Beyond Shareholder Value: Normative Standards for Sustainable Corporate Governance

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This Article explores whether the modern corporate governance model is sustainable. For many corporations, particularly large ones, there is a separation between ownership and management, with a management emphasis on short-term gains at the expense of long-term sustainability. This Article explores the role of corporate directors, particularly vis-à-vis shareholders, from an interdisciplinary perspective, analyzing legal case law as well as legal, management, and finance literature. This Article explores emerging trends in expanding notions of corporate governance that incorporate concerns beyond just shareholders, recognizing the interrelationship between business and society. It is suggested that in order to remain viable and competitive, corporations need to normalize longer views of sustainability which encompass numerous stakeholders, rather than simply trying to maximize profits during a current quarter.
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INTRODUCTION

This Article explores whether the modern corporate governance model is sustainable. The corporation is unquestionably an important element of the United States economy. Although not the most prevalent form of business—representing less than 20 percent of business organizations—corporations generate approximately 80 percent of American business revenues.¹ Throughout history, the corporate form has served as the most appropriate vehicle to raise and marshal substantial resources.²

From its formal inception, the corporation has offered two principal advantages: legal existence separate from its owners and transferability of owners’ interests in the corporation. Separate legal existence allows the corporation to own assets, enter contracts, and incur liabilities that are legally separate from those of its owners and managers.³ Importantly, not only are the owners’ personal assets shielded from the corporation’s creditors,⁴ but also the corporate assets are shielded from the claims of the owners’ personal creditors.⁵ Transferability of ownership means that the corporation does not need to liquidate in the event that one or more owners wish to terminate their interest in the firm.⁶

For many corporations, particularly large ones, there is a separation between ownership and management. How can the corporation’s owners

2. See, e.g., Alfred D. Chandler, Organizational Capabilities and the Economic History of the Industrial Enterprise, 6 J. ECON. PERSP. 79, 79 (1992) (noting that firms have been the main vehicles for the production and distribution of goods).
4. See, e.g., id. at 1339 (contrasting a corporation with a general partnership form of business in which, for example, a bankruptcy trustee may hold general partners personally liable for partnership debts not satisfied with partnership assets); see also, 11 U.S.C. § 723 (2006) (authorizing a partnership trustee to proceed against a partner for debts owed by the partnership).
5. Hansmann et al., supra note 3, at 1336.
(the shareholders/stockholders) be assured that the managers (directors and officers) will not pursue their own personal gains over those of the owners? The answer is that the managers of the corporation act essentially as trustees of corporate resources and as agents of the owners. Managers may not use corporate resources for their own purposes in conflict with their duties to shareholders.

In theory, imposing fiduciary duties upon corporate managers to protect the property interests of shareholders is the preferred approach. After all, “millions of individuals are willing to turn over a significant portion of their wealth to organizations run by managers who may have little interest in their welfare.” Additionally, these investors are residual claimants—they rely on the managers to operate the firm profitably so earnings will accrue to the shareholders.

Shareholders invest in corporations with the understanding that managers will strive to maximize shareholder value—i.e., maximize

7. The English philosopher Adam Smith discussed this dichotomy, noting that:

Like the stewards of a rich man, [directors] are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.


8. See Wardell v. R.R. Co., 103 U.S. 651, 657 (1881) (holding that directors are “clothed with power to manage the affairs of the company for the benefit of its stockholders and creditors. Their character as agents forbade the exercise of their powers for their own personal ends against the interest of the company.”); Lofland v. Cahall, 118 A. 1, 3 (Del. 1922) (“Directors of a corporation are trustees for the stockholders and their acts are governed by the rules applicable to such a relation, which exact of them the utmost good faith and fair dealing, especially where their individual interests are concerned.”). See generally Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 308-10 (1976) (discussing agency costs associated with corporate management).

9. See supra note 8.


12. Id.
profits. But is this so-called shareholder primacy theory of profit maximization sustainable? This Article explores issues related to that question, starting with a brief overview of the historical development of corporations and their role in the American economy. The role of corporate directors is considered next, particularly vis-à-vis shareholders, from an interdisciplinary perspective, analyzing case law as well as legal, management, and finance literature. Recent trends suggest that the major role of large, publicly-traded corporations is not so much to maximize the wealth of their shareholders, but rather to maximize the wealth of investors—that is, they exist not necessarily to build a lasting business, but to provide continually increasing short-term profits. It is argued that this approach is not sustainable from a long-term competitive perspective.

This Article explores emerging trends in expanding notions of corporate governance that incorporate concerns beyond just shareholders, recognizing the interrelationship between business and society. It then suggests that in order to remain viable and competitive, corporations need to normalize longer views of sustainability that encompass numerous stakeholders, rather than simply trying to maximize profits during the current quarter.

I. A BRIEF HISTORY OF THE CORPORATE FORM OF BUSINESS

The immediate precursor to the corporation can be traced to joint-stock companies that offered transferrable shares of ownership, appearing as early as the thirteenth century. The first English joint-stock company was formed in 1554, and the first joint-stock company to operate in


15. See generally id.

America was formed in 1587. In England, formal chartering of a joint-stock company required special permission by the Crown or an act of Parliament. Typical of the joint-stock companies formed during this time was the East India Company, chartered by Queen Elizabeth in 1600, granting a monopoly to an association of merchants trading in the East Indies. Because the expense of outfitting ships for voyages, often taking several years to complete, was too great for individual merchants, the East India Company offered the financial opportunity for “noblemen, gentlemen, shopkeepers, widows, orphans, and all other subjects [to] be traders, and employ their capital in a joint stock,” with profits to be distributed in the same proportion as the amounts contributed. In fact the whole advance of English discovery, commerce, and colonization in the sixteenth and early seventeenth centuries was due not to individuals but to the efforts of corporate bodies. These early corporations had a direct or quasi-governmental purpose, legitimizing a range of public functions performed by foreign trading companies like “organizing terms of trade, setting up local governments, controlling customs, and … making foreign policy in their areas of operation.” General civil corporations were also formed for the benefit of cities and towns, while other “special” corporations were formed to promote specific governmental objectives, such as facilitating trade, promoting charity, or running hospitals.

17. See Lobingier, supra note 16, at 58. The American joint-stock company was under an “indenture of grant” from Sir Walter Raleigh to thirteen “of London, Gentlemen,” who were declared a body corporate as “Gouvernour and assistants of the Citie of Raleigh in Virginia.” Id. (footnote omitted).


19. Williston, Part I, supra note 16, at 109-10. The formal name of the company was “the Company of Merchants of London, trading to the East Indies.” Id. at 109.

20. Id. at 109; see also Edward P. Cheyney, Some English Conditions Surrounding the Settlement of Virginia, 12 AM. HIST. REV. 507, 511 (1907) (“The multiplicity and extent of costs involved in procuring and fitting out vessels, in providing military equipment and all other supplies for mariners and colonists, and in supporting employees and settlers; the long waiting for any returns; the slight development of instruments of credit—these made demands beyond the means of any individual gentleman or group of gentlemen, burdened as they already were by the living expenses of their rank.”).


Just as the free transferability of stock protects corporations from liquidation demands by stockholders, it also creates a secondary market in that stock. As the number of joint-stock companies grew, secondary trading in their stock increased, to the extent that speculation by “stock-jobbers” in “Exchange Alley” in London became the rage in the early part of the eighteenth century. As an offshoot of rampant speculation in the stock of one charted company, the South-Sea Company, hundreds of joint-stock “Bubble” companies were formed between 1719 and 1720, many lasting only two weeks or less. The number of enterprises seeking to raise capital far outstripped the number of charters Parliament or the Crown were willing to grant; therefore, most Bubble companies only imitated joint-stock companies since they lacked a government charter. In July 1720, the English government tried to tame the speculation by dismissing all petitions for charters and declaring illegal all Bubble companies. Specifically, by passing the Bubble Act, Parliament made it illegal to act as a corporation, including issuing transferable stock, without a charter. Thus the world’s first stock bubble was burst.


25. See MACKAY, supra note 24, at 54. Historians have described joint-stock speculation in 1720 as a year “of fantasy, panic, folly, and grotesqueness.” Ron Harris, The Bubble Act: Its Passage and Its Effects on Business Organization, 54 J. ECON. HIST. 610, 610 (1994). Stock trading became such a mania in 1720 London that one prospectus to raise half a million pound sterling described the venture as “[a] company for carrying on an undertaking of great advantage, but nobody to know what it is.” MACKAY, supra note 24, at 55 (internal quotations omitted). This particular promoter was able to raise 2,000 pound sterling, never to be seen again. Id. at 55-56. It is estimated that nearly one and one-half million pound sterling was won and lost by speculating in these Bubble companies, “to the impoverishment of many a fool, and the enriching of many a rogue.” Id. at 54.

26. Blair, supra note 6, at 415; Paul G. Mahoney, Contract or Concession? An Essay on the History of Corporate Law, 34 GA. L. REV. 873, 887 (2000) (arguing that “what frequently distinguished incorporated from unincorporated joint-stock companies ... was that the former were owned by politically well-connected merchants who had paid a handsome price to secure a monopoly, while the latter lacked the money or connections to gain similar privileges”).

27. See MACKAY, supra note 24, at 57-63.


29. Mahoney, supra note 26, at 887.

30. Harris, supra note 25, at 610. The bursting of the South-Sea bubble “constituted the first international stock market bust[; a] crisis that...threatened to unravel the whole web of English public finance.” But see Julian Hoppit, Financial Crises in Eighteenth-
Although the bursting of the South Sea Bubble engendered "great distrust in corporate enterprises," and despite passage of the Bubble Act, unchartered joint-stock companies continued to be created and operated until the repeal of the Act in 1825. According to Mahoney, as a result of the Bubble Act, there was no development of a common law of joint-stock companies until the Act's repeal. Judges, who had not dealt with these joint-stock entities, were reluctant to provide them with their own set of legal rules.

The Bubble Act was extended to the American colonies in 1741. According to Williston, Pennsylvania became the first colony to charter a corporation in 1768, and only five more charters were issued in America prior to 1787. Upon enactment of the United States Constitution, the authority to issue corporate charters passed to the individual states, but

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Century England, 39 ECON. HIST. REV. 39, 48 (1986) (suggesting that the South-Sea bubble mostly impacted merchants and that “[f]or the business community as a whole, through the length and breadth of England, the Bubble was not a catastrophe”).

32. Mahoney, supra note 26, at 888 (footnote omitted).
34. Mahoney, supra note 26, at 888. "The notion of separate legal personality without incorporation had ceased to reside in the judicial mind." Id. But see Harris, supra note 25, at 623 (arguing that it was not the Bubble Act that deprived the Bubble companies of corporate privileges, but rather common law). Harris argues that "[t]he legal ambiguity of the [Bubble Act], together with a weak enforcement mechanism ... and a wide-spread disregard of it by businessmen, made it practically a dead letter." Id. The Bubble Act was never invoked against an unincorporated joint-stock company in America. HURST, supra note 22, at 8. Alternatively, English Courts of Equity accepted the legitimacy of pooling assets by a deed of settlement, which put the pooled resources in the control of trustees to manage them for designated business purposes, and recognized the transferability of shares in those pools. Id. at 6 (also noting such business arrangements could be designated as “limited,” providing notice to creditors that owners would have limited liability for debts).
35. Mahoney, supra note 26, at 888.
36. 1741, 14 Geo. 2, c. 37 (Eng.); see also Luce, supra note 33, at 1293 n.14.
37. Samuel Williston, History of the Law of Business Corporations Before 1800, 2 HARV. L. REV. 149, 165-66 (1888) [hereinafter Williston, Part II]. In fact, “[i]n colonial days ... American corporations for business purposes were few and relatively unimportant.” 2 DAVIS, supra note 18, at 4. Davis records seven corporate charters during the colonial period. Id. at 22.
38. Blair, supra note 6, at 415; Luce, supra note 33, at 1293. The U.S. Constitution makes no mention of corporations, and American citizens generally accepted “the
only a handful of states, such as Delaware, Massachusetts, New York, and Pennsylvania, initially passed the necessary legislation providing for these charters. Though estimates vary, it appears that fewer than 335 corporate charters had been granted in the United States by the end of the eighteenth century, 295 of those in the last decade of the century. In contrast to England earlier in the eighteenth century, speculation in corporate securities in America was minimal.

Incorporation in America required a special act of a state legislature until approximately the mid-nineteenth century. Following the economic depression of 1837-1844, many states held constitutional conventions where the states added provisions separating corporate business opportunities from state politics. Legislatures began to enact general incorporation statutes under which anyone could organize a business corporation by preparing and filing articles of incorporation, resulting in a watershed moment in the development of the modern American corporation.

legitimacy of [state] legislative determinations as to how far the corporate device should be used.” Hurst, supra note 22, at 113 (footnote omitted). “Whether the corporate privilege shall be granted or withheld is always a matter of state policy.” Louis K. Liggett Co. v. Lee, 288 U.S. 517, 545 (1933) (Brandeis, J., dissenting).


40. 2 Davis, supra note 18, at 22-23. Massachusetts and Connecticut granted the most charters during this period; a combined 30 percent. Id. Davis also classifies the purposes of these charters, from colonial times through 1800: Financial (banking and insurance) 20 percent; Highway (inland navigation, toll-bridges, and turnpikes) 65 percent; Local Public Service (water supplies and docks) 11 percent; and Business (manufacturing, mining, agriculture, land, and commercial) 4 percent. Id.; see also Blair, supra note 6, at 389 n.3. But see Williston, Part II, supra note 37, at 166 (stating that by the end of the eighteenth century approximately 100 charters had been issued, half in Massachusetts).

41. 2 Davis, supra note 18, at 294.

42. Luce, supra note 33, at 1294.


44. Luce, supra note 33, at 1294 (noting that demands for special charters had led to widespread corruption in obtaining charters). New York, for example, amended its constitution in 1846 to allow corporations, in all but limited, special circumstances, to be formed under the general laws, versus special acts of the legislature. See William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663, 664 (1974) (citing N.Y. Const. art. VIII, § 1 (1846)).

While many of the early American corporations were devoted to quasi-governmental purposes, such as building canals and toll roads, it was the surge of manufacturing businesses seeking incorporation coupled with the growing railroad concerns needing substantial capital that drove the need for general purpose incorporation legislation. "By 1886 the corporation ... was becoming dominant in important lines of manufacturing and [was] being used to a substantial extent for conducting many other types of business enterprises."

By the end of the nineteenth century and into the twentieth century, American business began to expand into nationwide activities and compete globally in a number of industrial segments, requiring high levels of mass-production. The industrial enterprises that dominated America’s most vital industries by the end of the nineteenth century—the archetypes of today’s large, publicly-held corporations—resulted from the integration of the processes of mass production and mass distribution within a single firm. The corporate form of business was ideal for this environment, providing a means to finance increasing capital costs as well as a mechanism for managing resources.

In 1896 New Jersey adopted what is regarded as the first of the fully modern corporation statutes. In 1899 Delaware enacted its modernized General Corporation Law. Although the law was modeled after New Jersey’s, it contained numerous restrictions preventing easy incorporation. For example, an 1875 amendment to the Delaware Constitution permitted general incorporations, but only for specific business endeavors, and the legislation enacted from this amendment required a Superior Court judge’s approval of the articles of incorporation; an 1883 corporation act simplified the procedure somewhat, but still required judge approval. See S. Samuel Arsht, A History of Delaware Corporation Law, 1 DEL. J. CORP. L. 1, 4-5 (1976). Meanwhile, the Delaware
Jersey’s corporation statute, Delaware’s General Corporation Law soon became the most popular in the United States because of “three principal features: a simple procedure for formation; low corporate taxes; and a broad statement of the powers granted to the corporation by the State.” Delaware’s laws granted to corporations the power to conduct business in other states, to hold stocks and bonds of other companies, and the power to merge, as well as limited shareholder liability to the amount of their investment. Initial liberalization of incorporation laws by New Jersey and Delaware sparked competition among a handful of states to further liberalize their own statutes to compete for corporate charters. In particular, these updated laws allowed those controlling the corporation the opportunity to create the corporate structure most favorable to management by writing both the charter and the bylaws. For example, revisions in the 1920s to Delaware’s General Corporation Law “gave almost unlimited power to directors vis-à-vis investors, [attesting to] the importance attached to a free hand for those who sat atop broad stockholder constituencies.”

From the financial perspective, larger businesses needed to raise capital far beyond the capacity of a few investors. For example, capital injected into the railroad network rose from $300 million in 1850 to over $21 billion in 1916. As a consequence, a financial industry arose to facilitate raising large sums of capital from a large number of people. By the second decade of the twentieth century, publicly held stocks and bonds...
financed most of the leading economic sectors in the United States.\textsuperscript{60} By 1912, securities represented 19 percent of total United States assets.\textsuperscript{61}

The combination of relaxed corporation codes and increased need for capital is reflected in the number of incorporations each year in the nineteenth and twentieth centuries. There were never more than 1,000 incorporations in any single year in the United States prior to 1880, with an average of approximately 250 incorporations per year from 1800 through 1879.\textsuperscript{62} However, annual new incorporations exceeded 5,000 in 1892 and 10,000 in 1901, peaking at over 45,000 by 1929 before falling precipitously to just over 12,000 by 1943.\textsuperscript{63} After 1943 no one has compiled state-by-state annual incorporations. The United States Census Bureau began tracking the total number of corporations in the United States beginning in 1916.\textsuperscript{64} The aggregate data reflect a similar trend, with 341,000 total corporations in the United States in 1916, peaking at 533,000 in 1935 before a decline through 1946.\textsuperscript{65} Since the mid-1940s, there has been a steady increase in the number of corporations in the United States, reaching 1 million in 1958,\textsuperscript{66} and climbing to over 5.5 million in 2005.\textsuperscript{67} Though Delaware has long had the reputation of being

\textsuperscript{60}. \textit{Id.} at 223. In 1913, for example, AT&T raised nearly $350 million in capital from just over 53,000 shareholders; U.S. Steel had just over $500 million in common stock outstanding among just over 44,000 shareholders; and General Motors, small by comparison, had capital stock of $31.5 million held by just under 3,000 shareholders. \textit{Id.}

\textsuperscript{61}. \textit{Id.} at 221.

\textsuperscript{62}. GEORGE HEBERTON EVANS, JR., BUSINESS INCORPORATIONS IN THE UNITED STATES 1800-1943, at 95-151 app. 3 (1948). Exact numbers of incorporations during the nineteenth century are not available. The U.S. Census Bureau did not begin collecting corporate statistics until 1916. \textit{See infra} note 64 and accompanying text. Limited figures for total incorporations in specific states during the nineteenth century are available. For example, New Jersey, 1791-1875: 2,318; Pennsylvania, 1790-1860: 2,333; and Wisconsin, 1848-1871: 1,130. HURST, \textit{supra} note 22, at 17-18. All of these were special charters. \textit{Id.} This snippet of figures clearly indicates that even with the requirements of special charters, incorporations were growing dramatically in the nineteenth century compared to the eighteenth century.

\textsuperscript{63}. EVANS, \textit{supra} note 62, at app. 3.


\textsuperscript{65}. \textit{Id.}

\textsuperscript{66}. \textit{Id.}

\textsuperscript{67}. Statistics of Income, \textit{supra} note 1.
the most popular state in which to incorporate, it was never home to more than 20 percent of incorporations between 1800 and 1943.

Since the mid-twentieth century, however, Delaware has maintained its prominence, primarily because it initially attained the status as the preferred state for incorporation due to its liberal laws. Recently, the Delaware Division of Corporations has boasted that Delaware is the corporate home of 64 percent of the Fortune 500 companies. This is significant because, for example, in 2005, the largest 500 American companies, out of nearly 30 million business entities, generated 28 percent of total United States business revenues.

II. THE NATURE OF THE MODERN CORPORATION

The shareholder primacy theory “derives from the concept that the shareholders are the owners of the corporation and, as such, are entitled to control it, determine its fundamental policies, and decide whether to make fundamental shifts in corporate policy and practice.” Before corporations expanded in size and professionalism, “owners managed and managers owned.” As corporations began to grow and dominate economic activity in the United States, commentators began to examine the role of governance in the evolving corporate culture. Writing in 1932, Berle and Means noted the widening dispersion of stock ownership, particularly

68. See, e.g., Arsh, supra note 53, at 1 (noting a general consensus that Delaware has the most popular corporation law).
69. EVANS, supra note 62.
70. In 1956, approximately one-third of the largest industrial, merchandising, and utility companies in the United States were incorporated in Delaware. HURST, supra note 22, at 150.
74. CHANDLER, supra note 50, at 9.
among the largest corporations. They observed that as a result, control of the corporation was passing from the shareholders to the directors. The shareholder was evolving from a holder of rights in the property, management, and wealth of the corporation, to essentially a bondholder—merely a supplier of capital with minimal power to participate in management. Berle and Means argued that this separation of control from ownership led to a perverse logic: any profits exceeding a "fair return" should be distributed to those in control to induce them to manage efficiently, an idea that resulted in corporations operating in the financial interests of management, leaving shareholders "merely the recipients of the wages of capital."

Berle and Means were reacting to the fact that the process of raising significant amounts of capital from large numbers of investors led to a separation of equity ownership from strategic control over the allocation of corporate resources, which was increasingly vested in the hands of career managers. The role of the shareholder began to change from one of "owner" to "investor," along with a commensurate change of attitude by management toward the shareholder. In management's view, shareholders play a passive role in the corporation, buying or selling shares based solely on price fluctuations. "Stockholders know nothing about the business nor do they care anything about it."

But shareholder primacy was not abandoned as the number of shareholders increased while their participation in management decreased.

76. Id. at 244.
77. Id. at 245.
78. Id. at 302.
79. O'SULLIVAN, supra note 51, at 75.
81. Id. (quoting a 1926 letter written by Owen D. Young, Chairman of the Board of Directors of General Electric, from 1922-1939, 1942-1945) (original quotations omitted); see also Past Leaders, Owen D. Young, http://www.ge.com/company/history/bios/owen_young. html (last visited Jan. 26, 2010).
In the 1960s, the “shareholder value” approach began to dominate corporate practice: “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 as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud.”

Theoretically, if firms devoted their resources to maximizing profits, the interests of the shareholders would be protected. This approach dovetailed nicely with the historic role of management, which satisfied Adam Smith’s concern of ensuring that shareholder interests were protected from managers who had possibly conflicting priorities. “Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.”

Shortly thereafter, a principal-agent theory began to take hold—shareholders, who are unable or unwilling to actively manage the corporation, are principals who appoint directors as their agents to run the business. The principal-agent theory addressed not only methods to

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82. MILTON FRIEDMAN, CAPITALISM & FREEDOM 133 (1963); see Elletta Sangrey Callahan et al., Integrating Trends in Whistleblowing and Corporate Governance: Promoting Organizational Effectiveness, Societal Responsibility, and Employee Empowerment, 40 AM. BUS. L.J. 177, 180 (2002) (discussing contractarianism, an environment wherein maximizing shareholder value also maximizes value for other stakeholders). “Nonshareholder constituencies are presumed to be able to bargain with the corporation to protect their interests. Thus, market forces—including the managerial labor market, the product market, and the market for corporate control—provide the ultimate check on organizational wrongdoing by penalizing inefficiencies.” Id. at 180-81 (footnote omitted).

83. See SMITH, supra note 7.


A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.

Id.

prevent managers from stealing capital from shareholders, but also methods to address managers’ self-interested motives that differed from the shareholder primacy/profit maximization priorities of the firm. “Given information asymmetry between principals and agents—that is, the agents are much better informed both about their own actions and about their outcomes—it is never likely to be optimal for the agents to act in a way that is optimal for the principals.” Jensen, Meckling, and Fama argued that shareholders can ensure managers act in the shareholders’ best interests through monitoring and incentives. Incentives for management can be increased to minimize monitoring costs. As a result, managers have been financially rewarded for maximizing shareholder value in firms. “For most economists and legal scholars, the debate is more about how to implement shareholder value than about its legitimacy. Much of this debate focuses on what constitutes an efficient monitoring structure.”

The time horizon for management’s incentives is also critical. Too short of a time horizon can result in management pursuing high, short-term profits at the expense of future profitability, particularly if the managers leave after the high-profit period. Granting stock options can lessen short-termism, since stock prices also incorporate anticipated future performance of the firm. The problem is, however, that because managers’ compensation will potentially decline if the corporation’s share price also declines, managers will therefore become more risk-averse.

86. See, e.g., Shleifer & Vishny, supra note 85, at 737.
87. See, e.g., id. (“How do the suppliers of finance get managers to return some of the profits to them?”).
89. RAKESH KHURANA, FROM HIGHER AIMS TO HIRED HANDS 317-18 (2007).
90. Id.; see also TYLECOTE & VISINTIN, supra note 88, at 16-17.
91. TYLECOTE & VISINTIN, supra note 88, at 17-18 (noting that managers have an incentive to perform when they receive a profit-based bonus).
93. TYLECOTE & VISINTIN, supra note 88, at 17.
94. Id.
95. Id. But see James McConvill, Executive Compensation and Corporate Governance: Rising Above the “Pay-for-Performance” Principle, 43 AM. BUS. L.J. 413, 416 (2006) (arguing that the view of agency theorists regarding the importance of remuneration is misguided; that executives are not principally motivated by money in terms of their relationship with the company, nor is money the best mechanism to appeal
There is an inherent conflict between managers and shareholders when it comes to risk. Shareholders generally prefer high-risk investments that have the potential to generate higher returns later on, and investors can minimize risk by maintaining a diversified portfolio. Executives, meanwhile, whose investment portfolios may be significantly invested in their own firms, are more inclined to avoid these same high-risk investments that may not return positive short-term yields.

There is evidence that managers are exploiting a flaw in the interrelationship between the principal-agent and shareholder value approaches. Commentators have argued that these approaches have distracted corporations from their substantive business models causing them to pursue increasing share prices. In a continual attempt to increase share prices, directors resort to share repurchases, restructuring, and reshuffling finances, such as changing inventory valuation methods, accelerating income, deferring expenses, and changing pension actuarial assumptions. For example, from the fourth quarter of 2004 through the third quarter of 2008, companies in the S&P 500, as a group, earned revenues of $2.42 trillion and distributed $2.64 trillion to shareholders through dividends and stock buy-backs. As noted by O’Sullivan, the "alignment of the interests of the strategic managers of US public corporations with the demands of the stock market is now typically regarded as a defining feature of the market-oriented U.S. system of corporate governance."

97. Id.
98. See, e.g., ROGER LOWENSTEIN, ORIGINS OF THE CRASH: THE GREAT BUBBLE AND ITS UNDOING 7 (2004). But see Matheson & Olson, supra note 73, at 1332 (suggesting the conflicts between shareholder and manager interests are more subtle; "the pursuit of longterm stability, the reinvestment of earnings, and the growth and diversification of the corporate business tends to solidify the corporate enterprise and maintain managers in their positions").
101. O’SULLIVAN, supra note 51, at 70. This market oriented approach was also emphasized when the first significant federal legislation was enacted in the twentieth century to protect shareholders. The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa.
“Innovation is the process through which productive resources are developed and utilised to generate higher quality and/or lower cost products than had previously been available.”\(^{102}\) And it is corporate governance that influences how corporations allocate resources and returns; it “shapes who makes investment decisions in corporations, what types of investments they make, and how returns from investments are distributed.”\(^{103}\) Tylecote and Visintin found that United States corporations that are directly controlled by shareholders, family- and venture capital-dominated firms, tend to be governed for the longer view; whereas firms with substantial outside shareholder interest tend to focus on maximizing shareholder value and spend relatively less on research and development.\(^{104}\) Other commentators have reached similar conclusions: Hayes and Abernathy have argued that lower post-WWII productivity growth in the United States, compared to Germany and Japan, was due in part to management’s focus on short-term cost reduction rather than long-term development of technological competitiveness.\(^{105}\) A decade later, Porter concluded that the innovative shortcomings of American businesses were the result of short time horizons, ineffective corporate governance, and high costs of capital—all symptoms of larger problems within the United States’ capital investment system.\(^{106}\)

“To be successful, corporations must innovate to provide products and services that their customers prefer to competitive alternatives. This continual innovation is a risk-oriented process which entails the possibility of failure and inadequate economic results.”\(^{107}\) Corporate decisions to carry on R&D activities “are typically risky, unpredictable, long-term
oriented and multistage, labour intensive and idiosyncratic."  

Studies have identified a relationship between stock ownership and risk-taking; namely, corporations with large numbers of stockholders engage in fewer and less risky R&D projects. This appeared to be especially critical in the 1980s, as United States firms faced stagnation in productivity coupled with increased competition from countries like Japan who began gaining prominence in both internal and external markets.  

In the 1980s, with American corporations beginning to experience significant competition from overseas competitors, "US corporate managers faced a strategic crossroads: they could find new ways to generate productivity gains on the basis of 'retain and reinvest,' or they could capitulate to the new competitive environment through corporate downsizing." The focus of corporate activities shifted to maximizing shareholder value by externalizing costs.  

Although studies have indicated that corporations with large numbers of stockholders engage in fewer R&D projects, there is still some debate as to whether diverse stock ownership, particularly associated with institutional investors, helps foster a low-risk, less innovative corporate culture.  

Institutional ownership of corporate stock grew from 12 percent of New York Stock Exchange companies in 1949 to over 50 percent in the

108. Federico Munari & Maurizio Sobrero, Corporate Governance and Innovation, in CORPORATE GOVERNANCE, MARKET STRUCTURE AND INNOVATION 13 (Mario Calderini, Paola Garrone & Maurizio Sobrero eds., 2003) (citation omitted).

109. Id.

110. O'SULLIVAN, supra note 51, at 154.

111. Id.

In the past two decades there has been a noticeable shift in US corporate behaviour away from a strategy of retaining both people and money within corporate enterprises towards releasing them onto labour and capital markets. To account for such actions, US corporate managers have proclaimed that the prime, if not only, responsibility of the corporation is to "create value for shareholders." For their success in "maximizing shareholder wealth," these strategic managers receive ample, and often exorbitant, personal rewards, even as most other corporate employees experience lower earnings and less employment stability.

Id. at 70.

112. Samuel B. Graves & Sandra A. Waddock, Institutional Ownership and Control: Implications for Long-Term Corporate Strategy, 4 ACAD. MGMT. EXEC. 75, 76 (1990) (noting the "increase in institutional ownership ... fueled by the growth in pension funds following [enactment] of the Employee Retirement Income Security Act (ERISA) of 1974").
1980s across a number of industry sectors. Some research has suggested "that institutions are good investors and look for long-term gains from their investments," and that "the large holdings of [institutional] investors provide ... an incentive to monitor ... managers and influence firm actions, if necessary." However, Graves and Waddock concluded that "[i]nstitutional investors, of necessity, evaluate their holdings largely based on financial performance measures" and that "only a very small percentage even consider a clear measure of long-term competitiveness ... in their investment decisions;" that "the very size of the institutional holdings has forced investment managers to become more active in influencing the strategies of their portfolios of companies, so that institutions influence corporate managers not only by their presence but by their advice and influence in major corporate decisions;" and that pressures imposed by institutional investors are "heavily weighted on the short-term."

Strategies focusing on innovation are often considered high risk because of the high failure rate of most innovations and the risk that a successful innovation may be rendered obsolete by the technological advances of a competitor. As a result, corporations are hesitant to undertake these "high stakes gamble[s]" on innovation out of fear that institutional investors will sell their stake in the firm. Although

113. Id.

114. Rahul Kochhar & Parthiban David, Institutional Investors and Firm Innovation: A Test of Competing Hypotheses, 17 STRATEGIC MGMT. J. 73, 73 (1996) (citations omitted). Kochhar and David concluded that "institutions apparently do not invest for the short term," but instead "look for long-term benefits from their investments." Id. at 82; see also Baysinger et al., supra note 96, at 212-13 (speculating that "the prospect of high financial returns attracts institutional investors to companies that engage in long-term R&D strategies," or, in the alternative, "institutional investors who own large stakes in a company's stock are less able to move ... in and out" of their ownership position and therefore "try to influence the return of their investment by becoming [more] actively involved in ... company[management]"); Gary S. Hansen & Charles W.L. Hill, Are Institutional Investors Myopic? A Time-Series Study of Four Technology-Driven Industries, 12 STRATEGIC MGMT. J. 1 (1991) (finding evidence that higher levels of institutional ownership may be associated with greater R&D expenditures).

115. Graves & Waddock, supra note 112, at 80.


117. Id. at 56-57. These concerns remain prevalent, as exemplified by the Harvard Business Review's decision in 2007 to reprint Hayes' and Abernathy's 1980 article, Managing Our Way to Economic Decline, noting that the article's analysis is still relevant. Robert H. Hayes & William J. Abernathy, Managing Our Way to Economic Decline, 85 HARV. BUS. REV., July-Aug. 2007, at 138; see also Hayes & Abernathy,
commentators have argued that "short-termism," driven by shareholders demanding "unsustainable ever-increasing (quarterly) earnings growth," has contributed to the current financial crisis,\(^\text{118}\) these same commentators do not acknowledge that directors bow to, and are rewarded by, these short-term pressures, to the long-term detriment of their firms.

III. MODERN CORPORATE GOVERNANCE STANDARDS—
DEFERENCE TO DIRECTORS

Corporate law grants directors and officers significant deference when seeking to maximize shareholder value, even when shareholders lose substantial sums of money.\(^\text{119}\) Powers granted to the corporation and its managers have been derived primarily through competition among the states for corporate charters.\(^\text{120}\) States have sought to attract corporate charters, primarily for the revenues they generate, by lowering incorporation costs and eliminating restrictions on corporate activities.\(^\text{121}\) States that sought to maintain restrictions found that local businesses would simply obtain foreign, i.e., out-of-state, charters.\(^\text{122}\) As a result, as one state loosened restrictions, other states followed. This race to the bottom "was one not of diligence but of laxity."\(^\text{123}\) This argument is supported by the history of the development of Delaware's General Corporation Law.\(^\text{124}\) Delaware corporation law provides significant leadership in United States corporate governance standards because of

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1980, supra note 105.
119. Officers and directors are apparently also still entitled to significant compensation even when their companies' shareholder values decline. See, e.g., The Pay at the Top, N.Y. TIMES, Apr. 12, 2009, http://projects.nytimes.com/executive_compensation (reporting compensation data for 200 chief executives at 198 publicly traded companies). For a majority of corporations, CEOs received increased compensation from 2007 to 2008, despite declines in their companies' share value over the same period. Id.
120. See supra Part I.
122. Id. at 557.
123. Id. at 559 (footnote omitted); see also John D. Ayer, The Role of Finance Theory in Shaping Bankruptcy Policy, 3 AM. BANKR. INST. L. REV. 53, 58 n.17 (1995); Cary, supra note 44, at 664.
124. See supra notes 52-58 and accompanying text.
Delaware's historic role as the preferred state of incorporation for large, publicly-held corporations—over half the firms that generate 28 percent of total American business revenues are regulated by the Delaware General Corporation Law.125

A director's fiduciary duty to the shareholders has been characterized as a “triad” of “due care, good faith, and loyalty.”126 “That triparte fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided.”127 As laudable as these duties may be, in practice, they may now actually be anachronistic.

It is argued that “[w]ealth is maximized when corporations are run by directors who know that their decisions will be reviewed by investors, by analysts, by stockholders, and by business partners—but not by the courts.”128 When Delaware courts look at director fiduciary duties, they “balance specific policy considerations, such as the need to keep directors and officers accountable to shareholders and the degree to which the threat of personal liability may discourage beneficial risk taking.”129 In practice, the Delaware courts have continually granted great deference to director decisions, as long as there was no overt intent to personally profit from the decision or to harm the corporation.

For example, the Delaware Chancery Court recently considered a complaint by Citigroup shareholders that the Citigroup board breached its fiduciary duties by failing to understand the risks associated with the firm’s exposure to the subprime lending market.130 The court began its

125. See supra notes 71-72 and accompanying text.
127. Id.
128. David Rosenberg, Galactic Stupidity and the Business Judgment Rule, 32 J. CORP. L. 301, 303 (2007) (footnote omitted). This same sentiment was echoed by the Delaware Chancery Court—when directors make poor decisions, “redress...must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court.” In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006).
130. Id. at 124. Though the facts in this case may seem a bit ironic in that Citigroup appears to have taken excessive risks, ultimately it can be viewed as a case of seeking short-term profits at the expense of long-term viability. See, e.g., Eric Dash & Julie Creswell, Citigroup Pays for a Rush to Risk, N.Y. TIMES, Nov. 23, 2008, at A1 (reporting that Citigroup risk managers charged with overseeing deal makers eager to increase short-term earnings—and executives' multimillion-dollar bonuses—failed to rein them in).
analysis by distinguishing “between (1) a board decision that results in a loss because that decision was ill advised or ‘negligent’ and (2) an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.” In the former case, directors are protected by the business judgment rule and are not subject to judicial second guessing short of evidence of gross negligence. In the latter case, to establish liability it must be shown that “the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities such as by failing to act in the face of a known duty to act.”

The Court summarized the shareholders’ claims as attempting to hold the directors “personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the company.” This type of decision-making, according to the court, falls within the business judgment rule: “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” The burden is on the shareholders who are challenging the directors’ decision to rebut this presumption. [A]bsent an allegation of [self-] interestedness or disloyalty to the corporation, the business judgment rule prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information.

The great deference to management decisions is tempered by the notion that it is the shareholders who ultimately control the board of


132. Id. Gross negligence has been defined as a “reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.” In re Walt Disney Co. Derivative Litig., 907 A.2d at 750 (internal quotation marks and footnote omitted).


134. Id. at 124. Citigroup’s stock value dropped seventy-three percent from 2007 to 2008. The Pay at the Top, supra note 119.


136. Id.

137. Id. “This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.” Id. at 139; see also Gantler v. Stephens, 965 A.2d 695, 705-06 (Del. 2009) (holding same).
directors. Corporate managers have a great deal of authority to pursue business strategies, subject to certain constraints which assure that managers will not abuse the powers granted to them.\textsuperscript{138} These constraints supposedly instill confidence in investors that their capital may be safely entrusted to corporate managers.\textsuperscript{139} In theory, shareholders may use their voting power to displace elected representatives with whom they are displeased.\textsuperscript{140} Arguably, this shareholder power instills a "fear of replacement" in the directors, giving them incentive to serve the shareholder interest and remain accountable.\textsuperscript{141} This replacement power is especially important when director decisions are insulated from judicial review.\textsuperscript{142}

But in reality, at least for large, publicly-held corporations, the "powers of corporate democracy" may be missing.\textsuperscript{143} While shareholders elect the directors, in actuality they are left with little opportunity to actively participate in the director nomination process.\textsuperscript{144} One major impediment is Securities Exchange Act Rule 14a-8(i)(8), which regulates shareholder proposals that can be included in proxy statements for corporate annual shareholder meetings.\textsuperscript{145} Under this rule, a shareholder must meet certain eligibility requirements in order to include their proposal in the corporation's proxy statement.\textsuperscript{146} However, a corporation

\textsuperscript{138.} Leo E. Strine, Jr., \textit{Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America}, 119 \textit{Harv. L. Rev.} 1759, 1762 (2006) (providing a list of some of these constraints— that "stockholders approve certain important transactions such as mergers, vote for directors annually, and have access to books and records; that stockholders can hold managers accountable for failing to fulfill their fiduciary duties; and that state and federal policies give independent directors the clout and duty to police corporate insiders") (footnotes omitted).

\textsuperscript{139.} \textit{Id.}

\textsuperscript{140.} Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985).


\textsuperscript{142.} \textit{Id.}


\textsuperscript{144.} Bebchuk, \textit{The Myth}, supra note 141, at 688 (concluding that even when shareholder dissatisfaction with board actions and decisions is substantial, the evidence indicates that "challengers face considerable impediments to replacing boards"); \textit{see also} Rose A. Zukin, \textit{We Talk, You Listen: Should Shareholders' Voices Be Heard or Stifled when Nominating Directors? How the Proposed Shareholder Director Nomination Rule Will Contribute to Restoring Proper Corporate Governance}, 33 \textit{Pepp. L. Rev.} 937, 941 (2006).

\textsuperscript{145.} 17 C.F.R. § 240.14a-8 (2005).

\textsuperscript{146.} \textit{See Am. Fed'n State, County & Mun. Employees v. Am. Int'l Group, Inc.}, 462
may exclude a shareholder proposal "[i]f the proposal relates to an election for membership on the company’s board of directors or analogous governing body."147 The result is that if shareholders wish to contest directors nominated by the existing board, they have to prepare and distribute their own proxy materials.148

Empirical evidence suggests this is a substantial impediment. Bebchuk examined contested director elections for publicly-held corporations during the decade 1996-2005. During the decade, there were only 118 director contests seeking to change the leadership team governing the corporation.149 The majority of the contests involved small firms; there were only twenty-four such contests within firms with market capitalization exceeding $200 million—and of those, only eight challenges

F.3d 121, 125 (2d Cir. 2006).

147. Id. (quoting 17 C.F.R. § 240.14a-8(i)(8)). On May 20, 2009, the Securities and Exchange Commission voted to propose a new Securities Exchange Act Rule 14a-11 which would permit owners of between 1-5 percent of an exchange-traded corporation’s voting stock, who have held the stock at least one year, the ability to include their nominees for director in the company’s proxy materials unless the shareholders are otherwise prohibited—either by applicable state law or a company’s charter/bylaws—from nominating a candidate for election as a director. Press Release, Sec. & Exch. Comm’n, SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors (May 20, 2009), available at http://www.sec.gov/news/press/2009/2009-116.htm. SEC Commissioner Elisse B. Walter has stated that she does not expect the new rule to be adopted until 2010. Elisse B. Walter, SEC Comm’r, SEC Rulemaking—‘Advancing the Law’ to Protect Investors, Speech at the 4th Annual Corporate Counsel Institute, Northwestern University School of Law (Oct. 2, 2009), available at http://www.sec.gov/news/speech/2009/spch100209ebw.htm; see also infra notes 162-63 and accompanying text (discussing a similar provision in the proposed Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009)); infra note 161 and accompanying text (discussing an amendment to Delaware’s General Corporation Law permitting corporations to include in their bylaws provisions requiring the corporation to include in proxy materials directors nominated by shareholders).

148. Zukin, supra note 144, at 940-41. According to critics of current shareholder powers to challenge boards, there are structural impediments beyond Rule 14a-8(i)(8), such as the cost to mail out separate proxies, staggered boards which result in less than a majority of contested board seats in any one election, and the ability of shareholders to “withhold” votes that do not count as a vote “against.” Bebchuk, The Myth, supra note 141, at 688-91, 694, 701-04; see also infra notes 162-63 and accompanying text (discussing the proposed Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009), which would eliminate staggered boards and require that directors be elected by a majority of votes cast).

149. Bebchuk, The Myth, supra note 141, at 685. This is from the universe of firms that filed proxy statements with the SEC during the decade. Id. at 682-84.
were successful.150 During the 2008 proxy season, there were fifty-six contests involving director elections in which shareholders distributed a separate proxy; only eleven of these were successful.151

IV. QUESTIONING THE SHAREHOLDER PRIMACY APPROACH TO CORPORATE GOVERNANCE

Anecdotal evidence suggests that shareholder-director interests are not necessarily aligned and that the current corporate governance structure is not sustainable based on concerns that American companies are losing their competitive edge in innovation;152 the near-collapse of the domestic American automobile industry;153 the transfer of manufacturing overseas;154 and the stagnation of wages,155 coupled with the exponential rise in executive compensation.156 Regarding the 2008-09 financial crisis, one commentator has flatly stated: "There's no other way of saying it: today's doctrines of shareholder primacy and managerial self-interest have brought many companies to the brink of self-destruction."157 These

150. Id. at 686-87.
152. See, e.g., MICHAEL L. DERTOUZOS ET AL., MADE IN AMERICA: REGAINING THE PRODUCTIVE EDGE 1 (1989) (noting that the U.S. buys far more overseas than it can sell in other countries, that the U.S. rate of productivity improvement has fallen behind several Western European and Asian nations, and that managers are criticized for seeking quick profits rather than pursuing long-term goals); Steve Lohr, U.S. Said to be Losing Competitive Edge, N.Y. TIMES, Feb. 25, 2009, at B9.
155. See, e.g., Peter S. Goodman, A Shopping Guernica Captures the Moment, N.Y. TIMES, Nov. 30, 2008, § WK, at 3 (noting that "[w]ages for most Americans have fallen in real terms over the last eight years").
156. See, e.g., PHILLIPS, supra note 154, at 67 fig.2.10 (reporting the top compensation of American CEOs in 1981: $5.7 million; 1988: $40.1 million; 2000: $290 million); The Pay at the Top, supra note 119.
157. Simon Caulkin, Corporate Apocalypse, MGMT. TODAY, Jan. 1, 2009, at 50, 52; see also Grant Kirkpatrick, The Corporate Governance Lessons from the Financial
developments lend support to the argument of "[c]apital market myopia ... as the determinant of lower levels of investment in innovation."\textsuperscript{158} Though not addressing corporate governance directly, Lewis and Einhorn aptly describe the current situation: "Obviously the greater the market pressure to excel in the short term, the greater the need for pressure from outside the market to consider the longer term. But that's the problem: there is no longer any serious pressure from outside the market."\textsuperscript{159}

Pressure could come from the courts or shareholders. But the Delaware courts have clearly indicated the business judgment rule is alive and well.\textsuperscript{160} The Delaware legislature has just enacted an amendment to its General Corporation Law which permits corporations to include in their bylaws provisions requiring the corporation to include in proxy materials directors nominated by shareholders,\textsuperscript{161} thus potentially eliminating one of the major obstacles to shareholder control over the actions of the directors. But the amendment only allows corporations to include this provision; it does not require them to do so. It is too early to know whether this change will have significant impact on corporate governance.

Meanwhile, Congress has taken an interest in corporate governance and sustainable business prosperity. It has found that the widespread failure of corporate governance has been a leading cause in the current financial crisis, noting specifically that management has failed to adopt compensation policies linked to long-term profitability, as well as remain accountable to their shareholders.\textsuperscript{162}

\textit{Crisis}, 96 Fin. Market Trends 1, 2 (May/June 2009), available at \url{http://www.oecd.org/dataoecd/32/1/42229620.pdf} (concluding that "[t]he financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements").

\textsuperscript{158} Munari & Sobrero, supra note 108, at 5.

\textsuperscript{159} Michael Lewis & David Einhorn, Editorial, The End of the Financial World as We Know It, N.Y. Times, Jan. 4, 2009, § WK, at 9.

\textsuperscript{160} See supra notes 128-37 and accompanying text.

\textsuperscript{161} 77 Del. Laws 14 (2009); DEL. CODE ANN. tit. 8, §§ 112-13 (2009); \textit{see also supra} note 147 (discussing the Securities and Exchange Commission's vote to propose a new Securities Exchange Act Rule 14a-11 which would permit qualified shareholders the ability to include their nominees for director in the company's proxy materials, if also permitted by the company's charter/bylaws).

The Shareholder Bill of Rights Act of 2009 would require the SEC to amend its rules to allow shareholders who have owned at least one percent of the company’s voting shares for at least two years to use the company’s proxy materials to nominate members of the board of directors. While the Delaware and potential federal legislation are aimed at strengthening shareholder powers, shareholders are not the only constituents that have a stake in a corporation’s activities. In the 1980s, Freeman argued that businesses were facing increasing needs to interact with external forces and pressures. Freeman recognized that in order to be successful, managers needed to adapt to strategic shifts in their operating environment, which required recognizing not only the priorities of the shareholders, but also the needs of external stakeholders—including employees, suppliers, local citizens and community organizations, governments, and customers. Justification for maximization of shareholder value is based on the fact that “shareholders are the only economic actors who make investments in the corporation without any contractual guarantee of a specific return.” “As ‘residual claimants,’ shareholders thus bear the risk of the corporation’s making a profit or loss and have an interest in allocating corporate resources to their ‘best alternative uses’ to make the residual as large as possible.” The argument is that “[s]ince all the other stakeholders in the corporation will receive the returns for which they have contracted, the ‘maximization of shareholder value’ will result in superior economic performance not only for the particular corporation but also for the economy as a whole.”

163. S. 1074, § 4. The Act would also require that in proxy materials, companies must provide for an advisory vote on the compensation packages for executives, and that in any acquisition, merger, consolidation, or proposed sale or other disposition of substantially all of the assets of a company, it must disclose, and provide an advisory shareholder vote on, any type of compensation for executives of the issuer or acquiring issuer. Id. § 3. In order to remain listed on stock exchanges, issuers must elect a Chairperson of the Board of Directors who is not currently serving, and has not previously served, as an executive officer of the issuer, eliminate staggered boards, elect board members only by a majority of shareholder votes cast, and maintain a risk committee comprised entirely of independent directors, responsible for the risk management practices of the issuer. Id. § 5.
165. Id. at 24-25.
166. Id.
167. O'SULLIVAN, supra note 51, at 43.
168. Id. This argument ignores, however, stakeholders who do not have contractual claims on the corporation, such as members of the community who must suffer from
Commentators are beginning to recognize, however, that there is an alternative to the shareholder primacy approach to corporate governance and that corporations have broader social responsibilities which include economic, legal, ethical, and discretionary (i.e., philanthropic) considerations. Even the classical capitalist ideology—maximizing shareholder value—"logically entails a market morality that makes individuals and firms responsible for maximizing profits so long as they comply with the law, adhere to familiar moral standards of honesty, fidelity and fairness, and respect those individual moral rights that are presupposed by capitalist market arrangements." Many of these broader social responsibilities were recognized over fifty years ago by Bowen, who argued that the system of laissez faire—i.e., a market-based exchange economy—declined because of conflicts between individual and social interests, essentially because business people did not achieve their moral obligations.

171. HOWARD R. BOWEN, SOCIAL RESPONSIBILITIES OF THE BUSINESSMAN 19 (1953). Bowen summarized the historical moral obligations of business people:

- (1) to observe the rules of property;
- (2) to honor contracts;
- (3) to refrain from deception and fraud;
- (4) to be efficient and to promote economic progress;
- (5) to protect life, limb, and health of workers and the general public;
- (6) to compete vigorously, and in case of failure of competition to act with restraint;
- (7) to accept and respect the economic freedoms of consumers, workers, and owners; and
- (8) to have regard for the human rights of workers.

Id.; see also Edwin M. Epstein, The Corporate Social Policy Process and the Process of Corporate Governance, 25 AM. Bus. L.J. 361 (1987) (discussing the American Law Institute’s proposed Principals of Corporate Governance § 2.01, which requires, inter alia, that in the conduct of business, corporations “may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes”).

172. See BOWEN, supra note 171, at 20. Bowen attributed the decline of laissez faire to additional issues, familiar in modern society:

- (1) growth of large-scale enterprise and concentration of economic power;
- (2) fluctuating general business activity with recurrent periods of unemployment;
- (3) technological unemployment;
- (4) personal insecurity of people with reference to sickness, old age, and death;
- (5) disparities in the distribution of income;
- (6) disparities in the distribution of economic opportunity;
- (7) overly rapid and wasteful exploitation of natural resources;
- (8) materialistic, competitive, and
The federal government has served as a source of imposing social responsibilities on businesses, in the form of laws such as the National Environmental Policy Act of 1969, the Sherman Antitrust Act of 1890, Title VII of the Civil Rights Act of 1964, and the Sarbanes-Oxley Act of 2002. But, as Rodewald notes, "the legal mechanisms through which government must act are an inherently crude, ineffective, costly, and sometimes counterproductive means for controlling corporate behavior," and additionally have a problem of being reactive with a time lag that can result in irreparable damage between recognition of a problem and enactment of legislation.

Rodewald further argues that "managers are morally responsible for considering the likely human, social and environmental consequences of the alternative courses of action open to them, as well as the interests of all those who will be affected by their decisions." Rodewald concludes that managers ultimately "should try to pursue the course of action that they conclude, all things considered, is reasonable to expect will maximize individual and social benefits over costs in a way that is consistent with the requirements of social justice." These are significant responsibilities. Conversely, Mayer expresses the more contrarian—and cynical—view of the corporation's role in society: that business ethics "is clearly an instrumental strategy rather than something worth doing for its own sake."

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invidious standards of consumption; and (9) frequent disregard for the social costs of economic activity and the social values that might be derived from economic activity.

Id. at 21; see also, Daniel T. Ostas, Cooperate, Comply, or Evade? A Corporate Executive's Social Responsibilities with Regard to Law, 41 AM. BUS. L.J. 559, 562-63 (2004) (discussing Bowen's view that the lapse of business ethics contributed to the Great Depression).


177. Rodewald, supra note 170, at 453.

178. Id. at 455 (footnote omitted).

179. Id.

But if society as a whole cannot agree precisely which values should be advanced, why should it be the responsibility of corporate managers? But if society as a whole cannot agree precisely which values should be advanced, why should it be the responsibility of corporate managers? Further, while theories promoting profit maximization may have their flaws with respect to maintenance of long-term corporate sustainability, sacrificing corporate profits in pursuit of nonmarket social goals can make a firm uncompetitive and, ultimately, unsustainable. Further, while theories promoting profit maximization may have their flaws with respect to maintenance of long-term corporate sustainability, sacrificing corporate profits in pursuit of nonmarket social goals can make a firm uncompetitive and, ultimately, unsustainable.

While some may argue the "era of self-interested companies trying to maximize shareholder wealth at any cost appears to have been supplanted by an era of corporate social responsibility," firms must remain financially viable. Trudel and Cotte found that "[c]onsumers are willing to pay substantially more for ethically produced goods, suggesting that there is a financial reward for socially responsible behavior." In addition, Trudel and Cotte found that consumers will punish the producer of unethically produced goods more than they will reward a company that offers ethically produced goods: "The negative effects of unethical behavior have a substantially greater impact on consumer willingness to pay than the positive effects of ethical behavior."

Margolis, Elfenbein, and Walsh performed a meta-analysis of the empirical link between corporate social performance and corporate financial performance through 167 studies over thirty-five years; they found a positive, though small, link. In a follow-up discussion of the meta-analysis, Margolis and Elfenbein suggest that while acting in a socially responsible way may not be highly profitable, doing good does not destroy shareholder value.

Porter and Kramer emphasize that business and society are mutually dependent and must make choices that benefit both sides. Holcomb has

181. See Rodewald, supra note 170, at 458.
182. See id. at 463.
184. Id. at 67.
185. Id. (emphasis in original).
188. Michael E. Porter & Mark R. Kramer, Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility, HARV. BUS. REV., Dec. 2006, at 78, 83 (arguing that corporations need a healthy society to create expanding demand for business; meanwhile society needs successful companies to create jobs and
observed that there is "pressure to build a business case for social involvement as an integrated part of firm strategy." He notes that "concepts of corporate responsibility and sustainability have gained increasing momentum as measurements of corporate performance[; ... companies are beginning to embrace the idea that corporate responsibility can be good for business performance[;]" recent surveys indicate a majority of consumers expect firms to be involved with social causes; there is growing belief among global CEOs that "corporate responsibility measures can help firms manage legal liabilities, financial performance, reputation, and relations with stakeholders[;]" reports covering non-financial information (such as sustainability, triple bottom line, and environmental, health, and safety issues) are growing in significance; and "[a]n increasing number of institutional investors are becoming interested in approaches to asset management that include environmental, social, and corporate governance criteria or metrics."  

Commentators are now arguing that for a corporation to be truly sustainable, it will have to adopt a stakeholder, rather than a shareholder, value approach; stakeholder engagement and collaboration are necessary conditions for a sustainable business model. Wheeler, Colbert, and Freeman argue that for a firm to be sustainable, the notion of corporate social responsibility—"an ethical appeal to organizational leaders to minimize the harm done by corporations in the pursuit of profits and, in some cases, to make a case for linking conventional philanthropy to constructive community involvement"—must include additional stakeholders. Wheeler and his colleagues recognize that business value

pay taxes).


190. *Id.* at 12-13; *see also id.* at 14-15 (summarizing the relationship between financial performance and corporate responsibility, particularly that corporate responsibility "performance done correctly and strategically has a positive impact on business success["]"). "Triple bottom line" is a paradigm "that a corporation's ultimate success or health can and should be measured not just by the traditional financial bottom line, but also by its social/ethical and environmental performance." Wayne Norman & Chris MacDonald, *Getting to the Bottom of "Triple Bottom Line,"


creation can be regarded from different perspectives. They believe that "a business model that places value creation at its core will allow concepts of CSR [(corporate social responsibility)], sustainability and the stakeholder approach to find their natural homes, whether at a strategic or a managerial level." They have also developed a three-tier model to explore how firms may create value across the three dimensions of the aspirational notion of sustainability, i.e., economic, social, and ecological priorities (also referred to as the "triple bottom line").

Wheeler recognizes, however, that "embracing stakeholder notions of value and striving for sustainability are consistent but not synonymous." Ultimately, they argue, a sustainable business model does not have to be a theoretical ideal. "Whether it is a recognition of the strategic value of reputation, or brand value, few business leaders today ignore the tangible business benefits of loyal, trust-based relationships with networks of customers, suppliers and distributors." According to Wheeler, "the evidence is now mounting that what is said to one stakeholder group, i.e., the investors, need no longer be in conflict with what is said to employees, customers, supply chain partners and local communities."

Criteria have already been established to assist corporations in assessing expanded social responsibility activities. For example, the Global Reporting Initiative has developed a reporting framework in which corporations can detail their economic, environmental, and social impacts; identify their stakeholders and explain how the corporation has responded

193. Id. at 2.
194. Id.; see also Callahan et al., supra note 82, at 183 (arguing that a blended model of corporate governance that enhances individual moral identity by structuring the organization as a community that nourishes moral virtue would have particular efficacy in limiting corporate wrongdoing).
195. Wheeler et al., supra note 192, at 10.
196. Id. at 17.
197. Id. at 19 (footnotes omitted).

Some would argue that the best firms have always sought to leverage their communities of interest for the instrumental purpose of creating value. In many cases they have done this by balancing (or ideally integrating) stakeholder interests and combining them with a clear vision of what is achievable for customers, employees, investors and other stakeholders—whatever their corporate officers may have said to the analysts or investors at annual general meetings.

198. Id. at 18 (footnote omitted).
to the stakeholders’ reasonable expectations and interests; and present the organization’s performance in the wider context of sustainability. 199

V. EVOLVING NORMATIVE STANDARDS FOR SUSTAINABLE CORPORATE GOVERNANCE

In the relatively short history of the modern, publicly-held corporation in the United States, a convergence of factors has led to what is arguably an unsustainable corporate governance model: states engaged in a legislative race to the bottom which gave corporate directors almost unlimited powers to control corporate activities;200 corporate ownership became separated from control as ownership became more dispersed;201 the tandem rise of the shareholder primacy and agency theories encouraged low-risk, short-term returns over innovation and long-term prosperity;202 all of which are supported by a business judgment rule that refuses to question director conduct short of misappropriation or gross misconduct.203 Executive compensation policies out of sync with long-term profitability and a lack of management accountability to shareholders have been identified as contributing factors to the current financial crisis.204

But there has recently been a strategic shift in the corporate operating environment.205 There is a growing recognition that there are others besides managers and their shareholders who have an economic stake in corporate activities. This shift goes beyond consumers demanding that businesses behave ethically.206 There is increasing momentum to demand more than just improved financial performance; shareholders are also demanding improved social and environmental performance as well.207 Shareholder value can be maximized, in the long run, when managers act

200. See text accompanying notes 57-58.
201. See text accompanying notes 74-78.
203. See text accompanying note 137.
204. See text accompanying note 162.
205. See text accompanying note 165.
206. See, e.g., text accompanying notes 189-90.
in the best interests of those who also have a stake in the success of the corporation—such as employees, suppliers, customers, and society. If corporate activities promote a healthy society, that society, in return, can support an environment of business growth.208

While the shareholder value perspective continues to dominate corporate governance, direct incentives can be provided to encourage companies to incorporate stakeholder perspectives, particularly by participating in reporting standards such as those developed by the Global Reporting Initiative.209 Dividends could be distributed tax-free and/or capital appreciations could be tax-free or taxed at a lower rate for corporations that can certify compliance with social responsibility reporting requirements. In this way, the same market forces that contributed to the unsustainability of corporations can be used to reverse that trend. “Stakeholder capitalism bases our understanding and expectations of business, not on the worst that we can do, but on the best. It sets a high standard, recognizes the common-sense practical world of global business today, and asks managers to get on with the task of creating value for all stakeholders.”210

CONCLUSION

The corporate form of business organization has a long and important role in the American economy. From its earliest formal origins, investments by shareholders were protected by legally imposed fiduciary duties on corporate directors. Over time, these duties have morphed into a mantra for maximizing shareholder wealth. But lately, maximizing shareholder wealth has meant achieving continuing short-term stock price gains, sometimes to the detriment of the long-term health of the corporation. This Article has suggested that corporations can redirect their focus to long-term sustainability by expanding corporate governance standards to encompass multiple stakeholders and allowing corporations to mitigate their impact on the environment and society so as to increase their odds of long-term survival.

A review of the literature analyzing stakeholder value and corporate social responsibility philosophies reveals wide disparity in approach—from completely altruistic/society first, to simply avoiding harmful or

208. See text accompanying note 188.
209. See text accompanying note 199.
unethical behavior and illegal activities. Logically, there must be a middle ground in which refined corporate governance norms can be established to promote sustainable business enterprises—for both shareholders and society. A significant amount of empirical and anecdotal evidence suggests that the current mantra of maximizing shareholder value is not sustainable. And since this approach to business is fully supported by current laws, it will require management, and perhaps proactive shareholders, to lead corporations in new, sustainable directions. The race to the bottom which laid the foundation for current corporate governance standards can perhaps be reversed, driving a race to the top.\footnote{See Kyte, supra note 207, at 565.}