Today’s readings deepen our look at the US corporation. Now that you understand the peculiar structure of the US corporation – and its state-based private ordering – you are ready to consider the specific case of the US public corporation. Although there is great variation among public corporations (Exxon-Mobil vs. Google), you will notice unifying legal and structural themes.

You will begin your readings with an overview of fiduciary duties of directors in US corporations – the “glue” of US corporate law. You’ll want to focus on the operation of the duties of care and loyalty, and the “judicial abstention” implicit in the business judgment rule. The BJR, as it is called, is one of the most important aspects of US corporate law, relieving directors of personal liability for their decisions – absent fraud, corruption, illegality or complete disregard of their duties.

Next you’ll read a comparison I have made between private US corporations and the US constitutional structure. Both the corporation and the constitution create hierarchical structures in which the principals have delegated authority to agents. And in both cases the principals retain important exit, voice and loyalty prerogatives. Over time, those who define the contours of the corporation have drawn from constitutional norms and language. And, somewhat surprisingly, the constitutional structure may have originally drawn from the early US corporation.

Finally, you’ll find interesting an article by Leo Strine, the former Chancellor of the Delaware Court of Chancery and now the Chief Justice of the Delaware Supreme Court – thus, the most important business judge in the United States. His article describes how the “for-profit corporation” in the United States is designed to make profits for its shareholders, unless government regulation makes clear that the corporation is to seek other ends. You’ll notice that Chief Justice Strine has a somewhat irreverent view of the corporation, suggesting that when left to its own (at least, current) devices it may not serve the social ends we intended for it.

Readings:

- E&E 11 (Duties of Directors)
- Palmiter, Public Corporation as Private Constitution (2008)
- Strine, For-Profit Corporation (2012)
CHAPTER 11

Corporate Fiduciary Duties—An Introduction

At the heart of corporate law lie duties of trust and confidence—fiduciary duties—owed by those who control and operate the corporation’s governance machinery to the body of constituents known as the “corporation.” Directors, officers, and controlling shareholders are obligated to act in the corporation’s best interests, which traditionally has meant primarily for the benefit of shareholders—the owners of the corporation’s residual financial rights.

State courts, not legislatures, have been the primary shapers of corporate fiduciary duties. Judicial rules balance management flexibility and accountability, producing often vague and shifting standards. The American Law Institute has contributed the Principles of Corporate Governance (see §1.2.4) to articulate and provide guidance on corporate fiduciary duties and the standards of judicial review they entail. Fiduciary duties fuel the ongoing debate over the function and responsibility of the corporation in society.

This chapter introduces the theory and nature of corporate fiduciary duties (§11.1), gives an overview of the duties of care and loyalty (§11.2), and describes the reality of fiduciary duties in modern corporations (§11.3), particularly as they relate to independent directors (§11.4). The chapter also offers an overview of recent federal legislation—the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010—that introduce a variety of corporate governance reforms in public corporations and thus federalize some corporate fiduciary duties (§11.5).

§11.1 THE CORPORATE FIDUCIARY—A UNIQUE RELATIONSHIP

§11.1.1 Analogies to Trusts and Partnerships

What is the corporate fiduciary’s relationship to the corporation? Early courts analogized the corporation to a trust, the directors to trustees, and the shareholders to trust beneficiaries. But modern courts recognize that the analogy is flawed because trustees have limited discretion compared to directors.

Sometimes the corporation, particularly when closely held, has also been analogized to a partnership. But corporate fiduciaries operate in a system that prizes corporate permanence, as well as centralized management and the discretion specialization entails. Although some cases have implied partner-like duties for participants in close corporations (see §27.2.2), the cases are exceptions to the broad discretion afforded corporate directors.

In the end, the most that can be said is that directors have a unique relationship to the corporation. The relationship arises from the broad authority delegated directors to manage and supervise the corporation’s business and affairs, subject to the rights of shareholders to elect directors.
Note on Duties of Other Corporate Insiders

Courts have generally imposed on corporate officers and senior executives the same fiduciary duties imposed on directors. MBCA §8.41. Those employees who are officers in name but have no actual authority, as well as other employees, have traditional duties of care and loyalty as agents of the corporation. In addition, corporate officers and employees have a duty of candor that requires them to give the corporation (the board of directors or a supervisor) information relevant to their corporate position.

In general, persons retained by the corporation do not have corporate fiduciary duties. For example, an attorney who advises a majority shareholder in an unfair squeezeout of minority shareholders is not bound by fiduciary duties to the corporation, though the attorney can be liable for tortious aiding and abetting of the majority’s breach.

§11.1.2 Theory of Corporate Fiduciary Duties

The genius of the U.S. corporation lies in its specialization of function. The corporation separates the risk taking of investors and the decision making of specialized managers. This separation creates an inevitable tension.

- **Management discretion.** The efficiency of specialized management suggests that managers should have broad discretion. Giving shareholders (and courts) significant oversight would undermine this premise of the corporate form. In cases of normal business decision making, judicial abstention is appropriate.

- **Management accountability.** Entrusting management to nonowners suggests a need for substantial accountability. As nonowners, managers have natural incentives to be lazy or faithless. Although shareholder voting constrains management abuse, voting is episodic. Without supplemental limits, management discretion would ultimately cause investors to lose confidence in the corporate form. In cases of management overreaching, judicial intervention is the norm.

Corporate fiduciary law must resolve this tension. Like much of corporate law, fiduciary rules aim to minimize “agency costs”—the losses of investor-owners dealing through manager-agents.

§11.1.3 To Whom Are Fiduciary Duties Owed?

Corporate directors are said to owe fiduciary duties to the "corporation," not the particular shareholders who elected them. Some courts and many commentators assert that fiduciary rules thus proceed from a theory of maximizing corporate financial well-being by focusing on *shareholder wealth maximization*. The theory posits that any fiduciary rule—whether governing boardroom behavior or use of inside information—must maximize the value of shareholders’ interests in the corporation. As residual claimants of the corporation's income stream, shareholders are the most interested in effective management. Under this theory, the corporation’s other constituents such as bondholders, creditors, employees, and communities where the business operates are limited to their contractual rights and other legal protections. See *Equity-Linked Investors, LP v. Adams*, 705 A.2d 1040 (Del. Ch. 1997) (finding that new borrowing by financially troubled firm did not violate rights of preferred shareholders, which “are contractual in nature”). To the extent other
constituents have unprotected interests inconsistent with those of shareholders, the interests of shareholders prevail—a *shareholder primacy* approach.

In most instances, courts have said that corporate fiduciary duties run to equity shareholders. When the business is insolvent, however, these duties run to the corporation’s creditors—who become the corporation’s new residual claimants. See *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del. Ch. 1992). When the corporation is on the verge of insolvency, the question arises whether directors should be allowed to take risks to return to solvency (for the benefit of shareholders) or avoid risks to preserve assets (for the benefit of creditors). Some cases suggest that the board’s role shifts in such circumstances from being an “agent for the residual riskbearers” to owing a duty to the corporate enterprise. *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*, No. 12150 (Del. Ch. 1991).

**Dodge v. Ford Motor Co.**

Despite its prevalence, the theory of shareholder wealth maximization has gaps. For example, the case most often cited as supporting the theory may actually have turned on nonshareholder concerns. In *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919), the Michigan Supreme Court reviewed Ford Motor’s decision to discontinue paying a special $10 million dividend, ostensibly to finance a new smelting plant while paying above-market wages and reducing the price of Ford cars. Minority shareholders claimed the decision was inconsistent with the fundamental purpose of the business corporation—to maximize the return to shareholders. The court agreed and faulted Henry Ford for reducing car prices and running Ford Motor as a “semi-eleemosynary institution and not as a business institution.” The court ordered the special dividend, though curiously refused to enjoin Ford’s expansion plans since “judges are not business experts.”

At first blush, the case seemed to turn on Ford’s stated view that his company “has made too much money, has had too large profits ... and sharing them with the public, by reducing the price of the output of the company, ought to be undertaken.” Nonetheless, more was below the surface. The plaintiff Dodge brothers (former suppliers of car chassis and motors to Ford Motor) hoped to use the special dividend to finance their own start-up car manufacturing company, and Henry Ford’s dividend cutback was meant to forestall this competition, despite the attendant benefits of competition to the car-buying public and Michigan’s auto industry. The court’s decision to second-guess perhaps the most successful industrialist ever is at odds with the general judicial deference to management, as well as with the Michigan court’s specific observation that Ford Motor’s great success had resulted from its “capable management.”

Using corporate law, the court advanced a social agenda. Fixing on snippets from Henry Ford’s public relations posturing, the court labeled him an antishareholder altruist. This allowed the court to order Ford to fund the Dodge brothers’ new car company, thus injecting some competitive balance into the expanding auto industry and ultimately into Michigan politics. Soon after, the Dodge brothers parlayed their court victory into a sizeable buyout of their Ford Motor holdings. (It is worth noting that no other minority shareholders participated in the case, though Henry Ford eventually bought them out, too.) Ironically, the case so often cited as declaring a philosophy of shareholder wealth maximization turns out—on closer examination—to have been about a squabble between two competitors where the stakes were consumer prices, product choice, employee wages, industry competition, and political pluralism.
“Other Constituency” Statutes

Some states have recently enacted “other constituency” statutes that permit, but do not require, directors to consider nonshareholder constituents (or stakeholders), particularly in the context of a corporate takeover. See Pa. BCL §1715 (directors may consider “shareholders, employees, suppliers, customers and creditors of the corporation ... communities in which offices or other establishments of the corporation are located ... short-term and long-term interests of the corporation”). The statutes have been controversial. Some commentators have praised them as signaling a new era of corporate social responsibility; others have criticized them as a ruse for incumbent entrenchment and fecklessness. By permitting directors to rationalize corporate decisions on such open-ended concepts as “long-term interests” and “communities where the corporation operates,” the statutes appear to dilute director accountability.

Although no cases have confronted the meaning of the “other constituency” statutes, other cases give mixed signals about directorial deference to nonshareholder stakeholders. Some cases suggest directors can take stakeholders into account only if rationally related to promoting shareholder interests. See Revlon v. MacAndrews & Forbes Holding, 506 A.2d 173 (Del. 1986). Yet others suggest directors have significant latitude to consider “corporate culture,” not just immediate shareholder returns, when responding to takeover threats. See Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1142 (Del. 1990).

Corporate Social Responsibility (CSR)

Over the past decade, many companies have recognized that the company's responsibilities extend beyond the legal duties toward shareholders and others with whom the company does business. Although not required by law, many companies (particularly multinational companies) have voluntarily taken responsibility for their impact on customers, workers, communities, and other stakeholders, as well as the environment.

Companies tout their CSR activities—such as “green” initiatives or “fair labor” commitments—to bolster their reputations as corporate citizens. To show their commitment to CSR, many companies have agreed to reporting guidelines and operational standards developed by various nongovernmental organizations (NGOs). In addition, some institutional investors seek to take into account in their investment and voting decisions whether companies have implemented CSR programs.

Proponents see CSR as “applied business ethics” and a means more suited than regulatory compliance for companies and their decision-makers to internalize externalities (the costs imposed by business on others). Critics claim that CSR is superficial window-dressing that companies use to divert attention from the harms they cause and to forestall government regulation.

Recently, the CSR movement has received support from various quarters. In a nod to the growing relevance to investors of environmental concerns, the SEC has issued interpretive guidance to reporting companies on their disclosure regarding climate change. Guidance on Climate Change Disclosure, Securities Act Rel. No. 9106 (2010) (pointing out the insurance industry lists climate change as the number one risk facing the industry). While not taking a stance on the climate change debate, the SEC pointed out that under existing disclosure requirements (such as management's discussion of future contingencies) companies may have to disclose material information about (1) the impact on the company’s business of existing (and even pending) climate

Sustainable Corporations (Spring 2014)
change laws; (2) the impact of international accords on climate change; (3) the actual or indirect consequences of climate change trends (such as decreased demand for carbon-intensive products or higher demand for lower-emission products); and (4) actual and potential physical impacts of environmental changes to the company's business. As some have pointed out, "what gets measured gets managed."

In addition, nongovernmental organizations (such as Ceres) are organizing investor groups, environmental organizations, and other public interest groups to work with for-profit corporations to address sustainability challenges such as climate change, resource use, and water scarcity. Even as governments have been paralyzed to act, many investors and businesses in the private sector are moving ahead on sustainability initiatives. They understand that environmental and social sustainability presents risks (and opportunities) for their business and that sustainability considerations must be a part of their core business strategies if they are to achieve a competitive advantage—including corporate governance, stakeholder engagement, corporate disclosure, and performance. Some studies bear this out, finding a relationship between company sustainability performance and financial performance.

In a similar vein, the United Nations has reconceptualized the modern corporation as being quasi-governmental, with responsibilities not only to comply with law but also to respect human rights. For example, the U.N. Human Rights Council has adopted a set of guiding principles for business (known as the Ruggie Principles, for the professor who drafted them) that are designed to ensure that companies do not violate human rights in the course of their operations and provide redress when they do. The guiding principles—which place companies in the position of "private states"—lay out specific steps that companies should take to make sure they respect human rights. For example, companies are called on to undertake a "human rights due diligence," which includes an impact assessment, monitoring, community engagement, and a grievance mechanism, so people who have even minor complaints against a company have a place to go to have issues addressed. The assessment should cover not only potential for adverse human rights impacts of the company's activities but also the impacts of business partners. The guidelines call on companies to use leverage to prevent or mitigate human rights abuses by business partners or to end the business relationship.

§11.2 FIDUCIARY DUTIES OF CARE AND LOYALTY

According to traditional fiduciary analysis, corporate managers owe two duties to the corporation: care and loyalty. Each duty describes standards for judicial review of corporate decision-making and fiduciary activities.

Duty of Good Faith

Delaware courts have recently articulated a duty of "good faith" that applies when directors act intentionally to violate positive law, with a purpose other than the corporation's best interests, or with a conscious disregard for their duties to act. Walt Disney Co. Deriv. Litig., 906 A.2d 27 (2006). The courts have said that the duty of good faith is breached when directors fail to consider the financial ramifications of an executive's contingent pay package, when directors fail to establish an oversight system to monitor the corporation's legal compliance, or when directors act as "stooges"
for a controlling shareholder. The courts have explained the good faith duty as a subset of the duty of loyalty and, as such, a duty that cannot be exculpated. See Del. GCL §102(b)(7) (see §15.1).

§11.2.1 Duty of Care

The duty of care addresses the attentiveness and prudence of managers in performing their decision-making and oversight functions. The famous “business judgment rule” presumes that directors (and officers) carry out their functions in good faith, after sufficient investigation, and for acceptable reasons. Unless this presumption is overcome, courts abstain from second-guessing well-meaning business decisions even when they are flops. This is a risk that shareholders take when they make a corporate investment. See Chapter 12.

To encourage directors to take business risks without fear of personal liability, corporate law protects well-meaning directors through exculpation provisions in the corporation’s articles (see §12.5), statutory and contractual indemnification (see §15.1), and directors’ and officers’ insurance (see §15.2).

§11.2.2 Duty of Loyalty

The duty of loyalty addresses fiduciaries’ conflicts of interest and requires fiduciaries to put the corporation’s interests ahead of their own—that is, fiduciaries cannot serve two masters. Corporate fiduciaries breach their duty of loyalty when they divert corporate assets, business opportunities, or proprietary information for personal gain.

Flagrant Diversion

Diversion can be as simple, and as reprehensible, as a corporate official stealing tangible corporate assets. This is a plain breach of the fiduciary’s duty of loyalty since the diversion was unauthorized and the corporation received no benefit in the transaction. Besides disaffirming the transaction as unauthorized (see §3.3.3), the corporation can sue for breach of fiduciary duty and in tort.

Self-Dealing

Diversion can be masked in a self-dealing transaction. When a fiduciary enters into a transaction with the corporation on unfair terms, the effect (from the corporation’s standpoint) is the same as if he had appropriated the difference between the transaction’s fair value and the transaction’s price. Courts, as well as statutes, address when a self-dealing transaction is unfair. See Chapter 13.

A parent corporation that controls a partially owned subsidiary can breach its duty to the minority shareholders of the subsidiary if the parent prefers itself at the expense of the minority. See §17.2. The ultimate form of preferential dealing occurs when the parent squeezes out the minority (in a merger or other transaction) and forces the minority to accept unfair consideration for their shares. See §17.3.

Executive Compensation

When a director or officer sells his executive services to the corporation, diversion can occur if the executive’s compensation exceeds the fair value of his services. See Chapter 14.

Usurping Corporate Opportunity
When a corporate fiduciary seizes for herself a desirable business opportunity that the corporation may have taken and profited from, diversion occurs if the fiduciary denies the corporation the opportunity to expand profitably. See Chapter 16.

**Disclosure to Shareholders**

Corporate officials who provide shareholders false or deceptive information, on which the shareholders rely to their detriment, not only undermine corporate credibility and transparency, but frustrate shareholders' expectations of fiduciary honesty and accountability. Duties of disclosure arise when directors seek a shareholder vote (see Chapter 8—state law; Chapter 10—federal proxy fraud) and when corporate officials communicate to stock trading markets (see §21.1—state law; Chapter 22—federal Rule 10b-5).

**Trading on Inside Information**

When a fiduciary is aware of confidential corporate information—such as the impending takeover of another company—and he buys the target's stock, diversion can occur if the fiduciary's trading interferes with the corporation's takeover plans. By the same logic, when the fiduciary trades with the company's shareholders using inside information, the fiduciary diverts to himself information belonging to the corporation. See Chapter 23.

**Selling Out**

A corporate official who accepts a bribe to sell her corporate office breaches a duty to the corporation. Likewise, a controlling shareholder who sells his controlling interest to a new owner who then diverts corporate assets to herself exposes the remaining shareholders to the new owner's looting. See §20.2.

**Entrenchment**

A manager who uses the corporate governance machinery to protect his incumbency effectively diverts control from the shareholders to himself. Besides preventing shareholders from exercising their control rights—whether by voting or selling to a new owner—management entrenchment undermines the disciplining effect on management of a robust market in corporate control. See Chapter 8 (voting manipulation); §39.2 (takeover defenses).

There is no uniform standard for judging these conflict-of-interest transactions. Some are flatly prohibited (insider trading), others receive searching judicial fairness review (squeezeouts), and others are subject to internal corporate safeguards (executive compensation).

**§11.2.3 Judicial Enforcement of Fiduciary Duties**

Fiduciary duties generally are said to be owed to the corporation and not to particular shareholders, and must be enforced in the name of the corporation. This reflects the practical and conceptual danger of one shareholder purporting to speak for the body of shareholders. Rarely, however, are fiduciary breaches challenged by the corporation, because those who abused their control are unlikely to sue themselves. Instead, fiduciary breaches usually are challenged by shareholders in derivative litigation brought on behalf of the corporation (see Chapter 18).
§11.3 FIDUCIARY DUTIES—CORPORATE AND MARKET REALITIES

§11.3.1 Fiduciary Duties in Closely Held Corporations

In closely held corporations (those that do not have a trading market for their shares) the corporate participants often have a relationship of special trust. No market exists for their shares. Some courts have implied a duty among participants akin to that of partners. Other courts have used statutory protections against "oppression" to intervene on behalf of minority shareholders. See Chapter 27.

A frequent issue in close corporations is whether fiduciary duties can be modified by agreement. Although modern partnership law permits partners to waive fiduciary rights, courts have been less willing to see corporate fiduciary duties as default terms. Compare RUPA §103(b) (permitting partners to waive duty of loyalty as to categories of activities, if not manifestly unreasonable, and to reduce duty of care if not unreasonable). Rather, corporate fiduciary duties have been viewed as immutable aspects of the corporate relationship.

§11.3.2 Fiduciary Duties in Modern Public Corporations

In public corporations, management has three principal functions. First, directors and senior executives make “enterprise” decisions concerning operational and business matters—such as where to locate a new facility or whether to discontinue a product line. The board establishes the strategic plan; senior executives carry it out. Directors rely on the senior executives for information in establishing and monitoring the business plan. Shareholder and management interests typically overlap as to these enterprise decisions, as reflected in the deferential business judgment rule.

Second, directors act on “ownership” issues—such as initiating a merger with another company or constructing takeover defenses. Outside directors (that is, directors who are not employed by the corporation) have assumed special prominence on these issues, as courts often defer to the independent judgment of outside directors when corporate control is at stake. Although directors in public corporations once were criticized for acting as “rubber stamps” for management, directors lately have become more forceful. Spurred by activist institutional investors and the clamor after Sarbanes-Oxley, outside directors have asserted themselves by replacing CEOs, negotiating takeovers, and making themselves more accountable. Outside directors, sometimes acting in special committees, often turn to their own legal and investment advisors.

Third, directors are responsible for “oversight” of the corporation—such as reviewing senior executives’ performance and ensuring corporate compliance with legal norms. In public corporations the board often establishes compliance programs and receives regular management reports. As corporate responsibility has grown in such areas as regulatory compliance and foreign bribery, courts have increasingly insisted on higher levels of board oversight. In addition, disclosure by the company to public trading markets allows shareholders to gauge how well management is overseeing the corporation.

Management in public corporations lives under the watchful eye of the securities markets. When the market detects mismanagement, the trading price of the company’s stock falls. This makes it attractive for outside bidders or shareholder insurgents to acquire control and oust the
ineffective management. In extreme cases, a collapse in the stock price signals to creditors that the company is insolvent and should be put in the hands of a bankruptcy court. Fiduciary norms take these corrective mechanisms into account, relaxing scrutiny when control markets are available to discipline poor management and tightening scrutiny when the board attempts to insulate itself from these markets.

Note on "Imperial CEO"

In the United States corporate management in public corporations often refers to the Chief Executive Officer (CEO), whose vision and leadership make him (and sometimes her) the ultimate manager of the company. In most companies, investors focus on outside directors only when something goes wrong. The CEO puts together a management team—including a Chief Operating Officer (COO), Chief Financial Officer (CFO), and Chief Legal Officer (CLO or General Counsel)—to oversee and run the company’s business. Generally, investors and employees look to the CEO as the symbol of ultimate authority for the company. This is not, of course, what the law says. But the reality is that outside directors, chosen through a nominating process often heavily influenced by the CEO, have few incentives to be suspicious or adversarial. They are mostly dependent on the CEO’s management team for information and analysis. Strategy is typically developed by the management team in internal discussions, and then presented to the board for approval.

§11.4 Independent Directors

Over the last several years, directors who do not have an employment relationship with the corporation—so-called independent directors—have assumed increased prominence in U.S. public corporations. The accounting and financial scandals that came to light in the early 2000s focused attention on the failures of outside directors to monitor and oversee corporate management. Paradoxically, the response has been to assign even greater importance to independent directors. Empirical studies are mixed on whether outside directors increase company profitability and whether they have an effect on controlling management excesses.

Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 specifies the responsibilities of independent directors on the audit committees of public corporations. As required by Sarbanes-Oxley, stock exchanges have adopted listing standards that specify the composition and functions of the audit committees of listed companies (including foreign issuers and small business issuers). Under these standards, audit committees must be composed entirely of independent directors, as defined by the SEC.

In addition, all reporting companies must disclose whether at least one member of the audit committee is a financial expert. Sarbanes-Oxley §407, Reg. S-K, Item 401 (defining “audit committee financial expert” as one with significant auditing, accounting, financial, or comparable experience).

In addition, the exchanges’ governance listing standards must also specify that the audit committee of listed companies be responsible for appointing, compensating, and overseeing the company’s independent audit firm—a curtailment of the power of the full board and shareholders over outside accountants. The audit committee (not the board) must have the authority to hire independent counsel and other advisors, their fees to be paid by the listed company. Rule 10A-3; Exchange Act Rel. No. 47,654 (2003).
Dodd-Frank

The Dodd-Frank Act of 2010 also intrudes into the boardroom of public corporations, requiring the stock exchanges to adopt listing standards that require all the directors on the corporation's compensation committee to be independent. Dodd-Frank §952. The committee must also have the authority to hire independent compensation consultants.

Delaware

State courts, particularly in Delaware, have increasingly deferred to independent directors in various contexts. Delaware courts review deferentially corporate transactions in which management has a conflicting interest if a majority of the board is composed of directors who are disinterested (no conflicting financial interest in the transaction) and independent (neither beholden to interested party because of financial or business relationships, nor dominated by interested party through family or social relationships). See Orman v. Cullman, 794 A.2d 5 (Del. Ch. 2002) (distinguishing between “interest” and “independence” of directors).

Delaware courts focus on director independence in deciding whether

- to shift the burden to the challenging shareholder in transactions involving management conflicts. See §13.3.3 (director self-dealing transactions), §17.3.3 (squeeze-out mergers).
- to review executive pay under a waste standard, rather than the more burdensome fairness standard. See §14.2.3 (executive compensation).
- to indemnify corporate officials who become liable or settle claims arising from their corporate position. See §15.1.2 (permissive indemnification).
- to approve settlement of derivative litigation. See Kahn v. Sullivan, 594 A.2d 48 (Del. 1991) (approving settlement of claim that company had wasted corporate assets in donating money for art museum to house CEO’s personal art collection).
- to dismiss shareholder derivative litigation, either on the basis of “demand futility” or recommendations of a special litigation committee. See §18.5.3 (demand requirement), §18.5.4 (special litigation committee).
- to uphold antitakeover measures (whether in anticipation of unwanted bids or in response to particular threats) and deal protection measures. See §8.2.2 (shark repellents), §39.2.3 (takeover defenses), §39.2.4 (deal protections).

Delaware courts have recently shown more willingness to inquire into the social and business relationships between outside directors and management—to test whether there exists implicit directorial bias. For example, the Delaware Chancery Court questioned the independence of a tenured Stanford law professor, who as a member of a special litigation committee was asked to determine whether suit should be brought against various corporate executives who allegedly had engaged in insider trading. The court concluded the professor’s and executives’ close and overlapping ties to Stanford—as large donors, fellow professors, and members of a university policy institute—suggested an institutional context in which motives of “friendship and collegiality” could not be ignored. In re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch.
2003). But the Delaware Supreme Court has stopped short of saying that social and business relationships alone undermine independence. See *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) (finding directors sufficiently “independent” in demand-futility case, despite longstanding personal friendships and close business relationships to CEO, who held 94 percent of company’s voting power).

The MBCA goes one step further and makes lack of independence a basis for imposing liability on directors in an interested-party transaction. See MBCA §8.31(a)(2)(iii) (making director liable if director’s judgment is affected because of a lack of objectivity due to director’s familial, financial, or business relationship with interested person, or a lack of independence due to director’s domination or control by interested person). Upon such a showing, the director has the burden to prove that he reasonably believed the challenged conduct was in the best interests of the corporation. MBCA §8.31(a)(2)(iii)(B).

**Corporate Governance in Stock Listing Standards**

The New York Stock Exchange and the NASDAQ have adopted standards that compel listed companies to adopt corporate governance structures that emphasize “independent directors.” In many instances, these listing standards are mandated by Sarbanes-Oxley and Dodd-Frank:

<table>
<thead>
<tr>
<th>Governance Listing Standards (NYSE and NASDAQ)</th>
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<tbody>
<tr>
<td><strong>Independence of majority of directors</strong></td>
</tr>
<tr>
<td>• Majority of directors must be “independent” and not have “material relationship” with company (NYSE only)</td>
</tr>
<tr>
<td>• Majority of directors must be “independent” (NASDAQ only)</td>
</tr>
<tr>
<td>• Determination of director qualifications disclosed in proxy statement (or annual report if company not subject to proxy rules)</td>
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<tr>
<td><strong>“Independence” defined</strong></td>
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<tr>
<td>Director not “independent” if</td>
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<tr>
<td>• director is company employee, or director’s family member is company executive</td>
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<tr>
<td>• director (or family member) receives payment from company (NYSE—more than $100,000; NASDAQ—more than $60,000)</td>
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<tr>
<td>• director (or family member) affiliated with current or past auditor</td>
</tr>
<tr>
<td>• company executives sit on compensation committee of outside director’s company</td>
</tr>
<tr>
<td>• company has significant dealings with outside director’s company (NYSE—$1,000,000 or 2 percent of outside company’s revenues; NASDAQ—$200,000 or 5 percent of outside company’s revenues)</td>
</tr>
</tbody>
</table>
### Executive sessions
- Independent directors must meet at regularly scheduled meetings without management.
- Company must have method for internal and shareholder communications to independent directors (NYSE only).

### Committees
- **Audit committee** must be comprised solely of three or more independent directors who are “financially literate”; members must meet SEC standards on independence; at least one member must meet SEC “financial expert” standard.
- **Nominating committee** must be composed solely of three or more independent directors (with limited exception for one outside, nonindependent director); company must certify adoption of nomination process.
- **Compensation committee** must be composed only of independent directors (as defined by SEC rule) with exclusive power to hire independent compensation consultants.

### Code of conduct
- Company must adopt and disclose code of conduct that meets requirements of Sarbanes-Oxley.
- Any waivers for directors and officers must be approved by board and disclosed on Form 8-K.

### Corporate governance guidelines
- Company must adopt and disclose guidelines on director qualifications, compensation, education, responsibilities, succession, annual evaluation, access to management (NYSE only).

### Audits
- Company must have internal audit function, cannot be outsourced to company’s outside auditor (NYSE only).
- Company must disclose receipt of audit opinion with “going concern” qualification (NASDAQ only).

### Related party transaction
- Audit committee, or group of independent directors, must approve related party transactions (NASDAQ only).

### Certification
- CEO must certify annually that company is in compliance with governance listing standards (NYSE only).
- Company must notify NYSE or NASDAQ if company executives become aware of material noncompliance.

### Exceptions
- Independent director requirements not applicable to companies controlled 50 percent or more by individual, group, or another company.
- Investment companies generally not subject to governance listing standards.
- Foreign issuers listed on NYSE not subject to governance listing standards, except SEC standards on audit committee independence.
- Foreign issuers listed on NASDAQ may apply for exemptions from governance listing standards, except SEC standards on audit committee independence.
§11.5 Federalization of Corporate Governance

Although corporate fiduciary duties arise mostly under state law, federal law has come to play an important role in corporate governance of public corporations. Since the 1930s, federal securities regulation has imposed disclosure requirements that compel corporate fiduciaries in public corporations to reveal information about the operational and financial details of the business as well as the roles of the fiduciaries in the corporation. Thus, corporate fiduciaries in public companies must disclose information to new public shareholders (see Chapter 5) when shareholders vote (see Chapter 9) and when shareholders tender their shares (see Chapter 38). Corporate fiduciaries also face restrictions on their ability to trade in company shares while in the possession of nonpublic material information (see Chapter 23). But, with rare exceptions, the federal regulatory scheme has been premised on disclosure to shareholders.

Recently, federal law has expanded beyond requiring corporate disclosures. The corporate scandals of the early 2000s and the financial crisis of 2008 have caused Congress to rethink the place of federal law in corporate governance of public corporations. In 2002 Congress responded to the misdeeds at companies like Enron and WorldCom by enacting the Sarbanes-Oxley Act, which revamped the regulation of the accounting profession and imposed a variety of new rules on the boards of directors and officers of public companies. In 2010 Congress responded to the financial crisis in the banking sector by enacting the Dodd-Frank Act, not only to reregulate the financial markets but also to add new rules on corporate governance and executive compensation in all public companies.
PUBLIC CORPORATION AS PRIVATE CONSTITUTION

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Abstract: The large publicly-traded corporation in the United States derives its essential structure and metaphoric language from the republican form of government laid out in the US Constitution. Public shareholders elect a decision-making body that formulates and supervises an executive bureaucracy, subject to review by a judiciary (typically, in Delaware) that balances shareholder interests and management prerogatives. The analogy to the republican government structure found in the federal Constitution and replicated in all 50 states is unavoidable. Both “specialized hierarchies” create a principal-agent model of separated powers that contains similar sets of voting rights, nearly identical standards of judicial review, and generally parallel recognition of exit opportunities. Thus, an understanding of US corporate governance inevitably compels an understanding and appreciation of the structures of US political governance. Metaphorically, the public corporation is private constitution.

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"It may be that universal history is the history of a handful of metaphors."

Jorge Luis Borges
"The Fearful Sphere of Pascal" in Labyrinths (1962)

Human society depends on human institutions. In fact, human institutions are at the root of civilization. Our institutional instincts may be genetic, deeply rooted as we are in human hierarchies. Even casual observation of primate societies reveals our attachment to specialized structures. No doubt some of our hierarchies are also learned. Human organizations vary from society to society, and within society.

My inquiry is simple to state: how and why is our US Constitution (political governance) similar to our large business organizations (corporate governance)? At a superficial level, the analogies have long been recognized. In the eighteenth century Blackstone observed in his Commentaries on the Law of England that the corporation is a “little republic.” He described -- as generations of corporate commentators have since -- the their formation, powers
and privileges, the composition and decision-making prerogatives of their governing board, their answerability to interested persons, and ultimately their dissolution.

At a rhetorical level, corporate governance borrows freely from political governance – and, to some extent, vice versa. Consider a handful of linguistic counterparts from constitutional and corporate court decisions:

(1) “One person, one vote” becomes “one share, one vote.”

(2) “Government serves the will of the people” finds its analogy in “the Board cannot impose its will on the stockholders.”

(3) The “rational basis test” (judicial deference to legislative policy)” is mirrored in the “business judgment rule” (judicial deference to board decisions).

(4) The dictum that political “voting is clearly a fundamental right” is echoed in the dictum that the “stockholder’s vote is a fundamental right of owning stock.”

(5) “the people are masters and all officials of the state are servants of the people” takes wing with “Directors are agents of shareholders, not their Platonic masters.”

Beyond rhetoric, the texts and structures of our Constitution and corporate statutes bear remarkable similarities – powerfully suggesting a common source. The US Constitution begins with a preamble declaring prerogatives of the people and the formation of a new nation, followed by specification of the powers of the legislature, the responsibilities of the executive, and the jurisdiction of the judiciary, and concluding with provisions specifying rights of citizenship, expansion into new territories, and the process of amendment. Of course, personal liberties are guaranteed in the first set of amendments – the Bill of Rights.

The typical US corporate statute follows a similar schematic. It first describes the process for formation of the corporation, followed by a statement of corporate powers, the powers and operation of the board of directors, the titles and duties of officers, the various rights and prerogatives of shareholders (particularly voting rights), and concluding with the processes for corporate expansion through merger, for corporate change through amendment of the articles, and for corporate death through dissolution. Implicit (and sometimes explicit) is judicial oversight of the corporate structure.

Noticing these similarities Albert Hirschman – in 1970 – pointed out that organizational answerability and thus legitimacy is achieved through a confluence of voice, exit and loyalty – in many human organizational spheres, including the corporate and the political. But my inquiry, I believe, involves more than reciting and specifying Hirschman’s insight. For example, partnerships and families can be usefully compared – offering an interesting and fruitful line of inquiry. Or imperial CEOs could well be compared to imperial political rulers. My thesis is that our notions of republican government (and its democratic ideals and practices) inform our notions of corporate
governance. And thus to understand the modern public corporation -- and to set its agenda -- compels us to understand and dissect its republican impetus.

As we consider the calls for governance reform of public corporations, the dramatic and recent arrival of institutional investors in their governance, the internationalization of corporate ownership and thus governance, it is useful to bear in mind the Japanese proverb, “Vision without action is a daydream; action without vision is a nightmare.” To contemplate the public corporation merely as an economic phenomenon or as a set of historical financial adventures fails to see its essentially borrowed and political character, to see its animating metaphors. And just as republican government shows its inherent limitations -- the Arrow Theorem perhaps only grazing the surface -- we cannot afford not to regard the political constitutional underpinnings, both rhetorical and theoretical, of the modern corporation.

That we have borrowed from the political sphere to structure the private/economic sphere is not new. The constitutional/corporate borrowing is a relative newcomer to a long history of human reference and reliance on one organizational mode to inform another. We operate on analogies, on metaphors. Consider how the business partnership draws its egalitarian principles from the family structure -- and how family precepts and vocabulary in turn dominate that of the partnership. Consider how the patriarchal business model draws from its imperial counterpart -- for example, the Roman economic unit is cast from the same mold as the Roman political empire.

The US Constitution precedes the modern public corporation, and thus the structuring vocabulary and doctrinal formulas seems to flow from the political to the economic. Recent scholarship, however, suggests that constitutional structures may actually have been drawn from British stock companies. Whoever inspired the other, each offers us a wealth of lessons about how we have constituted (and should constitute) the other. And each presents a host of open questions for which answers, theoretical and practical, can be found in the literature and scholarship of each. That this dialogue across disciplines has not been formalized is perhaps evidence of how deep the distrust government has had of the corporation, and the corporation of government. Or how little constitutional (political scientists) and corporate law scholars (economists) mix.

I begin my inquiry by sketching the emergence of the corporation as the dominant social institution in modern society. I then draw the obvious parallels between the US constitutional structure (focusing on the federal level, which is replicated in every state) and the US public corporation (looking at the Delaware phenomenon, which is largely duplicated in all other states). I then turn to consider the essential protective prerogatives of citizens and shareholders -- voice, loyalty, and exit -- the techniques identified by Hirschman to oversee and discipline wayward governance.

If nothing else, this exercise suggests that an understanding of the US public corporation depends on an understanding of the US constitutional structure -- our corporate metaphor. And any argument that the modern corporation has a manifest global destiny fails to confront and acknowledge the variety of constitutional notions that still inhabit the globe. That is, metaphorical variations may well supply different visions for the corporation.
1. The emergence of the public corporation

Significant to my thesis is the modern movement, well underway, from a US society dominated by political institutions and public norms (republican government) to one dominated by private institutions and private norms (public corporations). The transformation in the United States has received much attention – both from an adoring right and from an appalled left.

Consider the most obvious measure of any society’s most important institution: its tallest structures. The pyramids of Ancient Egypt; the Parthenon of Ancient Greece; the Towers of Babel; the Temple in Jerusalem; the Gothic churches and looming castles of medieval Europe; the Mayan temples; the majestic legislative houses of the Nineteenth Century; and the Twin Towers. The exceptions – like the Capitol in Washington, DC or the Duomo in Florence – prove the rule.

Or consider for a moment the power of the modern corporation in our private lives. The essential elements of human existence (food, shelter, movement, belonging, sex) are lately functions assumed or, at least, fomented by the corporation. What (no longer “who”) supplies our livelihood? our food? our agriculture? our transportation? our acquaintances? our energy? our communication? our health care? Nearly compartmentalized in a public sphere – at least in the United States -- are our collective defense, our education, our water supply.

In fact, when one looks at the most important public concerns in the United States as revealed in contemporary public surveys (the following from recent Gallup polls), the problems and thus the solutions rest nearly as much with public government as with the public corporation.

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Curiously, some of the problems (such as the Iraq war, the immigration dilemma, and global warming) are popularly perceived as more the brainchild of the corporation than of government. And political depravity and corporate perfidy vie for top public vilification. Whether the perceptions have substance, the collective perception becomes reality. Whether assumed or imposed, the public corporation’s economic, social and political roles are not about to go away.

So my inquiry becomes as much a window into two overlapping legal regimes as one into US society and our allocation of power. It is at once a study of the history and jurisprudence of the US
Constitution, and a study of the history and jurisprudence of the public corporation. It is a story of political powers and individual rights, of corporate powers and shareholder rights. Ultimately, it sketches our shared conception of what a “specialized hierarchy” should look like. Curiously, it was this inquiry that animated the ground-breaking study of the modern US corporation by Adolf Berle, a Wall Street lawyer and law professor whose data was collected by an economist colleague Gardiner Means. Berle and Means decried that the modern US corporation had assumed so much power in American life, without adequate systems of answerability. They identified the separation of ownership and control essentially as a political one, borrowing from the logic and rhetoric of political discourse. That Berle and Means are now identified with identifying an economic problem – the agency costs in the public corporation -- is a testament of how effectively the government/corporate parallelism is (or has been) hidden from view.

2. The parallels – two specialized hierarchies

The principals in the US Constitution are “the people,” and in the US corporation “the shareholders.” Both are described as masters and owners of their collective hierarchical enterprise. Both are described as the principal beneficiaries of their enterprise – all men to enjoy inalienable rights of life, liberty and the pursuit of happiness, and the common equity shareholders to have their wealth maximized.

Of course, in both organizations, deep and ongoing questions exist about the contours of membership. Does membership extend to other constituencies, such as black men and women and immigrants, or creditors and employees and communities? The failure of the political constitution to adequately resolve these questions has resulted in a history of regular and continuing episodes of violence. The ability of the economic sphere to adequately define the corporation’s boundaries will test its legitimacy.

Both principals -- though dispersed, quite heterogeneous and suffering from collective action deficits -- have the power to elect the organization’s law-making bodies. The citizens vote for congressional representatives to the Congress for fixed terms; the shareholders vote for the board of directors, also for fixed terms. The Congress (a decision-making body) has the power of making laws, sharing it in only limited circumstances with the executive and judiciary. The board (required to act as a body) has the power of directing all corporate business and affairs, sharing it in only limited circumstances with shareholders.

The delegation of power to the executive is the hallmark (and a controversial one) of the modern US government and the modern US corporation. In theory, the executive branch in each case operates only with respect to delegated power, except in the special carveouts. In practice, the executive branch operates with significant prerogatives, given its numerical superiority, the power to spend, the power to set the organizational agenda, the power over information. The label “imperial presidency” and “imperial CEO” are rhetorical devices used to bemoan the lack of oversight, on the one hand by the Congress and the other by the board of directors.

The executive – at least in the United States -- is chosen through different mechanisms under the Constitution and in the public corporation. The US President, sometimes called the “chief
executive,” is chosen by citizens through a bizarre intermediated process (the Electoral College) meant to provide a buffer against popular willfulness. The cabinet and other senior executive officers then must be vetted by the legislature (specifically, the consent of the Senate). The corporate CEO, formerly called the “corporate president,” is selected (along with the other executive officers) by the board, despite calls for a direct shareholder vote on executive pay, if not more.

Removal of government/corporate officials also turns out to be difficult in both organizational structures. Under the US Constitution, to remove the president or any federal judge, the official must be charged by the House of Representatives, and tried and convicted by the Senate, subject to a super-majority vote. No US president has ever been formally removed from office; judges have fared nearly as well. The removal of directors by shareholders follows a similar pattern – with charges, a chance to defend, and a vote whose expense is borne in most cases by the complaining shareholder. By comparison, the CEO can be removed by the board at will, though this has been a rare occurrence.

The judiciary, which oversees the exercise of organizational power for the protection of the principals, is constituted in similar ways. Federal judges serve for life; Delaware judges for renewable 12-year terms. Judicial appointment is supposed to be non-political: federal judges by practice and law are prevented from political activities; Delaware judges are appointed to maintain a political balance on the state’s bench, and must be scrupulously independent of corporate officials. In fact, Delaware courts (especially the Court of Chancery) can be seen as a system of alternative dispute resolution that is part of the overall organizational package offered to corporations that choose a Delaware incorporation.

Central to the judicial function under both regimes is respect for re-composition of the structure. Amendments to the corporate articles and bylaws receive special judicial attention and deference. Amendments to the US Constitution, as well as changed societal conceptions over time, constitute the bulk of the Supreme Court’s agenda. In addition, both regimes pay special attention to process, sometimes over substance. Harsh administrative rules are acceptable if procedurally sound; harsh corporate decisions are acceptable if vetted by informed, independent directors.

One curiosity of these two parallel “specialized hierarchies” has been how each contemplates the other. The constitutional structure has long viewed with a jaundiced (even fearful) eye the corporate structure. Corporations were originally permitted by legislative grant only for limited purposes, with limited capital, with limited duration. For the past century, corporations have been specifically forbidden to participate in political elections – though their money, like water flowing downstream, has found its way. Lobbying and commercial/investment speech by corporations is tolerated, but subject to sometimes heavy regulation.

And just as corporations are not to cross into government, government in the United States is forbidden from owning private corporations. In fact, to ensure broad ownership (and thus to guard against concentrated ownership) institutional shareholders such as mutual funds and insurance companies are prohibited from owning more than 5-10 percent of any corporation’s voting power.
Likewise, US banks are prevented from the role assumed in other countries of holding voting corporate securities for their own account.

3. Protective devices in specialized hierarchies

   a. Voice

Hirschman identifies voice as an effective, and socially desirable, way of avoiding decline in an organization. Rather than exiting in disgust or loyally standing by in the face of organizational inattention, members express their views and thus foment change. In the US Constitution, voice is enshrined as the fundamental right to vote. Voting in political elections receives special recognition in many ways. Regular voting is specified. The state cannot interfere with each citizen’s right to vote. Discrimination is prohibited on a variety of grounds – both the usual (race, gender, national origin) and the unusual (economic, place of residence, party affiliation). Thus, while taxes on virtually all other activities are permitted, poll taxes are not. Access to the ballot is limited, typically requiring party nomination or not insubstantial signatures.

In the public corporation, voting is also viewed as fundamental. Although voting is not inherent, shareholders subject its absence to a heavy discount. For voting shareholders, voting for directors (as well as on fundamental corporate transactions and shareholder resolutions) is treated as mandatory and non-waivable. Regular director elections are specified; judicial intervention, often on an expedited basis, applies in cases of voting irregularities. Discrimination (through such devices as high-voting and non-voting shares) is permitted, but viewed with disfavor. Access to the ballot, though theoretically open, is limited in practice by the proxy mechanism.

In the political sphere, votes cannot be sold – though money can be spent lavishly to educate, convince, and cajole the voters. Public funding of candidate campaigns is seen with favor, though disregarded in practice. In the corporate sphere, votes can be sold, but only under limited circumstances. The political rhetoric against vote-selling permeates (and once permeated even more) corporate doctrine on the subject. While shareholders have nearly unlimited freedom to slice and dice their economic rights, their attempts to treat voting rights as they do cash-flow rights have met stolid resistance.

Curiously, political voting did not originally contemplate that citizens would vote beyond electing Representatives, with the President and the Senate buffered from direct elections. At most, the Constitution contemplated the possibility of amendments through a vague convention process, which has never been exercised. Nonetheless, the tendency has been toward more direct voting. The Senate came to be elected directly in 1913, Western states added voter-initiated referenda to their constitutions, and primary voting became the norm after Watergate.

Similarly, voting in US public corporations traditionally has expected that shareholders would elect a board slate selected by the incumbent board or would vote on board-initiated mergers and article amendments. Rubber-stamping was the norm. Lately, with the emergence of institutional shareholders, voting in the corporation has taken new directions. The shareholder’s dormant power to initiate bylaw amendments has found new life; the potency of shareholder-initiated
resolutions has been proved; and shareholders have even sought to have access to the corporation-funded nomination process. At each step, shareholder activists – both self-styled and derided as a political movement -- have borrowed the forms and rhetoric of political activism. Whether shareholder activism “works” has led to debates that pit reformers against traditionalists.

The US Constitution contemplates that political voting will be supported by information rights – the First Amendment enshrining the freedom of speech (especially political speech), the freedom of the press (especially when covering political matters and persons), and the right to assemble (particularly for political purposes). Although electoral fraud is not regulated – candidates can say and promise what they please – it is often punished politically. Beyond these freedoms, which protect against government interference, citizens have access to internal government information under the Freedom of Information Act – a stated purpose for which was to facilitate informed voting.

In like manner, the public corporation since its christening in the New Deal also carries information rights that support corporate suffrage. In particular, federal securities laws require that shareholders receive specified information when they vote (proxy statements), regulated ballots (proxy cards), and updates on the corporation (annual reports). Proxy fraud is heavily regulated, both at the federal and state level. And for information that is not made available through the proxy process, state law has its own FOIA in the form of inspection rights – with voting specifically recognized as a “proper purpose” for shareholder information requests.

Voting follows wealth in both systems. Although money is not supposed to buy political elections, the recognized truth is that a federal campaign (whether to Congress or for the Presidency) requires the support of wealth. And the Supreme Court has enshrined the ability of candidates to spend as they choose. Likewise, attempts to limit corporate voting rights on a “per shareholder” basis have failed. Although some institutional shareholders face statutory (populist) caps on the voting power they may hold, many do not. For example, takeover firms and hedge funds exercise unrestricted corporate voting rights – sometimes through naked vote buying – and are celebrated and denounced.

In a departure (though with historic antecedents) from political voting, corporate voting contemplates that intermediaries will vote on behalf of the ultimate beneficial shareholders. Institutional shareholding, with its recent ascendance and with similarities to old-time voting along party lines, creates a new voting dynamic that the metaphorical tools borrowed from political voting are ill-suited given the new face of corporate governance. For example, it remains unclear whether institutional investors (whose portfolio turnover is legion) should have voting rights, at all. Possible reforms include broader voting transparency, requirements to survey beneficial owners, duties of care and loyalty akin to corporate managers. As to these issues, the regulatory apparatus that molds the corporation, particularly judicial review, will have to forge new metaphors.

b. Loyalty

Hirschman understands “loyalty” as the adherence of members to the organization. The more loyalty, the less often are voice and exit necessary as disciplining strategies. But loyalty, like trust, is
earned. For purposes of thinking about the overlap between political and corporate governance, I regard loyalty as the rights that social members have to demand respect for their organizational position – that is, the judicially-enforceable norms that inhere in the organizational structure.

Under the US Constitution, the loyalty owed by the government is reflected in the Bill of Rights (and its extension to the states through the Fourteenth Amendment). These rights, particularly as measured against legislative prerogatives, have led to classifications that guide judicial review. Similarly, the officials of public corporations owe fiduciary duties – classified as loyalty and care -- to shareholders, with the shades of judicial review varying according to the extent of conflicts between shareholder and manager interests. Remarkably, the levels of review in each context – and their justifications – are nearly identical in wording and substance.

Legislative action is subject to minimal review ("rational basis") when the legislature is not seen as intruding on personal liberties, such as in the area of commercial regulation; in these areas, the political process, with voting as its backstop, is seen as sufficiently protective. Legislative action that touches on categories that the political process is seen as defective – race, national origin, religion – are subject to intrusive review ("strict scrutiny") because of the danger of majority tyranny. In between, legislative action that raises questions about majority overreaching, subject to some political pressure – such as gender -- is subject to balanced review ("intermediate scrutiny").

Board decisions are subject to essentially the same three tiers of review, each varying according to the perceived level of conflict between managerial (whether the board or the majority shareholder) and non-managerial owner interests. Board decisions dealing with corporate operations are presumed to be consonant with general corporate interests and receive minimal review ("duty of care" and "business judgment rule"). Board decisions that involve clear financial conflicts between decision-makers and shareholder interests – director self-dealing transactions, squeeze-out mergers, and manipulation of shareholder voting – receive extensive and intrusive review ("duty of loyalty"). Board decisions that combine elements of business as usual and managerial self-interest are subject to a careful balancing ("proportionate review").

In looking at these review standards, courts and academic observers sometimes characterize the approach as “abstention” – that is, when matters are either “too political” or “too business” for judicial competence. Similarly, notions of standing – complex topics both in Delaware and before the US Supreme Court – define the limits of judicial involvement. Whether a shareholder or citizen can claim rights, and thus a day in court, tends in both cases to turn on the directness of his pecuniary injury. Standing doctrine, which measures individual injury against collective harm, follows the money both under the US Constitution and in the corporation.

While political governance has long sought space for human rights, as reflected in venerable doctrines such as due process, free expression, right to privacy, even human integrity, corporate governance is only lately called upon to identify and act upon that space. Although (cynical) non-shareholder constituency statutes purport to abjure judicial interference when boards act on behalf of creditors, employees, suppliers, customers and communities, the “corporate social responsibility” movement has largely been one carried on outside of the judicial sphere. That is, the powerful political metaphors of respecting other’s humanity increasingly find expression in
director surveys, corporate codes of conduct and as a marketing device – though not yet fully in the legal structure of the corporation.

While corporate organization has as one of its main attributes the externalization of risk (both through limited-liability rules against flow-through of corporate liability to participants and through "separate entity" rules against flow-back of participant liability to the corporation), the externalities of government action are less studied – as such. Corporate law has developed elaborate rules for internalizing risk in limited circumstances under the "piercing the corporate veil" doctrine. But, by and large, corporate externalization of risk is one of its great and catastrophic characteristics.

Political organization under the US Constitution recognizes the dangers of externalization in some contexts. The Contract Clause prevents the government from reneging on its debt obligations; the Third Amendment prohibits the forced quartering of soldiers; the Fifth Amendment requires payment of just compensation in cases of government property takings. Curiously, the morphing of the US Constitution into the vessel for a modern social state has meant that the government's taxing and regulatory powers have assumed a broad scope. That is, externalities have come to be viewed as the price we citizens pay.

c. Exit

Hirschman sees exit as the option of last resort for disaffected social members. The rise of stock markets in the corporation and the disciplining effect that mass exit (selling, followed by hostile takeovers) has on corporate governance is now orthodoxy. The tension between voice and exit in this context has been much debated, with voice seeming to be currently more popular (and available) in the public corporation.

Public corporations are built on, and defined by, exit rights. The availability of liquidity through stock markets distinguishes the public corporation and the privately-held one. Exit rights (as share liquidity) are jealously guarded under corporate law. For example, shareholders in a public corporation can sell without restriction; although management has latitude to discourage hostile bids by adopting poison pills, it cannot formally squelch the shareholders' right to sell.

In the process, the stock markets facilitate (and perhaps necessitate) the specialized structure of the public corporation. An iterative loop pushes corporation governance to adopt modalities to conform to stock market expectations, and market expectations are then molded by governance structures. Exit (and entry) becomes the clearest form of expression of shareholder interests; and governance mechanisms compel executives (through stock-based compensation) to become fluent in the market's language.

The US Constitution recognizes exit, though more subtly. The brilliance of the US federal system, it is often said, resides in the ability for migration from state to state. Each state serves as a social laboratory, whose failings and successes are tested through the protected exit and entry rights of the country's citizenry. In fact, the Privileges and Immunities Clause can be seen as essentially designed to ensure free and unimpaired exercise of the ability to exit one state and enter another.
Not surprisingly, the US Constitution does not formally recognize a right of exit. This proved costly. A bloody civil war was fought over the nature and extent of the exit rights of states from the Union. Nonetheless, exit rights have been assumed. While immigration is regulated (even cruelly), emigration is not. Moreover, loyalty oaths are no longer permitted, while flag burning is. In fact, violent exit from the constitutional structure, if it were to go awry, is specifically preserved in the Second Amendment and its right of militias (and perhaps citizens) to bear arms. The notion that the right to bear arms constitutes an exit right is deeply held by many.

Moreover, free trade – a matter left in the US Constitution to the political process – serves as a sort of exit right. If US laws and regulations become too burdensome, or if US government services become too inadequate, it is possible to take umbrage elsewhere. Exit to avoid heavy environmental regulation, labor standards, taxation, even substandard health care lately animate a central part of the political dialogue. That is, just as corporate exit communicates about the viability of corporate management, political exit communicates about the viability of government competence.

**Conclusion**

Perhaps this game of analogies is trite, revealing little insight. Maybe it is overdrawn, failing to recognize the inherent differences between political and economic activity. Or perhaps, when the details are flattened and the edges softened, it reveals an ineluctable common conceptual source for republican government and the public corporation. Their genetic makeup establishes their co-fraternity.

Thus, the language of private choice, contract and markets (still in vogue) may actually mislead us about the true nature of the corporation. For example, contemplations about what the corporation would be if contractual, drafted from scratch, fails to appreciate that there is no tabula rasa. The private corporation is an iteration, built on a set of metaphors, of the public constitution. In fact, when corporations have been drafted as contracts – whether 17th Century British deeds of settlement or 19th Century Sardinian banks – their specialized hierarchy has been that of republican constitution.

The constitutional form – with specialization built into its separation of powers, with group decision-making to foster wisdom, with voting to ensure its legitimacy, with judicial supervision as a necessary protection, and with exit always available – has enjoyed a powerful place in the American mind. And today, just as important as these republican notions and their metaphors are to our body politic, they are essential to understanding the public corporation and molding it to our collective will.
This Essay addresses an issue that, to be candid, perplexes me. That issue is the continuing dismaly evidenced in Western, capitalist nations when public corporations that pursue profit for their stockholders take actions that adversely affect the nation’s economic stability, the corporation’s employees, or the environment.

When a corporation’s ardor for profits leads it to take excessive risks that endanger the firm’s solvency, commentators react with shock and dismay. How can corporate managers be so blinded by the immediate prospect of profit that they would ignore what, in hindsight, seem like such obvious risks? Likewise, we rent our garments in anger and chagrin when energy companies take environmental shortcuts in drilling for oil or mining coal, surprised that profit-maximizing firms have been less than optimally protective of the environment and their workers, that they did not go beyond what was simply necessary to ensure that regulators allowed them to operate. Similarly, we anguish when the board of a venerable homeland corporate icon reacts receptively to a premium takeover bid from a foreign acquirer. How could the board sell out and undermine the traditional values the firm stands for? It cannot be that the long-term stockholders would put their desire for a one-time, short-term profit ahead of the continued independence of a nationally important institution?

In this Essay, I identify some recent instances that reflect our continued inability to view the for-profit corporation with a gimlet eye. These examples track recurrent patterns. I begin with a couple stories in the headlines of corporate greed at BP in connection with the Deepwater disaster in the Gulf of Mexico and at the U.S. banks that were bailed out by the federal government. I then proceed to less obvious stories where courts have affirmed the preeminence of stockholders in the for-profit corporation, the first in an older case challenging Henry Ford’s stated preference for employees over stockholders and the second in a recent one challenging Craigslist’s attempt to protect its online community from stockholders selling in a takeover. Next, I consider how stockholders have fared in other capitalist countries, looking at Kraft’s successful takeover of Cadbury in the United Kingdom and BHP Billiton’s failed bid to acquire the Potash Corporation of Saskatchewan. In the end, policy makers should not delude themselves about the corporation’s ability to police itself; government still has a critical role in setting the rules of the game.

I. Oil Spills and Bailed-Out Banks: Relearning Obvious Lessons of History

The first situations I address exemplify the tendency to underestimate the extent to which firms subject to pressures to deliver short-term profits for their stockholders pose a serious risk of generating societally destructive externalities. I will only briefly discuss these examples because they are, at least in my estimation, so obvious.

A. Risk Taking with Underwater Drilling
The first story is the BP oil spill disaster in the Gulf. In the wake of the spill, there was widespread outrage about corporate callousness. How could a corporation drill so deep with no reliable plans as to how to address a leak in the well? How could so many safety features be inoperable? To me, it is to be expected that a corporation that stands to gain large profits from aggressive drilling activity would less than optimally consider the environmental risks and occupational hazards that novel drilling activity posed. BP, after all, stood to gain all the profits from its activities, while the risks to the environment would be borne largely by others.

Not only do corporations have incentives to disregard risks for the sake of profits, but there is a natural tendency to pay attention to short-term profits over long-term risks. In fact, most of us place a higher value on immediate satisfaction than on the long-term risks created by such satisfaction. If we can get all the benefits of the immediate satisfaction for ourselves, and know that the longer-term costs will be shared with a lot of others, we go for today over tomorrow even more. And, when an industry is among the leaders in having lobbyists precisely for the purpose of minimizing governmental regulation of its activity, trusting that industry to balance environmental concerns and worker safety responsibly against the prospect of immediate profit would seem even more naïve.

B. Risk Taking with Now Underwater Mortgages

The other rather obvious example of silly surprise is the recent financial crisis. This crisis was in no small measure caused by the signing of trillions of dollars in risk-shifting transactions, the bulk of which had at their root packages containing subprime mortgages. The parties who wrote these mortgages did not act or think as typical lenders. They did not expect the borrowers to pay off the mortgage contracts as written. Instead, the idea was that the mortgages would be refinanced again as already inflated real estate prices continued to rise. Even better, of course, the loans were securitized so the underwriters--the first-instance “lenders”--could pass the risk down the line. Buyers of these securities were plentiful. Most of these transactions were motivated by a desire to make speculative trading profits, not to hedge risks. And the willingness of rating agencies to give the packages a triple-A rating allowed fiduciaries --so-called “sophisticated investors”--to buy them for pension funds.

As Professor Lynn Stout has recently pointed out, there was an even bigger warning sign. In 2008, the $67 trillion credit default swap market was made up almost exclusively of credit default swaps written on mortgage-backed bonds in a market in which the total value of all underlying asset-backed and corporate bonds in the United States that year was a mere $15 trillion. Rank speculation was thus the rule, not the exception.

The mismatch between immediate reward and the bearing of ultimate risk could not have been more extreme, as speculation ran wild in the wake of the erosion of key legal barriers to gambling of this kind. But legislators and regulators had become drunk on their own cocktails, having naïvely (or worse) assumed that markets would “price” these risks. So, indeed, had many academics, such as many of my law and economics scholar-friends in the academy who confidently told me in the years before the meltdown that my worries over the credit bubble and increased leverage in the
financial sector reflected my inadequate appreciation of the keen ability of current financial and capital markets to price risks accurately.

Nor, of course, did one need worry that financial institutions that had regularly received government bailouts because of their systemic importance would be less than optimally incentivized to prudently assess risks. And the growing complexity of financial institutions themselves was no worry, again, for the same reasons. Markets would take care of it and price it, ignoring of course that the capital markets themselves had grown in complexity and churned like a meth-fueled gerbil's wheel. Whatever these capital markets were driven by, a deep examination of the long-term risks of transactions generating large short-term profits did not, in the end, turn out to be high on the list.

And when it all crashed down, the first to receive treatment were those who had profited most. No doubt they felt pain, but not enough that one can confidently believe they are worse off today than if they had not behaved recklessly. Most obviously, though, the importance of these institutions to our economies made it impossible not to bail them out. And bailed out they were, given huge subsidies, partly comprised of free money to borrow in order to make profitable trades and return to health.

The borrowers, who share a good deal of responsibility, too, but whose need to take risks was perhaps easier to rationalize as moral--a house to live in and bills paid off versus the ability to buy an even cooler sports car--got a rawer deal. Rawest of all, though, was the deal for millions of hard working people who were paying their bills until the calamity destroyed economic growth and resulted in double-digit, persistent unemployment. They continue to suffer as do many others who have retained their jobs but endured furloughs, benefit cuts and pay freezes, and seen their local taxes increase as services by budget-crunch governments diminish.

For now, however, the important lesson is simple. For-profit businesses have incentives toward current profit-maximization that make them poorly positioned to evaluate risk and be safe regulators. The environmental wreckage in the Gulf of Mexico and the global human wreckage caused by the financial sector's imprudence should be rather plain evidence of that truth.

II. “Community Values” on the Assembly Line and in Online Classifieds: Recognizing the Incentives in the Stockholder-Financed Corporation

Another enduring myth is that there exist “special” for-profit corporations, ones that will behave differently from others over the long-run because they are controlled by visionaries who will place some idea of the public good ahead of profit. In saying this is a myth, I don't mean to imply that there are not very talented entrepreneurs who figure out how to do well by doing good. There are, thankfully, a number of businesses that do pay good wages, provide safe working environments and livable weekly hours, treat the environment with respect, and play the competitive game fairly. Instead, my point is that managers in stockholder-financed corporations are inevitably answerable to the stockholders, whatever the “community values” articulated by the corporation’s founders or others, which is why regulations designed to protect against the externality risks inherent in profit-seeking are critical.
A. A Taste of History: Henry Ford’s Social Vision for Ford Motor Company

Ultimately, any for-profit corporation that sells shares to others has to be accountable to its stockholders for delivering a financial return. This is not a new notion. An American entrepreneur by the name of Henry Ford tested that proposition and lost some ninety-three years ago in a famous case. In that case, Ford brazenly proclaimed that he was not managing Ford Motor Company to generate the best sustainable return for its stockholders. Rather, he announced that the stockholders should be content with the relatively small dividend they were getting and that Ford Motor Company would focus more on helping its consumers by lowering prices and on bettering the lives of its workers and society at large by raising wages and creating more jobs.

To simplify, the Michigan Supreme Court held that Ford could not justify his actions that way, and that although he could help other constituencies such as workers and consumers, as an instrument to the end of benefiting stockholders, he could not subordinate the stockholders’ best interest. This holding was central, in my view, to the court’s embrace of what we call the business judgment rule. Under that rule, the judiciary does not second-guess the decision of a well-motivated, non-conflicted fiduciary. Fundamental to the rule, however, is that the fiduciary be motivated by a desire to increase the value of the corporation for the benefit of the stockholders. By confessing that he was placing his altruistic interest in helping workers and consumers over his duty to stockholders, Henry Ford made it impossible for the court to afford him business judgment deference.

B. History Repeats Itself: Craigslist as a “Community” Corporation

In 2010, Chancellor Chandler decided a case in Delaware with some striking similarities to Dodge v. Ford Motor. The case pitted the founder of Craigslist, the online classifieds firm, against eBay, the well-known online auction giant. As with the Dodge brothers and Ford, eBay (the suing stockholder) was also a competitor of the firm being sued. Also, as in Dodge v. Ford Motor, the firm being sued had a leader who openly argued that he was running the firm primarily to the end of something other than stockholder wealth, subordinating stockholders’ financial well-being to his own unique social perspective. At Craigslist, according to this argument, the superior interest was the supposed community of users of its services, services the firm had been selling cheaply or giving away, when higher prices seemed to be readily attainable.

But that core issue was not the subject of eBay’s lawsuit, which instead focused on the measures Craigslist’s founder took to ensure that he and his heirs would control Craigslist and to cement his vision that Craigslist be a community-oriented and community-driven corporation, not a cold-blooded profit machine. To that end, Craig Newmark (the Craigslist founder, controlling stockholder, and director) and Jim Buckmaster (the other controlling stockholder and director on Craigslist’s three-member board) implemented actions aimed at stopping or slowing eBay’s ability to acquire Craigslist, or otherwise disrupt what Craig and Jim called Craigslist’s “corporate culture.”

The most important antitakeover measure was the adoption of a shareholder rights plan that would have diluted eBay’s ownership of Craigslist upon even a minor increase in eBay’s minority
stockholding position. In defending their decision in court, Jim and Craig did not argue that they employed the poison pill to protect the economic interests of the company's stockholders. No, instead Jim and Craig argued that the pill was justified by their heartfelt desire to protect Craigslist's coveted social values and community-centered culture from the disruption an eBay acquisition might have on those values and culture.

Echoing what I view as a standard notion behind the business judgment rule, Chancellor Chandler rejected Jim and Craig's argument. In so ruling, he stated, "Directors for a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization--at least not consistently with the directors' fiduciary duty under Delaware law." This, to my view, rather expected statement, drew fire from both ends of our corporate law political spectrum, if there be such a thing.

A group promoting a new form of for-profit corporation, the charter of which indicates that other ends, such as philanthropic or community-aimed ends, can be put ahead of profit, reacted with hyperbole, urging corporations to leave Delaware. If, they said, you remain incorporated in Delaware, your stockholders will be able to hold you accountable for putting their interests first. You must go elsewhere, to a fictional land where you can take other people's money, use it as you wish, and ignore the best interests of those with the only right to vote. In this fictional land, I suppose a fictional accountability mechanism will exist whereby the fiduciaries, if they are a controlling interest, will be held accountable for responsibly balancing all these interests. Of course, a very distinguished mind of the political left, Adolph Berle, believed that when corporate fiduciaries were allowed to consider all interests without legally binding constraints, they were freed of accountability to any. Equally unrealistic is the idea that corporations authorized to consider other interests will be able to do so at the expense of stockholder profits if voting control of the corporation remains in the stock market. Just how long will hedge funds and mutual funds subordinate their desire for returns to the desire of a founder to do good?

From a different political perspective come those who seem to take umbrage at plain statements like the Chancellor's for unmasking the face of capitalism. These commentators seem dismayed when anyone starkly recognizes that as a matter of corporate law, the object of the corporation is to produce profits for the stockholders and that the social beliefs of the managers, no more than their own financial interests, cannot be their end in managing the corporation. Maxwell Kennerly, in his review of the eBay decision, noted what he perceived to be a triad of conservative academic commentators who were unhappy with Senator Al Franken's statement that "it is literally malfeasance for a corporation not to do everything it legally can to maximize its profits" -- a statement, that in Kennerly's view, encapsulates a material portion of the holding in the eBay opinion.

The consternation at Chancellor Chandler's eBay decision is surprising for another related reason. The whole design of corporate law in the United States is built around the relationship between corporate managers and stockholders, not relationships with other constituencies. In the corporate republic, only stockholders get to vote and only stockholders get to sue to enforce directors' fiduciary duties. The natural focus of the managers in such a system is therefore supposed to be on advancing the best interests of the stockholders, subject to the legal constraints
within which the firm operates. Precisely because it is ultimately the equity market that is the primary accountability system for public firms, efforts to tinker around with the margins of corporate law through initiatives like constituency statutes, the so-called Corporate Social Responsibility movement, and antitakeover provisions have been of very little utility in insulating corporate boards from stockholder and stock market pressures.

The public interest, in the end, depends on protection by the public’s elected representatives in the form of law. The well-intentioned efforts of many entrepreneurs and company managers, who have a duty to their investors to deliver a profit, to be responsible employers and corporate citizens is undoubtedly socially valuable. But it is no adequate substitute for a sound legally determined baseline. By so stating, I do not mean to imply that the corporate law requires directors to maximize short-term profits for stockholders. Rather, I simply indicate that the corporate law requires directors, as a matter of their duty of loyalty, to pursue a good faith strategy to maximize profits for the stockholders. The directors, of course, retain substantial discretion, outside the context of a change of control, to decide how best to achieve that goal and the appropriate time frame for delivering those returns.

III. National Interests in Community Icons: Some Instructive Lessons from Abroad

The power of stockholders’ ardor for profits shows up especially in corporate takeovers, where the benefits to stockholders are on full display and the costs to other corporate constituencies can be stark. The tension revealed in a takeover is highlighted when the corporation is an icon with a long history of presence and responsibility in a community. How does corporate and takeover law choose? An interesting answer comes from outside the United States. In Kraft’s takeover of the iconic Cadbury, long-standing U.K. law tilted decidedly in favor of stockholder interests, but U.K. politicians found the logical consequences of their own settled law dismaying. By contrast, when the Australian mining firm BHP Billiton sought to acquire the Potash Corporation of Saskatchewan, the Canadian government had the legal authority to express its objection in full conformity with the law, and did so. It turns out that even in capitalist societies whose economies are premised on profit-seeking, the full implications of giving stockholders the power to make societally-important decisions remains controversial.

A. Frustrations of Nonfrustration: Lessons from the Odd Case of Cadbury

Perhaps the most surprising manifestation of political naïveté about the nature of the corporation comes from England and the controversy over Kraft’s acquisition of Cadbury, the maker of very sweet, nearly chocolate products. The idea that the maker of Dairy Milk would be acquired by a maker of boxed macaroni and cheese was seen as a threat to a British icon, and to British jobs, rather than as a natural alliance of culinary co-travelers. Despite the fact that Kraft was already an employer of many in England and had a good reputation as a quality employer responsive to environmental and free trade concerns, opposition to a Kraft takeover was widespread in the United Kingdom.

A wide range of commentators, the British public, and Members of Parliament from not just the Labour party, but also the Tory and Liberal Democrat parties, voiced objection to the idea that an
English icon would be owned by an American company. Even though the current British ownership was already well on its way to shutting down some of the company's most historic operations and shipping production to lower wage Poland, U.S. ownership was thought to make the prospect of even more moves of this kind possible. Despite the fact that Cadbury was itself a company that had prospered by buying up other nation’s icons—remember A&W Root Beer, or Dr. Pepper, or Canada Dry Ginger Ale—its Chairman, Sir Roger Carr, was aghast that so-called short-term stockholders had taken shares from the company's long-term investors when Kraft made its bid public. How could these long-term stockholders have abandoned the company, and why should these new short-termers decide the fate of a 200 year old British treasure?

It is hardly surprising that Kraft eventually succeeded in its bid. The whole focus of the U.K. approach is that if the stockholders like the price of a takeover bid, they get to take it. The U.K. regime leaves no real room for a board to block a financed bid except by convincing its stockholders that the price is too low. If the stockholders believe the price is right, they get to accept the bid. And all market evidence has long made clear that, absent board or government interposition, stockholders will sell out into any bid offering a substantial premium. What was more surprising was to see politicians of all the major parties in the United Kingdom bemoan the foreordained result that followed from the United Kingdom's long-standing approach, especially given that Cadbury could have had a lot of suitors less savory than Kraft. The Cadbury takeover confirms how deeply rooted the power of the stockholder profit motive is in the for-profit corporation.

It is revealing to consider the aftermath of the Cadbury takeover. After the Code of the Takeover Panel rejected all three of Carr’s proposals, it instead offered its own proposals as to how the Takeover Code might be amended to prevent future Cadbury-like hostile takeovers. I offer a couple of the most material proposals as examples. First, the Code Committee recommended that the formal offer period—the period in which an interested acquirer may make an offer or bid for the target—be shortened by requiring a potential offeror to make a bid within twenty-eight days of announcing its interest to make a bid. Second, the Code Committee proposed a prohibition of certain deal protection devices currently legal under the Code—very limited termination fees and matching rights.

Upon a preliminary inspection of the Code Committee’s proposals, however, it appears that were the Takeover Code modified as proposed, it might actually make hostile takeovers more, not less, likely, at least insofar as the proposed changes would make it more difficult for U.K. target companies to negotiate and secure a friendly acquisition over a hostile one. For instance, take the proposal that would truncate the put-up or shut-up time period and require that target companies make public the identity of any potential offeror that has expressed an interest in making a bid. Although the purpose of this change is to dissuade the practice of making so-called “virtual bids”—ones where a would-be hostile acquirer announces that it is interested in making a bid well before that potential acquirer has any intention of doing so—the Committee’s proposal to make mandatory the reporting and public disclosure of the interested bidder’s identity might have the unintended consequence of dissuading overtures from would-be friendly acquirers, particularly friendly strategic acquirers, who would rather remain anonymous and maintain the confidentiality of merger negotiations with the target until a binding contract is inked.
The Code Committee’s second material proposed modification, the prohibition of termination fees and matching rights, poses a similar deterrent to would-be friendly acquirers. A friendly bidder is less likely to negotiate an acquisition with a target if it is unable to secure assurances from the target that the target is serious about doing a deal, and more crucially to the friendly bidder, serious about doing the deal proposed by the friendly bidder. Without the availability of modest deal protection devices, friendly acquisition partners may be even more reluctant to emerge than now, where the current regime already leaves strategic partners and private equity funds with very little compensation if they get topped.

For an American, the Cadbury situation is, as our philosopher Yogi Berra put it, like déjà vu all over again. For over thirty years in the United States, a variety of palliatives, such as state constituency statutes allowing boards to block bids harmful to other constituencies, and the infamous poison pill, have done little but give target boards some room to get a better deal from a so-called white knight if a hostile bid loomed. The pressures boards faced from their stockholders to accept lucrative bids made resistance in most cases futile. As a result, U.S. communities have seen icon after icon fall into foreign hands, and our own major stock exchange may soon be a subsidiary of a merger vehicle formed by the owners of the German Boerse.

B. Candid Canada: The Refreshing Honesty of the Potash Decision

By comparison, I come now to the Canadian government’s decision to block the $40 billion bid of an Australian corporation, BHP Billiton, Ltd. (“BHP”), to acquire the Potash Corporation of Saskatchewan. As I have learned, potash is not an illicit admixture to add to brownies, but a valuable crop nutrient and with a capital letter, for our purposes, a company. And Saskatchewan is the Saudi Arabia of potash with a little “p” and the current home of Potash with a capital “P.” As I have further learned, the province has an economic strategy to leverage its advantage in potash (and the resulting stream of governmental royalties) into a better overall economic position. Potash Corporation was already managed from the United States and BHP made certain assurances that it would protect provincial interests. But the provincial government was dubious that under BHP’s ownership, Potash would maintain its commitment to the province’s version of OPEC, Canpotex. Canpotex is an industry-wide marketing initiative fostered by the province. Rather, the provincial government concluded that BHP’s commercial interests as a profit-maximizing firm might lead it to cut prices, reduce royalties to the province, and otherwise be less likely to generate royalties and jobs for the province than if Potash remained independent.

The Investment Canada Act was the tool used by the province to get its way. Under that statute, the Canadian government can block any transaction above C$312 million if the transaction does not promise “net benefits” to Canada. After extensive advocacy by the Provincial government, Canadian Industry Minister Tony Clement blocked BHP’s bid, finding that it would not produce a net benefit for Canada. That this action was taken by a conservative government that generally advocates for a more open form of capitalism had special resonance.

For present purposes, however, I wish to focus only on one refreshing aspect of the application of the Investment Canada Act to the Potash situation, which is its total lack of pretense or sham. The statute is a naked grant of power to the national government to block a takeover when it believes...
Canada will be better off without it. Obviously, there are legitimate questions to be asked about the overall utility of such a statute and I do not intend to comment one way or the other on the wisdom of the decision to use the statute to block the BHP bid. But I do think that the statute’s candor deserves applause because it forces Canadian society to ask genuine questions about what is in the public interest. In other analogous situations, governments have twisted their antitrust rules, come up with situation-specific corporate law rules, or taken a strained view of what was a national security (i.e., military-terrorist) threat in order to find a basis to block transactions that were, in reality, feared to be economically injurious to the target company’s nation.

Although Australians may have been chagrined by the Canadian government’s blockage of BHP’s bid, Aussies could not claim shock because their nation has a similar statute. Moreover, the reality that another possible bidder for Potash was a Chinese-government-owned firm highlights the difficult reality of the so-called global market. Canada faced a situation in which a corporation that controlled an important national resource could pass into the hands of owners who either (in the case of BHP) were deemed more likely to be driven by market forces to reduce the benefits to Saskatchewan of the company’s operations or (in the case of a potential Chinese-government-owned bidder) would have been free to take actions not directed primarily at producing benefits for stockholders, but rather for advancing the self-interest of another nation.

C. Globalized Capital and Product Markets Make Regulation in the Public Interest More, Not Less, Vital

The most critical issue before us is that we have globalized capital markets. These capital markets put more intense pressure than ever on corporations to deliver short-term profits. In almost all the Organization for Economic Cooperation and Development ("OECD") nations, only capital has a vote on who comprises the board of directors. With increasing institutional ownership and greatly decreased holding periods, corporate electorates are more demanding than ever and unlikely to give serious thought to the long-term, given that few stockholders hold their shares for longer than a year at a time.

Although we have globalized capital markets and have opened our product markets to exports, we have done little to effectively globalize the regulatory structures that ensure that for-profit corporations do not generate unacceptable levels of harm to others in their pursuit of profit. Although the World Trade Organization does in fact at times act as an effective club in keeping nations from preventing exports from entering their markets, no similarly powerful international body ensures that all corporations participating in international commerce must meet minimally decent standards of labor treatment or environmental safety and respect. Likewise, although financial institutions can and do take actions that affect the stability of all nations, their safety and soundness is remitted to a patchwork of national regulation. Nations fear that if they require fair treatment of workers, protection of the environment, the payment of taxes to support the nation’s needs, and sound capital requirements for financial institutions, corporate activity will flee to other nations where there is little or no regulation.

The examples I have discussed above are not designed to convince you that any particular level of regulation is optimal. But they are designed to point out this reality: if, as I do, you believe that

Sustainable Corporations (Spring 2014)
Week 01 / Day 03 – Nature US Public Corporation
the temptations of profit can lead to corporate behavior that can harm society, you should be skeptical about claims that corporations are better-positioned to regulate themselves now than they used to be.

In many ways, the opposite is in fact true. Corporations increasingly have no genuine connection to any particular community or even nation. A huge disconnect has arisen between the wealth, lifestyle, daily experiences, and interests of the top corporate managers and that of most of the employees in the various nations in which their corporations have operations. Corporate managers are increasingly subject to removal at the instance of highly aggressive institutional investors who do not hold shares or think long-term. The actual long-term providers of capital are more and more divorced from the ownership of the shares of particular companies, and have largely yielded their votes to money managers compensated largely on short-term metrics. Providers of debt are also less well positioned to act as monitors, as corporate debt is syndicated and trades largely like equity capital, leading to far less stable lender-borrower relationships and less intensive, long-term monitoring of corporate risk-taking.

To deliver profits, corporations must endure competition from competitors willing to locate jobs in nations without labor or environmental protection. That creates incentives to reduce wage rolls and pay, particularly in the European Union or in nations like Canada and the United States that have responsible regulatory standards, and to take fewer product safety and environmental precautions. When their competitors seem to be making large, short-term profits by suspect means that have substantial long-term risk--see the subprime debacle discussed above--corporate managers face strong pressure from the capital markets to get in the game, regardless of whether they personally believe the game to be just another form of gambling.

Concluding Thoughts: Rules for the Global Game

Milton Friedman is a person who has written a lot of things I don’t necessarily agree with. But he wrote a famous article in which he said that “there is one and only one social responsibility of business--to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game . . . .” When the pressure to deliver profits becomes, as it has, more intense, the rules of the game become even more important. Human nature, the founders of my nation teach, should be taken into account in designing those rules, and we should not assume that men and women of commerce are somehow better than average.

To ensure that for-profit corporations do not generate excessive externalities, strong boundaries remain critical. To address externality risk and fundamental concerns about appropriate protection of workers and the environment in globalized capital and product markets, the rules of the game must ultimately become global, too. But in the meantime, enlightened societies must resist the temptation to roll back the societal protections that spread the blessings of capitalism more broadly, ended child labor, gave workers safe places to work, protected consumers from harmful products, provided decent wages and humane working hours, and ensured that the pursuit of profit would not pollute the world in which we live. After all, it was speedy national, not international, action that kept the financial crisis from being even worse. We cannot dispense with the protections provided by the nation-state until we come up with an effective replacement.