealth-creating mechanism has a powerful ethical presupposition: In a world of scarcity and physical suffering, more wealth is central to what "should be" respecting production organizations.[60]

This leaves the proponent of an expanded definition of the firm with an extraordinary burden. It really will take a theory to beat this theory—a prospective theory of wealth creation that includes constituent rights rather than a theory of equitable allocation of an existing quantum of wealth.

3. The Model of the Person and the Ethics of Microeconomics

The law's vision of the corporation as a wealth-creating mechanism also implies a grim relational perspective: Since corporations are primarily in-

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to Resolve an Institutional Impasse, 28 UCLA L. REV. 343 (1981) (proposing "altruistic capitalism"). For a critique, see Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 965-66 (1984).

59. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-15 (1991).

60. A response to the idea that corporations should focus on creating wealth can be found in Lewis Solomon's paper in this symposium. He points to environmental limits and suggests that growth be limited. Lewis D. Solomon, *On the Frontier of Capitalism: Implementation of Humanomics by Modern Publicly Held Corporations: A Critical Assessment*, 50 WASH. & LEE L. REV. 1625, 1633-35 (1993).

struments of wealth production, individual participants should and do view corporate participation in terms of individual welfare enhancement. The wealth creation ethic and the individualist coloration of corporate relationships tend to appear simultaneously. They combine to weigh in against constituency inclusion in the definition of the firm.

But, of course, injuries to personality occur in corporate life in addition to injuries to pocketbook. The constituent who invests his or her whole personality in firm participation suffers a deep injury from a sudden restructuring. The case for employees must be distinguished from that of other constituents.[61] Employee dependence is more than economic. A workplace is a quasi-community. Some element of identity will take shape in connection with a long-term employment relationship. A bondholder, in contrast, does not invest substantial personality in the relationship—indeed, with bondholders, institutional ownership patterns make it hard to find a flesh and blood human being to play the role of injured constituent.

In any event, the legal model of the firm and its implicit model of the corporate actor is unreceptive to recognition of injuries to identity. The normative choice is to model actors in reduced, economically-informed terms.[62] The assumption is that although corporations take prominent places in many lives, people's identities do not take shape in corporate communities.[63] Like the corporation itself, corporate actors are assumed to undertake corporate activities solely in the pursuit of material gain.[64] Those who stake their identities on firm participation do so at their peril; their only recourse is protection through the institution of contract.

Some of the commentary further accentuates the legal actor's economic coloration by conflating the legal actor with the purely self-interested rational actor of microeconomics. Cast into that role, unprotected constituents have no ethical case at all. The microeconomic paradigm, considered in ethical terms, sees the primary ethical problem as the threat that state regulation

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61. This proposition is worked out in detail in Terry A. O'Neill, *Employees' Duty of Loyalty and the Corporate Constituency Debate*, 25 CONN. L. REV. 681 (1993).

62. The individualist strain appears most pointedly in contract law, which limits recovery for mental distress to a very narrow class of cases. *See, e.g.*, Valentine v. General Am. Credit, Inc., 362 N.W.2d 628 (Mich. 1984).

63. People's identities take shape in communities in the strong sense described by Sandel. MICHAEL J. SANDEL, LIBERALISM AND THE LIMITS OF JUSTICE 149-50 (1982). One suspects that "communitarians" would be particularly unlikely to conceive of their identities as the product of the defining influence of business corporations.

There is an alternate view, of course, pursuant to which the corporate actor aspires to form a corporate identity. The "organization man" of popular post-war culture sought to conform to corporate cultural norms. But sacrifice was not the motivation: "he" did so in exchange for a secure position. WILLIAM H. WHYTE, JR., THE ORGANIZATION MAN 75-76, 178 (1956).

64. According to Coase, given a preference for individual freedom, the choice of production through participation in a firm over production on an individual basis can only be explained as a means to the end of transaction cost reduction. *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); *see also* Steven N.S. Chueng, *The Contractual Nature of the Firm*, 26 J. L. & ECON. 1 (1983).

poses to individual autonomy and private wealth creation. The imperative of meeting that threat trumps concerns about the threat that legally sanctioned opportunism poses to the fabric of business relationships and the well being of communities. Indeed, the very articulation of an ethical component of the constituents' case is associated with the statist threat.

Nor does an ethic of protecting the vulnerable figure into the microeconomic vision of what "should be"—a world of self-reliance and self-protection. Legal protection of constituents, if activated by an ethic of protection rather than by an *ex ante* contractual calculation, only retards the evolutionary disappearance of the helpless. It thus is suppressed in microeconomic models of the law as a matter of ethical choice.

4. Summary

The foregoing should not be taken as dismissing either the ideal of constituency recognition, the seriousness of injuries to constituents, or the ethical corrosion that results from legal sanction of that injury. But it does reflect a judgment that substantial ethical problems would follow if these concerns were transposed into a legal mandate. As a practical matter, the solution of those problems and the mandate itself can come to corporate law only as the result of a broad, sustained political process. Let us assume that constituency rights would make us less well off due to production disincentives and enforcement costs. A political consensus in favor of constituency recognition would ameliorate the resulting welfarist objection. Nothing prevents a polity from deciding to be less well off in pursuit of a notion of the good. So long as the underlying conflict between economic welfare and the ethic protection is controverted and discussed in the process that gives rise to constituency rights, it cannot be said that the wealth sacrifice unduly disregards anyone's material needs.[65] But that process has a long way to go.

B. *Near Term Prospects for Constituent Inclusion*

A redefined firm including constituency rights is always a possibility for corporate law. But no breakthrough in the direction of a constituent right of action seems likely in the near term. The reasons are many and not hard to see.

Recent discussions focus on the question of whether the constituency provisions that appeared in state corporation statutes during the 1980s provide a present basis for a judicial declaration of constituency rights. Those who disfavor the statutes, whether narrowly or broadly read, dismiss them as the product of the antitakeover political climate that prevailed in those days.[66] They have a point. The statutes did originate as interest group

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65. *See* Bratton, *supra* note 11, at 685, 686.

66. Successful lobbying by the managers of large firms is a frequent explanation for use of constituency statutes. *See* EASTERBROOK & FISCHEL, *supra* note 59, at 220-21; Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120-45 (1987).

legislation, devised and enacted to make it safe for managers defending against takeovers to refer to constituent interests in justifying their actions. But these commentators, like all commentators who insist on shareholder primacy as an absolute, also miss a point. Shareholder primacy is not the law, and the statutes neatly fit the received legal framework. Although management's lawyers drafted the statutes,[67] and management saw to their passage, they gain legitimacy from popular consensus against the open market in corporate control that prevailed in the mid-1980s.

Commentators who propose broad readings of the other constituency statutes also miss a point. They have characterized constituency injury as an externality. With the injury thus placed in a legally cognizable slot, they invent a tort to remedy it.[68] But the analogy to tortious externalities, while apt to some extent, does not complete the discussion. This is an allocational problem arising from imperfect contracting in complex relationships. A difficult cost-benefit decision remains open respecting the interpolation of rights, and these commentaries tend to avoid confronting it. That confrontation is unavoidable in the present climate. A new tort action no longer necessarily follows from the perception of a tortious injury. Now that the person in the street has experienced the costs of the tort system, tort

67. *See* Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 163 n.2 (1991).

68. David Millon succinctly disposes of the tort action when he opines that the constituency statutes impliedly reject the efficiency norm and its premises. Millon, *supra* note 18, at 275 n.180. The other approach is to argue that constituency rights do not create an efficiency problem but solve one. These interesting arguments certainly weigh into the final cost-benefit analysis on the constituents' side. They do not determine the matter, however.

Larry Mitchell characterizes constituent injury as an externalized cost. Constituency rights, on this analysis, force the internalization of the cost. Mitchell, *supra* note 20, at 584-85; the approach is anticipated in Millon, *supra* note 18, at 275 n.180. Constituency rights thus are presumably efficient, by analogy to the law of torts. The problem with Mitchell's treatment lies less with the characterization of constituency injury as an externalized cost, than with the conclusion that the efficient solution lies in the cost's internalization. Job loss and bond event risk are not strictly analogous to air pollution and inattentive driving from an economic regulatory perspective. For one thing, if takeovers have salubrious governance effects and shareholder profit incentives are a necessary part of the governance dynamic, then the efficient result may be to leave these "costs" where they lie. For another thing, these stakeholders differ from tort claimants because they possess the theoretical opportunity to contract to force the cost's internalization *ex ante*. The doctrine of disregard of the corporate fiction, at least according to most commentators, is tolerant of the externalization of cost on the creditor where it seeks to recapture an externality on a tort claimant. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 112 (1985); Cathy S. Krendl & James R. Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DENV. L.J. 1, 34-36 (1978). *But cf.* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1068-70 (1991) (noting that piercing occurs more frequently in contract claims than tort claims).

The same points provide the basis for a response to Morey McDaniel's suggestion that gains be redirected to cover all stakeholder losses and assure that restructuring transactions are Pareto optimal. Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121, 126-39 (1991). Such gainsharing exercises presumably would retard market processes at cost.

plaintiffs are no longer favored figures in public policy discussions. Newly minted torts, even corporate torts, are scrutinized strictly. Other modes of legal recognition for constituents, such as management inclusion or ownership incentives for labor, resonate better.

The constituency statutes do bear expansive interpretation as a linguistic and structural proposition.[69] But the statutes do not compel that interpretation.[70] A look at the context makes it safe to predict that we are unlikely to see an expansive interpretation in the law. The fragmented process that led to the statutes' adoption does not provide judges with a solid basis to assume that a material expansion of the definition of the corporation was the statutes' intended or inevitable role. The management driven process of enactment did not force the implications of constituency empowerment forward as matter for legislative consideration. These facts invite an ordinarily cautious interpreting judge to fit the statutes into corporate law's inherited framework of management empowerment: Since constituency rights disempower managers, the statutes do not imply them.[71] In any event, the statutes have not yet prompted a leading case,[72] even as we now enter the fifth year following the collapse of the 1980s takeover market.

Prospects for constituency inclusion do not look any better if we put the statutory interpretation question to one side. Simply, the case for constituents does not speak with the equitable urgency of five or ten years ago. A special sense of tortious injury to constituents surrounded the restructurings of the 1980s. But the perception of wrong did not stem from the fact of constituent injury alone. It also had a restitutionary aspect.[73] The restructurings that caused constituent injuries were perceived as unnecessary transactions, means only to the end of windfall gain for Wall Street actors. The story that justified them left open plenty of room for this view. High debt and downsizing were said to be cures for suboptimal capital reinvestment and ill-conceived conglomerate combinations. The story was true—there can be no doubt many of the 1980s restructurings eventually would have been forced by product and capital market competition. But that long run was not perceived to present a near term problem for many of the subject firms. This made the huge shareholder gains seem gratuitous and exploitative. Surely, high debt, large payouts, and layoffs were not

69. *See* Millon, *supra* note 18, at 242-46, 265-70; Mitchell, *supra* note 20, at 630-39.

70. The point that the statutes can be interpreted expansively should not be taken to assert that Millon, *supra* note 18, and Mitchell, *supra* note 20, predict that courts will adopt expansive readings of the statutes.

71. Here I am happy to make reference to Eric Orts' careful discussion of the statutes' impact on standards of review under the duty of care. Orts, *supra* note 2, at 40-44.

72. Courts have brought constituency statutes to bear in upholding management defensive tactics and devices. *See* Georgia-Pacific Corp. v. Great N. Nekoosa Corp., 727 F. Supp. 31 (D. Me. 1989); Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984 (E.D. Wis.), *aff'd on other grounds*, 877 F.2d 496 (7th Cir.), *cert. denied*, 493 U.S. 955 (1989); Keyser v. Commonwealth Nat'l Fin. Corp., 675 F. Supp. 238 (M.D. Pa. 1987); Baron v. Strawbridge & Clothier, 646 F. Supp. 690 (E.D. Pa. 1986).

73. *See* McDaniel, *supra* note 68, at 128.

inevitable concomitants; surely, if restructuring at the expense of some employees was necessary, it should be justified in terms of a firm's future as a competitor, not in terms of short-term shareholder maximization.

Now compare today's restructurings, which occur without the drama, leveraging and shareholder windfalls of those of seven or eight years ago. It is everyday news for a large firm, often but by no means necessarily a firm known to be experiencing business reverses, to "restructure" by reducing staff levels five percent, ten percent, or more.[74] There is a consequent shareholder benefit—the announcement can cause a sudden jump in the stock price.[75] Of course, from the employee point of view, this 1990s restructuring differs from a 1980s restructuring only by degree—both sacrifice the employee's interest to the shareholder's. Yet one suspects that opinion about employee rights divides more to the side of management discretion, now that the long-term business plan has its ordinary justificatory effect. The allocational politics change also. Downsizing is like a recession caused by a new Republican administration: Although it injures ten percent of the working population, it benefits the other ninety percent that does not lose its job (in addition to the stockholders and, here, the bondholders). The winners now work for a fitter competitor, and the losers did not have any job security anyway.

The equitable case respecting bondholder injury has undergone an even more drastic diminution in strength. During the 1980s, wealth transfers incident to restructurings affected the bonds of the largest issuers in a sudden break with past patterns.[76] The expectations of those holding bonds issued prior to those events were palpably upset. But protective covenants effective against these risks were designed.[77] These covenants appeared in a substantial proportion of new bond contracts for a couple of years, only to disappear in new issues by 1992.[78] This occurred despite the well-known fact that the disappearance of takeovers did not imply the disappearance

74. Layoffs of 225,000 employees were announced in the first half of 1993. Large manufacturing and service companies are downsizing in part due to slow expansion of domestic markets and recession in export markets and in part due to management's long-term projection of slow growth, overcapacity, and keen price competition on a global basis. *See* Louis S. Richman, *When Will the Layoffs End?*, FORTUNE, Sept. 20, 1993, at 54, 54. White collar as well as blue collar workers are affected. In 1992, middle management positions composed more than 20% of jobs eliminated. Lisa Baggerman, *The Futility of Downsizing*, INDUSTRY WK., Jan. 18, 1993, at 27, 28.

75. *See* Richman, *supra* note 74, at 56 (noting Union Carbide stock increase).

76. *See* William W. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 136-42; John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance As a Multi-Player Game*, 78 GEO. L.J. 1495, 1505-09, 1515-19 (1990).

77. *See* VICTOR BRUDNEY & WILLIAM W. BRATTON, BRUDNEY & CHIRELSTEIN'S CORPORATE FINANCE: CASES AND MATERIALS 205-06 (4th ed. 1993) (quoting Steinwurtel & Gardner, *Super Poison Puts as a Protection Against Event Risks*, 3 INSIGHTS, Oct. 1989).

78. *See* Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 969-71 (1993).

of easy ways to transfer wealth from unprotected bondholders.[79] Although such events retain some shock value, they are not unexpected. Since bond prices reflect the presence or absence of protective covenants,[80] the contract failure argument[81] has become harder to make.[82] Most will see a case of actors who had a chance to protect themselves and chose not to do so in exchange for a present payment. The legal definition of the firm does not appear to require readjustment in order to protect these people, or, more precisely, these portfolios.

Political pressure for change may further diminish as small-scale corporate restructurings continue in the absence of constituent rights. Downsizing and cost reduction have come to replace constant growth in the ordinary business plan. Expectations change as a result. Insecurity begins to become an intrinsic part of the corporate employment relationship.[83] The pattern of employee investment in firm-specific assets may diminish in response, and with it the gravity of the injury. At the same time, efficiency arguments against legal inhibition of restructuring activity will continue to be made, tailored to the new circumstances.[84] No doubt the new institutional investor activists stand ready to channel these points into the political arena.

C. *Redirecting the Discussion for the Long Term*

The Berle-Dodd debate of a half a century ago[85] covered all points made in today's discussions about constituencies. Expanded definitions of the firm also were considered in the corporate governance discourse of a generation ago.[86] The contemporary debate once again confirms that corporate law includes conceptual bases for its own transformation in the direction of constituency inclusion. It also reminds us that economic wel-

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79. Lately, issuers have been initiating wealth transfers by spinning profitable divisions off so as to leave existing bonds attached to weak, highly leveraged divisions. *See* BRUDNEY & BRATTON, *supra* note 77, at 220-21.

80. *See* Kahan & Klausner, *supra* note 78, at 974-75, 979-80.

81. *See id.* at 980-82.

82. The change in the picture of bondholder expectations makes it difficult to support a right under the contract law good faith doctrine. *See* Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821 (1992), and Bratton, *supra* note 11, both of which advocate a good faith duty with power to substitute for covenants and constrain opportunism in respect of bonds issued prior to the appearance of new event risks. Only a transformative shift to complete fiduciary protection will support a bondholder right. *See* Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165 (1990).

83. *See* Baggerman, *supra* note 74, at 27 (noting that employees remaining after downsizing encounter significant added stress and may no longer trust the company).

84. *See* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 865-66 (1993).

85. *Compare* Berle, *supra* note 9, *with* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

86. For a synthesis of the literature on expanded definitions of the corporation, see Elliott J. Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 UCLA L. REV. 343, 418-34 (1981).

farism does not completely describe corporate law—that those who conceive of the law only as a means to realize our material aspirations overlook points at which ethics of sharing and protection presently or potentially affect the law.[87]

But the inherited legal definition of the firm still prevails, despite the disruptions of the 1980s and the sudden recognition of constituencies in corporate statutes. Norms of protection for constituents still figure into corporate law on a strictly secondary basis. Following Berle's recommendation, we still vindicate them primarily as a matter of outside regulation.

Since the concepts themselves do not dictate this result, we need to look elsewhere for an explanation. The wealth-maximization norm provides a part of the answer, but it plays a determinative role mainly in academic discussions. To explain the practice, further reference must be made to corporate law's institutional framework. There the salient point is management control. Constituency rights would disempower management. Constituency statutes, in contrast, empower management in the likely event that they import no independent constituency rights. They merely extend the pattern of the fiduciary law of takeover defense; there management discretion remains the dominant theme despite suggestions to the contrary in cases like *Unocal*[88] and *Revlon.*[89] Corporate law never tends to stray very far from management empowering results, as a general proposition. Delaware's position as the corporate jurisdiction of choice assures this result.

We cannot look to Delaware to redefine the firm and break the context. The possibility of an outbreak of regulatory competition keeps it faithful to management interests. Nor is there much point in looking to any other state. Management makes its influence felt nationwide. Furthermore, lawmakers can be expected to be disinclined to undertake reform schemes that carry any risk of wealth depressive effects and feel well justified in so doing. And even if a maverick jurisdiction made a different assessment and sought to limit management's discretion respecting constituencies, it would encounter difficulties at the implementation stage. Since it might lose the charters of its larger firms to other states, its authority as a practical matter extends only to the interests of constituents within its borders.[90] Difficulties

87. *Cf.* Amartya Sen, *Goals, Commitment, and Identity,* 1 J.L. ECONS. & ORGANIZATIONS 341, 341 (1985):

> The ability of groups and societies to deal with conflicts of interests, and of goals, among their members depends largely on the way individuals think and act and how they assess their respective objectives, achievements and obligations.

Id.

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

89. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

90. Under the internal affairs principle of United States conflict of laws doctrine, host states to foreign corporations honor the law of the incorporating jurisdiction governing internal relationships. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971). Only local matters are regulated. This, however, can extend to some aspects of foreign corporations' internal affairs. *See, e.g.,* CAL. CORP. CODE § 2115 (West 1990) (applying sections of state corporations code to foreign corporations that meet tests concerning location of assets, employees and shareholders).

might arise even at home because the regulated firms would compete in outside product and capital markets. If constituent regulation is costly, then in the long run the maverick jurisdiction materially disadvantages those firms.

At the bottom line, then, the constituency rights discussion collapses into the state competition discussion.[91] This gives rise to two questions about the direction the discussion has taken: First, whether corporate law is the appropriate venue, and second, whether constituent injury should be the principal focus. We take a leaf from Berle here,[92] but not because the contemplated redefinition of the firm would empower management. Constituency rights are intrinsically disempowering to management. We look to Berle for the proposition that law reform to control inappropriate corporate conduct should originate outside the corporate law system.

On the first question, whether corporate law is the appropriate venue for discussion of constituency rights, note two facts. First, no state has an incentive to act unilaterally, and, second, an evenly distributed federal mandate ameliorates the problem of product and capital market competition. These facts suggest that this law reform discussion should be redirected to the federal arena. Note also that labor is the preeminent constituency. The state corporate law system opens a door to labor empowerment through the purchase of control.[93] But collective action problems make that door hard to open. State law otherwise remains committed to labor disempowerment, and no theoretical manipulation of loose basic concepts is likely to shake that commitment. It is an uncongenial environment in which to pursue a fundamental restructuring of labor's rights.[94]

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91. For other discussions of the point that the constituency rights theory collapses into the state competition model, see Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1492 (1992); Michael E. DeBow and Dwight R. Lee, *Shareholders, Nonshareholders and Corporate Law: Communitarianism and Resource Allocation*, 18 DEL. J. CORP. L. 393, 405-15 (1993).

92. *See* Berle, *supra* note 9.

93. The most prominent recurring candidate for an employee buyout is UAL. A third round of negotiations was in the news during the fall of 1993. As of this writing, both the pilot's union and the ground crew worker's union had approved an employee buyout plan. A shareholder vote, expected in the spring, is still necessary to approve the deal. *Airlines*, L.A. TIMES, Jan. 29, 1994, at D2. For a description of an earlier round of negotiations, see Coffee, *supra* note 76, at 1521-28. For a description of recent experiences with employee ownership of large firms, see Alan Hyde, *Ownership, Contract, and Politics in the Protection of Employees Against Risk*, 43 U. TORONTO L.J. 721, 737-39 (1993).

94. Law reform to strengthen the rights of dislocated employees has proceeded on the federal level in recent years. *See* Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-2109 (1988) (requiring employers to give 60 days notice of plant closing or mass layoff to union or employees, State dislocated worker unit, and local government; statute became effective in February 1989); Economic Dislocation Worker Adjustment Assistance Act, 29 U.S.C. §§ 1651-1662c (1988) (creating State dislocated worker units to plan for provision of services in wake of plant closings). Various states and localitites also have enacted legislation. A few states mandate severance benefits. *See* CONN. GEN. STAT. ANN. § 31-51o (West Supp. 1993) (mandating 120 days' paid group health insurance); ME. REV. STAT. ANN. tit. 26, § 625-

On the second question, whether the discussion should focus on constituent injury, note that productivity concerns cannot be avoided in any facet of this discussion—they figure into legal, social, and ethical, as well as economic, calculations. The constituency rights discussion thus also collapses into the broader discussion of the theory of the firm. There the problem for solution is the organization of the firm for effective cooperative production. Allocations of rights follow from the resolution of that problem; firm structures do not result from juridical dispositions of rights. A case can be made out for labor in this context. It lies with the promise of productivity gains through information-sharing.[95] Models of the firm designed to capture that value center on co-ownership or legally mandated co-determination.[96] This approach aligns the case for employee rights with both the economics and the ethics of corporate production. The constituency debate, in fact, has begun to surmount its tendency only to look backward to adjust past allocative patterns and move simultaneously in this direction.[97] The *ex ante* case for labor inclusion has a long way to go, however. The matter ultimately devolves into the amount of wealth to be accessed and the ancillary costs of new arrangements, especially in respect of equity capital.[98]

It bears noting that structural modifications to facilitate more effective inputs of human capital need not entail full codetermination or equal coownership. A model of intermediation might suit better at first, given the pervasive and cautious view that the law should not impair management's authority to run the business. That is, the employees would receive a legally

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B (West 1988 & Supp. 1992) (one week's current wages for every year of service). A long-term attack on the practice of employment at will also continues at the state level: In 1991, the National Conference of Commissioners on Uniform State Laws approved a Model Employment-Termination Act for submission to state legislatures. *See* 9A Lab. Rel. Rep., (BNA) 540:21 (Dec. 1991). For a survey of present and proposed legislation and suggestions for further reform, see Fran Ansley, *Standing Rusty and Rolling Empty: Law, Poverty, and America's Eroding Industrial Base*, 81 GEO. L.J. 1757, 1860-83 (1993).

Severance benefits also are provided by contract, sometimes by willing managers. During the 1980s, management defenses included "tin parachute" plans, pursuant to which employees departing during a set period following a takeover receive lump sum payments. *See* Patrick J. Ryan, *Corporate Directors and the "Social Costs" of Takeovers—Reflections on the Tin Parachute*, 64 TUL. L. REV. 3 (1989).

95. For a description of productivity through information sharing, see Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 922-27 (1993).

96. *See, e.g.*, Alan Hyde, *In Defense of Employee Ownership*, 67 CHI. KENT L. REV. 159 (1991); O'Connor, *supra* note 95, at 946-65 (suggesting "neutral referee" variation on codetermination); William H. Simon, *Social-Republican Property*, 38 UCLA L. REV. 1335, 1368-86 (1991) (describing cooperative form of enterprise).

97. *See* O'Connor, *supra* note 95; Hyde, *supra* note 96.

98. Henry Hansmann has suggested that worker ownership is viable only if the worker-owners have homogeneous interests. In other cases, the properties of collective choice mechanisms create significant barriers. For a summary of his views, see Henry Hansmann, *Worker Participation and Corporate Governance*, 43 U. TORONTO L.J. 589 (1993). For criticism, see Hyde, *supra* note 93.

mandated right to advise—if not the board itself, then designated intermediaries. Such a scheme would bring them inside the legal firm only to allow information flow and consultation. The objective would be to influence the contractual evolution of governance norms to assure that the firm responds to employee concerns.[99]

Even such a modest plan seems visionary in this country at this time. But a more receptive future environment can be projected. We can take the current pattern of retrenchment and leaner management practice and project the twenty-first century firm. Assume a world economy characterized by technological advances, declining costs, increasing labor productivity, and decreasing growth of labor income.[100] In this environment, the skills of the firm's managers will be as much directed to trimming capacity and redeploying capital as to making new capital investment. To stay competitive, this twenty-first century organization will have to be too flexible to permit its participants to make the mistake of thinking it to be an institution that endures and protects indefinitely. It will not have the luxury to stumble into a web of unproductive relational patterns, and will have to develop a strong internal control system to prevent their development.[101] This projection creates a problem. The more pure and market-like this competitor becomes, the more difficult it becomes to imagine incentives for firm specific investment and full exploitation of production information by its managers and employees. Cooperative production is ill-suited to an organizational model that procures its inputs of human capital on an exclusively arms-length, at will basis. Yet, in this scenario, such cooperation will be demanded as a means to the end of productivity.[102] If competition discourages the trust that arises in more settled conditions, then investment of human capital may depend on new rights. In a world in which the risks of attachment to a given firm loom larger because of constant competitive demands to exit from lines of production, more flexibility respecting voice and distribution of residual returns may be required to stimulate that investment. The particular mix of contract and legal mandate necessary to secure such arrangements is left to the reader to project; but a mix there will be.[103]

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99. Several European countries have a system ensuring firm response to employee concerns. *See* G. Schnorr, *European Communities*, *in* COMPARATIVE LABOUR LAW AND INDUSTRIAL RELATIONS 65, 72-74 (R. Blanpain ed., 1982). Rights of consultation and participation are included in the European Economic Communities' Community Charter of Fundamental Social Rights, COM(89)248 final. For discussion, see David C. Dowling, Jr., *Worker Rights in the Post-1992 European Communities: What "Social Europe" Means to United States-Based Multinational Employers*, 11 NW. J. INT'L L. & BUS. 564 (1991). Worker participation rights appear as a law reform suggestion in the American literature. *See* O'Connor, *supra* note 95, at 962-63.

100. For a detailed projection of the twenty-first century firm, see Michael C. Jensen, *supra* note 84.

101. *Id.* at 862-70.

102. *Cf.* Baggerman, *supra* note 74, at 28 (noting that small businesses, while least likely to resort to layoffs, have become more productive).

103. A "just so" story can be told from the rational expectations side: If equity

Conclusion

Corporate law has a remarkable capacity to afford conceptual building blocks to those who desire its fundamental reform. Its principal-agent component gives shareholder primacy advocates an excellent basis to contend that management should not be privileged to thwart takeovers. At the same time, its gestures in the direction of community responsibility and its open-ended fiduciary principle make it plausible to argue that constituents should have rights. Somehow, neither shareholders' nor other constituents' programs seem to find a way into the law, despite support in the law's literal terms. Corporate law is an institution that holds a commitment to management.

The fact that context most probably controls should not be allowed to obscure the important contribution made by today's constituency rights advocates. Their work destabilizes settled assumptions about the inherited legal framework. Lawmaking proceeds in a more flexible climate. We will need that flexibility as competitive forces continue to change corporate institutions.

participation is needed to stimulate human capital investment, contractual arrangements will evolve.