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In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green

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Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers. Indeed, one rarely finds stronger judicial rhetoric than that used by the court in the now classic case of Dodge v. Ford Motor Co.:

> 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.[1]

Our hosts nonetheless posit that these are no longer words to live by, arguing that the shareholder wealth maximization norm is both descriptively and normatively deficient. Frankly, I am not persuaded. Despite a smattering of evidence to the contrary,[2] the mainstream of corporate law remains committed to the

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[1] Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

[2] A few cases suggest that directors need not treat shareholder wealth maximization as their sole normative objective. Upon close examination, however, most of these cases in fact are not inconsistent with Dodge. In A. P. Smith Manufacturing Co. v. Barlow, 98 A.2d 581 (N.J. 1953), for example, the New Jersey Supreme Court validated corporate charitable giving 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." Id. at 586. Ultimately, however, the rhetorical differences between Barlow and Dodge have little more than symbolic import. Shareholders' long-run interests are often served by decisions, such as charitable giving, that appear to be harmful in the short-run. In Barlow, 98 A.2d at 586, the court recognized that such arguments justified the challenged contribution, arguably rendering its broader language on corporate social responsibility mere dictum.

Other cases appear to be inconsistent with Dodge based not so much on language, as upon result. In Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. 1968), for example, a minority shareholder in the Chicago Cubs sued Wrigley, the team's majority shareholder, over the latter's famous refusal to install lights at Wrigley Field. Shlensky claimed the decision against lights 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. Id. at 778. Despite Shlensky's apparently uncontested evidence that Wrigley was more concerned with nonshareholder than with shareholder interests, the Illinois Appellate Court dismissed for failure to state a claim upon which relief could be granted. Id. at 778-80. Although this result on superficial examination may appear to devalue shareholder wealth maximization, on close examination the case involves nothing more than a wholly unproblematic application of the business judgment rule. See Stephen M. Bainbridge, Interpreting Nonshareholder Constituency Statutes, 19 PEPP. L. REV. 971, 978-79 (1992).

Professor Green suggests that the nonshareholder constituency statutes adopted by slightly over half the states also indicate erosion of the shareholder wealth maximization norm. See Ronald M. Green, Shareholders as Stakeholders: Changing Metaphors of Corporate Governance, 50 WASH. & LEE L. REV. 1409, 1411-12 (1993). Professor Green's reading of these statutes, however, errs in two important and contradictory respects. On the one hand, he reads these statutes as codifying the business judgment rule "as it has recently been interpreted by the Delaware courts." Id. at 1412. This is wrong. These statutes clearly reject the Delaware approach to nonshareholder constituency issues. See Bainbridge, supra, at 993-94. On the other hand, Green's assertion that the statutes do not "really challenge" the shareholder wealth maximization norm is

principles espoused by the Dodge court. By mainstream I refer of course to Delaware's courts and legislature which are still our premier corporate lawmakers. As it has long done, Delaware law still requires directors to put shareholder interests ahead of those of nonshareholders.[3] At least in Dela-

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also wrong. They are best interpreted as permitting directors to make trade-offs between shareholder and nonshareholder interests when making corporate decisions. Compare Green, supra, at 1412 with Bainbridge, supra, at 994-95. In these jurisdictions, it is thus possible to argue that the shareholder wealth maximization norm is no longer descriptively accurate. But while the statutes modify the norm, their long-term impact is hard to measure. First, given Delaware's unchallenged position as the preeminent corporate law jurisdiction, Delaware's failure to adopt such a statute leaves the nonshareholder constituency statutes on the fringes of the law at least insofar as public corporations are concerned. So too does the lack of any meaningful case law applying and interpreting the statutes. Second, the statutes plausibly can be regarded as special interest legislation designed to protect corporate managers from hostile takeovers. See Bainbridge, supra, at 996. Courts therefore may treat them as being limited to the hostile takeover context, even though most statutes on their face apply to all corporate decisions. In fact, this may partly explain the continuing dearth of cases applying the statutes. If so, the shareholder wealth maximization norm may survive even in states with nonshareholder constituency statutes.

[3] The recent Delaware law on this point arose out of the takeover battles of the 1980s. In Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), the Delaware Supreme Court held that a target's board of directors may consider "the impact [of a takeover bid] on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally). . . . " Id. at 955. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), however, the court added two crucial provisos to Unocal. The first is of general applicability, dealing with all situations 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 nonshareholder constituency wealth, Revlon forecloses that interpretation. Revlon expressly forbids management from protecting nonshareholder interests at the expense of shareholder interests. Rather, anything directors do to make nonshareholders better off must also make shareholders better off. Revlon, 506 A.2d at 182.

Second, once the Revlon auctioneering duty triggers, nonshareholder interests become entirely irrelevant. If an auction whose object is selling the business begins, whether benefitting nonshareholder interests may also benefit shareholders no longer matters. Instead, shareholder wealth maximization is the board's only appropriate concern. Id. Revlon thus sharply limits the directors' ability to consider nonshareholder interests. To be sure, Revlon has teeth only in takeover situations, given that the business judgment rule will protect directors from liability in most other settings, but the point remains the same: directors are supposed to put shareholder interests first.

Our hosts have argued that the Delaware Supreme Court's decision in Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989), at least invites one to rethink the shareholder wealth maximization norm. See Lyman Johnson & David Millon, The Case Beyond Time, 45 BUS. LAW. 2105, 2117-20 (1990). While Johnson and Millon's argument is creative and provocative, in my view Time has very little to do with concern for nonshareholder constituencies. Rather, it is better explained simply as an extreme example of the court's deference to the board's decisionmaking authority.

ware, the shareholder wealth maximization norm thus remains a more accurate description of the state of the law than any of its competitors.[4]

A more interesting question is posed when we ask whether shareholder wealth maximization continues to suffice from a normative perspective. In my view, Professor Green brings a valuable perspective to the table on this question.[5] At the end of the day, however, I remain unpersuaded that the principle of shareholder wealth maximization is normatively deficient.

As I read his paper, Professor Green views the choice between shareholder wealth maximization and the "multi-fiduciary stakeholder perspective"[6] as a morally neutral one. In other words, he treats the debate as taking place solely on the public policy level.[7] I doubt whether he is correct on this score, but that is a question perhaps best left for another day. It is principally those portions of his paper directed at or relevant to questions

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[4] The Revised Model Business Corporation Act is the only source of public corporation law rivaling Delaware law. Its drafters' refusal to add a nonshareholder constituency provision to the Act thus has considerable symbolic importance. See The Committee on Corp. Laws of the Am. Bar Ass'n, Other Constituencies Statutes: Potential for Confusion, 45 BUS. LAW. 2253 (1990) (arguing that Revised Model Business Corporation Act should not contain nonshareholder constituency provision).

The recently approved ALI Principles of Corporate Governance explicitly permit boards to take into account ethical considerations reasonably regarded as appropriate to the responsible conduct of the firm, even if shareholder wealth is not thereby advanced. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(b)(2) (Proposed Final Draft 1992). In light of the cases discussed supra notes 2 and 3, however, the ALI has not restated existing law, but rather created a poorly explained and wholly unwarranted departure therefrom.

[5] Thomas Shaffer has pointedly observed that modern law schools "have systematically—theologically!—discounted, discouraged and disapproved of the invocation of the religious tradition as important, or even interesting." Thomas Shaffer, The Tension Between Law in America and the Religious Tradition, in THE WEIGHTIER MATTERS OF THE LAW: ESSAYS ON LAW AND RELIGION 315, 327 (John Witte & Frank Alexander eds., 1988). It is unfortunate, as well as disappointing, that Professor Green's paper does so little to counter that trend.

[6] Green, supra note 2, at 1419. A semantic point is in order here. While Professor Green uses the term "stakeholder" to refer both to shareholders and to nonshareholders having some connection with the firm, I prefer the term "nonshareholder constituents" for the latter. From my perspective, to use the term stakeholder would concede much of the battle before it has been joined. Describing someone as a stakeholder implies that they have a stake in the firm, which may imply that they have claims on the firm that the firm is legally or morally bound to respect. In contrast, to be a constituent as I use it here means only that one is a component part of the greater whole, which does not carry the same connotations.

[7] Id. at 1421 ("[T]his discussion takes place on the plane of public policy. The question concerns which model of corporate governance makes most sense and best serves all of our needs in a modern business environment.").

of policy, rather than of morality, with which I intend to take issue.

Professor Green begins with the premise that shareholders do not own the corporation.[8] From this he concludes that the law can and should move toward a new definition of corporate managers' fiduciary obligations. So stated, I impute both a positive and a normative component to Green's conclusion. The positive component is that corporate law can move away from the shareholder wealth maximization norm. The normative component is that corporate law should do so.

Although Green states the normative conclusion somewhat diffidently, devoting most of his attention to his premise and positive conclusion, only his normative conclusion merits detailed analysis. This is so because a neoclassical proponent of the shareholder wealth maximization norm can quite cheerfully concede both Green's premise and his positive conclusion without conceding his normative conclusion. Indeed, the former are wholly consistent with the prevailing neoclassical model of the firm.

Nexus of contracts theory visualizes the firm not as an entity, but as an aggregate of various inputs acting together to produce goods or services.[9]

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[8] Green's argument also rests on two other premises: (1) the shareholder-corporate manager relationship is not a principal-agent relationship; and (2) shareholders are not "individuals dependent on fiduciaries." Id. at 1413-16. I consider the latter point infra notes 69-84 and accompanying text. As to the former, neither legal nor economic theory bases the primacy of shareholder wealth upon the existence of an agency relationship between shareholders or managers. See infra notes 9-13 and accompanying text.

[9] See generally Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM. L. REV. 1416 (1989); Michael C. Jensen & William H. 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 (1980); Eugene F. Fama & Michael C. Jensen, Separation of Ownership & Control, 26 J. L. & ECON. 301 (1983). For a somewhat different take, see William A. Klein, The Modern Business Organization: Bargaining Under Constraints, 91 YALE L.J. 1521 (1982). Although Professor Green's paper indicates familiarity with nexus of contracts theory, his premise is based instead upon the separation of ownership and control in public corporations. I suspect he did this at least in part because nexus of contracts theory, as we shall see, ultimately takes him places he probably does not want to go. In any case, while the separation of ownership and control is an undeniable fact of life, it does not provide a meaningful basis for concluding that shareholders have no ownership rights in public corporations. Consider the Parable of the Talents, which seems an appropriate illustration for what was originally billed as an exercise in moral discourse. Recall the operative facts: a master entrusted assets to three servants. He then left the country. By doing so, the master created both legal and physical separation of ownership and control. Two of the servants invested the assets in productive uses, doubling their value, and were rewarded when the master returned. The third, however, simply returned the master's assets without even having earned interest on them and was punished. Matthew 25:14-30. (A somewhat different version of the parable, perhaps taught on a different occasion, appears in Luke 19:11-27.) While Christ used this parable to make a theological point, its religious significance depended upon the illustration's secular validity. Here, the parable was effective because its hearers understood that the departed master retained his ownership rights even though the stewards had been entrusted with control over the property. Those of us who find the parable effective today do so because we see a separation of ownership and control in a host of secular settings and because we still understand that separating control from ownership does not divest the owner of his rights.

Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The firm is seen as simply a legal fiction representing the complex set of contractual relationships between these inputs. In other words, the firm is treated not as a thing, but rather as 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 in nexus of contracts theory. Someone owns each input, but no one owns the totality. Professor Green thus is quite correct when he asserts that "shareholders are not property owners."[10]

Professor Green is equally correct when he asserts that shareholders have none of the moral rights normally associated with ownership. Like many proponents of nonshareholder constituency rights, Green directs much of his fire at Milton Friedman's famous defense of the shareholder wealth maximization norm. Friedman argued that when a board of directors puts nonshareholder interests ahead of those of the shareholders, the directors literally are stealing from the shareholders:

> In a free enterprise, private-property system, a corporate executive is an employe 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, ...
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> . . . Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money.[11]

I agree that Friedman's analysis is flawed, but the problem is not that Friedman is relying on a Dickensian metaphor, as Green suggests.[12] Rather, the major flaw in Friedman's argument is his reliance on what is now an out-dated theory of the firm.

Friedman relied upon the traditional model of the public corporation, under which stock ownership is no different than any other species of private property. Under this model, the corporation is a thing, so it can be owned. The shareholders own the corporation, so directors are merely stewards of the shareholder's interests. In economic life, as in religious life,[13] no one can serve two masters at the same time. Directors thus

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[10] Green, supra note 2, at 1416.

[11] Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32, 33.

[12] Green, supra note 2, at 1409-10.

[13] "No one can serve two masters. Either he will hate the one and love the other, or he will be devoted to the one and despise the other." Matthew 6:24 (NIV).

cannot be loyal to both shareholders and nonshareholder constituencies. Rather, their role as stewards requires them to prefer the interests of their shareholder masters.

Because private property is such a profound part of the American ethos, this model's normative implications long dominated our approach to corporate law. The traditional model, however, broke down when confronted by the new contractarian model. The old model depended upon the corporation being a thing capable of being owned. In other words, it required one to reify the corporation: to treat the firm as an entity separate from its various constituents. As we have seen, however, nexus of contracts theory squarely rejects this basic proposition. By throwing the concept of ownership out the window, along with its associated economic and ethical baggage, the contractarian model also eliminates Friedman's principal argument for favoring shareholders over nonshareholders.

But let's not throw out the baby with the bath water. The normative conclusion that we should displace the shareholder wealth maximization norm does not necessarily follow from the positive conclusion that we can do so. There is a considerable difference between showing that the traditional private property model is inadequate and showing that we should adopt a new decisionmaking norm to which corporate officers and directors must conform their behavior. Surely the latter conclusion requires some affirmative justification. If we are to strike out in new directions, as our hosts suggest, shouldn't we know why we are doing so?

Two principal normative arguments run through Green's paper. The first envisions the limited liability rule as a privilege conferred by society, in return for which society can demand socially responsible corporate behavior.[14] The second, translated into economic terms, treats limited liability as a mechanism through which shareholders harm nonshareholders by externalizing certain costs onto them.[15]

The first argument, that limited liability is a privilege conferred by society, is not very convincing when considered in light of the public and private functions of limited liability. The nexus of contract model treats corporate law as doing little more than providing a standardized form contract. In other words, corporate law exists mainly to provide default rules that facilitate private ordering. So long as the default rules are properly chosen, most parties will be spared the need to reach a private agreement on the issue in question. Corporate law thus serves to reduce bargaining costs, just as a standard form contract does, because most people will accept the default rules without undertaking

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[14] See Green, supra note 2, at 1414-15. This aspect of Green's analysis is little more than a variant on the old concession theory, which regarded the corporation as a quasi-state actor exercising powers delegated by the state. It has been over a half-century since corporate legal theory, of any political or economic stripe, took the concession theory seriously. See William W. Bratton, Jr., The "Nexus of Contracts" Corporation: A Critical Appraisal, 74 CORNELL L. REV. 407, 433-36 (1989).

[15] See Green, supra note 2, at 1415.

costly negotiations. At the same time, however, because the default rules can be modified by contrary agreement, idiosyncratic parties wishing different rules can be accommodated.[16]

From this perspective, limited liability is not a privilege granted by society. It is just one of the default rules. Refusing to hold shareholders personally liable for firm debts thus is the precise equivalent of enforcing a standard form sales contract, nothing more and nothing less.

Professor Green undoubtedly would argue that the contractarian model is flawed because shareholders and creditors do not bargain over these sorts of issues.[17] This premise is true for shareholders of public corporations, although these sorts of negotiations take place all the time in close corporations, but the conclusion misses the point. It is precisely because shareholders and creditors do not bargain over the question of limited liability that the doctrine is so important.

The default rule's substantive content does not matter very much if transaction costs are low.[18] If the law imposes full personal liability on shareholders,

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[16] A great deal of ink, and even some blood (figuratively speaking, at least to date), has been spilled over both the positive and normative aspects of what might be termed the enabling debate. This debate asks to what extent corporate law is actually made up of default rules, and whether mandatory rules are ever appropriate. Probably the best introduction to this debate is Symposium, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1395 (1989). My position is an essentially pragmatic one. From a positive perspective, corporate codes are chock full of rules that purport to be mandatory, but in fact are often subject to evasion. From a normative perspective, I believe that mandatory rules are sometimes justifiable, but only in relatively few contexts. Indeed, given the advantages associated with default rules, a fairly compelling case ought to be required before we impose a mandatory rule. In my view, mandatory rules usually are justifiable only if a default rule would allow the contracting parties to impose negative externalities on outsiders or if one of the contracting parties is demonstrably unable to protect itself through bargaining. Whether fiduciary duties qualify for treatment as mandatory rules is, fortunately, a question beyond the scope of this paper.

[17] Cf. Green, supra note 2, at 1413 ("At what point do shareholders and managers ever freely enter into a relationship in which one party promises to perform specified services in return for payment or other consideration?"). This objection to the nexus of contracts model, which shows up in several places in Green's paper, is premised on a flawed notion of contractual relationships. Green apparently would apply the term contract only to situations in which actual negotiations result in an agreement reflecting bargained-for consideration. This interpretation is too narrow. As Larry Ribstein recently observed, "voluntary commercial arrangements, such as those provided by the default terms of the Uniform Commercial Code and standard form indenture provisions, realistically must be characterized as contractual. Corporate arrangements are clearly contractual under this broader definition of contract." Larry E. Ribstein, The Mandatory Nature of the ALI Code, 61 GEO. WASH. L. REV. 984, 990 (1993).

[18] The assertion that the substance of a default rule does not matter if transaction costs are zero of course is nothing more than a relatively straight-forward application of the Coase Theorem. The obligatory cite is Ronald H. Coase, The Problem of Social Cost, 3 J. L. & ECON. 1 (1960).

but limited liability is the efficient rule, shareholders and creditors will contract around the law through private bargaining. When transaction costs are high, however, the default rule's substantive content matters very much. If the law imposes full personal liability on shareholders, but limited liability is the efficient outcome, the parties by definition must incur substantial and, worse yet, unnecessary bargaining costs to contractually override the legal rule. Indeed, when transaction costs are very high, bargaining around the rule is wholly impractical, forcing the parties to live with an inefficient rule.

It should be apparent that bargaining between a public corporation's shareholders and its creditors takes place in a prohibitively high transaction cost setting. In this setting, we cannot depend on private contracting to achieve efficient outcomes. Instead, legal rules must function as a substitute for private bargaining. Thus it is critical that the party for whom getting its way has the highest value be identified. In effect, we must perform a thought experiment: "If the parties could costlessly bargain over the question, which rule would they adopt?" Despite Professor Green's apparent misgivings, it seems likely that both contract and tort creditors of public corporations would agree to a rule of limited liability.

Creditors would face a costly, if not insurmountable, practical enforcement problem if they sought to hold shareholders liable for corporate debts. Even if a creditor tried the case as a class action with all shareholders treated as a defendant class, which is theoretically possible but practically difficult, the creditor likely would still have to bring numerous individual suits to collect its judgment. If shareholders are jointly and severally liable, the creditor could solve this problem by suing a few shareholders and letting them worry about obtaining contribution from their fellow shareholders, but substantial claims typically would still require multiple suits.[19]

More importantly, limited liability makes creditors better off by providing deeper pockets against which their claims may be brought. Under a rule of personal liability, few people would be willing to become shareholders.[20] In such a world, large-scale businesses would be conducted by highly-

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[19] Under a personal liability regime, contract creditors face the further problem of monitoring the creditworthiness of individual shareholders. If shareholders are personally liable, creditors will rely on the ability of each shareholder to repay at least some portion of the debt. Such creditors would be obliged to assess and monitor the creditworthiness of all shareholders, which would make borrowing capital more costly or, for some firms, even impossible. Interestingly, Herbert Hovenkamp reports that in early nineteenth century Massachusetts, which followed a rule of full personal liability, corporations with wealthy shareholders had little difficulty obtaining debt financing, while those with poor shareholders had considerable difficulty. See HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW: 1836-1937 50 (1991).

[20] One suspects that most people whose entire personal estate is subject to claims arising out of the conduct of a business would want, at the bare minimum, to know how that business was being conducted and, more likely, also would want to have a proportionate voice in deciding how the business was to be conducted. Either way, the whole point of being a shareholder is defeated. Shareholders want to be passive investors holding a diverse portfolio of many stocks. Fully diversified shareholders have neither the time nor the resources to monitor actively the conduct of a particular corporation's business or the solvency of their fellow shareholders (the latter being relevant because shareholders would want to know whether their fellow shareholders are able to bear their share of any loss). To require shareholders to actively participate in firm management makes even less sense, because in a large firm doing so would result in chaos. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 41-42 (1991).

leveraged firms having a very small amount of equity capital and a very large amount of secured debt. The mass tort plaintiffs that concern Professor Green,[21] in particular, would have a very difficult time satisfying their claims against such a firm.[22] By encouraging equity investment, the limited liability doctrine thus actually makes it easier for all creditors to be compensated.

By providing the rule that the parties would choose if they could bargain, society facilitates private ordering. To be sure, this benefits shareholders, but it also benefits the firm's other constituencies.[23] Because society benefits as well,[24] Professor Green's description of limited liability as a "'social subsidy' in the form of an unpaid insurance policy"[25] is incorrect. Limited liability is less a social subsidy than a social contract supported by consideration.

Professor Green probably would object that this version of the limited liability story does not account for his second point: namely, that the doctrine allows shareholders to externalize various costs onto nonshareholder constituencies and society at large.[26] This objection, however, fails to consider the variety of mechanisms by which the law can reduce negative externalities created by corporate conduct. Forcing shareholders to internalize those costs by imposing personal liability is one option. General welfare laws designed to deter corporate conduct through criminal and civil sanctions imposed on the corporation, its directors, and its senior officers are another. In the long run, the latter option is probably more efficient.

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[21] See, e.g., Green, supra note 2, at 1414-15.

[22] For an overview of mass tort claims in insolvency proceedings, see 3 DAVID G. EPSTEIN ET AL., BANKRUPTCY § 11-8 (1992). The point is not that limited liability never imposes costs on mass tort plaintiffs, but only that those claimants are, nevertheless, better off as a class under a rule of limited liability than one of full personal liability. In any case, the incentives a corporation's managers have to insure the firm further protect tort creditors, even under a rule of limited liability. See EASTERBROOK & FISCHEL, supra note 20, at 52-53.

[23] After reviewing the historical evidence, Hovenkamp concluded that "limited liability on the whole made corporate creditors better off [rather] than worse off." HOVENKAMP, supra note 19, at 55.

[24] Society benefits in a variety of ways from limited liability. In particular, society benefits from an expanded economic pie whenever private parties are able to maximize the gains available from transacting. Indeed, the gains flowing from limited liability are enormous. There is a widely shared view that limited liability is essential to attract the enormous amount of investment capital necessary for industrial corporations to arise and flourish. See, e.g., HOVENKAMP, supra note 19, at 54 ("limited liability clearly encouraged the flow of capital into new enterprise"). By allowing the modern public corporation to develop, limited liability was in large measure responsible for the development of our modern economic system.

[25] Green, supra note 2, at 1415. Hovenkamp points out that limited liability is properly regarded as a subsidy only if "it effectively transfer[s] wealth from one class of people to another." HOVENKAMP, supra note 19, at 54. Based on the historical record, he concludes that "[i]t is hard to make such a showing about limited liability." Id.

[26] Cf. Green, supra note 2, at 1415 ("Thanks to limited liability, shareholders . . . remain immune to some of the costs of misconduct or misjudgment by their corporate agents.").

The social costs of legal rules include not only the costs they impose upon the parties, but also the costs the legal system incurs in enforcing those rules. As we have seen, the former option entails substantial enforcement costs both for creditors and, as a result, for the judicial system.

In any case, while it is obvious that Professor Green is deeply pained by the costs corporate conduct can impose on nonshareholder constituencies, the alternatives he offers are poor substitutes for shareholder wealth maximization. Although the metaphors he proposes as substitutes for the shareholder wealth maximization norm are not clearly spelled out, Green seems to suggest two different models for restructuring corporate managers' fiduciary obligations. Under the first model, managers would have "multifiduciary" obligations to both shareholders and nonshareholder constituents.[27] Under the second model, managers would be permitted to pursue their own ethical preferences.[28]

Does Green really believe that either of these models would have prevented the Bhopal tragedy?[29] Consider the "multi-fiduciary stakeholder perspective." Green asserts that Union Carbide's managers knew about the risks at the Bhopal facility, but concedes that the risks were "slight" and that "major outlays" were required to make the plant safe.[30] Therefore, Green correctly concludes that the decision not to make the necessary repairs was a sensible business decision from the shareholder wealth maximization perspective.[31] But Green ignores the very real possibility that the decision also was a sensible one from the perspective of the plant's workers and the local community.

Unless managers are to be held strictly liable for decisions that harm some nonshareholder constituency, hindsight cannot be used when measuring their compliance with their multi-fiduciary responsibility. Rather, their compliance must be measured by what they knew or should have known at the time the decision was made. Union Carbide management knew that the plant was losing money and that there was little chance the plant could be turned around.[32] Under those circumstances, their only realistic choices were to close the plant or to forego maintenance. Given those options, and knowing that the risks were slight, both management and, more important, the plant's workers and the surrounding community probably would have thought foregoing repairs to be a gamble worth taking if it meant preserving jobs and the local economy.

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[27] See id. at 1411.

[28] Id. at 1410.

[29] A word is perhaps in order with respect to Professor Green's use of the Bhopal disaster and similar examples. In my view, he grossly overstates the magnitude of the negative externalities created by corporate conduct by focusing on instances that achieved prominence precisely because they were extraordinary.

[30] Green, supra note 2, at 1420. I assume arguendo the Bhopal facts to be as stated by Professor Green.

[31] Id.

[32] See id.

Professor Green likely would insist that there is a third choice: keep the plant open and undertake the necessary maintenance. This is consistent with his apparent view of shareholders as geese that lay golden eggs for the benefit of nonshareholder constituencies:

> In most cases today, [shareholders] commit only a small portion of their wealth to any one firm. With diversified portfolios, their overall risk in investing in a firm is relatively low. Indeed, some shareholders may even profit elsewhere in their portfolio as a result of reverses suffered by one of the firms whose stock they own. Furthermore, if they do not like the policies or directions taken by a firm in which they have invested, they are free at any time to sell their stock in a very active public market.[33]

In other words, taking the argument to its logical extreme, it is acceptable to wipe out the entire shareholder value of a particular firm because only part of the shareholders' portfolio will be lost.[34] (But what happens if all firms follow Green's prescription?)

To see the problem with Green's analysis, consider this: would most investors be willing to invest their retirement savings in corporate stock if his approach became law? If not, why not? Probably because most investors do not regard their investment in corporate stock as a charitable donation made to benefit nonshareholder constituencies.[35] Their investment in corporate stock must bring them a rate of return commensurate with the risks they are taking. If it does not, they will divest stock in favor of other investments or, at least, monitor management more closely. In either case, the cost of equity capital will rise. Ironically, Professor Green's approach thus will ultimately redound to detriment of nonshareholder constituencies, because the firms with the greatest need for infusions of equity capital are the very same small and medium size firms that produce most of our economic growth.

Yet, even if Green's model precluded managers from disregarding shareholder wealth concerns, it would still be troubling. His model gives directors a license to reallocate wealth from shareholders to nonshareholder

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[33] Id. at 1414.

[34] See id. at 1421 ("Sometimes . . . a moral commitment to other stakeholders may require a willingness to exhaust the resources of the company . . . . ").

[35] Professor Green might object that some, perhaps many, investors have investment objectives other than wealth maximization. In other words, wealth maximization is too narrow a goal because it fails to account for the variety of nonwealth factors that must be incorporated into even a purely utilitarian analysis. The point is well taken, as evidenced by the popularity of so-called socially responsible investment funds, but it does not justify creating a multifiduciary obligation. Analysis should begin with the assumption that wealth maximization is a significant part of the utility function for virtually all investors. Once we move beyond this common goal, the probability is very high that the shareholders' nonwealth concerns will vary considerably. In a large and diverse shareholder community, the nonwealth components of the collective utility function are thus likely to wash. Shareholder wealth maximization therefore becomes not just the lowest common denominator, but the only common denominator.

constituencies. As such, it strikes squarely at the heart of corporate law. The shareholder wealth maximization norm is premised on long-standing gain allocation rules, under which nonshareholder constituencies are paid first, but shareholders are entitled to whatever is left over after all of the formers' claims are satisfied. In contrast, Green's model gives nonshareholder constituencies a second bite at the apple. As we shall see, however, nonshareholder constituencies can adequately protect their claims through the contracting and political processes.[36] This makes a second bite both unnecessary and wholly undeserved.[37] There is an old saying: "God helps those who help themselves." So too does the law. Employees, local communities, and other nonshareholder constituencies are not wards of the court. If they fail to protect themselves, why should the law give them a second bite at the apple?

Green's other model, which allows managers to act in accordance with their own ethical preferences, would prove an equally ineffective constraint on the costs with which Green is concerned. One who relies on management's moral sense to prevent corporations from externalizing certain costs relies upon a very thin reed indeed. Again, consider the Bhopal disaster. Under current law, the business judgment rule almost certainly would have insulated Union Carbide's directors from liability if they had chosen to undertake the necessary repairs.[38] Yet, they did not do so. Given that Union Carbide's board had almost unrestricted freedom to pursue their own ethical precepts under existing law, why would Green's model have led to a different outcome?[39]

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[36] See infra notes 74-82 and accompanying text.

[37] Assuming competitive markets, those who enter into voluntary relationships with the firm should be viewed as having done so on the understanding that they are making trade-offs and accepting certain risks. Giving them unbargained-for ex post protection when those risks materialize thus gives them a windfall.

[38] See Bainbridge, supra note 2, at 976-80 (noting leading cases that reveal shareholder challenges to operational decisions usually fail because of business judgment rule). If Union Carbide was subject to a nonshareholder constituency statute, its directors would be even further insulated from liability. See id. at 997-1002 (using examples to show that nonshareholder constituency statutes insulate directors from liability in connection with operational decisions).

[39] Consider that unless Union Carbide's decisionmaking structure was unusually authoritarian, a number of decisionmakers likely would have had to approve the decision to effect repairs on the Bhopal plant. It is highly unlikely that all of these decisionmakers would bring identical ethical perspectives and concerns to the table. Even those who share the same concerns and values may not agree that a particular decision best advances their goals. Some sort of consensus therefore has to be reached. Given the socialization and training of modern U.S. corporate managers, shareholder wealth maximization is the norm most likely to prevail in any consensus-building process. As Green himself acknowledges, this metaphor dominates both legal and business thinking about fiduciary duties. See Green, supra note 2, at 1410. To be sure, Green states that the metaphor is flawed, Green, supra note 2, at 1413, but changing the metaphor is easier said than done. Indeed, Green's whole approach strikes one as an example of what Harold Demsetz describes as the pointless exercise of expecting people to behave differently than they actually do. See Harold Demsetz, Information and Efficiency, 12 J. L. & ECON. 1, 6 (1969). To be effective, public policy must be based on how people behave, not how we wish they behave.

A clarifying point is in order here. For purposes of analyzing Green's proposed model, I have assumed that management's decisions are driven solely by ethical concerns. In fact, however, management's decisions are at least as likely to be driven by self-interest as by ethical concerns. (I do not claim that management always pursues its own self-interest nor that it always acts rationally. I claim only that it does so with considerable frequency.) As we shall see, management's self-interest often will coincide to a greater extent with nonshareholder interests

Despite the absence of any compelling affirmative justification for replacing the shareholder wealth maximization norm with either of the models Professor Green proposes, it nonetheless seems appropriate to outline what I regard as the two major arguments against doing so.[40] The first might be termed the "two masters" problem. The second might be termed the problem of "managerial sin."

As Green acknowledges, management occasionally faces situations in which it is impossible to advance shareholder interests and to protect simultaneously nonshareholders from harm.[41] Yet, whose interests should management pursue when shareholder and nonshareholder interests are in irreconcilable conflict? Green's principal answer seems to be that management should make trade-offs between shareholder and nonshareholder interests, balancing the harms and benefits more or less equitably, although he is clearly prepared to permit management to eliminate shareholder value completely when necessary to protect nonshareholder interests.[42]

His approach not only leads directly to the managerial sin problem, but also raises a host of practical issues collectively making up the two masters problem. What happens when there is a conflict between shareholders and nonshareholders and also between various nonshareholder constituencies? Suppose, for example, that management is considering closing down an obsolete plant. The closing will harm the plant's workers and the local community, but will benefit shareholders, creditors, employees at a more modern plant to which the work previously performed at the old plant is

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than with those of shareholders. As it turns out, however, that is an argument against—rather than an argument for—Professor Green's approach. See infra notes 64-68 and accompanying text.

[40] Both problems, "two masters" and "managerial sin," are well documented in the literature, but that is part of my point. Despite the rather apocalyptic tone of some of the papers presented at this conference, we have been here before. Just as sunspots come in cycles, so too does the corporate social responsibility debate. In the 1930s, we had the Berle-Dodd debate. In the 1950s, Berle and others revisited the issue, prompted by cases like Barlow. In the 1970s, there was a major fracas over corporate social responsibility. Finally, today we have the nonshareholder constituency statutes. The twenty-year spacing is particularly interesting, because that is about the life span of one academic generation. In other words, the present debate is not being driven by any crisis in corporate law. It is just a perennial problem on which each new generation of corporate law scholars feels obliged to put its stamp. Herewith my spin.

[41] Green, supra note 2, at 1420-21. In most cases, of course, taking nonshareholder interests into account is in the shareholders' long-run interest. If the cases Professor Green is concerned about are rare, as I believe them to be, his solution risks permitting the tail to wag the dog.

[42] Id. at 1421.

transferred, and communities around the modern plant. Assume that the latter groups cannot gain except at the former groups' expense. By what standard should management make the decision?[43]

According to Green, these problems are overstated:

> [F]iduciaries of various sorts commonly find themselves pulled between competing duties. . . . In all these instances, professionals are expected to do the best they can by both developing and working within a framework of reasonable and defensible priorities. Why cannot corporate directors and senior managers be asked to do the same?[44]

For one thing, what Green asks of them is more easily said than done. As a theological matter, the proposition that no one can serve two masters simultaneously is at least two thousand years old.[45] As a secular proposition, it is certainly even older. Indeed, those of us who find the theological proposition persuasive do so in part precisely because we recognize its validity from our secular experience.

To take one of Professor Green's examples about which I have personal experience, being the "lawyer for the situation"[46] is at best uncomfortable and not infrequently untenable. Consider the example of Louis Brandeis, who coined this term. After a thorough examination of Brandeis' professional conduct, John Frank concluded:

> [T]he greatest caution to be gained from study of the Brandeis record is, never be "counsel for a situation." A lawyer is constantly confronted with conflicts which he is frequently urged to somehow try to work out. I have never attempted this without wishing I had not, and I have given up attempting it. Particularly when old clients are at odds, counsel may feel the most extreme pressure to solve their problems for them. It is a time-consuming, costly, unsuccessful mistake, which usually results in disaffecting both sides.[47]

Even authorities who are disposed more favorably toward the idea of lawyers for the situation acknowledge that that role "is not easy, may fail, and will often bring recrimination in its wake."[48]

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[43] When trying to determine what standard management should use when faced with conflicts between nonshareholder constituencies, the distinction between Green's two models becomes critical. Suppose that management concludes, under whatever standard the law creates, that its "multi-fiduciary" duty requires it to close the plant. Management's ethical consensus, however, is that the harms that its decision causes must be given greater weight than the benefits. Which course should management pursue: its own ethical preferences or its obligation to those who would benefit from the decision?

[44] Green, supra note 2, at 1418.

[45] See supra note 13.

[46] Green, supra note 2, at 1418.

[47] John P. Frank, The Legal Ethics of Louis D. Brandeis, 17 STAN. L. REV. 683, 708 (1965).

[48] 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING § 2.2:103, at 513 (2d ed. 1990 & Supp. 1993).

Professor Green fails to offer us a solution for this problem. Instead, he simply expresses confidence that those of us in the legal profession will be able to "develop the outlines of a multi-fiduciary" duty after "years of painstaking legal reasoning."[49] Based on the legal profession's poor experience with "lawyers for the situation," I am less sanguine.

Even if it proves possible to develop meaningful standards under which a multi-fiduciary duty might be enforced,[50] however, it seems likely that those standards would operate mostly by virtue of hindsight, and thus deprive managers of the critical ability to determine ex ante whether their behavior comports with the law's demands. The conflict of interest rules governing the legal profession again provide a useful analogy. Despite many years of refinement, these rules are still viewed as inadequate, vague, and inconsistent;[51] hardly the stuff of which certainty and predictability are made.[52] Yet,

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[49] Green, supra note 2, at 1419.

[50] To some extent, Professor Green's multi-fiduciary model poses problems similar to those that the nonshareholder constituency statutes raise, because both permit managers to make trade-offs between shareholder and nonshareholder interests. I have proposed elsewhere a model by which courts can review director actions taken pursuant to nonshareholder constituency statutes. See Bainbridge, supra note 2, at 997-1023. My interpretation of the nonshareholder constituency statutes, however, was based on certain aspects of the statutes that differ significantly from Professor Green's model. The nonshareholder constituency statutes do not permit managers to disregard shareholder interests, whereas Green's model apparently does. See supra text accompanying notes 33-34. Under the nonshareholder constituency statutes, managers have no fiduciary duties to nonshareholders, and nonshareholders have no standing to challenge management decisions, whereas neither of these rules may be true under Green's model. See infra note 62. Finally, the nonshareholder constituency statutes have no impact on the business judgment rule, whereas Green's models may contemplate restricting or eliminating it. See infra note 62. These differences make the task of developing coherent standards under which Green's model can be applied significantly more complex than that under the nonshareholder constituency statutes.

In any case, my interpretation of the nonshareholder constituency statutes was not premised on the assumption that the statutes were a good idea. To the contrary, I explicitly questioned the statutes' soundness as a matter of corporate law policy. See Bainbridge, supra note 2, at 1013, 1023-24. I am now even more convinced than ever that the statutes are a bad idea, because they share many of the same flaws as Professor Green's "multi-fiduciary" model. Because the statutes were on the books in over half of the states and were unlikely to be repealed any time soon, my interpretation was put forth as a way of making the best of a bad situation: if we must have the statutes, at least we can interpret them in ways that minimize their harmful effects. Why should we start down that rather unattractive road by adopting Professor Green's new directions when we have the option of staying the course?

[51] See Marc I. Steinberg & Timothy U. Sharpe, Attorney Conflicts of Interest: The Need for a Coherent Framework, 66 NOTRE DAME L. REV. 1, 2 (1990); see also RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 cmt. c, reporter's note (Tentative Draft No. 4, 1991) ("cases that carefully articulate the proper conflict of interest standard are rare"). See generally Nancy J. Moore, Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy, 61 TEX. L. REV. 211 (1982).

[52] Cf. Joel C. Dobris, Ethical Problems for Lawyers upon Trust Terminations: Conflicts of Interest, 38 U. MIAMI L. REV. 1, 51 (1983) ("When a person is unhappy about an irrevocable financial arrangement that he has entered into with the participation of a lawyer who also represents another person who is interested in the transaction, there is no certainty or predictability for the lawyer.").

despite the central importance of those virtues in corporate law,[53] this is the principal model Professor Green wishes to foist upon us.[54]

The problem is not just uncertainty or unpredictability. Ultimately, Professor Green's models are fundamentally flawed because of their failure to account adequately for the problem of managerial sin. Under either of Professor Green's models, management could freely pursue its own self-interest by playing shareholders off against nonshareholders. When management's interests coincide with those of shareholders, management could justify its decision by saying that shareholder interests prevailed in this instance, and vice-versa. The plant closing decision described above again proves a useful example. Recall that shareholders and some nonshareholder constituents will benefit if the plant is closed, but other nonshareholder constituents will lose. If management's compensation is tied to firm size, we can expect it to resist down-sizing the firm. The plant likely will stay open, with the decision being justified by reference to the impact of a closing on the plant's workers and the local community. In contrast, if management's compensation is linked to firm profitability, the plant will likely close, with the decision being justified by management's concern for the firm's shareholders, creditors, and other benefitted constituencies.

Now we come to the crux of the matter. If Professor Green's models are treated as a serious proposal for reform, two paradigms by which they might be implemented suggest themselves. Under the more limited of the two, a change in the prevailing norm leaves the rest of corporate law largely intact. The more expansive of the two envisions a fundamental reshaping of corporate law.

I take the limited paradigm quite seriously. Although I doubt that Delaware will reject the shareholder wealth maximization norm in the near future, the limited paradigm arguably has already come into effect in those states with nonshareholder constituency statutes. Those statutes limit the shareholder wealth norm by allowing the board to make trade-offs between shareholder and nonshareholder interests, but they work no direct changes on other corporate law doctrines.[55] The more expansive paradigm, however, is hard to take very seriously. Specifically, states are not going to repeal the business judgment rule in favor of another approach to fiduciary duty any time soon.[56]

Assuming the business judgment rule will remain in place regardless of which norm we settle upon, the analysis must be expanded to include the

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[53] See, e.g., Harff v. Kerkorian, 324 A.2d 215, 220 (Del. Ch. 1974) ("It is obviously important that the Delaware corporate law have stability and predictability.").

[54] See Green, supra note 2, at 1419.

[55] See supra note 2; see also Bainbridge, supra note 2, at 990-94.

[56] The only nonshareholder constituency statutes to explicitly state the standard of review applicable thereunder specified the business judgment rule. See Bainbridge, supra note 2, at 994.

legal context in which the chosen norm will operate. In most situations, shareholder and nonshareholder constituency interests coincide.[57] The tough cases, of course, are those in which the interests diverge. One suspects that, despite the shareholder wealth maximization norm, directors and officers often take nonshareholder constituency interests into account even in these cases. This is not particularly surprising because no one other than the occasional law or economics professor seriously expects managers to leave their ethical and moral concerns at home. Nor is it particularly problematic from a legal perspective because the business judgment rule will insulate directors from liability without regard to the shareholder wealth consequences of the board's decision in the vast majority of cases.[58]

At this point, Professor Green might reasonably ask what happened to the "two masters" and "managerial sin" problems. If these problems are valid reasons for rejecting his approach, how do I explain the freedom the business judgment rule gives directors to consider nonshareholder interests? Contrary to Professor Green's models, management accountability to shareholder welfare is a central goal of the legal regime from which the business judgment rule arises.[59] That regime, however, treats preservation of management discretion as an equally important goal.[60] While both accountability

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[57] See id. at 999-1000. It is tempting to justify the shareholder wealth maximization norm on the grounds that a rising tide lifts all boats. In many cases this will be true. Nonshareholder constituencies have a claim on the corporation that is both fixed and prior to that of the shareholders. So long as general welfare laws prohibit the corporation from imposing negative externalities on those constituencies, the shareholder wealth maximization norm redounds to these constituencies benefit. In some cases, however, the rising tide argument is inapplicable because it fails to take into account the question of risk. Pursuing shareholder wealth maximization often requires one to make a decision that increases the firm's risk, which disadvantages nonshareholder constituencies. The increased rate of return usually associated with increase in risk does not benefit nonshareholders, because their claim is fixed, whereas the simultaneous increase in the corporation's riskiness makes it less likely that nonshareholder claims will be satisfied.

[58] See Bainbridge, supra note 2, at 998 (noting that cases in which business judgment rule does not shield operational decisions from judicial review are so rare as to amount to little more than aberrations).

[59] See supra note 2.

[60] See Stephen M. Bainbridge, Independent Directors and the ALI Corporate Governance Project, 61 GEO. WASH. L. REV. 1034, 1073-74 (1993), which drew on Michael P. Dooley, Two Models of Corporate Governance, 47 BUS. LAW. 461 (1992), which in turn drew upon KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974). Dooley premises his justification of the business judgment rule on the shareholder wealth maximization norm. Dooley, supra, at 466. Arrow's work, however, is not so limited. According to Arrow, authoritative allocation of decisionmaking, i.e., "the giving and taking of orders, having someone tell someone else what to do, is an essential part of the mechanism by which organizations function." ARROW, supra, at 63. Authority-based decisionmaking structures arise whenever the organization's members have differing interests and access to information. See id. at 68-70. Arrow further points out that the benefits of authority-based processes cannot be obtained if outsiders are empowered to review the decisionmaker's choices: "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B . . . . " Id. at 78.

Arrow's model, of course, aptly describes the publicly-held corporation. Bainbridge, supra, at 1056. The business judgment rule thus follows a fortiori from the corporation's decisionmaking structure because it prevents courts from usurping the board's authority. Dooley, supra, at 469-70. Interestingly, however, if we make the plausible assumption that the description would remain apt even following a shift to Green's models, public corporations will have an authority-based

and discretion are important goals, they are also ultimately irreconcilable. One inevitably reaches a point at which additional accountability can be had only by limiting management discretion.[61] The business judgment rule thus reflects a policy decision to accept the risks encompassed by the two masters and managerial sin problems in order to capture the benefits flowing from broad managerial discretion. Management's freedom to consider nonshareholder interests is merely an incidental by-product of that determination.

The essential differences between a regime premised on shareholder wealth maximization and a regime premised on Green's models should now be apparent. A shift to the latter would increase the underlying costs the managerial sin and two masters problems create, without any corresponding gains for shareholders on the benefit side of the equation. Of course, so long as we adhere to the limited paradigm,[62] replacing the shareholder wealth maximization norm with Professor Green's models nevertheless might have more of a psychological than a legal impact. Despite the greater costs

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decisionmaking structure regardless of the norm by which decisions are made. As a result, the policy justification for preserving management discretion is independent of the choice between the competing norms. (Note that the limited paradigm is thus supported by a sound policy argument, as well as by political realities.)

Having said that, however, one aspect of Arrow's model is quite important in assessing the present debate. Decisionmakers in hierarchial structures may use their authority in irresponsible ways. ARROW, supra, at 73-76. In particular, the agency cost literature shows that decisionmakers may shirk their responsibilities in a variety of ways that benefit themselves at the expense of the organization's other members. See Bainbridge, supra, at 1057; Dooley, supra, at 469. This results in the tension described in the text between the competing virtues of discretion and accountability. Arrow's model contemplates that in some cases accountability concerns will require limits on the decisionmaker's authority. ARROW, supra, at 77-79. Hence the various exceptions to the business judgment rule. Dooley, supra, at 476. In cases covered by those exceptions, the shareholder wealth maximization norm is preferable because it provides a surer source of management accountability. See infra notes 64-68.

[61] See Dooley, supra note 60, at 470 (arguing that business judgment rule is intended to protect authority of board).

[62] Green's approach seems to embrace the more expansive of our two paradigms. He apparently favors imposing "on managers and directors a multiplicity of significant but potentially competing obligations" and holding "them accountable for fulfilling" those obligations. Green, supra note 2, at 1418. If so, his models become even more problematic because they would reduce or eliminate the benefits of managerial discretion.

This is another point at which the distinction between Green's models becomes critical. Under his multi-fiduciary model, nonshareholder constituencies presumably would have the right to bring suit when management allegedly breaches its fiduciary duty to that group. In contrast, under the model in which management is simply freed to pursue its own ethical preferences, nonshareholders presumably would not have standing because that model does not seem to envision any formal fiduciary duties running to those constituencies.

associated with Green's models, the business judgment rule would continue to insulate management discretion from judicial review in most cases. The psychological effects of a switch, however, should not be downplayed. As we have seen, the shareholder wealth maximization norm is central to management's socialization.[63] Accordingly, the norm provides a forceful reminder of where the director's loyalty lies. Even if the business judgment rule renders its rhetoric largely unenforceable, the shareholder wealth maximization norm is an ever present goad. By removing the psychological constraint that the shareholder wealth maximization norm provides and simultaneously exacerbating the managerial sin problem, Green's approach is less likely to encourage managers to pursue the collective interests of the firm's various constituents than it is to encourage management to pursue their own self-interest.

The critical difference between the existing regime and Green's models, however, emerges when we turn to those cases in which the business judgment rule does not apply with full force. In this context, the two masters and managerial sin problems not only justify retaining the shareholder wealth maximization norm, but also giving it teeth.[64] Suppose, for example, that our hypothetical corporation receives a takeover bid from a bidder with a history of closing obsolete plants. The board rejects the bid, citing the bidder's history. All of the practical problems discussed above are present. More important, while an honest concern for the threatened workers may have motivated the directors' decision, so too might a concern for their own positions and perquisites. Indeed, corporate managers are much more likely to suffer losses as a result of takeovers than are other nonshareholder constituencies.[65] Accordingly, it is not at all difficult to imagine a target board using nonshareholder interests as nothing more than a negotiating device to extract side payments from the bidder.

Under current law, the business judgment rule would not protect the directors' decision unless they could show that it also benefitted the shareholders.[66] Indeed, the emergence of a control auction would wholly preclude the board from considering the impact of their decision on the firm's nonshareholder constituencies.[67] Because Professor Green's models permit managers to play off one constituency against another, however,

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[63] See supra note 39 (arguing that given socialization and training of modern corporate manager, shareholder wealth maximization norm is most likely to prevail in any consensus building process).

[64] I reject the view that target management has no legitimate role to play in takeover fights or proxy contests. To the contrary, I believe incumbent management properly has substantial discretionary authority even in contests for control. But this is a question for another day. My point here is only that the shareholder wealth maximization norm should guide, and be used to evaluate, management's exercise of its decisionmaking authority, however broad or narrow it may be.

[65] See Bainbridge, supra note 2, at 1009-12 (discussing inherent tension between interests of target managers and target shareholders).

[66] Id. at 982.

[67] Id. at 983.

the accountability provided by current law would be completely lost.[68] Thus, Green's model is less likely to transfer wealth from shareholders to nonshareholder constituencies, as he apparently envisions, than it is to transfer wealth from both shareholders and nonshareholders to managers.

The justification for Professor Green's models becomes even more tenuous when one recognizes that shareholders are more vulnerable to this sort of management misconduct than are nonshareholder constituencies. Professor Green asks: "Can it really be said that employees (or local communities or dependent suppliers) are really better able to 'negotiate' the terms of their relationship to the corporation than are shareholders?"[69] While he presumably intended this to be a purely rhetorical question, in fact it has an answer and the answer is an affirmative one.

Shareholders have no meaningful voice in corporate decisionmaking. As a legal matter, shareholders have essentially no power to initiate corporate action and, moreover, are entitled to vote on only a very few corporate actions.[70] Rather, formal decisionmaking power resides mainly in the board of directors.[71] As a practical matter, of course, the sheer mechanics of undertaking collective action by thousands of shareholders preclude them from meaningfully affecting management decisions.

In effect, shareholders have but a single mechanism by which they can "negotiate" with management: withholding capital. If shareholder interests are inadequately protected, they can refuse to invest. The nexus of contracts model, however, demonstrates that equity capital is but one of the inputs that a firm needs to succeed. Nonshareholder corporate constituencies can thus "negotiate" with management in precisely the same fashion as do shareholders: by withholding their inputs. If the firm disregards employee interests, it will have greater difficulty finding workers. Similarly, if the firm disregards creditor interests, it will have greater difficulty attracting debt financing, and so on.

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[68] The problem of management playing shareholders off against nonshareholders is especially pronounced when we turn to Professor Green's second model, because a system allowing management to pursue its own ethical preferences seems to defy any notion of accountability.

[69] Green, supra note 2, at 1418.

[70] Under the Delaware Code, shareholder voting rights are essentially limited to the election of directors and the approval of charter or by-law amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolutions. As a formal matter, only the election of directors and the amendment of the by-laws do not require board approval before shareholder action is possible. See Del. Code Ann. tit. 8, §§ 109, 211 (1991). In practice, of course, even the election of directors, absent a proxy contest, is predetermined by the existing board nominating the following year's board.

[71] To be sure, one of the few issues on which shareholders have input is the selection of directors. As a practical matter, however, the corporate voting system and shareholder apathy usually combine to render this a meaningless formality. This phenomenon may be changing somewhat as institutional investors become more active with respect to corporate governance matters. I am doubtful, however, that institutional investor activism will have more than marginal effects. See Stephen M. Bainbridge, Redirecting State Takeover Laws at Proxy Contests, 1992 WIS. L. REV. 1071, 1088-90.

In fact, withholding one's inputs may often be a more effective tool for nonshareholder constituencies than it is for shareholders. Some firms go for years without seeking equity investments. If the management groups in these firms disregard shareholder interests, the shareholders have little recourse other than to sell out at prices that will reflect management's lack of concern for shareholder wealth.[72] In contrast, few firms can survive for long without regular infusions of new employees and new debt financing. As a result, few management groups can prosper for long while ignoring nonshareholder interests.[73]

In any case, nonshareholders have a variety of other mechanisms available with which to influence management decisions that shareholders lack.[74] One mechanism is contract negotiations.[75] Unlike shareholders, employees regularly bargain with employers both individually and collectively. So do creditors. Even local communities sometimes bargain with existing or prospective employers, offering firms tax abatements and other inducements in return for which they could and should extract promises about the firm's conduct. Those nonshareholder constituencies that enter voluntary relationships with the corporation thus can protect themselves by adjusting the contract price to account for negative externalities imposed upon them by the firm.[76]

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[72] To be sure, management's ability to disregard shareholder values is constrained by a variety of legal and market forces. As we have seen, however, Professor Green's models might well weaken those forces. Indeed, Professor Green's models only make sense if they are intended to weaken the forces that prevent management from ignoring shareholder wealth.

[73] In addition, nonshareholders are often indirectly protected from management misconduct, because management's interests are more likely to be aligned with those of nonshareholder constituencies than with those of the shareholders. Salaried managers hold what amounts to a fixed claim on the corporation's assets and earnings, which is not too dissimilar from the claims of other nonshareholder constituencies. Moreover, much of corporate managers' wealth is tied up in undiversified firm-specific human capital. These factors tend to make them more concerned with ensuring the firm's survival than with taking risks that would maximize shareholder wealth.

[74] The analysis herein applies mainly to voluntary constituencies of the firm, although the political process point is not wholly inapt with respect to involuntary constituencies. In any case, corporate law is an exceptionally blunt instrument with which to protect involuntary constituencies (and voluntary constituencies, as well, for that matter). Tort, contract, and property law, as well as a host of general welfare laws, provide them with a panoply of protections.

[75] See generally 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 (1991). Granted, the extent of negotiations between the corporation and nonshareholders is likely to vary widely. In many cases, such as hiring shop floor employees, the only negotiation will be a take it-or-leave it offer. But so what? Is a standard form contract any less of a contract just because it is offered on a take it-or-leave it basis? If the market is competitive, a party making a take it-or-leave it offer must set price and other terms that will lead to sales despite the absence of particularized negotiations. As long as the firm must attract inputs from nonshareholder constituencies in competitive markets, the firm similarly will have to offer those constituencies terms that compensate them for the risks they bear.

[76] To be sure, shareholders can protect themselves from management misconduct in a similar fashion. As we have seen, shareholders can refuse to invest unless the contract price reflects the risks to which they are exposed. The trouble is that this is a one-time mechanism. Once the shareholders have purchased the company's stock, the pricing mechanism ceases to function. The twin problems of uncertainty and bounded rationality mean that shareholders cannot fully anticipate all possible future changes in management behavior. Accordingly, the pricing process cannot fully protect shareholders from midstream changes in managerial behavior that increase the

Perhaps an even more important consideration is the ability many nonshareholder constituencies have to protect themselves through the political process. Public choice theory teaches that well-defined interest groups are able to benefit themselves at the expense of larger, loosely defined groups by extracting legal rules from lawmakers that appear to be general welfare laws but in fact redound mainly to the interest group's advantage. Absent a few self-appointed spokesmen, most of whom are either gadflies or promoting some service they sell, shareholders—especially individuals—have no meaningful political voice. In contrast, many nonshareholder constituencies are represented by cohesive, politically powerful interest groups. Consider the enormous political power wielded by unions, who purportedly represent the interests of employees, a group whose interests Professor Green obviously cares deeply about.[77] Unions played a major role in passing state anti-takeover laws.[78] Those laws had a significant part in killing off hostile takeovers.[79] From the shareholders' perspective, the unions helped kill the goose that laid the golden egg.[80] From the union's perspective, however, hostile takeovers were inflicting considerable harm on workers. The unions were probably wrong on that score,[81] but the point is that the unions used their political power to transfer wealth from shareholders to nonshareholder constituencies.[82]

In sum, Professor Green's models are unnecessary because nonshareholder constituencies have adequate mechanisms to protect themselves from the negative externalities created by management misconduct.[83] To be sure,

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risks to which they are exposed. In contrast, the firm and many of its nonshareholder constituencies engage in repeat transactions, which allows those constituencies to demand changes in the contract price for the next round that compensate them for midstream changes in managerial behavior.

[77] For another example, consider the political power of local communities, which is so great that Congress was forced to create the Base Closing Commission in order to resolve the political gridlock that prevented it from closing obsolete military bases.

[78] Bainbridge, supra note 2, at 1009 n.154.

[79] Bainbridge, supra note 71, at 1068-88.

[80] The evidence is overwhelming that shareholders reap substantial gains from takeovers. See Bainbridge, supra note 2, at 1009-10.

[81] Id. at 1008-09.

[82] See Roberta Romano, A Guide to Takeovers: Theory, Evidence, and Regulation, 9 YALE J. ON REG. 119, 172-73 (1992) (discussing studies of nonshareholder constituency statutes). Of course, in the long run, corporate managers benefited the most from state anti-takeover laws. But this is precisely the sort of irony inherent in the managerial sin problem.

[83] The same mechanisms that protect nonshareholder constituences from managerial misconduct, of course, also enable nonshareholder constituencies to protect themselves from the negative externalities created when faithful corporate managers make decisions based on solely on shareholder interests. As such, these mechanisms not only affirm the positive case for retaining the shareholder wealth maximization norm, they also effectively undercut the arguments against the norm. Indeed, for this reason, many of the costs that concern Professor Green are not even properly categorized as negative externalities. An externality "is defined as a cost or benefit that the voluntary actions of one or more people imposes or confers on a third party or parties without their consent." ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 45 (1988). Because voluntary nonshareholder constituencies are compensated through the contracting and political processes for costs the corporation imposes upon them, those costs are not true externalities. The political and contracting processes will force the corporation to internalize them. Not perfectly, of course, but the question then becomes whether the benefits of closing the gap

neither the contracting nor the political process is perfect, but each standing alone probably provides nonshareholder constituencies with more meaningful protections than would both of Green's models combined. More to the point, shareholders are more vulnerable to management misconduct than are nonshareholder constituencies, because shareholders lack meaningful access to many of the protective mechanisms of which nonshareholder constituencies may avail themselves.[84]

Professor Green acknowledges some of these concerns, but blithely dismisses them: "[t]aken individually and collectively, these arguments do not constitute a very convincing justification of the principal-agent, fiduciary model."[85] In contrast, I regard them as a compelling set of reasons for retaining the shareholder wealth maximization norm. Granted, saying it does not make it so, but is that not a road that runs both ways?

In any case, the arguments in favor of the shareholder wealth maximization norm reflect a more pragmatic and realistic view of human nature. As Michael Novak has pointed out: "Any social order that intends to endure must be based on a certain realism about human beings and, therefore, on a theory of sin and a praxis for dealing with it."[86] Here the "sin" in question is that of self-interest. No informed corporate lawyer can doubt the very real risk that some corporate directors and officers will use nonshareholder interests as a cloak for actions taken to advance their own interests.

In fact, as I have argued elsewhere,[87] all too many U.S. corporate managers are hypocritical about nonshareholder interests. Many of the same managers who vigorously lobbied state legislators in favor of nonshareholder constituency statutes, were equally vigorous in opposing plant closing laws and other worker protection statutes. Many of the same managers who bewailed the jobs lost after successful corporate takeovers, were

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justify the costs of doing so. As we have seen, Professor Green's models are unlikely to close the gap and, in any case, would do so only at considerable cost.

[84] A related point was made by the Model Act's drafters, who point out that "the reallocation of wealth is a function for which directors are not especially suited and one beyond the general pale of their perceived mandate from society. Such allocations of wealth (which essentially a balancing of the interests of various constituencies would be) are political decisions." The Committee on Corp. Laws of the Am. Bar Ass'n, supra note 4, at 2270. Such reallocations therefore should take place as a result of political, not corporate, processes.

[85] Green, supra note 2, at 1418.

[86] MICHAEL NOVAK, TOWARD A THEOLOGY OF THE CORPORATION 22 (1981).

[87] See Bainbridge, supra note 2, at 1012.

silent about the jobs lost because of management defensive tactics. Ironically, much of the anecdotal evidence on the harm to nonshareholders caused by takeovers relates to employees fired after defensive restructurings used by incumbent managers to defeat a hostile bid.[88]

This is not to say that all actions taken on behalf of nonshareholder constituencies are motivated by self-interest. The key point, however, is that all such actions involve a potential conflict of interest. This is true even if the managers honestly believe they are 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."[89] Professor Green has simply failed to offer us a praxis for dealing with this problem. Nor does it seem likely that one is in the offing. Absent such a praxis, however, the shareholder wealth maximization norm remains the far more attractive choice.[90]

In closing, it seems appropriate to again note that my critique of Professor Green's paper has unfolded wholly on a public policy plane. In thinking about the moral aspect of the debate, however, I was struck by a question Professor Green poses in his book, The Ethical Manager, which I paraphrase here: How would I feel about living in a world governed by the moral rules implicit in the shareholder wealth maximization norm?[91] Frankly, my answer is: "pretty good." In fact, that is precisely the world in which we live. For many years, the basic rule that shareholder interests come first has governed public corporations.[92] That rule has helped produce an economy that is dominated by public corporations, which in turn has produced the highest standard of living of any society in

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[88] See id.

[89] City Capital Assoc. v. Interco Inc., 551 A.2d 787, 796 (Del. Ch.) (emphasis deleted), appeal dismissed, 556 A.2d 1070 (Del. 1988).

[90] There was a great deal of talk at the conference about burdens of proof. Shifting the burden of proof to the other side is a useful debating trick, but, as Chuck Yablon pointed out, a burden of proof is a litigation concept that has very little to do with academic discourse.

A related point needs to be made, however. While the burden of proof is a fiction in this context, the burden of effecting legal change is not. Because shareholder wealth maximization is a more accurate description of legal reality than is the multi-fiduciary approach, advocates of the latter unavoidably bear the burden of effecting change. As a practical matter, I am dubious that they will be able to accomplish that goal. Most state governments bend over backwards to protect management prerogatives, a point vividly illustrated by the takeover statute phenomenon. Even the nonshareholder constituency statutes have more to do with preserving management discretion than with protecting nonshareholder interests. This was probably the motivation for Bill Bratton's suggestion at the conference that change takes place at the federal level. Unfortunately for would-be reformers, federal help is unlikely to be forthcoming. The SEC lacks authority over corporate governance, while Congress repeatedly has proven incapable of serious corporate governance reform. See generally Stephen M. Bainbridge, The Short Life and Resurrection of SEC Rule 19c-4, 69 WASH. U.L.Q. 565 (1991).

[91] See RONALD M. GREEN, THE ETHICAL MANAGER 243 (forthcoming 1994) (draft materials cited by permission).

[92] See supra notes 2-3 and accompanying text.

the history of the world.[93] A system with that record of success cannot be all bad. Nor should it be replaced without a much stronger showing than Professor Green has made here.

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[93] In an address delivered in 1934, Mr. Justice, now Chief Justice, Stone declared that the fiduciary principle of undivided loyalty was, in effect, "the precept as old as Holy Writ, that 'a man cannot serve two masters.' More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can long endure without loyalty to that principle." He went on to say that "The separation of ownership from management, the development of the corporate structure so as to vest in small groups control of resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function."

Bayer v. Beran, 49 N.Y.S.2d 2, 5 (N.Y. App. Div. 1944) (quoting Harlan F. Stone, The Public Influence of the Bar, 48 HARV. L. REV. 1, 8-9 (1934)).