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Author
Bainbridge, Stephen M.

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INTERPRETING NONSHAREHOLDER CONSTITUENCY STATUTES

Symposium On Current Issues In Securities Regulation
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Stephen M. Bainbridge
Professor, UCLA School of Law
405 Hilgard Avenue
Box 951476
Los Angeles, CA 90095-1476
bainbrid@law.ucla.edu

Abstract: Nonshareholder constituency statutes permit directors to consider the effects of their decisions on a variety of nonshareholder interests, such as employees, customers, suppliers, and local communities. Although highly controversial within the corporate law academy, such statutes are on the books in well over half the states and are likely to remain so for the foreseeable future. Because the statutes offer surprisingly little guidance to directors faced with corporate decisions or to courts faced with reviewing those decisions, however, courts urgently need a coherent interpretation of the statutes. But coherence alone is not enough; courts must also be faithful to the legislative intent behind the statutes. Courts cannot ignore the statutes, wish them away, or fairly interpret them as having no meaning or impact. This article therefore proposes an interpretation of nonshareholder constituency statutes that is faithful to the apparent legislative intent while also maintaining continuity with well-established principles of director fiduciary duties. The proposed approach distinguishes between two basic categories of director decisions: (i) operational issues, such as plant closings; and (ii) structural decisions, such as takeovers. The latter pose a much more serious conflict of interest for directors than do the former and therefore demand closer scrutiny. Accordingly, while arguing that director decisions with respect to operational matters should be conducted under the business judgment rule, the article argues that director decisions in the structural setting should be reviewed under a variant of the conditional business judgment rule developed by the Delaware supreme court in *Unocal Corp. v. Mesa Petroleum Co*.

JEL Classification: K22

Keywords: corporate social responsibility, nonshareholder constituency statutes, statutory interpretation, corporate takeovers

INTERPRETING NONSHAREHOLDER CONSTITUENCY STATUTES

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Stephen M. Bainbridge*

Every couple of decades the corporate social responsibility debate heats up again.[1] While it is almost as old as the corporate form itself, the debate took its modern form in the 1930s in an exchange between Professors Adolf Berle and Merrick Dodd.[2] Berle showed that ownership and control had separated in the modern publicly-held corporation.[3] As he demonstrated, in most public corporations no one shareholder or group of shareholders owns enough stock to control the firm.[4] Rather, such a firm is effectively controlled by the managers [**972**] who operate it.[5]

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* Associate Professor, University of Illinois College of Law. J.D., University of Virginia, 1985; M.S., University of Virginia, 1983; B.A., Western Maryland College, 1980. Subject to the usual disclaimers, the author thanks Michael Ariens, Gerry Bradley, Lyman Johnson, Tom Mengler, Morey McDaniel, David Millon, Marleen O'Connor, Tom Ulen, and the participants in a workshop held at the 1991 Hamline University Symposium on Law, Religion and Ethics, where an earlier version of this paper was presented, for helpful comments and criticisms. The author also thanks Stephanie Barrick for her excellent research assistance. [Pagination in original indicated by bond numerals within brackets.]

[1] "Corporate social responsibility" actually is a misnomer. A corporation is not a moral actor: "Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?" PENGUIN DICTIONARY OF QUOTATIONS 398 (1960) (attributed to Edward, First Baron Thurlow). The corporate social responsibility literature, however, frequently falls into the reification trap. Reification is useful because it permits us to utilize a form of shorthand. It is easier to say "General Motors ought to do so and so" than to describe the complex process that is actually necessary for General Motors to do something. Indeed, it is very difficult to think about large firms without reifying them. Reification, however, can be dangerous. Reification makes it easy to lose sight of the fact that firms do not do things; people do things. The proper focus is thus not on the corporation's obligations, but on the moral obligations and legal duties of the actors who make corporate decisions.

[2] *Compare* Adolf Berle, Corporate Powers as Powers in Trust, 44 HARV.L.REV. 1049, (1931) and Adolf Berle, For Whom Corporate Managers Are Trustees, 45 HARV.L.REV. 1365 (1932) with Merrick Dodd, For Whom Are Corporate Managers Trustees?, 45 HARV.L.REV. 1145 (1932) and Merrick Dodd, Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?, 2 U.CHI.L.REV. 194 (1935).

[3] ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119-25 (1933).

[4] *Id.* at 84-89. Berle and Means also identified two other basic types of corporations: majority controlled firms, in which a dominant shareholder (or group of shareholders acting together) owns

Berle contended that, in light of this separation, the board of directors should operate the corporation for the sole benefit of the shareholders. Berle, and his fellow advocates of this position, argued that corporate concern for nonshareholder interests is appropriate only if shareholder interests are thereby advanced.[6] As Milton Friedman once stated, "The social responsibility of business is to increase its profits."[7] A fairly standard litany of supporting arguments evolved, ranging from concerns over management accountability to claims that a sole focus on maximizing shareholder wealth benefits all members of society.[8]

Dodd generally accepted the separation of ownership and control as describing public corporations, but rejected Berle's views on corporate social respons i-

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more than 50% of the outstanding voting shares; and minority controlled corporations, in which a dominant shareholder (or group of shareholders acting together) owns less than 50% of the outstanding voting shares, but is nevertheless able to exercise effective voting control. *Id.* at 70-84. Berle and Means argued that these two types of firms show a partial separation of ownership and control; that is, the dominant shareholder controls the firm, leaving the minority shareholders (who "own" part of the firm) without significant control power. *Id.*

[5] All corporation codes reflect and perpetuate this separation. In each, the basic corporate governance model is one in which the board of directors acts and the shareholders react. In theory, the board of directors makes most corporate decisions. The few decisions made by shareholders almost uniformly are cast as approving or rejecting a recommendation by the board of directors. Thus, shareholders have virtually no power to initiate corporate action.

In most public corporations, of course, the vast majority of all decisions will be made by officers and other corporate employees. In practice, the board often is simply a rubber stamp for senior management. In theory, however, all corporate decisions are either to be made by the board or pursuant to authority properly delegated by the board. *See, e.g.,* REVISED MODEL BUSINESS CORP. Act § 8.01(b) (1984). Periodically a board will exercise that power and override the wishes of senior management. In any event, this article's focus on the board of directors can perhaps be justified as a useful shorthand for the more complex decision-making system that exists in reality.

[6] For simplicity's sake, this Article ignores the many and sometimes complex distinctions that divide the members of each camp amongst themselves. For example, Berle suggested that the time might come when managers would "develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community." BERLE & MEANS, *supra* note 3, at 356. Until that time, however, Berle thought it better to treat directors as trustees for the shareholders. *Id.* at 355. For some of Berle's followers, that time still has not come. For others, like Milton Friedman, a corporation's sole social responsibility always should be profit maximization. *See infra* text accompanying note 7.

[7] Milton Friedman, The Social Responsibility of Business is to Increase its Profits, N.Y. TIMES, Sept. 13, 1970, (Magazine) at 32.

[8] In the interests of brevity, this Article does not attempt a full treatment of the corporate social responsibility debate. For useful summaries, see KEITH DAVIS, THE CASE FOR AND AGAINST BUSINESS ASSUMPTION OF SOCIAL RESPONSIBILITIES, IN MANAGING CORPORATE SOCIAL RESPONSIBILITY 35, 40-44 (Archie B. Carroll ed. 1977); Lyman Johnson, Corporate Takeovers and Corporations: Who are They For?, 43 WASH. & LEE L.REV. 781, 789-98 (1986).

bility. Dodd, and his fellow proponents of this side of the debate, saw shareholders as absentee owners whose interests [**973**] can be subjugated to those of other corporate constituencies and those of society at large. Members of this camp thus define the "socially responsible firm" as "one that becomes deeply involved in the solution of society's major problems."[9] Again, a fairly standard litany of supporting arguments evolved, ranging from long-run shareholder self-interest to the very viability of capitalism.[10]

In the wake of the 1980s' merger mania, the corporate social responsibility debate resurfaced, but in a slightly different guise. This time, the controversy focuses on the corporation's responsibility to so-called stakeholders, or nonshareholder corporate constituents, such as employees, customers, suppliers, and local communities.[11] On one side are those who argue that corporate actions affect not only shareholders, but also a variety of nonshareholder constituencies having legitimate interests in the corporation's actions.[12] On the other side are those who still argue for the primacy of shareholder interests. In a sense, it is the Dodd and Berle debate all over again.[13]

The resurgence of this debate coincided with what some regard as the most significant change in United States corporate law since the New Deal federal securities laws or even the enabling corporate codes of the last century: the rise of nonshareholder constituency statutes. These statutes explicitly permit directors to consider the effects of their decisions on a variety of nonshareholder interests. As such, they are potentially revolutionary. United States corporate law has generally come closer to Berle's position than to Dodd's, at least in the sense of rhetorically

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[9] ROBERT D. HAY & EDMUND R. GRAY, SOCIAL RESPONSIBILITIES OF BUSINESS MANAGERS, IN MANAGING CORPORATE SOCIAL RESPONSIBILITY 8, 11 (Archie B. Carroll ed. 1977).

[10] *See* generally Davis, *supra* note 8, at 36-40.

[11] The name "stakeholders" reportedly originated in a 1963 Stanford Research Institute memorandum as a descriptive term for "those groups without whose support the organization would cease to exist." Freeman & Redd, Stockholders and Stakeholders: A New Perspective on Corporate Governance, 25 CAL.MGMT.REV. 88, 89 (1983).

[12] The United States Catholic Bishops, for example, argue that employees, customers, creditors, suppliers, and the communities in which the firm does business all have a stake in the corporate enterprise and are entitled to have their interests considered in corporate decisionmaking. NATIONAL CONFERENCE OF CATHOLIC BISHOPS, ECONOMIC JUSTICE FOR ALL: PASTORAL LETTER ON CATHOLIC SOCIAL TEACHING AND THE U.S. ECONOMY 145-52 (1986) [hereinafter BISHOPS' LETTER].

[13] This debate over a corporation's responsibilities to stakeholders is not new. In 1929, Owen D. Young, an executive officer of General Electric, similarly argued that not only shareholders, but also employees, customers, and the general public have an interest in the corporation, which the firm's managers are obliged to protect. Address of Owen D. Young (Jan. 1929), quoted in Dodd, For Whom Are Corporate Managers Trustees?, *supra* note 2, at 1154-55.

requiring directors to act in the share-[**974**] holders' best interests.[14] Many observers, however, believe that the nonshareholder constituency statutes either reject the primacy of shareholder wealth maximization or at least may lead to such a rejection.[15]

Given their enormous potential for affecting corporate law, the nonshareholder constituency statutes offer surprisingly little guidance to directors faced with corporate decisions or to courts faced with reviewing those decisions. Indeed, with very few exceptions, the statutes do no more than authorize director consideration of nonshareholder interests. Rarely is any legislative effort made to provide substantive or procedural standards for applying the statutes.

This Article proposes a model for interpreting nonshareholder constituency statutes. The model strives to be consistent with both the legislative intent underlying the statutes and the basic normative precepts of corporate law. Part I briefly describes the legal landscape as it existed before the nonshareholder constituency statutes (and, of course, as it still exists in states without them). As Part I explains, corporate law draws an important distinction between two basic types of business decisions: (i) operational decisions, such as plant closings; and (ii) structural decisions, such as takeovers. The former generally receive much less probing review than do the latter.

Part II describes the statutes themselves and identifies the few things that can be said with confidence about them. Part II also identifies the numerous critical issues the statutes leave unresolved.

Part III proposes a model that resolves the statutory ambiguities. As with the pre-statutory common law, this model distinguishes operational and structural de-

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[14] *See infra* Part I. Surprisingly, Berle himself believed that his argument with Dodd "ha[d] been settled (at least for the time being) squarely in favor of Professor Dodd's contention." ADOLF BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954). This concession appears to have been motivated in large part by the New Jersey Supreme Court's decision in A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J.), appeal dismissed, 346 U.S. 861 (1953), which upheld a state statute authorizing corporate charitable giving. *See* Berle, supra, at 158. In doing so, the court broadly endorsed the corporate social responsibility doctrine. As described *infra* notes 43-47 and accompanying text, however, *Barlow*'s result is not inconsistent with the profit maximization theory and, in any event, it remains in the minority among the decided cases.

[15] *E.g.*, David Millon, Redefining Corporate Law, 24 IND.L.REV. 223, 277 (1991) ("these statutes raise fundamental normative questions about the appropriate aims of corporate law and about corporate purpose itself."); Marleen A. O'Connor, Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect, 60 N.C.L.REV. 1189, 1260 (1991) ("the [nonshareholder constituency] statutes, in addition to general fiduciary duty principles, could serve as a basis for expanding the directors' fiduciary duties to employees in the context of fundamental corporate changes."); James J. Hanks, Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Have Come, 3 INSIGHTS 20, 25 (Dec. 1989) ("these statutes revolutionize corporation law").

cisions. In making operational decisions, directors routinely consider nonshareholder interests. Part III argues [**975**] that this phenomenon should be neither surprising nor particularly controversial. Accordingly, Part III suggests that courts should not aggressively review operational decisions, but instead should generally defer to the directors' determination.

Structural decisions are more problematic. While stakeholder and shareholder interests do not necessarily conflict in this context, conflict between management and shareholder interests is inherent in all structural decisions. The law's dilemma is thus apparent. On the one hand, the statutes permit directors to consider nonshareholder interests. On the other, the statutes should not provide a cloak behind which the behavior of self-interested directors may escape scrutiny. Part III concludes with a proposed legal regime that reconciles these competing goals.

I. THE LEGAL LANDSCAPE

Analytical clarity requires a sharp distinction between two different types of corporate decisions.[16] Structural decisions relate to changes in the ownership structure of the corporation. Operational decisions encompass everything else—all of the decisions necessary to run the firm on a continuing basis.

All corporation codes assign plenary authority over operational decisions—the corporation's "business and affairs"—to the board of directors.[17] The board has similarly broad decision-making powers with respect to negotiated acquisitions.[18] Even in hostile tender [**976**] offers, which theoretically permit the bidder

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[16] The word "decision" is used herein for semantic convenience to describe a process that is much less discrete in practice. As Bayless Manning observes, most board of director activity "does not consist of taking affirmative action on individual matters; it is instead a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision." Bayless Manning, The Business Judgment Rule and The Director's Duty of Attention: Time for Reality, 39 BUS.LAW. 1477, 1494 (1984).

[17] *See, e.g.,* Revised Model Business Corp. Act § 8.01(b) (1984).

[18] Modern corporation statutes give considerable responsibility and latitude to target directors in negotiating a merger agreement. Initially, the target's board possesses broad authority to determine whether to merge the firm and to select a merger partner. *See, e.g.,* CAL.CORP.CODE § 1101 (West 1990). The initial decision to enter into a negotiated merger transaction is thus reserved to the board's collective business judgment, with shareholders having no statutory power to initiate merger negotiations. Jewel Cos., Inc. v. Pay Less Drugstores Northwest, Inc., 741 F.2d 1555, 1560 (9th Cir.1984). The board also has sole power to negotiate the terms on which the merger will take place and to arrive at a definitive merger agreement embodying its decisions as to these matters. *Id.* at 1561. Shareholders have no statutory right to amend or veto specific provisions, their role being limited to approving or disapproving the merger agreement as a whole, with most statutes only requiring approval by a majority of the outstanding shares. *See, e.g.,* Revised Model Business Corp. Act §§ 11.03(e), 12.02(e) (1984).

to eliminate the need for target management's cooperation by purchasing a controlling share block directly from the stockholders, the target board's power to erect takeover defenses and otherwise impede the bidder gives it considerable influence over the outcome. Although the board thus has a pervasive role in both the operational and structural contexts, United States corporate law nevertheless treats these categories in quite different ways.

A. *Operational Decisions*

There is relatively little authority on the question of whether directors may consider nonshareholder interests in making operational decisions. What authority does exist mainly relates to corporate philanthropy.[19] Nonetheless, one thing can be said with considerable confidence: shareholder challenges to operational decisions usually fail.

Dodge v. Ford Motor Co.[20] exemplifies the courts' initial approach to reviewing operational decisions. It also remains the classic statement of the directors' duty to maximize shareholder wealth. In *Dodge*, Henry Ford embarked on a plan of retaining earnings, lowering prices, improving quality, and expanding production.[21] According to the plaintiff, an improper altruism towards his workers and customers motivated Ford.[22] The court agreed, rebuking Ford in a famous passage:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[23]

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[19] In most states, the specific problem of corporate charitable giving has been solved by the adoption of statutes authorizing corporations to make reasonable charitable donations. *See, e.g.*, Revised Model Business Corp. Act § 3.02(13) (1984); see generally Kenneth B. Davis, Discretion of Corporate Management to do Good at the Expense of Shareholder Gain—A Survey of, and Commentary on, the U.S. Corporate Law, 12 CAN.-U.S.L.J. 7 (1988). While corporate law codes are uniformly silent on the broader question of a board of directors' power to generally consider ethical factors in making operational decisions, the American Law Institute has proposed a rule permitting corporations to devote reasonable amounts to charity and to otherwise take into account ethical considerations reasonably regarded as appropriate to the responsible conduct of the firm. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (Tentative Draft No. 11, 1991) [hereinafter ALI PROJECT].

[20] 170 N.W. 668 (Mich.1919).

[21] *Id.* at 683.

[22] *Id.* at 683-84.

[23] *Id.* at 684. *See also* Brinson Ry. Co. v. Exchange Bank, 85 S.E. 634 (Ga.1915).

Thus, "it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental [**977**] benefit of shareholders and for the primary purpose of benefiting others."[24]

The force of this extravagant pronouncement was immediately undercut by the court's invocation of the business judgment rule,[25] which provides a presumption that the corporation's directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.[26] Unless the plaintiff is able to rebut this presumption,[27] the rule prohibits a court from reviewing the board's decision.[28] Advancing the rule's traditional justification, namely that judges are not business experts,[29] the *Dodge* court therefore declined to interfere with Ford's plans for expansion and dismissed the bulk of the plaintiff's complaint.[30]

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[24] *Dodge*, 170 N.W. at 684.

[25] Although the court did not use that term, both the holding and rationale of *Dodge* are consistent with the modern doctrine. *See id.*

[26] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del.1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del.1984); Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); Treadway Cos., Inc. v. Care Corp., 638 F.2d 357, 382 (2d Cir.1980); Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir.1980), cert. denied, 450 U.S. 999 (1981); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y.1979).

[27] The relationship between the business judgment rule and the duty of care is a highly complex one. Most jurisdictions recognize that the business judgment rule only protects an actual decision. In other words, while a decision not to act is protected, a failure to decide is not. *See, e.g.*, Francis v. United Jersey Bank, 432 A.2d 814 (N.J.1981). Second, most jurisdictions require that the board have used adequate procedures in reaching its decision. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del.1985). Beyond this, various formulations have been used to describe the types of evidence necessary to rebut the business judgment rule's presumptions. In general, however, the rule will not protect a decision that is irrational or which is tainted by fraud, illegality, or self-dealing. *See, e.g.*, Joy v. North, 692 F.2d 880 (2d Cir.1982), cert. denied, 460 U.S. 1051 (1983); Kamin v. American Express Co., 383 N.Y.S.2d 807, aff'd, 387 N.Y.S.2d 993-94 (N.Y.App.Div.1976).

[28] The Delaware Supreme Court has recognized, but not adopted, a distinction between the business judgment rule, which shields corporate officers and directors from personal liability in connection with business decisions, and the business judgment doctrine, which shields the decision itself from review. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 n. 10 (Del.1986).

[29] *Dodge*, 170 N.W. at 684.

[30] *Id.* The court did affirm a lower court order requiring Ford to resume paying dividends. *Id.* at 685.

As the law evolved, corporate altruism[31] began to be seen as proper so long as it was likely to provide direct benefits to the corporation and its shareholders.[32] Moreover, applying the business judgment [978] rule, many courts essentially presumed that an altruistic decision was in the corporation's best interests. The Illinois Court of Appeal's decision in *Shlensky v. Wrigley*[33] exemplifies this approach. In *Shlensky*, a minority shareholder in the Chicago Cubs challenged the majority shareholder's famous refusal to install lights at Wrigley Field. Shlensky claimed the decision was motivated by Wrigley's beliefs that baseball was a day-time sport and that night baseball might have a deteriorating effect on the neighborhood surrounding Wrigley Field.[34] During the relevant period, the Cubs consistently lost money, which Shlensky claimed was attributable to their poor home attendance, which in turn he claimed was attributable to the board's refusal to install lights and play night baseball.[35] According to Shlensky, Wrigley was indifferent to the effect of his continued intrasigence on the team's finances.[36] Shlensky argued that his complaint thus stated a cause of action under *Dodge*.

Despite Shlensky's apparently uncontested evidence that Wrigley was more concerned with stakeholder than with shareholder interests, the court did not require Wrigley to justify his decision.[37] Instead, the court presumed that Wrigley's decision was in the firm's best interests.[38] Indeed, the court basically invented reasons why a director might have made an honest decision against night baseball. For example, the court stated that "the effect on the surrounding neighborhood might well be considered by a director."[39] Additionally, the court said that "the long-run interest" of the firm "might demand" protection of the neighborhood.[40]

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[31] The word "altruism" is used here to describe any decision motivated by considerations other than shareholder wealth maximization. It thus includes, but also is much broader than, corporate philanthropy.

[32] *See, e.g.*, Corning Glass Works v. Lucas, 37 F.2d 798 (D.C.Cir.1929), cert. denied, 281 U.S. 742 (1930); Virgil v. Virgil Practice Clavier Co., 68 N.Y.S.2d 335, 337 (N.Y.Sup.Ct.1900); Steinway v. Steinway & Sons, 40 N.Y.S.2d 718, 722 (N.Y.Sup.Ct.1896).

[33] 237 N.E.2d 776 (Ill.App.Ct.1968). *See also* Ella M. Kelly & Wyndham, Inc. v. Bell, 266 A.2d 878, 879 (Del.1970); Union Pacific R.R. Co. v. Trustees, Inc., 329 P.2d 398, 401-02 (Utah 1958).

[34] *Shlensky*, 237 N.E.2d at 778.

[35] *Id.*

[36] *Id.*

[37] *See id.* at 780.

[38] *Id.*

[39] *Id.*

[40] *Id.*

Accordingly, Shlensky's case was dismissed for failure to state a claim upon which relief could be granted.[41]

The rhetorical emphasis shifted significantly between *Dodge* and *Shlensky*. Where *Dodge* emphasized the directors' duty to maximize profits, *Shlensky* emphasized the directors' authority and discretion. Ultimately, however, they are consistent. The Illinois Appellate Court [**979**] did not reject the profit-maximizing norm laid down by *Dodge*, but rather followed *Dodge* in holding that the business judgment rule immunized the directors' decision from judicial review.[42]

In contrast, some recent cases appear to posit that directors need not treat shareholder wealth maximization as their sole guiding star. *A.P. Smith Manufacturing Co. v. Barlow*,[43] the most frequently cited example, upheld a corporate charitable donation on the ground, inter alia, that "modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate."[44] Ultimately, however, the differences between *Barlow* and *Dodge* have little more than symbolic import. As the *Barlow* court recognized, shareholders' long-run interests are often served by decisions (such as charitable giving) that appear harmful in the short-run.[45] Because the court acknowledged that the challenged contribution could be justified on profit-maximizing grounds, its broader language on corpo-

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[41] *Id.* at 778-80. The court also stated that Shlensky's claim was defective for failing to show a causal link between the lack of night baseball and the firm's low profits. *Id.* at 780-81. This passage is dictum, however, because the business judgment rule required the court to dismiss the complaint without reaching the merits.

[42] *Shlensky* can be plausibly read in a variety of ways. This author reads it as standing for two propositions: (1) corporate altruism is appropriate only if it is likely to provide direct benefits to the corporation and its shareholders; but (2) applying the business judgment rule, the court will essentially presume that the directors' decision was in the corporation's best interests. In contrast, while Dean Clark acknowledges that *Shlensky* can be read as standing "for the proposition that the business judgment rule precludes a shareholder attack on the directors' business decisions on the ground that the decisions were actually motivated by the directors' perceptions of social values," he argues that *Shlensky* is really "based on considerations of appropriate judicial process." Robert C. Clark, Corporate Law 137 (1986). In his view, "courts should usually prohibit shareholders from attempting to prove management's real motivations in this kind of case." *Id.* The end result, of course, is the same under either interpretation: Shlensky loses.

[43] 98 A.2d 581 (N.J.1953).

[44] *Id.* at 586. In Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del.Ch.1969), the court similarly opined that corporate social responsibility was a desirable goal. *See id.* at 404. The challenged corporate donation in question, however, was ultimately upheld on the grounds that it produced long-term benefits for the stockholders. *See id.* at 405. In contrast, one year later the Delaware Supreme Court upheld a challenged corporate gift based solely on the business judgment rule. Ella M. Kelly & Wyndham, Inc. v. Bell, 266 A.2d 878, 879 (Del.1970).

[45] *See Barlow*, 98 A.2d at 586.

rate social responsibility is arguably mere dictum.[46] In any case, *Barlow* and its ilk are still in the minority.[47]

In sum, the law governing operational decisions has a somewhat [**980**] schizophrenic feel. In most jurisdictions, courts will exhort directors to use their best efforts to maximize shareholder wealth.[48] In a few jurisdictions, courts may exhort directors to consider the corporation's social responsibility. In either case, however, the announced principle is no more than an exhortation. The court may hold forth on the primacy of shareholder interests, or may hold forth on the importance of socially responsible conduct, but ultimately it does not matter. Under either approach, directors who consider nonshareholder interests in making corporate decisions, like directors who do not, will be insulated from liability by the business judgment rule.

B. *Structural Decisions*

Because courts analyze most aspects of negotiated acquisitions in a manner similar to operational decisions,[49] this Article's analysis of structural decisions focuses mainly on a target board of director's response to contested changes in ownership. The law governing a target board's conduct in a corporate control contest is most fully developed in *Unocal Corp. v. Mesa Petroleum Co*.[50] and its progeny. In *Unocal*, the Delaware Supreme Court adopted a two-pronged standard for reviewing takeover defenses. The first prong requires the directors to "show that they had reasonable grounds for believing that a danger to corporate

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[46] *See* CLARK, *supra* note 42, at 682 n. 11.

[47] *See id.* at 682 (stating that "[w]ith a possible exception or two, courts have not retreated from the assumption that the primary or residual purpose of a business corporation is to make profits for its shareholders"); Lyman Johnson, The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct, 14 J.CORP.L. 35, 43 (1988) (same).

[48] Even in such jurisdictions, of course, the duty to maximize shareholder wealth has always been subject to exceptions, most prominently the corporation's obligation "to act within the boundaries set by law." ALI PROJECT, *supra* note 19, at § 2.01.

[49] Most aspects of negotiated acquistions—such as a board decision to approve or reject a merger proposal—are reviewed under a business judgment rule analysis closely akin to that applied to operational decisions. *See, e.g.,* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del.1989); Smith v. Van Gorkom, 488 A.2d 858 (Del.1985). Some board decisions in connection with a negotiated acquisition, however, are reviewed under the two-pronged standard described below. The most important of these is a board decision to grant a lock-up or exclusive merger agreement to the bidder. *See* Time, 571 A.2d at 1151. The special problems of negotiated acquistions are discussed *infra* note 207.

[50] 493 A.2d 946 (Del.1985).

policy and effectiveness existed."[51] Among other things, this requires proof that they acted in good faith and conducted a reasonable investigation.[52] The second prong requires a showing that the defensive measure was reasonable in relation to the threat posed by the hostile bid.[53] The directors are entitled to the business judgment rule's protections only if they carry their burden of proof on both prongs. In contrast to operational decisions, [**981**] structural decisions thus are carefully scrutinized to insure that the board really is acting in the corporation's best interests.[54]

Unocal appeared to allow directors to consider interests other than short-term shareholder wealth maximization. Under *Unocal*, target directors may balance the takeover premium a bidder offers shareholders against the bid's potential effects on the corporate entity.[55] Among other factors, the board was explicitly permitted to consider "the impact of the bid on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community)."[56]

Unfortunately, *Unocal* was not entirely clear as to what the language just quoted meant. Unocal's board was faced with a structurally coercive bid by "a corporate raider with a national reputation as a 'greenmailer.'"[57] Accordingly, the

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[51] *Id.* at 955. The *Unocal* standard is applied to a challenged takeover defense not only when it is adopted, but also when it is utilized by the target in connection with a particular tender offer. Moran v. Household International, Inc., 500 A.2d 1346, 1357 (Del.1985).

[52] *Unocal*, 493 A.2d at 955.

[53] *Id.* at 953-55.

[54] Dynamics Corp. of America v. CTS Corp., 805 F.2d 705, 708 (7th Cir.1986).

[55] *Unocal*, 493 A.2d at 955. The court also spoke of the directors' duty of care as running to both "the corporation and its owners," id., implying that those interests might diverge.

[56] *Id.* Several judicial opinions outside Delaware suggest that nonshareholder interests may be considered in making structural decisions. *See, e.g.,* Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255 (2d Cir.1984); Herald Co. v. Sewell, 472 F.2d 1081 (10th Cir.1972); GAF Corp. v. Union Carbide Corp., 624 F.Supp. 1016 (S.D.N.Y.1985); Enterra Corp. v. SGS Associates, 600 F.Supp. 678 (E.D.Pa.1985); Abramson v. Nytronics, Inc., 312 F.Supp. 519 (S.D.N.Y.1970). It is difficult to form a coherent picture from these cases. Most courts outside of Delaware face corporate law issues on a sporadic basis, which precludes detailed doctrinal development. *Cf.* Treadway Cos., Inc. v. Care Corp., 638 F.2d 357, 382 (2d Cir.1980) (stating that "[t]he law in this area is something less than a seamless web").

[57] *Unocal*, 493 A.2d at 956. Structurally coercive takeover tactics are defined as those creating a "risk that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions." Ronald J. Gilson & Reinier Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Proportionality Review, 44 BUS.LAW. 247, 267 (1989). Two-tier tender offers are perhaps the most commonly recognized form of structural coercion. In a two-tier offer, the bidder announces a partial tender offer and, at the same time, announces that if the offer succeeds it will be followed by a back-end merger to freeze-out the remaining shareholders. The back-end merger is typically at a lower price and/or in a different type of consideration, such as junk bonds instead of cash. If shareholders believe that the offeror is likely to obtain a controlling interest in the

directors reasonably believed that the bid was not in the best interests of any corporate constituency and, on the facts before the court, there arguably was no conflict between shareholder and stakeholder interests.

[**982**] Other situations are not so clear-cut. Suppose, for example, the bidder makes a fairly priced, non-coercive offer, but also announces plans to close plants and lay off numerous workers. The target's board of directors reasonably concludes that the negative impact on its employees exceeds the gains shareholders will garner. Did *Unocal* permit the board to turn down such an offer?[58]

In *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*,[59] the Delaware Supreme Court said *Unocal* did not. *Revlon* involved a common takeover situation: an initial hostile bid, followed by a friendly bid from a white knight solicited by target management, and several subsequent rounds of bidding. The Delaware Supreme Court held that once the target's directors decided to sell the company to one of the bidders, their sole remaining responsibility was maximizing shareholder value.[60] In the court's apt phrase, they became "auctioneers charged with getting the best price for the stockholders."[61]

Revlon adds two crucial provisos to *Unocal*'s treatment of nonshareholder constituencies. The first is of general applicability, dealing with all structural decisions except those in which the *Revlon* auctioneering duties have triggered. If *Unocal* arguably allowed target boards to trade off a decrease in shareholder wealth for an increase in stakeholder wealth, *Revlon* forecloses that interpretation. *Revlon* expressly forbids management from protecting stakeholder interests at the expense of shareholder interests.[62] Rather, any management action benefitting

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front-end transaction, they face the risk that they will be squeezed out in the back-end for less desirable consideration. Thus they are coerced into tendering into the front-end to avoid that risk, even if they believe the front-end transaction itself is undesirable. Stephen M. Bainbridge, Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions, 75 MINN.L.REV. 239, 313 n. 315 (1990).

[58] In Newell Co. v. Vermont American Corp., 725 F.Supp. 351 (N.D.Ill.1989), the court, applying the *Unocal* test, determined that the offer would maximize short-term shareholder profits, but nevertheless upheld the target's defensive measures. Although the principal threat appeared to be to nonshareholder interests, the court avoided the question posed in the text by finding that long-term shareholder interests were threatened. *See id.* at 372-76. As to the notion that shareholders have long-term interests in the takeover context, see *infra* note 66.

[59] 506 A.2d 173 (Del.1986).

[60] *Id.* at 182.

[61] *Id.* Determining whether the *Revlon* auctioneering duties have triggered is a relatively complex question. *See* generally Bainbridge, *supra* note 57, at 301-17.

[62] As described *supra* notes 31-33 and accompanying text, some courts have imposed a similar requirement of proportionality between stakeholder and shareholder gains to operational decisions. Therefore, in a sense, this aspect of *Revlon* is not new. *Revlon*'s rule is more restrictive,

stakeholders must produce ancillary shareholder benefits.[63] In other words, directors may only consider [**983**] stakeholder interests if doing so would benefit shareholders.[64]

Second, if the *Revlon* auctioneering duty triggers, stakeholders become entirely irrelevant. Once a *Revlon* auction begins, it no longer matters whether benefitting nonshareholder interests may also benefit shareholders. Instead, shareholder wealth maximization is the board's only appropriate concern.[65] Indeed, in this context, considering any factors other than shareholder wealth violates the board's fiduciary duties.[66]

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however, because the business judgment rule does not preclude courts from evaluating structural decisions. In contrast, nothing in *Revlon* affects the business judgment rule's continued application to operational decisions.

[63] "A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders." *Revlon*, 506 A.2d at 182 (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del.1985)). A somewhat weaker formulation was used in Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del.1989), which allows consideration of nonshareholder interests provided they bear "some reasonable relationship to general shareholder interests." *Id.* at 1282 n. 29.

[64] *Compare* Buckhorn, Inc. v. Ropak Corp., 656 F.Supp. 209, 231-32 (S.D.Ohio), aff'd, 815 F.2d 76 (6th Cir.1987) (employee stock ownership plan invalidated because there was "no evidence in the record as to how the ESOP would benefit the stockholders nor as to how Ropak's tender offer posed a threat to Buckhorn's employees") with Shamrock Holdings, Inc. v. Polaroid Co., 559 A.2d 257, 276 (Del.Ch.1989) (employee stock ownership plan upheld because it was "likely to add value to the company and all of its stockholders").

[65] *Revlon*, 506 A.2d at 182.

[66] *Id.* at 185. *Accord* Black & Decker Corp. v. American Standard, Inc., 682 F.Supp. 772, 786-87 (D.Del.1988) (board actions protecting employees improper when *Revlon* duties triggered); C-T of Virginia Inc. v. Barrett, 124 Bankr. 689, (board consideration of creditor interests improper once *Revlon* duties triggered), argued on other grounds, 124 Bankr. 694 (W.D.Va.1990), aff'd on other grounds sub nom, C-T of Virginia, Inc. v. Euroshoe Assoc., No. 91-1578 (4th Cir. Jan. 29, 1992) (LEXIS, Genfed Library, CA4 File).

The American Law Institute proposes a rule pursuant to which the target's board may "have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders." ALI PROJECT, *supra* note 19, at § 6.02(b)(2). This rule apparently would apply to all takeover situations, including those in which a control auction has begun. *See id.* at 540-41. This is a very odd formulation. Even the ALI's reporter seems puzzled by it. *See id.* at 558-59. For one thing, the shareholders have long-term interests in the takeover context only if the target remains independent. The standard thus seems to put the cart before the horse. Additionally, how much injury to the shareholders can the target board work before the shareholders are "significantly disfavor[ed]"? The ALI failed to coherently answer that question. The unsatisfactory treatment of this issue by the ALI becomes more explicable when one realizes that Section 6.02 was one of the most hotly debated sections of the ALI Project. The final version is a compromise that seems to have satisfied no one. *See* Steven Wallman, Section 6.02: Is ALI Provision on Director Duties

In sum, *Revlon* sharply limits directors' ability to consider nonshareholder interests in structural decisions.[67] Moreover, [**984**] by withholding the business judgment rule's protections from directors, *Revlon* puts considerable teeth into the shareholder wealth maximization norm. Unlike the operational context, directors who make structural decisions based on stakeholder interests rather than shareholder interests face the very real threat of personal liability.[68]

II. NONSHAREHOLDER CONSTITUENCY STATUTES

The takeover wave of the 1980s produced a host of target corporation defensive tactics. A variety of so-called shark repellents developed early on. These are charter or, less commonly, by-law provisions designed to impede changes of control opposed by incumbent management.

So-called nonmonetary factor provisions are a relatively common variant on the shark repellent theme.[69] They permit, and in some cases require, directors to consider a variety of nonprice factors in evaluating a proposed acquisition. In particular, most allow directors to consider "the social, legal and economic effects of an offer upon employees, suppliers, customers and others having similar relationships with the corporation, and the communities in which the corporation conducts its business."[70]

Consistent with Evolution in Thinking about Takeovers?, Corp. Counsel Weekly (BNA) at 8 (Aug. 7, 1991).

[67] Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del.1989), retreated from *Unocal* by broadening the types of threats to corporate policy that justify a defensive response. Time also limited the circumstances in which the *Revlon* auctioneering duty applies. Unfortunately, Time did not squarely address the role of stakeholder interests under either *Unocal* or *Revlon*. *See* Bainbridge, *supra* note 57, at 306-17. But see Lyman Johnson & David Millon, The Case Beyond Time, 45 BUS.LAW. 2105 (1990) (Time implicitly allows target managers greater freedom to consider nonshareholder interests); Millon, *supra* note 15, at 237-38 (same).

[68] Delaware's director liability limitation statute permits corporations to adopt charter provisions eliminating monetary liability for violations of the duty of care but not for violations of the duty of loyalty. DEL.CODE ANN.GEN.CORP.LAW §§ 102(b)(7), 145 (1990); see generally Marc I. Steinberg, The Evisceration of the Duty of Care, 42 SW.L.J. 919 (1988); Lynne A. Whited, Note, Corporate Directors—An Endangered Species? A More Reasonable Standard for Director and Officer Liability in Illinois, 1987 U.ILL.L.REV. 495. Because takeover defenses implicate both duties, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284 n. 34 (Del.1988), monetary liabilities should remain available in this context. *See* Bainbridge, *supra* note 57, at 322 n. 349.

[69] As of 1989, over eighty corporations had adopted such provisions. American Bar Association Section of Business Law Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, 45 BUS.LAW. 2253, 2257 (1990) [hereinafter ABA Committee].

[70] Proxy Statement and Text of Amendment for Nortek, Inc. (May 26, 1982), reprinted in 1 SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTI-

From management's perspective, nonmonetary factor provisions have two principal drawbacks. First, except in the case of a newly incorporated firm, they must be adopted as amendments to the corporation's charter, which requires shareholder approval. Shareholder resistance to shark repellents steadily grew throughout the 1980s, especially among institutional investors. In 1989, for example, over half of the institutional investors responding to an industry survey reported that they had opposed some nonmonetary factors provisions, [**985**] while another one-quarter reported that they did so routinely.[71] This growing opposition may deter some firms from proposing amendments.[72]

Second, and more seriously, state law arguably does not permit corporate organic documents to redefine the directors' fiduciary duties. In general, a charter amendment may not derogate from common law rules if doing so conflicts with some settled public policy.[73] In light of the well-settled shareholder wealth maximization policy, nonmonetary factors charter amendments therefore appear vulnerable.[74]

These sort of problems are rarely allowed to stand in the way of a good idea. In the unrelenting takeover arms race, legislative defenses are especially important. Well over two-thirds of the states now have takeover laws,[75] which in fact are almost uniformly better termed anti-takeover laws. Typically, they are adopted at the behest of corporate managers, many being emergency legislation designed to fend off a pending takeover bid for an in-state company.[76]

TIONER 198 (Robert L. Winter, Robert D. Rosenbaum, Mark H. Stumpf, and L. Stevenson Parker eds., 1983 & Supp.1989) [hereinafter SHARK REPELLENTS]. The full laundry list also usually includes: the legality of the offer; the bidder's financial condition, prospects, and reputation; and the offer's structure and bidder's intentions for the target. *See id.* at 194.

[71] LAUREN KRASNOW, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1989 PROXY SEASON 37 (1989).

[72] While virtually all nonmonetary factor charter amendments still receive shareholder approval, the average affirmative vote in 1989 was 68.1 percent of the shares voted, which is quite low by corporate voting standards. *Id.*

[73] Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del.1952); ERNEST L. FOLK, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 10 (1972).

[74] *Cf.* ALI PROJECT, *supra* note 19, at 90-92 (unclear under current law whether charter provisions derogating from the profit maximization norm are valid without unanimous shareholder approval).

[75] Investor Responsibility Research Center, State Takeover Laws 2 (1989).

[76] *Id.*

Nonshareholder constituency statutes are one of the more common variants on the state takeover law theme,[77] with more than twenty-five states now having some version of them.[78] Usually they are [**986**] adopted as amendments to the existing statutory statement of the director's duty of due care.[79] The basic model followed by most of the statutes provides that in discharging their duty of care, directors may consider the effects of a decision on not only shareholders, but also on a list of other constituency groups.[80] With minor variations, the list of permissible interests typically includes employees, suppliers, customers, creditors, and the local communities in which the firm does business.[81] In addition to the laundry list of constituency factors, some statutes more generally authorize directors to consider both the long-and short-term effects of the decision.[82]

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[77] Early writing on these laws tended to refer to them as nonmonetary factor statutes. *E.g.*, 3 SHARK REPELLENTS, *supra* note 70, at 55. The nonshareholder constituency name used herein, however, is currently the fashionable one. If nothing else, the name change is useful in keeping the statutes separate from the comparable charter provisions.

[78] ARIZ.REV.STAT.ANN. § 10-1202.A (1987); CONN.GEN.STAT.ANN. § 33-313(e) (West 1990); FLA.STAT.ANN. § 607.0830(3) (West 1991); GA.CODE ANN. § 22-202(b)(5) (Harrison 1989); HAW.REV.STAT. § 415-35 (1990); IDAHO CODE § 30-1602 (1990); ILL.ANN.STAT. ch. 32, para. 8.85 (Smith-Hurd 1990); IND.CODE ANN. § 23-1-35-1 (West 1990); IOWA CODE § 490.1108 (1990); KY.REV.STAT.ANN. § 271B.12-210(4) (Baldwin 1990); LA.REV.STAT.ANN. § 92(G) (West 1991); ME.REV.STAT.ANN. tit. 13-A, § 716 (West 1989); MASS.ANN.LAWS ch. 156B, § 65 (Law.Co-op.1990); MINN.STAT.ANN. § 302A.251 (West 1991); MISS.CODE ANN. § 79-4-8.30(d) (1990); MO.ANN.STAT. § 351.347 (Vernon 1991); NEB.REV.STAT. § 21-2045(1)(c) (1990); N.J.STAT.ANN. § 14A:6-1 (West 1990); N.M.STAT.ANN. § 53-11-35(D) (Michie 1990); N.Y.BUS.CORP.LAW § 717(b) (Consol.1991); OHIO REV.CODE ANN. § 1701.59(E) (Anderson 1990); OR.REV.STAT. § 60.357(5) (1990); 15 PA.CONS.STAT. § 1715-16 (Supp.1991); R.I.GEN.LAWS § 7-5.2-8(a) (1990); S.D.CODIFIED LAWS ANN. § 47-33-4 (1991); TENN.CODE ANN. § 48-35-204 (1988); WIS.STAT.ANN. § 180.0827 (West 1991); WYO.STAT. § 17-16-830 (1989). A proposed nonshareholder constituency amendment to the Revised Model Business Corporation Act has been rejected. *See* ABA Committee, *supra* note 69, at 2253.

[79] The Revised Model Business Corporation Act's phrasing of the duty of care is typical:

"A director shall discharge his duties as a director, including his duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interested of the corporation."

Revised Model Business Corp. Act § 8.30(a) (1984).

[80] 3 SHARK REPELLENTS, *supra* note 70, at 55.

[81] *Id.*

[82] *E.g.*, FLA.STAT.ANN. § 607.0830(3) (West 1991); MINN.STAT.ANN. § 302A.251 (West 1991). Arizona's statute omits the typical laundry list of nonshareholder constituencies and instead merely authorizes directors to consider long-term effects of a decision. ARIZ.REV.STAT.ANN. § 10-1202.A (1987).

A couple of things can be said with confidence about nonshareholder constituency statutes. First, unlike many nonmonetary factor charter provisions, most nonshareholder constituency statutes are not limited to takeover decisions.[83] As a result, the interests of nonshareholder constituencies may be considered in all structural and operational decisions.

[**987**] Second, most statutes are permissive.[84] Directors "may," but need not, take nonshareholder interests into account. There are no express constraints on the directors' discretion in deciding whether to consider nonshareholder interests and, if they decide to do so, which constituency groups' interests to consider.[85] As a result, the statutes should not be interpreted as creating new director fiduciary duties running to nonshareholder constituencies and the latter should not have standing under these statutes to seek judicial review of a director's decision.[86]

A long-term effects provision is presumably intended to reaffirm that a board of directors may properly pass up short-term profits in order to pursue long-term gains. Millon, *supra* note 15, at 243. Of course, the same is true under the common law. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del.1989) (stating that "absent a limited set of circumstances, as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any per se duty to maximize shareholder value in the short-term, even in the context of a takeover").

[83] Only Connecticut, Iowa, Louisiana, Missouri, Oregon, Rhode Island, and Tennessee limit their nonshareholder constituency statutes' effect to corporate acquisitions. *See* CONN.GEN.STAT.ANN. § 33-313(e) (West 1990); IOWA CODE § 490.1108 (1990); LA.REV.STAT.ANN. § 92(G) (West 1991); MO.ANN.STAT. § 351.347 (Vernon 1991); OR.REV.STAT. § 60.357(5) (1990); R.I.GEN.LAWS § 7-5.2-8(a) (1990); TENN.CODE ANN. § 48-35-204 (1988).

[84] Only Connecticut requires directors to consider both shareholder and nonshareholder interests. *See* CONN.GEN.STAT.ANN. § 33-313(e) (West 1990). A few states require directors to consider shareholder interests, while being merely permissive with respect to stakeholder interests. *See infra* notes 92-93 and accompanying text (discussing various state formulations).

[85] Had the legislatures desired to force management to consider specific nonshareholder constituency interests, more direct tools were readily at hand. For example, the legislature could have mandated worker ownership of firms. Alternatively, the legislature could have mandated worker participation along the lines provided by the European Community's system of co-determination. *See* generally MICHAEL P. DOOLEY, EUROPEAN PROPOSALS FOR WORKER INFORMATION AND CODETERMINATION: AN AMERICAN COMMENT, IN HARMONIZATION OF LAWS IN THE EUROPEAN COMMUNITIES: PRODUCTS LIABILITY, CONFLICTS OF LAWS, AND CORPORATION LAW (P. Herzog ed. 1983). The legislatures' uniform failure to adopt either of these widely known options strengthens the argument that the statutes should be construed as being purely discretionary.

[86] Although most statutes are silent on this point, the New York and Pennsylvania statutes explicitly state that they create no duties towards any party. N.Y.BUS.CORP.LAW § 717(b) (Consol.1991); 15 PA.CONS.STAT. § 1721 (1991 Supp.). Some commentators assert that the nonshareholder constituency statutes are, or should be, enforceable by stakeholders; alternatively, some posit that the nonshareholder constituency statutes create, or may lead to the creation of,

[**988**] Beyond this, most statutes are frustratingly silent on many key issues: How should directors decide whether particular claimants fall into one of the protected constituent categories, some of which, such as customers and communities, are very amorphous? What weight should directors assign to shareholder and nonshareholder interests? What should directors do when those interests can not be reconciled? What should directors do when the interests of various nonshareholder constituencies conflict amongst themselves? What standards should courts use in reviewing a director's decision not to consider nonshareholder interests? What standards of review apply to director action claimed to be motivated by concern for nonshareholder constituents? With two prominent exceptions, discussed below,[87] the statutes simply do not address these questions.[88]

Nor is there, as yet, any significant guidance from the courts. The few decisions involving nonshareholder constituency statutes to date have not squarely addressed these basic issues. Rather, the decisions are usually limited to an observation that the statutes permit director consideration of stakeholder interests.[89]

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management fiduciary duties to the stakeholders. *E.g.,* Morey W. McDaniel, Bondholders and Stockholders, 13 J.CORP.L. 205, 265-313 (1988); Millon, *supra* note 15; William R. Newlin & Jay A. Gilmer, The Pennsylvania Shareholder Protection Act: A New State Approach to Deflecting Corporate Takeover Bids, 40 BUS.LAW. 111, 114 (1984); O'Connor, *supra* note 15, at 1232; see generally Marleen A. O'Connor, Introduction to the Symposium on Corporate Malaise Stakeholder Statutes: Cause or Cure?, 21 STETSON L.REV. 3 (1991).

Whatever the policy merits of creating fiduciary duties running from the directors to the stakeholders, it is difficult to find such a duty in the statutory language. Even a leading proponent of creating fiduciary duties running to stakeholders has recognized this point: "Because these statutes do not mandate that directors consider nonshareholder interests, these [stakeholder] groups probably do not have standing to enforce these statutes." O'Connor, *supra* note 15, at 1233-34. Given that the extrinsic information about legislative intent suggests that the legislatures saw the statutes as making only minor changes in the law, the legislative history likewise provides no basis for reading such a duty into the current statutes. *See infra* notes 100-103 and accompanying text. Finally, it is important to note that at common law the board of directors has no duty to consider nonshareholder interests. *E.g.,* Local 1330, United Steel Workers v. U.S. Steel Corp., 631 F.2d 1264 (6th Cir.1980). Accordingly, judicial creation of such a duty should require a clearer legislative statement and proposals for stakeholder standing therefore seem more appropriately addressed to legislatures than to courts seeking to interpret the existing laws.

[87] *See infra* notes 106-110 and accompanying text (discussing Indiana and Pennsylvania statutes).

[88] In fairness to the statutes' drafters, the model set forth in this Article fully resolves only the last of the questions asked above. This limitation, however, was effectively imposed by the drafters, who left management with almost unbridled discretion on a host of issues. As discussed in Part III, however, this discretion is not particularly troubling, so long as management's potential conflict of interest is effectively constrained.

[89] *See, e.g.,* Keyser v. Commonwealth Nat'l Fin. Corp., 675 F.Supp. 238, 265-66 (M.D.Pa.1987); Baron v. Strawbridge & Clothier, 646 F.Supp. 690, 697 (E.D.Pa.1986).

The nearest thing to an actual interpretation of one of these laws is a federal district court opinion, stating that Wisconsin's nonshareholder constituency statute "appears to have codified *Revlon*'s holding that a board can consider other constituencies in the context of a tender offer."[90] If by this the court interpreted the statute as codifying *Revlon*'s requirement that benefits given nonshareholders must also benefit shareholders, then the statute has no effect on current law. Presumably, however, the court did not intend such a reading, as it went on to hold that the business judgment rule protected the board's conclusion that the takeover bid threatened long-term interests of nonshareholder constituents.[91] The waters thus remain quite murky.

Plausible interpretations of nonshareholder constituency statutes fall on a spectrum between two extremes. At one end of the spec-[**989**] trum is a reading that allows directors to ignore shareholder interests in making corporate decisions. At the other end is a reading under which the statutes simply codify the pre-existing common law, including an unmodified shareholder wealth maximization norm. As I indicate below, neither extreme is likely to emerge as the prevailing interpretation.

At one end of the spectrum of possible interpretations of the statutes is an interpretation permitting directors to disregard shareholder interests in the face of a threat to nonshareholder constituencies. For example, a board could refuse a takeover offer carrying a substantial premium, and enforce that refusal through takeover defenses, because of threats to nonshareholder interests. That refusal, as well as the decision to consider nonshareholder interests in the first place, would be protected by the business judgment rule.

Courts are unlikely to adopt this interpretation. For one thing, it is inconsistent with the plain language of the statutes. No statute authorizes directors to ignore shareholder interests. Instead, the statutes merely authorize directors to consider a variety of additional interests. The right to consider a wider variety of interests does not equal a right to ignore the shareholders' interests. To the contrary, most statutes either explicitly or implicitly oblige directors to consider shareholder interests. Connecticut, Idaho, Mississippi, New Mexico, Ohio, and Wyoming expressly require directors to consider shareholder interests. In contrast, however, except for Connecticut, those statutes are merely permissive with respect to stakeholders.[92] A number of other states use a formulation providing that non-

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[90] Amanda Acquisitions Corp. v. Universal Foods Corp., 708 F.Supp. 984, 1009 (E.D.Wis.), aff'd on other grounds, 877 F.2d 496 (7th Cir.), cert. denied, 493 U.S. 955 (1989).

[91] *Id.* at 1012-13.

[92] CONN.GEN.STAT.ANN. § 33-313(e) (West 1990); IDAHO CODE § 30-1602 (1990); MISS.CODE ANN. § 79-4-8.30(d) (1990); N.M.STAT.ANN. § 53-11-35(D) (Michie 1990); OHIO REV.CODE ANN. § 1701.59(E) (Anderson 1990); WYO.STAT. § 17-16-830 (1989).

shareholder interests may be considered "in addition to shareholder interests" or making reference to the "best interests of the corporation and its shareholders."[93] At a minimum, these formulations [**990**] recognize the continuing importance of shareholder interests in corporate decision-making.

Second, this interpretation would essentially eliminate all vestiges of management accountability without any corresponding gains in, for example, protection of nonshareholder constituents. If directors are entitled to ignore shareholder interests, the directors' fiduciary duties are rendered meaningless. No meaningful legal mechanism would remain to hold managers accountable to shareholders. At the same time, because the statutes create no fiduciary duties running to nonshareholder constituencies and are not enforceable by them,[94] management could not be held accountable by stakeholders. Accordingly, this interpretation would result in unbridled management discretion.

Similarly, and even more importantly, in light of the traditional primacy of shareholder interests, this interpretation would amount to a total rejection of corporate law's basic normative principle. Surely the legislatures would have spoken more clearly had they intended such a dramatic change in the law.[95] This is not to say that the statutes codify shareholder wealth maximization as the sole, or even the principal, guiding norm of corporate decision-making. To the contrary, the statutes do modify shareholder wealth's traditional position at the top of the cor-

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[93] ARIZ.REV.STAT.ANN. § 10-1202.A (1987); FLA.STAT.ANN. § 607.0830(3) (West 1991); GA.CODE ANN. § 22-202(b)(5) (Harrison 1989); HAW.REV.STAT. § 415-35 (1990); IND.CODE ANN. § 23-1-35-1 (West 1990); IOWA CODE § 490.1108 (1990); KY.REV.STAT.ANN. § 271B.12-210(4) (Baldwin 1990); LA.REV.STAT.ANN. § 92(G) (West 1991); ME.REV.STAT.ANN. tit. 13-A, § 716 (West 1989); MASS.ANN.LAWS ch. 156B, § 65 (Law.Co-op.1990); MINN.STAT.ANN. § 302A.251 (West 1991); N.J.STAT.ANN. § 14A:6-1 (West 1990); N.Y.BUS.CORP.LAW § 717(b) (Consol.1991); OR.REV.STAT. § 60.357(5) (1990); 15 PA.CONS.STAT. § 1715-16 (Supp.1991); R.I.GEN.LAWS § 7-5.2-8(a) (1990); WIS.STAT.ANN. § 180.0827 (West 1991). In the absence of some such formulation, of course, a more tenable argument can be made for an interpretation permitting directors to ignore, or at least subordinate, shareholder interests. In light of the strong tradition of shareholder primacy, however, such an interpretation seems unlikely unless the legislatures speak more clearly. *See infra* notes 95-96 and accompanying text.

[94] *See supra* note 86 and accompanying text.

[95] The legislative history of these statutes suggests that most legislators thought they did not significantly change current law. *See infra* notes 100-103 and accompanying text. But see Millon, *supra* note 15, at 277 ("It is conceivable that the directors' duty statutes herald the beginnings of a radically different understanding of corporate law and corporate purpose."); Newlin & Gilmer, *supra* note 86, at 123 n. 53 (speculating whether nonshareholder constituency statutes "will be seen as an historic shift from corporate decisions being made on a purely economic basis to such decisions being made after taking into account various community and other interests.").

poration's list of priorities.[96] The point here is only that, absent clearer legislative guidance, courts are unlikely to read these vague statutes as rendering shareholders wholly irrelevant.

At the other end of the spectrum of possible interpretations is the view that the statutes merely codify the existing common law rules.[97] [**991**] Under this approach, the statutes have no new content and, in particular, do not affect the shareholder wealth maximization norm. If so, courts properly could look to cases like *Dodge* and *Revlon* for guidance in applying nonshareholder constituency statutes.[98]

This interpretation is even less likely to prevail than the preceding one. If the statutes do nothing more than codify current law, with no changes at all, why did the legislatures of well over half the states bother adopting them?[99] Presumably, the statutes do something more than merely enshrine the status quo ante.

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[96] *See infra* notes 100-110 and accompanying text. The Indiana and Pennsylvania statutes are exceptional not only because they mandate review under the business judgment rule, but also because they provide that a board need not consider shareholder interests as taking precedence over stakeholder interests. But even these extreme formulations do not go so far as to render shareholders wholly irrelevant. *See infra* note 109 and accompanying text.

[97] A leading proponent of this interpretation is the ABA Committee on Corporate Laws. ABA Committee, *supra* note 69, at 2263-68. The principal basis advanced by the Committee for its position, however, is its desire to maintain the unchallenged primacy of shareholder interests, *id.* at 2269, a goal the statutes reject. *See infra* notes 100-110 and accompanying text. The ABA Committee did advance one rather convoluted statutory interpretation argument for this interpretation. The committee noted that many statutes use a formulation stating "that the directors in considering the best interests of the corporation may take into account other constituencies." ABA Committee, *supra* note 69, at 2265 (emphasis omitted). The ABA Committee then equates the corporation's best interests with corporate profit and shareholder gain. *Id.* There are many problems with this argument. First, the committee's description of the formulation used by many states is incomplete. The typical formulation refers to the interests of the corporation and its shareholders, which suggests that the corporation's best interests and the shareholders' best interests may be different. Second, their sole authority for this approach is the American Law Institute's corporate governance project. *See* ALI PROJECT, *supra* note 19. That project has been highly controversial. Finally, and perhaps most damningly, just one page after making the foregoing argument, the ABA Committee acknowledges that legislatures normally "do not adopt statutes that merely confirm the state of existing law." ABA Committee, *supra* note 69, at 2266. It is difficult to reconcile that statement with the Committee's claim that the nonshareholder constituency statutes merely codify the preexisting common law.

[98] An eminent practitioner has noted an alternative interpretation pursuant to which the statutes codify all of the pre-existing law, except for *Revlon*'s restrictions on consideration of stakeholder interests in the structural context. *See* James J. Hanks, Playing with Fire: Nonshareholder Constituency Statutes in the 1990s, 21 STETSON L.REV. 97, 107 (1991). *See infra* notes 100-115 and accompanying text (rejecting this interpretation for different reasons).

[99] True, some statutes are intended to codify existing law. Moreover, there is an old canon of statutory construction pursuant to which "[n]o statute is to be construed as altering the common

Admittedly, the legislative history in some states suggests that the statutes were not seen as a dramatic departure from the common law [**992**] standards.[100] One possible explanation for these statements is legislative misunderstanding of the common law standards. As seen in Part I, the common law in almost all states requires directors to maximize shareholder wealth. While that requirement has real teeth only in the structural context, it applies to all corporate decisions. In contrast, the legislative history frequently reflects a belief among the statutes' supporters that the common law allows directors to make trade-offs between shareholder and stakeholder interests. To the extent the common law allows such trade-offs, however, it does so only because the business judgment rule shields most board decisions from judicial-review. Where the business judgment rule does not apply in full force, as in the structural context, such trade-offs are sharply restricted.

In any case, the statutes' supporters were not principally concerned with endorsing the pre-existing common law. The Ohio legislative history, for example, states:

> The Committee believes that Ohio law presently permits a director to take into account interests other than those of shareholders; however, the

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law, farther than its words import. It is not to be construed as making any innovation upon the common law which it does not fairly express." Shaw v. Railroad Co., 101 U.S. 557, 565 (1879). On the other hand, "most statutes that affect the common law are enacted for the very purpose of changing it." REED DICKERSON, THE INTERPRETATION AND APPLICATION OF STATUTES 206 (1975). In addition, "[w]hile the canon strictly construing statutes in derogation of the common law has never been repudiated, we believe it has generally become subordinate to the canon liberally construing remedial statutes." WILLIAM ESKRIDGE & PHILLIP FRICKEY, CASES AND MATERIALS ON LEGISLATION: STATUTES AND THE CREATION OF PUBLIC POLICY 656 (1988). Being remedial legislation designed to protect the interests of nonshareholder corporate constituents, the statutes should be broadly construed to effect that goal. Finally, both the legislative context of the statutes and their plain language suggest that they do something more than just codify the pre-existing common law. *See infra* notes 100-110 and accompanying text.

[100] In supporting the Pennsylvania nonshareholder constituency statute adopted in 1990, for example, several Pennsylvania legislators argued that the law would not eliminate the rights of shareholders or fundamentally change the fiduciary duties of corporate directors. *See, e.g.*, Pa.Legis.J., House, Apr. 3, 1990, at 548 (Rep. Bortner); *id.* at 779 (Rep. Bortner); Pa.Legis.J., Sen., Dec. 12, 1989, at 1508 (Sen. Williams). Similar views had been expressed in 1983 by the drafters of Pennsylvania's original nonshareholder constituency statute. *See* Charles J. Dangelo, Comment, Community Effects as a Factor in Corporate Decisions under Pennsylvania's New Business Corporation Law: Objective Evidence of a Subjective Process, 28 DUQ.L.REV. 533, 536 (1990).

> Committee believes that it is desirable to specify and clarify the breadth of interests which a director may consider.[101]

This statement, like similar comments in other states,[102] is principally a legislative endorsement of board power to protect stakeholder interests. Thus, the controlling legislative intent is not a desire to codify the existing common law, but rather a desire to ensure that directors can weigh nonshareholder interests in making corporate decisions. To the extent that the common law rules limit the board's power in that respect, as *Revlon*, for example, clearly does, the statutes should be seen as derogating from the common law.[103] There-[**993**] fore, courts should not treat the statutes as codifying *Dodge* and *Revlon*, but rather as allowing directors greater freedom to reallocate gains and losses amongst the corporation's various constituencies.

The argument that the statutes simply codify the pre-existing common law is also undercut by the context in which they were adopted. Like most state takeover laws, nonshareholder constituency statutes are typically adopted at the request of target corporation management actively engaged in resisting a hostile takeover bid. Unquestionably, the legislative intent was to make takeovers harder.[104] What better way do so than by tempering the shareholder wealth norm exemplified by *Revlon*?[105] This interpretation is especially apt for those statutes that expressly

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[101] Addendum to Report of the Corporation Law Committee, Ohio State Bar Ass'n Rep. 540 (1984), quoted in Charles Hansen, Other Constituency Statutes: A Search for Perspective, 46 BUS.LAW. 1355, 1357 (1991).

[102] The legislative history in Pennsylvania and Maine, for example, includes similar statements. *See* Hansen, *supra* note 101, at 1357-58. The legislative history in New York goes even further, explicitly qualifying the shareholder wealth maximization norm. *See* Hanks, *supra* note 98, at 107.

[103] This interpretation is supported by the legislative history in those states where the drafters viewed the common law more realistically. As the Florida legislature recognized, for example, "under present law there remains a potential for objection to a director's consideration of factors that are not directly related to the corporation's interest only." Florida State Committee on Commerce, Senate Staff Analysis and Economic Impact Statement on SB 0864, 2 (Apr. 28, 1989), quoted in Hansen, *supra* note 101, at 1358.

[104] In a legislative debate on Pennsylvania's latest package of takeover laws, which included a new nonshareholder constituency statute, one of the bill's sponsors observed, "To Sam Belzberg, to Carl Icahn, to Boone Pickens, to the Bass Brothers, to Don Trump and all you other corporate raiders, you do not have a friend in Pennsylvania." Pa.Legis.J., Sen., Dec. 13, 1989, at 1539 (Sen. Armstrong). *See also id.* at 1507 ("legislation in defense from corporate raiders is no vice") (Sen. Williams); Pa.Legis.J.House, Apr. 24, 1990, at 778 ("By passing this antitakeover measure, we will send a loud and clear message to those who would make our Pennsylvania corporations simple, quick-profit chop shops, and that is, Pennsylvania is no longer your playground.").

[105] Professors Johnson and Millon have argued that state takeover laws are generally intended "to protect nonshareholders from the disruptive impact of ... hostile takeovers." Lyman Johnson & David Millon, Missing the Point About State Takeover Statutes, 87 MICH.L.REV. 846, 848

permit directors to consider the corporation's long-term interests even in takeover contests. These statutes can only be read as implicitly rejecting *Revlon*'s command that short-term shareholder wealth maximization be the director's sole concern once a corporate control auction begins.

The rejection of *Revlon* implicit in most statutes is made explicit by Indiana's nonshareholder constituency statute, the first statute to squarely face this problem. The legislation was obviously drafted in response to a pair of Seventh Circuit decisions striking down a series of poison pills adopted by a target corporation.[106] Because Indiana [**994**] had no applicable precedents, the Seventh Circuit looked to *Unocal* and *Revlon* for guidance. Specifically, the court followed *Revlon* by requiring that a target board's takeover decisions promote "the goal of stockholder wealth maximization."[107] The Indiana nonshareholder constituency statute was specifically intended to reverse that approach, giving courts astonishingly blunt guidance:

> Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article.[108]

Revlon is the statute's clear target, for it goes on to expressly reject the primacy of shareholder interests: "directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as

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(1989) (emphasis in original). Whether or not this claim is true of state takeover laws generally, it is difficult to reject as to nonshareholder constituency statutes. *See* ROBERT D. ROSENBAUM & L. STEVENSON PARKER, THE PENNSYLVANIA TAKEOVER ACT OF 1990: SUMMARY AND ANALYSIS 28-30 (1990) ("The basic argument made in support of the new [Pennsylvania] stakeholder provision was that public corporations are and should be more than vehicles to generate maximum profits— particularly in the short term—for shareholders.").

[106] Dynamics Corp. v. CTS Corp., 805 F.2d 705 (7th Cir.1986), prior op., 794 F.2d 250 (7th Cir.1986), rev'd on other grounds, 481 U.S. 69 (1987). This takeover battle went on to fame as CTS Corp. v. Dynamics Corp., 481 U.S. 69 (1987), in which the Supreme Court upheld the constitutionality of a different Indiana takeover statute. No decision to date has squarely addressed the constitutionality of nonshareholder constituency statutes. In the course of upholding a different type of state takeover statute, however, Judge Easterbrook offered the following noteworthy dictum: "States could choose to protect 'constituencies' other than stockholders." Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 500 n. 5 (7th Cir.), cert. denied, 493 U.S. 955 (1989).

[107] *Dynamics*, 794 F.2d at 256.

[108] IND.CODE ANN. § 23-1-35-1(f) (West 1990).

a dominant or controlling factor."[109] Moreover, the board's determinations in this respect are conclusive unless a challenger proves that the board did not act "in good faith after reasonable investigation."[110]

In sum, neither of the foregoing extremes is likely to gain widespread acceptance. Rather, the correct interpretation lies somewhere in the middle. But where?

At a minimum, if the statutes do anything beyond merely codifying present law, they presumably permit directors to select a plan that is second-best from the shareholders' perspective, but which alleviates the decision's impact on the firm's nonshareholder constituencies.[111] [**995**] In other words, the directors may balance a decision's effects on shareholders against its effect on stakeholders. If the decision would harm stakeholders, the directors may trade-off a reduction in shareholder gains for enhanced stakeholder welfare.

This interpretation is virtually compelled by the statutory language. What purpose is there in giving the directors the right to consider nonshareholder interests if the directors cannot protect those interests? Without the right to act on their deliberations, the right to include stakeholder interests in those deliberations is rendered nugatory. If the statutes are to have any meaning, they must permit directors to make some trade-offs between their various constituencies.

Recognizing that the nonshareholder constituency statutes authorize such trade-offs, however, does not answer the question of how courts should review the directors' decision. One possible answer is suggested by the Indiana statute. Courts might simply apply the business judgment rule to all decisions, both operational and structural.

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[109] *Id.*

[110] *Id.* § 23-1-35-1(g). Pennsylvania's new nonshareholder constituency statute largely tracks the Indiana statute. Like the Indiana law, Pennsylvania's makes the board's determinations conclusive unless a challenger proves that the board did not act "in good faith after reasonable investigation." 15 PA.CONS.STAT. § 1721 (Supp.1991). Similarly, Pennsylvania also precludes courts from imposing any burden greater than the business judgment rule on directors seeking to justify takeover defenses. *Id.* Finally, the Pennsylvania statute does not require directors to treat any corporate constituency interest as having paramount importance. *See id.* Although Pennsylvania omitted any direct reference to Delaware law, the prohibition on imposition of a higher standard of review is clearly intended to follow Indiana in precluding courts from adopting *Unocal* or *Revlon*.

[111] *Cf.* Hanks, *supra* note 15, at 21 (stating that "the real purpose of non-stockholder constituency statutes must be to enable directors to provide benefits to non-stockholder groups even when doing so would not benefit the stockholders."); Millon, *supra* note 15, at 266 (the statutes "should be read as an effort to deny shareholders the power to realize short-term profits at the expense of management's discretion to pursue longer-term strategies from which both shareholders and nonshareholders might benefit."); Morey W. McDaniel, Stockholders and Stakeholders, 21 STETSON L.REV. 121, 137-38 (1991) (statutes permit directors to pursue a "dual goal" of maximizing shareholder gains, while minimizing stakeholder losses).

The business judgment rule, however, is an inappropriate standard for situations implicating the directors' duty of loyalty. Constraining corporate directors and officers from pursuing their own self-interest at the expense of the firm's interest has long been one of corporate law's central purposes. Indeed, one is hard pressed to find more forceful judicial rhetoric than that used in self-dealing cases:

> While technically not trustees, [officers and directors] stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty.... The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[112]

Courts (and most legislatures too) have thus consistently refused to extend the business judgment rule to situations where self-dealing is likely. Rather, in such situations, directors are held to a very high standard. A director charged with usurping a corporate opportunity, for example, must "show that his every act ... was in the exercise of [**996**] the utmost good faith" towards the corporation.[113] In interested director transactions, absent an effective ratification by the disinterested directors or the shareholders, the interested director must show that the transaction is fair to the corporation.[114]

Nonshareholder constituency statutes obviously are intended to permit consideration of stakeholder interests, and, at the same time make hostile takeovers more difficult. Moreover, it is clear that the corporate managers who supported these statutes expected them to help protect incumbent target management. But theirs is not the controlling intent. There is no support in the legislative history for the proposition that the legislatures intended to reject corporate law's long-standing concern with preventing selfish director conduct; nor is there any basis for claiming that the legislatures wished for such conduct to go unreviewed.[115] Courts out-

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[112] Guth v. Loft, 5 A.2d 503, 510 (1939).

[113] *Id.* at 512.

[114] Cohen v. Ayers, 596 F.2d 733, 739-41 (7th Cir.1979).

[115] *Cf.* Millon, *supra* note 15, at 251 (stating that nonshareholder constituency statutes do not preclude shareholder litigation based on management conflict of interests). In the 1983 legislative debate over Pennsylvania's original nonshareholder constituency statute, one state senator objected that the proposed statute "could protect poor management rather than benefitting shareholders." Dangelo, *supra* note 100, at 536. The bill's principal sponsor reported that the statute "was meant to benefit shareholders as well as the members of the enumerated classes" of stakeholders. *Id.* A student commentator summarized the legislative intent by arguing that the Pennsylvania statute's drafters intended "to benefit shareholders as well as the other corporate constituencies," not "to protect poor corporate management." *Id.*

side of Indiana and Pennsylvania should therefore be free to develop an interpretation that allows directors to consider nonshareholder interests, but also meaningfully constrains self-interested director behavior.

III. A CONFLICT OF INTEREST INTERPRETATION OF NONSHAREHOLDER CONSTITUENCY STATUTES

Absent explicit legislative direction, such as that provided by the Indiana statute, judicial interpretations of the nonshareholder constituency statutes should focus on the likelihood that directors are using the statutes as a cloak for their own self-interest. Where the likelihood of self-dealing is low, the business judgment rule provides an appropriate standard. But where it is likely that directors will act in their own interest, rather than those of shareholders or stakeholders, [997] a higher standard will be necessary.[116]

A. *Operational Decisions and Nonshareholder Interests*

Assume the XYZ Company operates a manufacturing plant nearing obsolescence in an economically depressed area. XYZ's board of directors is considering three plans for the plant's future. Plan A will keep the plant open, which will pre-

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Consider also that in most nonshareholder constituency statutes corporate officers are the one group conspicuously absent from the laundry list of nonshareholder interests a board may properly consider. To some extent, of course, corporate officers may be subsumed within the broader employee category. That corporate officers were not broken out as a separate category undoubtedly reflects on a political decision by the drafters to focus on the interests of rank and file workers. Having done so, however, they surely can not be heard to object if courts review board decisions to insure that it is in fact the rank and file workers who will benefit from the decision and not senior management alone.

[116] For purposes of developing the arguments in this section, it is assumed that the interests of all nonshareholder constituencies converge. In the real world, of course, that assumption is unlikely to hold true. To take but one example, consider a plant closing occasioned by shifting production from the high labor cost environment of the United States to a lower labor cost site in a developing country. The firm's United States workers and the local community are injured, but the developing country is benefited, customers will have lower product costs, and creditors may be more secure. The probability of these sorts of divergences at least justifies, if it does not explain, the legislative decision to give management broad discretion. In any event, it strains credulity to interpret the statutes as contemplating any restrictions on management's discretion in this regard. Accordingly, the model proposed in this Article follows the clear legislative guidance by giving management full discretion in deciding which stakeholder interests to consider and in deciding how to balance those interests when they conflict. Under this approach to interpreting the statutes, this essentially unbridled management discretion is not particularly troubling. As long as management is precluded from preferring their own interests, management's evaluation of the competing interests affected by a proposed corporate action is no different than any other business decision they make.

serve the jobs of two hundred fifty workers, but will reduce earnings per share by ten percent as long as the plant remains open. Plan B will close the plant immediately, which will put the two hundred fifty plant employees out of work in an area where manufacturing jobs are scarce, but will cause earnings per share to rise by ten percent. Plan C contemplates closing the plant, but implementing a job training and relocation program for its workers as a supplement to state-provided programs. Plan C will cause a ten percent reduction in earnings per share for one year.

A shareholder threatens to bring a derivative action against the directors charging breach of their duty of care if they pick any plan other than Plan B. Under traditional corporate law principles, XYZ's board is required to choose the plan that maximizes shareholder wealth: Plan B.[117] However, because the statutes permit directors to balance shareholder and stakeholder interests, the board should be [**998**] free to adopt either Plan A or Plan C without fear of liability if a shareholder challenges the board's decision.

As a practical matter, however, the result would be no different under traditional common law rules. The business judgment rule undoubtedly would preclude judicial review of the board's decision. Wrigley's stubborn opposition to lights probably cost the shareholders money over the short term, but the business judgment rule prevented Shlensky's lawsuit from even coming up to bat.[118] The same was true with respect to Ford's concern for his workers and customers.[119] Just so, the business judgment rule would shield XYZ's decision from judicial review. In theory, of course, absent a nonshareholder constituency statute, a shareholder might be able to rebut the business judgment rule's presumption of good faith and hold directors liable for considering nonshareholder interests.[120] In

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[117] *See supra* notes 20-42 and accompanying text. Under the ALI's proposed formulation, the board would be obliged to close the plant, but would be permitted to "make reasonable provision to cushion the transition of long-term employees who are about to be discharged." ALI PROJECT, *supra* note 19, at 84.

[118] *See supra* notes 33-41 and accompanying text (discussing Shlensky v. Wrigley, 237 N.E.2d 776 (Ill.App.Ct.1968)).

[119] *See supra* notes 20-30 and accompanying text (discussing Dodge v. Ford Motor Co., 170 N.W. 668 (Mich.1919)).

[120] The rules governing derivative suits will normally keep things from getting that far. Suppose that the board of directors made a decision based on stakeholder, rather than shareholder, interests. A shareholder sues (necessarily derivatively) for breach of fiduciary duty. If the case is brought under New York law, demand will be excused on the grounds that a majority of the board participated in the challenged wrongdoing. *See* Barr v. Wackman, 329 N.E.2d 180 (N.Y.1975). The defendant board will thereupon appoint a special litigation committee. To no one's surprise, the committee will recommend dismissal. *See* James D. Cox, Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, 1982 DUKE L.J. 959, 963 (out of 20 special litigation cases, the committee recommended litigation in only one

practice, however, cases in which the business judgment rule does not shield operational decisions from judicial review are so rare as to amount to little more than aberrations. Therefore, the defendant board normally will prevail regardless of whether the state has a nonshareholder constituency statute. In sum, the probability of holding directors liable for operational decisions was so low before non-[**999**] shareholder constituency statutes came along that the statutes could not further lower it.[121]

This result is tolerable because most operational decisions do not pose much of a conflict between the interests of directors, shareholders, and stakeholders. Granting, for example, that Ford and Wrigley appear to have preferred their stakeholders' interests to those of their shareholders, what selfish interests were Ford and Wrigley advancing? They probably were simply trying to comply with what they saw as appropriate business ethics. At most, perhaps they reaped psychological benefits from implementing their paternalistic attitudes towards stakeholders.

Even assuming arguendo that these sort of psychological benefits implicate the kinds of duty of loyalty concerns that justify setting aside the business judgment rule, it is not clear that Ford's or Wrigley's "self-interest" conflicted with the interests of their shareholders. With their theoretically perpetual duration, corporations must plan for the long term.[122] Considering a decision's impact on non-

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instance). So long as the committee was independent and used adequate procedures, the court will defer to its recommendation and the case will be dismissed. *See* Auerbach v. Bennett, 393 N.E.2d 994 (N.Y.1979).

Under Delaware law, the other leading standard in this context, demand will be required unless the plaintiff alleges specific facts creating a reasonable doubt that: (1) a majority of the directors are (a) disinterested, and (b) independent; or (2) the challenged transaction was a valid business judgment. *See* Grobow v. Perot, 539 A.2d 180, 186 (Del.1988). In other words, it is not enough to allege that the directors approved the challenged transaction. Rather, the plaintiff must allege an improper motive or conflict of interest affecting a majority of the board or allege facts showing the transaction to be so egregious on its face that it cannot be regarded as a valid business decision. *See* Levine v. Smith, 591 A.2d 194, 205-06 (Del.1991). This is a very difficult standard to meet and, in most cases, demand will therefore be required. If demand is required, the board will probably refuse demand. If so, its refusal will be reviewed under the business judgment rule. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 784 n. 10 (Del.1981). In all probability, the board's decision to terminate the litigation will therefore be upheld.

[121] Moreover, many states have now adopted director liability statutes that limit a board of directors' exposure to monetary damages for violations of the duty of care. *See supra* note 68. This development virtually precludes director liability in the operational context, absent self-dealing or other unusual circumstances.

[122] Accordingly, directors may pursue plans that are in the corporation's "best interests without regard to a fixed investment horizon." Paramount Comm., Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del.1989).

shareholder constituencies may sometimes produce short-term shareholder losses, but still ultimately prove to be in the shareholders' best long-term interests.[123]

It is possible, for example, to construct a plausible argument that Wrigley's opposition to lights was in the shareholders' best long-term interest. Drunken fans reveling in the darkness might have had a deleterious effect on the neighborhood. If so, attendance might decline as the neighborhood declined.[124]

[**1000**] Equally plausible arguments can be made for most corporate decisions, including Ford's and the hypothetical XYZ board's. Both situations unquestionably involve short-term shareholder losses. Ford Motor Company was selling all the cars it produced, so any reduction in prices necessarily reduced profits. XYZ's Plan C requires the corporation to expend funds on former employees, for example, which is stipulated to result in a substantial one year reduction in earnings. In both cases, however, the plan should generate favorable publicity. Employee morale should improve with commensurate gains in productivity.[125] A variety of other benefits might be reaped. The short-term earnings hit thus should pay long-term benefits.

The classic example of this phenomenon is corporate charitable giving. General Motors ("GM") shareholders get no direct monetary benefit when GM funds Public Broadcasting Station ("PBS") programs; moreover, the shareholders have no voice in which programs GM funds. As the theory goes, however, charitable giving produces good will and favorable publicity. In effect, charitable giving is simply another form of advertising.[126] As such, it ultimately results in more business and higher profits.[127]

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[123] In re TW Services, Inc. Shareholders Litigation, Fed.Sec.L.Rep. (CCH) ¶ 94,334 (Del.Ch.1989); ALI PROJECT, *supra* note 19, at 68; William J. Carney, Does Defining Constituencies Matter?, 59 U.CIN.L.REV. 385, 421-22 (1990); Lyman Johnson, The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct, 14 J.CORP.L. 35, 43 (1988).

[124] Noting that "the effect [of night baseball] on the surrounding neighborhood might well be considered by a director," the court said "the long-run interest" of the firm "might demand" efforts to preserve the local community from those effects. Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill.App. 1968). *See also* In re Reading Co., 711 F.2d 509 (3d Cir.1983) (corporate pricing and dividend policies that failed to maximize short-term profits nevertheless could rationally be seen as in corporation's long-term interest).

[125] *Cf.* PETER F. DRUCKER, CONCEPT OF THE CORPORATION 182, 182-91 (rev. ed. 1972) (worker productivity enhanced when employees given opportunities for flexibility and creativity); Lewis D. Solomon, Humanistic Economics: A New Model for the Corporate Constituency Debate, 59 U.CIN.L.REV. 321, 342-46 (1990) (worker participation in corporate decision-making makes workers more productive).

[126] The most persuasive objection to this argument is the oft-made observation that the charities supported by most corporations tend to be rich people's charities: art, music, public television, and the like. One can question how big a bang a company gets for its advertising buck in giving to

Board concern with stakeholder interests thus need not be inconsistent with its traditional duty to maximize shareholder wealth. Over a very broad spectrum of corporate actions, a decision that benefits stakeholders is likely to benefit shareholders as well. The fact that the directors feel good about themselves for having made such a decision hardly seems like the kind of self-dealing that justifies heightened judicial scrutiny.

In the operational context, moreover, directors are subject to a variety of extra-judicial constraints, which give directors strong incentives to ensure that a board decision to benefit stakeholders will also redound to the shareholders' benefit, thus eliminating the need for exacting judicial review. Operational decisions are species of what economists refer to as repeat transactions. Where parties expect to have repeated transactions, the risk of self-dealing by one party is constrained by the threat that the other party will punish the cheating [**1001**] party in future transactions. Just so, in the operational context, self-interested management is subject to shareholder discipline. Indeed, the system biases directors to favor shareholders: directors are elected by shareholders, not stakeholders;[128] management compensation is often linked to stock performance; and directors owe fiduciary duties to shareholders, not stakeholders. The markets for corporate control and managerial services, in addition to a variety of other extra-judicial forces, also constrain management's ability to structure corporate transactions for its own benefit.[129] As a result, even though one suspects that directors routinely consider a decision's effect on nonshareholder constituents, boards of directors rarely make operational decisions demonstrably contrary to shareholder interests.[130]

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those charities. However, this is an implementation problem, which can be fixed. It is not a flaw in the basic theory.

[127] For critiques of this argument, see Davis, *supra* note 19, at 11-19; Lyman Johnson, The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law, 68 TEX.L.REV. 865, 901-02 (1990).

[128] While shareholders voting directors out of office traditionally has been regarded as merely a theoretical possibility, the growing importance of institutional investors and various related developments is helping to make it more of a reality. *See* Stephen M. Bainbridge, Redirecting State Takeover Laws at Proxy Contests, 1992 WIS.L.REV. (forthcoming); Bernard S. Black, SHAREHOLDER PASSIVITY REEXAMINED, 89 MICH.L.REV. 520 (1990); A.A. Sommer, Jr., Corporate Governance in the Nineties: Managers v. Institutions, 59 U.CIN.L.REV. 357 (1990).

[129] Carney, *supra* note 123, at 422. *See* generally Ronald A. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 STAN.L.REV. 819, 836-40 (1981); Millon, *supra* note 15, at 261-63.

[130] The ALI posits that "corporate decisions are not infrequently made on the basis of ethical considerations even when doing so would not enhance corporate profit or shareholder gain. Such behavior is not only appropriate, but desirable." ALI PROJECT, *supra* note 19, at 76. But, as a leading corporate law practitioner observes: "You're never going to see a set of board meeting minutes that say the directors have wittingly, knowingly and deliberately placed the interests of

True, these constraining forces do not eliminate the possibility of director error. The directors may still be wrong in concluding that a given decision benefits both shareholders and stakeholders. However, that is precisely the sort of error that the courts traditionally eschew reviewing. Accordingly, in applying nonshareholder constituency statutes to challenged operational decisions, courts should continue to review those decisions under the business judgment rule.

In sum, despite the considerable hand-wringing the statutes have generated, the nonshareholder constituency statutes' effect on review of operational decisions actually is quite limited.[131] Granted, the [**1002**] statutes modify the common law's rhetorical command to maximize shareholder wealth. Because the business judgment rule will continue to shield operational decisions from review, however, just as it did at common law, one might argue that the statutes do no more than to bring the law's rhetoric into line with its reality.[132]

B. *Structural Decisions and Nonshareholder Interests*

The preceding analysis of operational decisions rests on two basic assumptions: (1) stakeholder and shareholder interests normally coincide; and (2) directors are capable of objectively evaluating those interests. While neither of these assumptions necessarily holds true in structural decisionmaking, the latter is especially dubious in this context.

1. *The Impact of Structural Decisions on the Major Corporate Constituents*

The fundamental assumption underlying nonshareholder constituency statutes is that stakeholders, especially employees, are significantly worse off because of corporate takeovers.[133] This assumption is widely shared in our society. To cite

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the employees or the community ahead of shareholders." Panel Discussion, 59 U.CINN.L.REV. 467, 474 (1990) (statement of A.A. Sommer, Jr.).

[131] If this model is adopted, the legislative statements that the statutes would not change the pre-existing common law begin to make sense. Because the business judgment rule governed both at common law and under the statutes, the rhetorical changes worked by the statutes are essentially unimportant. The important question regarding who wins or loses remains unchanged. As the next Section postulates, however, those legislative statements remain wholly inapplicable to the structural context.

[132] Some may object that the traditional rhetoric is important as a forceful reminder of where the director's loyalty lies. Even if the rhetoric was unenforceable, it was an ever present goad. By removing it, the statutes may effectively encourage directors to depart from shareholder interests. If so, the statutes' main impact will not be a legal one, but rather a change in the psychology of board decision-making. As indicated in the text, however, most operational decisions do not pose significant conflicts between long-term shareholder and stakeholder interests.

[133] Opponents of state takeover legislation generally posit, that nonshareholder constituency statutes are not designed to protect stakeholders, but rather are designed to protect senior corporate

but one prominent example, the United States Catholic Bishops, in their controversial pastoral letter on economic justice, stated: "Corporate mergers and hostile takeovers may bring greater benefits to shareholders, but they often lead to decreased concern for the well-being of local communities and make towns and cities more vulnerable to decisions made from afar."[134] Polling data confirms that this sort of skepticism toward takeovers is widely shared.[135]

The Bishops' arguments, like those made by supporters of non-shareholder constituency statutes, pose two inextricably intertwined [**1003**] policy issues. First, do stakeholder and shareholder interests in fact diverge in the structural context? Second, are the duties of corporate directors an appropriate place to address that problem?

a. *Shareholders versus Stakeholders*

A wealth of anecdotal evidence suggests that stakeholders are harmed by corporate takeovers. Some commentators also propose a theoretical basis for so concluding. On close examination, however, neither argument is fully persuasive.

i. *The Anecdotal Evidence*

The AFL-CIO estimates that 500,000 jobs were lost as a direct result of takeover activity between 1983 and 1987.[136] According to The Wall Street Journal, between January 1984 and mid-July of 1985, there were ninety-eight operational restructurings of companies resulting from or following acquisitions, which affected approximately 557,464 employees.[137] In addition to lost jobs, takeovers may adversely affect employees in a variety of other ways. For example, acquiring companies frequently utilize funds taken out of the target company's pension plans to help finance the acquisition.[138] Because of these well known phenomena,

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managers. *See, e.g.*, Carney, *supra* note 123, at 423-24. This was almost certainly the intent of the lawyers who draft these statutes, but the limited legislative history that is available reflects a real concern for nonshareholder constituencies on the part of many legislators. *See supra* note 115.

[134] BISHOPS' LETTER, *supra* note 12, at 152.

[135] Roberta Romano, The Future of Hostile Takeovers: Legislation and Public Opinion, 57 U.CIN.L.REV. 457, 490-503 (1988).

[136] S.REP. NO. 265, 100th Cong., 1st Sess. 14 (1987). *See* generally O'Connor, *supra* note 15, at 1196-1203 (discussing impact of takeovers on target employees).

[137] Shifting Strategies, WALL ST. J., Aug. 12, 1985, at 1.

[138] One commentator identified the following examples of this phenomenon: Mobil obtained $29 million from the Superior Oil fund; Pantry Pride, $88 million from *Revlon*'s fund; Irwin Jacobs, $97 million from AMF's pension fund, nearly 20% of the total purchase price; Texaco, $250 million from the Cities Service pension fund. In conclusion, the commentator asked, "What is the long-range impact on the morale and productivity of the American work force, white collar

many employees quit immediately when a takeover bid is made; those who do not quit often are so distracted from their work that the company suffers anyway.[139] Peter Drucker thus spoke for many when he observed that "employees, from senior middle managers down to the rank and file in the office [**1004**] or factory floor, are increasingly being demoralized—a thoughtful union leader of my acquaintance calls it 'traumatized'—by the fear of a takeover raid."[140]

Corporate takeovers also affect the communities in which the corporation has plants and other facilities. In the wake of Boone Pickens' raid on Phillips Petroleum, for example, Phillips eliminated 2,700 jobs in its Bartlesville, Oklahoma headquarters. Because Bartlesville's population was only 36,000, this reduction devastated the local community.[141] Similar tales of woe could be told of many communities affected by takeover-related corporate restructurings.[142]

Highly-leveraged takeovers likewise affect the interests of bondholders and other corporate creditors. As the theory goes, pre-takeover creditors assessed the corporation's creditworthiness and set their loan terms based on the corporation's existing assets and debt-equity ratios. In a highly-leveraged acquisition, the raider finances the acquisition by borrowing against target corporation assets and/or selling target assets. This significantly lowers the corporation's creditworthiness, yet pre-takeover creditors are not compensated for this loss. Bondholders are particularly hard hit. Bond rating agencies routinely downgrade a corporation's

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as well as blue collar?" LEIGH B. TREVOR, HOSTILE TAKEOVERS—THE KILLING FIELD OF CORPORATE AMERICA, Address to the Financial Executives Institute, Mar. 11, 1986 at 15-16.

[139] Here Comes the "Tin" Parachute, DUN'S BUS. MONTH, Jan. 1987, at 62. According to one takeover specialist:

> [i]f there are wholesale firings or, as usually happens following a hostile takeover, many executives leave, the acquired business often loses momentum. The people who leave are usually key employees, and many of those who remain vegetate rather than make waves. Employee morale and efficiency decline. Productivity suffers, creativity fades. In time the damaged company is quietly "phased out" or, if it is salvageable, sold off.

Arthur Burck, The Hidden Trauma of Merger Mania, BUS. WEEK, Dec. 6, 1982, at 14.

[140] Peter P. Drucker, Taming the Corporate Takeover, WALL ST. J., Oct. 30, 1984, at 30.

[141] S.Rep. No. 265, 100th Cong., 1st Sess. 77 (1987) (separate views of Senators Sasser, Sanford, and Chaffee).

[142] *See, e.g.*, Newlin & Gilmer, *supra* note 86, at 111 (Gulf Oil's acquisition by Standard Oil of California estimated to have cost Pittsburgh 2,000 jobs and $2 million per year in lost charitable contributions).

pre-takeover bonds to reflect the firm's increased riskiness post-takeover. That downgrading immediately lowers the pre-takeover bonds' market value.[143]

ii. *A Contractarian Theory*

Recently, a number of commentators have advanced theoretical bases for the claim that takeovers are detrimental to nonshareholder corporate constituents. Typically, these theories build on the so-called nexus of contracts model of the corporation. Because they allow the anecdotal evidence recounted above to be generalized as indicative of the societal impact of corporate takeovers, these arguments have been used by some to justify director consideration of stakeholder interests in the decision-making process.

As the public corporation was traditionally conceptualized,[144] stock [**1005**] ownership is no different than any other species of private property. Shareholders own the company. Directors are fiduciaries employed by the shareholders to conduct the business on their behalf. If a board decision protects stakeholder interests by harming those of shareholders, the directors are quite literally stealing from the shareholders:

> In a free enterprise, private property system, a corporate executive is an employee of the owners of the business. He has a direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of society.... Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money.[145]

Because private property is such a profound part of the American ethos, this model's ethical implications strongly influence United States courts and lawmakers. The corporation is a thing, so it can be owned. The shareholders own the corporation, so directors are merely stewards of their interests. Because no one can serve two masters at the same time, if shareholder and stakeholder interests conflict, directors cannot be loyal to both constituencies. The board of directors' role as stewards requires it to prefer the interests of its shareholder masters.

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[143] McDaniel, *supra* note 86, at 206-09. Excessive takeover-related debt also purportedly produces a short-term focus by management that is detrimental to economic growth. *See* S.Rep. No. 265 at 73-75.

[144] Various theories of the firm have been advanced over the years. This Article describes the two leading candidates: the corporation as a thing; and the corporation as a nexus of contracts. For a useful overview of the broader debate over the nature of the firm, see David Millon, Theories of the Corporation, 1990 DUKE L.J. 201.

[145] Davis, *supra* note 8, at 41 (quoting Milton Friedman).

Although this argument has surface attraction, it depends upon the corporation being an entity capable of being owned. The traditional model reified the corporation by treating it as an entity separate from the various inputs making up the web. While reification is a necessary shorthand, it also is really all that permits one to think of the corporation as having owners.

The nexus of contracts theory of the firm rejects the traditional model. While the contractarian approach naturally obtains a somewhat different spin from each of its proponents,[146] all visualize the firm not as an entity but as an aggregate of various inputs acting together to produce goods or services. Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of loss and monitor the performance of management. Management monitors the performance of [**1006**] employees and coordinates the activities of all the firm's inputs. In this model, the firm is a legal fiction representing a complex set of contractual relationships. In other words, the firm is not a thing, but rather a nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm. Because shareholders are simply one of the inputs bound together by this web of voluntary agreements, ownership is not a meaningful concept under this model.[147] Each input is owned by some one, but no one input owns the totality.

The contractarian model potentially has profound implications for the relationship of shareholders and stakeholders. It arguably jettisons the ethical baggage inherent in the private property model, eliminating the principal basis for favoring shareholders over stakeholders. Most contractarians nevertheless remain devout believers in shareholder wealth maximization.[148]

For a few contractarians, however, the nexus of the contracts model provides a theoretical basis for protecting nonshareholder interests. As the basic argument goes,[149] many of the contracts making up the corporation are implicit and there-

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[146] *See* generally Frank A. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM.L.REV. 1416 (1989); Michael Jensen & William Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J.FIN.ECON. 305 (1976); Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J.POL.ECON. 288, 291-93; Eugene F. Fama & Michael Jensen, Separation of Ownership and Control, 26 J.L. & ECON. 301 (1983).

[147] John C. Coffee, Jr., Shareholders versus Managers: The Strain in the Corporate Web, 85 MICH.L.REV. 1, 16 (1986); Fama, *supra* note 146, at 290; Jonathan R. Macey, Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes, 1989 DUKE L.J. 173, 179; O'Connor, *supra* note 15, at 1204.

[148] *See, e.g.*, Frank A. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & ECON. 395, 403-06 (1983); Bengt Holmstrom, Comment, in CORPORATE TAKEOVERS 56 (Alan J. Auerbach ed. 1988); Macey, *supra* note 147.

[149] *See* generally Coffee, *supra* note 147; McDaniel, *supra* note 111, at 123-26; O'Connor, *supra* note 15, at 1203-22; Andrei Shleifer & Lawrence H. Summers, Breach of Trust in Hostile

fore judicially unenforceable. Some of these implicit contracts are intended to encourage stakeholders to make firm-specific investments. Consider an employee who invests considerable time and effort in learning how to do her job more effectively. Much of this knowledge will be specific to the firm for which she works. In some cases, this will be because other firms do not do comparable work. In others, it will be because her firm has a unique corporate culture. In either case, the longer she works for the firm, the more difficult it becomes for her to obtain a comparable position with some other firm.

An employee will invest in firm-specific human capital only if rewarded for doing so. An implicit contract thus comes into existence between employees and shareholders. On the one hand, employees promise to become more productive by investing in firm-specific human capital. They bond the performance of that promise by accepting long promotion ladders and compensation schemes that defer [**1007**] much of the return on their investment until the final years of their career. In return, shareholders promise job security.

While the employee-shareholder relationship is the paradigmatic implicit contract, other stakeholders supposedly make similar investments in firms. Communities, for example, often specialize around a given firm. The community receives a variety of services from the firm, but also provides the firm with a specialized infrastructure, tax breaks, and other benefits.

The long-term nature of the relationship between stakeholders and corporations forces the stakeholders to rely on implicit, rather than explicit, contracts.[150] Bargaining is costly, especially where future contingencies are hard to predict. The longer the contractual term, the more costly bargaining becomes. Implicit contracts can be readjusted as needed and thus save all the parties bargaining costs.

The implicit nature of these contracts, however, leaves stakeholders vulnerable to opportunistic corporate actions. Shareholders can protect themselves against opportunism by holding a fully diversified portfolio. By definition, the

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Takeovers, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, 33 (Alan J. Auerbach ed. 1988).

[150] Some commentators aver that stakeholders can protect themselves from the breach problem through explicit contracts, such as bond indenture trusts and union collective bargaining agreements, or through reliance on competitive markets for their services. *E.g.,* Carney, *supra* note 123, at 394-417; Hanks, *supra* note 15, at 25; Macey, *supra* note 147; 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, 36-43 (1991). This argument is too glib for other commentators, who point out that explicit contracting is always costly and in some cases, as in a non-unionized workplace, impractical. *E.g.,* O'Connor, *supra* note 15, at 1214-18; Katherine Stone, Employees as Stakeholders under State Nonshareholder Constituency Statutes, 21 STETSON L.REV. 45, 54-61 (1991).

stakeholder's investment in firm-specific human capital is not diversifiable. The shareholders' ready ability to exit the firm by selling their stock also protects them. In contrast, the stakeholder's investment in firm-specific human capital also makes it more difficult for them to exit the firm in response to opportunistic behavior.

As the theory goes, this vulnerability comes home to roost in hostile takeovers. In all hostile acquisitions, the shareholders receive a premium for their shares. Where does that premium come from? Recall that the employees' implicit contract involved delaying part of their compensation until the end of their careers. If the bidder fires those workers before the natural end of their careers, replacing them with cheaper young workers, or if the bidder obtains wage or other concessions from the existing workers by threatening to displace [**1008**] them or to close the plant, the employees will not receive the full value of the services they provided to the corporation. Accordingly, a substantial part of the takeover premium consists of a wealth transfer from stakeholders to shareholders.[151]

iii. *Summary*

In light of the foregoing arguments, public suspicion of hostile takeovers is not particularly surprising. Shareholders seem to be getting rich at the expense of rank and file employees and other stakeholders. Moreover, in light of the moral obligation to keep one's promises, shareholders appear to be acting immorally by breaching the implicit contracts they made with the stakeholders. When directors resist hostile takeover bids, they seem to be protecting their non-shareholder constituents from unethical shareholder behavior.

There are any number of problems with this thesis, however. For one thing, there simply is no good empirical evidence that any class of stakeholders is systematically harmed by takeovers. Granted, there is a wealth of anecdotal evidence that stakeholders are harmed by corporate takeovers. However, good news rarely makes headlines. Just so, good takeovers rarely become anecdotes.

In fact, there are few credible empirical studies of the effect of takeovers on nonshareholder constituents of target companies. The existing studies, most of which find little or no detrimental effect on stakeholders, must be approached with some caution, as all can be criticized on various grounds. One study, for example, found that takeovers had no adverse affect on bondholders.[152] But it in-

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[151] Of course, even proponents of this theory would not contend that this is the sole source of takeover premia. *See, e.g.*, John C. Coffee, Jr., The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups, 1988 WIS.L.REV. 435, 443-47 (describing sources of takeover premia).

[152] *E.g.*, Asquith & Kim, The Impact of Merger Bids on the Participating Firms' Security Holders, 37 J.FIN. 1209 (1982).

volved negotiated mergers rather than hostile takeovers and, moreover, antedated the wave of highly-leveraged bids in the 1980s. Another study found that takeovers had little effect on employee wages.[153] But its sample included only very small firms and data from only one state. In light of these flaws, relatively little can be said with confidence and firm conclusions cannot be drawn.

The theoretical justification for protecting nonshareholders is not unappealing, but is counterbalanced by sound theoretical arguments that stakeholders are not systematically harmed by takeovers. Takeovers resulting in wholesale purges of the blue collar work force are [**1009**] rare. Indeed, the firm's workers may actually benefit from a change of control. A fairly standard explanation for takeover premiums posits that the bidder profits by displacing inefficient incumbent managers. Another fairly standard explanation posits that the bidder reaps synergistic gains by meshing the target's business with its own. In either case, if the takeover makes the target firm more profitable and productive, the target's rank and file workers should have improved job security and higher wages.[154] The point is not that stakeholder and shareholder interests always converge in takeovers; sometimes they do diverge. The point is simply that there is no systematic conflict between stakeholders and shareholders; instead, analysis must proceed on a case by case basis.

All of this leads us to the second question posed at the beginning of this section: Are the fiduciary duties of target managers an appropriate place to address potential stakeholder injury? States adopting nonshareholder constituency statutes clearly have answered that question in the affirmative. In light of the foregoing analysis, proponents of nonshareholder constituency statutes might argue that there is no practical, general legislative solution to the risks posed by corporate takeovers. Instead, they might argue, each case must be analyzed on its own merits and no one is in a better position to make that analysis than the corporation's directors. The next section, however, suggests reasons to be skeptical about that line of reasoning. Indeed, when corporate managers resist hostile takeover bids, they are more likely to be looking out for their own interests than those of their shareholders or their stakeholders.

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[153] Charles Brown & James L. Medoff, The Impact of Firm Acquisitions on Labor, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 9 (Alan J. Auerbach ed. 1988).

[154] Admittedly, few labor leaders seem to see it this way. Nonshareholder "interests regularly join the clamor for protection from hostile bids and appreciate the fact that facing a rifle with one bullet (managerial latitude) is better than facing one with two (hostile bidders as well)." Lyman Johnson, Sovereignty Over Corporate Stock, 16 DEL.J.CORP.L. 485, 542 (1991) (footnote omitted).

b. *Shareholders and Stakeholders versus Managers*

Inherent in all corporate takeovers is a well-documented conflict between the interests of target managers and target shareholders. The tension between shareholders and managers is perhaps most obvious in hostile takeovers. Shareholders unquestionably benefit from a successful takeover. Successful bids produce positive abnormal returns for targets ranging from 16.9 percent to 34.1 percent, with a weighted average of 29.1 percent.[155] Moreover, target shareholders [**1010**] appear to capture the most of the gains, as abnormal positive returns to bidding firms range from 2.4 percent to 6.7 percent, with a weighted average of 3.8 percent. If a hostile takeover bid fails because of management resistance, the consequences to target company shareholders are thus quite severe.[156]

In contrast, incumbent target managers are the one group unarguably harmed by hostile takeovers. In today's hostile takeover environment, target directors and officers know that a successful bidder is likely to fire many of them.[157] Any defensive actions by management are thus tainted by the specter of self-interest. This may be so even if the directors are nominally independent outsiders. As Judge Posner explains:

> When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority.... No one likes to be fired, whether he is just a director or also an officer. The so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of the insiders, to whom they are likely therefore to defer.[158]

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[155] *See* Frank A. Easterbrook & Daniel R. Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 BUS.LAW. 1733 (1981); Frank A. Easterbrook & Gregg A. Jarrell, Do Targets Gain From Defeating Tender Offers?, 59 N.Y.U.L.REV. 277 (1984); Gregg A. Jarrell, James A. Brickley & Jeffry Netter, The Market for Corporate Control: The Empirical Evidence Since 1980, 2 J.ECON.PERSP. 49 (1988); Michael Jensen & Richard S. Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J.FIN.ECON. 5 (1983).

[156] Proponents of corporate takeovers generally argue that shareholders benefit not only directly from takeover premiums, but also indirectly because the disciplining effect of hostile takeovers encourages all corporate managers—not just those fighting off a takeover bid—to maximize shareholder wealth. Accordingly, they argue that any restrictions on takeovers eliminates an important check on management shirking and self-interest. *See* Clark, *supra* note 42, at 589-92.

[157] Kenneth J. Martin and John J. McConnell, Corporate Performance, Corporate Takeovers, and Management Turnover, 46 J.FIN. 671 (1991).

[158] Dynamics Corp. v. CTS Corp., 794 F.2d 250, 256 (7th Cir.1986), rev'd on other grounds, 481 U.S. 69 (1987).

Similar conflicts of interest arise in negotiated acquisitions. Because approval by the target's board of directors is a necessary prerequisite to most acquisition methods, the modern corporate statutory scheme gives management considerable power in negotiated acquisitions. To purchase the board's cooperation, the bidder may offer side payments to management, such as an equity stake in the surviving entity, employment or non-competition contracts, substantial severance payments, continuation of existing fringe benefits or other compensation arrangements.[159] Although it is undoubtedly rare for [**1011**] side payments to be so large as to materially affect the price the bidder would otherwise be able to pay target shareholders, side payments may affect management's decision-making by causing them to agree to an acquisition price lower than that which could be obtained from hard bargaining or open bidding.[160]

Even where management is not consciously seeking side-payments from the bidder, a conflict of interest can still arise:

> There may be at work [in negotiated acquisitions] a force more subtle than a desire to maintain a title or office in order to assure continued salary or perquisites. Many people commit a huge portion of their lives to a single large-scale business organization. They derive their identity in part from that organization and feel that they contribute to the identity of the firm. The mission of the firm is not seen by those involved with it as wholly economic, nor the continued existence of its distinctive identity as a matter of indifference.[161]

Although such motivations are understandable, they conflict with the shareholders' economic interests.

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[159] *E.g.*, Singer v. Magnavox Co., 380 A.2d 969 (Del.1977) (target directors offered employment contracts); Gilbert v. El Paso Co., 490 A.2d 1050 (Del.Ch.1984) (plaintiff alleged tender offeror modified bid to benefit target managers); Repairman's Service Corp. v. National Intergroup, Inc., No. 7811, slip op. (Del.Ch. Mar. 15, 1985), reprinted in 10 DEL.J.CORP.L. 902 (1985) (plaintiff claimed target managers sought "preferences for themselves" in surviving entity).

[160] *E.g.*, Pupecki v. James Madison Corp., 382 N.E.2d 1030 (Mass.1978) (plaintiff claimed that consideration for sale of assets was reduced due to side-payments to controlling shareholder); Barr v. Wackman, 329 N.E.2d 180 (N.Y.1975) (plaintiff claimed target directors agreed to low acquisition price in exchange for employment contracts).

[161] In re Time Inc. Shareholders Litigation Fed.Sec.L.Rep. (CCH) ¶ 94,514 at 93,268-69 (Del.Ch. July 14, 1989), aff'd Paramount Comm. Inc. v. Time Inc. sub nom. 571 A.2d 1140 (Del.1990). While a potential conflict of interest therefore is present in all negotiated acquisitions, that conflict is usually constrained by the threat of competing bids. *See* Bainbridge, *supra* note 57, at 275. But where the target board of directors seeks to preclude competitive bidding by granting a lock-up to the favored bidder, for example, a more intrusive standard of review is required. *See id.* at 323. Although the model developed below focuses on hostile takeovers, its application to negotiated acquisitions is described *infra* note 207.

Corporate acquisitions are thus a classic example of what economists refer to as "final period problems."[162] Recall that in repeat transactions the risk of self-dealing by one party is constrained by the threat that other party will punish the cheating party in future transactions. In a final period transaction, this constraint disappears. Because the final period transaction is the last in the series, the threat of future punishment disappears.

Just so, the various extrajudicial constraints imposed on management in the operational context break down in the structural context. As a result, management is no longer subject to either shareholder or market penalties for self-dealing.[163] Accordingly, in [**1012**] the structural context there is good reason to be skeptical of management claims to be acting in the shareholders' best interests.

The conflict between management and shareholder interests is especially troubling because it also provides a good reason to be skeptical of management claims to be acting in the stakeholders' best interests. Suppose, for example, that the hypothetical XYZ board receives a hostile takeover bid. The bidder's disclosure documents state its intention to close a target plant. The board rejects the bid, citing the bidder's plans for the plant. An honest concern for the threatened workers may have motivated the directors' decision. But so too may have a concern for their own positions and perquisites. Indeed, it is not at all hard to imagine a target board using nonshareholder interests as nothing more than a negotiating device to extract a higher acquisition price and/or side payments from the bidder.

In fact, all too many United States corporate directors are hypocritical about nonshareholder interests.[164] Many of the same directors who so vigorously lobby state legislators in favor of nonshareholder constituency statutes are equally vigorous in opposing plant closing laws and other worker protection statutes.[165] Many of the same directors who bewail the jobs lost after successful corporate takeovers are silent about the jobs lost because of management defensive tactics. Many of the same directors who champion stakeholder interests in disputes with shareholders champion shareholder interests in disputes with unions and other

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[162] RONALD J. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 579 (1986).

[163] *Id.* at 579; Carney, *supra* note 128, at 422-23.

[164] This is not to say that all directors who claim to be concerned for nonshareholder constituencies are hypocrites. While many directors are hypocritical, many are legitimately concerned for stakeholder welfare. The key point, however, is that all directors, hypocritical or not, have a conflict of interest. This is true even if the director honestly believes that he is acting in good faith. As Chancellor Allen has pointed out, "human nature may incline even one acting in subjective good faith to rationalize as right that which is merely personally beneficial." City Capital Assoc. v. Interco Inc., 551 A.2d 787, 796 (Del.Ch.) (emphasis omitted), appeal dismissed, 556 A.2d 1070 (Del.1988).

[165] O'Connor, *supra* note 15, at 1233.

constituencies. Indeed, the ultimate irony may be that much of the anecdotal evidence on stakeholder injury described above relates to employees fired after defensive restructurings used by incumbent managers to defeat a hostile bid.[166] In sum, as Judge Easterbrook put it, "no evidence of which we are aware suggests that bidders confiscate workers, and other participants' investments to any greater degree than do incumbents—who may (and frequently do) close or move plants to follow the prospect of profit."[167] [**1013**]

c. *Summary*

There is a very real possibility that unscrupulous directors will use nonshareholder interests to cloak their own self-interested behavior. Selfish decisions easily could be justified by an appropriate paper trail of tears over the employees' fate. This then is the real vice of nonshareholder constituency statutes. While they allow honest directors to act in the best interests of all the corporation's constituents, they also may protect dishonest directors who are acting solely in their own interest. All of this tends to suggest that legislatures ought to think twice about adopting nonshareholder constituency statutes without first addressing management's conflict of interest.[168]

This Article, however, is mainly concerned with the problems courts will face in interpreting the nonshareholder constituency statutes that are already on the books. What does the foregoing analysis tell such courts? The point is not that target directors have no role to play in corporate takeovers or that target directors should ignore stakeholder interests in making structural decisions. Whatever the theoretical merits of a rule requiring management passivity in the face of a hostile takeover bid,[169] the nonshareholder constituency [**1014**] statutes plainly reject any

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[166] For example, although much has been made of the lay-offs at Gulf Oil following Boone Pickens' attempted takeover of Gulf, Gulf had voluntarily eliminated over 15,000 jobs even before Pickens appeared on the scene. 20 Sec.Reg. & L.Rep. (BNA) 423-24 (1988).

[167] Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 500 n. 5 (7th Cir.), cert. denied, 493 U.S. 955 (1989).

[168] In particular, this Article's analysis suggests that legislatures should not follow Indiana and Pennsylvania's approach of limiting judicial review to the business judgment rule. Because business judgment review is wholly unsuited to cases involving conflicts of interest, this Article proposes a more exacting level of judicial scrutiny, which should deter much management misconduct and assist courts to capture misconduct when it occurs. By prohibiting such an approach, Indiana and Pennsylvania have precluded meaningful judicial review and allow management misconduct to go unsanctioned.

[169] Judge Easterbrook and Professor Fischel, are the leading proponents of the passivity approach. *See* Frank A. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV.L.REV. 1161 (1981); Frank A. Easterbrook & Daniel R. Fischel, Auctions and Sunk Costs in Tender Offers, 35 STAN.L.REV. 1 (1982). Their

such requirement. Rather, as we have seen, their premise is that shareholder and stakeholder interests conflict in corporate takeovers and that the target's directors are in the best position to reconcile those competing interests.[170] Nor, in fairness, is this a wholly implausible assumption. Despite the need for skepticism about management's motives, it is worth remembering that "having a 'conflict of interest' is not something one is 'guilty of'; it is simply a state of affairs."[171] The fact that the board has a conflict of interest thus does not necessarily mean that its conduct will be inconsistent with the best interests of any or all of the corporation's other constituents.[172] Given human nature and the temptations otherwise left unchecked, however, courts should interpret the statutes so as to provide a mechanism for distinguishing legitimate concern for stakeholders from false concern motivated by self-interest. The next section turns to that task.

2. *A Model for Structural Decisions*

Virtually no operational decisions are judicially reviewed; indeed, virtually none are noticed by shareholders or even by directors. Once again, the structural context is quite different. When directors seek to justify takeover defenses by reference to nonshareholder concerns, their decision inevitably will be challenged by shareholders and/or the hostile bidder. While the nonshareholder constituency

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model has been uniformly rejected by the courts. *See, e.g.*, GAF Corp. v. Union Carbide Corp., 624 F.Supp. 1016, 1020 (S.D.N.Y.1985) (stating that "[t]he exercise of independent, honest business judgment of an enlightened and disinterested Board is the traditional and appropriate way to deal fairly and evenhandedly with both the protection of investors, on the one hand, and the legitimate concerns of employees and management of a corporation who service the interests of investors, on the other"); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 n. 10 (Del.1985) (stating that "[i]t has been suggested that a board's response to a takeover threat should be a passive one. However, that clearly is not the law of Delaware, and as the proponents of this rule of passivity readily concede, it has not been adopted either by courts or state legislatures." [citations omitted]).

[170] The GAF court could have been speaking for the legislative proponents of non-shareholder constituency statutes when it observed:

> A corporation with a perceived threat of dismemberment ... owes substantial regard for [employee's] pension benefits, and in the case of loyal management, severance benefits. These legitimate concerns for [the directors'] past conduct of the enterprise and its requirements need not be left to the goodwill of an unfriendly acquirer of corporate control in the jungle warfare involving attempted takeovers.

GAF Corp. 624 F.Supp. at 1019-20.

[171] Committee on Corporate Laws, Changes in the Model Business Corporation Act—Amendments Pertaining to Directors' Conflicting Interest Transactions, 44 BUS.LAW. 1307, 1309 (1989).

[172] *Id.* (stating that "while the history of mankind is replete with acts of selfishness, we have all also witnessed countless acts taken by persons contrary to their personal self-interest").

statutes clarify that it is appropriate for directors to consider those concerns in structural, as well as operational, decisions, the legal system should not ignore the very real risk that the directors' justification is a ruse. In structural decisions, the law therefore must separate those instances of honest director concern for nonshareholder interests from selfish director concern for their own positions. Happily, such a mechanism is close at hand: *Unocal*'s shifting burdens of proof will do quite nicely by analogy.[173]

[**1015**] In *Unocal*, the Delaware Supreme Court acknowledged "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[174] As discussed in Part I, the court responded by adopting a two pronged standard requiring directors who adopt a takeover defense to show that (1) they had reasonable grounds for believing that a threat to corporate policy and effectiveness existed, a burden which, among other things, requires proof of good faith and reasonable investigation, and (2) the defense was reasonable in relation to the threat posed by the offer.[175] If the directors satisfy this standard, they get the benefits of the business judgment rule and the burden of proof shifts back to the plaintiff to show that the directors breached their fiduciary duties.

As also discussed in Part I, threats to nonshareholder constituencies originally were a cognizable threat under *Unocal*. *Revlon*, however, limited the use of threats to nonshareholder interests to those cases in which the defensive action also benefited shareholders.[176] As Part II demonstrated, the nonshareholder constituency statutes reject the *Revlon* gloss. Absent the unique provisions found in the Indiana and Pennsylvania statutes, however, the nonshareholder constituency statutes need not be interpreted as barring a *Unocal*-type test.

An apt precedent for this thesis is provided by the prevailing judicial interpretation of interested director transaction statutes. Despite numerous variations, most interested director statutes follow the same basic theme. Typically, a transaction between a director and the corporation is not voidable solely because of the director's interest in the transaction if it is approved by a majority of the disinter-

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[173] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.1985). The *Unocal*-based model proposed herein draws principally on the interpretation of *Unocal* prevailing before the Delaware Supreme Court's decision in Paramount Comm., Inc. v. Time Inc., 571 A.2d 1140 (Del.1989). In addition to making a variety of changes to the *Unocal* standard (none directly relevant here), Time fairly can be read as indicating that *Unocal* will be applied with lessened vigor in future Delaware cases. *See id.* at 1153-55. If so, the standard's ability to capture cases of management misconduct will be significantly lessened as well. *See* Bainbridge, *supra* note 57, at 318.

[174] *Unocal*, 493 A.2d at 954.

[175] *Id.* at 955.

[176] *See supra* notes 59-67 and accompanying text.

ested directors or by a majority of the shareholders, or if the director can prove that the transaction is fair to the corporation.[177] On their face, most of these statutes appear to validate any transaction ratified by the board or the shareholders, even if the transaction is unfair to the [**1016**] shareholders. Most courts, however, have held that judicial review for fairness of the transaction can still be had even if the transaction has been ratified.[178]

Not every interested director transaction involves self-dealing, but the high probability of misconduct in this context led courts to permit review even of transactions that are properly ratified and to impose a very exacting standard on unratified transactions. The significant risk of self-interested director behavior in corporate acquisitions similarly justifies exacting judicial scrutiny of claims that the directors were acting to protect nonshareholder interests. Accordingly, unless the legislature has clearly prohibited courts from imposing a heightened standard of review, courts should read a *Unocal*-type standard into the nonshareholder constituency statutes.

As previously stated, under the first *Unocal* prong the directors must identify a threat to corporate policy and effectiveness. By analogy, under this Article's interpretation of nonshareholder constituency statutes, a court should first require the directors to show that the takeover bid poses a threat to one of the enumerated nonshareholder interests.[179] This initial task should not prove too difficult for the directors. Presumably, the requisite threats could take a variety of forms: lay-offs, plant closings, downgrading of bonds, and the like.[180]

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[177] CLARK, *supra* note 42, at 166-67.

[178] *Id.* at 169-70. In most jurisdictions, an effective ratification shifts the burden of proof to the complaining party who then must show that the transaction amounts to a waste of corporate assets. *Id.* at 178-79. If the transaction is not properly ratified by either the board or shareholders, the defendant directors have the burden of proving that the transaction is fair to the corporation. *Id.* Of course, the rules governing derivative litigation will frequently limit a shareholder's ability to obtain judicial review of an interested director transaction. *See supra* note 120 (describing effect of derivative suit rules on judicial review of operational decisions).

[179] Usually, decision-making should be delegated to independent directors. *See Unocal*, 493 A.2d at 955. Granting that purportedly independent directors are often biased in favor of managers, delegating responsibility to the outside board members at least avoids the appearance of impropriety and may actually help avoid some abuses. Once in charge, the independent directors should determine whether a threat to non-shareholder interests exists. If so, the directors should then determine what response is appropriate to the threat posed by the bid. *Id.*

[180] In the face of a nonshareholder constituency statute, especially as interpreted herein, the hostile bidder will have an incentive to keep its post-acquisition plans as secret as possible. By not disclosing its plans, the bidder makes it harder for target management to identify a threat to non-shareholder interests justifying management resistance to the bid. In many cases, however, this will not be a very serious problem.

[**1017**] Again, by analogy to the first *Unocal* prong, a court should also require directors to show that they acted in good faith and after a reasonable investigation. The good faith element requires a showing that the directors acted in response to a perceived threat to the corporation and not for the purpose of entrenching themselves in office.[181] As such, this element necessarily involves a subjective inquiry into the directors' motives. Admittedly, courts are poorly suited to this sort of inquiry.[182] Absent the proverbial smoking gun it will be difficult to distinguish cases involving self-interested director behavior from cases involving legitimate director concern for stakeholders. Nonetheless, retaining a subjective component to the analysis can be justified on several grounds. First, judicial review is better than no review. Many takeover decisions are subject to review by the market. For example, when a board agrees to merge with one of several potential bidders, motive analysis is unnecessary. As long as the board fairly conducted an auction amongst the competing bidders, the market will have demonstrated the merger's fairness.[183] However, when a board rejects a hostile takeover bid on nonmonetary grounds, by definition a market test is unavailable. In effect, the directors are asking to be exempted from a market test because of the takeover's alleged impact on nonshareholder constituents. As such, a motive based inquiry becomes more justifiable. At the very least, it captures gross cases

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Some aspects of the bidder's plans must be disclosed pursuant to the federal securities laws. For example, Item 5 of Schedule 14D-1 requires a tender offeror to disclose plans which would result in a sale or transfer of a material amount of target assets, which might alert management to potential effects on employees or communities; likewise, Item 4 requires disclosure of the sources of financing, which will alert management to a possible impact on existing creditors. 17 C.F.R. § 240.14d-100 (1990).

State antitakeover laws often require even more exacting disclosures. For example, Pennsylvania's control share acquisition statute requires the bidder to disclose, among other things, any plans to close target plants. 15 PA.CONS.STAT.ANN. § 2566(a)(6)(iii) (Purdon 1991). It is questionable, however, whether these state disclosure requirements will withstand constitutional scrutiny. *See* Hyde Park Partners, L.P. v. Connolly, 839 F.2d 837, 848-53 (1st Cir.1988) (state tender offer disclosure statute preempted where it required bidder to make disclosures at a time earlier than required by federal law); National City Lines, Inc. v. LLC Corp., Fed.Sec.L.Rep. (CCH) ¶ 98,374 at 92,260 (W.D.Mo.1981) (state insurance statute preempted by federal proxy rules because it required greater disclosures from proxy insurgent than required by federal law).

[181] *Unocal*, 493 A.2d at 955.

[182] *Cf.* ALI PROJECT, *supra* note 19, at 532 (stating that motive-based duty of loyalty analysis is inappropriate for the takeover context, because it "cannot effectively distinguish cases in which directors favored themselves and cases in which directors properly looked to the interest of the shareholders"); Bainbridge, *supra* note 57, at 291 (declaring subjective analysis inappropriate for lock-up decisions); Davis, *supra* note 19, at 23-25 (indicating that courts have difficulty with subjective analysis of director motives).

[183] Bainbridge, *supra* note 57, at 323-32.

in which there is good evidence—either direct or circumstantial—that the board acted for its own interest. Second, and more importantly, the test proposed here is not limited to a subjective motive analysis. Instead, the good faith element is primarily intended to force the directors to articulate a nonself-interested rationale for [**1018**] their action. The directors' stated rationale can then be tested against the model's objective standards, which have the primary responsibility for capturing cases of director misconduct. Finally, as further described below, the obligation to construct a disinterested rationale for the decision may deter many boards from self-interested behavior in the first place.

The reasonable investigation element requires a demonstration that the board was adequately informed, with the relevant standard being whether they were grossly negligent in conducting their investigation.[184] The problem, of course, is to define what constitutes gross negligence. In Smith v. Van Gorkom,[185] the Delaware Supreme Court held that directors who approved a friendly merger were grossly negligent because they failed to inform themselves of all material information reasonably available to them.[186] The ALI proposes a somewhat different formulation, pursuant to which directors must inform themselves merely to the extent that they reasonably believe is appropriate under the circumstances.[187] The ALI standard thus permits directors to make decisions on less than all reasonably available information if they reasonably believe doing so is appropriate given the situation.[188] In contrast, such a decision would violate Van Gorkom.

The ALI standard is preferable because information is costly. Societal resources are wasted if managers must invest an additional dollar in gathering information unless there is at least an additional dollar to be generated from better decision-making. By requiring directors to have all information "reasonably available" to them, Van Gorkom may often require directors to over-invest in information. Moreover, the limited time available to make the decision may require that the directors take risks to secure what appears to be a good outcome.[189] Those risks include the possibility that they do not have all of the relevant facts. A decision to accept this risk in order to secure the good outcome is perfectly defensible and should be permitted under appropriate circumstances.

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[184] Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356-57 (Del.1985).

[185] 488 A.2d 858 (Del.1985).

[186] *Id.* at 874. In Moran, the Delaware Supreme Court adopted the Van Gorkom definition for purposes of applying the *Unocal* standard. Moran, 500 A.2d at 1356.

[187] ALI PROJECT, *supra* note 19, at § 4.01(c)(2).

[188] *Id.* at 230.

[189] This seems especially true of the highly pressured, fast-moving hostile takeover environment.

The second *Unocal* prong is the critical one if self-interested management behavior is to be controlled. Unless the requirement of proportionality between threat and response has real teeth, management can still use a threat to nonshareholder interests as a cloak for pro-[**1019**] tecting their own jobs. Absent an effective proportionality standard, any threat to nonshareholder interests, no matter how mild or insignificant, would give management a free hand to develop takeover defenses to kill the hostile takeover bid.[190]

Unfortunately, the courts have not given much guidance as to when a defensive tactic is reasonable in relation to the threat posed by a takeover bid. While a defense which absolutely precludes a tender offer or proxy contests is unreasonable,[191] a difficult question is posed by defenses that are not completely preclusive. Here proportionality basically appears to require that the defense be no more restrictive than needed to meet the threat posed.[192]

Under this approach, management does not have unbridled discretion to disregard shareholder interests in the face of a threat to nonshareholder constituencies. Unlike *Revlon*, the test proposed here does not require that directors affirmatively benefit shareholders. As Part II demonstrated, one cannot reasonably interpret the nonshareholder constituency statutes as codifying *Revlon*. On the other hand, we also saw in Part II that one cannot reasonably interpret the statutes as allowing directors to disregard shareholder interests. Instead, the statutes allow directors to make trade-offs between shareholder and stakeholder interests in order to balance those interests. Accordingly, the standard proposed here merely requires that directors minimize the effect of their decision on shareholders.[193] In other words, their decision must impose no greater burden on the shareholders than necessary to protect the nonshareholder constituencies. If measures less harmful to the shareholders' interest would have adequately protected the nonshareholder interests at stake, the target's chosen defensive measures should be invalidated.[194]

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[190] *See* Gilson & Kraakman, *supra* note 57, at 254. Notably, Professors Gilson and Kraakman reject any consideration of nonshareholder interests. *Id.* at 267.

[191] *See Unocal*, 493 A.2d at 955 (where the court maintained that "[a] corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available.").

[192] *See* Paramount Comm., Inc. v. Time Inc., 571 A.2d 1140, 1155 (Del.1989).

[193] *Cf.* ALI PROJECT, *supra* note 19, at 537 (declaring that directors may consider nonshareholder interests only to the extent that doing so does not significantly disfavor shareholder interests); McDaniel, *supra* note 111, at 161 (stating that statutes reflect a dual goal of maximizing stockholder gain and minimizing stakeholder loss).

[194] Similar tests are used in other corporate conflict of interest transactions. For example, when a minority close corporation shareholder alleges a breach of fiduciary duty by the firm's controlling shareholder, the controlling shareholder must first demonstrate a legitimate business purpose for its actions. If the controlling shareholder does so, the minority shareholder can still prevail by showing that the same objective could have been accomplished through an alternative

[**1020**] The precise application of this standard will obviously vary from case to case. Nonetheless, a few suggestive examples may be helpful. Defenses permanently precluding hostile tender offers, such as defensive restructurings that transfers voting control to management and its allies, coupled with other defensive tactics that effectively force shareholders to choose the management-sponsored restructuring over the hostile bid,[195] will usually be disproportionate because they permanently preclude all takeover bids, including those posing no threat at all.[196] At the other extreme, it would be perfectly appropriate for a board to refuse to redeem a poison pill while negotiating with the hostile bidder and/or possible competing bidders.[197]

Somewhere in the middle is the *Revlon* fact pattern: an initial hostile bidder, followed by a competing bid from a white knight solicited by target management. Suppose the hostile bidder offers a higher price, but the white knight proposes a transaction that protects the target's stakeholders. The target board rejects the hostile bid, accepts the white knight's bid, and puts teeth into its decision by granting a lock-up option to the white knight.[198] In assessing the lock-up's validity, a court should consider such factors as the monetary difference between the two bids, the extent of the commitment the favored bidder has made to nonshare-

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course less harmful to the minority's interest. Wilkes v. Springside Nursing Home, Inc. 353 N.E.2d 657 (Mass.1976).

[195] In City Capital Assoc. v. Interco Inc., 551 A.2d 787 (Del.Ch.), appeal dismissed, 556 A.2d 1070 (Del.1988), the target corporation adopted a leveraged restructuring as a management-sponsored alternative to a hostile bid. In order to insure that the shareholders would choose the management-sponsored restructuring, the target's board refused to redeem a poison pill until after the restructuring was completed. Chancellor Allen refused to enjoin the restructuring, but did require the board to redeem the bill so that shareholders could choose freely between the two alternatives. *Id.* at 800.

[196] *See* Paramount, 571 A.2d at 1154-55 (Del.1989) (holding lock-up and related defenses granted to protect negotiated merger to be proportionate because, inter alia, they did not "cram down" a management-sponsored alternative on the shareholders and did not preclude the competing bidder from making a takeover bid for the combined entity); see also Gilson & Kraakman, *supra* note 57, at 269-70.

[197] *See* Interco, 551 A.2d at 798 (indicating that the board may leave poison pill in place while it pursues negotiations with the bidder and/or seeks out alternatives); Gilson & Kraakman, *supra* note 57, at 269-70.

[198] Under Delaware law, this scenario could trigger review under *Revlon*'s auctioneering duty; so too might the earlier example of a defensive restructuring that transfers voting control to management. *See* generally Bainbridge, *supra* note 57, at 295-317 (discussing *Revlon* duties pre-and post-Time). Whether the duty to auction control can be imposed in a state which has adopted a nonshareholder constituency statute is an open question. *See infra* note 207. At a minimum, however, the statutes do not permit courts to require that directors maximize shareholder wealth in the control auction context. *See supra* notes 100-110 and accompanying text.

holder constituents, and whether the target board's bidding procedures fairly tested the market.

Some will immediately object that courts eschew substantive review of board of director decisions. True, the business judgment rule [**1021**] precludes judicial review of most board decisions. But the rule's traditional justification—that judges are not business experts[199]—simply makes no sense in the structural context, as *Unocal* recognized.[200] Judges are not doctors, but they routinely review medical decisions. Judges are not engineers, but this does not preclude design defect litigation. Just so, courts can, and do, substantively review board decisions in contexts, like this one, in which the conflict of interest is so pronounced. The mode of review just proposed for lockup options, to take but one example, is perfectly familiar to corporate law courts. Even under *Revlon*, directors need not blindly focus on price to the exclusion of other relevant factors. The board may evaluate offers on such grounds as the proposed form of consideration, tax consequences, firmness of financing, antitrust or other regulatory obstacles, and timing.[201] The interpretive model for nonshareholder constituency statutes proposed herein merely adds stakeholder interests to the list. Courts thus should have little difficulty in accommodating that factor into their review.

In any case, judicial review under the proposed test can focus mainly on questions of process, which are well within the traditional bounds of judicial competence. In making proportionality assessments, the court should thus scrutinize closely management's arguments and require a convincing demonstration that no less restrictive defense is available. In doing so, the court should look to such evidence as the specificity of management's plans, the record of the board's deliberations, and expert testimony from both sides.[202] A showing that the directors were aware of and considered the threat to nonshareholder interests at the time they decided to resist the takeover bid is particularly important, because it lowers the likelihood that the threat is an ex post facto justification for selfish behavior.[203]

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[199] *See supra* note 29 and accompanying text.

[200] Alternative justifications for the rule are discussed in Joy v. North, 692 F.2d 880, 885-86 (2d Cir.1982), cert. denied, 460 U.S. 1050 (1983); ALI PROJECT, *supra* note 19, at 226; Michael P. Dooley, Two Models of Corporate Governance, 47 BUS.LAW. 461 (1992).

[201] Cottle v. Storer Communications, Inc., 849 F.2d 570, 577 (11th Cir.1988); Citron v. Fairchild Camera & Instrument Corp., Fed.Sec.L.Rep. (CCH) ¶ 93,915 at 90, 102-03 (Del.Ch.1988); Freedman v. Restaurant Assoc. Indus., Inc., Fed.Sec.L.Rep. (CCH) ¶ 93,502 at 97,220 (Del.Ch.1987).

[202] *See* Gilson & Kraakman, *supra* note 57, at 271 (proposing similar list for evaluating threats to shareholder interests).

[203] Dangelo, *supra* note 100, at 543.

[**1022**] Courts also should examine closely the negotiations, if any, between the bidder and target management. If there is any evidence that target management would set aside its concern for stakeholders in exchange for a higher acquisition price or side payments for itself, management's purported fears for nonshareholder interests should be seen as mere pretence.

The most important evidence probably will be the history of the firm's treatment of nonshareholder constituencies. A long history of board concern for the firm's workers tells a more plausible story than a sudden interest in their welfare. This is particularly relevant for firms that have previously used threats to nonshareholder constituencies to justify takeover defenses. Not infrequently, an unsuccessful hostile bid will be followed months or years later by another hostile bid from a new bidder. If management has largely ignored stakeholder concerns in the interim, it will be hard for them to use those concerns to justify resisting the new bid.

By carrying its burden of proof under both prongs of this test, the board of directors demonstrates that it is not disabled by a conflict of interest. Absent a disabling conflict, courts generally defer to board decisions. Accordingly, if the board carries its burden, the court should not inquire into the reasonableness of the board's decision unless the plaintiff is otherwise able to rebut the business judgment rule's presumptions.[204] But if the board fails to carry its burden, the court should enjoin the proposed corporate action and/or grant other appropriate relief.

Admittedly, judicial review is not especially well-suited to detecting management misconduct.[205] In addition to the possibility of capturing management misconduct ex post, however, an effective proportionality requirement may reduce management's ex ante incentives to cheat.[206] Dishonest management may find it difficult to construct a plausible story of nonshareholder injury. Dishonest management may not be able to locate experts who can or will support credibly a false nonshareholder injury story; indeed, stakeholders themselves may decline to support dishonest management's story. Independent directors may be unwilling to risk the reputational injury of supporting a false story. Finally, the hostile bidder will be actively seeking to rebut management's story and, perhaps, will be [**1023**]

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[204] Opponents of nonshareholder constituency statutes commonly object that the statutes provide no guidance to review the board's allocation of gains and losses between the various corporate constituencies. *See, e.g.*, Hanks, *supra* note 98, at 113-14. This objection, however, misses the point. Provided the board is not disabled by a conflict of interest, such standards are not needed. As with all corporate decisions, absent a disabling conflict, the business judgment rule will preclude review.

[205] *See* Bainbridge, *supra* note 57, at 291.

[206] *See* Gilson & Kraakman, *supra* note 57, at 272-73.

recruiting stakeholder support. All of these factors should deter management misconduct and, moreover, give management incentives to evaluate fairly whether shareholder and stakeholder interests in fact diverge.[207]

IV. CONCLUSION

Many, perhaps most, corporate law academics oppose non-[**1024**] shareholder constituency statutes, as do many other informed observers. Their basic objection

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[207] The description in the text of this Article's proposed model focuses principally on evaluating a board's response to a hostile tender offer. Nevertheless, the model has general applicability to the full range of structural decisions, all of which are covered by nonshareholder constituency statutes. For example, the model can be readily applied to board decisions that impede an insurgent's efforts to wage a proxy contest. Under Delaware law, the incumbent board must show a compelling justification for actions interfering with the shareholder franchise. Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1120-22 (Del.Ch.1990). As Chancellor Allen has observed, however, this standard rests on the "traditional model of the corporation that sees shareholders as 'owners.'" *Id.* at 1124. He went on the observe that "[i]f the law adopts some other model of the corporation," as some argue that nonshareholder constituency statutes do, "shareholder action through the vote might well be seen as constituting a threat to other corporate constituencies or to a distinctive corporate 'entity.'" *Id.* Nonshareholder constituency statutes thus arguably permit incumbent boards to impede proxy contests where necessary to protect nonshareholder interests. At the same time, however, courts could use the model developed herein to insure that the board is not acting in its own self-interest.

Similarly, the model can be applied to negotiated acquisitions. Suppose the board of directors is considering a friendly merger proposal, in which the potential acquirer has requested a lock-up option. If the board grants the lock-up option, competitive bidding may be impeded. *See* Bainbridge, *supra* note 57, at 287-89 (describing the deterrent effects of lock-ups). If so, a shareholder or a subsequently emerging competing bidder may challenge the board's decision to grant the lock-up. Under a nonshareholder constituency statute, the board may try to justify its decision to grant the lock-up by pointing to the favored bidder's promises to protect target stakeholders. The model proposed by this Article could then be used to test the board's decision.

The latter example brings up a question of personal interest. I have argued elsewhere that the validity of exclusive merger agreements and lock-ups in negotiated acquisitions should turn on whether they are likely to preclude competitive bidding. *Id.* at 272-92. I proposed that non-preclusive provisions should be evaluated under traditional business judgment rule standards, *id.* at 317-23, but that preclusive provisions should be upheld only if the target board has fairly auctioned the company before entering into the lock-up arrangement. *Id.* at 323-32. This proposal could be adopted by courts even in states that have a nonshareholder constituency statute. To the extent that the proposal calls on courts to apply a traditional business judgment standard of review, the statutes have no practical effect, just as they have no practical effect on evaluation of operational decisions. Nor need the statutes be read as precluding an auction requirement. Instead, the statutes could be read as merely affecting the board's decision between two competing bidders. In other words, the board still could be required to auction the company before agreeing to a lock-up, but under a non-shareholder constituency statute the board's decision to favor one bidder over another properly could be influenced by nonshareholder interests. As suggested above, such a decision thereupon could be tested under the model this Article proposes.

is that the statutes permit directors to reallocate wealth from shareholders to stakeholders.[208] As such, these statutes strike squarely at the heart of traditional corporate law norms. The shareholder wealth maximization norm was premised on long-standing rules allocating gains, under which stakeholders are paid first but shareholders are entitled to whatever is left over after all stakeholder claims are satisfied. The nonshareholder constituency statutes thus appear to give stakeholders a second—and undeserved—bite at the apple.

Ultimately, however, these broad policy issues are beside the point, or at least the point of this Article. The statutes are on the books in over half the states and are likely to remain so for the foreseeable future. Courts urgently need a coherent interpretation of the statutes. But coherence alone is not enough; courts must also be faithful to the legislative intent behind the statutes. Courts cannot ignore the statutes, wish them away, or fairly interpret them as having no meaning or impact.

Some board of director decisions increase the overall size of the corporate pie and thus benefit all of their constituents. But almost all board decisions affect the distribution of the corporate pie, and thus result in winners and losers. Enabling directors to transfer part of the pie from shareholders to stakeholders is the stated purpose of nonshareholder constituency statutes. Courts must be true to that purpose, but they need not interpret nonshareholder constituency statutes as allowing directors and managers to reallocate a bigger piece of the pie to themselves.

As to operational decisions, nonshareholder constituency statutes pose few problems. Despite the law's rhetorical emphasis on shareholder interests, the reality is quite different. Directors in fact routinely consider nonshareholder interests and are not held liable for doing so. The statutes thus merely bring the law's rhetoric into line with its reality. As such, in the operational context, the statutes should not result in significant reallocations of gains from stakeholders to shareholders. Corporate altruism, which gives stakeholders a bigger slice of pie in the short run, will often redound to the shareholders' benefit, thereby increasing the size of the pie in the long run. Moreover, a variety of extra-legal forces continue to constrain target managers even in the presence of nonshareholder constituency statutes, which assures that long-term shareholder gains will in fact [**1025**] flow from corporate altruism.[209]

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[208] *E.g.*, Hanks, *supra* note 97, at 112-13. Some may argue that the statutes allow directors to correct wealth transfers from stakeholders to shareholders. I am skeptical that such transfers are a systematic problem. *See supra* note 154 and accompanying text. In any case, the statutes are not limited to transfer situations.

[209] This is a point missed by many opponents of nonshareholder constituency statutes. These opponents focus too extensively on the role of legal systems in holding corporate management accountable, ignoring the far more important role of market forces in doing so.

As to structural decisions, however, the statutes pose significant problems. For directors, structural decisions introduce a temptation absent in operational decisions. All structural decisions present a serious risk that directors may favor themselves at the expense of both shareholders and nonshareholder constituents. The nonshareholder constituency statutes thus threaten to provide a shield for self-interested behavior by unscrupulous directors. Claiming to act on behalf of employees or communities, they may be acting to protect their own perquisites. Wealth transfers are thus highly likely in this context, although they will not necessarily involve reallocations from shareholders to stakeholders. A far more likely scenario is that wealth will be transferred from shareholders to managers. The legal regime proposed by this Article responds to this fundamental problem by providing incentives for managers to pursue the best interests of all the corporation's constituents, while enabling courts to detect those cases in which management fails to do so.