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A Critical Look at Corporate Governance

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I. Introduction

The internal law of corporations is built upon the problem of competition—not competition with the world outside the corporate entity, which, according to liberal economic theory, is essential to the increase of wealth and well-being in society, but competition among the various groups of individuals that animate the corporation. The problem is (to extend the implicit metaphor) as if a human being's internal organs were constantly battling to capture all of the body's energy, rather than working together to contribute to the well-being of the whole. Like the human body, the corporation's "energy" (its assets) is, at any given point in time, limited so that successful competition by one group necessarily deprives others of a share of these resources.

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Of course without some form of check, such constant internal competition would destroy the corporation, much as it would destroy the human body. A large portion of the entity's energy would be spent in the internal battle for control. Even if one group (or organ) were to emerge dominant, all are interdependent and cannot survive alone, so that the dominant group could not support the entity against the outside world, and all would succumb collectively to external pressures.

An examination of the corporate governance structure[1] that has evolved in American law leads to the conclusion that corporate law, like nature, has created devices to avoid such a result by regulating this internal competition. Corporate law does this in two ways. First, it limits the possibility of internal competition to two groups, stockholders and managers, by artificially excluding from the corporate structure other groups that, in reality, are essential to the corporation's survival: employees, debt-holders, suppliers, customers, and the community at large.[2] The traditional structure of corporate law reflects the assumption that without such exclusions, the corporation would implode from the competition among these groups for the limited assets that define the corporation.[3] By imposing such exclusions, the law limits the web of

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1. In this Article I am concerned only with large, publicly-held corporations. Although I do not define the term "large," adequate definitions exist. See, for example, *American Law Institute Principles of Corporate Governance: Analysis and Recommentations* § 1.19 at 28 (Am. Law Inst., Tent. Draft No. 11, 1991) (hereinafter "*ALI Principles of Corporate Governance*"); Melvin A. Eisenberg, *The Structure of the Corporation: A Legal Analysis* § 5.2 (Little, Brown, 1976).

2. It does this, as I shall explain in notes 79-120 and accompanying text, by imposing fiduciary duties on directors which, in effect (although not in form), benefit only the stockholders. For more elaboration on this argument, see Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 Texas L. Rev. 579, 631-33 (1992).

There is no serious disagreement with the proposition that directors' fiduciary duties are directed towards the stockholders. Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 Harv. L. Rev. 597, 602 (1982) (identifying as a "conventional assumption" the duty of management to maximize wealth for the exclusive benefit of stockholder/owners); Jay William Lorsch, *Pawns or Potentates: The Reality of America's Corporate Boards* at 11, 38, 45, 49 (Harv. Bus. Press, 1990) (confirming that most corporate directors believe that their legal responsibility is to the stockholders). Martin Lipton and Steven Rosenblum question the stockholder-centric model, but see the path to broader constituency consideration and long-term social welfare as best achieved by reordering the structure of corporate governance in a way that intermittently increases the power of large stockholders. Martin Lipton and Steven Rosenblum, *A Proposal for a New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187 (1991).

Some corporations statutes permit the corporation to grant voting rights to bondholders, but this is exceptional and outside of the traditional structure of corporate law. See Harry G. Henn and John R. Alexander, *Law of Corporations and Other Business Enterprises* at 155 (West, 3d ed. 1983).

3. This implication, which I shall discuss further in Part II, arises from a comparison of the legal structure of the corporation with the reality of its operations, as well as from the reactions of judges and commentators to whom expansion of the legal model is suggested. For examples of such reactions, see, for example, James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency*

competition for corporate assets to a manageable bilateral structure, making possible the second device employed by corporate law to ensure corporate survival: restraint of competition between managers and stockholders by imposing upon managers the legal duty to act in the interests of the stockholders. Corporate law thus attempts to destroy internal competition by proclaiming that the managers' interests are to be those of the stockholders.[4] At the same time, corporate law adopts the perspective of neòclassical economics, assuming that managers, like all individuals, are rational utility maximizers who naturally act in their own best interests.[5] Thus, the identification of managers' and stockholders' interests is enforced by means of a series of rules designed to

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Statutes in the 1990s, 21 Stetson L. Rev. 97 (1991); James J. Hanks, *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Have Come*, 3 Insights No. 3 at 20 (1989); Section of Business Law of the American Bar Association, Committee on Corporate Law, *Other Constituencies Statutes: Potential for Confusion*, 45 Bus. Law. 2253 (1990). For a different reading that attributes the artificiality of the corporate structure to a desire for certainty, see Christopher Stanley, *Corporate Personality and Capitalist Relations: A Critical Analysis of the Artifice of Company Law*, 19 Cambrian L. Rev. 97, 102 (1988). See also Kathleen A. Lahey and Sarah W. Salter, *Corporate Law in Legal Theory and Legal Scholarship: From Classicism to Feminism*, 23 Osgoode Hall L. Rev. 543 (1985) (looking at corporate law from a feminist perspective).

4. This, of course, is the fiduciary duty of loyalty. See generally Robert C. Clark, *Corporate Law* at 141-262 (Little, Brown, 1986); *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) (stating that directors are agents of stockholders); *Harff v. Kerkorian*, 347 A.2d 133 (Del. 1975) (holding that derivative litigation standing is limited to stockholders); *American Law Institute Principles Of Corporate Goverance: Analysis And Recommendations* § 7.02 at 624-25 (Am. Law Inst., Tent. Draft No. 8 1988) (standing granted to convertible bondbolders); Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. Rev. 1165, 1191 n.103 (1990) (suggesting that "directors' duties are to be exercised for the ultimate benefit of the stockholders"); Mitchell, 70 Texas L. Rev. at 579 (cited in note 2).

Agency cost theorists suggest that self-interested managerial behavior will lead to the protection of stockholders' long-term interests without the need for extensive legal regulation. See, for example Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288, 295-305 (1980).

5. Richard A. Posner, *Economic Analysis of Law* at 3-4 (Little, Brown, 3rd ed. 1986). The pedigree of a neoclassical perspective (descriptive and normative) with respect to stockholders' behavior is extensive. See, for example, *Cone's Executors v. Russell*, 21 A. 847, 849 (N.J. Ct. App. 1891); *Schreiber v. Carney*, 447 A.2d 17, 24 (Del. Ch. 1982); Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 Brook. L. Rev. 1, 29 (1991). Compare Christopher D. Stone, *Corporate Social Responsibility: What It Might Mean, If It Were Really to Matter*, 71 Iowa L. Rev. 557, 566, 571 (1986) (describing as the "anti's" arguments the prevailing neoclassical philosophy that animates the principle of profit maximization and describing this position as the one prevailing in the literature); Steven M. H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 Stetson L. Rev. 163, 167 (1991). Wallman asserts:

> The theory is plain: The desire for pecuniary gain on the part of sbareholders will result in the production through corporations of goods and services that society needs. The classical capitalistic concept of the invisible hand will ensure that every individual "in pursuing his own selfish good . . . [will] achieve the best good for all."

Id. For a more general statement of the importance of "classicism" in early American law, see Herbert Hovenkamp, *Enterprise and American Law, 1836-1937* at 2, 3 (Harvard Univ., 1991).

eliminate, or lessen the consequences of, conflicts arising from this natural behavior.[6]

In creating this structure, corporate law attempts to force into a simplified and traditional bilateral model[7] an inherently intricate and complex web of relationships that exists within collectivities.[8] In short, corporate law attempts to manage the collectivity by denying its existence. Law-and-economics scholars have, through the device of the nexus of contracts, descriptively attempted to reintroduce some of the complexity that exists within such organizations,[9] but have failed to improve the traditional analysis because of their adherence to the assumption that relationships exist only bilaterally.[10] Law-and-economics scholars have conceived of this complex web as consisting of a series of bilateral relationships in which each side bargains and competes with the other in its own self-interest.[11] As a result, they ignore both the possibility of covariance among these relationships and the possibility of altruistic or other nonutilitarian motivations for behavior.[12]

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6. These rules, known under the general rubric of the duty of loyalty, are described generally in Henn and Alexander, *Law of Corporations* at 235-44 (cited in note 2). See also William L. Cary and Melvin A. Eisenberg, *Cases and Materials on Corporations* at 556-690 (Foundation, 6th ed. 1988).

7. The pervasiveness of the bilateral model of legal relations in American law is demonstrated in Hohfeld's exposition on the subject of basic juridical concepts, analyzed in terms of correlatives and opposites. Wesley N. Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 Yale L. J. 16 (1913).

8. For a recent attempt (including a survey of the philosophical literature) to examine the uniquely organizational characteristics of the corporation, see Jeffrey Nesteruk, *Legal Persons and Moral Worlds: Ethical Choices Within the Corporate Environment*, 29 Am. Bus. L. J. 75 (1991). See also Meir Dan-Cohen, *Rights, Persons, and Organizations: A Legal Theory for Bureaucratic Society* (Univ. of Cal. 1986).

9. For general discussions of the nexus-of-contracts theory, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 Stan. L. Rev. 1471, 1513 (1989); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 Geo. Mason L. Rev. 99, 110-22 (Summer 1989); Lucian Arye Bebchuk, et al., Symposium: *Contractual Freedom in Corporate Law*, 89 Colum. L. Rev. 1395, 1396-97, 1408, 1426, 1449-57, 1487, 1536, 1550-51, 1590, 1620, 1764-74 (1989).

10. See, for example, Butler, 11 Geo. Mason L. Rev. at 110-22 (cited in note 9) (describing the contractual characteristics of the corporation).

11. The assumption that individuals are rational utility maximizers lies at the heart of neoclassical economics. Amartya K. Sen, *On Ethics and Economics* at 15 (Oxford, 1987). See also Herbert Hovenkamp, *The First Great Law & Economics Movement*, 42 Stan. L. Rev. 993, 1014 (1990) (discussing early institutionalist economics' rejection of this assumption). For a relatively complete attempt to apply this perspective generally to corporate law, see Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard Univ., 1991).

12. For economic models that accept the role of altruism in motivating behavior, see Amitai Etzioni, *The Moral Dimension: Toward a New Economics* (Free, 1988); Roland N. McKean, *Economics of Trust, Altruism, and Corporate Responsibility*, in Edward S. Phelps, ed., *Altruism, Morality and Economic Theory* at 29 (Russell Sage Foundation, 1975). See also Nesteruk, 29 Am. Bus. L. J. at 75 (cited in note 8); Stanley, 19 Cambrian L. Rev. at 101-08 (cited in note 3); Stone, 71 Iowa L. Rev. at 571 (cited in note 5) (objecting to setting the terms of the corporate responsibil-

By hypothesizing and describing this bilateral and competitive model, both legal doctrine and the law-and-economics model create and perpetuate a particular set of expectations and course of behavior. Because they posit bilateral relationships, the effects of all other relationships on the two dominant relationships are made to seem peripheral at best[13] and irrelevant at worst.[14] By assuming competitive behavior, they deny the relevance, if not the possibility, of other forms of behavior, while at the same time defining the central legal problem as the restraint of management's competition with stockholders. And by restraining competitive behavior within the corporation while at the same time encouraging competition in all other areas, they ensure that the costs of restraining competition will be borne by all but the noncompeting groups.[15] Finally, and most importantly, by focusing on restraining management-stockholder competition as the central concern of corporate law, both traditional legal doctrine and law-and-economics scholars encourage corporate management to expend its energies demonstrating that it is not, in fact, competing with the stockholders. In other words, in the corporate context, managers prevent their ouster by election or takeover, or their discipline by derivative litigation, by constantly and publicly demonstrating their devotion to stockholder interests.[16] To do this, management must divert its focus from its primary task of ensuring corporate success in long-term competition with other corporations and instead focus on achieving short-term profits and high current stock prices.[17]

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ity debate on the basis of utilitarianism). Even some neoclassical economists have recognized the limitations this behavioral assumption places on their ability to explain all human behavior. See, for example, Robert D. Tollison, *Public Choice and Legislation*, 74 Va. L. Rev. 339, 345 (1988) (noting the inability of economics to explain why persons with life tenure work rather than "play a lot of golf"); id. at 363 (noting the difficulty of explaining why people vote).

13. See, for example, *ALI Principles of Corporate Governance* § 2.01 at 69 (cited in note 1); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (stating that the board may consider the impact of takeover on a variety of constituencies); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (interpreting *Unocal* as permitting constituency consideration only if "rationally related benefits" accrue to stockholders); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1988) (same).

14. *Revlon*, 506 A.2d at 182 (stating that the only appropriate object of directorial concern when the sale of a corporation is inevitable is the stockholders).

15. See notes 100-06 and accompanying text.

16. Christopher Stone sees share values and freedom from litigation as management's proxy for success. Stone, 71 Iowa L. Rev. at 569 (cited in note 5).

17. It is noteworthy in this context that many financial measures of successful management are keyed either to current profitability or stock price. I discuss this fact in evaluating certain empirical data in note 204. Although the efficient capital market hypothesis would suggest that current stock prices reflect a current perception of the corporation's long-term prospects, both the hypothesis and this implication are subject to some controversy. See, for example, Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 Cal. L. Rev. 1055, 1064-78 (1991);

This imperative for management to focus on short-term profits is a perennial problem in corporate governance, and I wish to expand upon this theme by using these insights.[18] The distortions caused by the inaccurate description of internal corporate dynamics embodied in traditional legal doctrine and by the narrow and arid analysis of such dynamics canonized by law-and-economics theorists are an important cause of the fundamental failure of American corporations to provide for their own long-term health. Put differently, the short-term focus of American corporations can be traced, at least in part, to the essential failure of American private-law jurisprudence, when applied to internal corporate governance, to create and sustain a realistic theory of the collectivity that maximizes group welfare.[19] Instead, our law attempts to

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Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 Colum. L. Rev. 891, 898-99 (1988).

18. Corporate governance reform has been a recurrent theme in corporate scholarship and practice. Descriptions of various corporate governance reform movements can be found in Daniel R. Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259 (1982); Bayless Manning, *A Taxonomy of Corporate Law Reform*, in Donald E. Schwartz, ed., *Commentaries on Corporate Structure and Governance* at 109 (A.L.I.-A.B.A., 1979); Bayless Manning, *Book Review*, 67 Yale L. J. 1477 (1958); A. A. Sommer, Jr., *Corporate Governance in the Nineties: Managers v. Institutions*, 59 U. Cinn. L. Rev. 357 (1990).

Recently there has been a resurgent interest in corporate governance reform, stimulated by the recognized predominance of institutional investors. For leading examples and reform proposals, see, Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. Rev. 1135 (1991); Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991); Lipton and Rosenblum, 58 U. Chi. L. Rev. at 187 (cited in note 2); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 Wis. L. Rev. 881; Sommer, *Corporate Governance* at 357 (cited in this note); Lorsch, *Pawns or Potentates* (cited in note 2); Robert G. Monks and Nell Minow, *Power and Accountability* (Harper Business, 1991). In 1986, Myles L. Mace published an updated edition of his now classic study, *Directors, Myth and Reality* (Harv. Bus. School, 1986), reaffirming the conclusions he reached in 1971 as to the actual role of corporate directors. See notes 37-39 and accompanying text.

19. Some nascent recognition of the problems caused by this failing is implicit in the increasing popular and scholarly interest in Japanese keiretsus. See, for example, *Seminar Examines Operation and Impact of Keiretsu System*, 61 (BNA) No. 1541 at 616 (Nov. 14, 1991); Paul Blustein, *Japan's Corporate Connections Create Challenge for U.S. Businesses*, Wash. Post A1 (Oct. 6, 1991); Carla Rapoport, *Why Japan Keeps on Winning*, Fortune 76 (Jul. 15, 1991); Angelina Helou, *The Nature and Competitiveness of Japan's Keiretsu*, J. World Trade 99 (June 1991); Richard Nanto, *Japan's Industrial Groups: The Keiretsu* (1990); Marie Anahordoguy, *A Brief History of Japan's Keiretsu*, 68 Harv. Bus. Rev. 58 (Jul.-Aug. 1990), and their apparent success. I say "apparent" success because there is some suggestion tbat the keiretsu is not as successful as it appears. See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 Colum. L. Rev. 1277, 1298-1302 (1991).

Peter Drucker argues that a major reason for the long-term growth and success of Japanese business has been the conscious adoption of a policy and culture of cooperation among conflicting groups within the business and corporate structure. Peter F. Drucker, *Behind Japan's Success*, 59 Harv. Bus. Rev. 83, 86 (Jan.-Feb. 1981). My proposal is based on tbe premise that adopting corporate rules and structures tbat foster cooperation, rather than maintaining our current rules and structures which foster confrontation and exclusion, will similarly benefit American business.

organize the collectivity around the individualistic and self-interested struggles upon which American capitalism is based.

I have analyzed elsewhere some of the specific, real-world intracorporate relationships that have reflected this narrow legal understanding of group relationships, and suggested other ways of analyzing these relationships (using traditional legal concepts, untraditionally applied) that might reduce internal corporate conflict and promote more just, and therefore more desirable, group behavior.[20] But in doing so, I have failed to develop ways in which these broadened ideas of corporate community could be infused within the day-to-day functioning of the corporation, rather than in an episodic manner requiring legal enforcement. In this Article I will attempt to cure this failure by focusing on the structure and duties of the central corporate constituent group, the board of directors. Rather than reject the traditional centrality of the board, I will, in the somewhat conservative discursive mode of the corporate literature, demonstrate how the board can fulfill a critical management and monitoring function while also recognizing and rewarding as central and vital to the corporation all of the constituent groups upon whom its long-term survival depends. In doing so, I reject for the internal corporate governance model both the bilateral structure of traditional corporate law and the insistence upon individualistic competition associated with law-and-economics theorists and implied by the structure of corporate law.[21]

This is a critical time for the reexamination of the principles upon which corporate governance is based. The overwhelming concentration of corporate equities in the hands of institutional investors,[22] the tenta-

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20. See Mitchell, 70 Texas L. Rev. at 582-603 (cited in note 2); Mitchell, 65 N.Y.U. L. Rev. at 1177-86 (cited in note 4). I have taken a different approach in the very different context of close corporations. See Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. Pa. L. Rev. 1675 (1990).

21. In this respect I depart significantly from other reform proposals, all of which are (more or less) predicated on the traditional model. See Dent, 1989 Wisc. L. Rev. at 881 (cited in note 18); Gilson and Kraakman, 43 Stan. L. Rev. at 863 (cited in note 18); Lipton and Rosenblum, 58 U. Chi. L. Rev. 187 (cited in note 2); Monks and Minow, *Power and Accountability* (cited in note 18); Edward D. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 Geo. L. J. 445 (1991). One major problem with these reformers is that they focus on the form, rather than the substance, of corporate governance. For an interesting case study supporting the conclusion that formal restructuring alone is inadequate to result in true reform, see Lesley Levy, *Reforming Board Reform*, 59 Harv. Bus. Rev. 166 (Jan.-Feb. 1981). But see Barnard, 69 N.C. L. Rev. at 1170 (cited in note 18) (noting that social scientists have concluded that improving decision-making processes can improve results).

22. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 567 (1990); Carolyn Kay Brancato, *The Pivotol Role of Institutional Investors in Capital Markets: A Summary of Economic Research at the Columbia Institutional Investor Project* (1990); Buxbaum, 57 Brook. L. Rev. at 16-18 (cited in note 5); Coffee, 91 Colum. L. Rev. at 1291-92 (cited in note 19).

tive but increasing corporate activism of those investors,[23] and the overwhelming embrace of these developments by corporate scholars as the panacea for what ails American corporations,[24] suggests that the opportunity to deconstruct and reconstruct corporate governance may soon be past.

It is with this sense of urgency that I suggest in this Article a model for reconceptualizing the board of directors. The model consists of two parts. The first, related (although indirectly) to the problems caused by corporate bilateralism, addresses the longstanding scholarly concern that the board performs no useful function in corporate law.[25]

23. Barnard, 69 N.C. L. Rev. at 1152-56 (cited in note 18); Buxbaum, 57 Brook. L. Rev. at 22 (cited in note 5); Roberta S. Karmel, *Is It Time For A Federal Corporation Law?*, 57 Brook. L. Rev. 55, 68-69 (1991); *Victories of Governance Proposals Rose By Significant Margin in 1990, Study Says*, 6 Corp. Couns. Wkly. (BNA) 2 (Oct. 30, 1991).

Some of the flavor of this activism is provided in Rock, 79 Geo. L. J. at 1357 (cited in note 21). On October 4, 1991, tbe CEO of the California Public Employees' Retirement System ("CalPERS"), "[t]he nation's largest institutional investor," announced that CalPERS would abandon the use of stockholder proposals to influence corporate governance and instead seek direct negotiations with individual corporations in order to avoid public scrutiny. *CalPERS to Drop Shareholder Proposals*, Sec. Law Daily (BNA) (Oct. 7, 1991).

Institutions also have exerted significant pressures on legislators in order to increase their voice in corporate governance. Both the United Shareholders Association and CalPERS have petitioned the Securities Exchange Commission to change the current proxy regulations in favor of greater stockholder participation. Petition of the United Shareholders Association, dated and filed Mar. 20, 1990; Letter from CalPERS to Linda C. Quinn, Director, Division of Corporate Finance, dated Jul. 25, 1990. Other institutional action has been aimed at preventing dimunition of stockholder voices. As a result of the enactment of Pennsylvania's new antitakeover law diminishing the effect of stockholder pressure on directors of Pennsylvania corporations, several institutional investors expressed doubts as to whether they would continue to invest in Pennsylvania corporations. *Foe Studying Takeover Act*, N.Y. Times D4 (Aug. 24, 1990); Leslie Wayne, *Takeovers Face New Obstacles*, N.Y. Times D1 (Apr. 19, 1990); Diana B. Henriques, *A Paradoxical Anti-Takeover Bill*, N.Y. Times D15 (Apr. 8, 1990); Gregory A. Robb, *SEC Chief Criticizes Bill to Thwart Takeovers*, N.Y. Times D2 (Apr. 3, 1990).

24. See Barnard, 69 N.C. L. Rev. at 1135 (cited in note 18); Coffee, 91 Colum. L. Rev. at 1277 (cited in note 19) (with some reservation as to practicality); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. Mich. J. L. Ref. 117 (1988); Dent, 1989 Wisc. L. Rev. at 881 (cited in note 18); Gilson and Kraakman, 43 Stan. L. Rev. at 863 (cited in note 18); Lipton and Rosenblum, 58 U. Chi. L. Rev. at 190 (cited in note 2) (proposing to make the proxy system accessible to the corporation's largest stockholders); Monks and Minow, *Power and Accountability* (cited in note 18); Black, 89 Mich. L. Rev. at 525 (cited in note 22) (deferring to a forthcoming article the question of the desirability of stockholder monitoring but suggesting its possibility); Rock, 79 Geo. L. J. at 452 (cited in note 21) ("reluctantly" concluding, however, that efficiency of institutional hegemony is limited.) Even if institutional activism has been hampered and thus far has not had overwhelming effect because of the current structure of legal rules, see, for example, Mark Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. Fin. Econ. 7, 9-21 (1990), the fact that the overwhelming majority of academics who have written on the subject have encouraged the destruction of these barriers is cause enough for the concern tbat they may soon erode, resulting in the reality of increased institutional activism. Lorsch, *Pawns or Potentates* (cited in note 2), is the notable exception in opposing institutional activism.

25. Dent, 1989 Wisc. L. Rev. at 914 (cited in note 18) (noting the problem of what to do with the board and identifying commentators who have raised the issue). As I will discuss in notes 40-43

After analyzing this claim and examining the evidence, I conclude that it is correct and suggest that the solution lies in differentiating the board's duties from those of full-time managers. My answer to this argument is to make the board exclusively responsible for the corporation's capital structure (including its broad employment structure) and for the distribution of the corporation's assets (including, broadly, the compensation of its employees).[26]

The second part addresses the problem of short-term management.[27] It does so by focusing on the root causes, internal bilateralism

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and accompanying text, the major cause of board dormancy is the board's co-option by management. James D. Cox and Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 Law & Contemp. Probs. 83, 91-99 (Summer 1985); Dent, 1989 Wisc. L. Rev. at 909 (cited in note 18); Lewis D. Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 Mich. L. Rev. 581, 583-86 (1978). See generally, Lorsch, *Pawns or Potentates* (cited in note 2); Mace, *Directors* (cited in note 18).

26. In this formal respect, my proposal bears some superficial resemblance to the German model of corporate governance. See, for example, Alfred F. Conard, *The European Alternative to Uniformity in Corporation Laws*, 89 Mich. L. Rev. 2150, 2183 (1991); Gouter J. Roth, *Corporate Social Responsibility: European Models*, 30 Hastings L. J. 1433, 1453 (1979); Clive M. Schmitthoff, *Social Responsibility in European Company Law*, 30 Hastings L. J. 1419, 1426 (1979). The idea of separate board functions also bears some resemblance to the very different proposals of Nader, Green and Seligman. See Ralph Nader, Mark Green, and Joel Seligman, *Taming the Giant Corporation* at 118-31 (Norton, 1976) (advocating creating the board as an independent monitor with specific social responsibilities and enhanced stockholder oversight).

By employment structure and compensation I mean (i) the hiring, compensation, and firing of top executives, (ii) the structure of employee compensation generally, with particular attention to noncash programs such as ESOPs and pension plans, and (iii) the supervision of the negotiation of collective bargaining agreements. These broad issues seem to present the greatest potential for the types of conflicts I describe below, and require a relatively low level of corporation-specific expertise. Most hiring and specific compensation decisions will, necessarily, be left to management for the reasons I describe below.

27. Short-termism is the predominant concern among contemporary reformers. See, for example, Coffee, 91 Colum. L. Rev. at 1282-83 (cited in note 19); Dent, 1989 Wisc. L. Rev. at 919-24 (cited in note 18); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. Pa. L. Rev. 1, 5-9, 23-28 (1987); Lorsch, *Pawns or Potentates* (cited in note 2); Monks and Minow, *Power and Accountability* at 251 (cited in note 18). An excellent statement of the problem (as well as an interesting theory as to its causes) is provided by Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. Rev. 137, 138-40 (1991).

An obvious relationship exists between the problem of short-termism and the corporate social responsibility debate. See, for example, id. at 200 (stating that "[c]onsidering the interests of . . . other constituencies is not only consistent with, but necessary for the long-term health of the corporation"); Stone, 71 Iowa L. Rev. at 568-73 (cited in note 5). This is another of the predominant reformist concerns that has sometimes framed the discourse. Fischel, 35 Vand. L. Rev. 1259 (cited in note 18); Manning, *A Taxonomy of Corporate Law Reform* (cited in note 18). Although I readily admit that my goal is enhanced responsibility, it seems to me that such responsibility can best be achieved within the limitations of the internal corporate framework by focusing on the problem of enhancing long-term corporate well-being. Compare Fischel, 35 Vand. L. Rev. at 1269 (cited in note 18) (stating that "[s]ubstantial overlap exists . . . between the pursuit of profit maximization and other social goals"). In fact, the clear implication of Lorsch's work, discussed in notes 121-33 and accompanying text, is that the two issues are directly related, a recognition that may unify the and competition, and demonstrates that the traditional model drains management's energies, diverts its attention from long-term planning, and results in the unjust imposition of the costs created by the model on constituents external to the traditional legal corporate structure. An important cause of this short-term focus is the stockholder-centric view imposed upon management by traditional corporate law and reinforced by the law-and-economics model. All other proposals suggest that longer-term management be encouraged by strengthening the bonds between the board and the stockholders.[28] My solution is to break these bonds and to recast the board of directors as a mediating body among the different corporate constituent groups.[29] In its new role as arbiter of asset distribution, the board would be charged with the duty to ensure that the corporation's assets are fairly distributed.[30] To make this possible, I propose eliminating stockholder elections and making the board, with certain limitations, a de jure self-perpetuating body.

In the course of developing this proposal, I will answer critics who fear that an unelected and broadly charged board is an unaccountable board, both by showing that their fears of managerial self-dealing (which is partly cured by my redefinition of the board's duties) are exaggerated and by introducing the principles and enforcement devices that will encourage the board to act in the corporation's interest. The end result of liberating the board from the stultifying constraints of the

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bases of social utility and social responsibility identified by Hurst as undergirding the legitimacy of American corporations. James W. Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1970* (U. Va., 1970).

28. This central approach of enhancing board responsiveness to stockholders appears to have some political appeal. After the Securities and Exchange Commission announced that it would delay action on reforming proxy rules to ease stockholder communication, Senator William Cohen introduced legislation to permit stockholder nomination of directors and enhance stockholder voting. Similar legislation is pending in both the House and Senate. *Shareholders Could Nominate Directors Directly Under Senate Bill*, Sec. Reg. & L. Report (BNA) 1703 (Dec. 6, 1991).

29. For purposes of discussion, I assume that the constituent groups that should appropriately receive directorial consideration are those which are identified by typical constituency statutes. See, for example, N.Y. Bus. Corp. Law § 717(b) (McKinney, 1989) (identifying current employees, "retired employees and other beneficiaries receiving or entitled to receive" corporate benefits, customers and creditors, and the communities in which the corporation does business). Analysis of the correctness of this legislative choice is beyond the scope of this Article.

30. European company law has progressed significantly towards enhancing the responsibility of corporate management to a wider variety of constituencies than the stockholders. Conard, 22 Mich. J. L. Ref. at 1286 (cited in note 24) (European Community law); Karmel, 57 Brook. L. Rev. at 89 (cited in note 23) (same); Roth, 30 Hastings L. J. at 1436-41 (cited in note 26) (European laws generally); Schmitthoff, 30 Hastings L. J. at 1431-32 (cited in note 26) (same); Clive M. Schmithoff, *Employee Participation and the Theory of the Enterprise*, 1975 J. Bus. Law 265, 265-66 (British law). A simple form of this balancing proposal was suggested by Schmitthoff. Id.

Wallman, 21 Stetson L. Rev. at 168-70 (cited in note 5), also argues that constituency legislation is likely to lead to more long-term corporate management. He argues that a "best interests of the corporation" standard similarly will cast the board in the role of balancing among competing constituent interests. Id. at 170.

traditional legal model should be to empower it to fulfill the organization's objectives in healthy competition with other organizations in the neoclassical world.

II. The New Board

It is the law of American corporations that the corporation's business is to be managed by, or at least under the direction of, its board of directors.[31] It is now a platitude that the reality is different, at least in the case of large and medium-size corporations.[32] In reality, management[33] manages and the board rarely acts in even a supervisory capacity.[34]

Recent evidence of the board's dormancy is provided by Myles Mace in a 1986 update of his classic study, *Directors: Myth and Reality*,[35] and to a lesser extent by Jay Lorsch in his book, *Pawns or Potentates*.[36] Mace identifies three functions commonly ascribed to corporate boards[37] and concludes that the typical board performs none of these functions.[38] Lorsch, who focuses on how well the board performs, rather than whether it has a role to perform, credits directors with performing more of the crisis functions that Mace believes they perform only in rare cases,[39] but also sees them as performing a very limited role.

In both studies, as well as others, the clear message is that boards

31. See, for example, Del. Code Ann. § 141(a) (1953); N.Y. Bus. Corp. Law § 701 (McKinney, 1961); Rev. Model Bus. Corp. Act § 8.01(b) (1985).

32. Mace, *Directors* at 39-42 (cited in note 18). See also *ALI Principles of Corporate Governance* § 3.01 at 107 (cited in note 1) (stating "[t]he management of the business of a publicly beld corporation . . . should be conducted by or under the supervision of such principal senior executives . . . as are designated by the board of directors"). Eisenberg, *The Structure of the Corporation: A Legal Analysis* at 140 (cited in note 2); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 Bus. Law 1477 (1984); Solomon, 76 Mich. L. Rev. at 583-86 (cited in note 25).

33. By "management" I mean the corporation's employees who are responsible for setting and implementing corporate policy, including those employees who may serve on the board of directors.

34. Both Lorsch, *Pawns or Potentates* at 97-167 (cited in note 2), and Mace, *Directors* at 39-42 (cited in note 18), conclude, although to differing degrees, that the board performs some function in crisis situations, although both agree that boards in no sense manage the corporation's business, and in fact are subordinate to management. It has been argued, however, that the board's presence serves a sort of checking function. Mace, *Directors* at 23.

35. Mace, *Directors*.

36. Lorsch, *Pawns or Potentates*.

37. The functions are (i) establishing basic corporate objectives, strategies, and policy, (ii) asking discerning questions of management, and (iii) selecting the corporation's president. Mace, *Directors* at 43.

38. Id. at 68.

39. Lorsch, *Pawns or Potentates* at 97-167.

fail to perform because they are co-opted by management.[40] This is true whether or not the board includes a significant number, or even a majority, of outside directors.[41] The reasons for this co-opting go well beyond the composition and socialization of boards (although these are real and observed phenomena).[42] Rather, they stem from the broad truth that the board and management perform coterminous functions, and everyone recognizes that management performs them better.[43]

The primacy of management is not evident from the legal structure of the corporation. Although some corporation statutes identify a role for officers,[44] most do not,[45] and instead treat them as optional components of corporate governance. Their existence and their duties are defined by the board, which is an integral component of the statutory scheme and which determines the number and type of officers and their specific duties.[46]

The reality of modern corporations reverses this statutory scheme,

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40. See, for example, Cox and Munsinger, 48 Law & Contemp. Probs. at 91-99 (cited in note 25); Solomon, 76 Mich. L. Rev. at 583-86 (cited in note 25); Comment, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 Harv. L. Rev. 1894, 1898-1900 (1983).

41. A recent report by the Conference Board, surveying 589 medium to large corporations, demonstrates tbat in 1989 the overwhelming majority of all manufacturing, financial, and nonfinancial service corporations had boards with a majority of outside directors. The time period of tbis report overlaps with tbat of Lorsch's survey. The Conference Board, *Membership and Organization of Corporate Boards*, Res. Report No. 940, at 9 (1990) ("*Conference Board*"). The Conference Board counted former employees as outside directors, but the Report also provides figures on outside directors with this treatment reversed so tbat former employees are counted as insiders. Even with this, however, the number of boards with a majority of outside directors, although significantly reduced, is substantial. Id. at 2.

42. Brudney, 95 Harv. L. Rev. at 610-13 (cited in note 2); John C. Coffee, Jr. and Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and Proposal for Legislative Reform*, 81 Colum. L. Rev. 261, 283 (1981); Cox and Munsinger, 48 Law & Contemp. Probs. at 91-99 (cited in note 25); Dent, 1989 Wisc. L. Rev. at 909 (cited in note 18); George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U. L. Rev. 96, 121-22 (1980). *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), presents an excellent example of a case in which the possibility of board co-option because of socialization was pervasive. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786-88 (Del. 1981), and *Clark v. Lomas & Nettleton Fin. Corp.*, 625 F.2d 49, 52-53 (5th Cir. 1980), are two cases in which courts expressly recognize the problem of structural bias.

43. Dent, 1989 Wis. L. Rev. at 909 n.158 (cited in note 18), seems to recognize tbe causal relationsbip. See also Solomon, 76 Mich. L. Rev. at 583-86 (cited in note 25); Comment, 96 Harv. L. Rev. at 1898-99 (cited in note 40). See also Noyes E. Leech and Robert J. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799, 1803-04 (1976). But see Robert J. Haft, *Business Decisions By the New Board: Behavioral Science and Corporate Law*, 80 Mich. L. Rev. 1 (1981) (surveying the literature on group dynamics, analyzing board bebavior in tbat light, and concluding that boards should be more active managers).

44. See, for example, Minn. Stat. Ann. § 302.A.311 (West 1985) (specifying certain duties of statutorily required officers but providing for further duties to be set forth in the cbarter, the bylaws, or by board resolution).

45. Rev. Model Bus. Corp. Act Ann. § 8.41, Statutory Comparison (1991). No statutes identify or describe roles for nonofficer employees.

46. See id. § 8.01.

leaving no meaningful role for the board.[47] The agency cost theorists have, with little success, attempted to cast boards in the role of monitors, whose existence reduces agency costs by ensuring managerial diligence and fealty.[48] But the heavy reliance of these theorists on the market as a primary disciplining mechanism leaves a modest role for the board as well,[49] a role insufficient to justify its importance in the corporate legal framework.[50] Moreover, these theorists have never satisfactorily answered the question of who will monitor the monitors.[51]

If corporate governance required no more than managing business operations, perhaps it would be time to recognize the board's obsolescence and to do away with it as an institution. But there is more to corporate governance, as can be seen by dividing the corporation's affairs into two major categories: (i) operational matters, and (ii) structural and distributional matters. While these two categories necessarily overlap,[52] they address different problems and perhaps require different

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47. This reality is described well in Haft, 80 Mich. L. Rev. at 1-3 (cited in note 43) and Solomon, 76 Mich. L. Rev. 581 (cited in note 25).

48. Fama, 88 J. Pol. Econ. at 288 (cited in note 4). The term "agency costs" is used to define the costs arising from the separation of functions within the corporation, including the cost incurred by stockholders in monitoring management, the cost of devices employed by management to guarantee its loyalty ("bonding costs"), and the cost of self-dealing that is simply too expensive to prevent. See William A. Klein and John C. Coffee, *Business Organization and Finance* at 160-63 (Foundation, 4th ed. 1990); Eugene F. Fama and Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. Law & Econ. 327, 327-49 (1983).

49. Harold Demsetz, *The Monitoring of Management*, in *Statement of the Business Roundtable on the American Law Institute's Proposal "Principles of Corporate Governance and Structure: Restatement and Recommendations,"* B-1, B-b (ALI, 1983); Fama, 88 J. Pol. Econ. at 288 (cited in note 4); Eugene F. Fama and Michael C. Jensen, *Separation of Ownership and Control*, 26 J. Law & Econ. 301 (1983); Fischel, 35 Vand. L. Rev. 1259, 1283-89 (cited in note 18).

50. Non-economists who favor a monitoring role for the board see its ultimate efficacy as modest. Melvin A. Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 Geo. Wash. L. Rev. 582, 596-98 (1984). Dent also seems to assume a monitoring role for the board, and claims only modest improvement from his proposal, which is not directed at enhancing monitoring so much as it is designed to make boards more responsive to stockholders. 1989 Wis. L. Rev. at 911 (cited in note 18). He does suggest that his proposal would enhance directors' incentives to monitor management. Id. at 912.

51. See Frank H. Easterbrook and Daniel R. Fischel, *Corporate Control Transactions*, 91 Yale L. J. 698, 701 (1982) (noting that "[f]ull time monitors become managers themselves, in all but name, and monitors who do not work full time lack both the incentive to watch carefully and the information to determine how well others are performing their tasks.") Fama's answer is the market. Fama, 88 J. Pol. Econ. at 288 (cited in note 4). Rock identifies monitor monitoring as a significant problem blocking the effective use of institutional investors to accomplish corporate governance reform. Rock, 79 Geo. L. J. 445 (cited in note 21). Gilson and Kraakman amply demonstrate this by adding yet another monitoring layer (which itself requires monitoring) to the corporate structure. Gilson & Kraakman, 43 Stan. L. Rev. 863 (cited in note 18). They argue that their new monitoring structure will not create significant agency costs, id. at 890-91, & n.86, but their reasoning seems unpersuasive given the history of the monitoring problem.

52. I deal with the issue and problem of overlap in more detail in notes 61-64 and accompanying text.

information levels and skills. A brief story will illustrate.

Greenacres Corporation is a medium-size public corporation engaged in the manufacture of IBM-compatible personal computers. Greenacres' capital structure consists exclusively of common stock, the shares of which are listed on the American Stock Exchange. Greenacres' board is fairly typical and includes three inside directors (one of whom is president and CEO), and five outside directors. The board meets monthly (except in August), and has a weekend-long retreat once every two years at a conference center near the company's headquarters.

Greenacres is at a critical point in its corporate development. Growth in the independent manufacture of IBM-compatible computers is likely to be small, especially in light of the recent decision of IBM and Apple Computers to work jointly to make their products compatible.[53] Software development (on which the company's research and development department has been working) seems to promise greater potential in terms of growth and profitability. Management wants to enter the software business and is considering two options: developing and marketing a product through a new subsidiary corporation, or acquiring an existing company and its employees. To pursue either option, management believes it will need greater financial resources than are available from the company's retained earnings and projected cash flow.

Greenacres has never paid a dividend to its stockholders and has issued no new stock since its initial public offering five years ago. In addition, the company's stock price has remained fairly static, rising and falling with the market for technology stocks generally. Finally, management has established a pension plan and modest ESOP to provide for the company's 300 full-time employees.

Two different, if ultimately related, types of decisions confront Greenacres. The first, dealing with the question of software development and the issue of acquisition versus internal growth, is a matter of business strategy and relates to the company's operating goals and methods for attaining them. The second type of decision, how the funds will be raised and what the relationship of new investors to the corporation's current stockholders will be, involves the company's capital structure and distribution of its assets. While the first set of decisions requires intimate knowledge of the company's business, the abilities of its employees, and the markets and industry in which it operates, the second set of decisions does not. The second set of decisions requires

53. Ronald Rosenberg, *IBM, Apple Take a Giant Step Into the Future,* Boston Globe 33 (Oct. 3, 1991); Carla Lazzareschi, *Rivals IBM, Apple Will Exchange Technologies,* Los Angeles Times A1 (Jul. 4, 1991).

some financial sophistication and an appreciation of the company's financial position, as well as a concern for balancing management's ambitions against the rights and concerns of corporate claimants.

Importantly, the first set of decisions provides relatively little opportunity for managerial malfeasance. Consequently, it does not require the rigorous oversight of an active board of directors. While management may, as a group, shirk its duties—a fact that would be more or less observable to an informed outsider, like an analyst—an active management will find little opportunity in the overall conduct of operations and corporate strategy for personal enrichment. For example, although managers might occasionally have the chance to usurp a corporate opportunity or engage in business relationships with the corporation, such events are likely to be rare.[54] More importantly, unlike decisions regarding either managerial compensation and perks or dividend policy, operational decisions are not intimately related to the distribution of the corporation's limited assets. Such decisions merely raise the possibility that the corporation will be deprived of potentially profitable opportunities rather than that constituent groups will be deprived of a portion of their rightful share of the corporation's assets.[55] Finally, and importantly (as I shall discuss later), legally, if not morally, validated self-dealing behavior is an aspect of corporate life.

By contrast, decisions dealing with capital structure and asset distribution[56] create significant conflicts of interest, not only between or among management, employees, and security holders, but also between or among current and future security holders and employees.[57] Because management always will depend upon the corporation for employment

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54. That this is true at the board level is supported by the Conference Board report, which indicates that, except for lawyers serving as directors, only a small minority of hoards in each category had directors who were employed by major customers, banks, investment banks, or suppliers of the corporation on whose board they served. *Conference Board* at 9 (cited in note 41).

55. See also Fischel, 35 Vand. L. Rev. at 1290 (cited in note 18) (stating that "[t]he importance of the derivative suit should not be exaggerated. . . . Management that consumes excessive leisure or is not sufficiently diligent in choosing projects, or otherwise does not maximize shareholders' wealth in any of an infinite number of ways short of fraud, has little to fear from the derivative suit").

56. Asset distribution often entails the distribution of costs as well. See Mitchell, 70 Texas L. Rev. at 579 (cited in note 2) (arguing that the law permits externalization of costs as a by-product of favoring stockholders). For example, a large distribution to stockholders may diminish the value of outstanding debt or a merger resulting in substantial stockholder gains may result in the termination of employees. Thus, by the concept of distribution of assets, I also mean to include the allocation of costs attendant upon such distributions.

57. I have analyzed elsewhere the types of conflicts that can occur within the corporation by dividing them (roughly) into operational and distributional conflicts, which I term vertical and horizontal conflicts. This division permits analysis of legal principles with a better understanding of the problems they are designed to address. Mitchell, 70 Texas L. Rev. at 579 (cited in note 2); Mitchell, 65 N.Y.U. L. Rev. at 1189-1215 (cited in note 4).

and financial well-being, these conflicts cannot be eliminated. Most obviously, management might try to expropriate an unfair share of the corporation's assets by excessive salaries, perks, or incentive compensation arrangements. Management may prefer a potentially dilutive issue of common stock to the acquisition of bank debt containing covenants restricting management's discretion, thus further dispersing share ownership and further entrenching itself. Highly compensated top management may also choose to underfund the company's pension plan to increase retained earnings, thus limiting its exposure to the discipline of financial markets. It may attempt an acquisition by issuing a new class of securities, raising the possibility that it could obscure the true cost of the acquisition and thus remain free from stockholder or market challenge.

In addition, once the securities have been issued, management may find itself in a position to benefit by recapturing some of the costs of those securities.[58] Management might prefer to retain earnings rather than pay dividends, even if profitable investment opportunities are lacking, in order to avoid the discipline of financial markets, or for a variety of other self-serving reasons.[59] If financing is obtained through the public issuance of debt, management will attempt to limit the indenture's covenants to a bare minimum, and may later attempt to decrease the cost of the debt by risk-taking or expropriating behavior that falls through the indenture's thin covenants.[60] Also, management may attempt to repurchase securities (including debt, preferred or common stock) on the market (for the ESOP or for retirement) when the price is depressed or when the corporation's business is in a slump that it expects to be temporary.

None of the decisions that give rise to this possible opportunism requires particular operational expertise. Rather, like capital structuring decisions, they require a reasonable understanding of financial principles, familiarity with the corporation's financial statements, and a basic sense of decency and fairness. The typical board of directors pos-

58. By stating the problem in this way, I am implicitly suggesting bad faith conduct in terms of the test developed by Steve Burton. Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. Rev. 369, 387-92 (1980) (developing a test for bad faith conduct in contract law as one party's attempting to recapture costs it has bargained away).

59. See Booth, 79 Cal. L. Rev. at 1057 (cited in note 17); Kraakman, 88 Colum. L. Rev. at 897 n.21 (cited in note 17) (discussing reasons managers might prefer to retain earnings). See generally Lawrence E. Mitchell and Lewis D. Solomon, *Corporate Finance and Governance: Cases, Materials and Problems for an Advanced Course in Corporations* at 680-712 (1992).

60. This is made easy by the judicial treatment of bondholders' rights. Mitchell, 65 N.Y.U. L. Rev. at 1174-77 (cited in note 4); Mitchell and Solomon, *Corporate Finance* at 272-342 (cited in note 59). For a discussion of the decline in covenant protection in modern indentures, see Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 Bus. Law. 413, 424-26 (1986).

sesses all of these characteristics.[61] Moreover, the board lacks management's financial dependence upon the corporation and thus is not subject to the same conflicts of interest,[62] except to the extent that members of the board have financial interests in the corporation—a problem easily eliminated—or, more importantly, identify socially and psychologically with management—a problem that is likely to be reduced dramatically by the second part of my proposal. The one remaining type of conflict to which directors ordinarily are, and under my new set of duties would continue to be, subject are what Professor Eisenberg calls "positional conflicts." These conflicts arise when directors are required to make decisions that might adversely affect their own incumbency.[63] In Part III of this Article, I resolve these potential conflicts by eliminating the possibility that they will occur.

Looked at in this way, the board can perform a very significant function in corporate governance. Whether as the initial planning body or simply as a meaningful check on management, the board of directors can have ultimate responsibility for determining the corporation's capital structure and for allocating its wealth. The modest understanding of finance, and the relatively small amounts of time such decisions require, as well as their ease of delegation to a small professional financial staff reporting to the board, fits the amount of time and the nature of the input that a generalist board composed largely of outside directors brings to the job. This division of duties also diminishes the need to monitor management by removing from management those decisions that are most susceptible to conflicts of interest.

Under such a scenario, the board is unlikely to be co-opted by management because its functions are qualitatively different from those of management, and thus the board is not dependent upon, or necessarily deferential to, management's expertise. For this reason, as well as to ensure board independence, I would prohibit present and former corporate employees from serving on the board. I would also prohibit directors from owning stock in the corporation to preclude the possibility of financial conflicts of interest with other stockholders. In addition, the external discipline of the federal securities laws should counteract any incentive management might have to withhold or falsify information necessary to the board,[64] although a modest development of state statutory and common-law principles will help to serve this goal. Moreover,

61. Lorsch, *Pawns or Potentates* at 30 (cited in note 2); Mace, *Directors* at 109 (cited in note 18).

62. See *Conference Board* at 9 (cited in note 41).

63. Eisenberg, 52 Geo. Wash. L. Rev. at 1472 (cited in note 50).

64. *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), illustrates the possible federal securities law consequences of giving withheld or falsified information to the board.

if necessary, the board could employ a very small financial staff to meet with management and analyze the corporation's financial needs.[65]

No proposal for governance reform is perfect. While my proposal goes a long way towards removing some of the major conditions that lead to board co-option and some of the opportunities for self-serving conduct from both management and the board, some possibilities for co-option will continue to exist. As Professor Brudney trenchantly put the matter in assessing the utility of independent directors: "No definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs . . . as, the persons whose compensation or self-dealing transaction he is asked to assess."[66] The problem is exacerbated by the remarkable homogeneity of boards,[67] a homogeneity that I attempt to limit in the self-perpetuating board described in Part III. These factors could, for example, continue to make it difficult for a board to limit the compensation of the corporation's CEO. However, once the functions and membership of the board and management are separated, the self-perpetuating board I describe in Part III should partially ameliorate the effects of this problem.

One objection to this proposal, creating doubts about its likely efficacy, may be that boards are charged under current law with precisely those duties, among others, that I want it to deal with exclusively. In fact, capital structuring and distributional issues are among those few aspects of corporate governance dealt with expressly in most corporations statutes[68] as a specific realm for the board—although the power is sometimes shared with stockholders. Thus, the argument would go, all my proposal does is to liberate management from board oversight in the corporation's operations, while retaining the status quo as to structural and distributional decisions.

This argument misconceives the nature of the board's co-option as well as the extent to which my proposal would empower the board to act as a meaningful independent governing body by liberating it from management's domination. In the first place, the evidence seems clear that boards are co-opted by management because they feel inferior to management in the overall governance of the corporation.[69] This co-option creates a boardroom atmosphere in which management board

65. According to the Conference Board report, a significant number of responding corporations already provide some staff assistance to the board. *Conference Board* at 37-39.

66. Brudney, 95 Harv. L. Rev. at 613 (cited in note 2).

67. Lorsch, *Pawns or Potentates* at 18 (cited in note 2); *Conference Board* at 10-12, Tables 10-13 (cited in note 41).

68. See, for example, 8 Del. Code Ann. §§ 151-174, 251-253, 263, 271 (1983).

69. Lorsch, *Pawns or Potentates* at 1-2 (cited in note 2); Mace, *Directors* at 185-86 (cited in note 18); Solomon, 76 Mich. L. Rev. at 583-86 (cited in note 25).

members, particularly the president or chairman, control both the flow of information to, and the agenda of, the board with respect to both operational decisions and structural and distributional decisions. While it certainly is possible that aggressive managers could continue to exercise some informational control over board members under my proposal, the absence of managers on the board and the clear demarcation of board and officer responsibilities would diminish this risk.

In addition, one reason the board is co-opted is its lack of time and expertise to deal with all of the complexities of modern public corporation business.[70] Structural and distributional issues are part of the overall package of managerial and supervisory responsibilities with which the board is charged, and thus exist somewhere in the morass of board duties. Separating out these relatively less company-specific, or at least more discrete, decisions would liberate the board to focus the time it devotes to these matters and to deal only with the information necessary to making an informed decision. If even this proves excessive, the board could create a small corporate office, answerable directly to the board—and perhaps even physically located away from corporate headquarters—to digest the relevant information and assist the board in its decision-making. This suggestion is considerably more modest, and therefore more manageable, than earlier suggestions to create a board staff to monitor operations.[71]

Again, no solution is perfect. Business life rarely presents the simplified dichotomy between operating and financing decisions that I have described thus far.[72] For example, the decision to retain earnings rather than pay dividends ideally presupposes the availability of profitable investment opportunities for the corporation. Under my model, management will be responsible for developing investment proposals and can, through the use of particular projections and discount rates, present optimistic information that leads the board to agree to retain earnings to management's benefit.[73] Of course nothing in my proposal is meant to release the board from its duty of care, including its duty of inquiry. This may serve as a check on management, although recent experience with the duty of care suggests that its sanctions serve as a weak incen-

70. Solomon, 76 Mich. L. Rev. at 583-86.

71. See Nader, Green, and Seligman, *Taming the Giant Corporation* at 121 (cited in note 26) (suggesting that boards should be staffed with "a trim group of attorneys, economists, and labor and consumer advisors").

72. Nevertheless, financial theory strongly suggests that investment and financing decisions ought to be kept separate. Mitchell and Solomon, *Corporate Finance* at 133 (cited in note 59).

73. See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 Am. Econ. Rev. 323, 323 (1986) (discussing reasons for management's retention of earnings.). See also note 58.

tive.[74] More to the point, however, legal rules have a limited ability to constrain persons who choose to act in bad faith. My proposal for a reconceived board would not prevent bad faith conduct. By eliminating most of the conditions that lead to co-option, however, it would significantly limit the board's automatic deference to management.

My proposal would leave management unsupervised in the corporation's operations, and thereby formalize the current effective absence of supervision. It might seem that board oversight of managerial decision-making should be strengthened rather than weakened. Such a response, however, would do nothing to alleviate, and possibly would increase, the problem of co-option. In order for boards to exercise meaningful oversight of corporate operations, they would have to obtain the information and ask the probing questions that they thus far have failed to do.[75] The fact that boards (including outside directors) have subordinated themselves to management under the current monitoring model, and the reasons they have done so,[76] strongly suggest that pursuing some form of this model will result in failure.

Moreover, while my proposal results in substantial board independence, it does not result in similar independence for management. A corporation often cannot undertake substantial new business without financing. The board's control over management's access to financing, including the corporation's retained earnings, will be an effective check on management.[77] Moreover, the removal of compensation and distributional decisions from management's purview is the removal of much of the temptation to self-deal. Finally, top management will be replaceable by the board and will be disabled from using financial manipulation,

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74. See James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 Bus. Law. 1207, 1243-45 (1988); Karmel, 57 Brook. L. Rev. at 73 (cited in note 23).

Although the issue is beyond the scope of this Article, the new duties of the board, if implemented as law, create the need for a reexamination of the strength and applicability of the business judgment rule to these board decisions.

75. Fischel calls the distinction between monitoring and management "more apparent than real," suggesting that monitoring requires at least as much knowledge of the corporation's business as running it. 35 Vand. L. Rev. at 1282 (cited in note 18).

76. See Cox and Munsinger, 48 Law & Contemp. Probs. at 85-131 (cited in note 25); Dent, 1989 Wis. L. Rev. at 883-84 (cited in note 18); Lorsch, *Pawns or Potentates* (cited in note 2); Mace, *Directors* (cited in note 18); Solomon, 76 Mich. L. Rev. at 583-86 (cited in note 25).

77.. This may be seen as sneaking in through the back door the balance of the board's current duties that my proposal seeks to take away from the board. This is not my intent; it arises from the obvious interrelationship between operating and financing decisions. To the extent it causes concern, it perhaps can be dealt with by requiring the board to finance—in some fashion—all management proposals, subject to a rationality and conflicts of interest test. The board's liability for the wisdom of such decisions might need to be adjusted accordingly, although the board's current exposure is so weak, see *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982), that no serious adjustment would need to be made.

accomplished through financial structuring and distributional decisions, to mask its successes and failures.

In short, I believe this proposal, unlike others, is directly responsive to the problems that have resulted in board passivity and inefficacy. In order for the proposal to work, however, the public and the board must reach a consensus on the overall purpose of public corporations, as well as the identity of those who are included within its structure. As a gapingly broad base line generality, virtually everyone can agree that the corporation exists to enhance the welfare of our society.[78] In practice, this has meant that corporations exist principally to increase stockholder wealth. I turn next to the failings of this precept in order to identify and describe the goals of the reconceptualized board.

III. Stockholder-Centrism and the Problem of Short-Term Focus

The problem of short-term managerial focus in American corporations is caused in large part by the legal and practical pressures on directors and managers to look exclusively to the interests of stockholders, resulting in managerial obsession with current profitability and stock price. In this section, I will first describe the processes by which legal principles and devices work to create this short-term focus, arguing that the unreality of the traditional corporate model underlies the problem. I will next look at the way the rise in institutional investor stock ownership is certain to exacerbate this problem of short-termism as long as the traditional model continues. I will next examine recent empirical evidence supporting the conclusion that directors believe that corporate management would be made more rational and effective by expanding directors' focus. I will conclude the section by arguing that the primary underlying rationale of the traditional model, preventing directorial self-dealing, is no longer a valid concern of legal or public policy.

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78. Justice Marshall in the *Dartmouth College* case established that this is the purpose for which all corporations are created. *Trustees of Dartmouth College v. Woodward*, 17 U.S. 250, 304 (1819); G. Michael Epperson and Joan M. Canny, *The Capital Shareholder's Ultimate Calamity: Pierced Corporate Veils and Shareholder Liability in the District of Columbia, Maryland, and Virginia*, 37 Cath. U. L. Rev. 605, 626 (1988); John H. Bryan, Jr., *The Corporation and the Executive in the Community*, 1987 Colum. Bus. L. Rev. 695, 696 (stating that "[t]he primary purpose of business—and of a corporation—is only, and simply, to serve society in the most efficient manner"). See David Millon, *Theories of the Corporation*, 1990 Duke L. J. 201, for an explanation of the historical manifestations of this precept.

A. *The Force of the Law and Stockholder Profit: A World of Black and White*

At this point in our legal history, there is no serious dispute over the proposition that corporate managers' duties are owed to the stockholders.[79] Although the traditional doctrinal formulation—which continues in the American Law Institute's Principles of Corporate Governance[80]—directs those duties to the corporation (either exclusively or in addition to the stockholders), the application of such duties reflects purely a stockholder-centric view.[81] As I have argued elsewhere, this view is compounded by the fact that enforcement mechanisms are available exclusively to stockholders, as well as the fact that stockholders are the sole voting constituents in the election of directors and the only constituents able to effect a change in control through the sale of the corporation.[82] Thus, it seems clear that any suggestions that the law, as currently formulated and applied, permits consideration of nonstockholder interests in any meaningful way can be put to rest. My point is not to rehash this argument. Rather, my intention is to show that this generally accepted bilateral model of corporate law is precisely the cause of directors' excessive focus on the short term.

As I suggested earlier, corporate law has eliminated the potential

79. Brudney, 95 Harv. L. Rev. at 602 (cited in note 2). Lorsch notes that some corporate lawyers have suggested that the law is broader than this, Lorsch, *Pawns or Potentates* at 53 (cited in note 2). However, no court, to my knowledge, has squarely endorsed the view that directors may consider the interests of other constituent groups without reference to stockholder profit in the general management of the corporation. Certainly there has been some motion in this direction. See, for example, *ALI Principles of Corporate Governance* § 6.02, at 547 (cited in note 1) (stating that "the board may [in evaluating takeovers] . . . have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders"). The proliferation of constituency legislation heralds the possibility of a much broader directorial view. Mitchell, 70 Texas L. Rev. at 588-610 (cited in note 2). However, the ALI principle is not yet law, see *ALI Principles of Corporate Governance* § 6.02 at 578, Reporter's Note 2, even in its rather modest formulation, and constituency statutes are too new to have been tested in a meaningful way. But see *Baron v. Strawbridge & Clothier*, 646 F. Supp. 690, 697 (E.D. Pa. 1986) (construing the predecessor to Pennsylvania's constituency statute); *Herald Co. v. Seawell*, 472 F.2d 1081, 1091-97 (10th Cir. 1972) (stating that directors who establish an employee stock option plan pursuant to Colorado law are protected by the business judgment rule even though the purchase of stock for the plan and the transfer of treasury stock to the plan caused the corporation to lose money).

For a recent, well-reasoned argument in favor of stockholder-centrism based on financial theory, see Henry T. C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. Rev. 277, 320-27 (1990).

80. *ALI Principles of Corporate Governance* § 2.01 at 69 (cited in note 1).

81. Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 Texas L. Rev. 865, 900-931 (1990). I have taken the term "stockholder-centrism" from Johnson. Id. Professor Millon notes that the doctrinal distinction between the corporation's interests and those of the stockholders "has never been explained," at least as a matter of Delaware jurisprudence. Millon, 1990 Duke L. J. at 255 (cited in note 78).

82. Mitchell, 70 Texas L. Rev. at 579 (cited in note 2).

internal complexity and turmoil of the corporation by limiting the definition of the corporation to two meaningful groups: stockholders and directors. It assumes that, absent restraint, directors (as humans) will act in their own best interests rather than in those of the stockholders, who lack power to protect themselves. Consequently, the law regulates conflicts that might arise between these groups by mandating that directors act in the stockholders' interests, thus creating a world of black and white. Under the rules defining this mandate, two courses of action are available to directors: action that enhances stockholder wealth, and action that does not. Dismissing for the moment the dormant duty of care,[83] actions that enhance stockholder wealth are consistent with directorial responsibilities. Actions that do not enhance stockholder wealth are not, and constitute self-dealing or some more subtle form of breach of fiduciary duty.[84] Except in the relatively limited (and currently unimportant) area of takeover defenses in Delaware, there is no middle ground.[85] The world is one of good and bad.

Thus is created the environment in which corporate governance occurs, a bilateral environment in which maximizing its own material well-being is presumed to be the goal of each side. The simplicity of this world permits a choice to be made, and that choice is made in the law by deeming the stockholders' interests to be the only ones that matter, through the fiction of calling stockholders the "owners" of the cor-

83. The dormancy of the duty of care as a meaningful check on directorial conduct, at least so far as the threat of actual liability is concerned, has been noted often, with the classic articulation in Joseph W. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 Yale L. J. 1078 (1968). Equally noted (although more recently) is the rush of state legislatures to provide statutorily authorized hold-harmless clauses for directors breaching their duty of care following *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), in which both the inside and outside directors of a Delaware corporation were held liable for damages following a finding that they had breached their duty of care. See generally Hanks, 43 Bus. Law. at 1207 (cited in note 74).

84. The business judgment rule gives directors substantial latitude within these parameters. *Joy v. North*, 692 F.2d 880, 885 (2d. Cir. 1982). Nonetheless, action taken within the boundaries of that rule is required to be in the best interests of the corporation, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), which, as I discuss in notes 86-97 and accompanying text, means the best interests of stockholders. Directorial discretion is thus directed towards the choice of means to achieve this goal rather than the goal itself, *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668, 684 (1919), although recent cases have suggested a questioning of this goal. See Millon, 1990 Duke L. J. at 251-61 (cited in note 78); Mitchell, 70 Texas L. Rev. at 579 (cited in note 2).

85. The middle ground in Delaware derives from the combination of the *Unocal* standard of judicially reviewing defensive tactics, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); Ronald J. Gilson and Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 Bus. Law. 247, 249-60 (1989), which expressly permits the board to consider the interests of other constituencies, and the opinion in *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1990), in which the court refused to interfere with the judgment of the board in resisting a hostile tender offer in the interests of the broader corporation, rather than exclusively in the immediate interests of the stockholders.

poration. As I have argued elsewhere,[86] this labelling technique has successfully resulted in the corollary that the interests of no group other than the stockholders is relevant to corporate law. Careful analysis reveals that the relationship between many of these other constituent groups and corporate managers exhibits the characteristics of a fiduciary relationship,[87] a proposition generally unacknowledged in corporate law.

In this world, it is essential both to the directors' survival and their freedom from litigation that they display themselves to be working in the stockholders' interests. Any other behavior is characterized as self-dealing (by which I mean all actions not taken in the stockholders' interests). Directors are punished for self-dealing by electoral removal, hostile takeovers, or derivative litigation. Although none of these is likely to happen to a particular board of directors, their aggregate pressure, at least theoretically, disciplines directors to act in the stockholders' interests.[88]

Unfortunately, characterizing directorial actions as stockholder wealth-enhancing or self-dealing is not so easy in specific cases. This is because the business world is not as orderly as the world of legal doctrine.[89] In the business world, actions may be taken that temporarily deprive the corporation of profit, or defer profit, in the interests of long-term gain. The long-term gain might be direct, in that enhanced earnings are anticipated as a result of a particular project, or indirect, for example, in the cementing of a relationship with an important supplier or customer.[90] These actions might result in lower share prices,[91]

86. Mitchell, 70 Texas L. Rev. at 579 (cited in note 2).

87. Id. See also Mitchell, 65 N.Y.U. L. Rev. at 1177-78 (cited in note 4). For my view of the general characteristics of a fiduciary relationship, see *Fiduciary Duty* at 1684-87 (cited in note 2).

88. In recent years the hostile takeover mechanism has been seen to he the principal disciplinary mechanism, particularly by those of the law and economics stripe. Easterbrook and Fischel, *Economic Structure of Corporate Law* at 171-74 (cited in note 11).

89. In fact, the history of corporate law largely is the history of judicial and legislative accommodation to the needs of an industrializing society. See Hurst, *Business Corporation* at 22-27, 39-40 (cited in note 27).

Wallman argues that one reason the stockholder-centric model fails is because of the diversity of different interests existing within a group of public stockholders. 21 Stetson L. Rev. at 173-77 (cited in note 5).

90. Stone notes that situations may often exist in which no "most profitable" alternative exists, or at least not clearly so. Stone, *Corporate Social Responsbility* at 588 (cited in note 5).

91. Assuming the existence of market imperfections answers those in the law-and-economics camp who would argue that the long-term advantages to the corporation from taking these actions, translated into corporate earnings, will be discounted by the market and impounded in the stock price such that the stock price will not in fact drop. Regardless of how one feels about the efficient capital market hypothesis, sufficient theoretical and empirical doubt exists to permit such an assumption to be made easily. See Booth, 79 Cal. L. Rev. at 1064-78 (cited in note 17); Kraakman, 88 Colum. L. Rev. at 898-99 (cited in note 17).

More importantly, the very real practical pressures on institutions to demand high current and probably will result in diminished net income. A sense of fairness may even motivate a board to interpret liberally a bond contract or a union contract, in a manner that might cost stockholders some wealth or forego some gain, in order to compensate for the harsh effects of a particular transaction or even to redress a contractual omission not intended or foreseen by either side.[92] Finally, cases exist in which self-dealing might be efficient, for example, as when a director who owns a general contracting business undertakes to supervise construction for the corporation as the least-cost provider.[93]

The difficulty is in evaluating whether this conduct is good or bad for the corporation.[94] The determination is more easily made, at least in an immediate way, from the perspective of the stockholders, for if stock prices or earnings drop, they will suffer an immediate decrease in wealth, leading to the conclusion that the board's conduct was bad. It may well be that, with full information, skill, and ability, stockholders would understand these decisions to be "correct" in a long-run economic sense or in an ethical sense, but stockholders are not in the same position as directors to evaluate these considerations. Consequently, stock prices and financial statements become a surrogate for directorial performance.[95] Given these facts, and the fact that distinguishing those actions that are bad from those that are neutral, at least, is difficult without significant information (or hindsight), directors have an incen-

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dividends, see notes 113-19 and accompanying text, coupled with the illiquidity of institutional positions, Coffee, 91 Colum. L. Rev. 1277 (cited in note 19), suggests that current distributions are the only relevant form of wealth-enhancement to institutional investors, and the assumption of market imperfections is unnecessary.

92. The ALI would permit boards to act from such fairness concerns without a demonstration even of long-run stockholder gain in a very limited variety of circumstances. *ALI Principles of Corporate Governance* § 2.01 at 69, § 6.02 at 547 (cited in note 1).

93. See, for example, *Talbot v. James*, 259 S.C. 73, 190 S.E.2d 759, 766 (1972) (Bussey dissenting).

94. This difficulty in separating the good from the bad is analogous to the difficulty of evaluating fiduciary breaches in terms of subjective motivation that has led courts to focus on objective considerations when deciding these matters. Compare, for example, *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 114-15 (Del. Ch. 1986) (holding that objective fairness rather than subjective intent or belief is the test).

95. Easterbrook and Fischel, two of the most fundamentalist adherents of the law-and-economics movement, view this obsession with share price as both descriptively and normatively correct. Frank J. Easterbrook and Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 Bus. Law. 1733, 1744 (1981). Of course this flows from their faith in the notion of efficient markets and properly discounted share prices. Id. at 1743. See also Stone, 71 Iowa L. Rev. at 569 (cited in note 5). As to financial statements, a great deal of recent criticism has been levied at accounting-based concepts of financial well-being. See, for example, Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies* (Wiley, 1990). In fact, cash-flow-based methods of valuation have achieved primacy in Delaware since they were permitted by the court in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). See, for example, *Cede & Co. v. Technicolor, Inc.*, 1990 WL 161084 (Del. Ch. 1990); *In re Shell Oil Co.*, 1990 WL 201390 (Del. Ch. 1990).

tive at the time actions are taken to make them appear to be as beneficial to stockholders as possible. In their voting and selling capacities, stockholders can bring significant pressure to bear on managers that instill in them an incentive to avoid demonstrably actions that in this world appear to be bad. This produces the well-known risk averseness of corporate managers,[96] and a focus on stock prices and earnings statements.

Thus, a predicate question to each corporate action necessarily is: How will it look to the stockholders? And as Lorsch demonstrates—and as I shall discuss shortly—one need not assume that management desires to avoid punishment to recognize the centrality of this question. Directors seem to believe that their legal duty is to the stockholders.[97]

This narrow legal model was hardly inevitable. Case law occasionally acknowledges a "community of interests" in the corporation,[98] and even a casual observer would readily realize that a corporation consisting exclusively of directors and stockholders is unlikely to be competitive.[99] At a minimum, the corporation requires employees, customers, suppliers, and the like for its survival. But corporate law does not recognize these groups as part of the corporation.

In fact, corporate law permits directors to externalize the costs of benefitting stockholders on other corporate constituent groups.[100] By creating the circumstances under which stockholder-centric behavior is the only rational strategy, and by providing avenues of attack for stockholders against boards who digress from the stockholder-centric model, the law permits, and even encourages, directors to externalize the costs of stockholder-centrism either by directly expropriating wealth from other constituents to benefit stockholders,[101] or by imposing the costs of enhancing stockholder profit on other constituent groups.[102] For exam-

96. For a discussion of the risk averseness of managers relative to stockholders, see John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 Geo. Wash. L. Rev. 789, 808 (1984).

97. Lorsch, *Pawns or Potentates* at 49 (cited in note 2).

98. See, for example, *Pepper v. Litton*, 308 U.S. 295 (1939). Stone presents a broader model, as does European company law. *Corporate Social Responsibility* (cited in note 5). See also note 26.

99. Compare Stanley, 19 Cambrian L. Rev. at 108 (cited in note 3). Stanley states that "[c]ompany law serves to legitimate and mask the relations involved in the mode of production. Because of its inherent artificiality the concept of corporate personality presents a false representation of reality." Id.

100. I develop the argument contained in this paragraph in more depth in Mitchell, 70 Texas L. Rev. at 579 (cited in note 2).

101. McDaniel describes this expropriation process in detail in Morey W. McDaniel, *Bondholders and Stockholders*, 1988 J. Corp. Law 205, 206-09. See also Morey W. McDaniel, *Stockholders and Stakeholders*, 21 Stetson L. Rev. 121 (1991).

102. See 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) (discussing the extent to which employees can be made to bear the cost of stockholder-centric behavior).

ple, boards can undertake highly risky transactions that hold the (remote) possibility of significant gains for stockholders but, as a consequence, diminish the value of outstanding bonds by creating risks for which their fixed interest rate does not compensate.[103] A board can also agree to sell the corporation to a highly leveraged purchaser with the knowledge that the purchaser will have to close plants and terminate employees in order to service or retire its debt.[104] Although some have argued that contracting processes suffice to protect these nonstockholder constituents,[105] others disagree.[106] Regardless of which side of the debate one comes out on, however, it seems odd to build a legal model of the corporation in such conflict with reality.

Why should corporate law be so different from corporate reality? Why should directorial duties be owed only to putative "owners,"[107] and why should such "ownership" be without corresponding public responsibility?

The answer lies in the way in which the corporation's conscience can be asserted through the board of directors, combined with the neoclassical assumption that individuals are self-interested utility maximizers. Put differently, centralized corporate management is a major reason for the public corporation's efficacy, but according to traditional corporate theory it will act in its own self-interest to the corporation's detriment unless it is restrained.[108] As I have suggested, that restraint is found in directors' duties to stockholders and in the mechanisms that have developed to enforce those duties.

Those who support the stockholder-centric model argue that

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103. The process of expropriation is well-described in Klein and Coffee at 235-37 (cited in note 48).

104. O'Connor, 69 N.C. L. Rev. at 1191-92 (cited in note 102).

105. See, for example, William W. Bratton, *The Interpretation of Contracts Governing Corporate Debt Relationships*, 5 Cardozo L. Rev. 371, 383-407 (1984); 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, 26-43 (1991); Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate Over Corporate Bondholder Rights*, 1989 Colum. Bus. L. Rev. 1.

106. See Johnson, 68 Texas L. Rev. at 891-98 (cited in note 81); David Millon, *State Takeover Laws: A Rebirth of Corporate Law?*, 45 Wash. & Lee L. Rev. 903, 913-26 (1988); Mitchell, 70 Texas L. Rev. at 632-39 (cited in note 2); Mitchell, 65 N.Y.U. L. Rev. at 1170, 1199 (cited in note 4); O'Connor, 69 N.C. L. Rev. at 1194-95, 1212-17 (cited in note 102). For a nice introduction to the parameters of the debate, see Marleen A. O'Connor, Introduction to Symposium, *Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 Stetson L. Rev. 1 (1991).

107. That some sort of ownership rigbt is a necessary predicate to the identification of a relationship as fiduciary has been long established. See *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988); Mitchell and Solomon, *Corporate Finance* at 395-402 (cited in note 59).

108. Agency cost theorists believe that management's self-interested conduct will redound to the benefit of stockholders. Easterbrook and Fischel, *Economic Structure of Corporate Law* at 4 (cited in note 11).

broadening the corporate legal model to include other constituents would destroy the ability to impose such restraints.[109] If directors were permitted to justify their actions by reference to the interests of another group, their ability to mask or justify self-dealing would be increased dramatically. In fact, case law and commentary is replete with assertions that directors would be put in an impossible position if they had to decide among the claims of competing groups and, conversely, that legal authorization to so decide would make management unaccountable.[110] This, at least in part, is responsible for the doctrinal limitations of preferred stockholders' preferences and creditors' rights to those clearly and expressly articulated in their contract, as well as the limited consideration given to the rights of employees.[111] Thus, the possibility of structuring corporate law to account for the real-world diversity of corporate constituents is, typically, dismissed summarily. Instead, directors are encouraged, through legal duty and self-protection, to demonstrate their allegiance to stockholder interests, which (as has been observed) is most effectively accomplished by attention to the bottom line. This behavior leads to an unremitting focus on the short term.

Commentators who look to institutional investors and their newfound power to improve corporate management overlook this important cause of short-term focus in favoring proposals that strengthen the role of institutional stockholders in corporate governance.[112] In fact, increased institutional involvement is likely to exacerbate the problem of short-termism. In the first place, institutional stockholders have fiduciary obligations of varying degrees of stringency to maximize profits for their beneficiaries.[113] All of the reasons that the stockholder-centric

109. See the discussion in Sommer, *Corporate Governance in the Nineties: Managers v. Institutions* (cited in note 18).

110. See Mitchell, *Constituencies Statutes*, 70 Texas L. Rev. at 586-610 (cited in note 2); Christopher Smart, Note, *Takeover Dangers and Non-Shareholders: Who Should Be Our Brother's Keeper?*, 1988 Colum. Bus. L. Rev. 301, 310-14 (1988); Roberta S. Karmel, *Duty to the Target: Is an Attorney's Duty to the Corporation a Paradigm for Directors?*, 39 Hastings L. J. 677, 696-97 (1988).

111. See, for example, *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584 (Del. Ch. 1986) (limited rights to preferred stockholders); *Dalton v. American Investment Co.*, 490 A.2d 574 (Del. Ch. 1985) (same); *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989) (bondholders' rights limited to contract); *Katz v. Oak Industries Inc.*, 508 A.2d 873 (Del. Ch. 1986) (same).

112. See Black, 89 Mich. L. Rev. at 529 (cited in note 22); Dent, 1989 Wis. L. Rev. at 919-24 (cited in note 18); Barnard, 69 N.C. L. Rev. at 1135 (cited in note 18); Coffee, 91 Colum. L. Rev. at 1282-83 (cited in note 19); Conard, 22 U. Mich. L. J. at 167-68 (cited in note 24); Gilson and Kraakman, 43 Stan. L. Rev. 863 (cited in note 18); Lipton and Rosenblum, 58 U. Chi. L. Rev. at 187 (cited in note 2) (at the time of quinquennial elections); Rock, 79 Geo. L. J. at 445 (cited in note 21).

113. Under the Investment Advisors Act, the advisor is required to act solely for the benefit

model in corporate law has led to short-termism are magnified in the case of institutional fiduciaries, whose performance is more clearly measurable (by portfolio value) than that of corporate management.

More important are the very real practical pressures on institutions to insist on maximizing short-term corporate profit. Pension funds, the largest class of institutional stockholders,[114] have recently experienced significant negative cash flow.[115] In both 1989 and 1990 the nation's largest funds made benefit payments that exceeded contributions to those funds by over $10 billion.[116] Further evidence exists that corporate pension funds have experienced negative cash flow for four consecutive years.[117] As contributions diminish, investment gains will therefore become an increasingly important source of cash flow.[118] In order to counter this negative cash flow, the logical institutional response will be to demand higher current returns from equity investments. The current legal model of corporate governance provides institutions with the power to make these demands felt by the board. The importance of rejecting this stockholder-centric model thus grows as institutions' need for current cash increases.[119]

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of her client, 15 U.S.C. §§ 80b-1 to 80b-21 (1988); Tamer Frankel, 2 *The Regulation of Money Managers* at 347-48 (1978). According to the Investment Company Act, a money manager must seek and obtain the best execution of a transaction for the investment company. 15 U.S.C. §§ 80a-1 to 80a-63 (1988); Frankel, *The Regulation of Money Managers* at 359-60. The Employee Retirement Income Security Act requires that a plan fiduciary discharge her duties with respect to the plan solely in the interest of the plan participants and beneficiaries for the exclusive purpose of providing benefits to them and defraying reasonable expenses of administering the plan. 29 U.S.C. § 1104(a)(1)(A) (1988). But see *Foltz v. U.S. News and World Report, Inc.*, 865 F.2d 364 (D.C. Cir. 1989) (holding that ERISA creates no exclusive duty of the fiduciary to maximize pecuniary benefits).

114. Brancato, *Institutional Investors* at Chart 1 (cited in note 22).

115. Peter Drucker predicted in 1976 that pension funds would experience negative cash flow by 1990. Peter F. Drucker, *The Unseen Revolution: How Pension Fund Socialism Came to America* at 75 (Harper and Row, 1976).

116. Sabine Schramm, *Managers Endure Stagnant Year*, Pensions & Investments 1, 1 (May 20, 1991) (with respect to the 200 largest defined benefit plans). A defined benefit plan provides a definite formula for determining the amount of a participant's pension; the employer's contribution is actuarially determined each year based on factors such as the number of plan participants, the age of plan participants, and the investment returns of plan assets. Joseph R. Simone and Practicing Law Institute, *Understanding ERISA: An Introduction to Basic Employee Retirement Benefits* at 14 (Practicing Law Institute, 1991).

117. Lori Miller, *Cash Flow Problems Worsen for Corporates*, Pensions & Investments 91, 91 (May 20, 1991).

118. Id.

119. The high turnover rate of institutional investors may also be evidence that institutions are focused on the short term. Turnover data of New York Stock Exchange-listed stocks shows that the turnover rate increased from 19% in 1955 to 55% in 1988. *The Impact of Institutional Investors on Corporate Governance, Takeovers, and the Capital Markets*, Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, No. 497, 101st Cong., 1st Sess. 33, 68 (1989). Similar findings were shown for the institutional holdings of

Thus the law is structured in a manner that drives managers to favor short-term stockholder wealth over long-term corporate welfare. The practical problems faced by institutional investors create a strong incentive for short-term management. Some commentators have suggested that the problem can be ameliorated by bridging or reuniting ownership and control.[120] As I have argued, such reunification or bridging would have the opposite effect.

B. *View From the Top: Directors' Views of Directors' Duties and the Problem of Corporate Irresponsibility*

The limited vision created by narrow legal principles is more than theoretical. It has had a significant real-world impact on directors' behavior. In his important book, *Pawns or Potentates: The Reality of America's Corporate Boards*, Jay Lorsch analyzes the results of an extensive survey of over 900 directors of the Standard & Poor's 400 companies.[121] Starting from the premise that effective directors need sufficient power to enable them to govern,[122] he evaluates whether that power in fact exists. Although correctly observing that the legal power to govern is only one type of such power,[123] he concludes that directors' ambivalence over the focus of their duties and their accountability to stockholders and other constituencies has led to an inability of corporate boards to reach a consensus on their most fundamental goals.[124]

Lorsch contends that the majority of directors correctly believe

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the top 50 corporations. Id. at 69. Turnover rates for the top investment advisors ranged from 400% to less than one percent. Id. at 33-34, 70-85.

Commentators disagree as to the significance of this data to the question of institutions' motivation. Brancato states that the data does not mandate a conclusion that institutional investors as a group take a short-term view, id. at 35, because turnover varies widely for equity portions of portfolios and by type of institutional investor. Therefore, turnover cannot be directly related to the holding period of any particular stock, and the measure of turnover does not include the more highly volatile derivative securities. Id. at 34-35. Brancato's answer to the question of institutional investor motivations varies with the profile of the individual institutional investor. Id. at 42-43. The Business Roundtable determined that the above-noted data indicate that an institutional investor's focus is short-term, id. at 95-96, especially in the case of pension funds. The Financial Executives Research Foundation, however, believes that pension fund asset allocation does not change significantly over the short term, that funds generally invest with a long-term view, and that active fund management and high trading volume does not necessarily indicate a high turnover rate. Id. at 198-99.

120. See, for example, Dent, 1989 Wis. L. Rev. at 881 (cited in note 18); Gilson and Kraakman, 43 Stan. L. Rev. at 876 (cited in note 18); Monks and Minow, *Power and Accountability* (cited in note 18).

121. Lorsch, *Pawns or Potentates* (cited in note 2). Lorsch discusses the methodology of his survey in the book's Preface.

122. Id. at 12, 13.

123. Id. at 13.

124. Id. at 37-38, 39-45, 49, 70, 94, 176, 187.

that their legal responsibility is to the stockholders.[125] Nonetheless, most directors apparently believe that their moral and business duties are owed to a much broader constituent group[126] with a long-term focus.[127] This belief conflicts both with directors' understanding of their legal responsibilities[128] and the reality of the law.[129] It also conflicts with the realities produced by the limited legal mechanisms of derivative litigation, voting, and selling that I already have described.[130] The justified and very real conflict between directors' beliefs about appropriate corporate governance and the narrow focus of the law leads, according to Lorsch, to a board fragmented, and thus disempowered, by confusion over its proper role.

Lorsch suggests that the directors' conflicts are heightened by the presence of institutional investors as significant stockholders. As he puts it, not only are institutions the least loyal of stockholders, but "[directors] have difficulty taking the institutional owner seriously, believing its goals are at odds with the corporation's longer-term interests and are too concerned with short-term gain."[131] Thus, rather than making directors more concerned about the overall health of corporations, the presence of institutional investors exacerbates the narrow short-term focus already in place.[132]

Among Lorsch's prescriptions is the clarification of directors' legal duties in a manner permitting them to act in accordance with the reality of American corporations.[133] Such a clarification and alteration would be consistent with the historical judicial and legislative policy towards boards, permitting them to act in the manner they see as most advantageous to the corporation.[134] Often legal policy and specific legal

125. Id. at 49.

126. Id. at 41, 43, 47. Empirical evidence that stockholders agree with this view is provided in Larry D. Soderquist and Rohert P. Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management*, 1978 Duke L. J. 819, 835-40.

127. Lorch, *Pawns or Potentates* at 38, 44-46. Dent claims that "[e]xperience confirms that managers do not exercise discretion for the good of society." 1989 Wis. L. Rev. at 893 (cited in note 18). Lorsch does not appear to claim that they do, but rather that they would like to. Moreover, the reason they are not observed to consider social interests is obvious—they view it as inconsistent with the legal obligations to the stockholders. Id. Dent states that managers manage in their own interests, an assertion that contradicts his statement that most managers act in good faith. Id. at 886.

128. Lorch, *Pawns or Potentates* at 11, 45.

129. See notes 79-81 and accompanying text.

130. See note 96 and accompanying text.

131. Lorsch, *Pawns or Potentates* at 46-47.

132. Id. at 187.

133. Id. at 176-87.

134. Compare William H. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 Stan. L. Rev. 1471, 1502 (1989) (noting the extent to which corporate doctrine embodies practitioners' values which embrace corporate law as facilitating "the activities

rules have been derived from the needs of corporate boards and business realities. The practice should be discontinued, and directorial independence restricted, only if there is an important countervailing policy reason. The reason that has arisen most prominently in debates over expanding directorial power is the need to prohibit self-dealing or, perhaps more broadly, to ensure that directors act in the corporation's interest.

C. *The Myth of Self-Dealing*

An enormous amount of scholarly, judicial, and legislative energy has been aimed at preventing corporate management from engaging in self-dealing, or at providing corporate and stockholder remedies when such self-dealing actually occurs.[135] The basis for this concern is, as I earlier suggested, the neoclassical assumption that individuals are self-interested wealth maximizers who, left to their own devices, will pursue their own goals. The aggregate effect of this competitive behavior, according to economic theory, will be to enhance social welfare through the creation and efficient allocation of wealth. This would not be true with respect to the internal workings of the corporation, because stockholders never would invest their money if managers were permitted to appropriate it to their own benefit. Thus, at least implicitly, the law acknowledges the collective aspect of the corporate individual by delegitimizing the usually applauded neoclassical behavior of one group of actors—the directors—by decreeing that it should act in the interests of another group—the stockholders.[136] Thus, directors and stockholders are united in pursuit of a common goal, and the corporate individual can take its place alongside other individuals in the competitive capitalist environment in pursuit of its own self-interest. In order for this model to succeed, and for the substantial advantages of the corporate form to be realized, the internal law of corporations must work to control management's natural tendency to act in its own interests. Thus, the restraint of managerial self-dealing long has been the central focus of corporate law.

Over time, the strength with which the law has interdicted self-

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of others in a regulated context").

135. By "self-dealing" I mean board and management behavior tbat does not result in stockholder wealth-maximization, as defined in note 95 and accompanying text. Although my specific focus in this subsection is on directors' transactions with the corporation, all self-dealing behavior is evaluated under the fairness test, discussed in note 147, tbat underlies the following analysis. Behavior governed by the business judgment rule is, by definition, not self-dealing.

136. In contrast, agency cost theorists argue that, within a proper structural context, managerial pursuit of its own self-interest will result in stockholder well-being. Fama, 88 J. Pol. Econ. at 292-305 (cited in note 4).

dealing has eroded, perhaps because of a pragmatic realization that the human drive towards self-interest is too strong to be restrained by legal rules, or perhaps because of the belief that not all self-interested behavior is bad behavior.[137] This change has been accompanied by a shift in the emphasis of directors' fiduciary obligations from a command to pursue the best interests of stockholders to a direction to provide fairly for the stockholders.[138] But the central focus of corporate law has, despite this evolution, continued to be the problem of self-dealing.

This "obsession" with self-dealing, as Lipton and Rosenblum put it,[139] is entirely unjustified, not only because it is reasonable to assume that most directors actually operate in a good faith desire to benefit the corporation they serve,[140] but also because the law has legitimated some kinds of self-dealing for at least sixty years.[141] Because this concern with self-dealing also may encourage directors to focus on actions that demonstrably benefit stockholders which, as I have suggested, has the effect of focusing directors on the short term, it is not only unjustified but also potentially harmful.

Self-dealing is an accepted norm of corporate law.[142] Twenty-five years have passed since Harold Marsh first outlined the evolution of

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137. See *Oberly v. Kirby*, 592 A.2d 445, 467 (Del. 1991) (stating that "[t]he fact that some interested transactions are permitted under our corporate law demonstrates that they are not inherently detrimental to a corporation").

138. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 721-22 (Del. 1971) (holding that the intrinsic fairness test applies to self-dealing transactions); *TransWorld Airlines, Inc. v. Summa Corp.*, 374 A.2d 5, 9 (Del. Ch. 1977) (same); *ALI Principles of Corporate Governance* § 5.02 at 277-79 (cited in note 1) (stating that "[t]he great weight of authority today permits a director or senior executive to enter into transactions with his corporation so long as he has acted fairly in his dealings with the corporation"); David M. Phillips, *Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine*, 32 Rutgers L. Rev. 184, 188 (1979) (asserting that fairness is the "dominant doctrine" governing interested transactions); William M. Fletcher, *Cyclopedia of the Law of Private Corporations* at 918 (Callaghan, 1931).

139. Lipton and Rosenhlum, 58 U. Chi. L. Rev. at 195 (cited in note 2).

140. Lorsch, *Pawns or Potentates* at 30-31 (cited in note 2). See also The Conference Board at 9 (cited in note 41) (suggesting that the overwhelming majority of boards consist of directors with little opportunity for conflicts of interest). The assumption is, it seems to me, perfectly justified by the continued existence of the public corporation. If bad faith conduct were the norm, our corporate system could not survive no matter what the legal rules were.

141. See notes 142-52 and accompanying text.

142. Brudney, 95 Harv. L. Rev. at 607-08 (cited in note 2) (stating that "[t]he latest learning contemplates that there are values to be served by permitting management to self-deal, but subjects all such transactions to the formal requirement that they be disclosed to and approved hy directors who are not interested in the transaction"); Nader, Green, and Seligman, *Taming the Giant Corporation* at 114 (cited in note 26).

The Delaware definition of self-dealing seems to include any transaction between a manager and the corporation. In *Sinclair Oil Corporation v. Levien*, 280 A.2d 717, 720-23 (Del. 1971), the court defined "self-dealing" as occurring when the fiduciary (in that case a parent corporation) received a benefit at the expense of the beneficiary (in that case a subsidiary). The consequence of a finding of self-dealing is that the fairness test will be applied. Id. Since any transaction will fiduciary rules prohibiting self-dealing from strict prophylactic measures applicable in cases where conflict of interest existed to rules permitting self-dealing upon the approval of disinterested directors, stockholders, or a court which determined that the transaction in question was fair.[143] The evolution is significant for several reasons. First, the old rules prohibited transactions in which the potential for self-dealing existed, whether or not self-dealing actually occurred.[144] This is consistent with the design of prophylactic rules which typically apply in the law to situations that present a strong possibility of harm, but in which the actual existence of harm is difficult to determine.[145] The new rules actually permit self-dealing itself, and not simply transactions that may give rise to it. Therefore, upon fulfillment of a relatively low

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involve different forms of consideration on each side, self-dealing, as defined by the court, apparently always will exist in transactions between a manager and the corporation. See, for example, *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594-96 (Del. Ch. 1986) (applying the intrinsic fairness test when the controlling stockholder allocated different forms of merger consideration to himself and non-controlling stockholders). Contrast *Transworld Airlines, Inc. v. Summa Corp.*, 374 A.2d 5, 13 (Del. Ch. 1977) (holding that the intrinsic fairness test applied when a parent deprived its subsidiary of the power to bargain over contracts with third parties); *Summa Corp. v. Trans World Airlines, Inc.*, 540 A.2d 403, 406-07 (Del. 1988) (stating that "[i]t is well established . . . that one who stands on both sides of a transaction has the burden of proving entire fairness. . . . In the absence of arm's-length bargaining . . . this obligation inheres in, and invariably arises from the parent-subsidiary relationship."). But compare *In re Reading Co.*, 711 F.2d 509, 518 (3rd Cir. 1983) (suggesting that whether an arrangement constitutes self-dealing depends on the proportionality of burdens and benefits).

Of course the self-dealing nature of such a transaction can be cured by the use of an independent bargaining agent, such as a board with independent directors or an independent board committee. See, for example, Del. Code Ann. § 144 (1983); N.Y. Bus. Corp. Law § 713 (McKinney, 1986); Rev. Model Bus. Corp. Act. § 8.62 (1985). The importance of independent directors in sanitizing conflict of interest transactions was highlighted during the takeover wars of the 1980s. Mitchell and Solomon, *Corporate Finance* at 791 (cited in note 59). In the absence of such an independent bargaining agent, the only question that remains, and the one which is designed to distinguish acceptable self-dealing from that which is unacceptable, is whether the transaction was fair.

143. Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 Bus. Law. 35 (1966). The statutory formulation permitting self-dealing upon compliance with specified procedural prerequisites (including, in some cases, the substantive prerequisite of "fairness") is exemplified by Del. Code Ann. § 144 (1983); Rev. Model Bus. Corp. Act §§ 8.61, 8.62 (1985); N.Y. Bus. Corp. Law § 713 (McKinney 1986); *Tenzer v. Superscope, Inc.*, 39 Cal. 3d 18, 702 P.2d 212, 220-21 (Cal. 1985); *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66, 75 (Cal. 1952); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 68-70 (D.N.J. 1974); *Fliegler v. Lawrence*, 361 A.2d 218, 221-24 (Del. 1976); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983); *Rivercity v. American Can Co.*, 600 F. Supp. 908, 920-22 (E.D. La. 1984) (applying Louisiana law).

144. Marsh, 22 Bus. Law. at 36-39.

145. For classic applications, see *Globe Wooden Co. v. Utica Gas & Electric Co.*, 224 N.Y. 483, 121 N.E. 378 (1918); *Talbot v. James*, 259 S.C. 73, 190 S.E.2d 759 (1972). See also Edward Brodsky and M. Patricia Adamski, *Law of Corporate Officers and Directors: Rights, Duties and Liabilities* § 3.01 (Callaghan, Supp. 1991) (asserting that the strict rule removes all temptation for directors to deal with their corporation, thus protecting the corporation from the danger that the director would secure an undue advantage for himself at the corporation's expense).

threshold of disinterested approval[146] or fairness,[147] directors can deal adversely with their corporations.

Moreover, the "fairness" standard significantly dilutes the implied standard under the old formulation, which treated self-dealing as inherently bad. This observation leads to another significant aspect of the evolution: When self-interested behavior by directors was not absolutely proscribed, it became, at least at some level, morally acceptable. Although the new rules continue to prohibit the most egregious self-dealing, that which is demonstrably unfair to the corporation or the stockholders,[148] the obligation of directors to act in the best interests of the corporation and its stockholders is replaced with a much lower duty of fairness.

This validation of self-dealing has been accomplished through the statutory law of most jurisdictions.[149] The ALI has enshrined it in its

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146. The determination of whether a director is disinterested tends to he quite formal and objective and disregards subjective considerations or problems of structural bias. See, for example, *Grobow v. Perot*, 539 A.2d 180, 190 (Del. 1988); Rev. Model Bus. Corp. Act § 8.61(d) (1985). Consequently, the requirement of disinterested director approval is not terribly strenuous.

147. "Fairness" is a relatively low level of fiduciary conduct. See *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49, 54 (5th Cir. 1980); Note, *Suit for Breach of Fiduciary Duty Under Rule 10b-5 After* Santa Fe Industries, Inc. v. Green, 91 Harv. L. Rev. 1874, 1876 (1978) (stating that fairness is a low-level test); Fletcher, *Cyclopedia* at 915 (cited in note 138) (indicating that the consensus of commentators believe that the fairness standard is not effective). Contrast Ahmed Bulbilia and Arthur R. Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 Notre Dame L. Rev. 201, 223-26 (1977) (noting the weaknesses of the fairness test); *ALI Principles of Corporate Governance* § 5.02(a)(2)(B) at 277, 320-22, Reporter's Notes 6, 7 (cited in note 1); *Shlensky v. South Parkway Bldg. Corp.*, 166 N.E.2d 793, 805 (Ill. 1960) (stating that it is useless to analogize or distinguish circumstances of this case to those cited by the parties in light of the infinite factual variations affecting fairness of disputed transactions in each case). In *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983), the Delaware Supreme Court defined fairness in terms of fair dealing and fair price, the former requiring full disclosure, and considerations of timing, initiation, structure and the like, and the latter requiring "all relevant factors: assets, market value, earnings, future property, and any other [relevant] elements." Although anticipated as a strong duty, see, for example, id. at 709 n.7 (suggesting that replicating an arms'-length bargain, with each party exerting full bargaining power, through the use of an independent directors' committee, creates strong evidence of fairness), in application it is not terribly strenuous, compounded by difficult problems of valuation, and certainly much weaker than a prophylactic or other standard requiring absolute fiduciary loyalty. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988) (suggesting that fairness has two aspects: (i) fair dealing, which involves the initiation, structuring, negotiation, and candor regarding a transaction; and (ii) fair price, which mandates a director be committed to obtaining the highest price reasonably available to the shareholders in an action for corporate control).

148. Fiduciary rules often are stated in terms of the corporation's interest. See note 79. The statement in the text is not meant to contradict my earlier observations regarding the equation of the stockholders' and corporation's interests.

149. Rev. Model Bus. Corp. Act Ann. § 8.61 (1985). The ALI reports "safe harbor" statutes for directors' transactions with the corporation to have been adopted in 38 states. *ALI Principles of Corporate Governance* § 5.02 at 312-13, Reporter's Note 1 (cited in note 1). See also Ernest L. Folk, Rodman Ward, Jr., and Edward P. Welch, *Folk on the Delaware General Corporation Law* §

Principles of Corporate Governance,[150] and has moved it even further by applying similar standards not only in the traditional area of directors' transactions with the corporation, but also to the personal use by directors of corporate assets, directors' competition with the corporation, and the doctrine of corporate opportunities.[151] In each of these cases, disclosure by the self-dealing director, as well as disinterested approval, fairness, or both,[152] validates the act of self-dealing.

My present purpose is not to take issue with this validation of self-dealing.[153] My point, and one that is critical to meaningful corporate governance reform, is that the time has come to be realistic about self-dealing. We have accepted it as a part of corporate life. An ardently-voiced objection to loosening directors' constraints on the ground that it will open up a multitude of horizons for self-interested behavior appears at this stage in our development to be hypocrisy. If we permit directors to engage in self-dealing upon the approval of their colleagues, it seems silly to be concerned with giving them more flexibility to manage the corporation.

Nor do the positional conflicts of directors, identified as such by

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144.1 (Little, Brown, 1988) (stating that "[a]lmost all jurisdictions now have interested director statutes that are very similar to and in some cases identical to section 144").

150. *ALI Principles of Corporate Governance* Part V at 263-515 (cited in note 1). The ALI in this Part subtly acknowledges the change in fiduciary standard by calling what once was the duty of loyalty the "duty of fair dealing." Although the ALI explains this change as made to distinguish cases of fiduciary self-dealing from those involving other conflicts of interest, id. at 1, Introductory Note, it nevertheless accurately reflects a shift in the standard from loyalty to fairness.

The ALI offers a somewhat watered down statutory formulation permitting self-dealing, including disinterested director approval (or shareholder approval) and the possibility of a reasonable belief that the transaction was fair (or did not constitute waste). Id. § 5.02 at 312-13. A stronger result may be obtained by those cases interpreting typical statutes, sucb as New Jersey's or California's, as inclusive of fairness. See, for example, *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 65-68 (D.N.J. 1974); *Remillard Brick Co. v. Remillard-Dardini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66, 75 (1952). On the other hand, failure to disclose is fatal under tbe ALI Principles, regardless of fairness. *ALI Principles of Corporate Governance* § 5.02 (cited in note 1). See also, for example, *State ex. rel. Hayes Oyster Co. v. Keypoint Oyster Co.*, 64 Wasb. 2d. 375, 391 P.2d 979, 983-87 (1964); Talbot v. James, 259 S.C. 73, 190 S.E.2d 759, 768 (1972).

151. Id. In fairness, this extension is quite consistent with the common-law principles that otherwise govern in these areas. *Ellzey v. Fry-Puff, Inc.*, 376 So.2d 1328, 1332 (Miss. 1979) (remand for factual determination whether the director can justify his action by showing full disclosure of material facts and transaction ratified, or inherent fairness); *Miller v. Miller*, 301 Minn. 207, 222 N.W.2d 71, 82 (1974) (even though court found that the directors did not usurp corporate opportunity, court would find transaction sanitized because the directors fully disclosed material facts to the board and the directors acted with the board's acquiescence, if not with its approval).

152. *Scott*, 386 F. Supp. at 44; *Remillard Brick Co.*, 241 P.2d at 66.

153. But see Mitchell, 138 U. Pa. L. Rev. at 1680-81 (cited in note 20) (criticizing the dilution of fiduciary standards in the context of close corporations). I also examine and strongly criticize the fairness standard in a forthcoming article.

Melvin Eisenberg[154] and highlighted by the tender offer decade,[155] change much with respect to this observation. While Eisenberg argues—correctly, I believe—that "core structural rules" and "core fiduciary rules" addressing positional conflicts should be mandatory,[156] the rules that have developed provide directors with a great deal of latitude in resolving these positional conflicts in their favor.[157] For example, the old—but still current—learning on proxy contest reimbursement gives incumbent management the ability to protect its position by using corporate funds and processes.[158] While at the extreme this ability is checked,[159] enormous latitude remains.[160] In the more recent area of takeover defense law, although some jurisdictions view defensive tactics more strictly, the law of Delaware insulates the incumbents from changes in control. That insulation is enhanced in those states that have adopted some form of antitakeover statute.[161] In the general area of voting rights, recent case law has eased the conditions under which

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154. Melvin A. Eisenberg, *The Structure of Corporate Law*, 89 Colum. L. Rev. 1461, 1471-72 (1989) (defining "positional conflicts" of interest, in contrast to "traditional conflicts of interest," as resulting from managers' interests "in maintaining and enbancing their positions even at the shareholders' expense").

155. The essential, and obvious, problem arising from unwanted tender offers is that directors might act to protect their own status rather than the interests of the corporation or its stockholders. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (noting the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

156. Eisenberg, 89 Colum. L. Rev. at 1480-81 (cited in note 50).

157. See, for example, *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1142-55 (Del. 1989); *Salant Acquisition Corp. v. Manhattan Industries, Inc.*, 682 F. Supp. 199, 202 (S.D.N.Y. 1988); *Icahn v. Blunt*, 612 F. Supp. 1400, 1406-07 (W.D. Mo. 1985); Henry N. Butler, *Corporate-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 Wis. L. Rev. 365, 369-76; Mitchell and Solomon, *Corporate Finance* at 892-95 (cited in note 59) (listing and identifying by type state antitakeover statutes empowering corporate boards to resist unwanted takeovers).

158. See, for example, *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 340-45 (Del. 1983); *Street v. Laclede-Christy Co.*, 409 S.W.2d 691, 693-94 (Mo. 1966); *Rosenfeld v. Fairchild Engine and Airplane Corp.*, 309 N.Y. 168, 128 N.E.2d 291, 291-92 (1955); *Steinberg v. Adams*, 90 F. Supp. 604, 606-07 (S.D.N.Y. 1950) (applying Delaware law); *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 171 A. 226, 227-30 (Del. Ch. 1934); Lewis Loss and Joel Seligman, *Securities Regulations* at 860 (Little, Brown, 2d ed. 1961).

159. *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 654-55 (Del. Ch. 1988) (prohibiting a board from precluding an unwanted takeover by increasing the board size and filling vacancies in the form of a hostile consent solicitation); *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 885-87 (6th Cir. 1986) (requiring that corporate advantages be made available to challengers as a condition to management's use).

160. See *Stahl v. Apple Bancorp.*, 579 A.2d 1115, 1119-23 (Del. Ch. 1990) (permitting a board to reschedule an annual meeting in the face of a hostile takeover/proxy contest after the record date already had been set); *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437, 438-39 (Del. 1971); *Aprahamiam v. HBO & Co.*, 531 A.2d 1204, 1205-08 (Del. 1987).

161. The most famous of these statutes is the Pennsylvania act. See 15 Pa. Cons. Stat. Ann. §§ 1721, 2551, 2561, 2571, 2581 (Purdon 1990). See generally Robert H. Winter, et al., *State Takeover Statutes and Poison Pills* (Supp. 1990).

directors can affect the timing of important stockholder votes, including votes regarding the election of directors.[162] Finally, in the derivative suit area, case law firmly puts the progress of most derivative actions in the hands of the board.[163]

The fact that incumbent directors have firm control over their corporations' proxy machinery—subject to a relatively low threshold requirement of truthful disclosure—reinforces this reality,[164] as does the increasing ability of directors to prevent courtroom challenges to their actions by dismissing derivative suits.[165] Thus, even with respect to positional conflicts, the law has consistently demonstrated less than ardent concern over the possibility of directorial entrenchment. In fact, the law seems to encourage it. With respect to this central issue of those who oppose greater directorial discretion, the battle already has been lost.

D. Conclusion

The problem of short-term corporate focus that has been at the center of recent debate on corporate governance reform has been caused directly by the artificial bilateral structure of the corporation that attempts to organize the collectivity around the traditional concerns of law designed to regulate transactions and relationships between individuals. In terms of the current discourse, the central failing of American corporations has been caused by the stockholder-centric structure. When the problem is seen in this light, the law-and-economics nexus-of-contracts and agency-cost approaches can be dismissed on the mere observation that they replicate, as a normative matter, this bilateral, stockholder-centric structure.

Our inability to create a more realistic legal model of the corporation has been caused by the fear that liberating the directors from the shackles of the traditional model will cause them to act solely in their

162. See *Stahl*, 579 A.2d at 1121-22.

163. Deborah A. DeMott, *Shareholder Derivative Actions: Law and Practice* § 5.03 (Wilmette, Supp. 1991) (discussing a variety of judicial approaches to boards' control over derivative litigation).

164. Compare Lucian A. Bebchuk and Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal. L. Rev. 1073, 1074 (1990) (suggesting that because of wide dispersal of shareholdings, management's only real threat from stockholder voting is in the case of a proxy contest); Dent, 1989 Wis. L. Rev. at 903 (cited in note 18) (stating that management controls proxy voting). Contrast Eisenberg, *Structure of the Corporation* at 99 (cited in note 2) (asserting that the law does not give management "virtually exclusive access" to proxy machinery).

165. Compare *Grobow v. Perot*, 539 A.2d 180, 183-89 (Del. 1988) (narrowly defining the circumstances under which a demand on the board in a derivative suit will be excused), with *Kamen v. Kemper Financial Services, Inc.*, 111 S.Ct. 1711 (1991) (holding that the determination of whether a demand on a board required as a precondition to a stockholder derivative suit is a matter of state law).

own self-interest and to the detriment of the corporation. Thus, enormous energy has been expended on shoring up the traditional model by a series of fiduciary rules, now weakened to virtual inefficacy. Once we recognize that the substantial dilution of those rules has not in fact led to wholesale directorial theft, but rather has acculturated "fair" self-dealing, we can reconceptualize the basic model on more sensible and realistic terms.

IV. The Corporation Reconstructed: The Board as Mediator

I have demonstrated thus far the extent to which traditional and economics-based corporate theory ground the public corporation firmly in the traditional model of bilateral relationships based upon correlative rights and duties as well as neoclassical economics' assumptions about human behavior. I have argued that the assumptions upon which this structure was built, as well as those upon which it today is justified, result in the denial of the possibility of cooperative coexistence within a collective structure and the artificial exclusion from corporate law concern of a variety of constituent groups upon which the corporation depends for its survival and success. Moreover, I have suggested that the artificiality of corporate structure requires directors to repress their best business instincts by requiring an exclusive focus on stockholder concerns and, as a practical correlative, on short-term performance. What I have not yet done, and now will do, is use these observations to reconstruct the corporation into a collectivity that can overcome the problems of directorial dormancy, short-term focus, and, ultimately, social irresponsibility.

My starting point is the newly-charged board I described in Part I, a board whose members and duties are distinct from, and independent of, those of management, and which is responsible for those aspects of corporate governance most easily accomplished by a part-time body and most in need of protection from conflicting interests: the capital structure of the corporation and the distribution and allocation of corporate assets and costs, including the hiring and compensation of executive employees. In suggesting this focus of the board, I argued that the law's concern with managerial self-dealing could be diminished significantly by removing from operating management's control those decisions that present the greatest conflicts of interest. I acknowledged, however, that this did little to remove the possibility of positional conflicts of interest, in which the board of directors might be tempted to make structural or distributional decisions in a manner that best protected its own incumbency, and which are a significant factor in perpetuating short-term focus. Therefore, before moving on to the broadened focus of the board, I will deal with the problem of positional conflicts.

Positional conflicts arise because the stockholders have the power to replace the board, either through the electoral process or by sale of the corporation's stock to a single owner who can then use the electoral process to replace the board.[166] My proposal is simple, though radical, and is designed not only to remove the possibility of positional conflicts but also to establish the conditions necessary to permit the board to take a broader, long-term view of the corporation's interests. My proposal, in sum, is to eliminate the electoral process altogether.

Under my proposal, stockholders would no longer have the right to vote. This proposal, although radical, is not new, having been suggested (hypothetically) by Bayless Manning in 1958, in a model in which shares of stock would be much like voting trust certificates, with the board self-perpetuating much like voting trustees.[167] Thus, the proposal eliminates the possibility of positional conflicts by eliminating the condition—stockholder voting—that makes them possible.

Before further analyzing this proposal and arguing that it is an important component of ensuring corporate management in the long-term, a few preliminary details must be discussed. If stockholders are not to elect directors, one might wonder how the directors are to be selected. The solution is reasonably simple: the board selects the board. Public corporations rarely begin as such. Rather, they more typically begin life as close corporations and are brought public at some point in their existence to fulfill the need for additional capital, liquidity of stock, or for a variety of other reasons.[168] Obviously, when the corporation is brought public, it already has a board of directors. Even a corporation that begins operations as a public corporation must be formed with an incumbent board of directors prior to the commencement of a public offering. Thus the board is, in a real sense, *a priori* the public corporation.

The boards of most close corporations going public, however, are likely to consist of managers and stockholders.[169] As I suggested in Part

166. Eisenberg, 52 Geo. Wash. L. Rev. at 1472 (cited in note 50).

167. Manning, 67 Yale L. J. at 1490 (cited in note 18). The fact that boards are already largely self-perpetuating as a *de facto* matter is supported by the Conference Board report, which shows the median term of directors' service to be nine years. *Conference Board* at 21 (cited in note 41). Terms of service might be longer but for the combination of the relatively advanced ages of directors and the fact that 629 of the responding companies have mandatory retirement policies. See id. (listing median ages and percentage of corporations having mandatory retirement policies). The report also identifies a "dramatic movement" away from one-year board terms to staggered three-year terms. Id. at 16-17. The ages, gender, and race of board members support the conclusion that boards also self-replicate in selecting new directors. Id. at vii, 3-4, 16-17.

168. The advantages of "going public" are summarized in Carl W. Schneider, Joseph M. Manko, and Robert S. Kant, *Going Public: Practice, Procedure, and Consequences*, 27 Vill. L. Rev. 1, 3-4 (1981).

169. This is inherent in the generally accepted definitions of close corporations. See, for example, *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505, 511 (1975) (giving defini-

II, for the newly-revitalized board to work effectively, it should consist of no managers or stockholders at all. Therefore, prior to going public, the board would have to replace itself with a group of directors who are neither managers nor stockholders, thus severing the board from management and ensuring that the directors lack financial conflicts of interest as stockholders.[170] Because the board would be in a position to replace itself, it would be far less likely to feel allegiance to management, and its independence of management would then be complete. And the board, once in place, would perpetuate itself by means of the currently-extant expedient of permitting boards to fill vacancies that arise.[171]

Although I have attempted to eliminate the circumstances that typically give rise to self-interested directorial actions, no guarantee exists that such actions will not occur occasionally. While the broadened duties I will later suggest—together with the derivative suit mechanism and the traditional board duties of loyalty and care—are designed to provide some discipline for directors, circumstances may present themselves that require the removal of directors. Since elections for directors will no longer be held, a method must be provided to permit the removal of directors whose misfeasance or nonfeasance is detrimental to the corporation. Such a method already exists in statutory provisions providing for removal of directors for cause.[172] That power typically is provided to stockholders, as the corporate constituent group empowered to elect directors.[173] But this power can be broadened to include all of those constituent groups that are included within the new corporate structure. And while the power typically is exercised at meetings, it seems at least as efficacious, if not more so, to provide for the exercise of this power through judicial processes, perhaps as part of the expanded litigation mechanism I will next describe. Thus, directors who fail to exercise their responsibilities, or who act against the interests of the corporation in a manner constituting cause (a term that has been given meaning in the case law but can be statutorily enacted[174]), can be

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tions of close corporations).

170. Alternatively, but less likely, the directors could give up their managerial positions and remain on the board. In order to remain as directors, however, they will have to relinquish all of their stock, see note 64 and accompanying text, which further supports the likelihood that they will retain their management positions rather than their board positions.

171. See, for example, Rev. Model Bus. Corp. Act § 8.10 (1985); N.Y. Bus. Corp. Law § 705 (McKinney 1986).

172. See, for example, Del. Code Ann. § 141(k) (1983); Rev. Model Bus. Corp. Act § 8.08 (1985); Calif. Corp. Code § 303 (West 1990).

173. See note 172.

174. For cases discussing the meaning of "cause" for director removal, see *Campbell v. Loew's Inc.*, 134 A.2d 852, 860-61 (Del. Ch. 1957); *Alaska Interstate Co. v. McMillian*, 402 F.Supp 532, 580-81 (D. Del. 1975); *Williams v. Queen Fisheries, Inc.*, 2 Wash. App. 691, 469 P.2d 583, 585-

removed by a court in an action brought on behalf of the corporation by any member of a constituent group.[175] Perhaps such directors could also be removed for cause by the other directors, as some corporations statutes now provide,[176] with an appeal by the subject director to the appropriate court.

Some might object to the potential increase in costs and litigation that this proposal could create. These consequences are unlikely to occur. Director removal is in fact rarely litigated.[177] Given the documented proclivity of stockholders to reelect incumbents,[178] this hardly seems due to the fact that stockholders instead target certain directors to defeat for reelection.[179] Nor has the takeover market been described as working to remove individual directors who are not doing their jobs or who are engaging in self-dealing, except in the very broadest sense of replacing an entire management that persistently fails to maximize stockholder return,[180] a premise I already have rejected. Finally, such litigation as does occur will have to be frequent and costly even to approach the expense of annual meetings and proxy solicitations.[181] Thus, it seems, at least as a preliminary matter, that the director removal

86 (1970); *Ross v. 311 North Central Avenue Bldg. Corp.*, 130 Ill. App.2d 336, 264 N.E.2d 406, 412-13 (App. Ct. Ill. 1970); *Harkey v. Mobley*, 552 S.W.2d 79, 81 (Mo. Ct. App. 1977); *Bossier v. Connell*, No. 8624, slip op. (Del. Ch. Nov. 12, 1986).

175. Strike suits or malicious litigation could be avoided by limiting standing to a certain threshold interest in the corporation, or the posting of a bond as is commonly the practice in derivative actions, see DeMott, *Derivative Actions* §§ 3.01-3.04 (cited in note 163), and through analogies to the contemporaneous ownership rule, id. § 4.03.

176. See Rev. Model Bus. Corp. Act Ann. § 8.08, Statutory Comparison ¶ 5. (1985); Mass. Ann. Laws ch. 156B § 51(c) (Law Co-op. 1979); Minn. Stat. Ann. § 302A.233(2)(c) (West 1985); Mo. Ann. Stat. § 351.317 (Vernon 1991); N.D. Cent. Code § 10-19.1-41(2)(c) (1985); N.J. Stat. Ann. § 14A: 6-6(3) (West 1990); Ohio Rev. Code Ann. § 1701.58 (Page Supp. 1990); Tenn. Code Ann. § 48-18-108(d) (1988).

177. Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795, 806-07 (1983) (suggesting that the removal process, either with or without cause, is cumbersome and inappropriate, and thus is rarely used in a publicly held corporation).

178. The Conference Board report supports this observation. *Conference Board* at 21 (cited in note 41).

179. This is particularly evident in light of the common practice of nominating slates of directors. Robert S. Klein, *The Case for Heightened Scrutiny in Defense of the Shareholders' Franchise Right*, 44 Stan. L. Rev. 129, 131-32 (1991).

180. This is described by Professor Booth as the misinvestment hypothesis. Booth, 79 Cal. L. Rev. at 1056 (cited in note 17). See also Kraakman, 88 Colum. L. Rev. at 892, 897-98 (cited in note 17).

181. Constance B. Doris, *Proxy Contests and Corporate Control* at A-6, A-7 (BNA, 1990). In a 1984 battle between Carter Hawley Hale and The Limited, Inc., Carter spent $1.25 million and The Limited spent $1.1 million; in 1982, Gulf Resources and Chemical Corp. was challenged, and the insurgents spent $1.5 to 2.15 million, and Gulf management spent more than $2.15 million; in 1982, when Pabst Brewing Co. was challenged, insurgents spent approximately $7.5 million. Id.

problem can be handled without systemic damage and perhaps in a manner that diminishes its current costs.[182]

One final concern this self-perpetuation mechanism poses, and it is one that is properly raised in light of the board's broadened focus, is that the remarkable homogeneity of boards is likely to continue. For example, ninety-four percent of the directors of the Fortune 1000 corporations are white men, two-thirds of whom are over the age of fifty-five.[183] It seems unlikely that such boards would have the breadth of vision or experience to realize the potential of the board's broadened legal responsibilities. One possible solution might be to mandate that certain percentages of each board be selected from among certain groups, such as stockholders, employees, creditors, suppliers and the community.[184] Although similar proposals have been made before, they have been made in the context of interest group representation.[185] My proposal contemplates that all directors share the same duties, and any tendency towards interest group identification could be lessened by a requirement that the individuals selected for each category have the relevant relationship with corporations other than the one on whose board they serve. For example, the employee directors would be employees of other corporations, as would the stockholder directors, creditor directors, customer directors, and supplier directors. Certainly other ways of discouraging interest group directorships might be constructed.

A final detail concerns timing. I have suggested that boards would become independent and self-perpetuating at the time that corporations went public, but implied that the public offering would be with respect to voting stock. If so, my proposal might result in the continued close ownership of corporate stock, with financing achieved by public issuance of nonvoting preferred stock or debt, in order to permit the close corporation board to retain control and, with it, the opportunity to take advantage of other constituents. Although the cost of these methods of obtaining external financing might be prohibitive,[186] it is

182. It might be preferable to set up arbitral tribunals solely to adjudicate director removal actions, a detail that could be dealt with at such time as my proposals were adopted.

183. Lorsch, *Pawns or Potentates* at 18 (cited in note 2).

184. These are the constituents typically enumerated in state corporate constituency statutes. See Mitchell, 70 Texas L. Rev. at 579 (cited in note 2). Although this may be neither a sufficiently broad nor sufficiently narrow group of constituents, the definitive identification of the appropriate constituent groups is beyond the scope of this Article. Consideration might be given, for example, to having an executive of another corporation sit on the board to bring a management perspective to the board. On the other hand, creditor, supplier, and customer directors might well be corporate managers themselves, so this perspective would already be present.

185. See, for example, Nader, Green, and Seligman, *Taming the Giant Corporation* at 123-26 (cited in note 26) (discussing such proposals).

186. Although equity financing is considered to be more expensive than debt, see J. Fred Weston and Eugene F. Brigham, *Essentials of Managerial Finance* at 678-80 (Dryden, 8th ed.

foreseeable that such a shift could happen. More to the point, however, my position is that once corporations enter the public financing market at all, the possibility that stockholder-centrism could result in short-term focus and externalized costs clearly exists. In fact, in the case of a corporation with closely owned common stock, the conflict between stockholder welfare and the rights of others is more personal and thus other public financing methods might exacerbate the problem of stockholder-centrism and short-term focus.[187] In some sense, the increase in short-termism caused by institutional ownership presents an analogous problem, as the concentration of institutional ownership begins, at some level, to resemble the ownership structure of close corporations.[188] Consequently, my proposal is to have the board become self-perpetuating at any time that the corporation enters the public market for external financing. Developed concepts of "public offerings" under the Securities Act of 1933 could be adapted to provide a clear test for when this would occur.[189]

Transitional rules would have to be developed in order to alter the governance structures of existing public corporations. A relatively easy method of accomplishing this result would be to require each current management director to choose, within some established period of time, whether to remain as a manager or director and to tender the appropriate resignation.[190] The remaining directors would then have an interval in which they could fill the newly created vacancies.

Some might object that my proposal eliminates the market for corporate control and thus precludes the transfer of assets to their highest valued use that is necessary for a healthy economy. Such an objection would be unwarranted. In the first place, boards of directors would con-

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1987), debt has the disadvantage of regular required interest payments.

187. Larry D. Soderquist, *Reconciling Shareholders' Rights and Corporate Responsibility: Close and Small Public Corporations*, 33 Vand. L. Rev. 1387, 1410-13 (1980).

The need for protecting the owners of privately placed securities is lessened because of the meaningful negotiating opportunities available to such purchasers. See Mitchell, 65 N.Y. L. Rev. at 1177-86 (cited in note 4). Compare McDaniel, 41 Bus. Law. at 413 (cited in note 60) (describing the weak position of public debtholders).

188. Rock also notes this fact in terms of the similarity in collective action problems. Rock, 79 Geo. L. J. at 459 n.44 (cited in note 21). I don't want to exaggerate this point. It is unlikely that one or two institutions will dominate the public corporation in the same way that controlling stockholders dominate the paradigmatic close corporation. See Roe, 27 J. Fin. Econ. at 9-21 (cited in note 24) (describing the barriers to significant concentrations of capital in individual institutions).

189. See, for example, *Securities and Exchange Commission v. Ralston Purina Co.*, 346 U.S. 119, 119-25 (1953); *Doran v. Petroleum Corp.*, 545 F.2d 893, 897-900 (5th Cir. 1977); Sec. Act Rel. No. 6389 (1982) (announcing the adoption of Regulation D by the Securities and Exchange Commission); Loss and Seligman, *Securities Regulation* at 317-80 (cited in note 158).

190. For the reasons stated in note 170, I suspect that most manager-directors will choose to continue as managers.

tinue to be empowered, in the context of their structuring and distributional responsibilities, to sell all or a portion of the corporation's assets[191] or engage in a corporate combination.[192] Ensuring that such transactions are undertaken by the corporation rather than by the stockholders[193] puts the board in a position to control their timing and circumstances, thus diminishing the likelihood that stockholders can gratify their short-term desires. It also permits the board to allocate the consideration in a manner consistent with the duty of fairness I will describe[194] rather than permitting stockholders to capture all of the gains, frequently at the expense of other constituents.[195]

Moreover, nothing in my proposal prevents the corporation from being sold through the sale of its stock. In order to ensure the distributional fairness that is at the heart of my proposal, however, a purchaser would be required to buy all outstanding public debt as well as public stock. This would preclude the possibility of leveraged transactions that result in high premiums to stockholders while damaging the value of existing public debt or preferred stock, as I shall later illustrate.[196] In addition, although I leave elaboration of this point to another article, continuing to subject the newly private company to constituency responsibilities, at a minimum consistent with moderate interpretations of constituency legislation, would seem appropriate for the protection of employees and other constituents. As a result, a purchaser would be unable to recapture any of the purchase price by taking advantage of other corporate constituents.[197]

I acknowledged earlier that this proposal is radical, but that overstates reality. The proposal is radical only if you assume that it will free the board to engage in self-interested behavior and, more to the point, if you insist that the board's power must be legitimated by principles of democratic accountability. As to the first point, my proposal removes any opportunity for directors to gratify self-interest. If they are neither

191. See, for example, Del. Code Ann. § 271 (1983).

192. See, for example, id. § 251. Adopting my proposal would resolve effectively the issue of the legality of sales of control for a premium by strongly discouraging the sale of less than all of a corporation's stock. See *Perlman v. Feldmann*, 219 F.2d 173, 176-77 (2d Cir. 1955); William D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harv. L. Rev. 505, 506-15 (1965); George B. Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. Chi. L. Rev. 420, 420-28 (1965).

193. For an example of a transaction undertaken by the controlling stockholder that the court believed should have been a corporate transaction, see *Perlman*, 219 F.2d at 173.

194. See notes 205-21 and accompanying text.

195. Expropriation is discussed at notes 208-16 and accompanying text.

196. See note 223 and accompanying text.

197. Contrast Wallman, 21 Stetson L. Rev. at 163-65 (cited in note 5) (offering a modest interpretation of constituency statutes requiring that corporate decisions be made in the best interests of the corporation as a whole).

stockholders nor employees of the corporation, they have no financial interest in the corporation that could be gratified by self-dealing (short of outright theft). They will have no salaries or perquisites that they can take to excess, nor will they have stockholders' financial conflicts with other constituents or stockholders that can be turned to their advantage through opportunistic behavior. Of course the economist will then argue the flip side: if there is no self-interest, there is no motivation for directors to do their jobs.[198] This is where I part entirely with the neoclassicists and suggest that directors might do their jobs simply because they have the responsibility to do so. Moreover, their jobs as reconceived are sufficiently modest that the opportunity costs are not great. Finally, as Lorsch demonstrates, directors are now doing their jobs, such as they are, not out of self-interest but out of a sense of responsibility and, perhaps, altruism.[199] All my proposal does is liberate them to concentrate on their jobs rather than their incumbency and freedom from litigation.

More importantly, the need for legitimating directors' powers through democratic institutions is not intuitively obvious. Rather, the insistence upon legitimation through corporate democracy or, more particularly, stockholder suffrage, stems from the identification of the corporation as the stockholders' private property.[200] This is an outmoded concept[201] that, importantly, denies the state its substantial interest in long-term corporate success which, as I have demonstrated, is ill-served by stockholder governance. Although the concept of democratic processes as legitimating corporate power is commonly accepted and, I

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198. This is the fundamental premise on which agency cost theorists hase their heliefs that management will perform their functions. The classic article is Fama, 88 J. Pol. Econ. at 292-95 (cited in note 4). But see Sen, *Ethics* at 15 (cited in note 11) (challenging the narrow view of rationality as self-interest.)

199. Lorsch, *Pawns or Potentates* at 30 (cited in note 2).

200. See Cal. Corp. Code § 184 (West 1990) (defining stock as "units into which the propriety interests in a corporation are divided"); Brent Orrin Hatch, Note, *Repudiating the Sale-of-Business Doctrine*, 83 Colum. L. Rev. 1718, 1726-27 n.62 (1983) (stating that stock is generally defined as an interest in corporate property that belongs to the stockholders, not to the corporation) (citing Prentice-Hall, 1 *Corporations* ¶ 2103 (1980)). Easterbrook and Fischel have argued, as usual from an agency cost perspective, that stockholder suffrage is justified because stockholders, as residual claimants, have the greatest monitoring incentive. Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J. Law. & Econ. 395, 403 (1983). I have dealt with this assertion witb respect to debtholders at length in Mitchell, 65 N.Y.U. L. Rev. (cited in note 4). For present purposes it should be sufficient to note that (i) the state has a significant interest in the long-term success of its corporations tbat is impeded by the stockholder suffrage model, and (ii) if other constituents lack monitoring incentives, they will simply not use the mechanisms with which I suggest they be provided.

201. Lipton and Rosenblum, 58 U. Chi. L. Rev. at 193 (cited in note 2) (stating that "[t]he stockholders' intrinsic ownership interest is a financial interest . . . rather than the 'use and enjoyment' interest of the owner of a piece of personal property").

suspect, has strong emotional pull, such processes may serve neither the efficiency nor the responsibility of the corporation. Conversely, if such processes were desired, a truly democratic model would extend corporate suffrage to a broader variety of constituent groups than stockholders, with the probable result of interest group affiliation of directors resulting in greater internal corporate conflict rather than more unified and cohesive management. Therefore, the best result appears to be the complete removal of democratic decision-making from within the corporation. Moreover, to the extent that democratic processes are necessary to legitimate any substantial public or quasi-public power, those processes are implicit in the legislation that creates and empowers the corporation. At least since the *Dartmouth College* case,[202] the legislature has been a participant in corporate governance, and has not hesitated to modify governance processes when doing so was in the public interest.[203]

The newly conceived board, free of self-interest, can leave management free to use its talents to operate the business and to concentrate its time and energies on capital structure and distribution.[204] But on

202. *Dartmouth College v. Woodward*, 17 U.S. 518, 666 (1819) (Story concurring) (suggesting the reserve power of the state). Henn and Alexander, *Laws of Corporations* at 14 (cited in note 2) (noting the universality of reserve clauses in state constitutions or corporations statutes).

203. Hovenkamp, 42 Stan. L. Rev. at 1018-19 (cited in note 11).

204. A recent study by Lilli Gordon and John Pound for the Corporate Voting Research Project provides an empirical analysis of the relationship between various takeover defense structures and corporate performance. Lilli Gordon and John Pound, *Governance Matters: An Empirical Study of the Relationship Between Corporate Governance and Corporate Performance* (1991). Their study, which concludes that corporations without restrictive governance structures outperform those that have adopted such devices, purports to be methodologically superior to other such studies because of their inclusion of fundamental performance measures in their analysis. Id. at 20. The fundamental performance measures studied include return on assets and operating margin. Id. at 11. Gordon and Pound also use market-based measures such as earnings-to-price ratio, cash flow-to-price ratio, and one- and five-year stock returns. Id. In the market-based measures, they reflect the more commonly used methodology, including that of Pound in a prior study. John Pound, *The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence*, 30 J. Law & Econ. 353 (1987). Because my proposal rejects the legitimacy of stock price or return as a surrogate for performance, I will not analyze studies relying on this measure.

Gordon and Pound are appropriately unwilling to claim for their data the establishment of a clear causal relationship between restrictive governance structures and performance. Rather, they suggest that their data could lead either to the conclusion that such governance structures were adopted by poor performing firms to prevent takeovers, or that performance deteriorated once such governance structures were in place. Gordon and Pound, *Governance Matters* at 9, 20. Obviously, if the latter conclusion were to hold, the wisdom of adopting my proposal for a self-perpetuating board would be questionable.

In fact their data, regardless of their conclusions, are irrelevant to my proposal, because Gordon and Pound ask the wrong question. While the specific defensive devices adopted by individual corporations are interesting, Gordon and Pound disregard the fact that the vast majority of states, including Delaware, Illinois, New York, Massachusetts, Pennsylvania, and California, had state antitakeover legislation in effect throughout their testing period of 1985-89. Roberta Romano, *The Political Economy of Takeover Statutes*, 73 Va. L. Rev. 111, 113-17 (1987) ("In 1982 . . .

what principles is it to undertake those tasks? This question assumes even greater importance as the democratic checks on the board are eliminated.

The appropriate principles break down into two components: first, an aspirational governing principle, which sets the standard by which the board is to operate on a daily basis and expresses our society's ideals of good corporate management; and second, a remedial duty, which comes into play when the board dramatically fails to fulfill its aspirational goals. Because of their distinct functions, and to prevent the threat of litigation from paralyzing the board, the remedial duty necessarily is more limited than the governing principle.

The governing principle already exists in corporate law with respect to stockholders and has a well-developed history and meaning. That principle is fairness: fairness in the initial allocation of rights to corporate interests upon their creation and fairness in the distribution of corporate assets.[205] I have elsewhere developed this principle of fairness in the guise of a duty not to harm[206] but, with the introduction of

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thirty-seven states had takeover statutes. . . . Within four years of the [United States Supreme Court's decision in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), striking down Illinois' takeover statute,] new takeover laws have been adopted in twenty-one states"). See, for example, 8 Del. Code Ann. § 203 (1988); Ill. Rev. Stat. ch. 32 § 11.75 (1989); Mass. Gen. Laws Ann. ch. 110F, § 3 (1992); Mass. Gen. L. ch. 110D, § 3 (1987); N.Y. Bus. Corp. Law § 1600 (McKinney, 1986); N.Y. Bus. Corp. Law § 912 (McKinney, 1988); 15 Pa. Cons. Stat. § 2551 (Purdon, 1991); 15 Pa. Cons. Stat. § 2561 (1991). While corporations undoubtedly adopted their own defensive devices for some reason, even in light of these statutes it seems unreasonable to draw any conclusion from Gordon and Pound's data without some control testing of the relative performance of corporations incorporated in states without takeover laws and in those states that have such laws. Studies have heen done on the effect of antitakeover legislation on stock prices. See, for example, Donald Margotta, *Stock Price Effects of Pennsylvania Act* (Dec. 1990, revised Feb. 1991). For the reasons I stated earlier in this Article, these studies, in focusing on stock prices, use a measure of performance that is not relevant to my analysis.

The second reason that Gordon's and Pound's study is irrelevant to my proposal is based on the measures of fundamental performance they chose to analyze. Both return on assets and operating margin measure the corporation's performance after deducting distributions to all constituencies but stockholders, including debtholders, suppliers, customers, and employees. Return on assets measures the "ratio of net income to total assets," Eugene F. Brigham and Louis C. Gapenski, *Financial Management: Theory and Practice* at 882 (Dryden, 6th ed. 1991), with net income obviously excluding all expenses, Robert W. Hamilton, *Fundamentals of Modern Business* § 8.3 (1989). Operating margin relates pretax income to gross sales. Id. at § 9.10.1. Consequently, it too fails to account for distributions to other constituencies. Although these are both standard measures of financial performance, they are measures developed in a world of stockholder-centric analysis. They measure only the performance in terms of residual claims, and not in terms of the broader corporation. Thus, they cannot be used to dispute the desirability of adopting my proposal.

205. I have already described the fairness test existing in corporate law, see note 147. The fairness test I envision here originates in that test but, as I discuss below, is meant to he a higher level aspirational standard of conduct.

206. Mitchell, 65 N.Y.U. L. Rev. at 1222-28 (cited in note 4); Mitchell, 70 Texas L. Rev. at 579 (cited in note 2).

board duties to constituents at the capital structuring stage, this fairness principle must go even further. It means that boards are not to negotiate debt contracts, employment contracts, or other agreements with the goal of narrowly defining the rights of the parties thereto. Rather it means that boards must broadly exhibit good faith in negotiations, appreciating and acting upon the position that a reasonable third party would take in entering into a loan agreement, collective bargaining agreement, or supply contract. It means that boards must acknowledge the mutual interdependence of corporate constituencies and recognize the importance of each to the corporation's long-run survival.

At the distributional end, it means fairness in construing the contracts that have been negotiated. The law reports are full of cases in which corporations have insisted upon the strict construction of contract language with respect to matters that neither party could reasonably foresee, to recapture for the stockholders' benefit costs that, seen contextually, the stockholders (acting through the board) probably would, or at least should, have assumed.[207] It means recognizing the relative indeterminacy of many of the types of contracts that corporations enter into with constituents, and interpreting those contracts in light of the reality that neither party had any real intention with respect to the matter at issue at the time the contract was made, and therefore interpreting it in a manner that is fair and reasonable at the time the issue arises. This leads to using the contract as a baseline minimum, with the board avoiding harm to constituent groups by refraining from imposing upon them a disproportionate amount of the costs of enhancing corporate profit. In other words, and this should apply at the structuring stage as well, the costs to be borne by each constituent group should be proportional to the corporate wealth to which they are entitled or, to put it still differently, reflective of the extent to which such group provides benefits to, and justifiably relies upon, the corporation.

Perhaps the best way of explicating this duty is by example. Once the broad principle is acknowledged, the parameters of the duty can be set by common-law development. Case law is replete with examples of directors damaging other corporate constituent groups to enhance the interests of stockholders. For example, in *Van Gemert v. Boeing Co.*[208] the board failed to give proper notice of a call that would have led to bondholders' widespread conversion of their bonds into stock to enable them to capture a greater conversion value. In *Pittsburgh Terminal Corp. v. Baltimore and Ohio Railroad*,[209] inadequate notice of a spin-off

207. Some of the cases are identified in notes 208-15 and accompanying text.
208. 520 F.2d 1373 (2d Cir. 1975).
209. 680 F.2d 933 (3d Cir. 1982).

was given to debtholders to prevent their debt conversion to take advantage of newly-created value. *Wolfensohn v. Madison Fund, Inc.*[210] presents a similar problem. *Metropolitan Life Insurance Co. v. RJR Nabisco*[211] and *Eliasen v. Green Bay & Western Railroad Co.*[212] present situations in which the expropriation of bondholders' wealth to equity holders was justified on the basis of limited contract terms and stockholder profit-maximization. *Dalton v. American Investment Co.*[213] and *Jedwab v. MGM Grand Hotels, Inc.*[214] provide similar examples of restrictive contractual interpretation—and a narrow vision of directors' duties—to the detriment of preferred stockholders. *Glass Makers, Pottery, Plastics and Allied Workers International Union, AFL-CIO v. Wickes Companies, Inc.*[215] provides an example of employee dislocation caused for stockholders' benefit, and similar examples have been reported elsewhere.[216]

In each of these cases and others, the principle of corporate existence for the benefit of stockholders has led to board decisions that have serious negative effects on other constituencies. In almost all of these cases, courts have upheld boards' narrow contractual interpretations to permit opportunistic behavior to occur. Under the fairness principle, such conduct would be open to rigorous scrutiny to determine its propriety in light of all of the circumstances of the transactions and relationships.

For most boards, most of the time, articulating such a governing principle should be enough to ensure that it is followed. In other words, we can assume that the board will act in good faith. The strongest force of the principle of fairness may be in its aspirational qualities and its usefulness as a guiding principle for the board.[217] But inevitably the board will depart occasionally from its duties, and for such occasions a remedial enforcement mechanism must be crafted.[218]

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210. 253 A.2d 72 (Del. 1969).

211. 716 F. Supp. 1504 (S.D.N.Y. 1989).

212. 569 F. Supp. 84 (E.D. Wis. 1982).

213. 490 A.2d 574 (Del. Ch. 1985).

214. 509 A.2d 584 (Del. Ch. 1986).

215. 243 N.J. Super. 44, 578 A.2d 402 (1990).

216. For example, see O'Connor, 69 N.C. L. Rev. at 1238, 1241-42, 1255 (cited in note 102); Joseph William Singer, *The Reliance Interest in Property*, 40 Stan. L. Rev. 614, 725 (1988).

217. See Eisenberg, 52 Geo. Wash. L. Rev. at 582 (cited in note 50) (stating that "most people will voluntarily conform their conduct to the aspirational standards expressed by the society through its laws and indeed through its morality"); id. at 594 (noting that the "aspirational role of law may be much more effective in reducing agency costs than either the sanctioning role or other external checks, like markets").

218. The duties I discuss here, and for which I describe an enforcement mechanism, relate only to the allocation of corporate assets among competing groups. Elsewhere I have labelled these as "horizontal" duties. Mitchell, 65 N.Y.U. L. Rev. at 1213 (cited in note 4); Mitchell, 70 Texas L.

The enforcement mechanism I envision takes account of the fact that no one group is entitled to be treated as the center of the corporation, or entitled to any particular proportion of the corporation's assets. However, since enforcement of this duty now becomes the central mechanism of board discipline, some incentive must exist for a constituent to bring litigation. On the other hand, a culturally ingrained fear of strike suits and excessive litigation[219] suggests that some clear parameters need to be developed to prevent litigation from occurring too readily and to establish decisional principles for courts.

I suggest a remedial cause of action structured around the least common denominator of the new board's duties: the duty not to harm. Each constituent identified by legislation as entitled to the board's consideration would be permitted to bring an action against the board asserting that the board had breached its duty not to harm; that is, in making a corporate distribution or distributions, or by failing to do so, it allocated excessive corporate costs or insufficient corporate wealth to the complaining constituent. The court would be required to evaluate the terms of the constituent's initial contract with the corporation, to study the course of the constituent's relationship with the corporation to determine the overall fairness of its treatment by the board, and then to determine whether the board had harmed the constituent in light of the contract and relationship.

The way in which the duty not to harm would apply is based on a test drawn from close corporation law.[220] A constituent group could establish a prima facie case of breach of the duty not to harm by specifically alleging that a disproportionate amount of the costs or other burdens of a corporate decision were imposed upon it in light of the factors described above. In response, the directors could demonstrate that both the transaction and the cost allocation were designed to achieve a legitimate business purpose, and that the costs were allocated among a number of constituent groups. The plaintiff could then establish, by a preponderance of the evidence, that the allocation of burdens

Rev. at 579 (cited in note 2). This does not address the traditional duties of care and loyalty to the corporation, which the board would still possess and which would continue to be enforced through derivative litigation. I have described how derivative standing to enforce those duties should and could be extended to bondholders. Mitchell, 65 N.Y.U. L. Rev. at 1195 (cited in note 4). I suggest that the same principles could be applied to other corporate constituents, although complete analysis of this issue is beyond the scope of this Article.

219. See, for example, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740-42 (1975). See also Stanley M. Beck, *The Shareholders' Derivative Action*, 52 Can. Bar Rev. 159, 162-63 (1974) (describing American hostility to stockholder litigation).

220. Mitchell, 65 N.Y.U. L. Rev. at 1223-24 (cited in note 4); Mitchell, 70 Texas L. Rev. at 579 (cited in note 2). Specifically, the test is based on those developed in *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1977), and *Schwartz v. Marien*, 37 N.Y.2d 487, 335 N.E.2d 334 (1975).

to it was unfairly disproportionate to its benefits or contrary to its legitimate expectations based upon its initial contract and the course of its relationship with the corporation.

An illustration of how the self-perpetuating board, the aspirational principle of fairness, and the remedial duty not to harm might work together is provided by applying the scheme to a case involving the hypothetical Greenacres Corporation.[221] Assume that Greenacres Corporation is a publicly-held company with 30,000,000 shares of common stock outstanding, trading in the market at $25. Assume further that Clampitt Co. announces a hostile tender offer for Greenacres at $35. The Greenacres board, after determining the Clampitt offer to be grossly inadequate, announces an exchange offer for up to 10,000,000 shares pursuant to which it offers to exchange for each share of stock a note with a principal amount of $40 at an interest rate two percentage points above prime. The notes have protective covenants limiting Greenacres' ability to incur additional debt, sell assets, or pay dividends without the approval of a majority of Greenacres' independent directors.

The exchange offer is fully subscribed. Clampitt increases its offer to $40. In response, Greenacres' board negotiates an agreement with Drysdale, Inc. for a leveraged buyout pursuant to which Drysdale will sell off significant assets of Greenacres. Greenacres agrees to waive the note covenants to permit Drysdale's acquisition to occur. Immediately, the trading price of the notes, which had traded at par, drops to $33, and noteholders begin to threaten the board with litigation. After intensive negotiations and a bidding war, Drysdale ultimately acquires Greenacres for $1 per share more than Clampitt's final price, and the notes stabilize at $34 in the market.

The additional consideration paid to Greenacres' stockholders is $20,000,000. The value lost by the noteholders is $60,000,000. Ultimately, the cost of obtaining the best price for the stockholders is a loss for the noteholders three times as great as the price increase. The net cost to the corporation of ensuring that the board refrain from self-dealing is $40,000,000.

Assume further that Drysdale, after acquiring Greenacres, finds it necessary to close certain of Greenacres' factories and lay off workers in order to service the debt it incurred in the transaction. Also assume that Greenacres was the largest employer in each of the communities where the plant had operated. Without attempting to quantify these losses, it should be clear that employees would suffer by losing their

221. The following example is based upon the facts presented in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

jobs (perhaps without the prospect of new jobs in their communities), and that the communities themselves would suffer as a result of the plant closings and layoffs.

The decision of the board to accept the higher-priced Drysdale offer is mandated under existing law by the principle of stockholder-centrism.[222] The result might have been different if my proposed model were adopted. In the first place, the self-perpetuating board structure makes such a scenario unlikely to occur. My proposal would require purchasers who choose to acquire the corporation by means of a stock purchase to purchase all of the outstanding public debt in order to obtain control of the board. This requirement would probably eliminate buyers' use of leverage to pay stockholders enormous premiums at the expense of debtholders, employees, and other constituents. Instead, boards would be in a position (given antitakeover legislation and defensive measures) to negotiate a price for the entire company and then to allocate the consideration (as well as the burdens) among the constituents.[223] Under the principle of fairness, my proposal would require the board to consider the circumstances and expectations of each constituent group. In allocating financial consideration between stockholders and noteholders, for example, the board would have to consider the circumstances of the debt's creation, contract terms, returns already paid to each constituent, the reasonable expectations of noteholders and stockholders, and the trading price of the stock prior to the announcement of the transaction.

At the same time, the principle of fairness would require the board to provide for the interests of employees in order to diminish the potentially dislocating costs of the takeover. An example of this might be a promise from the purchaser not to lay off employees, at least for some period of time, and to provide transitional assistance (including severance pay and retraining) if such layoffs were to become necessary. The board would be empowered (and indeed would have the duty) to obtain such concessions to the extent that their cost (in terms of diminished consideration to stockholders and bondholders) was fair. The board could make similar transitional protective arrangements on the same basis with respect to other corporate constituents, although, as the constituent groups become less central to (and presumably less reliant upon) the corporation, the extent to which provision has to be made for them would diminish.

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222. This is the rule of *Revlon*, 506 A.2d at 173.

223. Examples of this process are provided by the facts in *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584 (Del. Ch. 1986), and *Dalton v. American Investment Co.*, 490 A.2d 574 (Del. Ch. 1985).

If for some unlikely reason an acquiror were to purchase only the equity of the corporation and retain the existing board, the duty not to harm would require the board to weigh the interests of all constituent groups in permitting the acquisition to occur. If, in the Greenacres hypothetical, the board permitted the higher priced, highly leveraged offer to succeed at the expense of the noteholders, the noteholders could bring an action against the board based on the duty not to harm. The significant loss in note value would establish a prima facie case, thus leaving the board to demonstrate the existence of a legitimate corporate purpose. Ultimately, the noteholders could prove that the same purpose could have been accomplished with less harm to the noteholders and a fairer allocation of the benefits and burdens of the takeover.

Whether the noteholders could sustain this burden would depend on an evaluation of all the circumstances including, in this hypothetical case, the fact that the noteholders received their notes as part of an exchange offer to help the corporation remain independent and thus, assuming no trading of the notes, were themselves current or former stockholders of the corporation. The board might have issued the notes at an above-market interest rate to compensate for the risk of a highly leveraged offer. Conversely, had the board permitted the lower-priced offer to succeed, it arguably could defend against a stockholders' suit on the basis of having legitimately prevented harm to the noteholders at only slight expense to the stockholders.

Greenacres' employees would have a similar cause of action, analyzed in a similar manner. In considering the employees' rights, relevant evidence would include express or implicit promises of job security, length of time that facilities had been opened, the average length of service of employees of such facilities, compensation levels relative to those of comparable jobs (to help evaluate, if possible, the trade-off between compensation and job security), severance benefits, and other forms of vested contingent compensation generally available to employees.

Any constituent group could also argue that a kind of protective synergy exists, that protecting one group would also result in protection to others, in a variation of the private attorney general model once common in challenges to the actions of administrative agencies. For example, the noteholder plaintiffs could argue that, in addition to the protection afforded them by the decreased leverage resulting from the lower-priced offer, employees and the communities in which they worked would similarly be protected by reducing the need for plant closings and layoffs to pay debt service. This would demonstrate that the net reduction in overall losses from accepting the lower priced offer dramatically exceeded the net gain to stockholders from accepting a higher offer.

Fashioning a remedy for breach of the duty not to harm is difficult. The easiest case is when litigation occurs prior to the closing of a given transaction or the implementation of a particular decision, because it permits a court to enjoin such action and order a reconsideration by the board of its effects on the constituent group that establishes breach.[224] Far more difficult is the context in which litigation is brought after action has been taken. While requiring rescission of a particular course of action might provide relief, such a remedy is not always possible nor desirable because of additional harm that it might cause. Alternatively, demanding that directors pay damages for actions that do not benefit them seems fundamentally unfair, as well as bad public policy. Perhaps the best remedy would be for the court to order the board to take compensating action to reallocate a portion of the corporate wealth to the injured constituent group within a given period of time.[225]

V. Conclusion

Corporate governance is at a crossroads. The short-term interests of institutional stockholders and the increasingly profound effect that the large public corporation has on society, all of which were amply illustrated by the 1980s takeover boom, have led to a reconsideration of the structure and substance of the governance of American corporations. I have suggested that a great deal of the problem lies with the bilateral legal structure of intracorporate relationships and the neoclassical assumptions on which corporate governance is built. I have suggested that the conditions which originally led to this structural response have been exaggerated or modified, and that the existing structure should be changed based upon a reconceptualization of the appropriate role of the board of directors. I have also argued that the current structure of corporate governance unrealistically excludes a number of constituent groups who are vital to the corporation's survival and who, in turn, depend upon the corporation for their well-being, and that the consequence of this exclusion is the repression of the board's exercise of its best long-term business judgment. Ultimately, I have suggested that these assumptions and narrowness of focus have led to the

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224. It is beyond my purpose here to evaluate the legal changes, if any, that would be required to assure constituents of a reliable flow of relevant corporate information. Nader, Green, and Seligman, *Taming the Giant Corporation* at 132-79 (cited in note 26), offer an interesting treatment of the problem.

225. Such a remedy could be similar to that of "compensatory side payments" proposed by Albert Barkey with respect to bondholders' rights. Albert Barkey, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 Creighton L. Rev. 47, 74-78 (1986).

short-term management characteristic of American corporations. The new model of corporate governance and of the board of directors I suggest has the potential to empower the board to enhance corporate welfare by creating a more realistic, and therefore more successful, corporate law.