

1-1-2005

Scrooge-The Reluctant Stakeholder: Theoretical Problems in the Shareholder-Stakeholder Debate

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Benedict Sheehy, *Scrooge-The Reluctant Stakeholder: Theoretical Problems in the Shareholder-Stakeholder Debate*, 14 U. Miami Bus. L. Rev. 193 (2005)

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SCROOGE—THE RELUCTANT STAKEHOLDER: THEORETICAL PROBLEMS IN THE SHAREHOLDER- STAKEHOLDER DEBATE

BENEDICT SHEEHY*

I.	INTRODUCTION	193
II.	HISTORY OF THE SHAREHOLDER-STAKEHOLDER DEBATE ..	196
III.	STAKEHOLDER THEORY	200
	A. <i>Origins and History</i>	200
	B. <i>Assumptions and Criticism</i>	201
	1. Assumptions of the Stakeholder theory	201
	2. Criticisms of the Theory	202
	C. <i>Replies to Stakeholder Criticism</i>	205
IV.	SHAREHOLDER THEORY	208
	A. <i>Origins and History</i>	209
	B. <i>Assumptions and Criticism</i>	213
	1. Assumptions of the Shareholder Theory	213
	2. Criticisms of the Theory	215
	C. <i>Replies to Shareholder Primacy Criticism and Further Criticism</i>	222
V.	MODELS OF THE CORPORATION AND THE DEBATE	225
	A. <i>Contractarian Model</i>	226
	1. Legal Contractarian Model	227
	2. Economic Contractarian Model	228
	B. <i>Communitarian or Concessionaire Model</i>	230
	C. <i>The History and the Development of Models</i>	232
	D. <i>The Ideological Divide</i>	232
VI.	A NORMATIVE COMMENT ON NATURE OF THE CORPORATION AND CORPORATE LAW	234
VII.	CONCLUSION	239

I. INTRODUCTION

A Christmas Carol is Charles Dickens' story about the spiritual conversion of Ebenezer Scrooge.¹ The story begins with Scrooge miserly guarding his

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¹ CHARLES DICKENS, *A CHRISTMAS CAROL* (Chapman Hall) (1843).

wealth. As the story develops, however, he encounters a series of spirits who show him the impact of his approach. The happy ending of the story occurs only after Scrooge sees the harm of his wealth maximizing ways and decides to benefit the poor family of his employee, Bob Cratchit, with an increase in salary, a Christmas turkey, and general assistance to his clerk's crippled son, Tiny Tim. In its essence, *A Christmas Carol* is an illustration of the shareholder-stakeholder debate, and that debate is at the heart of corporate governance.²

Stephen Bottomley, a leading Australian corporate law scholar, observes that "[c]orporate [g]overnance' . . . is a slippery term: it is used both in discussions about the role of companies in society . . . and also in discussion about the organization of affairs within companies. . . ."³ What one believes about the role of companies in society determines to a large degree what one believes about how the affairs of companies should be organized within the corporation. Essentially, corporate governance asks and attempts to answer four questions. These questions include: (1) what is the entity being governed?;⁴ (2) by whom should the entity be governed?; (3) what is the best way to govern the entity?; and (4) in whose interests should the entity be governed? The shareholder-stakeholder debate is one way of framing these problems and simultaneously provides a series answers.

The shareholder-stakeholder debate can be analyzed along a number of different lines. At the most basic level, this debate can be analyzed as a discussion between monotonic and pluralistic approaches to corporations. For example, one might ask whether the corporation is a vehicle for shareholder wealth or an instrument of a broader societal constituency.⁵ The debate can also be analyzed along cultural lines; for example, Anglo versus

² Farrar writes, somewhat reflectively, that

[C]orporate governance is about the legitimacy of corporate power, corporate accountability, and the standards by which the corporation is to be governed, and by who, it is obvious that the concept transcends legal standards and liability, perhaps reflecting the fact that the law deals with minimal morality of obligation rather than a morality of aspiration. Corporate governance is often about the method as opposed to the substance of corporate decision-making. Nevertheless it seems too narrow to limit it exclusively to questions of method and good house keeping.

JOHN FARRAR, CORPORATE GOVERNANCE IN AUSTRALIA AND NEW ZEALAND 431 (2002). The complexity and broad scope of corporate governance is well canvassed in Shann Turnbull, *Corporate Governance: Its Scope, Concerns and Theories*, 5 CORP. GOVERNANCE: AN INT'L. REV. 180, 193 (Oct. 1997).

³ Stephen Bottomley, *From Contractualism to Constitutionalism: A Framework for Corporate Governance*, 19 SYDNEY L. REV. 277 (1997).

⁴ One must assume for the moment, contrary to nexus of contract theorists, that there is an entity to be governed.

⁵ Thomas Dunfee, *Corporate Governance in a Market with Morality*, 62 LAW & CONTEMP. PROBS. 129 (1999).

Continental, or Continental versus Asian models.⁶ Additionally, the debate can be analyzed along the lines of business management versus legal obligations,⁷ as well as with a number of insider and outsider models. One such model concerns members of the corporate entity compared to non-members.⁸ Another insider-outsider model involves the juxtaposition of the corporation in opposition to the community.⁹ The stakeholder debate may also be subjected to economic analysis.¹⁰

The shareholder-stakeholder debate in corporate governance has been going on for decades, but the intensity of the debate increases as globalization increases.¹¹ As corporations come to dominate more of the planet and its resources, other voices demand to be heard, including those of indigenous people, women, and even governments, who are concerned about their role in the global economy and sovereignty itself.¹² The increased community of concerned parties puts additional force behind the stakeholder position. On the shareholder side, the political advance of the neo-conservatives who are aligned with the neo-classical economists, such as Milton Friedman, put their support behind the shareholder model. Additionally, corporate scandals

⁶ See, e.g., ANDREW KAKABADSE & NADA KAKABADSE, *THE GEOPOLITICS OF GOVERNANCE: THE IMPACT OF CONTRASTING PHILOSOPHIES* (2001). Path dependence theories cited by Jennifer Hill, *Introduction: Comparative Corporate Governance and Takeovers*, 24 SYDNEY L. REV. 319-20 n.7 (2002). See also *STAKEHOLDER CAPITALISM* (Andrew Gamble et al. eds. 1997); FARRAR, *supra* note 2, at 7 n.2; Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Convergence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999); Andrea Corfield, *The Stakeholder Theory and its Future in Australian Corporate Governance: A Preliminary Analysis*, 10 BOND L. REV. 213 (1998), available at <http://www.bond.edu.au/law/blr/vol10-2/5-Corfield.pdf>. Compare FARRAR, *supra* note 2, at 472 ("This is not the end of history of corporate governance."); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

⁷ See, e.g., Michael Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 7 EUROPEAN FIN. MGMT. 297 (2001) (discussing the management perspective); Thomas Donaldson & Lee Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications*, 20 ACAD. OF MGMT. REV. 65 (1995). However, in the legal literature, the discussion tends to focus as debate between contractarian and communitarian perspectives of the corporation. See, e.g., Stephen Bainbridge, *Community And Statism: A Conservative Contractarian Critique Of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997).

⁸ See FARRAR, *supra* note 2, at 417; Collin Mayer, *Stock Markets: Financial Institutions and Corporate Performance*, in *CAPITAL MARKETS AND CORPORATE GOVERNANCE* 179 (Nicholas Dimsdale ed., 1994).

⁹ See DAVID KORTEN, *WHEN CORPORATIONS RULE THE WORLD* (2d ed. 2001); JANET DINE, *THE GOVERNANCE OF CORPORATE GROUPS* (2000); Charlie Weir et. al., *Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies*, 29 J. OF BUS. FIN. & ACCT. 579 (2002).

¹⁰ Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

¹¹ See generally, KORTEN, *supra* note 9.

¹² See, e.g., *GOVERNMENTS, GLOBALIZATION, AND INTERNATIONAL BUSINESS* (John H. Dunning ed. 1999).

of increasing size shock, not only the investment community, but also society at large.¹³ For some, the debate is critical,¹⁴ but for others the debate is dismissed as "bogus."¹⁵

This paper analyzes the shareholder-stakeholder debate. Particular emphasis is placed on the legal arguments and assumptions behind the positions taken by the two groups, in addition to the models of corporations, normative issues of corporate law, and the implications for corporate governance. Part II provides a history of the shareholder-stakeholder debate. Part III discusses stakeholder theory, and Part IV discusses shareholder theory. Part V explains several models of the corporation and the debate surrounding these models. A normative comment on the nature of the corporation and corporate law is given in Part VI. Finally, this article concludes that corporations were never exclusively shareholder focused because in practical terms they cannot be, and that appropriate corporate law reform may be the best way to address some of the challenges facing the global community.

II. HISTORY OF THE SHAREHOLDER-STAKEHOLDER DEBATE

The shareholder-stakeholder debate can be traced back to Adolph Berle¹⁶ and E. Merrick Dodd's¹⁷ articles in the *Harvard Law Review* during the 1930's. The debate took place against the backdrop of the 1929 stock market crash, which prompted a deep suspicion among Americans concerning the

¹³ See A. A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later* 16 DEL. J. CORP. L. 33 (1991), who stated,

These reexaminations are usually triggered by a dramatic event or series of events and are initiated by some of those involved in the events whose interests in dealing with those events would be served by changing the rules. And generally others involved in those events see their interests served by preserving the rules that have historically guided people.

Id. at 33. See also Sarbanes-Oxley Act of 2002, 15 U.S.C. §§7201-66 (2002) (reacting to public calls for efforts to improve corporate governance in post-Enron times).

¹⁴ Millon sees it as a "crisis" in corporate law. David Millon, *New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1377 (1993). Dine cites Sullivan and Conlon who refer to a change from contract to constituency models—i.e. shareholder to stakeholder—of corporations as having "created a crisis in corporate governance." DINE, *supra* note 9, at 35.

¹⁵ Adam Reynolds, *Do ESOPS Strengthen Employee Stakeholder Interests?* 13 BOND L. REV. 95, 97 (2001) (quoting Phillip Goldenberg, *Shareholders v Stakeholders: the Bogus Argument* 19 (2) COMPANY LAWYER 34, 36 (1998) available at <http://www.bond.edu.au/law/blr/vol13-1/Reynolds.pdf>).

¹⁶ A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932).

¹⁷ E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) [hereinafter Dodd, *For Whom Are Corporate Managers Trustees?*].

corporations in their midst.¹⁸ Berle took the view that managers need to consider the views of shareholders.¹⁹ Dodd, however, took the view that even though the law supported Berle, the concerns of workers should be considered.²⁰ Support for each side in this debate has fluctuated over time, with Berle conceding in 1954 that Dodd was gaining the greater following.²¹ Of course, the debate continues at present.²² One fundamental issue is who

¹⁸ See Sommer, *supra* note 13, at 36.

¹⁹ *Id.* at 36-37.

²⁰ Dodd wrote that,

[this writer] believes that public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function, that this view has already had some effect upon legal theory, and that it is likely to have a greatly increased effect upon the latter in the near future.

Dodd, *For Whom Are Corporate Managers Trustees?*, *supra* note 17, at 1148. In response, Professor Berle said, Now I submit that you can not [sic] abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.

Berle, *For Whom Corporate Managers Are Trustees: A Note*, *supra* note 16, at 1367. Berle, *supra* note 16, at 1367. Professor Berle finished his analysis with this summary,

[u]nchecked by present legal balances, a social-economic absolutism of corporate administrators, even if benevolent, might be unsafe; and in any case it hardly affords the soundest base on which to construct the economic commonwealth which industrialism seems to require. Meanwhile, as lawyers, we had best be protecting the interests we know, being no less swift to provide for the new interests as they successively appear.

Id. at 1372. See also Joseph Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964).

²¹ A. A. Berle, Jr., THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954) (conceding that Dodd was gaining a greater following). See also Lynn Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1208-09 (2002). Compare William Beaver, *Is the Stakeholder Model Dead? It Looks Like the People Who Hold the Shares are Still Number One in the Mind of Corporate America*, 42 BUSINESS HORIZONS 8 (1999) (commenting that stakeholder theory appears to be finished). Berle remained unconvinced however, that popular acceptance of Dodd's position meant that Dodd's view was superior or correct. A. A. Berle, Jr., *Foreword* to THE CORPORATION IN MODERN SOCIETY, at xii (E. Mason ed. 1960).

²² A brief outline of the debate offered in Millon, *supra* note 14, at 1373. The triumphalist rhetoric of the shareholder primacy theorists is surprising. Consider, for example, the statement by commentators Hansmann and Kraakman:

[t]he triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured, even if it was problematic as recently as twenty-five years ago. Logic alone did not establish the superiority of this standard model or of the prescriptive rules that it implies, which establish a strong corporate management with duties to serve the interests of shareholders alone, and strong minority shareholder protections. Rather, the standard model earned its position as the dominant model of the large corporation the hard way, by out-competing during the post-World-War-II period the three alternative models of corporate governance: the managerialist model, the labor-oriented model, and the state-oriented model.

Hansmann & Kraakman, *supra* note 6, at 468.

should be included as a stakeholder. At one end of the spectrum are scholars and investors who argue that the only stakeholder to be considered is the shareholder. At the other end of the spectrum are those scholars who would include even the most inanimate objects in the physical environment as stakeholders.²³ One definition of a "stakeholder," which is generally accepted, is R. Freeman's definition. He explained that, "[a] stakeholder . . . is [by definition] any group or individual who can affect or is affected by the achievement of the organization's objectives."²⁴ Others, however, interpret the stakeholder model as one in which a corporation is governed by individuals, who are vital to the success and survival of the enterprise.²⁵ For purposes of this paper, *stakeholder* will mean those individuals directly affected by the acts and decisions of the corporation.²⁶

The positions of shareholder and stakeholder reflect a number of different concerns. Scholars and business interests, who favor the shareholder to the exclusion of all other stakeholders, are "minimalist pure stockholder[s]."²⁷ Minimalist pure stockholders argue that corporate law "should be minimal, i.e., limited to little more than enforcing contracts and preventing fraud, theft, and coercion. Such theories also declare that managers have a fiduciary obligation to stockholders."²⁸ These stockholders believe in the market and Adam Smith's²⁹ "invisible hand" in a manner that could be described as nearly religious.³⁰ At the other extreme are scholars who probably merit the supposedly pejorative epithet of a *communist*.

The stakeholder debate is complicated by the amount of involvement by the stakeholder. Is it a matter of control, voice, or consideration? As

²³ See, e.g., Elaine Sternberg, *The Defects of Stakeholder Theory*, 5 CORPORATE GOVERNANCE 3 (Jan. 1997), available at <http://www.blackwell-synergy.com>.

²⁴ R. Edward Freeman, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 46 (1984).

²⁵ For example, the "strictly business" stakeholders of the General Electric Company in the 1930's were seen as being "customers, employees, managers, and shareholders." Max B. E. Clarkson, *A Stakeholder Framework For Analyzing And Evaluating Corporate Social Performance*, 20 THE ACAD. OF MGMT. REV. 92, 106 (1995).

²⁶ This position has been selected as it is minimalist and, as such, the least controversial of the stakeholder positions.

²⁷ David Wood, *Whom Should Business Serve?* 14 AUST. J. CORP. LAW 262, 272 (2002) (quoting Bruce Langtry, *Stakeholders and the Moral Responsibilities of Business*, 4 BUS. ETHICS Q. 431 (1994)).

²⁸ Bruce Langtry, *Stakeholders and the Moral Responsibilities of Business*, 4 BUS. ETHICS Q. 431, 434 (1994).

²⁹ Wood, *supra* note 27, at 2 n.3. Adam Smith only refers to the invisible hand once in THE WEALTH OF NATIONS, and is more moderate in his views than commonly presented by neo-liberals. See generally ADAM SMITH, WEALTH OF NATIONS (1776).

³⁰ See DINE, *supra* note 9, at 110-11 (discussing Cooter's analysis of Coase's Theorem); Harvey Cox, *The Market as God*, ATL. MONTHLY, Mar. 1999, at 18. See also Linda McQuaig, ALL YOU CAN EAT 224 (2001) (discussing the new capitalists view of Smith's theories).

business professor Gerald Vinten notes, "There is no such thing as a tradeable stakeholding certificate, and neither is there any direct legal requirement [to consider stakeholders]."³¹ The lack of consensus on the stake in question certainly makes for a more muddled debate.

Another dimension to the debate derives from economists, who view the debate from the perspective of efficiency. Some have challenged stakeholder theory on the basis that stakeholder laws or "constituency states," such as anti-takeover legislation and non-exclusive wealth-maximizing, create distortions in the market harming the efficiency of the market and reducing overall social wealth, and hence, the overall well-being of society.³² Other economists claim that stakeholder theory more accurately reflects the situation by having internalized more costs, which current accounting principles inappropriately externalize.³³

Another aspect of the debate is introduced when one examines the nature of the corporation and its consequent role in society. Is the corporation merely a legal recognition afforded to a natural aggregation of business people, or is it a concession granted by government for the public good? Economists and law and economics scholars advocate the former position and believe that the corporation can stand as a nexus-of-contracts model.³⁴ These thinkers view the corporation as nothing more than a series of contracts between individuals and as having no separate existence apart from the contractors.³⁵ Lawyers, environmentalists, and business ethicists who look at corporate legal history as a way of supporting broader social responsibility advocate the latter position.³⁶ The legal aspect of the debate becomes more complex as one examines various legal concepts of corporate law arising from rulings, such as *Salomon v. Salomon & Co. Ltd.*,³⁷ and even more so when one examines the normative issues of corporate law.³⁸

The discussion takes on a different dimension when one examines the views of management theorists and practitioners. Such parties are concerned

³¹ Gerald Vinten, *The Stakeholder Manager*, 38 MGMT. DECISION 377, 377 (2000).

³² See, e.g., Jensen, *supra* note 7; Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAGAZINE, Sept. 13, 1970, at 32.

³³ See, e.g., Bryan Horrigan, *Fault Lines in the Intersection Between Corporate Governance and Social Responsibility*, 25 U.N.S.W. L.J. 515 (2002). See also Wood, *supra* note 27.

³⁴ FARRAR, *supra* note 2, at 30 n.69 (stating that concept was pioneered by Coase).

³⁵ FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

³⁶ See, e.g., Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 WASH. & LEE L. REV. 1565, 1623 (1993); MAX CLARKSON, *A RISK BASED MODEL OF STAKEHOLDER THEORY* (1994); Horrigan, *supra* note 33, at 551-53.

³⁷ [1897] AC 22.

³⁸ FARRAR, *supra* note 2, at 28.

with the practical matters of profitability, accountability, and control. These interests and concerns are intertwined with some of the interests and concerns of corporate lawyers. The discussion in this area considers, among other things, the best way to control the corporation and generally frames the discussion in terms of internal or external forms of regulation.³⁹

In dealing with the shareholder-stakeholder debate, another discussion comes into play. The issue concerns the role of government in dealing with corporations and the various interests they represent. Is the role of government to facilitate the market and the invisible hand as a shareholder's advocate, or is the government's role to regulate corporations to promote the common-good for the benefit of the stakeholders?

The stakeholder debate is multi-faceted, multi-disciplinary, interconnected, and in some aspects it is circular.⁴⁰ Government, as the ultimate external control, needs direction from the public and from scholars on the nature, purpose, and functioning of the corporation in order to develop appropriate systems to do its job of governing the nation. The role of government is made more complex by the influence of corporations and, of course, the debate on the proper role of government in the first place.

III. STAKEHOLDER THEORY

A. *Origins and History*

As a legal concern, stakeholder theory goes back to Dodd⁴¹ and concerns arising out of the Great Depression. However, stakeholder theory as a management concern can be traced back to at least 1963, where the Stanford Research Institute used the theory in an internal memorandum on management to signify "those groups without whose support the organization would cease to exist."⁴² Since that time, stakeholder theory has waxed and waned in popularity as the political landscape has shifted between social and liberal poles and the economy has either expanded or contracted. Generally, more socially concerned governments in challenging economic times will advance laws supporting stakeholder concerns.⁴³ Contemporary

³⁹ See generally Dine, *supra* note 9, ch. 4.

⁴⁰ In this paper, the author will not distinguish between the various particularities of corporate law in Anglo jurisdictions because the fundamental concerns and issues are the same: the nature of the corporation and its role in society.

⁴¹ See Dodd, *supra* note 17.

⁴² Freeman, *supra* note 24, at 56.

⁴³ See Peter Drucker, *Will The Corporation Survive? Yes, But Not As We Know It*, THE ECONOMIST, Nov. 9, 2001, available at <http://www.cfo.com/printable/article.cfm/3001916>. Leading management

management theories dealing with employee empowerment, 360 evaluations,⁴⁴ and TQM circles⁴⁵ may well be expressions of the stakeholder view.⁴⁶

A general review of the stakeholder literature leads one to conclude that stakeholder theorists argue four points. First, they advocate that the corporation is a concession from the government and an independent entity in itself.⁴⁷ If the corporation is a government grant and not simply an acknowledgement of spontaneous social organization as the contractarians argue, then the government has a right to control and define the proper purposes and structure of the corporation.⁴⁸ Second, stakeholder theorists argue that the corporation should be governed by those affected by the decisions and actions of the corporation.⁴⁹ This view is discussed as the political view of the corporation.⁵⁰ Essentially, the argument derives from basic democratic theory. Third, these theorists believe that the best way to govern the corporation is by having decision making structures in place that permit those affected by the decisions at least a voice, if not some control, on the decisions made.⁵¹ Finally, the theorists contend that the corporation should be governed in a way that promotes the overall social good.⁵²

B. Assumptions and Criticism

1. ASSUMPTIONS OF THE STAKEHOLDER THEORY

Stakeholder theory embodies the idea that the corporation is an entity that has profound effects on society. On that basis, those affected should have some influence or control over the corporation. The theory is based on

scholar, Peter Drucker, observes that the shareholder primacy model is a "fair-weather" model (last visited February 20, 2005).

⁴⁴ A 360 evaluation is an evaluation in which all members of a team or party who are in contact and available to assess and offer criticism of a person do so.

⁴⁵ TQM circles are groups of employees who collaborate together to solve problems and increase the quality of the product or service.

⁴⁶ See MICHAEL CZINKOTA, ILKKA RONKAINEN & MICHAEL MOFFET, INTERNATIONAL BUSINESS: UPDATE 2003 at 493-97 (2003), for a discussion of employee involvement in corporate governance in various countries and the related management theories.

⁴⁷ See Paul N. Cox, *The Public, the Private and the Corporation*, 80 MARQ. L. REV. 391, 401-11 (1997).

⁴⁸ *Id.*

⁴⁹ Freeman, *supra* note 24.

⁵⁰ See Jennifer Hill, *Visions and Revisions of the Shareholder*, 48 AM. J. COMP. L. 39, 51-57 (2000).

⁵¹ *Id.* at 53.

⁵² This is the general view of the communitarians. See Bainbridge, *supra* note 7, at 890.

fundamental legal principles and beliefs, including the idea that one must bear responsibility for the consequences of their actions. Economics and efficiency are not ultimate values, and there must be a voice in the distribution of cost and benefits for society's resources.⁵³

2. CRITICISM OF THE THEORY

Elaine Sternberg may be considered one of the champions among stakeholder critics.⁵⁴ As the leading spokesperson opposing stakeholder theory, her arguments merit analysis. Sternberg's criticism of stakeholder theory has four main areas of contention.⁵⁵ She argues that the stakeholder theory is incompatible with business and corporate governance, that the stakeholder theory of accountability is unjustified, and that stakeholder theory undermines private property, agency, and wealth. Sternberg's criticisms are by no means an exhaustive list of the criticisms of stakeholder theory; however, they are representative of general issues.⁵⁶

Sternberg's primary contention is that the "stakeholder theory . . . wholly precludes the activity of business . . ." ⁵⁷ She argues that business requires maximizing long-term owner value.⁵⁸ In contrast, the balancing requirement of stakeholder theory precludes such favoritism and this, by definition, obviates business.⁵⁹ Sternberg claims that the stakeholder theory is unworkable because the number of stakeholders is infinite, and given all the competing interests, the identification of what should be counted as a benefit

⁵³ Bottomley, *supra* note 3, at 290 (quoting M. Stokes, *Company Law and Legal Theory*, in TWINING, *LEGAL THEORY AND COMMON LAW* 180 (W ed.) (1986)).

⁵⁴ Jensen, *supra* note 7, at 298 n.2. Sternberg is a former investment banker turned philosopher. She includes in her argument certain legal grounds for opposing stakeholder theory. Her view of the stakeholder theory as some type of heretical cult can be seen from the title of her article, *Stakeholder Theory Exposed*, 2 CORPORATE GOVERNANCE Q., 4 (1996). It is interesting to note that few lawyers seem to oppose stakeholder theory—at least not on legal grounds as the nexus of contracts model is the dominant model. See EASTERBROOK & FISCHER, *supra* note 35. Perhaps this reflects an understanding that the law does not exist a priori, but follows from determined policy decisions, or alternatively, that law does have an inherent obligation of social justice. See also Friedman, *supra* note 32; Jensen, *supra* note 7.

⁵⁵ See Sternberg, *supra* note 23. Criticisms of stakeholder theory are generally variations on these same themes, whether the criticisms arise from legal scholars, economists, business theorists or others. See, e.g., Anant Sundaram & Andrew Inkpen, *The Corporate Objective Revisited*, 15 ORGANIZATION SCI. 350 (2004). See also Friedman, *supra* note 32; Jensen, *supra* note 7.

⁵⁶ Sternberg, *supra* note 23. See, e.g., Corfield, *supra* note 6, (identifying eight); Sundaram & Inkpen, *supra* note 55, (identifying five).

⁵⁷ Sternberg, *supra* note 23, at 4.

⁵⁸ *Id.*

⁵⁹ *Id.*

is not identifiable.⁶⁰ Since stakeholder theory has no means of weighing or balancing the competing interests of various stakeholders, the balancing task demanded by stakeholder theorists is impossible.⁶¹ Essentially, Sternberg is challenging the nature and purpose of corporations.

Furthermore, Sternberg argues that stakeholder theory is incompatible with corporate governance.⁶² In her view, accountability of directors to shareholders is the central issue in corporate governance, where as “an essential principle of stakeholder theory [is] that corporations should be equally accountable to *all* their stakeholders.”⁶³ Clearly, if one accepts her view of accountability and corporate governance, she is correct that stakeholder theory is incompatible with corporate governance.

In regards to the argument on accountability, Sternberg finds that stakeholder theory “gives full rein to arrogant and unresponsive management”⁶⁴ and assists in exploitation of corporations by management by failing to provide a single clear criterion for judgment of performance.⁶⁵ The stakeholder theory requires management to reject the obligations to owners that they accepted when taking their management jobs.⁶⁶ Thus, “[a]s the property of its owners, a business is properly accountable only to them.”⁶⁷

Finally, Sternberg claims that stakeholder theory undermines private property rights by denying owners of private property the right to deal with it as they choose.⁶⁸ If corporations act in the interests of anyone but the shareholders, corporations are converting and/or curtailing the private property rights of the owners.⁶⁹ This argument has significant legal implications and focuses the debate on a critical point—the underlying political views or agendas of the two positions. The noted corporate law scholar Millon observes:

[Stakeholder theorists] characterize the debate as a disagreement over whether it is appropriate to use mandatory rules to impede shareholder wealth maximization in order to benefit other corporate constituent groups or other affected interests outside the corporate

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² Sternberg, *supra* note 23, at 5.

⁶³ *Id.* (emphasis added).

⁶⁴ *Id.*

⁶⁵ *See id.*

⁶⁶ *Id.*

⁶⁷ Sternberg, *supra* note 23, at 6. Sternberg also briefly addresses corporate performance, Kantian moral theory, parallels with government, and social contract arguments for extra-corporate accountability.

⁶⁸ *Id.* at 8.

⁶⁹ *Id.*

enterprise. For contractarians [shareholder theorists], such rules represent an unjust imposition on the liberty of shareholders to pursue their own interests. They have made this point by criticizing communitarian [stakeholder] corporate law reform as the reallocation of wealth from shareholders to non-shareholders.⁷⁰

Sternberg applies Millon's propositions to the law of agency. Sternberg holds that the directors and managers of corporations are agents of the shareholders.⁷¹ Accordingly, stakeholder theory, which allows corporations to act independently of or contrary to the wishes of shareholders, undermines the duty of the agent to the principal.⁷² She argues that these two pillars of law underlie the success of western economies and political liberties; and therefore, these pillars must be protected by rejecting stakeholder theory. The law as it stands in support of capitalist, free market economies is correct and should be carefully guarded.

Sternberg concludes her attack on stakeholder theory with *ad hominem* arguments⁷³ that seem to characterize opponents of stakeholder theory.⁷⁴ She opines, "stakeholder theory seems to offer a free lunch; it attracts those would like to enjoy the benefits of business without the discipline . . . [and] those with most to gain from avoiding accountability: business managers . . . [and] promoters of worthy 'causes,' who believe they would be the beneficiaries."⁷⁵ Perhaps this type of personal and emotional attack reflects the very deep and personal ideologies that underlie the debate, which shall be addressed later in this paper.

Sternberg believes that stakeholder theory is fundamentally flawed because the theory does not make directors responsible to owners,⁷⁶ which is the classic Berle and Means agency problem.⁷⁷ Her concern is that the

⁷⁰ Millon, *supra* note 14, at 1383-84.

⁷¹ Sternberg, *supra* note 23, at 8-9.

⁷² Indeed, as Sommer observes: "it may be reasonably concluded that the legislature intended to do something common law did not do in affording directors flexibility in fending off a hostile tender offer—namely, favor non-shareholders over shareholders." Summer, *supra* note 13, at 43.

⁷³ An *ad hominem* argument is an attack on the person making the argument instead of addressing the substance of the argument itself.

⁷⁴ Sternberg, *supra* note 23, at 8-9. See also Jensen, *supra* note 7, at 306 (stating that "Stakeholder theory gives them [socialists] the appearance of legitimate political access to the sources of decision making power."). Millon, *supra* note 14, at 1388 (observing that "[t]he ideology and psychological predispositions that turn many corporate law scholars away from these kinds of inquiries explain the inability of at least some contractarians to acknowledge the crisis in corporate law.").

⁷⁵ Sternberg, *supra* note 23, at 8-9.

⁷⁶ *Id.* at 5.

⁷⁷ See generally ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1968). Berle and Means identified the problem as the power of corporate managers to service

agents will act in their own self-interest.⁷⁸ In Sternberg's view, directors cannot have any true accountability, unless the shareholder directly and exclusively supervises them.⁷⁹ Empirical studies of self-interest in management action and decision-making suggest that Sternberg is being driven by ideology more than evidence.⁸⁰ Studies indicate that managerial motivation is far more complex, because it includes aspects of altruistically motivated behavior along with self-interested behavior.⁸¹

C. Replies to Stakeholder Criticism⁸²

Many critics have sharply criticized the stakeholder theory. The strength of these criticisms revolves primarily around the above-noted issues of accountability and current legal norms. This portion of the article provides individual replies to each of the criticisms, which are easily understood when posed in interrogatory form as follows. First, is stakeholder theory contrary to business? For stakeholder theory to be against business, one must accept a certain definition of business, and more particularly, a certain theory of the corporation. If the corporation is, as economists argue, a nexus-of-contracts,⁸³ then there may be some credence to the argument. One must accept, however, that the appropriate and exclusive object of business is the increase of wealth for owners of the business.⁸⁴ In addition, one must also exclude the wealth of any other party, including the general social benefit as

their own interests without regard to the interests of the shareholders.

⁷⁸ Sternberg, *supra* note 23, at 8.

⁷⁹ *Id.* at 5-8.

⁸⁰ The literature on motivation in management is considerable and includes such motivating factors as trust, feeling appreciated, a desire to belong to a group, and personal acceptance. Joseph Badaracco & Richard Ellsworth, *Leadership, Integrity and Conflict*, 30 MGMT. DECISION 29 (1992). Badaracco and Ellsworth observe:

they (business leaders) also believed that these forces fail to explain fully the motivation of the high-caliber individual they sought for their organizations. Leaders understand that people need to find meaning in life through their work and that meaning is derived from creativity in the service of worthwhile purposes. Strong personal ethics, a positive belief in others, and a compelling vision were other characteristics of successful corporate leadership.

Id. at 31. In addition, one can consider Winter's theory that management looks to advance shareholder interests even where contrary to management self-interest. Ralph K. Winter, *The "Race to the Top" Revisited: a Commentary on Eisenberg*, 89 COLUM. L. REV. 1526 (1989).

⁸¹ Badaracco & Ellsworth, *supra* note 80, at 31.

⁸² See Vinten, *supra* note 31 (replying to Sternberg's four objections).

⁸³ See Coase, *supra* note 10.

⁸⁴ For example, Jensen argues that business can have but one objective and to require managers to coordinate more objectives, and in particular, conflicting objectives, will cause complications to the point of immobilization. Jensen, *supra* note 7, at n.7

being of interest or importance.⁸⁵ Furthermore, as will be discussed in greater depth, the situation is not clear as to whether the long-term stockholder interest should have priority over short-term stockholder interest, or whether shareholders are "owners" that have a unique or special position in the corporation.

Clearly, these assumptions are suspect. Not all members of society, or even a business, would agree that the only purpose of business is to increase wealth for shareholders. Neither would many say that the well-being of society as a whole is irrelevant or that any particular group of shareholders should be favored over others. For example, Farrar, who is a leading international corporate law scholar, laments about "the unsatisfactory state of affairs" in his authoritative analysis of the corporation.⁸⁶ Farrar outlines the mutations of the idea of the corporation and its purposes over time, and states that this also adds to the uncertainty in the proper identification of the nature and purposes of the corporation.⁸⁷ H.L.A. Hart, arguably the most distinguished jurist of the twentieth century, observed that none of the theories of the corporation (sociological, economic, or legal) adequately explains the phenomenon.⁸⁸ Theories of the corporations include sociological, economic, and legal theories. One can further analyze the corporation in terms of culture, power, politics, and cybernetics.⁸⁹ Therefore, without any consensus concerning a foundational understanding of the corporation or its purpose, one has difficulty seeing how Sternberg's criticism can stand. Stakeholder theory is merely outside of Sternberg's paradigm for the corporation.

Sternberg also argues that stakeholder theory is contrary to corporate governance and is based on the issue of accountability.⁹⁰ To be equally

⁸⁵ Later in this paper I will address the challenge that the increasingly unequal distribution of wealth creates for those who argue that overall wealth increases the social wealth of a country. See, e.g., Jensen, *supra* note 7, at 302-04. Cf. generally, Stephen Bottomley, *Taking Corporations Seriously: Some Considerations for Corporate Regulation*, 19 FED. L. REV. 203 (1990); Janet Dine, *Risks and Systems: A New Approach to Corporate Governance and the European Employee Consultation Structures?* 3 INT'L & COMP. CORP. L.J. 299, 302 n.11 (2001); Cf. generally, Ronald Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191 (1980).

⁸⁶ Farrar, *Frankenstein Incorporated or Fool's Parliament? Revisiting the Concept of the Corporation in Corporate Governance*, 10 BOND L. REV. 142, 161 (1998), available at <http://www.bond.edu.au/law/blr/vol10-2/2-Farrar.pdf> [hereinafter *Frankenstein*].

⁸⁷ *Id.* at 144-45.

⁸⁸ H.L.A. HART, *Definition and Theory in Jurisprudence*, in *ESSAYS IN JURISPRUDENCE AND PHILOSOPHY* at 21-48 (1983).

⁸⁹ See, e.g., Turnbull, *supra* note 2, at 193-96.

⁹⁰ Sternberg, *supra* note 23, at 5-8. See also Jensen, *supra* note 7, at 300 (arguing that from a management perspective, stakeholder theory is impossible because it requires management to consider more than one interest).

accountable to all, she argues, is to be accountable to none.⁹¹ This argument is a straw-man argument.⁹² Stakeholder theory, to the extent that one can speak of unanimity of views, does not advocate equality of all interests or the view this extreme position implies, which is the rejection of the profit motive.⁹³ Judges and legislatures balance conflicting interests by regularly examining policy objectives, among other things.⁹⁴

In fact, as noted by Professor Henry Hu in his award winning study, corporate directors already do just that: they attend to more than a single objective.⁹⁵ These answers, however, are not to denigrate the seriousness of the criticism. Stakeholder theory does have a considerable challenge to address when the issues arise of how and to whom the corporation should be accountable. Alternative answers lie in corporate governance structures in non-Anglo corporations. Some examples include the German two-tiered board that permits employees a strong voice in decision-making, and the Japanese model that permits a tripartite objective for the corporation.⁹⁶ More Anglo solutions lie in the "Triple Bottom Line" idea (profit, environmental protection, and social good), which seems to be gaining some acceptance, at least in Australia.⁹⁷

The most fundamental legal challenge to stakeholder theory comes from Sternberg's criticism of property and agency law.⁹⁸ These criticisms go back to the Berle and Dodd debate in which Berle cautioned against the stakeholder view, which "requires little analysis to make clear the fact that private property as understood in the capitalist system is rapidly losing its original characteristics."⁹⁹ If one accepts, however, that all rights, except the

⁹¹ Sternberg, *supra* note 23 at 5-8.

⁹² A straw man argument is an argument where the protagonist sets up a false opponent and then easily dismantles the ostensible arguments being put forward by the opponent.

⁹³ For example, Dunfee, *supra* note 5, at 129 n.2, suggests a plurality of interests none of which rejects or precludes the profit motive.

⁹⁴ For example, Judge Richard Posner finds economics as the policy driving force behind legal rationales. See, e.g., RICHARD POSNER, *THE ECONOMICS OF JUSTICE* (2d ed. 1983) [hereinafter POSNER].

⁹⁵ Henry T.C. Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, 38 UCLAL. REV. 277 (1994) (discussing the complexity of the concept of profit and demonstrating how the profit motive itself is not a single objective).

⁹⁶ "Japanese communitarian capitalism . . . [has] three intertwined strands of the common good—i.e. the pursuit of happiness and prosperity, the concern for justice and fairness, and the affirmation and importance of community." Horrigan, *supra* note 33, at 542.

⁹⁷ *Id.* at 543.

⁹⁸ Sternberg, *supra* note 23, at 8-9.

⁹⁹ BERLE & MEANS, *supra* note 72, at 247.

right to life,¹⁰⁰ are circumscribed and that no rights are absolute, then there is no reason that the right to private property should be any different. In fact, the law recognizes many limitations on private property rights. For example, the law recognizes the state's right to appropriate land or to prohibit the ownership of another human being and where and how one may drive their car. Additionally, if one accepts that the corporation is not the property of the stakeholder, but an independent entity in which the stakeholder has only three rights (voting, dividends, and residue), then the criticism from property and agency law does not stand. Sternberg's view of law appears naïve. Her argument appears to presume that law in some manner is *a priori*¹⁰¹ and has followed a logical non-ideological path. In her view, the law of property, agency and corporations stand independent of critical scrutiny and accordingly, efforts by stakeholder advocates to change the status quo are somehow illegitimate encroachments on the way things are supposed to be. Law is the product of its particular time¹⁰² and involves certain styles of thinking by a limited group of people, who are usually a propertied, privileged class with less concern for those less fortunate.¹⁰³

IV. SHAREHOLDER THEORY

To avoid a straw-man argument,¹⁰⁴ as Sternberg created in her criticism of stakeholder theory, the discussion of shareholder theory must start with a caveat. In all but its most extreme versions, the shareholder theory does not require that every other party be ignored and every possible action to advance profit be taken.¹⁰⁵ Rather, the theory requires that primacy be given to the shareholder. Accordingly, in at least American legal literature, shareholder theory is referred to as "shareholder primacy."¹⁰⁶

¹⁰⁰ This is a highly controversial matter in current USA society and law following from the recent Terri Schiavo case.

¹⁰¹ A pre-existent and assumed state of affairs.

¹⁰² As Sommer observes, "[t]he truth is that its content is constantly shifting, and notwithstanding the best efforts of justices to link their present decision making with the past in an effort to make it appear that nothing has changed, the truth is that change has occurred." Sommer, *supra* note 13, at 33.

¹⁰³ This concern is central to much of the Critical Legal Studies scholarship. Mocking the supposed equality of the law, Anatole France said "[t]he law, in its majestic equality, forbids the rich as well as the poor to sleep under bridges, to beg in the streets, and to steal bread." ANATOLE FRANCE, *THE RED LILY* (1894). The Oxford Dictionary of Quotations 292 (Angela Partington ed., 4th ed. 1992).

¹⁰⁴ See Sternberg, *supra* note 23.

¹⁰⁵ Shareholder theory does not, for example, require a corporation to hire "a hitman to murder the key witness against the firm in a major product liability case." Dunfee, *supra* note 5, at 132.

¹⁰⁶ See Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT'L LAW 45 (2002).

Shareholder primacy views the corporation's objective as maximizing shareholder wealth. Business scholars refer to this wealth maximization as the "corporate objective function."¹⁰⁷ Although shareholders can be viewed or characterized in a number of different ways,¹⁰⁸ for purposes of this debate, the view that most accurately represents the situation under discussion is the shareholder-as-investor view. The shareholder in this model is nothing more than a party looking for an increase in share value or dividends. This shareholder has no interest in the corporation as a business and no interest in how individuals act as directors, so long as they receive an acceptable return on investment. Shareholders in this model most accurately reflect the idea of shareholder in the shareholder primacy literature.

Shareholder primacy theorists advance a number of arguments in support of their position. These theorists argue: (1) corporate governance is a mere collection of contracts the terms of which govern the actions of the individuals involved, and therefore, no entity exists to govern; (2) corporations should be governed by shareholder appointees, such as directors; (3) the best way to govern the corporation is by a board of directors elected by and accountable to the shareholders; and (4) the corporation should be governed for shareholder wealth maximization.¹⁰⁹ In sum, the corporation is a bare contractual arrangement made for the benefit and control of the shareholder.

A. *Origins and History*

From the perspective of legal theory, one could argue that the primacy of shareholder rights arise from doctrines of private property. John Locke argued that private property is carved out of the common property based on a person's amount of labor. Locke stated, "[I]t hath by this labour something annexed to it that excludes the common right of other men."¹¹⁰ In other words, private property is derived from the direct connection of one's hands and the physical article, in which one has an ownership right; this is the right to exclusive use.¹¹¹ Justice Wilson wrote in the 1766 property case of

¹⁰⁷ See, e.g., Jensen, *supra* note 7.

¹⁰⁸ See Hill, *supra* note 50, at 42-64 (identifying seven models or views of shareholders: owner/principal, beneficiary, bystander, participant in a political entity, investor, Cerberus, and managerial partners).

¹⁰⁹ See generally Bainbridge, *supra* note 7.

¹¹⁰ JOHN LOCKE, SECOND TREATISE ON GOVERNMENT 185-86 (Hackett Pub. Co. 1980) (1690).

¹¹¹ *Id.* at 186. Interestingly, Locke uses the example of the activity of one's servant without explaining how that person becomes a servant in the first place.

Cornwallis v. Houghton,¹¹² concerning landowners denial of gleaning rights to commoners, that "the soil is his, the seed is his and in natural justice his also is the profit."¹¹³ This view of private property rights lends credence to the argument that the rights of ownership of capital led to the right to manage the enterprise. This view provided a stronger argument at a time when capital and management were more closely linked.¹¹⁴ In corporate law, one finds that the shareholders were historically those who invested their private property and money into a common fund, such as a joint stock company, with a view towards profit.¹¹⁵

Changes in corporate law, however, increased the separation between owners of financial capital and the income generating assets of the business. In both *Santa Clara County v. South Pacific Railroad*¹¹⁶ and *Salomon v. Salomon & Co.*,¹¹⁷ a case decided in the United Kingdom, the courts gave the corporation an independent personality. This personality existed, held property, and incurred liability in its own right. The corporation had complete independence from the shareholders and other members of the corporate entity. This change in the law permitted management to ignore the broader concerns of the general commercial environment, which included creditors and employees. Additionally, the change narrowed the focus to those interests of the "owner" shareholders.¹¹⁸

Prior to these court decisions, corporations did not have independent legal personalities, and hence, they were not able to sustain a legal action independently of the shareholders. Nor was limited liability a feature of corporations until 1855.¹¹⁹ With the combined benefits of independent legal personality and limited liability, shareholders no longer needed to consider any other interests. There was no greater personal financial risk in refusing to consider other interests, than the risk already accepted by making the investment in the corporation in the first place. As a result, people could become investors, carefree of corporate action and its consequences, except

¹¹² See E.P. THOMPSON, CUSTOMS IN COMMON (1991) at 139-42, 169.

¹¹³ McQuaig, *supra* note 30, at 209 (quoting E.P. THOMPSON, CUSTOMS IN COMMON (1991)).

¹¹⁴ See DINE, *supra* note 9, at 6. See generally Hill, *supra* note 50 (suggesting that such closeness of shareholder and management in earlier times could be "another myth of corporate law"). See also Wood, *supra* note 27, at 275 (discussing Adam Smith's comments on passive, uninterested, uninvolved investors).

¹¹⁵ FARRAR, *supra* note 2, at 158.

¹¹⁶ 118 U.S. 394 (1886).

¹¹⁷ [1897] AC 22.

¹¹⁸ FARRAR, *supra* note 2, at 22.

¹¹⁹ See DINE, *supra* note 9, at 5 (offering 1844 as the date of incorporation by registration and 1855 as the date of limited liability). See also FARRAR, *supra* note 2, at 9 (offering 1844 as the date that the UK's Companies Act first conferred limited liability).

for a return on capital.¹²⁰ While this phenomenon, as anticipated by Smith and Marx,¹²¹ is neither new nor unexpected, it creates certain problems. These problems particularly include the agency problem, and for some, a moral problem.¹²² Some individuals have suggested the phenomenon also carries a legal problem. As Wood states:

Berle and Means point out that having 'surrendered control and responsibility' over corporate assets, shareholders had 'surrendered the right that the corporation should be operated in their sole interest' and 'released the community from the obligation to protect them to the full extent implied in the strict doctrine of property rights.'¹²³

If Berle and Means are correct on this issue, their comment suggests a rather different view of shareholders' rights that seems oddly to have escaped attention.

Over time, corporate law came to reflect this single focal point¹²⁴ and more attention was paid to director accountability for the shareholders. Jennifer Hill, a noted corporate law scholar, however, argues that the trade-off of control was made at the same time that the courts moved the focus of corporate law to the maximization of shareholder wealth.¹²⁵ In other words, the agency problem created by the separation of ownership and management was resolved by the fiduciary nature of the duties placed on management.¹²⁶

Although shareholder primacy was developed by U.S. courts in the 1830's in terms of receiving dividends and voting,¹²⁷ the view of shareholder

¹²⁰ FARRAR, *supra* note 2, at 11.

¹²¹ *Id.* at 11 n.37 & n.40.

¹²² David Wood stated that:

[i]ndeed, passive investing may be looked upon as a morally questionable activity, dividends being quite undeserved. Adam Smith expressed very little concern for such an investor. He castigated what he referred to as 'proprietors' of joint stock companies, for they: 'seldom pretend to understand any thing of the business of the company; and when the spirit of faction happens not to avail among them, give themselves no trouble about it, but receive contentedly such half yearly or yearly dividend, as the directors think proper to make to them.'

Wood, *supra* note 27, at 275 (quoting ADAM SMITH, *THE WEALTH OF NATIONS* 699 (Random House ed. 1937)).

¹²³ Wood, *supra* note 27, at 276.

¹²⁴ See David Millon, *Frontiers of Legal Thought: Theories of the Corporation*, 1990 DUKE L.J. 201, 222 (1990) [hereinafter *Frontiers of Legal Thought*].

¹²⁵ Hill, *supra* note 50, at 42-61.

¹²⁶ Fiduciary duties are placed on directors, not managers, but the term *management* is used to keep linguistic symmetry and emphasize the idea of operators versus owners.

¹²⁷ D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 296 (1998).

wealth as the focus of the corporate enterprise was not pronounced by the courts until the 1919 case of *Dodge v. Ford Motor Company*.¹²⁸ In *Dodge*, the court opined that "[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."¹²⁹ Managers have followed this lead¹³⁰ and generally welcomed the focus because the holding simplified their responsibility and tied their success to clearly and easily measurable outcomes.¹³¹ In regulating corporations more recently, however, some governments have broadened the earlier restrictive laws that precluded non-shareholder interests.¹³² In doing so, the hope was that corporations, specifically directors, would consider other interests of the broader community or social development concerns.¹³³ Therefore, shareholders view the pursuit of non-shareholder interests, including stakeholder interests, as a tax or misuse of the private property of the shareholders.¹³⁴

In summary, the main idea is that the parties who put up the money for the enterprise, the shareholders, should have the right to control; they should be the sole concern of the enterprise. From the management perspective, current proponents of shareholder primacy, such as the Harvard Business scholar Michael Jensen, argue that "value maximization says that managers should make all decisions so as to increase the total long-run market value of the firm."¹³⁵

¹²⁸ 170 N.W. 668, 684 (1919).

¹²⁹ *Id.*

¹³⁰ Smith, *supra* note 119, at 278 (citing Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm* 21 J. CORP. L. 657, 657-71 (1996)). Note that Smith argues the contrary: in his view, shareholder wealth maximization is not, and has not been, the norm in corporate law. Nevertheless, Smith acknowledges that the consensus is the shareholder primacy norm. Smith, *supra* note 119, at 279.

¹³¹ Dean Clark describes the practical argument for this perspective:

A single, objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests. . . .

[B]etter monitoring means that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do, and do it efficiently.

Orts, *supra* note 36, at 1604 n.204.

¹³² For example, thirty of the fifty states in the United States have enacted laws permitting directors to consider stakeholders' interests. Millon, *supra* note 14, at 1375. See also Orts, *supra* note 36, at 1598-1612.

¹³³ This broadened ambit appears to have been used primarily, if not exclusively, in the development of anti-takeover strategies, and not the true interests of the community at large. See Corfield, *supra* note 6, at 230.

¹³⁴ *Frontiers of Legal Thought*, *supra* note 116, at 227-28 (citing Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAGAZINE, Sept. 13, 1970, at SM17).

¹³⁵ Jensen, *supra* note 7, at 299. Jensen adds that the long-term interests of the corporation include "equity, debt, preferred stock and warrants." *Id.* Interestingly, for purposes of the legal debate on stakeholder theory, Jensen would be included with the stakeholders. Stakeholders are defined as

The other main argument for shareholder primacy comes from the legal foundation of the corporation. Corporations are founded by one or more people, who contribute to a fund of capital for the purpose of carrying on a business with a view to making a profit. These founding contributors are the shareholders. As founders of an entity, shareholders have the right to control the entity—the corporation.

B. Assumptions and Criticism

1. ASSUMPTIONS OF THE SHAREHOLDER THEORY

Shareholder theorists fundamentally hold that the corporation is a free association of individuals for the purposes of wealth generation. In their view, individuals and more particularly, individual shareholders, must be left without restraint to increase their wealth. They see wealth as the objective or reason for social organization, and the more wealth, the better. The distribution of that wealth is a matter of little or no concern.¹³⁶ They have a liberal view of property rights and oppose government efforts at redistribution.¹³⁷

Most recently, shareholder primacy was brought into focus by the views of the economist, Milton Friedman. In his highly controversial article, *The Social Responsibility of Business is to Increase Its Profits*,¹³⁸ Friedman argues that the social good achieved by a corporation is to produce a profit.¹³⁹ He explains, “there is one and only one social responsibility of business - to use its resources and engage in activities designed to increase its profits so long

“variously, bondholders, suppliers, distributors, creditors, local communities . . . [and] users” Dunfee, *supra* note 5, at 131.

¹³⁶ Cox, *supra* note 34, at 434. When the issue of distribution is raised, shareholder theorists tend to deal with it by addressing the matter to R. Coase whose theory in simple terms is that where transaction costs are zero, initial allocation of rights is unimportant. R. Coase, *The Problem of Social Costs*, 1 J. OF LAW AND ECON. 1 (1960). Unfortunately, this appears to be a misreading of Coase. See N. MERCURO & S. MEDEMA, *ECONOMICS AND THE LAW: FROM POSNER TO POST-MODERNISM* 56 (1997).

¹³⁷ Cox, *supra* note 34, at 404-06.

¹³⁸ Friedman, *supra* note 32, at SM17.

¹³⁹ *Id.* Millon points out that Friedman was well aware

that profit seeking can generate externalities, and that various members of the public may be affected adversely. The question for Friedman was how such problems ought to be addressed, and he took for granted that a government accountable to the public, rather than private initiatives undertaking in the boardroom, should make the necessary cost-benefit decisions.

David Millon, *The Ambiguous Significance of Corporate Personhood*, 2 Stanford Agora: An Online Journal of Legal Perspectives (2001) at http://agora.stanford.edu/agora/cgi-bin/article2_corp.cgi?library=millon [hereinafter *The Ambiguous Significance of Corporate Personhood*].

as it . . . engages in open and free competition, without deception or fraud."¹⁴⁰ Additionally, he states that "[f]ew trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."¹⁴¹ Friedman and other profit maximization theorists¹⁴² make social welfare the ultimate justification for the exclusive focus on profit. In other words, the good end is social benefit, which will be achieved by ignoring that benefit and focusing exclusively on another end, which is shareholder wealth maximization.¹⁴³ Hansmann and Kraakman, the authors of the frequently cited work *The End of History for Corporate Law*, argue:

[t]he point is simply that now, as a consequence of both logic and experience, there is a convergence on a consensus that the best means to this end—the pursuit of aggregate social welfare—is to make corporate managers strongly accountable to shareholder interests, and . . . only to those interests.¹⁴⁴

In other words, Hansmann and Kraakman are arguing to prevent any other stakeholders from consideration and to prevent any other stakeholder interests from being considered. They claim a "convergence on a consensus"¹⁴⁵ or in other words, that there is a general agreement forming accepting the shareholder primacy model—despite the fact that there is no such agreement occurring as demonstrated by the stakeholder theorists already discussed.¹⁴⁶ Their ultimate point, etching Friedman's justification, is that shareholder primacy is "the best means to . . . aggregate social welfare."¹⁴⁷ Therefore, this social benefit becomes the justification for shareholder primacy.

¹⁴⁰ To trace the development of the view before it became famous in the New York Times article, see MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 133 (1962).

¹⁴¹ *Id.*

¹⁴² See e.g., Jensen, *supra* note 7, at 302 (stating that "[v]alue maximization is an important one because it leads . . . to the maximization of social welfare.").

¹⁴³ This position shows a remarkable faith in free market economics discussed by economist Joseph Stiglitz as "market fundamentalism." JOSEPH STIGLITZ, *GLOBALIZATION AND ITS DISCONTENTS* 35 (2002).

¹⁴⁴ See Hansmann & Kraakman, *supra* note 6, at 9. Note the same view reflected in Jensen's comment that value maximization "has its roots in 200 years of research." Jensen, *supra* note 7, at 299.

¹⁴⁵ See Hansmann & Kraakman, *supra* note 6, at 9.

¹⁴⁶ See *supra* Part III.A.

¹⁴⁷ See sources cited *supra* note 32.

A second series of justifications for shareholder primacy are based on the shareholder's place in the corporation and associated rights. These additional reasons are that shareholders: (1) hold the residual claims; (2) have the greatest risk; (3) have the greatest incentive to maximize firm value; and (4) have the least protection.¹⁴⁸ Still a third series of criticisms is leveled at the foundation of the shareholder primacy model's notion of a unified single shareholder constituency.¹⁴⁹ Finally, there are the more philosophical questions examining the position of shareholders, the value of wealth, and the nature of capital.

2. CRITICISMS OF THE THEORY

Given shareholder theorists' justification for their theory as producing the greatest social welfare, one should ask whether this social benefit has occurred. Economic studies do not support the increased welfare premise. For example, in the United States, where shareholder primacy has advanced over the last 30 years, there has been an increased concentration of wealth.¹⁵⁰ One finds a growing disparity between rich and poor, and a decline in the wealth of the middle class.¹⁵¹ In fact, corporate profits increased by 250 percent between 1980 and 1995, which is the same period in which worker compensation declined.¹⁵²

On a global level, the structural adjustment programs of the World Bank and International Monetary Fund¹⁵³ have opened borders to shareholder primacy corporations, but failed in increasing general social wealth or widely distributing the benefits of corporate activity.¹⁵⁴ The activities of these transnational corporations seem to do the opposite; they increase the

¹⁴⁸ Hill, *supra* note 50, at 11.

¹⁴⁹ See Hu, *supra* note 87.

¹⁵⁰ Michael Parenti, *The Super Rich Are Out of Sight*, COMMONDREAMS, December 27, 2002, <http://www.globalpolicy.org/soecon/inequal/2002/1227superrich.htm> (last visited Oct. 15, 2004).

¹⁵¹ "The 400 wealthiest taxpayers accounted for more than 1 percent of all the income in the United States in the year 2000, more than double their share just eight years earlier." David C. Johnston, *Very Richest's Share of Income Grew Even Bigger, Data Show*, N.Y. TIMES, June 26, 2003, at A1. Clearly, there are many reasons for such disparities such as government policies, performance of the economy, and changes in the labor force resulting from globalization, but the disparity noted parallels the shift away from stakeholder thinking and seems to suggest that shareholder primacy cannot be supported along these lines. See *Frontiers of Legal Thought*, *supra* note 124, at 229-30 (regarding the triumph of shareholder primacy in this era). See also McQuaig, *supra* note 30, at 97-107.

¹⁵² See Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1530-32 (1997) cited in Hill, *supra* note 50, at 63 n.179.

¹⁵³ See McQuaig, *supra* note 30, at 82-92 (regarding the discussions of Joseph Stiglitz, former chief economist at World Bank).

¹⁵⁴ See DINE, *supra* note 9, at ch. 5.

concentration of wealth and increase the disparity between the rich and the poor.¹⁵⁵ Accordingly, shareholder primacy as a general principal or a specific mechanism cannot be supported on the basis that the primacy benefits society overall.

Four reasons for the shareholder's position in the corporation are addressed in the following paragraphs. The four claims are that shareholders: (1) hold the residual claims; (2) have the greatest risk; (3) have the greatest incentive to maximize firm value; and (4) have the least protection.¹⁵⁶ As to the first reason, the only time shareholders have the actual residual claim is when the corporation is in bankruptcy or being wound-up.¹⁵⁷ Rarely is a corporation wound-up. Although bankruptcies have become more common, winding up is not generally considered a normal or desirable operating procedure. Accordingly, to argue that shareholders deserve to have their interests as the foremost consideration on the basis of their right to the residual claim is hardly compelling.¹⁵⁸

The second argument concerning risk is also challengeable on two fronts. First, one can raise a challenge using a comparison with the risks assumed by other stakeholders such as employees. Second, one can raise a challenge by comparing shareholders' risks with the risks and position assumed by other corporate financiers. One very important strategy for risk management is the exit option. With respect to publicly traded corporations, there is a highly liquid market for shares and at practically any point if the shareholder deems the risk unacceptable, then a party's shareholdings can easily be sold. In contrast, other stakeholders, such as employees who bear the risk of unemployment and who lack the general ability to *withdraw their investment*, shareholders appear to have less risk.¹⁵⁹

Shareholder primacy advocates argue that the risk shareholders take as equity investors is significantly different and greater than other capital providers. This argument is premised on a clear distinction between debt and equity. As Hill demonstrates, in a careful examination of the role of equity and the nature of equity in modern corporate practice, this distinction in contemporary corporate practice is very hard to maintain. She notes that

¹⁵⁵ *Id.* at 151.

¹⁵⁶ Hill, *supra* note 50, at 10-12.

¹⁵⁷ Stout, *supra* note 21, at 1193.

¹⁵⁸ Farrar suggests this residual claim is the basis of their right to vote. FARRAR, *supra* note 2, at 158 n.6.

¹⁵⁹ Jennifer Hill, *Public Beginnings, Private Ends—Should Corporate Law Privilege the Interests of Shareholders?* 9 AUST. J. CORP. L. 21, 27 (1998) [hereinafter *Public Beginnings, Private Ends*]. See also Corfield, *supra* note 6, at 216, n.15 (citing Margaret M. Blair, *Wealth Creation and Wealth Sharing: A Colloquium on Corporate Governance and Investments in Human Capital*, BROOKINGS INST. (1996)) (noting that employees lose a 10% job specific premium when they lose their jobs).

"with the rise of more complex funding instruments the traditional distinction between debt and equity fails to accord with economic reality and looks artificial, arbitrary and increasingly passé."¹⁶⁰ Furthermore, the disaggregation of equity investments, dividing the risk and control components, makes the notion of shareholder as risk bearer much less compelling.¹⁶¹ In fact, Hill believes that the courts are more likely to consider the interests of other financiers ahead of shareholders and the corporation's success or failure is independent of any particular interest group, including shareholders, in part because the higher exit barriers faced by other financiers make them as a group more vulnerable than the shareholders.¹⁶²

Moreover, Hill explains that the long-term involvement of some lenders causes them to have much more at stake than shareholders who have the easy exit option in a precarious financial situation.¹⁶³ Thus, the controlling positions of some lenders in securing their funds, but also in the operations of the corporations, makes them more like insiders than the traditional outsider role of creditors. However this situation, which she argues is the corporate reality, is not consistent with the shareholder primacy model advocated by shareholder primacy theorists.¹⁶⁴ This point of the more intimate or tied relationship of non-equity financiers is pressed further in a closely held corporation, where the creditor has a greater right of *ownership* to the cash flow of the corporation than the shareholder once the corporation has assumed the debt.¹⁶⁵ Therefore, shareholders are merely one group of financiers, whose characteristics do not fit the description set out by law and economics scholars.¹⁶⁶

A third argument supporting shareholder primacy is that shareholders have the greatest incentive to see that the corporation profit suffers from its own weakness.¹⁶⁷ While shareholders may be eager to see the value of the corporation maximized, there are certainly others with the same interest.

¹⁶⁰ *Public Beginnings, Private Ends*, *supra* note 159, at 27.

¹⁶¹ *Id.*

¹⁶² *Id.* In such instances the courts turn to the notion of the best interest of the corporation. See Sommer, *supra* note 13, at 46-51. See also Bottomley, *supra* note 3, at 284.

¹⁶³ *Public Beginnings, Private Ends*, *supra* note 159, at 26.

¹⁶⁴ *Id.*

¹⁶⁵ Stout, *supra* note 21, at 1190-94 (noting that shareholders have a first claim on profits and that they only have a claim on profits when the corporation is (a) profitable and (b) the directors declare a dividend).

¹⁶⁶ In his criticism of Salomon, Farrar notes, "[It] tipped the balance too far in favour of the equity investor at the expense of general and particularly involuntary creditors." *Frankenstein*, *supra* note 86, at 144.

¹⁶⁷ See Hill, *supra* note 50.

Groups, such as employees seeking job security, as well as directors and managers whose income may be directly tied to this measure (and those who lack the diversified portfolio common to shareholders), have a greater interest in seeing maximization than shareholders. The position that shareholders have the greatest interest in corporate profits, however, ignores the diversity among shareholder interest, including those parties taking a short position on the shares. Furthermore, profit and wealth are arbitrary abstractions that hold no innate value commanding a privileged position. Wood observes,

there is no 'prima facie' moral, as opposed to prudential, reason, why profit should be promoted, let alone maximized. Profit is a mere accounting concept, and profit-maximization is at most a highly artificial goal. Profit is certainly not in its own right a 'morally important social value' such as: 'the protection of the environment, the advancement of knowledge, the development of culture, the promotion of social prosperity, the fostering of community, and the protection of public health.'¹⁶⁸

Wood's point here is that compared to more universally-accepted values, wealth and profit fare poorly. As values, they do not attract the same type of universal acceptance or support. From Wood's perspective, the objective of shareholder wealth maximization appears to be the objective of corporate activity and, when contrasted with other valuable objectives, the shareholder primacy model comes up lacking.¹⁶⁹ This argument assumes an alignment of corporate interests and shareholder interests, as well as an identification of corporate profit with shareholder wealth. Neither of these assumptions, however, is tenable.

A fourth argument for shareholder primacy is that shareholders are in the most vulnerable or least protected position in the market. Compared to other sources of capital, shareholders have the least protection. Unlike

¹⁶⁸ Wood, *supra* note 27, at 10 (quoting C. McMahon, *The Political Theory of Organizations and Business Ethics*, 24 PHILOSOPHY AND PUBLIC AFFAIRS 292, 299 (1995)).

¹⁶⁹ *Id.* See Paula Dalley, *To Whom it May Concern: Fiduciary Duties and Business Associations*, 26 DEL. J. CORP. L. 515 (2001). Dalley supports the shareholder primacy argument from a sociological analysis of groups. She argues that corporations as purposive groups can include only shareholders because only their interests conform with those of the corporate group, with each shareholder determined to increase corporate profitability. This conclusion seems odd because shareholders do nothing to increase corporate profitability other than wish for it. Furthermore, corporations and their shareholders have at times different interests. Finally, Dalley's narrow view suggests that corporate interests such as increased market share, CEO and executive egos looking to increase size through acquisitions cannot form a purpose. Such a view is hardly supported by the facts. *Id.* See, e.g., Frankenstein, *supra* note 56, at 150.

insiders, they do not have information about the operations of the corporation, and unlike bondholders, shareholders do not have security. In addition to replies of the previous three arguments, which equally apply to this contention, shareholders are not in the most vulnerable position. Shareholders have the option of choosing to invest in whichever form of contract they believe suits their specific acceptable combination of risk and reward. In addition, shareholders are granted several special remedies at law, such as derivative actions and winding-up the company on just and equitable grounds, denied to other stakeholders.¹⁷⁰ Finally, as previously noted,¹⁷¹ in a stock market with so much liquidity, there is always the exit option.

A fundamental criticism of shareholder primacy arises from an examination of the shareholder constituency itself. As noted, shareholder primacy focuses on wealth maximization.¹⁷² This leads to the question: what is wealth maximization? Is it shareholder wealth, or is it corporate profit? In a groundbreaking study, Professor Henry Hu identified a significant difference between shareholder gain and corporate profit.¹⁷³ Although Hu's primary concern was investigating how corporate managers might more effectively manage the corporation and deal with shareholders, he uncovered some surprising tendencies. Hu found that shareholder gain does not necessarily lead to corporate profit.¹⁷⁴ This fact creates a problem for managers, who, on the one hand, seek job security with employment at a wealthy corporation, while, on the other hand, must remain answerable to shareholders seeking their own wealth.¹⁷⁵

In addition, Professor Hu analyzed the notion of common shareholder interests. He notes that a number of conflicts exist between shareholders.¹⁷⁶ For example, shareholders disagree about the nature and amount of risk each wants the management to take and they have different time lines regarding long-term capital gain.¹⁷⁷ In other words, while some shareholders may be

¹⁷⁰ There is discussion in Canadian corporate law concerning the meaning and applicability of oppression remedies which may be available to non-shareholders. KEVIN MCGUINNESS, *THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS* 947-59 (1999).

¹⁷¹ See *supra* Part IV.B.2.

¹⁷² See *supra* Part IV.

¹⁷³ See generally Hu, *supra* note 87.

¹⁷⁴ *Id.* at 302-06.

¹⁷⁵ Various commentators have noted the undercapitalization of USA corporations where directors under pressure from shareholders have taken too much money out of the corporation harming its long term viability and competitiveness in order to put money into shareholder hands. See Benedict Sheehy, *The Importance of Corporate Models: Economic and Jurisprudential Values and the Future of Corporate Law*, 2 DEPAUL BUS. & COM. L.J. 463, 502-03 (2004).

¹⁷⁶ Hu, *supra* note 95, at 298-99.

¹⁷⁷ *Id.* at 301-02.

interested in the long-term growth of the corporation, others are similar to speculators trying to take advantage of an acquisition announcement.¹⁷⁸ This critique leaves shareholder theorists subject to the same attack they level at stakeholders; there is evidently more than one objective and managers cannot focus on more than one objective.¹⁷⁹ In this instance, the objectives include corporate profit, shareholder wealth, short-term shareholder interests, long-term shareholder interests, high-risk shareholder interests, and low-risk shareholder interests. Worse yet, the law has neither denied, nor validated one shareholder over the other.¹⁸⁰ At this point, the law introduces yet another guidepost; namely, "the best interests of the corporation."¹⁸¹ By adding the interests of the corporation, in addition to the interests of shareholders, managers, employees and other stakeholders, the law instead of clarifying, adds a further murky concept.

This brings us to the more fundamental question of why shareholders should have their privileged position in the first place. Janet Dine, an eminent British corporate law scholar, raises the question from the dynamic aspect of the corporation. She observes that shareholders are necessary to start the corporation and claim primacy on that basis, but from an operational perspective once the corporation is up and running their role as founders loses significance.¹⁸² This foundational argument is even more seriously challenged by the practice among lawyers of having *shelf-companies*, which are companies organized and registered for the purpose of rapid and easy deployment of a corporate vehicle in a commercial transaction. Once the business corporation is operational, shareholders are an additional source of capital, and in truth, the least preferred source of capital.¹⁸³ From an operational perspective, therefore, shareholders really have no privileged position or interest.¹⁸⁴ In fact, were it not for their voting power, their existence would be of marginal interest.¹⁸⁵

¹⁷⁸ *Id.* at 296-97.

¹⁷⁹ See generally Jensen, *supra* note 7.

¹⁸⁰ Hu, *supra* note 95, at 301-02, 310-13. See also, Jensen, *supra* note 7 (arguing for the long term as bringing together shareholder, creditor and warrant interests). But see Dunfee, *supra* note 5; Orts, *supra* note 36, at 1575 (challenging Jensen's view).

¹⁸¹ Sommer, *supra* note 13, at 46-51.

¹⁸² DINE, *supra* note 9, at 24 (applying it to concessionaire theories; however, this criticism applies equally to the contractarian view being discussed here).

¹⁸³ *Public Beginnings, Private Ends*, *supra* note 159, at 37.

¹⁸⁴ See, e.g., FARRAR, *supra* note 2.

¹⁸⁵ See Wood, *supra* note 27, at 7. Interestingly, non-profit corporations exist without difficulty regardless of the fact that they are incorporated without shareholders.

In a related vein, shareholder primacy theorists argue that shareholders are true insiders, because they are founders.¹⁸⁶ Hill's study of corporations raises serious questions about the insider-outsider model of the corporation, and in particular, shareholder claims to primacy based on their special role as the ultimate insider. As previously noted, Hill's analysis, from the perspective of corporate finance, suggests that other traditional outsider financiers often play a much greater insider role than shareholders.¹⁸⁷ In addition, the demarcation lines between debt and equity have been sufficiently eroded to make ascribing one party "insider rights" denied to other "outsiders" nearly impossible.¹⁸⁸ Furthermore, one has difficulty seeing how such employees should be outsiders without some determinative power over the direction of the corporation while day-trading shareholders should be considered insiders with such power.¹⁸⁹

Dean Horrigan of the University of Canberra School of Law criticizes the shareholder primacy approach to capital. He observes that this definition of capital in this model is too narrow or "monodimensional."¹⁹⁰ Corporate enterprise as a type of human enterprise relies on "economic capital, human capital, intellectual capital, social capital and environmental capital."¹⁹¹ In reality, shareholders are just one type of capital provider among a vast collection of providers, including employees who provide human capital, creditors who provide debt capital, and suppliers and society that provide educated, assimilated workers.¹⁹²

Returning to the property rights argument for shareholder primacy, Hill points out that the early aggregate or partnership model of the corporation supported the view of shareholders as "owners" of the enterprise; hence, their importance rested on the idea that their interests are "distinct and inherently different" from other parties.¹⁹³ But as we have seen, the history

¹⁸⁶ See DINE, *supra* note 9, at 24.

¹⁸⁷ *Public Beginnings, Private Ends*, *supra* note 159, at 37.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* (citing Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. & SEC. REG. 155, 170 (1982)). Shareholder theory relies on a strong sense of private property as opposed to public, which distinction has its own set of distinctive and fundamental problems. See generally MICHAEL IGNATIEFF, *THE RIGHTS REVOLUTION* (2000).

¹⁹⁰ Horrigan *supra* note 33, at 516-17.

¹⁹¹ *Id.* at 517.

¹⁹² See *id.* at 535, 540. Further criticism of shareholder primacy arises from the effects of a single focus on wealth maximization. Presumably, somewhere down the line, the shareholders are ultimately controlled by or at least for the benefit of humans, and surely humans have interests in more than wealth maximization. Humans are interested in clean air and water, and a just society, and unless shareholder primacy wealth maximization is restricted to preserve these goods, there will be no point to wealth maximization. We will discuss the role of government and corporate law norms later in this paper.

¹⁹³ *Public Beginnings, Private Ends*, *supra* note 159, § 3.

of the corporation has moved it and its associated rights a considerable distance from these roots. From a legal perspective, shareholders are not "owners" of the corporation and accordingly, this argument fails.¹⁹⁴ Furthermore, as Stout observes, the options theory undermines at a most fundamental level the notion of shareholder ownership.¹⁹⁵

C. Replies to Shareholder Primacy Criticism and Further Criticism

If shareholders are neither dominant in management or in control, nor in terms of providing finance, why should they continue to have the level of control they do? Why should they have the vote?¹⁹⁶ In order to answer these questions in favor of shareholder primacy, one must accept a number of assumptions about the nature of society, the role of business, the role of law, the nature of economic problems and appropriate solutions to those economic problems.¹⁹⁷ In the narrower context of corporations, if this view holds that managers have one goal of wealth generation, then managers will be clear on their objective and do what they are able to do best, which is the generation of wealth.¹⁹⁸ It is less efficient to have the corporation involved with other social concerns, such as the just distribution of wealth, which are tasks that the corporation was not designed to perform. General social welfare is outside the scope of corporate concern. Externalized costs are acceptable in the creation of wealth since they are of minimal concern to non-shareholders.¹⁹⁹ Where costs are a concern, other societal organizations, such as government, have the role and the responsibility to address these costs or for non-shareholders to contract against those harms.²⁰⁰

The argument has been advanced that perhaps shareholders should enjoy the right to cause some general harm in the process of their wealth maximization on the basis that "they value it more highly than non-

¹⁹⁴ But see, Orts, *supra* note 36, at 1575 (noting that this is a mistake made by management theorist Jensen); Stout, *supra* note 21, at 1191-92 (noting that this is a mistake made by economist Milton Friedman).

¹⁹⁵ Stout, *supra* note 21, at 1191-92.

¹⁹⁶ See Wood, *supra* note 27. As noted earlier, Wood argues shareholders gave up these rights when they surrendered responsibility for the corporation. See *supra* Part IV.A.

¹⁹⁷ See generally Benedict Sheehy, *The Importance of Corporate Models: Economic and Jurisprudential Values and The Future Of Corporate Law*, 2 DEPAUL BUS. & COM. L. J. 463 (2004) (discussing these assumptions in detail).

¹⁹⁸ *Id.*

¹⁹⁹ Benedict Sheehy, *Corporations and Social Costs: The Wal-Mart Case Study* 24 J.L. & COM. 1 (2004).

²⁰⁰ *Id.*

shareholders would value the right not to be harmed."²⁰¹ Millon observes that at a factual level, non-shareholders tend to suffer more from shareholder exploitation than shareholders would suffer if they were not permitted the right.²⁰² This allocation of rights is based on the market notion of bargaining power. Millon raises the crucial question of why bargaining and bargaining power should be the basis of protection from the harmful effects of shareholder wealth maximization in the first place.²⁰³ Is our society to be organized to protect only those with greater bargaining power? Justice seemingly requires a very different approach to social organization.

A further criticism of shareholder primacy comes from the nature of shareholders themselves. Shareholders are by and large passive. As Hill observes, "[shareholders] invest in the investment, not in the corporation."²⁰⁴ They are not interested in building, operating, or controlling the corporation. When problems in the corporation become evident, shareholders prefer to exercise exit rights rather than working to resolve the situation.²⁰⁵

There are also some obvious factual arguments against shareholder primacy. Contrary to the claim that stakeholder corporations cannot function because of diverse objectives, in many places the law has successfully and without undue diminution of wealth by shareholders or society, integrated stakeholder theory. Whether one chooses to look at European corporations with their two tiered boards, or employee, creditor, and environmental liabilities placed on directors in Anglo-modeled corpora-

²⁰¹ Millon, *supra* note 14, at 1378.

²⁰² See Millon, *supra* note 14, at 1384.

²⁰³ Millon, *supra* note 14, at 1384. Millon states,

[O]ne might argue that shareholders should enjoy this right because they value it more highly than nonshareholders would value a property right not to be harmed. One response is to question the validity of the factual assertion. Many nonshareholders lose far more from shareholder exploitation of nonshareholder vulnerability than would shareholders if such opportunities were impeded. If an entitlement were with nonshareholders, shareholders would presumably sustain a somewhat lower rate of return on their investments (unless job security and other protections actually resulted in heightened productivity). In contrast, as long as the entitlement is with the shareholders, workers, for example, are vulnerable to the loss of their jobs and attendant human capital investments, to the prospect of potentially lengthy unemployment or inferior reemployment, and to the morale costs generated by insecurity. It seems reasonable to assume that workers would value *ex ante* protection more highly than would shareholders value a right to harm.

Id.

²⁰⁴ Hill, *supra* note 50, at 57 (quoting Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 28-29 (1991)).

²⁰⁵ See FARRAR, *supra* note 2, at 13. However, also note that shareholders are unlikely to expend the effort to get involved to resolve these problems as management *per se* is not likely to be their area of expertise and furthermore, there is the disincentive of the free-rider problem. *Id.*

tions, one finds that directors have successfully incorporated the conflicting concerns of their various constituent stakeholders in the supposedly exclusive shareholder model.²⁰⁶ One study indicates that managers understand the different objectives demanded by the difference between shareholder value and traditional accounting and have adapted their behavior accordingly.²⁰⁷

Shareholder primacy theorists also tend to ignore empirical studies demonstrating the success of stakeholder-oriented corporations.²⁰⁸ In reality, even in the United States, which is arguably the jurisdiction most committed to shareholder primacy, the law permits considerable latitude to management to deviate from shareholder primacy.²⁰⁹ Even among shareholder primacy advocates, the levels of deviation from shareholder primacy are noted. Whether one notes Friedman's caveat restricting shareholder wealth maximization to "conforming to the basic rules of society,"²¹⁰ Jensen's deviation from shareholder supremacy being modified by his concern for creditors,²¹¹ or Hansmann and Kraakman's departure from pure shareholder interests which causes them to state "creditors, to be sure, are to some degree an exception"²¹² (with no reason for the exception), shareholder supremacy appears unsatisfactory even to its most outspoken advocates. This deviation from strict shareholder supremacy suggests that these advocates recognize, as others have noted, that the corporation exists within society and relies on the social goods or capital supplied by it.²¹³

From the above discussion, clearly the debate is complex and difficult, if not impossible, to resolve within the parameters of the debate itself. To move forward one must step outside the narrow confines of the debate and

²⁰⁶ Bruce Langtry, *Stakeholders and the Moral Responsibilities of Business*, 4 BUS. ETHICS Q. 431 (1994). See Wood, *supra* note 27, at 13-20 (explaining Langtry's "Tinged Stakeholder Theory").

²⁰⁷ See Orts, *supra* note 36, at 1589-90 (citing MICHAEL USEEM, EXECUTIVE DEFENSE: SHAREHOLDER POWER & CORPORATE REORGANIZATION 4-5, 10-11 (1993)).

²⁰⁸ See Mohammad Omran & John Pointon, *Shareholders versus Stakeholders: Corporate Mission Statements and Investor Returns*, 11 BUSINESS ETHICS: A EUROPEAN REV. 318 (OCT. 2002) (conducting a 5 year longitudinal study of companies on the FTSE). Simon Webley & Elise More, *Does Business Ethics Pay?—Ethics & Financial Performance*, INST. OF BUS. ETHICS (2003).

²⁰⁹ See Dunfee, *supra* note 5, at 9-10. But see Sommer, *supra* note 13 (viewing the latitude to be limited to long-term shareholder interest). See also, DINE, *supra* note 9, at 37 n.3 (citing the contrary argument of BLUMBERG, THE AMERICAN LAW OF CORPORATE GROUPS (McCahery, Picciotto, & Scott, eds., 1993)).

²¹⁰ See Dunfee, *supra* note 5, at 9-10 (observing that Friedman's meaning is ambiguous and the statement open to both broad and narrow interpretation).

²¹¹ Jensen, *supra* note 7, at 299.

²¹² Hansmann & Kraakman, *supra* note 6, at 10.

²¹³ See FARRAR, *supra* note 2, at 409 (noting this idea of the necessity of society for the existence of the market goes back at least to ADAM SMITH, THEORY OF MORAL SENTIMENTS (1759)).

directly address the ideological and technical considerations underlying the tensions. From an ideological perspective, one should compare the political neoliberal,²¹⁴ neoclassical economics²¹⁵ focus on private property, and its generally anti-regulatory stance, with the social justice concerns of more communitarian oriented scholars.²¹⁶ These two opposing stances translate into the discussion of nature and purpose of the corporation, in addition to the nature and purpose of corporate law. The four questions of corporate governance can be answered from such an understanding.²¹⁷

V. MODELS OF THE CORPORATION AND THE DEBATE²¹⁸

Models of the corporation are intimately connected to the shareholder-stakeholder debate. One level of the debate hinges on one's theory of the corporation. Models are both a starting point and a conclusion for the various positions. Briefly, if one adopts the model of the corporation as a series of private contracts between individual shareholders, there can be no discussion about any interests but shareholder interests. If, however, one adopts the model of the corporation as a concession from society, then one may rightly claim some corporate obligations back to society. This section briefly examines the various models of the corporation and the significance of models for the debate. As Millon explains:

[a] standard argumentative move in these debates has been the effort to justify a position for or against legal reform by reference to some

²¹⁴ Neo-liberals as a political group are concerned particularly about individual liberties and in particular private property rights.

²¹⁵ Neo-classical economists are those economists who believe that most if not all of society's ills can be solved by the use of micro-economic tools and models. Basically the tools and models are: humans being mere rational utility maximizers, and left to function in perfectly competitive markets, everything will be fine. See generally Sheehy, *supra* note 189 (discussing and critiquing these assumptions).

²¹⁶ MALLOY, LAW AND THE MARKET ECONOMY: REINTERPRETING THE VALUES OF LAW AND ECONOMICS 1 (2001).

To the traditional law and economics scholar the relationship is positive, efficient, and wealth maximizing. It is a relationship that inherently promotes autonomy, prosperity, and social justice. To others, the relationship may seem exploitative, chaotic, and oppressive. It is a relationship that fosters self-interested behavior and institutions of greed and profit.

Id. Malloy views the issue not as a tension between efficiency and social justice but rather, in applying semiotic theory to the problem, Malloy frames the issues as a dynamic between creativity and efficiency. *Id.* Unfortunately, his set of solutions are beyond the scope of this paper's analysis of the traditional stakeholder-shareholder debate.

²¹⁷ See *supra* Part I.

²¹⁸ See DINE, *supra* note 9, at 3-28 (providing one view of the various models); Bottomley, *supra* note 3 (offering a different view).

kind of characterization of the corporate person. A descriptive assertion ("the corporation is x") is advanced on behalf of a normative claim ("therefore y should follow"). In this way, what might otherwise appear to be abstract, purely academic debates about corporate legal theory in fact support controversial political agendas.²¹⁹

Broadly speaking, there are three main models of the corporation.²²⁰ These models are: (1) communitarian concessionaire, or social, which roughly approximates the entity theory; (2) the contractarian, aggregational models; and (3) the socialist model, which will not be discussed, because it has largely been abandoned with the decline of state-run corporations.²²¹

A. Contractarian Model²²²

In essence, contractarians view the corporation as a form of contract between shareholders.²²³ This theory posits the corporation as a private matter between individuals, placing no additional duty on the corporation other than that which exists on the separate individuals involved in the corporation.²²⁴ The corporation as a private matter should be subject to the least possible government interference. There are two types of contractarians, legal and economic.²²⁵

²¹⁹ *The Ambiguous Significance of Corporate Personhood*, *supra* note 139, at 3. For an in-depth discussion, see Sheehy, *supra* note 197.

²²⁰ The terminology concerning corporate modeling is somewhat confused across the Anglo traditions. This confusion arises because of a mix of legal, economic and management concerns, political agendas, and different focuses at different times. Nevertheless, the issues facing Anglo and arguably all legal systems in terms of governance are much the same. In the USA, the debate is usually characterized as communitarians versus contractarians. See, e.g., Millon, *supra* note 14 (tying communitarians to concessionaire views). For examples of how others use models differently depending on the focus or interest, such as when the debate is described in terms of property versus entity, see, for example, Stout, *supra* note 21, at 1190 n.6 (citing William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992)).

²²¹ For example, see the discussion in Michal Sewerynski, *Trade Unions In The Post-Communist Countries: Regulation, Problems, And Prospects*, 16 COMP. LAB. L.J. 177 (1995).

²²² There are other approaches to the analysis of corporations as voluntary collectives. See, e.g., Dalley, *supra* note 161, at 539.

²²³ Coase, *supra* note 10, carried forward in Law and Economics scholarship by Bainbridge and Farrar.

²²⁴ DINE, *supra* note 9, at 5.

²²⁵ See Bottomley, *supra* note 3, at 277-87.

1. LEGAL CONTRACTARIAN MODEL

Legal contractarianism is the view that corporations arise when two or more people come together to form a legal contract to carry on commercial activity.²²⁶ From Bottomley's discussion, we may note three aspects of legal contractualism that are relevant to this discussion.²²⁷ First, the contract creates a legal entity in which directors and members are bound together in the corporation's articles of incorporation.²²⁸ Second, the contract defines the boundaries and membership of the corporation.²²⁹ Finally, contractualism favors the interests of members, rather than the interests of the individual.²³⁰ The contract is an "unusual type," to say the least.²³¹

The model's weakness lies in the interpretation of the corporation's founding articles or constitution. The "founding contract" is only enforceable by shareholders despite the fact that others may be party to the contract and, even then, shareholder legal remedies are greatly restricted.²³² A further problem is that the model posits the interests of the founding contractors as being identical to the corporate enterprise itself. As Professor Hu has demonstrated, however, this is simply not the case—corporate interests differ from shareholders' interests as do shareholders' interests differ among themselves.²³³

As previously noted, Dine identifies the difficulty in applying this foundational model to an operating company.²³⁴ Once a company is up and running, the rights and duties of the parties in a corporation change. Shareholders no longer have the absolute rights they had when the corporation was founded, and in particular, their rights vis-à-vis directors are weakened. As demonstrated in *Foss v. Harbottle*,²³⁵ the directors have independence from the shareholders and a level of immunity from shareholders, even if the directors take an action contrary to the wishes of

²²⁶ DINE, *supra* note 9, at 8-12.

²²⁷ Bottomley, *supra* note 3, 281-84.

²²⁸ *Id.* at 281.

²²⁹ *Id.* at 283.

²³⁰ *Id.* at 284.

²³¹ *Id.* at 281.

²³² *Id.* at 283-84.

²³³ Hu, *supra* note 87. See discussion *supra* Part IV.B.2.

²³⁴ See *supra* Part IV.B.2

²³⁵ 2 Hare 461 (1843). In this case, the court in its examination of minority shareholder rights determined that the appropriate party to take action against directors is the corporation itself. *Id.* See also FARRAR, *supra* note 2, at 171.

some shareholders. This suggests that the corporation is more than a mere contract between shareholders.

2. ECONOMIC CONTRACTARIAN MODEL

The economic contractarian model finds its origins with the economist Ronald Coase.²³⁶ Coase first proposed that the corporation is a type of firm.²³⁷ By classifying the corporation as one type of firm, Coase is suggesting that the corporation operates as a more efficient means of production by grouping people and inputs together, and that by combining tasks in one enterprise the corporation is able to lower transaction costs.²³⁸ In this model, there is a direct connection and related accountability between the capital providers—the shareholders and the managers.²³⁹ Friedman simply stated that “[an executive] has a direct responsibility to his employers. That responsibility is to conduct the business in accordance to their desire, which generally will be to make as much money as possible.”²⁴⁰

Contractarians reject the notion of the corporation being a body independent of the shareholders and, in fact, reject the very idea of the corporation.²⁴¹ According to this group, the corporation is merely a nexus of contracts.²⁴² Logically, a corporation cannot have obligations distinct from the obligations of its individual members. Therefore, the notion of corporate social responsibility, as distinct from the responsibilities of the individual shareholders, is a non-sequitor, a logical contradiction.

As Millon observes, the contractarian model favors shareholder primacy. He concludes:

state corporate law provides the terms of the contract by which shareholders purchase management's undivided loyalty to their welfare . . . to the extent that management's pursuit of shareholder

²³⁶ See generally Coase, *supra* note 10.

²³⁷ See generally *id.*

²³⁸ See generally *id.* See also, *Frontiers of Legal Thought*, *supra* note 116, at 229-32 (discussing Coase as the source of the 1980's nexus of contracts theorists). The issue for economic contractarians is: How the owner-shareholder principal can control and limit the manager-agent sufficiently to minimize “managerial opportunism” or “agency costs.” They find answers in the markets for capital, corporate control and management skill, and secondarily in the body of corporate law. Bottomley, *supra* note 3, at 285-87.

²³⁹ EASTERBROOK & FISCHER, *supra* note 35, at 37-38.

²⁴⁰ Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. Times Magazine, Sept. 13, 1970, 32-33, 122-26.

²⁴¹ See FARRAR, *supra* note 2, at 30.

²⁴² *Id.* at 30 n.69 (stating that concept was pioneered by Coase).

welfare threatens nonshareholder interests, workers, creditors, and other affected nonshareholders are free to bargain with shareholders (through their agents) for whatever protections they are willing to pay for. This view assumes that feasible (that is, not excessively costly) contracting strategies exist for correction of the harmful external effects of shareholder/management activity and, perhaps, that such effects are relatively uncommon.²⁴³

Millon presents the underlying philosophy that everyone involved in the corporation is there on the basis of free bargaining; that those involved or affected by the corporation are entitled to what they are willing to pay for, and that corporations and corporate activity is generally benign.

The contractarian model has a number of shortcomings. The model fails to explain the most significant feature of the corporation, limited liability.²⁴⁴ Contractarian models also fail to adequately address other corporate rights such as the corporation's right to hold property and the right to freedom of expression, which are rights held independently of its members. The univocal focus on efficiency²⁴⁵ supported by contractarian models raises the question of why efficiency should be set as the prime value. Millon observes that "[r]eferences to efficiency simply beg the underlying question of why efficiency should provide the sole normative criterion. As a society, we have not embraced the market as a totalizing model for the definition of rights and responsibilities."²⁴⁶ Furthermore, this focus on the bottom line always creates a strong incentive to externalize costs, increase production, and thereby increase profit.²⁴⁷ On this point, Horrigan observes, "[f]inancially

²⁴³ Millon, *supra* note 14, at 1378.

²⁴⁴ Dine notes the state involvement in creating the limited liability aspect of corporations. This grant of limited liability is what made corporations such an attractive option for conducting business and essentially what gave rise to their dominance in commerce. The explanation that this would eventually have been contracted for, according to Dine, is not supported by the facts. See DINE, *supra* note 9, at 4.

²⁴⁵ As Robin Malloy points out, contractarians' efficiency focus follows closely on the economists' view that creating wealth is the sole objective of corporate activity. Any increase in wealth (a) is a social benefit, and (b) it permits turning a blind eye to the distribution of that wealth or the costs of producing that wealth. Kaldor-Hicks theorem suggests that as long as there is an overall net gain in a transaction, regardless of the size of the loss sustained by any party, the parties should be coerced into the transaction for the benefit of the overall gain. See MALLOY, *supra* note 208, at 65. This author believes that this position seems to undermine some of the fundamentals of property rights that form the basis of the contractarian argument. Dine observes that in the contractarians model, the role of government is to create a more perfect market by correcting market failure. DINE, *supra* note 9, at 109. Economic contractualists believe that allocation efficiency is best served by permitting the market to adjust supply, demand, and costs with the least interference. EASTERBROOK & FISCHER, *supra* note 35, 37-38.

²⁴⁶ Millon, *supra* note 14, at 1386.

²⁴⁷ DINE, note 9, at 9; MALLOY, *supra* note 8, at 154-55.

based shareholder focus . . . allows corporations to externalize the costs of maximizing stock prices onto everyone except the stockholders; this includes employees, the environment, consumers, suppliers and the community at large.²⁴⁸

Contractarians are focused on internal corporate activity and apply a cost/benefit analysis to a relatively narrow range of items that are more easily subject to numeric measurement and analysis. A further criticism of this view is its explanation of the one-person corporation where the shareholder is also the director. How can one contract with one's self? The legal answer to this question, of course, comes from the *Salomon* case²⁴⁹ mentioned previously. Thus, shareholder primacy advocates for and argues from a contractarian model.²⁵⁰

B. Communitarian or Concessionaire Model

Communitarian or concession theorists note that corporate existence owes its origins to a governmental concession.²⁵¹ In the beginning, governments delegated and granted trading rights to corporations.²⁵² Corporations were permitted to carry on only those activities authorized in the concession granted by the government. This restriction was the basis for the now out-dated doctrine of *ultra vires* as applied to corporate activities. These limits on the concession were set out in the articles of incorporation or constitution of the corporation. Given this concessionary nature of the corporation, the government retained certain rights concerning the governance and operation of the corporation. Further, as Bottomley argues, "[corporations] themselves are systems in which power and authority, rights and obligations, duties and expectation, benefits and disadvantages, are allocated and exercised. . . . Each company is a body politic. . . ."²⁵³ If one accepts this view of the corporation, the argument for stakeholder involvement or at least for government regulation is more understandable. As a governmental concession, the corporation owes duties back to the

²⁴⁸ Horrigan, *supra* note 33, at 550 (quoting *Corporate Citizenship: A Conversation Among The Law, Business and Academia*, 84 MARQ. L. REV. 723, 728 (2000)).

²⁴⁹ [1897] AC 22.

²⁵⁰ For a brief discussion of how Rawls' interestingly uses a contractarian model to argue for a different result, see Millon, *supra* note 14, at 1377 n.19.

²⁵¹ See DINE, *supra* note 9, at 21-25.

²⁵² See *id.* at 21.

²⁵³ Bottomley, *supra* note 3, at 291.

government. This obligation, however, does not extend automatically to society.²⁵⁴

Although concession theory may explain the foundation of the corporation, the theory fails as an operational theory. Dine observes that the concessionaire view is susceptible to the criticism that the corporation is no more than a "mere fiction."²⁵⁵ If the corporation is not made up of the solid, physical shareholders acting in concert to create a common enterprise, then the corporation has no more substance than a mere idea. The theory does not explain by whom or how the corporation is to be run. Nor does the theory set any limits on state involvement. Indeed a pure concession view allows the corporation to be a mere instrument of the state.²⁵⁶

Models by definition are inadequate representations of that which they attempt to represent.²⁵⁷ In the context of corporate law, this limitation of models is exacerbated by the complexity of the subject. Orts observes:

To say 'corporation' is not like saying 'chair' or 'dog.' The reality to which 'corporation' refers is more complex than an easily identifiable material thing or animal, and any attempt to force a preconceived theory on a complex legal reality results in what Hart calls 'contrivances varying with tastes.' The idea of the corporation is complex precisely because it involves various relationships that presuppose the rules and principles, and methods of enforcement and compliance that compose a legal system.²⁵⁸

Orts' point is that to fail to understand the nature of the concept we are dealing with leads to facile analysis of a highly complex phenomena. In fact, Orts observes that "[a] survey of competing theories of 'the corporation' leaves one to conclude that none has survived intact."²⁵⁹ The contractarian fails to account for such things as the constitutional and limited liability aspects of the corporation while the communitarian visions fail to address effectively the behavior of players within the corporation. The criticisms of the various models leads us to conclude that neither contractarian nor communitarian models truly capture or fit the corporation.

²⁵⁴ See DINE, *supra* note 9, at 21.

²⁵⁵ *Id.* at 24.

²⁵⁶ *Id.*

²⁵⁷ As statisticians, George Box and Norman Draper have observed, "[a]ll models are wrong; the practical question is how wrong do they have to be to not be useful." GEORGE BOX & NORMAN DRAPER, *EMPIRICAL MODEL BUILDING AND RESPONSE SURFACES* 74 (1987).

²⁵⁸ Orts, *supra* note 36, at 1572.

²⁵⁹ *Id.* at 1570.

C. *The History and the Development of Models*

The contractarian and communitarian/concession models follow a historical development, which do not lead to any one conclusion as to the correct or appropriate model of the corporation.²⁶⁰ At the time of monarchical domination of trade, the communitarian/concession theory most accurately reflected the state of affairs. In addition, the state's involvement in the creation of corporations through acts of legislature, for example, also provided weight to the argument for state involvement and enforcement of broader social interests. With the development of the discipline of economics, the application of economic theory to law and the increasing interest in efficiency and its relation to wealth creation, the contractarian models began to take shape and move into a position of prominence.²⁶¹ As a result, the model of the corporation became clear, the appropriateness of the model came into question, and theories of private property and the role of government in the market began to be re-examined.²⁶²

D. *The Ideological Divide*

Underlying this war of models is a much deeper ideological conflict.²⁶³ Shareholder advocates begin with the idea that people should be free to decide how to live, including how they should dispose of their property.²⁶⁴ Millon explains that shareholder advocates focus "on the individual as an autonomous being and . . . human liberty as freedom from external, unconsented-to restraint."²⁶⁵ Stakeholder advocates, by contrast, view the individual as set in a social context; they view liberty as having positive duties.²⁶⁶ From the stakeholder advocates' perspective, "[l]iberty is empty

²⁶⁰ For an extensive discussion of corporate models, see generally Sheehy, *supra* note 189.

²⁶¹ *Id.* This application of economics to law gave rise to the sub-discipline of law and economics. The efficiency concerns dominating the sub-discipline can be traced to its roots to the University Chicago Law School which appointed its first economist, Henry Simons, in 1939 and particularly to the ground breaking work of Ronald Coase' seminal analysis of the application of economics to the firm. See Coase, *supra* note 10.

²⁶² See generally, Sheehy, *supra* note 189.

²⁶³ The ideological facets of the debate are masterfully discussed in Cox's discussion, generally, *supra* note 47.

²⁶⁴ Millon, *supra* note 14, at 1382.

²⁶⁵ *Id.*

²⁶⁶ *Id.* at 1383.

without taking into account those primary needs upon which adequate conceptions of individual dignity and human flourishing depend.²⁶⁷

There are those who view the corporation as a social body.²⁶⁸ These scholars view the corporation as a member of society, and a significant member at that.²⁶⁹ They emphasize the power and effects of corporations in society.²⁷⁰ In addition, they are, in Millon's words, "skeptical about the practical efficacy of contract as a mechanism by which non-shareholders can protect themselves ex ante from . . . harmful effects."²⁷¹ Others view the corporation as a nexus of contracts between private individuals in which the government has no business and by which the greatest efficiency can be achieved, and that those without contractual bargaining power have no right to be considered in the corporate contract.²⁷²

At a fundamental ideological level, contractarians and communitarians are deeply divided. Contractarians believe that justice is manifested in the status quo and the only legitimate interests are those bargained for.²⁷³ For communitarians, justice does not require endorsement of the existing distribution of wealth and bargaining capability. Millon writes, "[t]hey seek instead to reform corporate law so as to foster individual dignity and promote societal welfare."²⁷⁴ As Millon frames the debate, "what does set communitarians apart from contractarians is the communitarians' strong skepticism toward the baseline presumption that contract alone should specify the terms of corporate governance relationships."²⁷⁵ Such deep ideological debates are not going to be settled on the basis of superiority of models.²⁷⁶

²⁶⁷ *Id.*

²⁶⁸ See generally, Beth Mintz & Michael Schwartz, *THE POWER STRUCTURE OF AMERICAN BUSINESS* (1985).

²⁶⁹ Of the largest 100 economies of the world, 50 are corporations. WORLD BANK, *WORLD BANK DEVELOPMENT REPORT* (1996).

²⁷⁰ *Id.* See also DOMHOFF, G. WILLIAM WHO RULES AMERICA NOW? (1983); MILLS, C. WRIGHT POWER, POLITICS & PEOPLE: THE COLLECTED ESSAYS OF C. WRIGHT MILLS (1963); Mark J. Roe, *A Political Theory Of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

²⁷¹ Millon, *supra* note 14, at 1379.

²⁷² See discussion *supra* Part IV.B.1.

²⁷³ Millon, *supra* note 14, at 1384.

²⁷⁴ *Id.* at 1386. Millon has also summarized the issue at a personal level, stating that "[h]aving induced nonshareholders to rely on legitimate expectations of fair dealing, shareholders therefore may forfeit the right to insist on contract terms guaranteeing profits at the expense of others." *The Ambiguous Significance of Corporate Personhood*, *supra* note 139, at 23.

²⁷⁵ Millon, *supra* note 14, at 1381.

²⁷⁶ See generally DINE, *supra* note 9 for a discussion on a view in which founding theories are separated from operational theories. This view addresses the conflict between shareholder and stakeholder interest arguments, but this view does not resolve the conflict as to how different interests should be weighed.

VI. A NORMATIVE COMMENT ON THE NATURE OF THE CORPORATION AND CORPORATE LAW

From the foregoing discourse, the shareholder-stakeholder debate cannot be resolved by looking at models, the history of the corporation, or by looking at economics. Neo-classical, normative economics with its focus on efficiency is fundamentally at odds with certain legal principles, such as non-oppression of minorities, human rights, and social justice.

The shareholder-stakeholder debate can be resolved, at least for Westerners, by returning to first principles. Wood states, "[i]n short, [the duties of business] is a moral question—or more precisely an extra- or pre-legal question which typically involves complex practical and moral factors."²⁷⁷ The eighteenth century British philosopher Edmund Burke observed, "[t]he nature of man is intricate; the objects of society are of the greatest possible complexity: therefore no simple disposition or direction of power can be suitable, either to man's nature, or to the quality of his affairs."²⁷⁸ Burke's point is that society is a complex human endeavor, the purpose of which is not at all clear, unified, or universally accepted. Accordingly, we must shy away from one-sided, overly simplistic solutions to the complexity presented by the human society in which we find ourselves. The shareholder perspective as we have seen is an example of an overly simplistic solution, which should be avoided.

Essentially, we must then ask what are the objectives of law in general and of corporate law in particular? From the general perspective, Justinian offers that the law ought to cause a man "to live honestly, not to harm another, and give each his due."²⁷⁹ As interpreted by the modern legal philosopher, John Rawls, one of the pre-eminent jurists of the twentieth century, justice in the distribution of society's goods is fundamental to a just society.²⁸⁰ Rawls observes that "[s]ociety is a cooperative venture for mutual advantage."²⁸¹ He argues that we live in a world of limited resources, and that a just resolution to the conflicts concerning society's distribution and use of resources is necessary to have a society in the first place. He suggests that is society's enabling condition.²⁸²

²⁷⁷ Wood, *supra* note 27, at 13.

²⁷⁸ EDMUND BURKE, REFLECTIONS ON THE FRENCH REVOLUTION 99 (Charles W. Elliot ed., Collier & Son 1909-1914) (1790).

²⁷⁹ JUSTINIAN'S INSTITUTE, Book II 3 (cited in *Frankenstien*, *supra* note 86, at 148).

²⁸⁰ See JOHN RAWLS, A THEORY OF JUSTICE (1971).

²⁸¹ *Id.* at 4.

²⁸² *Id.* at 258-63.

This view is also reflected in management literature. As Vinten notes, "[T]o have any defensible property rights at all, one must recognize a fundamental commitment to helping those in need."²⁸³ Thus, law's proper role for justice is to support such a distribution. Rawls suggests equality of opportunity as the only way to prevent the stronger (or richer) in his just state from overpowering the weaker (or poorer) is enforcing the maxim.²⁸⁴

The power of corporations as concentrations of wealth,²⁸⁵ political power,²⁸⁶ and as controlling cultural development²⁸⁷ has long been recognized. Legal scholar Wolfgang Friedmann noted in 1957 that "[t]he corporate organizations of business and labor have long ceased to be private phenomena. That they have a direct and decisive impact on the social, economic, and political life of the nation is no longer a matter of argument."²⁸⁸ The current state of the law in Anglo countries, while permitting shareholder concerns to be overridden in certain circumstances, through constituency legislation and the business judgment rule, still places a heavy emphasis on shareholder primacy.²⁸⁹ In fact, directors who wish to include other stakeholders do so at their peril, both at law and in business.²⁹⁰ Judging by Rawls' principles, this state of the law cannot be correct.

On the level of the particular, one must ask and attempt to figure out what is the purpose of corporate law. The contractarian answer is that corporate law provides a set of off-the-shelf rules for the corporation; this can hardly be correct. Nor is the shareholder primacy theorists' position of wealth maximization correct. Wealth maximization, for all its popularity among law and economics scholars, fails to meet some of the most basic requirements for a just society. The concept's complete lack of concern for those without wealth makes the idea untenable as fundamental principle in any society which has citizens living in poverty²⁹¹—and most certainly the United States not to mention the rest of the planet—will continue to have

²⁸³ Vinten, *supra* note 31, at 380.

²⁸⁴ RAWLS, *supra* note 280.

²⁸⁵ See DINE, *supra* note 9, at 151-75.

²⁸⁶ NOAM CHOMSKY, PROFIT OVER PEOPLE 91-120 (1999).

²⁸⁷ See THE CULTURE OF CONSUMPTION: CRITICAL ESSAYS IN AMERICAN HISTORY, 1880-1980 (Richard W. W. Fox, and Jackson T. Lears, eds.) (1983); Bradley A. Harsch, *Consumerism and Environmental Policy: Moving Past Consumer Culture*, 26 ECOLOGY L.Q. 543 (1999).

²⁸⁸ Wolfgang Friedmann, *Corporate Power, Governance by Private Groups, and the Law*, 57 COLUM. L. REV. 155, 176 (1957).

²⁸⁹ See Sommer, *supra* note 13, at 39-46.

²⁹⁰ See, e.g., *id.* at 43-44 (stating that "[O]nly a reckless corporate advisor would permit board minutes, or an accurate rendering of the advice given a board, to suggest that the board had put non-shareholder interests before those of shareholders.").

²⁹¹ See, e.g., POSNER, *supra* note 94, at 61. (discussing value as the preferences of people with the money to pay for those values).

poverty in the foreseeable future.²⁹² Millon observes, "[n]either in practice nor in law has society ever accepted the ruthless, single-minded pursuit of shareholder wealth maximization as a justified end in itself."²⁹³

As seen from the previous discussion concerning the nature and models of the corporation, understanding and defining the corporation is not a simple matter. Indeed, as Professor Orts observes, reductionistic modeling²⁹⁴ is "not only unhelpful, but destructive."²⁹⁵ The problem resulting from such simplification can be seen in the economic argument for shareholder primacy; namely, the betterment of society.²⁹⁶ The argument runs as follows: first, by permitting the market to operate with the least restrictions, there will be the greatest possible efficiency, creating the most possible wealth; and second, this maximized wealth makes the greatest quantity of goods possible available to society. In other words, the greatest social good is achieved by permitting the markets to operate with the highest level of efficiency with corporations focused exclusively on wealth production.²⁹⁷

Using Hart's rule-based analysis, Orts identifies complex results from corporate law's normative conflicts.²⁹⁸ He discusses the following conflicting norms: the divided economic object of profit versus wealth, short versus long term, central management versus dispersed capital providers, capital

²⁹² For a cogent criticism of Posner, see Whitney Cunningham, *Testing Posner's Strong Theory of Wealth Maximization*, 81 GEO. L.J. 141 (1992).

²⁹³ Millon, *supra* note 14, at 1373-74. Millon goes on to write:

[f]or much of this century, at least since the publication of Berle and Means' classic in 1932, the orthodox assumption has been that corporate law's objective is to develop legal structures that will maximize shareholder wealth. This shareholder primacy vision of corporate law therefore disregards claims of various nonshareholder constituencies (including employees, creditors, customers, suppliers, and communities in which firms operate) whose interests may be adversely affected by managerial pursuit of shareholder welfare. Managerial accountability to shareholders is corporate law's central problem. Nonshareholder interests, if entitled to any legal protection at all, are for other, noncorporate law legal regimes.

Id.

²⁹⁴ Models work by reducing complex phenomenon to simple, understandable concepts. While reducing phenomena to a manageable level is necessary and important part of research to develop an improved understanding of the phenomena, failing to re-inflate models to meet the reality they were designed to help explain leaves the researcher investigating the phenomena with an inadequately truncated perspective or understanding of reality. See BOX & DRAPER, *supra* note 257.

²⁹⁵ Orts, *supra* note 36, at 1565.

²⁹⁶ See discussion *supra* Part IV.B.1.

²⁹⁷ See DINE, *supra* note 9, at 112-14 (discussing the fundamental flaws inherent in this argument). The view of the corporation's role and participation in society is certainly Panglossian (referring to Voltaire's character Pangloss in the novel, *Candide*, whose constant justification for the state of affairs was that he was living in the best of all possible worlds).

²⁹⁸ Orts, *supra* note 36, at 1570-74.

accumulation, protection of investors, and the protection of other interests.²⁹⁹ Orts also notes that following the law serves as an objective in itself by referring to the thinking and terminology of Dean Clark who describes this as "modest idealism."³⁰⁰ In such instances, managers may cause a corporation to take a course of action that produces a lesser profit, but complies with the law when non-compliance would be more profitable for the purpose of honoring the social-moral ideal of following the law.³⁰¹ Finally, Orts notes the ethical dimension of corporate law that allows for the noneconomic considerations of ethics and justice.³⁰² Orts observes that "policies underlying corporate law cannot be reduced to a unidimensional value, such as the economic objective of 'maximizing shareholders' wealth' or even, more generally, 'economic efficiency.'"³⁰³ A discussion of normative corporate law, however, should go beyond a mere distillation of principles and objects in the particular area of law.

Millon posits four norms for corporate law. He suggests that corporate law should: "(1) promote stable relations between certain non-shareholder constituencies and the corporation; (2) adjust the gains between shareholders and non-shareholders; (3) address the fairness in allocation of transaction costs; and (4) look for ways to include in decision making those most directly effected by such decisions."³⁰⁴ Orts adds that "[c]orporate law, like most law, is primarily about the rule-oriented structuring of social power, and it is specifically about the rules that structure the organization of economic power."³⁰⁵ Therefore, by following Rawls, a strong argument can be made that corporate law should include access to power by non-shareholders.³⁰⁶ Under such standards, Australia's Corporate Law Economic Reform Program ("CLERP") objectives, which include market freedom, investor protection, information transparency, cost effectiveness, regulatory neutrality

²⁹⁹ *Id.* at 1587-1612.

³⁰⁰ *Id.* at 1602. ROBERT CLARK, CORPORATE LAW 684 (1986).

³⁰¹ Orts, *supra* note 36, at 1602 (citing Robert C. Clark, *Agency Costs versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55-79 (John W. Pratt & Richard Zeckhauser eds., 1985)).

³⁰² This is a summary of Orts' extensive arguments. See Orts, *supra* note 36, at 1587-1612.

³⁰³ *Id.* at 1587.

³⁰⁴ Millon, *supra* note 14, at 1387-88. Interestingly, this fourth suggestion aligns with the fundamental ideology of shareholder advocates whose emphasis on individual freedom requires consent by the individual affected.

³⁰⁵ Orts, *supra* note 36, at 1577.

³⁰⁶ See RAWLS, *supra* note 280. See also W. Wilson Leung, *The Inadequacy Of Shareholder Primacy: A Proposed Corporate Regime That Recognizes Non-Shareholder Interests*, 30 COLUM. J.L. & SOC. PROBS. 587 (1997).

and flexibility, as well as business ethics and compliance, appear inadequate.³⁰⁷

Corporate law, like all law, should serve the betterment of society. Farrar takes the position that the fundamental tenet of corporate law, the independent legal entity doctrine, is fundamentally flawed and fails to meet or promote any of the three criteria advocated by Justinian.³⁰⁸ Wood notes that the effect of limited liability is to pass on the costs of business failure to others and, in the collapse of a big firm, a multitude of smaller victims or involuntary stakeholders.³⁰⁹ Corporate law that permits and promotes the on-going externalization of business costs is contrary to the fundamental principles of justice.³¹⁰ Shareholder primacy creates another problem in situations where hyper norms are involved. Such norms, argues Professor Thomas Dunfee, "serve to judge, and if necessary to invalidate, local laws and local morality. . . . [They] 'entail principles . . . fundamental to human existence . . .'"³¹¹

The effect of current corporate law, which emphasizes shareholder interest, is just the opposite. Recent computer modeling of the current free market economic model suggests that this concentration will increase, not decrease.³¹² This trend of increasing concentration of wealth suggests that a more fundamental modification to corporate law is required.

Corporate law, which permits and promotes increased inequalities between members of society, is fundamentally flawed for the very reason that the law contradicts the basic principles of justice. Admittedly, the distributive aspect could be dealt with through tax law; however, the fact that current Anglo corporate law, with its heavy shareholder focus, tends to exacerbate social inequalities, both political and economic realms, suggest that a profound re-examination of corporate law and corporate law reform is well overdue. As Dine points out:

[corporations] account for most of the world's industrial capacity, technological knowledge and international financial transactions. They mine, refine and distribute most of the world's oil . . . extract most of the world's minerals . . . harvest much of the world's wood

³⁰⁷ FARRAR, *supra* note 2, at 16; cf. Horrigan, *supra* note 33, at 516.

³⁰⁸ Frankenstein, *supra* note 86, at 148-49.

³⁰⁹ Wood, *supra* note 27, at 8; See also Frankenstein, *supra* note 86.

³¹⁰ See Ronald Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409 (1993). Cf. Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993).

³¹¹ Dunfee, *supra* note 5, at 153.

³¹² See Brian Hayes, *Follow the Money*, 90 AM. SCIENCE 400 (2002).

. . . grow many of the world's agricultural crops, while processing and distributing much of its food . . . hold 90 per cent of all technology and product patents worldwide and are involved in 70 percent of world trade.³¹³

What Dine is drawing attention to is the fundamental issue of justice Rawls has set out—the distribution of society's wealth, and hence, its power. From Rawls' perspective one might ask, how a society that concentrates so much of the planet's limited resources into the hands of a few—not to mention, unelected—people can claim to be a truly just society. A society that tolerates and continues to develop tools to perpetuate such injustice has become a tool for the on-going and increasing injustice. Moreover, this injustice works against the fundamental principles of democracy.

VII. CONCLUSION

The shareholder-stakeholder debate is a highly complex, multi-faceted, interdisciplinary debate; as such, it cannot be answered easily or completely.³¹⁴ The broader perspective of the role of the corporation in society seems to be the more realistic, logical perspective. If one takes that to be the better position, then let us briefly put the four answers to the four questions of corporate governance.

First, one must determine what entity is being governed. A combined answer looking at legal, economic, social, and dynamic aspects provides the best explanation. Clarkson offers the following answer:

[t]he Firm, is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stake holders by converting their stake into goods and services.³¹⁵

³¹³ DINE, *supra* note 9, at 152 (quoting JOSHUA KARLINER, *THE CORPORATE PLANET: ECOLOGY AND POLITICS IN THE AGE OF GLOBALIZATION* 5 (1997)).

³¹⁴ Wood makes an interesting ethical observation about the two perspectives: "[I]n the case of shareholder conception, the weakness is moral and the strength is practical; in the case of the stakeholder conception, the position is reversed. The shareholder conception therefore stands . . . in need of moral rehabilitation, and the stakeholder conception in need of practical rehabilitation." Wood, *supra* note 27, at 13.

³¹⁵ Turnbull, *supra* note 2, at 193-96 (citing MAX CLARKSON, *A RISK BASED MODEL OF STAKEHOLDER THEORY* (1994)).

The second question asks who should govern the corporation. It should be governed by a multi-tiered board, which includes other stakeholders. This suggestion is not impractical as can be seen by the relative efficacy of other stakeholder models of boards, such as the German model.

Third, the best way to govern the corporation must be determined. The corporation can be well-governed by permitting it to pursue commercial ends within more broadly drafted corporate statutes mandating a broader range of interests and integrating into the governance structure people whose interests more broadly represent the community of stakeholders affected by the corporation. The disclosure requirements of shareholder theory should be kept, but the accounting amplified to include "Triple Bottom Line" or "Quadruple Bottom Line" regimes.

Finally, it is necessary to decide in whose interests the entity should be governed. Given the great impact of corporations on society, the narrow shareholder primacy view that advocates the operation of corporations for the exclusive interests of people with sufficient wealth to be shareholders can no longer be supported. Corporations must be run for the benefit of society and cannot be merely instruments of the state.

Horrigan offers an interesting criticism of the whole shareholder-stakeholder debate. He focuses on what he believes is the falsely dichotomous structure of the debate and suggests that a reframing of the issue, as the effective functioning of different elements of society would serve all interests best.³¹⁶ Perhaps the best way to express this view as an aspiration for corporate law can be found in the words of Orts, who states:

[w]ise policy makers . . . should not convert the framework of corporate law into either an unfeeling gauntlet of economic madness, nor an overly sanguine vision of do-good business. New directions in corporate law should instead take society on a course that is morally and politically uplifting, as well as economically productive.³¹⁷

The current and expanding stakeholder views may permit us to limit the externalizing of social and environmental costs done in favor of maximizing shareholder wealth, and ultimately save our planet from destruction by the reluctant shareholder, who may state that "[t]he shadows of the things that would have been, may be dispelled."³¹⁸

³¹⁶ Horrigan, *supra* note 33, at 551-53.

³¹⁷ Orts, *supra* note 36, at 1623.

³¹⁸ DICKENS, *supra* note 1.