Readings

Week 03 / Day 08

Profits Externalities: Corporate Social Responsibility

Today’s readings continue our look at attempts to confront corporate externalities and the corporation’s unsustainable design. Specifically, we look at how “corporate social responsibility” – until now in the United States, a largely voluntary movement by corporate managers – has sought to make the corporation more responsive to a fuller range of constituents.

The first reading from the student book (which you have read from before) provides an overview of the place of CSR in corporate law and fiduciary duties. One of the cases described in the chapter, Dodge v. Ford Motor Co., is a case that we encountered before in connection with Chancellor Leo Strine’s article on The For-Profit Corporation. We now get to consider the case in its full glory, and consider whether it involves the confrontation of shareholder wealth maximization and corporate social responsibility. You’ll want to focus on how fiduciary duties fit with CSR. In particular, consider whether disclosure by public companies of how climate change is affecting or may affect their business is CSR or SWM.

The next reading is an interesting article that expounds two different CSR models. One is the conventional one in which CSR compels shareholders to make concessions to other non-shareholder constituents in a “zero sum” game. Another one seems the CSR movement as creating a larger set of opportunities of businesses, in which both shareholders and other constituents gain by management’s larger awareness of the value of sustainability.

Then I will ask you to go to a website to see how a private NGO coordinates CSR activities of some of the world’s largest corporations. I will ask you to browse part of the website and answer some (a total of 14) questions about this NGO and its work.

Finally, you will read a shortened version of an article (the most downloaded “forum” piece on corporate governance) in which the authors argue that institutional shareholders in US public corporations should have fiduciary duties when they vote. Corporate managers have fiduciary duties when they manage “other people’s money,” why not intermediary institutions?

Readings:
- E&E 11 (Fiduciary Duties - CSR, climate change)
- Millon, Two Models of CSR (2011)
- Scavenger Hunt - Ceres, Who We Are (2014)
- Anabtawi & Stout, Fiduciary Duties for Activist Shareholders (2009)
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).

The other chapters in this part describe corporate fiduciary duties in specific contexts, as well as the procedures for their enforcement:

- duty of care of directors in making decisions and monitoring corporate affairs, as well as the operation of the business judgment rule and statutory exculpation provisions (Chapter 12)
- duty of loyalty of corporate officials when they enter into self-dealing transactions with the corporation, and judicial review for fairness (Chapter 13)
- judicial review of executive compensation under corporate fiduciary law, and federal restrictions and disclosure requirements (Chapter 14)
- indemnification of corporate officials under corporate statutes and by agreement, and directors’ and officers’ insurance (Chapter 15)
- duty of loyalty of corporate officials who take business opportunities in which the corporation may be interested and who compete with the corporation (Chapter 16)
duties in corporate groups, including dealings by parent corporations with partially owned subsidiaries and buyouts of minority shareholders (Chapter 17)

- enforcement of fiduciary duties in derivative suits, including procedural requirements and the board’s role in litigation on behalf of the corporation (Chapter 18)

In short, this part focuses on fiduciary duties in the context of business operations. Other chapters focus on fiduciary duties in the context of shareholder voting (Chapter 8), disclosure to shareholders (Chapter 22), securities trading by corporate insiders (Chapter 23), and changes of control (Chapter 39).

§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 recklessness. 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

**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 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.
TWO MODELS OF CORPORATE SOCIAL RESPONSIBILITY

David Millon
46 Wake Forest L. Rev. 523 (2011)

There are two basic ways to think about business corporations: as mere aggregations of natural persons or as entities in their own right. As entities, they have been described as either natural or artificial, and the idea of the corporation as a person is itself fraught with ambiguity. This Article focuses on two perspectives and traces their respective implications for notions of corporate social responsibility ("CSR"). One is familiar and has impeded efforts to argue that corporations should be managed with attention to their obligations to society. The other, less familiar perspective draws on the concept of sustainability and offers potentially more promising prospects for those concerned about CSR.

The first perspective focuses on the corporation's constituent elements: senior management, shareholders, employees, creditors, consumers, and communities in which the corporation operates. Each of these constituencies has its own interests and these interests often conflict with those of other constituencies. For example, shareholders' desire for profit may be at odds with workers' desire for high wages. Here the primary normative question is the amount of weight that should be given to constituency interests and whose interests should take priority.

The second approach focuses on the corporation as an entity existing in time. Rather than an aggregation of numerous constituencies, the corporation is itself a distinct person. The primary emphasis then is on the various external relationships that determine its long-term survival. Here the key question is how the corporation should interact with its various stakeholders to ensure its long-run viability.

The structural approach ignores this temporal dimension and attends to the immediate impact of favoring the interests of one constituency over those of others, without reference to possible long-term considerations. So, for example, economic benefits to the corporation accruing in the future will not necessarily justify expenditures that reduce profits in the short term.

These different ways of thinking about the corporation support two different ways of thinking about CSR. The first model speaks in structural terms, emphasizing the broad range of interests that the corporation's management should take into account and balance -- subordinating the shareholders' desire for profit maximization to the claims of nonshareholder stakeholders. This view might be referred to as the “constituency” model of CSR.

The second model is temporal in focus, with the key question being the corporation's success over the long run. Long-run sustainability depends crucially on the viability of the various corporate stakeholders: workers, suppliers, and customers, as well as investors, and even the environment. Decisions of corporate management often affect the well-being of these stakeholders in positive or negative ways. If the corporation's long-run sustainability is a serious objective, management must cultivate and nurture these relationships. My main point in this Article is that a long-run orientation to corporate management – that considers both profits and the well-being of
nonshareholder constituents -- will achieve many of the objectives favored by CSR advocates. This model might therefore be referred to as the “sustainability” model of CSR.

This Article first considers the more-familiar constituency model of CSR, and its status in law and practice. I then turn to the sustainability model, which offers a new and potentially fruitful perspective on CSR, and provide illustrations to highlight its contrast with the constituency model. I close with some thoughts on the prospects for a sustainability approach to CSR.

I. The Constituency Model of CSR

A. The Model

The constituency model of CSR sees the corporation as an organization consisting of a number of different groups of people, in which the members within each group share common interests. Shareholders, for example, generally seek maximal return on their investments. Employees want rewarding work, satisfactory working conditions, and good wages. Creditors expect to be paid according to the terms of their contracts. Often, conflicts exist among these and other constituencies’ interests. High returns for shareholders can mean low wages for workers. Increased leverage may be good for shareholders but bad for bondholders. Conflicts like these mean that those in charge must make trade-off judgments. These choices are assumed to be zero-sum games.

According to this view of the corporation, CSR requires management to balance shareholder and nonshareholder interests. For example, shareholder profit maximization, even when pursued within the boundaries of the law, can lead to plant closings that harm workers and local communities, environmental damage, and human rights violations in developing countries. Socially responsible leadership therefore necessitates that management temper its pursuit of profit with regard for such considerations.

The constituency model of CSR largely takes for granted the trade-off or zero-sum assumption that sees benefit to nonshareholders coming at the expense of shareholders. Proponents must therefore rely on moral or ethical arguments, conceding the economic critique. Thus, for example, so-called corporate law progressives justify the balancing approach to CSR on fairness grounds, arguing that nonshareholders should not be required to rely on their own contractual bargaining capabilities to protect their interests. For the most part, however, the constituency model of CSR—which has long been the standard way of thinking about CSR—makes no effort to appeal to shareholder interests.

B. Current Legal Status

Corporate law endorses the constituency model of CSR, although only permissively. As of 2003, forty-one states had enacted “constituency statutes” that authorize management to take into consideration a range of nonshareholder interests in addition to those of shareholders. Importantly, however, these statutes only permit balancing of interests rather than requiring it.
Corporate boards would thus be free to pursue CSR policies but cannot be sanctioned for choosing not to do so.

Delaware—the state of incorporation for nearly two-thirds of U.S. publicly traded companies—has not enacted a constituency statute. Nevertheless, Delaware law is not committed to shareholder primacy. Management’s duties are owed to “the corporation and its stockholders,” rather than to the shareholders alone. Moreover, the Delaware courts have never stated plainly that management’s fiduciary responsibilities—the duties of care and loyalty—imply a general duty to maximize profits without regard to competing nonshareholder considerations. Thus, in the face of management policies to favor nonshareholder constituencies over shareholders, the shareholders lack the ability to challenge such policies even if the result is reduction of profits. Under the business judgment rule, courts will not second-guess decisions—including decisions that appear to benefit nonshareholders at the expense of shareholders—as long as management can assert some plausible connection with the corporation’s long-run best interests.

When the Delaware Supreme Court has directly addressed management’s authority to consider nonshareholder interests, the court declined to endorse shareholder primacy. Defining when a target company’s management can lawfully defend against a hostile bid, the court stated in Unocal Corp. v. Mesa Petroleum Co. that management can take into account “the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally).” The court will require maximization of shareholder value only if management voluntarily chooses to abandon its own long-run business strategy by undertaking a transaction that will result either in change of corporate control or break-up of the corporate entity. In short, although it is often assumed that corporate law mandates shareholder primacy, there is in fact very little doctrinal basis for such claims.

C. Current Practice

Although not required to do so by law, management of U.S. corporations typically pursues short-term profit maximization as measured by investors looking to quarter-to-quarter earnings. The objective is enhancement of share price, which depends on a reliable stream of regular earnings; failure to meet earnings targets usually results in immediate share price decline. Because the constituency model of CSR envisions expenditures—in the form of cash outlays or foregone revenues—that are designed to benefit nonshareholders, such policies would mean lower net income and therefore would conflict with management’s emphasis on the currently accepted short-term conception of shareholder value. In other words, current practice generally embraces shareholder primacy and rejects CSR.

There are several explanations for current practice, which as explained above, is not required by law. Today’s shareholders typically adopt a short-term perspective that manifests itself in a strong preference for immediate results measured in terms of current share price. Management thus finds itself under scrutiny to deliver results on a quarter-to-quarter basis and goes to great lengths to achieve accounting results that meet or exceed earnings targets. For example, in order to meet their own obligations to their beneficiaries, the California Public Employees Retirement System and
other state pension funds must achieve annual returns on their investments of eight percent. In the face of such demands, patience is not an option.

Management compensation also encourages concentration on current share price. Stock and stock option grants are significant elements of senior officer compensation at most U.S. corporations. The justification is alignment of shareholder and management interests in order to reduce agency costs. The effect is to encourage a short-term focus on profits in order to boost the value of shares and options awarded to executives of the corporation.

Social norms shape an environment in which management tends to understand its role in terms of maximization of current share prices. Business schools, apparently misapprehending the law, preach this ethic at the expense of a richer, more complex conception of responsibility. Corporate lawyers charged with advising boards on their responsibilities typically take shareholder primacy for granted. The business press insists on the same idea, and prominent corporate law academics—most of whom tend to embrace a conservative law-and-economics agenda—likewise assume that shareholder primacy rather than CSR is legally mandated.

II. The Sustainability Model of CSR

A. The Model

The sustainability approach to CSR posits that the corporate entity should remain economically viable over the long run. The corporation must generate profits because survival requires it, but survival most emphatically does not require short-term profit maximization. In fact, a short-term time horizon may impede the corporation's long-run sustainability because it can result in policies that sacrifice future earnings for current net income.

The connection between sustainability and CSR is simply the realization that the corporation's long-run prosperity depends on the well-being of its various stakeholders, including workers, suppliers, and customers. Sustainability also requires ongoing availability of natural resources and a natural environment in which the corporation and its various constituencies can survive and flourish. Well-functioning markets and stable and supportive governments are also essential. Because the corporation itself has a significant role to play in determining the welfare of these stakeholders and in nurturing productive, reliable relations with them, a sustainability approach to business success has the potential to achieve many of the goals that CSR proponents advocate.

The sustainability model of CSR differs from the constituency model in a fundamental way. The constituency approach sees attention to nonshareholder interests as a trade-off cost that comes at the expense of profit and therefore of shareholder value. In contrast, the sustainability perspective sees attention to nonshareholders—including investment in their well-being—as essential to the viability of the firm and therefore also to the enhancement of shareholder value. The key difference is the relevant time horizon.

B. Illustrations
The sustainability approach to corporate management accommodates CSR expenditures because it takes into account long-term payoffs that benefit the corporation and thereby its shareholders as well. For transnational corporations doing business in developing countries, sustainability may require investment in community-level infrastructure development projects, technological innovation, education, and health care. As these investments lead to greater productivity and better product quality, workers and producers can earn higher incomes, allowing the local population to enjoy a higher standard of living. An example is Nestlé’s entry into milk production in the Moga district of India. Investments in refrigeration, well drilling, veterinary medicine, and training have vastly increased output; enhanced product quality has allowed Nestlé to pay higher prices to farmers. The result is higher incomes for farmers and their employees, and the region now has a significantly better standard of living compared to neighboring communities.

By spending money on projects like these, corporations incur immediate costs that reduce current profits. Longer-run benefits, however, have the potential to generate net gains in the form of enhanced productivity, greater skills and knowledge, commitment, increased consumer demand, political and social stability, and long-run viability. The corporation and its shareholders benefit—but so too do the local communities in which its workers and producers live. In contrast, a narrow, short-term orientation seeks simply to locate production in developing countries in order to take advantage of low wages and lax regulations. Current expenses are reduced, but long-run productivity and sustainability considerations are ignored.

Closer to home, many U.S. companies have invested heavily in employee health through wellness and anti-smoking initiatives. Such programs are expensive and therefore stand in contrast to short-term profit enhancement strategies based on minimizing wages and benefits. Johnson & Johnson, for example, estimates that its Wellness & Prevention program has saved the company $250 million in employee health care costs over the past decade—representing savings of $2.71 on every dollar spent. There also appears to be a connection between employer-sponsored wellness programs and employee loyalty; companies with effective programs experience significantly lower voluntary attrition. Greater productivity and higher morale may also result.

Investment in research and development ("R&D") is another example of an upfront cost with potential longer-term payoffs. Despite the crucial importance of R&D for corporate sustainability, corporations have been reducing expenditures in order to maintain short-term earnings. A reversal of this trend would be socially beneficial because it would facilitate the development of new products and services, including those that address consumer demand for environmentally responsible offerings. For example, GE has invested billions in order to develop its "ecomagination" line of energy efficient products and now predicts that revenues from these products will grow at twice the rate of total company revenues over the next five years.

C. "Strategic" versus "Philanthropic" CSR

A strategic emphasis on investments that serve the interests of key stakeholders can bolster the corporation’s long-term sustainability. Because such policies are justified in economic terms—in
terms of the corporation's long-run profitability—there is no need to resort to moral or ethical arguments, as is the case with the constituency model of CSR. The whole point is to generate net gains in the future from expenditures incurred in the present—benefits to nonshareholders come not at the expense of shareholders but rather are deployed for their ultimate advantage.

For this reason, this approach to CSR objectives can be labeled “strategic.” In contrast, the notion that CSR requires firms to forego profits—and therefore reduce shareholder wealth—in order to spend corporate funds to benefit nonshareholder constituencies might be termed “philanthropic” CSR. An example would be refusal to immediately close a plant generating subnormal returns because of concerns about the harsh impact the closure would have on the labor force, the local community, and perhaps also on the company’s reputation among consumers, investors, and the general public. Such a decision could be characterized as “philanthropic” in the sense that corporate management has chosen voluntarily to forego profits in order to benefit nonshareholder constituencies. These benefits come at the expense of the shareholders. From that perspective, the decision is analogous to a charitable donation to a nonprofit organization.

Typically no serious effort is made to defend philanthropic CSR in economic terms. There may be assertions of long-run goodwill or reputational advantages but such claims are virtually impossible to document and the evidence of actual positive effects of CSR policies on worker, consumer, or investor attitudes is uncertain. Indeed, the key idea is not economic at all. It is instead based on a claimed moral or ethical imperative requiring that corporations perform good works regardless of their possible negative impact on profits. This is why this notion of CSR has made only limited headway beyond left-leaning academics and political activists for whom the profit motive may be suspect at best and shareholders are to be tolerated but no more than that.

Because sustainability CSR insists on corporate profitability over the long run, and benefits to key nonshareholder constituencies are designed ultimately to generate payoffs to the corporation and its shareholders, it need not rely on moral or ethical argument alone. Instead, strategic CSR should be understood as promoting the corporation’s financial interest and therefore those of the shareholders too. This approach avoids objections to the effect that management is “spending someone else’s money” when it uses corporate funds to improve the well-being of nonshareholder stakeholders. For this reason, strategic CSR ought to have significantly broader appeal than the constituency or philanthropic model has had.

Pressure from shareholders for immediate returns, however, is likely to skew the cost-benefit calculus. Management’s awareness that shareholders prefer current earnings may lead it to discount the value of future payoffs more heavily than it otherwise would. In other words, management may assume that a higher rate of return is necessary to justify current expenditures designed to benefit nonshareholders. This would discourage some investments that might be endorsed if shareholders were more patient than they typically are today.

Seen solely through a cost-benefit lens, CSR initiatives are not likely to go as far as some would advocate. The moral or ethical case for, say, environmentally responsible policies, or attention to human rights issues, may therefore continue to provide justification for business policies that
cannot be defended solely in economic terms. CSR may require attention to nonshareholder interests even when doing so is not in the long-run interests of the shareholders.

Further, if CSR is limited solely to strategic considerations, corporations may choose not contribute to efforts to solve social problems seen as unrelated to their long-run economic interests. Large corporations make significant cash and noncash contributions to a range of educational, health, community development, environmental, and cultural organizations. In 2009 the median total giving amount for sixty-one Fortune 100 companies exceeded $56 million. These gifts often have no direct connection to the donor’s business and are made for essentially philanthropic reasons. In short, sustainability CSR is not a complete substitute for philanthropic CSR.

III. The Prospects for Sustainability CSR

The economic argument for sustainability CSR ought to have broad appeal. Because it is not based on purely moral or ethical considerations, it avoids standard objections raised against the constituency CSR model based on the interests of shareholders and their claims of privilege vis-à-vis the corporation’s various nonshareholder groups. Further, unless blinded by short-term myopia, corporate executives should appreciate the importance of the corporation’s long-run viability. They therefore should be receptive to the idea that investment in the well-being of key stakeholders can generate significant financial returns. Indeed, the many examples of strategic CSR indicate that many executives understand this point and are incorporating it into their business strategy. Nonetheless, there are significant impediments to its widespread adoption.

A. Sustainability CSR’s Problematic Appeal

As discussed above, CSR policies based on a commitment to sustainable profits are a casualty of the current obsession with short-termism embraced by shareholders. And management compensation practices that typically include stock-based pay further encourage a short-term focus. So too do business norms that focus on quarterly earnings as the relevant metric by which management is to be evaluated. As long as corporate executives prioritize short-term results over long-run value, sustainability considerations will be of only secondary importance. Finally, executives who assume that shareholder primacy is the relevant metric may bridle even at CSR policies that are based on strategic, rather than philanthropic, motivations.

B. Accounting Conventions

Current accounting conventions generally do not express the future value of strategic investments in the well-being of nonshareholder constituencies. Thus, an investor who seeks information about the potential future payoffs of current expenditures that are designed to generate sustainable profits by promoting the interests of nonshareholders will find it difficult to obtain that information from the corporation’s financial disclosure. Similarly, corporate executives who approve expenditures benefiting nonshareholders may be frustrated at their inability to express the future value of those expenditures in the corporation’s financial statements.
According to Generally Accepted Accounting Principles, expenditures designed to benefit nonshareholders so as to create future value typically must be reported as expenses that reduce net income in the accounting period in which they are paid. The fact that they are supposed to generate future profits potentially extending over many years is not reflected on the income statement or balance sheet—instead they are accounted for as current expenses just as are, say, rent or salary or interest payments. So, for example, a corporation that spends money training farmers in more productive, less environmentally damaging agricultural practices or encouraging its employees to pursue healthier life choices will have to account for those costs on its income statement when the expenditures are made, reducing net income by the amount of the expenditure, even though the goal is to produce value in the future. Although these might better be thought of as investments rather than expenses, their value is not expressed on the balance sheet.

Compare in this regard expenditures made to acquire fixed assets, that is, assets that are expected to contribute value to the corporation over a number of years. The cost of these assets is allocated over their useful lives, rather than treated as an expense to be assigned entirely to the period in which they are purchased. The theory is that the cost of these assets should be accounted for over the entire period during which they generate value. Further, the value of fixed assets is included on the balance sheet, expressed in terms of historical cost.

For an investment community obsessed with quarterly earnings, these accounting conventions arguably fail to capture accurately the worth of the expenditures designed to produce sustainable future benefits. They therefore overstate the expenditures’ cost to the corporation. A thoughtful analyst could no doubt distinguish costs that generate immediate value—rent and wages, for example—from the kinds of expenditures that are designed to produce future value. He or she could then discount the latter category of expense accordingly, thus reducing the impact on the corporation’s net income. But even if management wished to do so, it may be reluctant to correct, through its financial disclosure, misleading information based on these conventions.

**Conclusion**

The orthodox model of CSR—which I have termed the “constituency” model—envisions the corporation as composed of a number of constituencies whose interests often conflict. Policies designed to benefit a nonshareholder constituency are assumed to reduce profits and therefore affect shareholder interests adversely. As management attempts to mediate among these conflicting interests, zero-sum trade-offs are assumed to be inevitable. Seen in this light, CSR has enjoyed limited traction among business leaders, academics, lawyers, and policymakers because it is widely taken for granted that shareholder primacy is the relevant benchmark.

The “sustainability” model of CSR rejects the zero-sum trade-off assumption of the constituency model and instead embraces the idea that the corporation’s long-run sustainability depends in part on the long-run viability of key stakeholders. The corporation has a role to play in ensuring that viability. Investment in the well-being of key nonshareholder constituencies—even though costly in the short run—can generate payoffs in the future that justify those expenditures. Indeed, failure to attend to such considerations may threaten the corporation’s long-run competitiveness.
The sustainability model of CSR avoids the standard objections to the constituency model based on shareholder primacy. Long-run sustainability requires economic success over time. Strategic investments beneficial to nonshareholders are thus designed ultimately to enhance profits. The long-run perspective facilitates appreciation of the relevance of future returns on current investments and their potential to promote shareholder value. Conceived in this way, CSR grounded in sustainability concerns can produce real benefits for nonshareholders. It is nevertheless important to bear in mind that it still may not do enough to satisfy fully the corporation’s responsibilities to society. Because it is grounded on cost-benefit analysis, sustainability CSR may not go far enough.

Even accepting these possible shortcomings, there is reason to doubt whether corporate self-interest can be sufficient to generate significant investment in CSR initiatives motivated by sustainability concerns. The contemporary preference of most shareholders for current returns means that they are likely to be unreceptive to expenditures that reduce quarterly earnings for the sake of potential future payoffs.

David Millon is the J.B. Stombock Professor of Law, Washington and Lee University. An earlier version of this Article was presented at the symposium on “The Sustainable Corporation” held at Wake Forest University School of Law in April 2011.
Scavenger Hunt – Ceres.org

1. Go to ceres.org. What is Ceres? How would you describe the organization to a family member? Click here. There’s a video that might interest you. Click here.

2. What is the history of Ceres? How was it founded? What have been some of its achievements? What do you find most impressive? Click here.

3. Who is part of the Ceres “coalition”? Who is part of the Ceres “network”? Would you say there is more interest in Ceres from institutional investors or large companies? Click here.

4. If you managed a large institutional investor, would you want to be part of the Ceres coalition? What might be your reasons for joining? Click here.

5. Ceres released a “Roadmap to Sustainability” for corporations in the 21st Century. What are the four broad areas that Ceres as necessary to create a business sustainability strategy? Click here.

6. The introductory letter to the Roadmap includes four “key pillars” to achieve global sustainability. What are they? Click here (page 6 of Report, also available on TWEN).

7. The report also lays out four broad areas that companies should focus on: governance, stakeholder engagement, disclosure and performance. What are the 20 key expectations in these four areas? Click here (page 14-15 of Report, also available on TWEN).

8. If you were a corporate CEO (or board chair), what reasons would there be for you to implement the governance reforms advocated by the Ceres Sustainability Report (p. 14)?

9. If you were the head of a mutual fund’s “voting policy group,” what reasons would there be for you to become involved in the stakeholder dialogue advocated by the Report (p. 14)?

10. If you were the General Counsel of a public company, responsible for disclosure of company information, what reasons would there be for you to have your company engage in the sustainability reporting advocated by the Report (p. 14)?

11. The report lays out five “performance” areas that companies in the Ceres network are supposed to achieve according to the Report (p. 15). Which areas seem achievable?

12. Find one aspect of the Report that you agree with. Find one aspect that you disagree with.

13. Ceres has partnered with the Tellus Institute to create “sustainability ratings” of companies and their operations. Click here. Have any companies been issued ratings? Click here.

14. Ceres is hiring. Would you be interested in working at Ceres? Click here.
Power in public corporations is dispersed among three key groups: shareholders; the board of directors; and the company's executive officers, including its Chief Executive Officer (CEO). Each group has rights and privileges. Each also has duties and responsibilities.

Contemporary corporate case law and scholarship, however, pay far more attention to corporate officers’ and directors’ duties than to those of shareholders. Officers and directors are understood to owe fiduciary duties of loyalty and care that are broad and deep, constraining their every material business decision. Shareholders, in contrast, are thought to have far more limited obligations. In fact, outside the narrow contexts of closely-held companies and self-dealing by majority shareholders, many commentators assume shareholders have no duties at all. Minority stockholders in public companies are often viewed as free agents, at liberty to try to influence corporate policy as they see fit—including trying to influence corporate policy in ways that favor their own interests over those of the corporation and other shareholders.

Why has the possibility that minority shareholders in public firms might use their power in self-serving ways attracted so little attention? First, until recently minority shareholders have played a largely passive role in public companies. The second reason is that, even when minority shareholders become active, it has been generally believed that their primary goal is to improve the firm’s overall economic performance—presumably a beneficial influence.

Both of these assumptions are becoming increasingly inaccurate. The economic and legal contexts in which American public corporations do business are changing swiftly in ways that create a pressing need to reexamine conventional notions of shareholder duties. As a result of recent developments in the financial markets, in business practices, and in corporate law, minority shareholders are finding it economically rational to try to influence corporate decisionmaking. Meanwhile, even as shareholders are becoming more powerful, their interests are becoming more heterogeneous. Increasingly, the economic interests of one shareholder or shareholder group conflict with the economic interests of others. The result is that some activist shareholders are using their growing influence not to improve overall firm performance, as has generally been assumed, but to profit at other shareholders’ and at the firm’s expense.

We believe fiduciary duty doctrine can and should be interpreted in a new way that takes into account changes in the corporate landscape and reaches such opportunistic behavior. Indeed, we believe that the law of fiduciary duty is uniquely suited to address the growing problem that opportunistic shareholder activism poses for corporate governance.

I. A Primer on Shareholder Fiduciary Duties
Fiduciary duties are usually applied to officers and directors. In some cases, however, courts impose fiduciary duties of loyalty on certain types of shareholders as well. When they do, the analysis tends to follow the application of loyalty duties in officer and director cases.

In particular, courts have held that majority shareholders, like corporate officers and directors, owe a fiduciary duty of loyalty to minority shareholders that precludes them from using their positions as controlling shareholders to extract material economic benefits from the firm at the minority’s expense. As articulated by the California Supreme Court in the famous case of *Jones v. H.F. Ahmanson & Co.*, “Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately.”

As in the case of corporate officers and directors, courts deem corporate actions that provide unique benefits to controlling shareholders to be potential violations of controlling shareholders' duties of loyalty. As in the case of corporate officers and directors, such actions are not utterly prohibited. A controlling shareholder can escape liability by proving, to the court’s satisfaction, that while a transaction was tainted by a conflict of interest, it was nevertheless intrinsically fair to the firm and other shareholders. Also as in the case of officers and directors, courts assessing the fairness of controlling shareholders’ transactions initially put the burden on the controlling shareholder to establish the intrinsic fairness of the deal, in terms of both process and price, to the corporation and its minority investors.

**II. Theoretical Foundations of Limited Shareholder Duties**

It thus appears that, at least in certain cases, courts subject shareholders to loyalty duties similar in nature to the loyalty duties imposed on corporate officers and directors. Nevertheless, most contemporary discussions of fiduciary duty in public corporations continue to orbit around officers and directors. Minority shareholders, historically passive, have been disregarded. As one commentator put it, “There is no need for concern about the oppressive propensities of persons who lack the power of implementation.”

In addition, when a minority shareholder would take an active role in corporate decision-making, that activism has tended to benefit both the corporation and other shareholders. According to this view, minority shareholders want to make the corporation as profitable as possible in order to maximize the value of their shares. To the extent they accomplish this objective, they serve not only their own interests but those of the other shareholders as well. This theory of uniform shareholder interest independently renders fiduciary limits on shareholder action unnecessary.

Taken together, the assumptions that shareholders in public firms are mostly passive and that shareholders share common interests have led many observers to conclude that shareholders, unlike corporate officers or directors, are not generally bound by fiduciary duties. Thus, “non-controlling” shareholders may vote as they please without objection that their motives are for personal gain.
III. Shaking Foundations: The Rise of Minority Shareholder Power

Changes in markets, business practice and business institutions, and in corporate and securities law have seriously eroded the realism of the conventional wisdom that minority shareholders are passive and powerless.

First, recent decades have seen the rise of institutional investors—typically pension funds and mutual funds—that aggregate the savings of millions of individuals into enormous investment portfolios that buy stock in public companies. A number of prominent institutional investors, including both mutual funds like Fidelity and Vanguard and pension funds like CalPERS, have emerged as activist investors willing to mount public relations campaigns, initiate litigation, and launch proxy battles to pressure corporate officers and directors into following their preferred business strategy. [Palmiter note: not really for mutual funds.]

Second, shareholders’ ability to influence policy in public companies received an important boost in 1992 when the SEC amended its federal proxy regulations for the express purpose of permitting large shareholders to exercise their voting power more effectively. The 1992 amendments exempted from the definition of a regulated “proxy solicitation” most shareholder communications not actually accompanied by a formal proxy solicitation, and also made clear that most shareholders were free to make public statements, including speeches, press releases, and internet communications. The 1992 amendments thus made it much easier for investors—including institutional investors and hedge funds—to coordinate with each other and combine their individual holdings into a single, much larger voting block.

Third, another recent development that has magnified shareholders’ collective influence is the creation of commercial “shareholder advisory services.” Shareholder advisory firms specialize in advising pension funds and mutual funds, for a fee, how to vote the proxies of the shares held in their investment portfolios. As a result, advisory services coordinate the voting policies of many different institutional investors, effectively aggregating their shares into one large voting bloc controlled, as a practical matter, by the advisory service itself. By far the largest and most influential shareholder advisory service today is Institutional Shareholder Services (ISS). The emergence of ISS as the dominant advisory service thus has dramatically reduced the collective action problem traditionally thought to plague shareholders in public firms. The widely dispersed individual shareholders who once routinely voted with corporate management have been replaced to a great extent by institutions that follow the advice of a single and far more independent-minded “voter”—ISS.

Fourth, perhaps the most important development in recent years contributing to greater shareholder activism is the rise of new type of institutional shareholder for whom activism is especially economically attractive—the hedge fund. Hedge funds are lightly-regulated investment pools that cater to wealthy investors, and so are exempt from most of the disclosure requirements and other legal burdens borne by mutual funds that take investment funds from the general public. Many hedge funds typically do not attempt to diversify their portfolios, but instead take large
positions in as few as two or three companies, and then demand that those companies pay special dividends, launch massive stock buyback programs, sell assets, or even put themselves on the auction block in order to add “shareholder value.” The popularity of hedge funds has grown enormously in recent years, and by some estimates by 2008 hedge funds controlled as much as $2 trillion in assets. The result is a new genre of public company shareholder that is aggressive, wealthy, and eager to play a role in setting corporate policy.

Fifth, yet another factor promoting greater shareholder activism is financial innovation. Today investors purchase not only stocks and bonds but also various alternative hybrid forms of equity, debt, and derivative instruments. Financial innovation encourages shareholder activism in at least two ways. First, it creates more incentives for activism, because the more complex a company’s capital structure becomes, the more opportunities are presented for investors who purchase one type of security to push for corporate actions that harm the value of another type of security issued by the same company. For example, a preferred stockholder in a troubled firm might push for an asset sale to trigger its liquidation preference, while common shareholders demand a risky strategy that could raise the value of the common if it succeeds but harms the value of the preferred. A second and more widely recognized reason why financial innovation has encouraged shareholder activism is that it has lowered the cost of activist strategies by allowing the separation of voting rights and economic interests. Thus, a hedge fund can buy a block of common stock and vote the shares while simultaneously entering a derivatives contract that hedges away its economic interest in the stock. Indeed, the fund can take a negative economic position in the firm by shorting its stock and then seek to profit from using its power as a formal shareholder to push for business policies that drive stock price down.

IV. Shaking Foundations More: The Problem of Shareholder Conflicts of Interest

As shareholders are becoming more powerful, they are also becoming more heterogeneous. Activist shareholders can have serious conflicts of interest with other shareholders arising from (1) their other relationships with the firm; (2) their investments in derivatives or securities issued by other corporations; and (3) their investments in other parts of the firm’s capital structure.

The dangers of shareholder self-interest are perhaps most apparent in the case of self-dealing transactions between the firm and the shareholder. Corporate law has long viewed with suspicion transactions between the firm and a controlling shareholder. Yet as minority investors in public companies have acquired more power, it has become clear that an activist minority may also have enough clout to push through interested transactions.

The high-profile proxy battle to remove Steven Burd as Chairman and CEO of Safeway Inc. provides an example of how activist investors can use their shareholder status to push for favorable treatment in their other dealings with the firm. Burd was taking a hard-line stance in labor negotiations with the United Food & Commercial Workers Union (UFCWU), which represents grocery workers. The California Public Employees’ Retirement System (CalPERS), a large pension fund representing California employees, organized a proxy campaign to remove Burd from the
corner office. It was soon revealed that the CalPERS campaign had been initiated by CalPERS' President, Sean Harrigan, who was also a career labor organizer and an official of the UFCWU.

A second common situation where conflicts of interest between activists and other shareholders in the firm can arise is when activist shareholders take “adverse positions” in derivatives or in securities issued by other companies. For example, an activist can become a formal shareholder with voting power while simultaneously either “shorting” the company’s shares, or entering a derivatives contract to hedge away its economic interest. Activists can also take adverse positions in the securities of another company. They can even combine both types of adverse interest.

A widely-cited example of this involved the potential purchase of King Pharmaceuticals by Mylan Laboratories. Hedge fund Perry Capital, which had recently purchased nearly ten percent of Mylan’s common stock, supported the acquisition, although industry observers perceived the deal as overpriced. Perry turned out to have a good reason to want Mylan to overpay for King. Perry was also a large shareholder in King, and it had used a derivatives contract to hedge away its economic interest in the Mylan shares it had purchased. Thus Perry stood to make money if the deal went through even if Mylan’s shares declined, as bidding companies’ shares often do in mergers.

**V. Using Fiduciary Duties to Address Activist Shareholder Conflicts of Interest**

Taken together, the two trends of shareholders becoming both more powerful and more divided point to a serious rise in the risk of shareholder opportunism. Corporate law can address this increased risk through the relatively straightforward mechanism of applying corporate fiduciary duties to shareholders more broadly.

In particular, activist shareholder overreaching can be deterred by (1) interpreting loyalty duties to apply not only to controlling shareholders, who can dictate board decisions in all matters, but also to activist minorities who succeed in influencing management with respect to a single transaction or business decision, and (2) applying shareholder fiduciary duties not only in the traditional contexts of freezeouts and close corporations, but in any factual situation where a shareholder reaps a unique personal economic benefit to the detriment or exclusion of other shareholders.

**VI. Expanding the Notion of "Control"**

Corporate fiduciary duties exist to restrain self-interested behavior by persons in a position to exert control over the corporate entity. Existing case law already applies this principal not only to corporate officers and directors, but to majority shareholders as well, and in some case to shareholders deemed to exercise “de facto” control over the corporation’s board of directors.

We believe shareholder control should viewed not a binary inquiry (either a shareholder has “control” or it does not), but as a spectrum of power and influence. At one end of the spectrum lies the sole shareholder who holds 100 percent of a firm’s outstanding voting stock and enjoys complete authority over the firm and its board of directors. At the other end there is the rationally
apathetic, atomized individual investor who cannot be bothered to return a proxy by mail. Between these two extremes lies a vast range of possible allocations of power between individual shareholders and directors. Indeed, more than one shareholder or shareholder group can be said to “control” the firm in some fashion.

The inquiry into whether or not a shareholder has control for purposes of activating the latent duty of loyalty is accordingly best framed as an inquiry into whether a particular shareholder can, formally or informally, influence corporate behavior with respect to a particular issue. Any attempt to exercise influence that produces the desired result—put differently, any shareholder act that is a “but for” cause of some corporate transaction or strategy—is an exercise of de facto control.

This formulation goes beyond the scope of the traditional shareholder control test in two important ways. First, it is context-specific, meaning it determines whether a shareholder is a controlling shareholder by referring to the role that the shareholder played with respect to a particular corporate decision. If a minority shareholder influences a particular corporate action, such as a decision to declare an extraordinary dividend, in a determinative way, it will have satisfied the control test with regard to that specific action.

A second distinction between our definition of shareholder control and the existing test is that our formulation does not rely on the sort of arbitrary threshold for voting power that underlies current doctrine. Our test would treat even a one percent shareholder as a controlling, if that shareholder’s assent was essential in determining the outcome of the vote at issue. Indeed, our formulation recognizes that minority shareholders can exercise control even when they are not voting. For example, a shareholder may be able to determine a board’s decision with regard to a particular matter—say, a share repurchase program—by threatening a proxy battle, or by undertaking an aggressive public relations campaign directed at the board.

Traditional case law offers a basis for this expanded notion of shareholder control. Smith v. Atlantic Properties, Inc. is an oft-cited case involving a corporation with four shareholders and a charter provision that required dividends to be approved by an 80 percent shareholder vote, giving each of the four partners an effective veto. After one shareholder had a falling-out with the other three, he steadfastly refused to approve dividends, either out of spite or a desire to minimize his personal tax liability. The unfortunate effect was to trigger tax penalties on Atlantic Properties’ accumulated earnings. The court found that the recalcitrant minority shareholder had violated his duty of loyalty to his fellow shareholders because the 80 percent provision had given the minority shareholder an “ad hoc” controlling interest.”

Although Smith v. Atlantic Properties is a close corporation case, its logic applies equally well to minority shareholders in public companies. When a single shareholder’s actions determine the outcome—as when an activist successfully extracts greenmail, or a hedge fund with five percent of shares casts the deciding vote in a hotly-contested merger—that minority activist, like the minority shareholder in Smith v. Atlantic Properties, has exercised “ad hoc” control and triggered latent loyalty duties.

**VII. Expanding the Notion of When Shareholder Interests Conflict**
In addition to expanding the idea of shareholder control, our approach would also expand shareholder fiduciary duties in a second fashion, by applying the duty of loyalty to any corporate transaction or strategy that provides one or more shareholders with a material pecuniary benefit not shared by other shareholders. We propose a flexible approach that mirrors that typically taken in duty of loyalty cases involving corporate officers and directors. Rather than trying to identify isolated instances in which shareholder conflicts arise, our approach instead asks the larger question typically asked in director and officer fiduciary duty cases: Does the shareholder have any material economic interest that is different from other shareholders’ interests in the matter?

VIII. Incorporating Traditional Loyalty Defenses

On first inspection, the suggestion that all shareholders should be subject to a latent fiduciary duty of loyalty might lead a casual observer to conclude the natural result will be an explosion of litigation. This is not the case. The practical scope of loyalty duties can and should be contained, and litigation confined to cases presenting real and serious conflicts of interest, through several restrictive measures.

One of the most important is to allow shareholders accused of breaching their duty of loyalty to use the affirmative legal defenses employed in cases involving officers and directors, defenses that have proven effective at discouraging frivolous litigation in that context. One such protection is the plaintiff’s burden of alleging facts demonstrating that the shareholder defendant (1) in fact exercised influence that may have determined the outcome and (2) had a material economic interest in the outcome that differed from that of other shareholders. The number of cases in which a plaintiff can make both showings is likely to be small, and also likely to involve circumstances where judicial scrutiny is appropriate and desirable.

Investors generally can use their formal shareholder status to influence corporations in three ways: (1) by voting; (2) by filing suit against the firm or its managers; and (3) by publicly seeking to embarrass or threaten incumbent management with a proxy fight or public relations campaign. Very few shareholders engage in the last two activities, and those that do are exactly the activists on whom it is most desirable to impose loyalty duties. Of course, all shareholders can vote. However, only in the relatively rare case where a vote is hotly contested and the outcome determined by a small margin can a plaintiff allege the outcome was determined by the vote of a particular minority shareholder.

Even then, litigation cannot be sustained unless the plaintiff can also allege facts establishing that the minority shareholder in question had a material personal economic interest in the outcome. This means that the plaintiff must allege facts supporting a specific conflict of interest of the sort discussed in earlier. Only then, and only if the shareholder subject to the conflict exercised de facto control, can a suit can be brought—and it is then that judicial scrutiny is most needed.

Even when a plaintiff can demonstrate both exercise of de facto control and a material conflict of interest, the activist minority shareholder defendant retains an important escape route against
liability. That escape route is the traditional defense, available to officers, directors, and controlling shareholders accused of loyalty breaches, that although the transaction at issue was tainted by self-interest it was nevertheless intrinsically “fair” in terms of both price and process. It is only if the transaction is unfair—again a situation where liability is appropriate—that the defendant shareholder will be held liable.

Finally, Section 144 of the Delaware General Corporation Law provides some defenses for corporate officers and directors who enter into interested transactions that might be extended to minority shareholders as well. In particular, Section 144(a)(2) provides a defense to the director whose interested transaction is approved, after full disclosure of the material facts of the transaction and the conflict of interest involved, by a majority of the firm’s disinterested shareholders. Case law has extended this defense to controlling shareholders, where it is called the “majority of the minority defense”—that is, the interested transaction with the majority shareholder was approved by a majority of the remaining minority shareholders. There seems no logical reason not to extend this defense to minority activist shareholders as well.

IX. Conclusion: The Wisdom of Using Fiduciary Duties to Constrain Shareholder Opportunism

There is no reason to believe activist minority shareholders are immune to the same temptations of greed and self-interest that are widely understood to face corporate officers and directors. Our proposed reinterpretation of shareholder fiduciary duties recognizes this reality.

Our approach has two advantages as a strategy for dealing with self-serving shareholder activists. First, it brings existing fiduciary duty doctrine into line with the changing reality of how and why shareholders assert power in the corporate governance arena. As a result, it offers a broad, flexible, and preemptive solution to the problem of shareholder overreaching. This seems likely to be a far more effective approach than the sorts of ad hoc, after-the-fact responses to particular forms of abusive shareholder behavior that regulators have adopted in the past, and that prominent corporate law scholars continue to propose today.

Second, we believe our reinterpretation of shareholder fiduciary duty can lend much-needed support to the controversial but increasingly influential normative claim that promoting “shareholder democracy” is a useful way to constrain managerial misbehavior. In the wake of recent corporate scandals, firms and regulators have urged the adoption of a variety of changes in corporate law and practice designed to increase shareholders’ power to pressure the directors of publicly-held firms into adopting particular business policies, from requiring more independent directors to requiring shareholder votes on CEO pay. Academics and investor interest groups are calling for even more “shareholder empowerment.” Whether or not the modern trend of shifting corporate power toward shareholders and away from boards and executives will ultimately serve shareholders’ own interests depends critically on how individual shareholders and shareholder groups actually exercise their growing influence. By limiting their ability to use it in opportunistic and self-serving ways, we hope to encourage a version of shareholder democracy that promotes, rather than destroys, shareholder welfare.
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Iman Anabtawi is Professor of Law, UCLA School of Law.

Lynn Stout is Paul Hastings Professor of Corporate and Securities Law, UCLA School of Law; Principal Investigator, UCLA-Sloan Research Program on Business Organizations.

This Editorial is based on the full-length Article: Iman Anabtawi & Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 STAN. L. REV. 1255 (2008).