

## DEBATE: SAVING THE WORLD WITH CORPORATE LAW?

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### ABSTRACT

*The current debate within corporate law is as fundamental as at any time since the New Deal, when the great exchange between Merrick Dodd and A.A. Berle defined the issues for a generation of scholars. Today, the community of corporate law scholars in the United States is split between two groups. The first, heavily influenced by economic analysis of corporations, argues the merits of increasing shareholder power vis-à-vis directors. The second, animated by concern for economic justice and regulatory efficiency, challenges the traditional, shareholder-centric view of corporate law and argues instead for a model of “stakeholder governance.” The following Essays present a debate between two prominent scholars, one from each of the two major groups, on the audacious question, “Can corporate law save the world?” Professor Greenfield, a leading proponent of “progressive corporate law” and the author of *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities*, uses this Essay to offer a provocative critique of the status quo using organizational and regulatory theory. In his Essay, Professor Smith, one of the nation’s leading advocates of increased shareholder power, contends that changes in corporate law cannot eradicate poverty, clean our air or our water, or solve “the labor question.” Indeed, he argues, the only changes in corporate law that will have a substantial effect on such issues are changes that will make matters worse, not better.*

**PROPOSITION: SAVING THE WORLD WITH CORPORATE LAW**

*Kent Greenfield\**

Corporate law can change the world.

This is an overstatement, to be sure, but more correct than false. Large, multinational corporations are immensely powerful—affecting investors, workers, governments, communities, and ecosystems the world over—and the law that governs them creates, channels, and cabins that power. Corporations are also immensely successful at creating financial wealth. They represent the world’s most successful business form for facilitating a cooperative process of investment by numerous stakeholders, who unite through the corporate entity to organize their various resources to produce goods or services for profitable exchange.

Despite the corporation’s collective nature and collectivizing function, corporate law in the United States is constructed as if the firm consists of only shareholders and executives.<sup>1</sup> Even though corporate law once served as a mechanism for injecting some aspects of public interest into the corporation’s structure and goals,<sup>2</sup> in recent decades the focus of corporate law has narrowed to a fixation on shareholder rights and executive prerogatives.<sup>3</sup> This narrow focus has become entrenched in mainstream scholarship and doctrine.<sup>4</sup> What’s

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<sup>1</sup> See Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283 (1998) (“Workers have no role, or almost no role, in the dominant contemporary narrative of corporate law.”).

<sup>2</sup> See ROBERT KUTTNER, *THE SQUANDERING OF AMERICA: HOW THE FAILURE OF OUR POLITICS UNDERMINES OUR PROSPERITY* 145 (2007) (“As late as the 1890s, many states demanded that corporations serve public purposes and strictly regulated their internal governance in exchange for the limited liability granted to general corporations in their charters.”); see also MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1870–1960*, at 77 (1992) (discussing traditional social responsibilities of business).

<sup>3</sup> See Greenfield, *supra* note 1.

<sup>4</sup> The most renowned corporate law casebook used in law schools contains fourteen chapters and almost 1,400 pages. Yet, not a single chapter is dedicated to the corporation’s responsibilities toward its employees, and less than twenty pages are dedicated to a section entitled “Interests Other Than Maximization of the Shareholders’ Economic Wealth.” See WILLIAM L. CARY & MELVIN ARON EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* (9th ed. 2005); see also Steven M. Bainbridge, *Directory Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (arguing for deference to directorial management and for shareholder passivity); Lucian Arye Bebchuk, *The Case for Increasing Shareholder*

more, as globalization intensifies, the narrow shareholder-executive focus of United States corporate law is increasingly exported, displacing the more expansive, public-oriented view of corporations in other nations.<sup>5</sup>

This Essay argues that this trend is unfortunate and that corporate law in the United States should be modernized and expanded. Changes in corporate law could make it possible to take advantage of the distinctive abilities of the corporation to create wealth, while making it less likely that corporations will do so through breaches of the public trust or the imposition of costly externalities on stakeholders or communities. Corporate law could also channel the power of corporations to make them a progressive force in society, using them not only to create wealth but also to spread it more equitably—addressing public policy problems, such as stagnant wages for American workers, which have been remarkably impervious to other public policy tools.<sup>6</sup> Indeed, this Essay's central claim is that most of us in the United States, as well as many people throughout the world, would be better off if corporate law were different.

This Essay and its companion, by Professor Gordon Smith, embody a debate going on broadly across the field of corporate law, which is currently experiencing significant intellectual ferment. While the mainstream, neoclassical view of corporations and corporate law continues to hold sway in most court opinions and in the legal academy, a growing number of scholars contest some of that dominant school's basic tenets.<sup>7</sup> Disagreements go to the

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*Power*, 118 HARV. L. REV. 833 (2005) (re-evaluating the allocation of power between boards and shareholders in public companies with dispersed ownership).

<sup>5</sup> See generally LAWRENCE MITCHELL, CORPORATE IRRESPONSIBILITY, AMERICA'S NEWEST EXPORT (2003) (arguing that the American corporate focus on profits, rather than stakeholders, is becoming increasingly prevalent abroad, as more countries adopt the American model for corporate governance).

<sup>6</sup> See *infra* Part III. For a further analysis of how corporate law could be used to address stagnant wages and income inequality, see KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS & PROGRESSIVE POSSIBILITIES 153–85 (2007); and Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 HARV. L. & POL'Y REV. 1, 2–5, 10–16 (2008) (outlining current economic statistics on inequality and the potential for using corporate law to address economic ills).

<sup>7</sup> See *infra* notes 78, 80. An accessible introduction to the mainstream view is Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001). For leading examples of the stakeholder school, see generally Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 305 (1999); Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 831–37; Theresa A. Gabaldon, *Like a Fish Needs a Bicycle: Public Corporations and Their Shareholders*, 65 MD. L. REV. 538 (2006); Timothy P. Glynn, *Delaware's VantagePoint: The Empire Strikes Back in the Post-Post-Enron Era*, 102 NW. U. L. REV. 91 (2008); GREENFIELD, *supra* note 6; Daniel J.H. Greenwood, *The Dividend Problem: Are Shareholders Entitled to the Residual?*, 32 J. CORP. LAW 103 (2006); Thomas W. Joo,

heart of the discipline: what corporations are; who owns them; whether they are public or private institutions; whether managers should be charged solely with maximizing profits or with looking after other social goals as well.<sup>8</sup> These disagreements are as central today as they have been since the great Berle-Dodd debates of the 1930s.<sup>9</sup> Moreover, there is now more disagreement at the core of corporate law than perhaps in any other area of law.

These disagreements are important, and not just to scholars of corporate law. Corporate law determines the rules governing the organization, purposes, and limitations of some of the largest and most powerful institutions in the world. By establishing the obligations and priorities of companies and their management, corporate law affects everything from the return on shareholder equity, to employees' wage rates (whether in Silicon Valley or Bangladesh), to whether companies will try to skirt environmental laws, to whether they will tend to look the other way when doing business with governments that violate human rights. Corporate law is a big deal.

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This Essay proceeds in several steps. Part I catalogues the power and success of the corporation. That Part also examines the basis for the corporation's success, drawing on evidence that suggests that a basis for the corporation's success over time is its ability to collectivize the inputs of a variety of stakeholders, all of whom expect the firm to provide more of a return on the input than the stakeholders could receive on their own. Also, organizational theory is brought to bear, suggesting that one of the ways through which the corporation is particularly able to achieve this collectivization process is its managerial structure. In this view, the corporation is not distinctive because of its method of financing, but because of

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*Contract, Property and the Role of Metaphor in Corporations Law*, 35 U.C. DAVIS L. REV. 779 (2002); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993); MITCHELL, *supra* note 5; Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991); Kellye Y. Testy, *Linking Progressive Corporate Law with Progressive Social Movements to Corporate Governance*, 76 TUL. L. REV. 1227 (2002); and Cynthia A. Williams, *The Securities Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

<sup>8</sup> For an excellent overview, see David Millon, *supra* note 7.

<sup>9</sup> See E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1152 (1932) (arguing that corporate managers ought to concern themselves not just with profits but also with serving the public interest); A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932) (arguing, in response to Dodd, that corporate managers ought to seek only to increase profits for their stockholders).

its structure—namely a vertical hierarchy of managers coordinating information and resources, overseen by a board of directors occupying a horizontal position at the very top of the hierarchy.<sup>10</sup> The differential success of the corporate form can be traced to the ability of the hierarchy to sort out which issues and decisions should flow up the chain and the capacity of the board to offer the benefits of group decisionmaking for the most momentous choices.<sup>11</sup>

Part II focuses on the failures of the corporation. Given their nature, governance, and objectives, corporations fail in predictable ways. They produce costly externalities; they are amoral; they fail to sustain implicit or explicit commitments to communities; they privilege some stakeholders (shareholders) at the expense of others (for example, employees).<sup>12</sup> They manipulate regulatory oversight and exert disproportionate political power; they compete with other firms to their collective detriment by over-utilizing resources or fouling the environment; they provide cover for managerial self-dealing of various kinds. They privilege the short-term at the expense of the long-term.

Corporations thus have long been the focus of various regulatory efforts to prevent these failures and to mitigate their effects, while seeking to preserve the firm's ability to create wealth.<sup>13</sup> These regulatory efforts take various forms, some affecting the internal structure and processes of the firm, and some external to it.<sup>14</sup> In the United States, the “internal” regulation of corporate law—for example, the legal imposition of fiduciary duties of care and loyalty on managers and directors—is used almost exclusively to protect shareholders or the firm itself.<sup>15</sup> Other stakeholders of the firm—for example employees, communities, or customers—are left to depend primarily on “external” regulations, such as minimum-wage laws, environmental regulations, and consumer safety rules.<sup>16</sup>

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<sup>10</sup> See *infra* notes 31–38 and accompanying text.

<sup>11</sup> See *infra* notes 43–46 and accompanying text.

<sup>12</sup> See *infra* notes 55–56 and accompanying text.

<sup>13</sup> See *infra* note 57 and accompanying text.

<sup>14</sup> See *infra* notes 58–59 and accompanying text.

<sup>15</sup> See *infra* note 60 and accompanying text.

<sup>16</sup> For an example of a regulatory protection that flows only to shareholders, even though workers deserve protection for the same reasons, see Kent Greenfield, *The Unjustified Absence of Federal Fraud Protection in the Labor Market*, 107 YALE L.J. 715 (1997) (pointing out that employees, like shareholders, are deserving of protection from fraud).

Drawing on regulatory theory, this Essay then argues that the divide between internal regulation to protect shareholders and external regulation to protect all others is misguided. Instead, the interests of non-shareholder stakeholders would be better protected if internal regulations were made available to protect them, as well. The overall goal of the regulation of the corporate form is to maximize its benefits to society while minimizing its costs.<sup>17</sup> This Essay argues that this balance is more likely to be struck if the full panoply of regulatory options—internal and external—is available to protect *all* the stakeholders.

Finally, this Essay argues that broadening the concerns of corporate law will have benefits that extend beyond merely defending stakeholders from harm. Corporate law also has the potential to work affirmatively, increasing the ability of the corporation to provide significant public benefits. As mentioned above, corporations are immensely successful at producing financial wealth.<sup>18</sup> They do so because of their ability to collect a diverse range of inputs and organize them through an advantageous managerial structure.<sup>19</sup> This Essay argues that these capacities are now being used disproportionately to benefit only a subset of the stakeholders—namely the shareholders and the executives. Instead, corporate law could be used to require corporations to spread the wealth that they create more broadly and more equitably.

Corporate law can achieve that goal in a variety of ways, while maintaining the important capacities of the corporation. The law could recognize non-shareholder stakeholders as important non-equity investors in the firm, and the legal obligations of the board could be expanded to require it to look after the interests of those non-equity investors. The same duties of care and loyalty that are owed to shareholders would be owed to non-equity investors.

More provocatively, the board's makeup could be broadened to include representatives of non-equity investors. This would lead, almost inevitably, to the more equitable distribution of the corporate surplus among the firm's equity and non-equity investors, which would inure to the benefit of both society and the firm over time. Moreover, instead of *weakening* the board's decisionmaking powers, broadening the board will likely *improve* the board's ability to make good decisions. The ability of the board to make good

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<sup>17</sup> GREENFIELD, *supra* note 6, at 127–30.

<sup>18</sup> *See infra* note 24 and accompanying text.

<sup>19</sup> *See infra* notes 34–38 and accompanying text.

decisions is a function of its ability to take advantage of the benefits of “the wisdom of crowds,” the capacity of groups to outperform individuals in making certain kinds of judgments.<sup>20</sup> This capacity of the board would *increase* with a more pluralistic makeup. We hold this truth to be virtually self-evident in other areas of public and private governance—diversity of thought is beneficial in legislatures, juries, law school faculties, and administrative bodies<sup>21</sup>—and it can be applied to good effect in corporations as well.

The arguments of this Essay depend on a distancing from traditional assumptions of corporate law: that shareholders are the owners of the corporation and that managers owe duties solely to them; that corporate law is “private” law instead of regulatory law; and that corporations have only one social obligation, which is to make money.<sup>22</sup> Each of these assumptions is both normatively and descriptively false. Corporate law is best seen as a part of the broader regulatory law of corporations and their managers. It can be a powerful tool to harness the power of the corporation toward satisfying important public policy goals.

## I. THE SUCCESS OF THE CORPORATION

Make no mistake, the business form that we call the corporation is an immensely successful mechanism for organizing business endeavors, and has been so since the late 1800s.<sup>23</sup> Compared to the other kinds of business entities available—partnerships, trusts, limited liability companies, and sole proprietorships—the corporate form is the dominant method of organizing large (and even small) business enterprises in the United States.<sup>24</sup>

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<sup>20</sup> See *infra* notes 43–44 and accompanying text.

<sup>21</sup> See, e.g., CASS R. SUNSTEIN, *WHY SOCIETIES NEED DISSENT* (2003) (arguing that conformity among individuals in a decisionmaking group breeds error).

<sup>22</sup> See Milton Friedman, *A Friedman Doctrine: The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32 (arguing that the responsibility of directors is to conduct the business in accordance with the “desires” of the shareholders, “which generally will be to make as much money as possible”).

<sup>23</sup> See generally JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, *THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA* (2003).

<sup>24</sup> The 2002 tax returns of enterprises in the United States show \$18.8 billion in receipts for corporations, as compared to \$2.6 billion for partnerships and \$1 billion for non-farm proprietorships. U.S. CENSUS BUREAU, *STATISTICAL ABSTRACT OF THE UNITED STATES* 503 tbl.727 (2006). The corporate business sector is the largest income-producing sector of the United States economy. See LAWRENCE MISHEL, JARED BERNSTEIN & SYLVIA ALLEGRETTO, *THE STATE OF WORKING AMERICA 2006/2007*, at 84 (2007).

Scholarly careers have been dedicated to explaining the dominance of the corporate form. The most famous explanation is that of Nobel Laureate Ronald Coase, who theorized that the firm exists because it is often more efficient to engage in intrafirm transactions (organized by direct authority) than in market transactions.<sup>25</sup> That is, compared to a situation where people could work together only after negotiating a contract for every task, the corporation is superior in that it allows various resources, including labor and capital, to be collected and used without negotiating price and terms for each use.<sup>26</sup> Other scholars building on Coase's work have focused persuasively on the ability of the corporation to gather resources from a variety of contributors and to organize those resources efficiently to create value.<sup>27</sup>

These explanations go more to why the corporation is superior to the market, rather than why the corporation is superior to partnerships, limited liability companies, or other business entities. For that answer, one has to look at the collection of benefits that the corporate form has to offer and that make corporations particularly successful at making money. These traits include (1) the liquidity and transferability of shares; (2) the protection of shareholders from personal liability for the debts of the entity; and (3) a perpetual existence separate from their shareholders.<sup>28</sup> Some of these characteristics can be found in other forms (for example, limited shareholder liability is a trait of limited liability companies), but they cannot be found together, except in the modern public corporation.<sup>29</sup>

These characteristics are very powerful. The easy transferability of shares allows thousands or even millions of small investors to finance the equity portion of a company. That, in turn, allows companies to amass enough capital to overcome high barriers to entry in a market sector, to take advantage of economies of scale in production or marketing, or to survive short-term

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<sup>25</sup> R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

<sup>26</sup> *See id.*

<sup>27</sup> *See, e.g.,* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972) (arguing that the firm exists to decrease the monitoring costs inherent in team production); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305, 310–11 (1976) (“Contractual relations are the essence of the firm, not only with employees but with [others as well] . . . [The firm] is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals . . . are brought into equilibrium . . .”); *cf.* Blair & Stout, *supra* note 7, at 305 (arguing that a firm’s success depends on maintaining the “team” of stakeholders over time).

<sup>28</sup> *See* GREENFIELD, *supra* note 6, at 130–34.

<sup>29</sup> *Id.*

downturns in the market. Limited liability for shareholders reassures investors that they will not suffer personal liability if the company fails or is unable to pay its debts. Shareholders can buy small numbers of shares and are protected from personal liability for the acts of the company. The separate legal existence of corporations makes it possible for them to be sustained over time, even as shareholders and management change. Moreover, the firm's separateness and legal personality give the corporation the capacity to sue and be sued, which allows it to protect its contractual rights in court and to reassure its business partners (not to mention employees, creditors, and the government) that it is subject to contractual and legal obligations that are also enforceable in court.

An additional characteristic of the corporation that is often cited as an important distinction is the so-called separation of ownership and control.<sup>30</sup> Shareholders, who in this view are considered the owners of the corporation, "have virtually no power to control either its day-to-day operation or its long-term policies."<sup>31</sup> Instead, they hire professional managers to direct the firm. These managers, in turn, owe their jobs to their ability to make the company successful.<sup>32</sup>

Even as the conceptualization of shareholders as owners has lost favor within corporate law doctrine and scholarship,<sup>33</sup> the significance of the fact that the firm is controlled by professional management has retained its centrality.<sup>34</sup> The use of professional management (the executives and senior managers in the firm, as opposed to the board) has great efficiency benefits, helping the corporation create financial surplus.<sup>35</sup> Managers have greater

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<sup>30</sup> See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 84–90 (1932).

<sup>31</sup> Steven M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 *VAND. L. REV.* 1, 4 (2002).

<sup>32</sup> See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 *J. POL. ECON.* 288 (1980).

<sup>33</sup> See, e.g., Bainbridge, *supra* note 31, at 4 n.9 ("In the dominant nexus of contracts theory of the firm, ownership is not a meaningful concept because shareholders are simply one of the inputs bound together by this web of voluntary agreements."); Greenfield, *supra* note 1, at 288 ("[T]his concept of 'ownership' no longer provides the dominant justification in corporate law scholarship for shareholder preeminence."); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 *DUKE L.J.* 173, 175 ("Contrary to popular belief, it is not particularly useful to think of corporations in terms of property rights.").

<sup>34</sup> See generally ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 484–500 (1977) (discussing the rise of professional management and its control of firms); Bainbridge, *supra* note 4.

<sup>35</sup> See Chandler, *supra* note 34, at 490–97

knowledge than shareholders and other stakeholders about the day-to-day dealings of the firm, and the market for corporate control, as well as the labor market for executives, creates incentives that help ensure that the managers perform their jobs dutifully and well.<sup>36</sup>

Typically, these professional managers are arranged in a hierarchy of authority, with each level of the hierarchy authorized to act on decisions appropriate to their level while passing information both up and down the hierarchy to other parts of the organization.<sup>37</sup> This hierarchy is also used to ease monitoring of the various participants in the firm—the lowest level of the hierarchy is monitored by the next level, the next level is monitored by the next higher level, and so on up to senior management. Thus, the hierarchy—made possible by the “separation of ownership and control”—helps keep the monitoring task manageable. “At each hierarchical level, the responsible monitor is responsible for supervising only a few individuals, which usefully limits and focuses his task.”<sup>38</sup>

There are some important caveats to this sanguine portrayal of the benefits of hierarchy. First, hierarchy is not unique to corporations. It is difficult to imagine any large institution, corporation or not, organizing itself without some kind of hierarchy. Second, a hierarchy’s efficiency depends on a range of variables. Hierarchy can be deep or shallow, easy to traverse or impenetrable. Some ornate hierarchies may be cost-effective, while others may impose dead-weight losses on the firm.<sup>39</sup> Hierarchy, while an important aspect of corporate organization, is not itself particularly unique to the firm and (as anyone who has worked in a large corporation can attest) can be more or less efficient.

So what is it about the management structure of the corporation that *is* more or less unique? More and more, scholars are focusing on the role of the board of directors, as opposed to the senior managers.<sup>40</sup> Instead of the hierarchy being topped by a single autocrat, the apex is occupied by a

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<sup>36</sup> *See id.*

<sup>37</sup> *See* Bainbridge, *supra* note 31, at 5–6 (“[H]ierarchy is a very efficient mechanism for information development and transmittal.”).

<sup>38</sup> *Id.* at 7.

<sup>39</sup> *See generally* DAVID M. GORDON, *FAT AND MEAN: THE CORPORATE SQUEEZE OF WORKING AMERICANS AND THE MYTH OF MANAGERIAL DOWNSIZING* (1996) (describing costs of corporate hierarchies and bureaucracies).

<sup>40</sup> *See, e.g.,* Bainbridge, *supra* note 31, at 8.

multimember body, a board of directors.<sup>41</sup> This board functions as a group decisionmaker for the most important questions that the company faces, and in the words of Stephen Bainbridge, the leading legal scholar of the board, “it seems useful to think of the board as a production team.”<sup>42</sup>

What the board produces is decisions, and the board is the kind of group decisionmaker that offers material benefits relative to solitary, individual decisionmakers of the sole proprietorship or to small groups of decisionmakers typical in partnerships or similar enterprises.<sup>43</sup> According to scholars, the benefits of group decisionmaking are significant and, in many cases, so outpace individual decisionmaking that the success of groups is higher, not only than the average individual in the group, but also even than the best individual in the group.<sup>44</sup> In experimental settings, groups outperform individuals not only at tasks that have a unique correct outcome<sup>45</sup> but also at tasks that require critical evaluative judgment, learning and concept attainment, creativity, and abstract problem solving.<sup>46</sup>

Scholars have presented various explanations for the superiority of groups in decisionmaking, and they essentially correlate with what one would intuit from everyday human experience. Groups are able to identify and dismiss individual biases more quickly than individuals themselves. Groups can pool their best resources, creating multiplier effects among the abilities of the individuals in the groups. Groups take advantage of different perspectives. All of this matches with what we see in wide areas of public life, from Congress to administrative agencies to universities. As it turns out, in most cases, two heads are indeed better than one.<sup>47</sup>

What’s more, corporate law seems to internalize these insights, recognizing and protecting the role of the board. Statutes explicitly give the board the

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<sup>41</sup> *Id.* at 7.

<sup>42</sup> *Id.* at 8.

<sup>43</sup> *Id.* at 12.

<sup>44</sup> *See id.* at 12–19 (reviewing the scholarship); *see also* JAMES SUROWIECKI, *THE WISDOM OF CROWDS* (2004).

<sup>45</sup> Bainbridge, *supra* note 31, at 12–13.

<sup>46</sup> *Id.* at 16 n.68, 19; *see also id.* at 54 (“With respect to the exercise of critical evaluative judgment, . . . groups have clear advantages over autonomous individuals.”).

<sup>47</sup> *Cf.* Alan S. Blinder & John Morgan, *Are Two Heads Better than One? An Experimental Analysis of Group vs. Individual Decisionmaking* (Nat’l Bureau of Econ. Res., Working Paper No. 7909, 2000), available at <http://www.nber.org/papers/w7909>.

authority to manage the corporation.<sup>48</sup> The most relevant statute is Delaware's, which states that the corporation "shall be managed by or under the direction of a board of directors."<sup>49</sup> This reflects the belief that "the effective oversight of an organization exceeds the capabilities of any individual and that collective knowledge and deliberation are better suited to this task."<sup>50</sup> Bainbridge drives the point home, saying that "corporations are well-served by group decisionmaking at the top."<sup>51</sup>

There are, however, numerous land mines in group decisionmaking, and scholars have identified some traits of groups that tend to lead to poor decisions. I will discuss that topic below.<sup>52</sup> For now, however, the point to emphasize is that the corporation's structure takes advantage of the benefits of both hierarchy and group decisionmaking. This appears to give it significant advantages over competing business forms, making the corporation a very powerful moneymaking institution. Other business forms—whether partnerships, sole proprietorships, small privately held corporations, or newer forms such as limited liability companies—have their advantages.<sup>53</sup> But none of them is as broadly successful as the public corporation in providing the framework for large, successful business enterprises.

## II. THE FAILURE OF CORPORATIONS

The corporation is an immensely successful business form because its distinctive mix of characteristics and organizational structure gives it the ability to collect input from a number of different kinds of contributors (such as shareholders, employees, creditors, and customers) and put them to work cooperatively to create goods and services for profitable sale. Making money is the corporation's comparative advantage.<sup>54</sup> But the corporation—as presently constructed and regulated in the United States—has its pathologies,

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<sup>48</sup> See, e.g., DEL. CODE ANN. tit. 8, § 141 (2000); N.Y. BUS. CORP. LAW § 717 (McKinney 2003); CAL. CORP. CODE § 300 (West 1990); IND. CODE ANN. § 23-1-35-1 (2007).

<sup>49</sup> DEL. CODE ANN. tit. 8, § 141 (a) (2000); see also Bainbridge, *supra* note 31, at 4 (quoting the Delaware Code).

<sup>50</sup> Daniel P. Forbes & Francis J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 490 (1999).

<sup>51</sup> Bainbridge, *supra* note 31, at 54.

<sup>52</sup> See *infra* Part III.C.2.b.

<sup>53</sup> For a review of the benefits and disadvantages of various business forms, see generally DAVID G. EPSTEIN ET AL., *BUSINESS STRUCTURES* (2d ed. 2007).

<sup>54</sup> For a more extensive discussion of this comparative advantage, see GREENFIELD, *supra* note 6, at 130–34.

as well, and they are a function of its advantages. Society creates an institution that is intended to generate wealth (broadly defined), and we give it significant power to do that. But without constraints, it can be too single-minded in the pursuit of profit. As an artificial entity, it has no conscience of its own. And with the separation between the company and its investors, the consciences of those investors are not easily brought to bear. The company has every incentive to externalize costs onto those whose interests are not included in the firm's financial calculus—and the firm can do this by polluting the environment, selling shoddy products to one-time purchasers, raiding its employees' pension funds, or producing its goods in sweatshops.<sup>55</sup> In fact, because of the corporation's tendency to create benefits for itself by pushing external costs onto others, the corporation could aptly be called an "externality machine."<sup>56</sup>

Society has long understood that the corporation's penchant for overlooking the negative impacts of its drive for profit means that, while corporations should be appreciated for their special ability to create wealth, they should also be treated warily because of their inability (absent regulation) to take into account values other than (and far more important than) financial wealth. Justice Brandeis explained this balance best when discussing the historical basis for greater regulation of the corporation:

The prevalence of the corporation in America has led men of this generation . . . to accept the evils attendant upon the free and unrestricted use of the corporate mechanism as if these evils were the inescapable price of civilized life and, hence, to be borne with resignation. Throughout the greater part of our history a different view prevailed. Although the value of this instrumentality in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, educational and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils. . . . There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations.<sup>57</sup>

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<sup>55</sup> For a related (and perhaps more provocative) example, see Kent Greenfield, *September 11th and the End of History for Corporate Law*, 76 TUL. L. REV. 1409 (2002).

<sup>56</sup> See MITCHELL, *supra* note 5, at 49–65 (calling the corporation an "externalizing machine").

<sup>57</sup> *Liggett Co. v. Lee*, 288 U.S. 517, 548–49 (1933) (Brandeis, J., dissenting) (citations omitted).

As Brandeis observed, it has long been the case that society has been mindful of the importance of monitoring corporations to make sure that they are moving us in a positive direction, given the form and powers that we have bestowed upon them. In other words, we should be wary of the power of the corporate form.

This wariness has translated into a willingness to regulate the corporation to ensure that it uses its ability to make money to further the collective good. While, in theory, the necessary regulation could come either in the form of external pressures on the corporation or as internal adjustments in corporate governance rules themselves, for most of the corporation's history we have chosen to regulate it from the outside rather than to require changes on the inside.<sup>58</sup> To be more precise, the "internal" regulation of corporate governance—for example, the legal imposition on managers and directors of fiduciary duties of care and loyalty—is used almost exclusively to protect shareholders (or the firm itself).<sup>59</sup> "External" regulations, such as minimum-wage laws, environmental regulations, and consumer safety rules, are used to protect other stakeholders.

In fact, there is a tension between the internal and the external regulation of the corporation. The internal regulation, intended to protect the shareholders, has long been interpreted to impose a duty on the managers to maximize the return to the shareholders.<sup>60</sup> What that means is that managers are held—or consider themselves held—to an obligation to take care of shareholders, even when it hurts other stakeholders or society at large, and even when the benefits to those shareholders do not outweigh the costs to others. This obligation is seen by some to be so important that leading scholars in corporate law have argued that managers have an obligation to violate *external* laws when necessary to meet their *internal* obligations to maximize returns to shareholders.<sup>61</sup> Because of that tension, and the drive that the internal

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<sup>58</sup> See Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, 67 LAW & CONTEMP. PROBS. 109 (2004).

<sup>59</sup> *Id.*

<sup>60</sup> See Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. LAW 277 (1998); Hansmann & Kraakman, *supra* note 7.

<sup>61</sup> See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1177 n.57 (1982) ("[M]anagers not only may but also should violate the rules when it is profitable to do so . . ."). For a comprehensive review and critical assessment of this view, see Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279 (2001). See also Cynthia A. Williams, *Corporate Compliance with the Law in the Era of Efficiency*, 76 N.C. L. REV. 1265 (1998).

obligation creates in the firm to disregard the interests of stakeholders other than shareholders, the profit-maximization norm may be the central flaw in all of corporate law.<sup>62</sup> The business judgment rule—which gives managers leeway in how they define profit and seek it out—offers protection to managers who make mistakes and may provide some cover for managers who want to benefit other stakeholders. But the business judgment rule, of course, does not create any affirmative obligation on the part of managers to look after the concerns of non-shareholder stakeholders. Moreover, even at its strongest, the business judgment rule protects managers who want to protect other stakeholders if the managers are dishonest about their rationale. If they honestly declare that they are acting to benefit other stakeholders at the expense of shareholders, then the business judgment rule will not protect the managers.<sup>63</sup>

### III. STAKEHOLDER GOVERNANCE TO ADDRESS THE FAILURES AND FULFILL THE POTENTIAL OF CORPORATIONS

This Essay now turns to addressing the potential of stakeholder governance. My principal argument is that stakeholder governance offers much promise in two ways. First, stakeholder governance is a better way to moderate and mitigate the pathological failures of the corporate form. Stakeholder governance will create regulatory controls internal to the corporation, which will allow society more efficiently to constrain corporate misbehavior. Second, stakeholder governance offers the potential of using the corporation's distinctive attributes to serve society even more than at present. Through stakeholder governance, the corporation can serve not only to create wealth but also to share it more broadly. This can be done without destroying the corporation's distinctive ability to make money, and stakeholder governance in fact has the potential of improving corporate decisionmaking for even broader benefit.

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<sup>62</sup> See GREENFIELD, *supra* note 6, at 2.

<sup>63</sup> See *id.* at 224–30. Here I differ from some other corporate law scholars who argue that the business judgment rule gives business managers such leeway that the profit maximization norm does not in fact exist as a matter of real constraint on corporations and their management. See, e.g., Blair & Stout, *supra* note 27, at 287–88 (arguing that corporate directors serve the interests not just of shareholders but of the corporation as a distinct entity with a much broader set of interests). For a more developed response to that argument, see Greenfield, *supra* note 6, at 8, 14–16.

### A. *Some Beginning Premises*

To begin this discussion, I should make explicit some of my premises. Perhaps the most fundamental is that *corporate law is not an area of law governed by rights or ownership in the traditional sense*.<sup>64</sup> This view is still championed by a few traditionalists who regard shareholder rights essentially as an article of faith, developed from a rights-based view of the private nature of corporations.<sup>65</sup> In this view, shareholders are seen as owners, and the corporation is their individual property. Their control is to be respected. Managers are agents, and the correct law to apply is the law of property and trusts. Corporations are to serve their owners, and the proper stance of government is one of deference, with minimal governmental regulation, if any.<sup>66</sup>

The defects with this model are numerous and pervasive, and the model does not find legitimacy in the reality of the corporate world today.<sup>67</sup> Shareholders do not have a complete “bundle of rights” to make them “owners” in the traditional sense, nor are they owners in any other way that would distinguish their contribution to the firm from the contributions of other stakeholders.<sup>68</sup> An argument that corporate governance operates in the realm of natural rights is a difficult, unpersuasive, and increasingly undefended contention. Even among the most vehement proponents of the shareholder primacy model, very few continue to make the natural rights argument because of its myriad difficulties.

This leads to my second major premise: *corporations, and therefore corporate law, are created in the interest of society as a whole*. They are state creations, and no state in its right mind would willfully allow for the creation of institutions as powerful as corporations unless there was a belief that, on

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<sup>64</sup> See Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as a Regulatory Tool*, 35 U.C. DAVIS L. REV. 581, 591–601 (2002) (arguing that corporate law should be treated as public law rather than private law); Thomas W. Joo, *Contract, Property and the Role of Metaphor in Corporations Law*, 35 U.C. DAVIS L. REV. 779 (2002) (discussing the various and conflicting metaphors of the corporation).

<sup>65</sup> The leading advocate of this view remains Milton Friedman, and the most famous statement of this view is his essay in *The New York Times Magazine* over 35 years ago. See Friedman, *supra* note 22, at 32 (“In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible . . .”).

<sup>66</sup> *Id.*

<sup>67</sup> See GREENFIELD, *supra* note 6, at 43–47.

<sup>68</sup> For a full articulation of this argument, see Greenfield, *supra* note 1, at 287–95.

balance, society would be better off because of their existence. To be clear, however, this does not mean that the internal rule of decisionmaking within the corporation should necessarily be that the managers should act always to maximize the benefit to society. (More on that below.) But it does mean that whatever rule we construct for corporate decisionmaking—whether one of shareholder primacy, or stakeholder balance, or societal protection—the ultimate goal is to create social welfare, broadly defined.<sup>69</sup>

In this light, the next and third premise becomes clear: *the socially optimal amount of regulation of corporations is not zero*. The free market is a figment of imaginations, and only of outlandish ones at that. Even the most shareholder-centric scholars would have to acknowledge that public policy demands regulation of the corporation; they just believe it should come in the form of external, rather than internal, regulations.<sup>70</sup> Corporations will not, through their own generosity, internalize the external costs of their decisions or keep an eye on the social harms that they produce.<sup>71</sup> Perhaps ironically, we use law to grant corporations the characteristics that make them capable of generating great wealth, but we also need to constrain them with law. Whether *corporate* law should be adjusted to take into account the interests of non-equity investors should therefore turn on whether such an adjustment would tend to create more social welfare, broadly defined, not on whether it is inconsistent with the so-called free market.

Finally, my use of the term “non-equity investor” as a way to characterize stakeholders embodies my fourth premise: *corporations are a collective entity, demanding a variety of investments from a variety of sources*. This fourth premise is simply a statement of one of the important implications of the first—that corporations are not an entity wherein “ownership” makes much sense. Shareholders own their shares, of course, but as Margaret Blair and

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<sup>69</sup> The most thoughtful mainstream scholars start from this premise as well. See Hansmann & Kraakman, *supra* note 7, at 441 (stating view that “all thoughtful people” agree that business should be organized to “serve the interests of society as a whole”).

<sup>70</sup> See, e.g., Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1271 (1982) (explaining that those who are concerned with corporate misdeeds should “seek redress through the political process and [should] not . . . attempt to disrupt the voluntary arrangements that private parties have entered into in forming corporations”); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 36, 42–43 (1991) (expanding the scope of a firm’s fiduciary duties to include local communities is unnecessary because such communities “can appeal to their elected representatives in state and local government for redress”).

<sup>71</sup> See GREENFIELD, *supra* note 6, at 131–32.

Lynn Stout write, “shareholders are not the only group that may provide specialized inputs into corporate production.”<sup>72</sup> Bondholders own their bonds, suppliers own their inventory, governments “own” their infrastructure, and workers “own” their labor. Each contributes something essential to the firm, and none does so as an altruistic act. They all believe that they will gain more by allowing the corporation to collect and use their inputs than if they keep them to themselves.<sup>73</sup> Indeed, the notion that corporations depend on multiple stakeholders is implicit in most theories of the firm.<sup>74</sup>

### *B. Using Corporate Law to Address the Failures of Corporations*

As argued above, corporations require regulation in order to keep them honed toward their central purpose of creating wealth for society, while moderating and mitigating the costs that those corporations impose on society in doing so. The core argument of this section—and indeed the entire Essay—is that corporate law should be a part of this regulatory framework.

In an important sense, corporate law is already a part of this legal regime. Corporate law’s imposition of the duties of care, loyalty, and good faith help ensure that managers perform their tasks dutifully and without acting on the basis of self-interest. The duties to disclose certain kinds of information to shareholders and not to commit fraud on shareholders (mostly arising from federal law but still best seen as “corporate law,” as I am using the term here) are other ways that corporations’ internal affairs are regulated in furtherance of public-policy goals. The question is whether corporate law should further those public policy goals that extend beyond creating money and protecting shareholders.

#### *1. The Current Shareholder Focus of Corporate Law*

To begin this discussion, it bears emphasizing that existing corporate law is so narrowly focused that it routinely makes the simultaneous generation of

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<sup>72</sup> Blair & Stout, *supra* note 27, at 250.

<sup>73</sup> For a more detailed argument, see GREENFIELD, *supra* note 6, at 47–53 (noting that workers have agency costs of their own).

<sup>74</sup> The modern theory of the corporation owes much to Ronald Coase, who theorized that the firm exists when it is more efficient to engage in intra-firm transactions (organized by direct authority) rather than market transactions. See R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 33 (1988). Thus, the theory of the firm depends much on insights about when it is most efficient for people to work together within a firm rather than through individually negotiated contracts. Other writings on the economics of the firm turn on arguments about the consolidation of productive work. See, e.g., sources cited note 27.

wealth and societal benefits *less* likely. The most obvious example is the requirement in corporate law that directors regard shareholders' interests as paramount. I understand that it is a contentious question as to whether directors have an enforceable duty to maximize profit. But there is little doubt that by law and norm, the managers feel constrained to put the shareholders first.<sup>75</sup> As an illustration, consider a situation in which a board of directors of a public company makes a decision that financially benefits its employees, but imposes real, long-term costs on shareholders (e.g., fully funding a pension fund, where such funding is routinely avoided by the company's competitors). Also assume that the board makes that decision because they have determined that benefits to the employees would far outweigh the costs to shareholders, and that they say so.<sup>76</sup> Such a decision would violate existing law.<sup>77</sup>

This makes little sense. Corporate law should not presume, without strong arguments, to prohibit corporate decisionmakers from taking into account the very societal interests that the corporation is ultimately meant to serve.<sup>78</sup> Instead, the presumption should be that corporate directors are empowered, or required, to take a broader view of their responsibilities and of the responsibilities of the corporation itself. If we mean to enable institutions to create financial wealth for an expansive range of stakeholders, the rules governing those institutions should align with that purpose, rather than work against it.

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<sup>75</sup> The best statement of this is still *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919): "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end." A more recent statement, arising in the context of hostile takeovers, but not limited in its language to those cases, came from the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986): The "board may have regard for various constituencies in discharging its responsibilities, provided that there are rationally related benefits accruing to the stockholders." For a more developed defense of the analysis that shareholder primacy is descriptive of present day business regulation in the United States, see Greenfield, *Reclaiming Corporate Law*, *supra* note 6, at 8–10, 14–16.

<sup>76</sup> If they lied about the reason and said that the long-term benefits to shareholders outweighed the long-term costs to shareholders, the business judgment rule might protect the decision. See GREENFIELD, *supra* note 6, at 228–30 (arguing that the business judgment rule gives latitude to managers in decisionmaking as long as they *say* they are acting in furtherance of shareholder interests).

<sup>77</sup> See JOHN C. COFFEE, JR. & WILLIAM A. KLEIN, *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 130 (9th ed. 2004) ("Directors have great discretion over how to maximize the return to shareholders, but not whether to."); see also *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's shareholders.").

<sup>78</sup> For an argument that the ultimate purpose of corporations is to serve society as a whole, see GREENFIELD, *supra* note 6, at 127–30.

The best arguments in favor of shareholder primacy do, however, assert that it is unnecessary or counterproductive for corporate law to mandate that corporate managers do anything but look after shareholder interests. Corporations make money, and (as the argument goes) if we want them to act with a broader set of goals in mind, then we should use money as a motivator, by subsidizing good behavior and imposing costs through taxes, fines, and the like on undesirable behavior. Judge Easterbrook and Professor Fischel make this point, arguing that society is better off when it “conscript[s] the firm’s strength (its tendency to maximize wealth) by changing the prices it confronts.”<sup>79</sup> They argue that an internal change in corporate structure to make the firm “less apt to maximize wealth” will yield less in both wealth and social goals.<sup>80</sup>

The argument is so well established that its audaciousness is often missed. The argument, as I understand it, is that corporate managers best advance society’s interests by ignoring them. And not only *should* managers ignore social welfare, but they should be *required* to ignore it. Not even Adam Smith’s invisible hand was assumed to be so powerful that people should be *prohibited* from taking the interests of others, or society in general, into account.<sup>81</sup>

So how is the argument made? While it is seldom spelled out in detail, the mainstream view seems to contain three separate claims: (1) advancing shareholder wealth trickles down and advances societal wealth;<sup>82</sup> (2) requiring managers to look after responsibilities other than advancing shareholder interests actually releases them from any real responsibility;<sup>83</sup> and (3) it is

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<sup>79</sup> EASTERBROOK & FISCHEL, *supra* note 70, at 38. Hansmann and Kraakman make this point as well. See Hansmann & Kraakman, *supra* note 60.

<sup>80</sup> EASTERBROOK & FISCHEL, *supra* note 70, at 38.

<sup>81</sup> See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 687–88 (R.H. Campbell & A.S. Skinner eds., Liberty Fund Press 1981) (1776).

<sup>82</sup> See, e.g., EASTERBROOK & FISCHEL, *supra* note 70, at 38 (arguing that society should choose to “conscript to the firm’s strength (its tendency to maximize wealth)” because it will benefit society in certain ways, including the creation of “jobs for workers and goods and services for consumers”); William W. Bratton, *Confronting the Ethical Case Against the Ethical Case for Constituency Rights*, 50 WASH. & LEE L. REV. 1449, 1462 (1993) (“Shareholder primacy in an agency framework thus is not the end being served, but a means to the end of maximizing the general wealth.”).

<sup>83</sup> See, e.g., JOE BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER 34 (2004) (discussing an interview with Milton Friedman in which he states that “[e]xecutives who choose social and environmental goals over profits—who try to act morally—are, in fact, immoral” because they avoid their responsibility of making as much money as they can for their shareholders); David Levi-Faur, *The Global Diffusion of Regulatory Capitalism*, 598 ANNALS AM. ACAD. POL. & SOC. SCI. 12, 21 (2005).

more efficient to regulate corporations from the outside than from the inside.<sup>84</sup> Even though these traditional claims have gone unquestioned for so long, they should all be rejected. The first two I answer here, and the third I answer in the next section.

*a. Trickle-Down*

First, some scholars claim that we need not worry about non-shareholder interests, since looking after shareholders will inevitably help other stakeholders, as well.<sup>85</sup> At a simple, mundane level, this claim can be true. A failing company is not much good to anyone with any sort of investment in the firm, whether that investment be in the form of labor, money, or infrastructural support. But when we look past this narrow circumstance of when the firm is failing, the claim becomes much more dubious. A firm that makes money for shareholders does not necessarily create wealth for others or for society.<sup>86</sup> Without a mechanism within the corporation to force it to absorb externalities or to share gains among all stakeholders, there is no inevitable gain on the part of workers or society, even when the company is making lots of money. The “trickle-down” is not inevitable. Indeed, shareholder profit could even result from a transfer of wealth *from* the company’s employees or from society generally *to* the shareholders.<sup>87</sup>

Moreover, a decisionmaking calculus that takes shareholder interests as its goal will sometimes result in decisions that are overly risky from the standpoint of society as a whole. Shareholders enjoy limited liability and thus suffer only a portion of the costs of bad decisions. On a societal basis, all costs have to be accounted for. There is no such thing as a “limited liability society” in which society contributes to the corporation in very meaningful ways

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<sup>84</sup> See Hansmann & Kraakman, *supra* note 7, at 442; see also Winkler, *supra* note 58. (arguing that the protection of non-shareholder stakeholder is more likely to come from “external” business law rather than through changes in corporate governance).

<sup>85</sup> Bratton, *supra* note 82.

<sup>86</sup> See Dodd, Jr., *supra* note 9, at 1152 (“It can not, however, be successfully maintained that the sort of industrial planning which may be found desirable to protect the employee is necessarily under all circumstances in line with the interest of the stockholders of each individual corporation.”).

<sup>87</sup> For example, by some accounts, Wal-Mart’s employee wages are so low that its workers must subsist on a range of government assistance programs. See generally GEORGE MILLER, H. COMM. ON EDUC. & THE WORKFORCE, EVERYDAY LOW WAGES: THE HIDDEN PRICE WE ALL PAY FOR WAL-MART (2004), available at <http://edlabor.house.gov/publications/WALMARTREPORT.pdf>. In effect, government programs subsidize the profits of Wal-Mart shareholders. According to one Congressional study, Wal-Mart costs federal taxpayers over \$2,000 per employee per year. *Id.* at 9.

(providing employees, real property) without fear of bearing the negative impact of its operation.

The trickle-down claim, even at its strongest, is not that a broader view of corporate obligations is a bad idea, but that it is simply unnecessary. The existing scope of duties is good enough not only for shareholders, but for society as well. This is less of an argument about facts than about beliefs.

*b. More Responsibility Means Less*

The second claim made by mainstream scholars is that a broadening of corporate responsibilities is counterproductive because managers can use the additional responsibilities to avoid responsibility.<sup>88</sup> If corporate managers have more than one “master,” they can play masters off of one another, as a child might do to parents. Instead of the manager actually serving all stakeholders, she will be absolved from obligation to any. Economists would call this an “agency costs” argument.<sup>89</sup> Enlarging the duties of management will increase the agency costs inherent in managing the firm, since it will be more difficult to monitor whether the managers are in fact doing their jobs carefully and in good faith.

The agency-costs assertion is made so often and so forcefully that few question it anymore.<sup>90</sup> In reality, the argument is tenuous and overblown, and so much so that it is rarely used outside the setting of corporate law. There are several responses to it.

Often missed is the fact that the agency-costs argument conflicts with the trickle-down argument. The trickle-down claim posits that the interests of shareholders and other stakeholders are not in conflict. If that is true, then agency costs will not rise much if the law requires managers to take into account the interests of other stakeholders.

My view is that there is indeed conflict between the interests of shareholders and other stakeholders in a range of cases. That conflict, however, is not a reason to fear that managers cannot handle increased responsibility or that it would be impossible to know whether managers are

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<sup>88</sup> See, e.g., A.A. Berle, *supra* note 9, at 1367; D. Gordon Smith, *Response: The Dystopian Potential of Corporate Law*, 57 EMORY L.J. 985, 1007. (2008).

<sup>89</sup> See Jensen & Meckling, *supra* note 9, at 312–13.

<sup>90</sup> Indeed, this argument has been made forcefully since the time of the New Deal. See, e.g., A.A. Berle, *supra* note 9, at 1367.

doing their jobs well. It is true, in a simple way, that a person who has two responsibilities may have more difficulty meeting both than if she had only one. But people routinely have more than one responsibility, some of them even conflicting, and we do not throw up our hands. I am a professor and also a parent. The obligations I owe to my employer sometimes conflict with the obligations I owe to my son. But it is not impossible to tell if I am a good professor or a good parent. In fact, humans are quite accustomed to having a range of obligations. Multiple obligations routinely exist even in business institutions. Corporate directors and managers, in actual practice, regularly balance a number of obligations—some arising from corporate law, some from other areas of law, and some from the market itself.

The only way that having more and broader responsibilities would make it easier for managers to avoid responsibility is that they could use one obligation as a defense to a claim that they failed to satisfy another. But this is not a function of the number and scope of responsibilities, but rather how they are enforced, and corporate law duties are simply not enforced in a way that would allow managers to play one duty off the other. Both the duty of care and duty of loyalty have been reduced in recent decades to essentially procedural obligations—to investigate various alternatives, to look at the various possible outcomes, to take the time necessary to make a good decision, to make decisions untainted by self-interest.<sup>91</sup> These obligations would not be weakened if they were owed to more stakeholders. On the contrary, adding to the number of people who benefit from managers' fiduciary duties will make it *more* difficult for managers to get away with violating those duties. More corporate stakeholders will have an interest in monitoring and remedying managerial misconduct. Furthermore, if faced by a shareholder duty-of-care claim, no manager would be able to erect a realistic defense by saying she was unable to pay attention to the impact of the decision on shareholders because she was thinking at the time about workers. If faced with a shareholder duty-

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<sup>91</sup> See Bainbridge, *supra* note 31, at 52–54 (discussing procedural requirements of the duty of care); see also *Smith v. Van Gorkom*, 488 A.2d 858, 892 (Del. 1985) (holding that director-defendants breached the duty of care because they failed to inform themselves of all information reasonably available to them and relevant to their decision and they failed to disclose all material information to the stockholders); *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968 (Del. Ch. 1996) (holding that director-defendants satisfied the duty of care by meeting and being informed by experts on the relevant issues and having monitoring information systems in place); *Francis v. United Jersey Bank*, 432 A.2d 814, 821–22 (N.J. 1981) (holding that a director-defendant breached her duty of care by nonfeasance because a director has a duty to act, including acquiring at least a rudimentary understanding of the business of the corporation); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710–11 (Del. 1983) (holding that directors who serve in a dual-director capacity owe a duty of loyalty that is to be exercised in light of what is best for both companies, with an emphasis on fair price and fair dealing).

of-loyalty claim, a manager will not be able to defend herself by saying that she was actually acting on behalf of the employees. That would be nonsense. A loyalty suit is essentially about theft—and theft from both shareholders and workers is no more defensible than stealing from shareholders alone.<sup>92</sup>

In the end, the argument that more responsibility means less is actually an argument that adding to the responsibilities of management will make it less likely that management will act like agents of the shareholders. Managers may indeed change their behavior in that way, but that simply begs the question of whether managers should serve only the interests of the shareholders, which is the question with which we started. One cannot answer the question circularly—it makes no sense to argue that shareholders should be supreme because any other rule makes it harder for them to be supreme. And the existence of shareholder agency costs is not itself a persuasive argument, since other stakeholders have agency costs, too. Other stakeholders make important contributions to the firm, and all of them depend on management to use those contributions to create wealth. All stakeholders depend on managers and therefore have an incentive to monitor them. A shareholder primacy rule makes it more difficult for these other stakeholders to depend on management, which raises the stakeholders' agency costs. A relaxation of the shareholder primacy model might increase the agency costs of shareholders, but it will *decrease* the agency costs of non-shareholder stakeholders, which are just as important as shareholders' agency costs.

To say that only shareholders should have a rule that lowers their agency costs assumes shareholder primacy. In other words, we cannot justify the rule of shareholder supremacy by pointing to shareholder agency costs, unless the agency costs of other stakeholders are discounted. And they can only be discounted if shareholders are supreme.

## 2. *External vs. Internal Regulation*

The contention that corporate law should focus on shareholders alone reduces to a third and final claim: it is more efficient to regulate corporations from the “outside” than from the “inside.” At base, this is simply an empirical question: if we want to regulate corporations to force them to consider the interests of non-equity investors, but still allow them to generate wealth, are

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<sup>92</sup> For a more developed version of this argument, see Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87 (2005).

we better off using corporate law along with other regulatory mechanisms or just those other mechanisms alone? Perhaps it is useful to begin with the acknowledgement that this “external” versus “internal” dichotomy is too simple. Regulations of corporations come in a multitude of forms. Even ones that are seen as external—tax law, for example—often have as a goal the adjustment of behavior within the firm.

It is more accurate, as a matter of regulatory theory, to characterize the regulation of the corporation as falling into three categories: (1) regulation requiring or encouraging certain results (e.g., pollution laws that prohibit the discharge of certain effluents); (2) regulation requiring or encouraging certain processes or actions (e.g., disclosure laws, nondiscrimination laws); and (3) regulation requiring or encouraging certain internal structures (e.g., a board that is elected by shareholders). When characterized this way, it becomes clear that the non-equity investors typically have to depend on regulatory initiatives that focus on results and on process. The only stakeholders that have any significant structural protection within the corporate form are the shareholders.

Consider the following chart.

## Examples of Regulatory Efforts to Constrain and Harness Corporate Power

<b>Stakeholders</b>	<b>-----Regulatory Focus-----</b>		
	<b>Results</b>	<b>Actions/Process</b>	<b>Structure</b>
Shareholders	Limited Liability Profit-Maximization Norm Capital Markets (Quasi-Legal)	Duty of Care Duty of Loyalty Disclosure Law Anti-Fraud Law (10b-5) Insider Trading Law	Shareholder voting for directors Right to sue derivatively Right to vote on major corporate changes
Employees	Minimum Wage OSHA	ERISA (regulates retirement benefits; limited protection) Tort/ Workers' Compensation Law Anti-Discrimination Law Federal Plant Closing Notification Requirements Labor Law (limited)	
Community/ Environment	"Command and control" Environmental Statutes; Superfund, Clean Air/Water Acts, etc.	Tort Law Environmental Impact Statements Planning/permitting/zoning processes	
Customers	Contract Law Consumer Safety Law Regulatory protections (food and drug, consumer protection, air safety, etc)	Anti-Fraud Law Tort Law Antitrust Law	
Creditors	Contract Law	Good Faith in Contract /Uniform Commercial Code Anti-Fraud Law Bankruptcy Law	

One might think that this chart shows the extent of the regulatory efforts aimed at protecting various kinds of stakeholders and that nothing else need be done. That response would be apt if the interests of stakeholders were in fact

adequately protected by these efforts. While some may disagree, another (and I believe more reasonable) response to this chart is to question why regulation of the corporate structure—the stuff of corporate law—is not being utilized to its full potential. The empty boxes in the rightmost column represent regulatory gaps and opportunities—presently ignored—to address employee, community, and environmental concerns. Whether we should use them is a question of whether the corporation's structure can be adjusted so that its distinctive abilities are being put to greater use.

Of course, the first question is whether there is a *need* to use the distinctive capacities of the corporate form. Even law professors do not believe that regulation is a good in and of itself. Regulation is a tool to address public policy ends, and the questions of what problems demand a public policy response and how best to mold that response should always be asked. The answer to the first question—*What problems demand a response?*—will be obvious to some and less obvious to others. Many people are increasingly convinced that failures in corporate accountability and governance have contributed to a number of serious public policy problems.<sup>93</sup> Two worries are particularly acute. First, environmental degradation generally, and global warming in particular, have in part come about because companies disregarded the long-term environmental implications of their products, services, or internal operations. Second, economic disparity, both domestically and internationally, can in part be traced to companies' fixation on the financial well-being of the managerial and shareholding elite.<sup>94</sup> The financial windfalls going to the wealthiest among us over the past generation come, in part, from increased labor productivity, the gains from which have not generally been shared with working people, whose wages have been stagnant for the past thirty years.<sup>95</sup>

So if we believe that there are public policy problems that are presently in need of further attention or of being attacked in a different way, there is reason to be hopeful that changing corporate governance law is indeed an important

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<sup>93</sup> For a comprehensive analysis of the role of corporate governance in creating public policy problems, see SUMMIT ON THE FUTURE OF THE CORPORATION, PAPER SERIES ON CORPORATE DESIGN (Allen White & Marjorie Kelly eds., 2007), available at <http://www.corporation2020.org/summitpaperseries.pdf> (collecting papers written for The Summit on the Future of the Corporation, a national forum convened at Faneuil Hall, Boston on November 13–14, 2007).

<sup>94</sup> See Greenfield, *supra* note 6.

<sup>95</sup> *Id.*

tool to consider. As such, corporate law may have comparative advantages over other kinds of law to address the concerns of its stakeholders.

For example, because the central purpose of the corporation is to create wealth, broadly defined,<sup>96</sup> it is likely to be more efficient for the corporation to distribute wealth among those who contribute to its creation, rather than the government redistributing wealth after the fact. Redistribution is important, to be sure, but it may be more efficient to distribute the corporate surplus fairly as an initial matter by using an internal mechanism than by settling up after the initial distribution by using tax and welfare law to accomplish economic fairness. Further, a fair distribution of corporate profits to employees, for example, will likely have significantly positive multiplier effects (such as workers being more productive because they feel they are being fairly treated) that would not likely occur with later governmental redistribution initiatives. (More on this below.)

Moreover, in dealing with issues such as economic well-being or environmental sustainability, corporate managers may have expertise in areas that government bureaucrats do not. There may be efficiencies in a corporate setting that do not exist in a governmental setting. A broadening of corporate responsibilities would allow corporations and their management to be proactive in addressing issues of social concern, which, in turn, might be more efficient than relying on the mostly reactive power of government regulation. In the end, if we believe that non-shareholder stakeholders need more regulatory protection than they now receive, then it is foolish and inefficient as a matter of public policy to leave corporate law as an untapped resource. Using corporate law to adjust the composition or duties of the board to force the consideration of stakeholder interests could be a powerful tool not only to rein in the worst excesses of the corporation but also to take advantage of the unique capabilities of the corporation to achieve important gains in social welfare.

### *C. Using Stakeholder Governance to Make Corporations Better*

The most powerful reason to accept changes in corporate governance is not to address the failures of the firm. Rather, the central reason to adjust corporate law is to take advantage of the successes of the corporation in order to achieve important gains in social welfare.

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<sup>96</sup> See GREENFIELD, *supra* note 6, at 130–34.

As pointed out at the beginning of this Essay, the corporation is immensely successful at creating wealth.<sup>97</sup> But because of the narrow fixation on shareholder benefit imbedded in the market, social norms, and corporate law, non-equity investors (employees, communities, etc.) are often shortchanged in the distribution of the wealth they help create. Even though the corporation is a collective enterprise when it comes to inputs, the distribution of the outputs is determined by a body—the board—that is dominated by representatives of only two stakeholders: the shareholders and the senior management. Changing this arrangement has the potential not only to improve the corporation's ability to create wealth but also to address serious and enduring social and economic ills. Almost certainly, if senior managers and the board were required to consider the interests of the firm more broadly—to include the well-being of all investors, equity or non-equity—in their decisionmaking calculus, the firm would be more successful in satisfying the social goal of creating wealth, broadly defined.

I should hasten to make clear that I am not proposing a wholesale revamping of the corporate structure. As discussed in Part I, the structure of hierarchy topped by a board is, by many accounts, a fundamental source of corporations' success. Accordingly, I propose (1) taking advantage of the existing structure's ability to satisfy the objective of creating wealth, but changing the definition of wealth within corporate law to mean the wealth of all the stakeholders rather than just the shareholders; and (2) improving the corporation's structure by diversifying the board to include representatives of stakeholders other than shareholders. I will look at these proposals in turn.

*1. Changing the Corporate Objectives to Include the Well-Being of Non-Equity Investors*

As emphasized throughout this Essay, the corporation is a collective enterprise, calling on the resources of a number of contributors to create goods or services for profitable sale. Also, as argued earlier, the reason that society cedes power to corporations is to create wealth, broadly defined. The argument here is that if the managers of the firm were required to consider the interests of the firm more broadly—to include the well-being of all investors, equity or non-equity—in their decisionmaking calculus, the firm would be more successful in satisfying the goal of creating social wealth. More precisely, directors should be held to a fiduciary obligation to all of the firm's

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<sup>97</sup> See *supra* Part I.

stakeholders that varies according to the nature of the stakeholders' contributions to the success of the firm.

Even though this might strike some as being a major change, as it does me, it could be achieved by way of a remarkably simple doctrinal adjustment. Courts could simply hold directors and management to a duty to the firm as a whole, defined as the collection of interests imbedded in the firm, rather than a specific subset of it (the shareholders). This is such a simple shift that some corporate law scholars—most prominently Margaret Blair and Lynn Stout<sup>98</sup>—believe that this is even the best description of *current* corporate law. Indeed, some cases can be read to presume such a broad reading of fiduciary obligations.<sup>99</sup> In any event, such a change in doctrine would not represent a huge transformation.

I believe that the benefits of this change would be significant. First, it would be better for firms themselves over time. One reason for this is that it would encourage stakeholders to make firm-specific investments. Firm-specific investments are great assets for the firm because it can then take advantage of and build on the knowledge and expertise of its investors, suppliers, communities and employees over time. The problem that has bedeviled corporate economists, however, is that the more that a particular stakeholder makes investments that are firm-specific, the greater the risk the stakeholder takes that the firm will collapse, violate some implicit or explicit contract with the stakeholder, or extort concessions from the stakeholder. As the stakeholder becomes more valuable to the company, she also becomes more vulnerable.<sup>100</sup>

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<sup>98</sup> See Blair & Stout, *supra* note 7, at 305.

<sup>99</sup> See, e.g., *Paramount Commc'ns v. Time, Inc.*, 571 A.2d 1140, 1148 (Del. 1989) (discussing how *Time*'s directors rejected Paramount's premium purchase offer because it threatened "Time Culture"); *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964) (considering a defense by directors against a hostile takeover that would be harmful to employees); see also Blair & Stout, *supra* note 7, at 298 (arguing that some cases presume a broad reading of fiduciary obligations).

<sup>100</sup> The shorter the time horizon used by management in making decisions for the firm, the more vulnerable non-equity investors become. At present, most large companies in the United States experience 100% turnover in their shares each year, virtually guaranteeing that the firm will take a short-term, rather than long-term, view when making managerial decisions. See NYSEData.com, Facts and Figures, <http://www.nysedata.com/factbook> (last visited Feb. 29, 2008) (search for "turnover"; from options select "NYSE Group Turnover 2007"); see also LAWRENCE E. MITCHELL, *THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY 277-78* (2007) (stating that the average stock turnover for Fortune 500 companies is over 100% a year, and is even greater for smaller companies). Short-termism is made worse by the size and power of institutional shareholders such as mutual funds, pension funds, hedge funds, banks, and insurance companies, which now own more than 60% of all public corporate equities and have their own incentive to

Because corporations are a collective effort, the key to sustainability is for those who contribute to the firm to believe that the firm can be trusted. Broad fiduciary obligations would help build this trust, ensuring that *all* stakeholders would be willing to make firm-specific investments.<sup>101</sup> This would help ensure that the firm survives over time.<sup>102</sup>

There is an additional reason why fair allocation of the corporate surplus would inure to the benefit of the firm over time. Numerous studies have shown the truth of what we intuit from our everyday interactions, namely that human beings are “reciprocators.”<sup>103</sup> Human beings tend to treat others the way that others treat them. Road rage is the negative example; the norm of giving gifts during the holidays is a positive example. In the working world, people are reciprocators as well. For example, workers who believe that they are treated fairly tend to work harder, be more productive, obey firm rules more often, and be more loyal to their employers.<sup>104</sup> This, in turn, likely makes those firms more profitable than they would have been absent such fair treatment.

Even if one is not convinced that more parity among stakeholders is better for firms themselves, there is an additional reason to push for broader fiduciary duties. When we take society’s interest as our ultimate guidepost, society is not concerned exclusively with the maximization of aggregate wealth. Rather, the fairness of the allocation of society’s wealth is an important principle in the United States, as well as other democracies. As a society, we look not only at the total social wealth but also at the equality of its distribution. This concern

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maximize the value of their portfolio in the short term. See KUTTNER, *supra* note 2, at 144 (arguing that these institutional investors “do not behave like owners,” but rather “act more as traders, seeking short-term gain”).

<sup>101</sup> It is worth noting the irony of the present legal regime, which offers more legal protection to shareholders—whose investment is not firm-specific at all—than to other stakeholders.

<sup>102</sup> The leading scholar arguing for recognizing the importance of the firm-specific investments of workers is Marleen O’Connor. For an example of her work discussing the importance of firm-specific investments, see Marleen A. O’Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 909–10, 923 (1993).

<sup>103</sup> See, e.g., Robyn M. Dawes & Richard H. Thaler, *Cooperation*, in *THE WINNER’S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE* 9–11 (Richard H. Thaler ed., 1992) (noting that people tend to reciprocate—“kindness with kindness, cooperation with cooperation, hostility with hostility, and defection with defection”); David Dickinson, *Ultimatum Decision-Making: A Test of Reciprocal Kindness*, 48 THEORY & DECISION 151, 153 (2000) (describing a study showing that “individuals will be fair and kind to those that show them kindness, and unkind to those that show them malice”); Greg Lester, *Psychologists Define Personality Types Involved in Group Projects*, INNOVATIONS REP., Jan. 21, 2005, [http://innovations-report.com/html/reports/social\\_sciences/report-39202.html](http://innovations-report.com/html/reports/social_sciences/report-39202.html).

<sup>104</sup> For an extensive analysis, see Greenfield, *supra* note 64, at 613–22.

is particularly acute now, as income and wealth inequality in the United States is worsening and compares unfavorably to every other industrialized nation.<sup>105</sup>

Presently, economic fairness is ignored in mainstream corporate law. In fact, a theory of corporate law that is based on the unconstrained ability to contract—the mainstream view—virtually ensures that inequality will be worsened.<sup>106</sup> When people use bargained-for exchange to distribute goods, the weaker bargainer will be less able to extract concessions from the other. So, unless there is some constraint on the ability of corporations to pass along the lion's share of profit to shareholders, the nation's inequality will worsen over time. A concern for economic fairness is a component of society's interests, and public policy needs to (and does, in a variety of ways) take that value into account.

The question, then, is why *corporate* law should be used to further the interest of fairness, rather than other areas of regulation. The answer to that query harkens back to the previous sections. As noted above, it may simply be more efficient, as a matter of regulatory policy, to use corporate law to redistribute wealth and income than to use other mechanisms. Public policy tools that redistribute wealth and income tend to either work after the initial distribution of financial wealth (e.g., taxes, welfare policy) or to benefit only those at the lowest rung of the economic ladder (e.g., the minimum wage). A stakeholder-oriented corporate law would work at the initial distribution of the corporate surplus and would benefit stakeholders up and down the economic hierarchy. Certainly, if we take economic fairness seriously as a value, we should not blindly accept a corporate law framework that makes fairness less, rather than more, likely.

## 2. *Changing the Composition of the Board*

The best way to realize the potential of the corporation as a progressive force is to adjust the composition of the board so that it contains directors who represent those who invest in the firm in addition to shareholders. At present, shareholders occupy not only a supreme position within the legal framework, being the only beneficiary of management's fiduciary duties, but also within the board itself.<sup>107</sup> Only shareholders vote in elections for corporate directors,

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<sup>105</sup> For a host of statistics, see MISHEL ET AL., *supra* note 24, at 56–92, 249–79, 344–49.

<sup>106</sup> For a more robust treatment of this argument, see GREENFIELD, *supra* note 6, at 125–22.

<sup>107</sup> See Rutheford B. Campbell, Jr. & Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. CORP. L. 491, 495 (2007) (noting that

and votes are weighed according to the number of shares they own.<sup>108</sup> Once we recognize, however, that corporations are to serve *all* their stakeholders, it becomes clear that the dominance of shareholders within corporate management is a mistake.

Why would a stakeholder board be beneficial? The answer is twofold. First, such a change will inevitably mean that the corporate surplus will be more equitably and efficiently shared, which will help ensure the sustainability (and profitability) of the enterprise over time. Second, a more pluralistic board will improve corporate decisionmaking, which will also help ensure the sustainability (and profitability) of the enterprise over time.

*a. Benefit #1: More Fairness*

The first benefit is straightforward. When the board decides how to allocate the corporate surplus, a stakeholder board will behave differently than a shareholder board. The market will be a constraint, to be sure, but the goal of the board will be to allocate the surplus so as to maintain the firm as a going concern. Shareholders will get their proportion, but so will others. In a sense, this conception would use the corporation not only as the mechanism for creation of wealth but its distribution as well.

This is not as jarring as it might seem at first. In the United States, and indeed in most industrialized countries, one of the most important tasks of the state is to redistribute wealth. Mechanisms include the tax and welfare system, minimum wage, and the Social Security program. At base, my proposal is simply to adjust the structure of corporate law so that it can better serve this purpose as well.

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directors “owe no fiduciary duty to the corporations ‘creditors’”); *see also* *Skinner v. Hulsey*, 138 So. 769, 773 (Fla. 1931) (“Directors are not liable to the creditors on the theory of their being fiduciaries.”); *Whitfield v. Kern*, 192 A. 48, 55 (N.J. 1937) (holding that management is not the agent for creditors); *Conrick v. Houston Civic Opera Ass’n*, 99 S.W.2d 382, 385 (Tex. 1936) (“Directors are not personally liable to creditors for mismanagement, or for waste of assets except on proof of the commission of actual fraud.”); *Pittsburgh Terminal Corp. v. Balt. & Ohio R.R.*, 680 F.2d 933, 941 (3d Cir. 1982) (“[D]irectors must act as fiduciaries to all equity participants.”); *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), *rev’d on other grounds*, 347 A.2d 133 (Del. 1975) (holding that no fiduciary duties existed between corporate directors and holders of convertible subordinate debentures).

<sup>108</sup> For an excellent critique of corporate law according to democratic principles, including the fact that voting power depends on number of shares owned, see Daniel J.H. Greenwood, *Markets & Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41 (2005).

The strength of this argument is bolstered by evidence from other nations. In a recent study, Sigurt Vitols measured the macroeconomic implications of worker participation in corporate management throughout Europe.<sup>109</sup> On a countrywide level, European countries with strong “codetermination” (i.e., worker participation on boards) had lower income inequality than countries that have no or weak worker participation.<sup>110</sup> Moreover, countries with strong codetermination had higher labor productivity, fewer days lost to strikes, and lower unemployment rates.<sup>111</sup>

The stakeholder board, in an ironic sense, is a genuine realization of the “nexus of contracts” view of the firm. If the firm is best seen as a microcosm of the market, then let us be honest about recognizing all contracts by putting the most important market participants in a position where they can be heard at the decisionmaking level of the firm. The specifics will be difficult, but not impossible: employees could elect a proportion of the board;<sup>112</sup> communities in which the company employs a significant percentage of the workforce could be asked to propose a representative for the board; long-term business partners and creditors could be represented as well.<sup>113</sup>

The specifics do not matter as much as the notion that the board itself should be a place where more than just a shareholder perspective will be heard. As they participate on the board, each stakeholder representative will have the incentive to build and maintain profitability in order to sustain the company over time. Moreover, the board will be the locus of the real negotiations among the various stakeholders about the allocation of the corporate surplus. Even though board members might be selected for their positions in different ways and from different constituencies, each would be held to fiduciary duties to the firm as a whole. Decisions that affect major stakeholders would no

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<sup>109</sup> SIGURT VITOLS, EUROPEAN TRADE UNION INST. FOR RES., EDUC., HEALTH & SAFETY, PROSPECTS FOR TRADE UNIONS IN THE EVOLVING EUROPEAN SYSTEM OF CORPORATE GOVERNANCE, FINAL REPORT FOR EUROPEAN TRADE UNION INSTITUTE (2005), available at <http://www.etui-rehs.org/research/media/files/reports/report92>. For an excellent overview of codetermination, see THE EUROPEAN COMPANY, PROSPECTS FOR WORKER BOARD-LEVEL PARTICIPATION IN THE ENLARGED EU 64–65 (Norbert Kluge & Michael Stollt eds., 2006), available at [http://www.seeuropa-network.org/homepages/seeuropa/file\\_uploads/booklet2006.pdf](http://www.seeuropa-network.org/homepages/seeuropa/file_uploads/booklet2006.pdf) (chart of codetermination forms around Europe).

<sup>110</sup> VITOLS, *supra* note 109, at 22–24.

<sup>111</sup> *Id.*

<sup>112</sup> See THE EUROPEAN COMPANY, *supra* note 109, at 36–39, 93–95 (summarizing methods of electing employee representatives).

<sup>113</sup> This form of stakeholder representation could be brought about in any number of ways, but could be achieved merely by defining different classes of stock allocated to different stakeholders, all with their requisite board representatives.

longer be made cavalierly without someone on the board being able to anticipate and articulate the likely impact that such a decision would have on the workers, creditors, and other interested stakeholders.

*b. Benefit #2: Better Decisions*

This proposal for board pluralism will strike most readers, at least in the United States, as outlandish. But codetermination is common in many countries in Europe and is used to good effect.<sup>114</sup> Perhaps the reason for its success is that, overall, board pluralism makes for better decisions.

Recall the discussion in Part I about the success of corporations being based in part on their dependence on a group decisionmaker at the top of the hierarchy.<sup>115</sup> But the benefits of group decisionmaking are drastically mitigated, and sometimes undermined completely, when the group is too homogeneous. In fact, more and more studies show that good decisionmaking requires diversity of viewpoints. As Cass Sunstein has detailed in his recent book *Why Societies Need Dissent*, conformity among people in a decisionmaking group inevitably breeds error.<sup>116</sup> Dissent is essential, and sometimes “social bonds and affection” can suppress dissent.<sup>117</sup> Sunstein notes, “[I]f strong bonds make even a single dissent less likely, the performance of groups and institutions will be impaired.”<sup>118</sup> He extends the points to corporate boards: “The highest performing companies tend to have extremely contentious boards that regard dissent as a duty and that ‘have a good fight now and then.’”<sup>119</sup>

If homogeneity is a flaw, then corporate boards are blemished indeed. At present, corporate boards are among the least diverse institutions in America. A 2002 survey found that 82% of the director positions on Fortune 1000 companies were held by white men, while only 11% were held by white women, 3% by African Americans, 2% by Asian-Americans, and 2% by

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<sup>114</sup> See VITOLS, *supra* note 109.

<sup>115</sup> See *supra* notes 30–38 and accompanying text.

<sup>116</sup> See generally SUNSTEIN, *supra* note 21.

<sup>117</sup> *Id.* at 27.

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* at 28 (quoting Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, HARV. BUS. REV., Sept. 2002, at 106, 111).

Hispanics.<sup>120</sup> Adding perspectives other than those of rich, white men will almost certainly improve the quality of business decisions made by the board.

This idea is hardly as radical as it might seem at first. Even mainstream scholars are sometimes found to recognize the benefits of board pluralism. For example, Stephen Bainbridge has said, in the context of suggesting that larger boards are better than smaller boards, that “[m]ore directors will usually translate into more interlocking relationships with other organizations that may be useful in providing resources such as customers, clients, credit, and supplies.”<sup>121</sup> Note that Bainbridge sees the benefits of including persons on the board who can speak for and offer insight from various non-equity investors, even though he notably does not include workers in his list.<sup>122</sup> He describes the benefits of this kind of board pluralism as including the ability to address information asymmetries and thus aiding in the creation of strategic alliances.<sup>123</sup> That insight, which seems right, would be true not only for business partners but also for all non-equity investors, including workers. Workers are also, in effect, entering into a strategic alliance with a firm when they invest their time, energy, and futures with the company. Thus, they too “need access to credible information about the competencies and reliability of prospective partners,” just as the firm needs credible information about their “competencies and reliability.”<sup>124</sup>

The worries often expressed about codetermination are overblown. No constituency would have an incentive to hurt the company in order to gain a larger piece of the pie. Even if they did, they would be violating their fiduciary duties to the firm as a whole and could be held to account for their behavior. Second, the possibility of strategic, “rent-seeking” behavior *already* exists in

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<sup>120</sup> See Gary Strauss, *Good Old Boys' Network Still Rules Corporate Boards*, USA TODAY, Nov. 1, 2002, at 1B.

<sup>121</sup> Bainbridge, *supra* note 31, at 43.

<sup>122</sup> See *id.*

<sup>123</sup> See *id.*

<sup>124</sup> *Id.* Bainbridge also suggests that boards perform better when a larger board includes a greater number of “specialists” who would aid in both the board’s monitoring and service functions. See *id.* As he says, “complex business decisions require knowledge in such areas as accounting, finance, management, and law. Providing access to such knowledge can be seen as a part of the board’s resource gathering function.” *Id.* Boards cannot expect to be, and probably should not be particularly specialized, but they benefit from having specialists among them. See *id.* While Bainbridge’s examples are of investment bankers and attorneys, his reasoning would extend to those having specialized insight about other non-equity investors. As Bainbridge argues, “[L]arger, more diverse boards likely contain more specialists, and therefore should get the benefit of specialization.” *Id.* (emphasis added). Bainbridge’s focus is more the *size* of boards, but he—perhaps inadvertently—makes my point about the *diversity* of boards, as well.

the firm. Directors are currently elected by shareholders only, and shareholders already have incentives in certain circumstances to put their interests ahead of the interests of the firm as a whole. A pluralistic board could actually retard those selfish impulses, because any behavior that benefits one stakeholder at the expense of the firm must be done in full view of the others.

To be sure, making the board less homogeneous will make decisions less tidy, since more views will have to be taken into account and the board will be forced to compromise so that decisions are acceptable to a majority or plurality of stakeholders. But the fact that decisions will be more difficult is not in itself a reason to refuse to improve boards by having them listen to a range of views and perspectives. The real question is whether additional diversity results in decisions that are worth the extra effort. A greater diversity in perspectives and backgrounds within the boardroom will create material benefits to the firm by lessening the risk over time that the board will engage in the defects and systematic mistakes of “groupthink.”<sup>125</sup>

On this point, we can gather insight from our experiences outside of business. The notion that decisions produced by a finely wrought process of dialogue and compromise are better than decisions made unilaterally by a uniform group of individuals is widely accepted by institutions other than corporate boards. We recognize in legislative bodies, administrative agencies, school faculties, and non-profit boards that diversity of viewpoints and people increases the likelihood that dissent will be welcomed, important perspectives will be heard, and decisions will be more fully vetted. As Madison argued in the *Federalist Papers*, a pluralistic federal government where power is balanced among many different groups actually *weakens* factions.<sup>126</sup> To make important decisions, one must build coalitions; individual factions cannot act on their own. The same is likely true in corporate governance.

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These principles of good decisionmaking are not new or earth-shaking. They are just systematically ignored in corporate governance. If we imported these insights into corporate law, the strengths of the corporate form could be maintained and then harnessed for a purpose higher than the aggregation of

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<sup>125</sup> See, e.g., SUNSTEIN, *supra* note 21, at 143 (arguing that “defective decisionmaking” is “strongly correlated with structural flaws,” such as “insulation and homogeneity”); Bainbridge, *supra* note 31, at 32 (discussing groupthink).

<sup>126</sup> THE FEDERALIST NO. 10 (James Madison).

shareholder profit. *Social* wealth could be built; social interests could be internalized into firm decisionmaking; wealth could be more fairly distributed. Perhaps the world will not be saved. But it would be better.