# Corporate Social Responsibility: A Law & Economics Perspective

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## INTRODUCTION

The law and economics of corporate social responsibility are simple. Assets are worth more to their owners if they are held exclusively by those owners rather than shared. This simple fact explains why shareholders prefer to be the exclusive beneficiaries of corporate fiduciary duties. If, however, the rules of the game were changed and corporations were deemed to have responsibilities to society in general, instead of exclusively to their shareholders, the shareholders would be harmed because the economic value of their shares would decline. Of course, shareholders would agree to a change such that corporations owed duties to society rather than to the shareholders exclusively if they were *compensated* for this diminution in rights. Thus, if non-shareholder constituencies such as local communities, workers, suppliers, or customers valued these rights sufficiently, they would have them because they would buy them from the shareholders. The fact that this does not happen is strong evidence that it is efficient to organize corporations such that they are run so as to maximize value for shareholders.

From a law and economics perspective, the corporate social responsibility debate is really a debate about how to interpret the contracts and understandings that allocate rights and responsibilities within corporations and other forms of business organizations (hereinafter "corporations"), and between corporations and those located outside of the corporation, such as local communities. The ineluctable reality is that when shareholders make investments in a corporation, they do not think that they are giving their money away. Rather, they invest

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* Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law, Yale Law School. This Article's content draws in substantial part from, and includes revisions and extensions of arguments in, earlier articles, including, for example, Jonathan R. Macey & Geoffrey P. Miller, *Corporate Stakeholders: A Contractual Perspective*, 43 U. TORONTO L.J. 401 (1993); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173 (1989); and Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

on the premise that they have the right to receive something in exchange for their investments. To say that corporations are supposed to be managed to maximize shareholder value is simply to recognize that part of the reciprocal promise made by the corporation in exchange for the investment is an agreement that the corporation will be managed for the benefit of the shareholders.

From this very basic perspective comes the insight that the fiduciary duties that officers and directors owe to shareholders simply reflect a central term of the standard form contract created when a corporation issues shares: the corporation is promising that the business will be run to maximize returns for shareholders. While there is some confusion on this subject, this basic contract is entirely mutable in every detail. In other words, it is the default rule that is in place unless the corporation, at its inception, chooses to make a different set of commitments to investors.

It is not entirely clear that fiduciary duties are particularly valuable assets. The fervor of the corporate social responsibility debate suggests that having the shareholders' right to have the corporation managed for their exclusive benefit, as opposed to the benefit of all stakeholders, including non-shareholder constituencies, must be worth something. Otherwise, it would not be worth fighting over.

The interests of the widely variegated groups of claimants on firms' assets conflict in numerous ways. By strengthening the bargaining position of one group, the law inevitably weakens the bargaining position of the other competing groups.

Building on the axiom that the corporation is a nexus of contracts,[1] fiduciary duties are simply corporate assets that are bargained for and auctioned off among the various groups of stakeholders. The bargaining process theoretically could lead to a wide variety of outcomes.

As long as the parties engaged in the bargaining process are rational, however, they will agree to stipulate that fiduciary duties will be exclusively enjoyed by one constituency, if the value of such duties is greater when enjoyed exclusively than when shared with other groups. Thus, the allocation of fiduciary duties exclusively to one group of claimants does not reflect any lack of bargaining power on the part of the groups that do not enjoy the privilege of being the beneficiary of such duties. Rather,

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1 *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 393 (1937) ("A firm, therefore, consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur.").

I argue that these other groups *benefit* by giving up any claims they might have on such rights by more than they lose.

The benefits will vary depending on the nature of the non-shareholder constituency at issue. They may take the form of higher interest rates for bondholders, higher wages or greater job security for workers, or higher taxes for local communities. Thus, the notion of forbidding companies from offering a standard form contract in which shareholders are the exclusive beneficiaries of fiduciary duties and requiring firms to allow directors to serve broad societal interests will not only make shareholders worse off, they make other constituencies worse off as well.

For over a century, state corporate law doctrine provided that the directors of both public and closely held firms owe fiduciary duties to shareholders and to shareholders alone. The applicable legal norm required directors to manage a corporation for the exclusive benefit of its shareholders. Protection for other sorts of claimants existed only to the extent provided by contract. This principle has been subjected to sustained attack.[2]

I argue that fiduciary duties should flow to residual claimants and to residual claimants alone. This conclusion stems from a contractual analysis, under which residual claimants receive the benefits of fiduciary duties, not because other groups do not value them, but rather because (1) the aggregate value of fiduciary duties to any group within a firm diminishes as those rights are shared with other groups; and (2) the shareholders value these rights more than any other group.

Non-shareholder constituencies also value these rights. It would be surprising indeed if rights were of value to one group but not to another group, just as it would be surprising if the rights were of exactly the same value to every group. The very nature of the interests and contractual claims of non-shareholder constituencies makes it easier for these constituencies to protect themselves from post-contractual opportunism by the firm. In addition, non-shareholder constituencies already enjoy the protection provided by judicial gap-filling and do not need the additional gap-filling protections afforded by fiduciary duties. All groups ultimately benefit from a legal regime that makes shareholders the exclusive beneficiaries of fiduciary duties.

A valid criticism leveled at other constituency statutes is that they require corporate agents to serve so

2 *See, e.g.*, Comm. on Corporate Laws, Am. Bar Ass'n, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2253 (1990) (criticizing other constituencies statutes for carrying the potential to change basic premises of corporate law).

many masters—employees, communities, bondholders, customers, suppliers—that the costs in terms of confusion and misunderstanding on the part of courts and litigants vastly outweigh any potential benefits that such statutes might provide. But this argument is not dispositive of the debate because it ignores the fact that corporations have long been able to issue multiple classes of shares with different economic and political rights, and corporate management has owed fiduciary duties to each of these classes. Thus, it simply cannot be said that corporate law is incapable of reconciling the claims of a variety of competing interests. The argument that other constituency statutes will cause confusion also neglects the fact that most managers' actions are insulated from judicial second-guessing by the business judgment rule. Accordingly, as a practical matter, the rights being taken away from shareholders by other constituency statutes were not rights that provided much in the way of concrete benefits for shareholders in the first place.

Interestingly, over a significant range of important corporate decisions, other constituencies such as fixed claimants or workers may actually have the greatest stake in the decisions being made. For example, shareholders may well benefit by a corporate decision to close a particular plant, but the workers who would lose their jobs in that plant closing likely would suffer to a much greater extent.

Similarly, other constituency statutes cannot be condemned on the grounds that they upset a system of legal rules that present a pre-existing set of clearly defined behavioral guidelines for officers and directors. No such set of guidelines exists.

Rather, the critical problem with other constituency statutes is that they fail to recognize that fiduciary duties are owed solely to residual claimants because they are the group that faces the most severe set of contracting problems with respect to defining the nature and extent of the obligations owed to them by officers and directors. Fiduciary duties should properly be seen as a method of gap-filling in incomplete contracts. And shareholders place a far greater value on the protection provided by this gap-filling than do the other constituencies of a corporation.

This observation, of course, raises an obvious follow-up question: if gap-filling is a useful device from the shareholders' perspective, why not from the perspective of these other constituencies as well? Here I argue that under modern principles of contract law, courts *do* fill in gaps for these other constituencies, but they do so against the background of the pre-

existing contracts that these groups have with the firm. Thus, gap-filling on behalf of such other constituencies as employees and bondholders is done in the context of interpreting the employment contracts, collective bargaining agreements, bond indentures, and covenants that these other groups have with the corporation. Necessary gap-filling is achieved in this context.

The obvious exception to this general rule comes from the local communities in which large corporations operate. Unlike the rest of the constituencies with which a firm deals, the local community has no preexisting agreement with the firm. As such, there simply is no gap for a court to fill. However, the local community is, or should be, well represented in the political process. Any grievance felt by the local community is best addressed to local political officials.

Finally, this paper considers—and rejects—the argument that other constituency statutes are worthwhile because they prevent inefficient wealth transfers from other constituencies, particularly bondholders and employees, to shareholders. The question is not whether such wealth transfers are theoretically *possible*, because they clearly are. Rather, the relevant issues are (1) whether the dangers associated with such wealth transfers can be avoided by contractually negotiated covenants between the fixed claimants and the firm; and (2) whether the social costs of attempting to mitigate this wealth transfer problem through the promulgation of other constituency statutes are greater than the social benefits. The answer to both of these questions is yes. It seems patently clear that the actual purpose and effect of these statutes is to benefit a single non-shareholder constituency, namely the top managers of publicly held corporations who want still another weapon in their arsenal of anti-takeover protective devices. In other words, like many other legislative initiatives, other constituency statutes do not benefit the interests or groups that they ostensibly are intended to benefit. Rather, such statutes benefit a well-organized, highly influential special-interest group, namely the top managers of large, publicly held corporations who wish to terminate the market for corporate control.

## I. Corporate Social Responsibility and Residual Claimants

Other constituency statutes and other efforts to require corporations to shift their focus from shareholders to society are inconsistent with the fact that shareholders' expectations of being the exclusive beneficiaries of fiduciary duties are legitimate because this is what they have contracted and paid for. This argument derives from the insight of modern financial theory

that "shareholders retain plenary authority to guide the fate of the corporate enterprise because . . . they have the greatest stake in the outcome of corporate decision-making . . . ."[3] Despite the fact that corporations are merely complex webs of contractual relations—and despite the fact that shareholders do not "own" the modern, publicly held firm in any meaningful sense—the ultimate right to guide the firm (or, more precisely, to have it guided on their behalf) is retained by the shareholders because they are the group that values it most highly.[4]

The implication of this analysis for the allocation of fiduciary responsibilities within the firm is not entirely clear. To say that shareholders place the highest value on the rights protected by fiduciary duties is not the same as saying that shareholders are the only group that values such rights. Clearly, many discretionary decisions within the corporation harm the rights of other claimants. For example, in recent years corporations have: (1) "[r]edeem[ed] refunding-protected debt with proceeds of an equity offering, while at the same time borrowing for other corporate purposes at" lower interest rates;[5] (2) "[d]eliberately engineer[ed] a technical default in a private debt covenant, in order to be 'forced' to retire a high coupon issue that was otherwise fully call-protected";[6] (3) "[b]orrow[ed] heavily in the short-term market, [and] then offer[ed] bondholders a choice between amending a covenant limitation on funded debt or leaving the issuer severely exposed to interest rate fluctuations and burdened with large near-term maturities";[7] and (4) "[l]everag[ed] . . . [their capital structure] to avoid a hostile takeover, thereby triggering a decline in the company's bond rating . . . , notwithstanding the bondholders' longstanding assumption that the issuer desired to maintain the highest possible rating in order to minimize its borrowing costs."[8]

Thus, the interesting question is not why shareholders receive the benefits of fiduciary duties, but why they should be the *exclusive* beneficiaries of fiduciary duties, given that other constituencies would benefit if they had the rights created by the imposition of such duties. But why would shareholders, as residual claimants, place the highest value on fiduciary duties?

3 Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 175 (1989).

4 *Id.*

5 Martin S. Fridson, *Bondholder Rights: A Survey of Current Issues*, EXTRA CREDIT: THE JOURNAL OF HIGH YIELD BOND RESEARCH, Jan.–Feb. 1992, at 33.

6 *Id.*

7 *Id.* at 34.

8 *Id.*

After all, once we accept the view that the firm is not an entity at all but a set of contracts or series of bargains:

> [The organization] . . . decomposes . . . into a group of identifiable participants—e.g., investors, managers, creditors, employees and suppliers—who negotiate an equilibrium position among themselves. An implication of this perspective is to deny that any one class of participants (i.e., the shareholders) have a natural right to view themselves as owners of the firm. Rather, shareholders are seen not as the firm's owners, but as suppliers of equity capital; they are the 'residual claimants,' who bring to the firm their special ability at risk-bearing, which creditors, managers, and employees tend to lack.[9]

Of course, "[o]nce we view the shareholders as simply the residual claimants who have agreed to accept a more uncertain . . . return because of their superior risk-bearing capacity, it is far from self-evident that they are necessarily entitled to control the firm,"[10] that is, to have managers' and directors' fiduciary duties flow exclusively to them.

The rationale for why shareholders place the highest value on such rights is said to be that,

> [u]niquely, the residual claimants . . . are interested in the firm's overall profitability, whereas creditors and managers [and presumably other constituents as well] are essentially fixed claimants who wish only to see their claims repaid and who will logically tend to resist risky activities. Having less interest in the overall economic performance of the firm, creditors can bargain through contract and do not need representation on the board to monitor all aspects of the firm's performance.[11]

Thus, fiduciary duties exist because the decisions that face officers and directors of corporations are sufficiently complex and difficult to predict. It would therefore not be feasible to specify, in advance, how such officers and directors should respond to a wide range of future contingencies. Fiduciary duties are the mechanism invented by the legal system for filling in the unspecified terms of shareholders' contingent contacts. It has been argued that these duties run exclusively to shareholders because, as residual claimants, "[t]he gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line."[12] As Easterbrook and Fischel have observed:

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9 JESSE H. CHOPER, JOHN C. COFFEE, JR. & C. ROBERT MORRIS, JR., CASES AND MATERIALS ON CORPORATIONS 28 (3d ed. 1989).

10 *Id.* at 29.

11 *Id.*

12 Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983), *available at* http://www.jstor.org/stable/725097.

> As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions. The firm should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion [or to have it exercised on their behalf].[13]

A simple illustration can be used to demonstrate this point. Suppose that a firm has two classes of claimants: fixed and residual. The firm will owe $1 million to the fixed claimants at the end of period one. Suppose further that the firm has to choose between two projects: A and B. Both of these projects will require the firm to allocate one hundred percent of its resources to that project for the relevant period. Project A has a 0.5 chance of producing a pay-off with a present value of $1 million, and a 0.5 chance of producing a pay-off with a present value of $5 million at the end of period one. Thus, the expected present value of project A is $3 million.[14] Project B, on the other hand, has a pay-off matrix in which there is a 0.5 chance of a pay-off with a present value of $6 million, and a 0.5 chance of a pay-off with a present value of $1 million. Thus, while project A has an expected value of $3 million, project B has an expected value of $3.5 million.

The shareholders will prefer project B, since they are better off by $500,000 if they select that project.[15] The fixed claimants, by contrast, are indifferent as to whether the firm selects project A or project B because under either outcome available under either project, the fixed claimants are absolutely certain to obtain the $1 million that is owed to them by the firm. Where a firm is making a decision like this, the fixed claimants clearly do not deserve a role in the decision-making process. The firm, and society, are better off if the firm selects project B, because that is

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13 *Id.*

14 (0.5 x $1 million) + (0.5 x $5 million) = $3 million.

15 Project A has an expected value to the shareholders of $2 million. If the project only makes $1 million, the fixed claimants will get all of the gains from the project, and there will be nothing left over for the shareholders. If the project makes $5 million, the shareholders will get $4 million, because the first million goes to satisfy the firm's obligations to the fixed claimants. Thus, project A has an expected value to the shareholders of $2 million (0.5 x $4 million = $2 million). Project B has an expected value of $2.5 million. As before, if the project only makes $1 million, the shareholders get nothing. If the project makes $6 million, the shareholders will get $5 million, because the first million will go to the fixed claimants of the firm. Thus, project B has an expected value to the shareholders of $2.5 million (0.5 x $5 million = $2.5 million).

the one that maximizes the firm's and society's stock of wealth. No purpose is served by giving the firm's fixed claimants any stake in the decision-making process. The only possible result from involving them would be to permit them to threaten to obstruct the firm's efforts to undertake project B in order to extract a side payment of some kind.

The sort of decision described in the above example lies behind the intuition that fiduciary duties should flow exclusively to a firm's shareholders because they are residual claimants. Because the relevant decision in this example, like so many decisions made by corporations, is infra-marginal with respect to all constituencies other than shareholders, the shareholders should be the only party with legal rights in the process leading to that decision. And, as Easterbrook and Fischel suggest, the shareholders' position within the firm is unique because shareholders are the only group with a meaningful stake in *every* decision made by a solvent firm.

But not all decisions made by a firm resemble the decision suggested in the above example. Suppose that the decision was between project A as described above and a third project, C. Project C has a 0.5 chance of producing a pay-off at the end of period one with a present value of $500,000, and a 0.5 chance of producing a pay-off at the end of period one with a present value of $10 million. The shareholders would prefer project C to project A (or project B, for that matter). Project C has an expected return to shareholders of $4.25 million, which compares favorably with project A's expected return to shareholders of $2 million, and project B's expected return to shareholders of $2.5 million. However, unlike project A and project B, the firm's fixed claimants are not indifferent with respect to the decision to select project C. Under project C, there is a 0.5 chance that the fixed claimants will be paid only half of the full $1 million that is owed to them. Indeed, the fixed claimants would be willing to pay for the right to block project C.

It is simply incorrect to say that the shareholders are the only group with the correct incentives to decide whether to adopt project C or project A or B. Nor is it the case that the society benefits by allocating the fiduciary duties within the firm exclusively to the shareholders on the grounds that the shareholders have the greatest incentives to maximize the value of the firm. It is possible to manipulate the numbers in the above examples—and the actual projects selected in the real world—to transfer wealth from the fixed claimants to the residual claimants while *reducing* rather than increasing the overall value of the firm.

Imagine, for example, that the firm is selecting between two projects: D and E. Project D presents a 0.5 chance of producing absolutely nothing, and a 0.5 chance of producing a present value pay-off of $1.5 million at the end of period one. Project E presents a one hundred percent chance of producing a present value pay-off at the end of period one of $1 million. Ex ante, the overall value of the firm is maximized by selecting project E, since that produces a present expected value of $1 million, while project D produces a present expected value of only $750,000. The shareholders, however, would prefer project D to project E, since under project E there is no chance that the shareholders will realize any pay-off at all, while under project D there is a 0.5 chance that the shareholders will realize something (that is, $500,000 after repaying the $1 million owed to fixed claimants). Thus, if the shareholders are left in complete control, they will have incentives "to adopt various strategies with the effect of transferring wealth from bondholders to shareholders, such as choosing risky investment projects and withdrawing assets from the firm."[16] This example strongly suggests that some of the strategies that shareholders can adopt to transfer wealth from the fixed claimants and other constituencies to themselves reduce the value of the firm, and overall societal wealth as well. The point of this discussion is that simply describing shareholders as residual claimants to the cash flow of the modern corporation does not fully explain why fiduciary duties flow exclusively to shareholders.

The shareholders' status as residual claimants provides a persuasive rationale for why their interests should trump with respect to a wide range of transactions. However, it is also clearly the case that other claimants have a strong interest in having their preferences taken into account, at least to some extent, in decisions about how to allocate corporate resources, because these claimants face the realistic prospect of tangible loss if their interests are neglected. Thus, the argument that shareholders, as residual claimants, have the greatest incentive to maximize the value of the firm, and therefore should be the beneficiaries of the legal protection afforded by fiduciary duties, is incomplete. It does not explain why the interests of other claimants should not be respected, at least as regards those decisions that have the potential to affect their interests directly.

The reason that shareholders should be the exclusive beneficiaries of fiduciary duties does not lie in the fact that the shareholders are residual claimants, but rather in the fact that

16 Easterbrook & Fischel, *supra* note 12, at 404.

fiduciary duties are not public goods. Because fiduciary duties are not public goods, the enjoyment by one group of the rights associated with such duties necessarily diminishes other groups' ability to enjoy those benefits. This is particularly true in the case of corporate fiduciary duties where the interests of the various stakeholders' groups actually conflict.

It is well understood that a discretionary decision by directors that increases the wealth of one stakeholder group often will diminish the wealth of another group. For example, just as a decision by a corporate board of directors to increase the overall riskiness of a firm above the expected level transfers wealth from fixed claimants to residual claimants, so too does a decision by the board to reduce the riskiness of the firm transfers wealth to fixed claimants from residual claimants. But the implication of this basic point has been lost on those who have supported statutes that expand the rights of non-shareholder constituencies to include fiduciary duties.

Another example illustrates this point. Suppose that there are only two groups of stakeholders: bondholders and stockholders. The bondholders value the right to be the exclusive beneficiaries of fiduciary duties at $50, while the shareholders value the right to be the exclusive beneficiaries of fiduciary duties at $75. If fiduciary duties are shared by both groups, however, the aggregate value of the corporate fiduciary duties declines to $40 ($20 for each group). If both groups have equal bargaining power and are rational, the parties will agree that the shareholders should be the exclusive beneficiaries of the directors' fiduciary duties. The bondholders would accept some amount greater than $20 in exchange for agreeing that the shareholders will be the exclusive beneficiaries of the directors' fiduciary duties. The shareholders would pay some amount less than $55 to obtain the right to be the exclusive beneficiaries of the directors' fiduciary duties. Within this range, both groups would be better off than if fiduciary duties were shared with the other group. In other words, in this example, as long as the shareholders pay the bondholders an amount greater than $20 but less than $55, both will be better off than if the fiduciary duties are shared and no exchange is made. Thus, corporate shareholders will *pay* other corporate constituencies for the right to have these duties inure to their sole benefit.

Suppose, for example, the shareholders place an aggregate value of $10 million on the legal protection provided by a corporate governance system that allocates fiduciary duties exclusively to shareholders, while other constituents place a value of $2 million on the protection afforded by such duties.

Under these assumptions, both parties will be better off if the shareholders are permitted to compensate these other constituencies—in the form of higher interest on bonds, higher wages to workers and managers, and better prices for suppliers and customers—to acquire the right to have fiduciary duties flow exclusively to them.

Thus, *all* constituencies will be better off by allocating fiduciary duties within the firm exclusively to shareholders because: (1) fiduciary duties are not a public good; and (2) shareholders are the group within the firm that places the highest value on such duties.

## II. The Too Many Masters Argument

Another criticism of embracing corporate social responsibility is that, to the extent that doing so effects any change in firm behavior or existing law, it complicates corporate governance immeasurably. Specifically, embracing corporate social responsibility requires directors to attempt the impossible: pleasing a multitude of masters with competing and conflicting interests. As the Committee on Corporate Laws of the American Bar Association's Section on Business Law has argued in its position paper on other constituency statutes:

> The confusion of directors in trying to comply with such statutes, if interpreted to require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling. Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.[17]

On one view, the "too many masters" argument is that other constituency statutes make life more difficult for corporate managers and boards of directors. In fact, the better view is that such statutes make life easier rather than harder for incumbent management of the large, public corporation. After all, these statutes enable management to justify virtually *any* decision on the grounds that it benefits *some* constituency of the corporation or other.

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17 Comm. on Corporate Laws, *supra* note 2, at 2269.

To illustrate the point that other constituency statutes increase rather than decrease the degree of freedom enjoyed by incumbent managers, one has only to imagine virtually any decision or transaction contemplated by a corporation. Take, for example, the issue of whether a firm should relocate its headquarters from the large metropolis that has served as its base for several years to a small town with better schools, lower labor costs, and lower taxes. While shareholders might benefit by this move, the community in which the firm is currently located clearly would suffer. Some employees might benefit by the move, while others might suffer. The firm could justify virtually any decision as serving the interests of one or more of the firm's constituencies. Imagine now that the proposal to relocate the company comes not from incumbent management, but from an outside bidder who is launching a hostile tender offer for the company at a substantial premium over the current market price of the firm's shares. Now the other constituency statute can be used to justify resisting an outside offer that may be in the best interests of the firm's shareholders. This is an additional reason why other constituency statutes diminish in value when they are shared by more than one group of stakeholders.

Thus, the primary beneficiaries of other constituency statutes are incumbent managers who can justify virtually any decision they make on the grounds that it benefits some constituency of the firm. Strong support for this assertion lies in the fact that not only are these statutes (with a single exception) permissive, they do not afford standing to sue to any of the other constituencies that they purportedly are designed to benefit.[18] A similar sentiment was expressed by Dean Robert Clark, who has observed that it is socially optimal for corporate law to promote the interests of shareholders in profit maximization in a rather single-minded fashion:

> A single objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all . . . interests. Assuming shareholders have some control mechanisms, better monitoring means that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do and do it efficiently.[19]

Like the argument that other constituency statutes are ill-advised because they ignore the special status of shareholders as residual claimants, the "too many masters" argument is not without merit. Indeed, this argument provides what is a logical

18 Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 165 (1991).

19 ROBERT C. CLARK, CORPORATE LAW 20 (1986).

explanation of state legislatures' eagerness to enact these statutes. As has been pointed out, "Nonshareholder constituency statutes . . . are intended to permit consideration of stakeholder interests, and, at the same time make hostile takeovers more difficult . . . . [I]t is clear that the corporate managers who supported these statutes expected them to help protect incumbent target management."[20] Of course the winners of the takeover battles of the 1980s were corporate shareholders, while the losers were incumbent managers. Other constituency statutes give such managers the ability to obtain politically what they were unable to obtain in the marketplace—meaningful job security regardless of the quality of their performance.

The problem with the "too many masters" argument is that it is overstated. Corporations traditionally have been able to issue multiple classes of common and preferred stock, and corporate managers and directors have owed fiduciary duties to all of these various classes of claimants simultaneously. Moreover, just as the interests of common shareholders can conflict with the interests of non-shareholder constituencies, so too can the interests of one class of equity claimant conflict with the interests of another class of equity claimant. In particular, certain preferred shareholders may have interests that more closely resemble the interests of fixed claimants than the interests of common shareholders. Such preferred shareholders may seek to discourage the firm from engaging in certain risky projects while the shareholders would support the firm's decision to undertake such projects.

With respect to corporate law jurisprudence, as the Committee on Corporate Law has observed, in no case has the all-important Delaware Supreme Court held that directors will be permitted to prefer the interests of other constituencies over shareholders or that they ought, as a normative matter, to take such interests into account.[21] The Committee has reformulated the position of the Delaware Supreme Court to be that

> directors have fiduciary responsibilities to shareholders which, while allowing directors to give consideration to the interests of others, compel them to find some reasonable relationship to the long-term interests of shareholders when so doing. In Delaware, this principle is modified when the decision is made to sell the company, at which time the directors may consider only the interests of shareholders.[22]

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20 Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 996 (1992).

21 *See* Comm. on Corporate Laws, *supra* note 2, at 2260.

22 *Id.* at 2261.

Another noteworthy facet of the Delaware approach is its recognition of the important point that over a wide range of issues, no conflict exists between the interests of other constituencies and those of shareholders. Acting to improve worker morale is good for workers and good for shareholders. Taking steps to improve relations with the local community has the same effect. Similarly, drafting strong bond covenants or developing a reputation for dealing fairly with bondholders or other constituencies benefits the shareholders in the form of lower interest costs for debt and a lower cost of doing business generally. However, as a corporation approaches insolvency, the shareholders' interests become less relevant, and non-shareholder constituencies take on all of the characteristics of residual claimants.

Delaware's approach recognizes the Hayekian argument that it generally is not possible to identify precisely which actions are in shareholders' interests and which are not.[23] Experimentation and after-the-fact observation is required. As such, managers require plenty of latitude for experimentation. In addition, many technological or managerial improvements to a firm's operations may well result from pure happenstance and fortuity, rather than careful strategic planning. Consequently, judicial efforts to hold managers to a strict profit-maximization standard through the palliative of ex post judicial review of corporate decisions and operations is not likely to benefit anyone other than the legal community. The obvious exception to this general rule occurs in the case where there is a palpable conflict of interest between the actions of managers and the interests of shareholders. Where this is the case, there is, of course, an important role played by judicial enforcement of corporate law norms.

In competitive markets, if managers act in ways that are sub-optimal from the shareholders' perspective, they will be disciplined, if at all, by the various markets in which such managers must operate.[24] Because of the problems of ignorance and uncertainty in the world of business, managers often base their actions on custom, tradition, force of habit, imitating the actions of more successful competitors, or a complex set of conflicting motivations. Courts are likely to be even more inept

23 A basic tenet of Austrian economic thought, as exemplified by the work of Friedrich A. Hayek, is that "there is an unpredictability and indeterminacy with regard to human preferences, expectations and knowledge." Israel M. Kirzner, *On the Method of Austrian Economics*, *in* THE FOUNDATIONS OF MODERN AUSTRIAN ECONOMICS, 48 (Edwin G. Dolan ed., Sheed & Ward, Inc. 1976); *see also* FRIEDRICH A. HAYEK, INDIVIDUALISM AND ECONOMIC ORDER 46 (1948).

24 These markets include the market for corporate control, the internal and external managerial labor markets, and the markets for the products offered by the firm.

than managers and directors in determining with any certainty which actions are in the best interests of shareholders and which actions are not. As noted above, over a wide range of issues, allowing managers to take the interests of a variety of constituencies into account simply recognizes the fact that ex post second-guessing of managerial decisions probably does more harm than good. Generally, it is best for all parties concerned if courts decline to second-guess managers' decisions. Only when such decisions are clearly being made self-interestedly should courts intrude on the internal process of corporate governance.

To the extent that other constituency statutes are interpreted in ways that are consistent with this general norm in corporate law, they will be efficient and will benefit societal interests, not harm them. Consistent with the approach taken by the Delaware Supreme Court, the fact that such statutes give incumbent managers more freedom is worrisome only if managers can use that freedom in ways that are inconsistent with shareholder welfare.

Thus, the problem with other constituency statutes is not that they require managers and directors to serve too many masters. Under current law, corporate officials must serve a shifting and highly variegated set of masters. Rather, the problem is that these statutes potentially permit such managers and directors to serve no one but themselves.

## III. SHAREHOLDERS AS THE GROUP WITH THE MOST ACUTE NEED FOR FIDUCIARY DUTIES

The real reason why shareholders value fiduciary duties more than other groups, and why non-shareholder constituency statutes are unproductive, is that such statutes ignore the severe contracting problems faced by residual claimants. These acute contracting problems, coupled with the fact that the value of being made the beneficiary of corporate fiduciary duties is not in the nature of a public good, provide the basic justification for the traditional common law rule that managers and directors owe their primary fiduciary responsibilities to shareholders.

Outside of insolvency, non-shareholder constituencies can protect themselves against virtually any kind of managerial opportunism by retaining negative control over the firm's operations. Workers, bondholders, even local communities, can protect their interests by contracting for the right to veto future proposed actions by management. By contrast, the shareholders must retain positive control over the actions of the firm in order to realize the full potential value of their shares.

Merely because non-shareholder constituencies decline to contract for the right to veto certain corporate transactions does not mean that they were *unable* to do so. Rather, the absence of contractual protection for other constituencies may simply reflect the fact that such other constituencies were unwilling to *pay* for such protection in the form of lower wages or lower interest rates on debt.

Workers are perhaps the group with which one sympathizes most when thinking about the possible benefits associated with other constituency statutes. Unlike shareholders, who are concerned with the overall profitability of the firm in which they have invested, workers are concerned with wages, hours, and working conditions. From a contracting perspective, wages and hours present few, if any, problems. Workers potentially could protect their expectations concerning wages with pension guarantees, severance agreement (golden parachute) contracts, stipulated cost-of-living adjustments, and other straightforward provisions. Similarly, workers can obtain credible assurances against being forced to work undesirable hours simply by stipulating the precise length of the workday. Employees can achieve guaranteed working conditions by making reference to a well-known status quo, and requiring the employer to maintain working conditions at that level or above.

The point here is not to suggest that workers have the contracting power to protect their wages, hours, and working conditions. Rather, the point is simply that, unlike the situation that pertains to the shareholders, it is at least *technologically* possible for workers to protect themselves contractually by drafting strong contractual provisions in their favor. Moreover, to the extent that future, unforeseen contingencies arise that cast doubt on the efficacy of contractual protection, courts can protect workers by construing their employment contracts in the light of the original purposes behind the agreement. Thus, the gap-filling functions provided by modern judges in interpreting contracts provides workers with the same sorts of protection that fiduciary duties provide for shareholders.

The above arguments apply with even more force to bondholders. First, bondholders can and do draft elaborately detailed contracts to protect themselves from transactions that upset the original understanding between bondholders and the firm regarding the sorts of transactions that are appropriate for the firm.[25] For example, bond indentures often contain provisions

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25 Clifford W. Smith Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–19 (1979).

that impose limitations on an issuer's ability to pay dividends, acquire stock, acquire debt or issue preferred stock, either directly or through a subsidiary, to sell assets, or to engage in transactions with affiliate companies. While these provisions would not provide much protection to shareholders (and indeed might be harmful to their interests), they do much to protect bondholders and other fixed claimants against wealth transfers by other corporate interests.

Again, it is worth emphasizing that, for the purposes of the arguments presented in this paper, the issue is not whether bondholders have the bargaining power to obtain every contractual protection they desire when covenants and indentures are drafted. After all, bondholders, like other constituencies, are free to decline to invest in the firm if they are not satisfied with the risk-return trade-off being offered. Instead, the relevant issue is whether it is technologically possible for the bondholders to protect themselves via contract.

As such, the only reason we do not observe the use of such contractual provisions in the real world is that they are prohibitively expensive. Unlike shareholders who, absent the gap-filling protection afforded by fiduciary duties, cannot obtain contractual assurances that a firm will maximize profits, bondholders can protect the present value of their fixed claims by drafting "put" provisions that give them the legal right to force the firm to repurchase the bonds at a pre-determined price upon the occurrence of certain contingencies. Put provisions may also require the firm to adjust the payments to fixed claimants to compensate them for the increased risks associated with certain transactions or with downgrades in the firm's credit rating.

The put provisions accompanying bond sales generally are triggered by a merger or transfer of a substantial number of assets to another firm, a change in the ownership of the firm, a significant share repurchase by the firm, or similar transaction.[26] Of course it would be possible to draft even more comprehensive protection for bondholders. The right to put the bonds back to the firm might be triggered any time the market price of the bonds reached a certain level in the open market. Such a broad provision would be easy to monitor and enforce, and would provide virtually complete protection for bondholders against unforeseen contingencies. Thus, to repeat, the issue is not whether other constituencies can protect themselves via contract, but whether they are willing to *pay* for such protection.

26 *See* Matthew Winkler, *Harris, Williams Cos. Unit Are First to Offer Super 'Poison Puts,'* WALL ST. J., Nov. 16, 1988 at C1, C23.

## IV. Gap-Filling for Non-Shareholder Constituencies

The familiar retort to the argument made in the preceding section is that shareholders and the corporate managers who serve them are endlessly creative. As such, no matter how elaborate the guarantees, non-shareholder constituencies will be unable to protect themselves without the broad-based gap-filling provided by fiduciary duties because new strategies will be devised to undermine whatever contractual protection other constituencies can devise.

An interesting variant on this argument has been made in an important article by Columbia's Professor John Coffee. He argues that the hostile takeover itself is best viewed as a shareholder strategy for reneging on the original bargain between non-shareholder constituencies (particularly managers) and the firm:

> [T]he hostile takeover can be seen not simply as a mechanism that compels a management to accept that level of business risk that shareholders deem appropriate, but as a means by which shareholders outflank the safeguards managers obtained to protect the promises of deferred compensation and job security [that shareholders have given to managers]. Thus, what appears from the bidder's perspective to be a process of purging organizational slack looks from the manager's viewpoint more like deceptive reneging on the original understanding.[27]

The ex post reneging argument seems flawed for two reasons. First, as noted above, non-shareholder constituencies can draft contracts that protect them against the consequences of future, unforeseen contingencies. Foreseeable contingencies, such as hostile takeovers and corporate restructuring are even easier for non-shareholder constituencies to deal with contractually. As discussed in the preceding section, poison puts for bondholders and golden parachutes for workers potentially provide virtually complete protection for non-shareholder constituencies.

Second, it is inaccurate to suggest that absent other constituency statutes, only shareholders enjoy the protection afforded by judicial gap-filling. An impressive literature on relational contracts indicates that modern judges should and do go a long way towards filling in unstated terms and conditions in long-term relational contracts such as those forged between non-shareholder constituencies and public corporations.[28]

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27 John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 24 (1986).

28 *See generally* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261 (1985).

Modern courts will examine the nature of the understanding between two contracting parties and interpret legal disputes between them in the light of this understanding. Thus, non-shareholder constituencies (with the exception of local communities) *already enjoy* a substantial degree of protection of the gap-filling sort.

For non-shareholder constituencies, the starting point for this judicial gap-filling process must be the contract itself. The contract that constitutes the starting point can take a variety of forms. It may be an employment agreement, a collective bargaining agreement, a bond indenture, or a standard form contract between a firm and its suppliers or customers. For shareholders, it is widely recognized that the contract between managers and shareholders establishes that managers have a duty "to make corporate decisions so as to maximize the value of [their] shares."[29]

Fiduciary duties are a corporate governance device uniquely crafted to fill in the massive gap in this open-ended bargain between shareholders and corporate officers and directors. On the basis of the preceding analysis, it should be clear that recent attempts to expand the scope of managements' fiduciary duties to non-shareholder constituencies are misguided for two reasons that previously have gone unrecognized. First, to the extent that such duties are legally enforceable, they shift the focal point of the legal analysis of the relationship between the non-shareholder constituency and the firm away from the actual contract between the parties. In other words, allocating fiduciary obligations to non-shareholder constituencies takes the judicial gap-filling process out of its proper framework, which lies in the actual contract that exists between the constituency and the firm, and puts it on some other dimension. Removing this gap-filling from its proper framework deprives judges of any coherent basis for allocating rights and responsibilities within the firm.

Inevitably, removing the gap-filling done by judges for non-shareholder constituencies from a contractual framework to a fiduciary duty framework creates potential conflicts between the express and implied terms of the actual bargains and the new "rights" being created by corporate constituency statutes. To the extent that these new rights are allowed to trump the terms contained in a contract between a non-shareholder constituency and the firm, such statutes simply transfer wealth from

29 CLARK, *supra* note 19, at 17–18; Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes,* 1989 DUKE L.J. 173, 186 (1989).

shareholders to these other constituencies. The specter of such wealth transfers deprives investors of incentives to invest in public corporations and reduces societal wealth generally. Thus, to the extent that other constituency statutes create rights for non-shareholder groups that are not expressly or impliedly contained in the actual agreements between these groups and the firm, they will impede the process of capital formation and wealth creation in the economy.

## V. THE LOCAL COMMUNITY

Local communities constitute a possible exception to the analysis presented above. Unlike other non-shareholder constituencies, local communities may have no pre-existing contractual relationship with the firm on which to base a reconstruction of the original understanding between the parties in the event of future conflict. Of course, it often will be the case that a local community will in fact enter into express negotiations with a particular firm and agree to provide certain services and infrastructure support in exchange for a decision by the firm to locate in that community. In such cases, for the reasons presented above, layering on a set of fiduciary duties to the local community in addition to express contracts between the firm and the community will only hinder the ultimate resolution of future disputes.

But often there will be no express or implied understanding between a firm and its community.[30] Where there is no agreement, it seems clear, at least to me, that creating an amorphous, open-ended fiduciary duty running from the firm to the "local community" in which the firm operates is a singularly bad idea. Creating such a duty transforms the role of top managers of public companies from that of private businessmen into that of unelected and unaccountable public servants. A decision to elevate the interests of a local community above the interests of a firm's shareholders is nothing less than a decision about how to allocate wealth within society. There seems to be a broad consensus that "the reallocation of wealth is a function for which directors are not especially suited and one beyond the general pale of their perceived mandate from society."[31]

30 *See* John William Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 618 (1988) (describing the disruptions caused to the community of Youngstown, Ohio, when the United States Steel Company closed two plants there).

31 Comm. on Corporate Laws, *supra* note 2, at 2270; s*ee also* Christopher J. Smart, *Takeover Dangers and Non-Shareholders: Who Should Be My Brothers' Keeper?*, 1988 COLUM. BUS. L. REV. 301, 326–39 (1988).

As with other non-shareholder constituencies, expanding the scope of a firm's fiduciary duties to include local communities is simply unnecessary. This is because local communities have unique access to the political process. To the extent that the actions of a firm are genuinely harmful to a local community, the members of that community can appeal to their elected representatives in state and local government for redress. Regardless of whether one has a pluralism or a republican perspective on the governmental process,[32] local communities should be able to mobilize into an effective political coalition to press for protection from actions by corporations that are truly harmful to such communities. Indeed, upon reflection, the better argument seems to be that corporations need protection from local communities' abuse of the political process at least as much as local communities need protection from opportunistic behavior by corporations. The political capital being made by local politicians over the strike at the *New York Daily News* illustrates this point nicely. There, politicians have been falling all over themselves to demonstrate solidarity with the striking *Daily News* employees with little or no regard for the substantive merits of the dispute.

The Worker Adjustment and Retraining Notification Act[33] illustrates the point that local communities are able to protect themselves in the political process and hardly need any additional protection that might be afforded by a plant closing law. The statute requires that, under virtually all conditions, firms with 100 or more workers give workers and communities sixty days notice prior to closing a plant. The bill requires that workers be paid for every day that they are deprived of notice.[34]

## CONCLUSION

The argument that the fiduciary duties of officers and directors in public corporations should run exclusively to shareholders and not to other constituencies is an uneasy one. As shown above, the shareholders' unique status as residual claimants provides a persuasive rationale for allocating fiduciary duties to shareholders in some but by no means all situations. In simple terms, in those situations in which other constituencies have no meaningful stake in a particular decision, they have no

32 For a republican perspective on government, see Cass R. Sunstein, *Beyond the Republican Revival*, 97 YALE L.J. 1539 (1988). For a pluralism critique, see Jonathan R. Macey, *The Missing Element in the Republican Revival*, 97 YALE L.J. 1673 (1988).

33 29 U.S.C. § 2102 (2012).

34 The statute provides exceptions for businesses struck by unforeseen circumstances and businesses in dire financial straits. *See* Elizabeth Wehr, *Reagan Bows to Politics on Plant Closing Bill*, CONG. Q. WEEKLY REP., AUG. 6, 1988, at 2216.

constructive role to play in the decision-making process. Including them in such decisions would lead to opportunism and to a diminution in societal wealth. On the other hand, non-shareholder constituencies plainly have a significant interest in a wide range of decisions that a firm may be called upon to make. Thus the special role of shareholders as residual claimants does not provide a complete explanation for why shareholders should be the exclusive beneficiaries of corporate fiduciary duties.

It is desirable to maintain a system of corporate governance in which fiduciary duties are owed exclusively to shareholders because no suitable alternative means of protecting shareholders' claims exist other than by way of a judicially enforced regime of fiduciary duties. By contrast, the obligations owed to other claimants can be enforced by contract because they are more precisely defined than the obligations to shareholders.

Moreover, in this article I have stressed that the fiduciary duties owed to shareholders are a device that serves to fill in the implied terms of the contract that exists between shareholders and the firm. This contract requires officers and directors of corporations to maximize overall firm value for shareholders. The fiduciary duties owed to shareholders are the only gap-filling device available to protect shareholders' investments, whereas other claimants enjoy the gap-filling that courts routinely supply when interpreting the terms of their contracts with the firm. Allocating fiduciary duties to shareholders does not really give shareholders a level of protection not enjoyed by non-shareholder constituencies. Instead, the fiduciary duties owed to shareholders simply provide the residual claimants with a level of judicial protection commensurate with the nature of the firm's contractual obligations to them. Ironically, the ostensible reason for passage of non-shareholder constituency statutes is to provide such non-shareholder constituents with the enhanced legal protections that shareholders enjoy. In fact, in the light of the pervasive conflicts of interest that exist between shareholders and managers, it seems clear that if any group within the firm is in need of additional legal protection it is the shareholders. Instead, the recent wave of non-shareholder constituency statutes has enhanced the ability of incumbent management to justify corporate strategies that reduce the overall value of the firm on the grounds that such strategies benefit some non-shareholder constituency or other.