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NOTES

CORPORATE SOCIAL RESPONSIBILITY THROUGH CONSTITUENCY STATUTES: LEGEND OR LIE?

INTRODUCTION

In the early 1930s, Professor E. Merrick Dodd, Jr. of Harvard Law School and Professor Adolf A. Berle, Jr. of Columbia Law School debated the question "for whom are corporate managers trustees?" Management, employees, creditors, communities and society still await a definitive answer. Central issues in this recurring debate include the significant role corporations play in American life, whose interests corporate management should nurture and the scope of those interests. An artificial entity theory of the corporation is advanced by certain commentators to bolster arguments that corporate social responsibility should be authorized, encouraged or even mandated. Conversely, a natural entity theory of the corporation is endorsed by others who suggest that a corporation should conduct its business activities with a view to enhancing corporate profit and shareholder gain.

This article accepts the concept that corporations are entities created by law and, as such, have obligations to the society from which the law arose. This author finds that corporations owe, in the very least, some sort of duty to society. The critical question, however, is determining the nature and the scope of this corporate social

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1. See E. Merrick Dodd, Jr., For Whom Are Corporate Managers Trustees?, 45 HARV. L. REV. 1145, 1153-54 (1932); see also Adolph A. Berle, Jr., For Whom Corporate Managers Are Trustees: A Note, 45 HARV. L. REV. 1365, 1367-68 (1932).
2. See infra notes 10-14 and accompanying text.
3. See infra notes 15-16 and accompanying text.
Traditionally, it has been beyond the scope of corporate directors' duties to conduct corporate activities in furtherance of nonshareholder interests. Corporate governance, however, has gradually evolved and currently embraces an expansion of fiduciary duties to include the accommodation and consideration of nonshareholder constituencies. Constituency statutes spur this dramatic shift in corporate governance. The new theory, corporate social responsibility, threatens to change the fiduciary duties traditionally embedded in the board of directors.

More than half the state legislatures in the United States have enacted constituency statutes that authorize or require directors to consider nonshareholder constituencies when making business decisions. Constituency statutes loosen the legal bindings, already rather worn and weak, tying directors to shareholders and replace a legal doctrine now considered obsolete by some commentators. It is the scope of these statutes and their potential for the transference of wealth that generates much concern.

Corporate constituency statutes, as they exist today, do not significantly shift wealth from shareholder to nonshareholder. Accordingly, these controversial statutes do not signify the demise of the American corporation. They do, however, pose a genuine danger and,


8. Richard C. Freedman & Robert A. Reed, Stockholders and Stakeholders: A New Perspective on Corporate Governance, 25 CAL. MGMT. REV. 88, 89 (1983) (reporting that the term "stakeholders," used by several commentators in lieu of "nonshareholders," derives from a 1963 Stanford Research Institute memorandum as a descriptive term for "those groups without whose support the organization would cease to exist").
therefore, should be interpreted narrowly. Alternatively, if Americans truly desire to alter the basic nature of our corporations, then legislatures need to amend constituency statutes to afford other constituencies tangible methods of enforcing their newfound rights.

The welfare that constituency statutes jeopardize is that of the shareholder. The real threat is not that these statutes will transfer wealth from shareholder to nonshareholder. Instead, the true danger is that these statutes promote wealth relocation from shareholder to management. A serious risk exists that unscrupulous management\(^9\) will use constituency statutes as a shield to protect their personal interests.

This article explores corporate constituency statutes and corporate social responsibility. In doing so, questions regarding the scope of corporate fiduciary duties and to whom these duties run are addressed. The article is divided into five sections. The first section provides a history and background of corporate social responsibility. Included in this section are discussions of the original scope of corporate law, the artificial entity and natural entity theories of the corporation, the shareholder primacy principle, the views of Adolph Berle, Gardiner Means and E. Merrick Dodd, and factors leading to the birth of constituency statutes. The second section examines approximately one hundred years of corporate social responsibility case law and discusses internal corporate adoptions of considerations for nonshareholder constituencies. The third section discusses various constituency statutes, provides an example of the "standard" statute, differentiates between permissive and mandatory nonshareholder statutes and addresses possible constitutional challenges to these statutes.

The fourth section of this article evaluates the statutes and their scope. Special attention is given to the power and activism of institutional investors in today's marketplace. A discussion ensues on the proper interpretation of these statutes, debt and equity financing considerations, who these statutes truly benefit, efficiency considerations, arguments against these statutes and responses to these arguments. This section also demonstrates why constituency statutes fail to protect nonshareholder constituencies and instead benefit management.

In the fifth and final section, this article argues that state legislatures have failed in their enactment of constituency statutes to address clearly what constituencies corporations should serve. This section

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9. See infra text accompanying notes 170-75. Executive compensation in excess of fifty million dollars per year is arguably an example of unscrupulous management conduct.
includes a model statute that serves the purposes of state legislatures that truly desire to empower nonshareholder constituencies. Also included is a commentary to the model statute. In conclusion, this article argues that corporations should be able to consider the interests of nonshareholder constituencies in every business decision. Such a consideration, however, should be limited in that corporations should be required to prove that any negative impact on shareholders is merely incidental.

I. HISTORY AND BACKGROUND

A. The Artificial Entity Theory and the Natural Entity Theory

The earliest American corporations were conceived principally to serve the public good and welfare. Although formed by the private initiative of individual incorporators with the expectation of profits, these corporations were nevertheless considered artificial owing their existence to the positive law of the state. Because they were chartered to provide a public service, these early corporations were also closely monitored by the sanctioning state. In 1819, Chief Justice John Marshall described a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law." Today, advocates of corporate social responsibility often refer to these origins to "argue that corporations exist at the sufferance of the government, which retains a legitimate role in conditioning its grant of a corporate charter (viewed as a concession of the government) on the receipt of some quid pro quo."
The natural entity theory of the corporation gradually supplanted the artificial entity theory during the nineteenth century and became firmly entrenched by the early twentieth century. The natural entity theory emphasized the corporation’s origin in the natural activities of private individuals and was reflected in the adoption of general incorporation statutes which gradually eliminated the prohibition of stock ownership by corporations and thus facilitated the creation of enormous holding companies and the gradual abolition of capitalization limits and duration.

Traditionally, corporate officers and directors owed fiduciary duties to shareholders and to shareholders alone. Milton Friedman said “[t]he social responsibility of business is to increase its profits.” In the corporate arena, a zero sum game is often played: if one constituency is favored, another is concomitantly disfavored. Traditional corporate law recognizes this theorem by limiting management’s fiduciary duties to the corporation and, for the most part, equating the duty to the corporation with a duty to act in the best interests of its shareholders. This traditional duty did not preclude management from considering and benefiting other constituencies; it merely limited such corporate social responsibility to conduct that was in the corporation’s self-interest.

B. Berle, Means and Dodd

In 1932, Adolph Berle and Gardiner Means published The Modern Corporation and Private Property. This book argued that own-
ership and control were separated in the corporation and that management had seized control from the shareholders. Berle and Means concluded that this separation concentrated economic power in management, decreased economic efficiency and misallocated resources. They analogized corporate law to the law of trusts to find that management should act as fiduciaries for the benefit of shareholders. They stated that “all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears.” This view rejected any argument that management could spend corporate assets or engage in other activities not financially beneficial to shareholders. It urged instead that corporate management should solely concentrate its attention to shareholder wealth maximization.

Professor Berle also authored an article in 1931 titled Corporate Powers as Powers in Trust. This article quickly spawned a prompt reaction by Professor E. Merrick Dodd. In 1932, Professor Dodd responded with his article For Whom Are Corporate Managers Trustees setting off a debate with Professor Berle that continued for over twenty years. Berle’s premise that corporations had undergone a separation of ownership and control was generally accepted by Dodd. Dodd, however, repudiated Berle’s arguments regarding corporate social responsibility. Dodd advocated that corporations served a social service as well as a profit-making function. He also contended that “business is permitted and encouraged by the law primarily because it is of service to the community rather than because it is a source of profit to its owners.” Dodd argued that corporate manag-

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23. BERLE & MEANS, supra note 22, at 4-5, 84, 86-88, 114.
25. BERLE & MEANS, supra note 22, at 248; see also Adolph Berle, Corporate Powers as Powers in Trust, 44 HARV. L. REV. 1049 (1931).
27. Millon, supra note 11, at 223.
28. See supra note 25 and accompanying text.
29. See supra note 1.
32. Dodd, supra note 1, at 1148.
33. Dodd, supra note 1, at 1149.
ers were not trustees for shareholders alone, but instead were trustees for employees, consumers and the general public.\textsuperscript{34} This debate continued for many years with both parties, at times, seemingly capitulating. In 1954, Berle’s reversal was formalized when he agreed that the corporate trust was not merely for the benefit of shareholders and instead extended to the entire community.\textsuperscript{35} Ironically, Dodd also later relented when he acknowledged that legislation enacted during the depression had weakened his argument that corporate managers had a legal responsibility to nonshareholders groups.\textsuperscript{36} Dodd recognized that the obligations of management toward labor had been accomplished, in part, by granting labor certain specific statutory rights that corporations and their managers were bound to respect and, in part, by encouraging labor to organize so that it could bargain with management on closer to equal terms.\textsuperscript{37}

C. Factors Leading to the Enactment of Constituency Statutes

The corporate social responsibility debate simmered for the next fifty years before it once again sprang into prominence in the 1980s in the wake of the feeding frenzy atmosphere of numerous hostile takeovers. Despite premiums paid to target company shareholders,\textsuperscript{38} these takeovers were met with great social criticism and viewed as a substantial threat to employees,\textsuperscript{39} creditors, suppliers, customers and communities. Because many of these takeovers were financed with junk bonds, acquiring companies immediately faced strong incentives to cut costs and maximize profits in relatively short time periods. “Bust-up” takeovers, where the acquiring company, upon gaining

\textsuperscript{34} Dodd, supra note 1, at 1148-63; see also Millon, supra note 11, at 218-20 (explaining that Dodd justified and demonstrated corporate policies that benefited nonshareholder constituencies based on a natural entity theory of the corporation in that the corporation was a distinct entity separate from its constituent elements, specifically, separate from its shareholders).

\textsuperscript{35} ADOLPH BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954).


\textsuperscript{37} Dodd, supra note 36, at 546-47.

\textsuperscript{38} Reinier Kraakman, Taking Discounts Seriously: The Implications of “Discounted” Share Prices as an Acquisition Motive, 88 COLUM. L. REV. 891, 892 (1988) (reporting that the average premium over market price paid to shareholders in takeovers was 50%).

\textsuperscript{39} See John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 MICH. L. REV. 1, 7 (1986) (remarking that “600,000 or more ‘white collar’ managerial position have been eliminated in recent years as the result of corporate restructurings and similar efforts to trim excess staff’); see also Bainbridge, supra note 31, at 1003 (reiterating the AFL-CIO claim that 500,000 jobs were lost as a direct result of takeover activity between 1983 and 1987).
control of the target quickly liquidates its assets, were common and frequently imposed negative effects upon nonshareholder constituencies. Additionally, target company management was typically replaced with newly installed management of the acquiring company, thereby creating a unique alliance between nonshareholders and target management in a takeover context.

This takeover hysteria resulted in corporations developing and adopting myriad defensive tactics to repel the acquiring corporation. Included in these efforts were supermajority requirements, staggered boards, limitations on the rights to act by consent, shareholders’ rights plans, greenmail,\(^40\) buying back of shares, poison pills,\(^41\) mergers with white knights,\(^42\) purchasing another corporation in the same line of business as the acquiring company to create anti-trust problems, alleging violations of the Williams Act and the crown jewel lock-up.\(^43\) Institutional investors,\(^44\) however, balked at some of these tactics.\(^45\) Conceivably, in the wake of today’s increased institutional activism, such tactics will not be so readily invoked.

State legislatures also responded to protect corporations based in their states by enacting antitakeover statutes. Virtually all of the first generation of statutes, however, were held unconstitutional by the United States Supreme Court in Edgar v. Mite Corp.\(^46\) In this case,

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40. Greenmail is a bribe paid to the corporate raider for the repurchase by the corporation of the shares the raider has purchased on the condition that the raider not attempt to take the company for a specified period of time. BLACK’S LAW DICTIONARY 702 (6th ed. 1990).

41. The poison pill defense makes the target more expensive or less desirable for the raider. The most common type of poison pill is the “call right” which gives shareholders in the target the ability to buy shares in the target at half price whenever a raider tenders for or buys more than a certain percentage of the target’s stock. They are generally revocable by the target’s board so that they only block hostile takeover attempts. “Call rights” or “poison pills” usually function to pressure the raider into making a deal with the target’s board. Courts usually strictly scrutinize these pills. Id. at 1156.

42. This defense is effectuated when the target corporation is acquired or merges with a friendly corporation in order to derail the raider’s attempt to acquire the target. Id. at 1596.

43. The crown jewel lock-up defense is realized when the target corporation sells its best or most attractive division to someone other than the raider in order to make the target corporation less attractive to the raider. Id. at 940.

44. Institutional investors now own slightly more than 50% of all shares in the market. Clifton R. Wharton et al., Advice and Dissent: Rating the Corporate Governance Compact, HARV. BUS. REV., Nov.-Dec. 1991, at 13605, 13606.

45. LAUREN KRASNOW, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1989 PROXY SEASON 37 (1989) (reporting that nonmonetary factor charter amendments received only 68.1% share approval in comparison to monetary factor charter amendments which received 98% share approval).

the Illinois takeover statute was held unconstitutional under the Commerce Clause because the Illinois Secretary of State had to determine and approve the substantive fairness of the tender offer prior to the offer's effectiveness. This required approval by the Secretary of State was determined by the Court, in a plurality opinion, to excessively burden interstate commerce. Although the Edgar Court failed to reach a majority decision regarding preemption under the supremacy clause of the Illinois statute by the Williams Act, the plurality concluded that the statute was in direct opposition to the Williams Act.47

In response to this decision, state legislatures enacted a second generation of statutes written to evade the scope of the Edgar decision. These statutes were also challenged in the courts. In CTS v. Dynamics Corp. of America,48 these statutes were found constitutional. In this case, the Supreme Court upheld an Indiana statute,49 which provided that once a raider takes a position in a target corporation owning over a certain amount of stock, the raider's shares lose their voting power unless other shareholders, unaffiliated with the raider or directors, approve the takeover. The Court found that the Indiana statute was not in conflict with the Williams Act because it simply enhanced shareholder protection and that it was possible for the offeror to comply with both acts while making its tender offer.50

Courts upholding these statutes and defenses assault the traditional shareholder primacy principle.51 Shareholder autonomy is replaced by unbridled managerial discretion through judicial and legislative activism. For example, in Moran v. Household Int'l, Inc.,52 the Delaware Supreme Court upheld management's poison pill defense53 designed to prevent shareholders from accepting certain tender offers by denying them decision-making authority. The court accepted management's paternalistic approach of subordinating shareholder autonomy as a legitimate exercise of business judgment and rejected the shareholders' contention the poison pill defense effectively stripped shareholders of their rights to receive tender offers.54

50. CTS, 481 U.S. at 94.
51. See Millon, supra note 7, at 277.
52. 500 A.2d 1346 (Del. 1983).
53. The defensive mechanism utilized here was a Preferred Share Purchase Rights Plan. Id. at 1348.
54. Id. at 1357.
Eventually, approximately thirty state legislatures enacted constituency statutes permitting directors to consider nonshareholder constituencies in making decisions.55 Some commentators justify these enactments because "the overall promotion of societal wealth is the primary goal of incorporation; providing attractive returns for shareholders is merely the means."56 Professor Lawrence Mitchell endorses these statutes because:

The increasing recognition of the modern corporation’s profound effect on the lives of a variety of groups not traditionally within the corporate law structure has the potential to lead corporate law into the next century in a manner more reflective of the role that this type of organization actually plays in our society.57

The Business Roundtable endorses constituency statutes stating:

Corporations are chartered to serve both their shareholders and society as a whole. The interests of the shareholders are primarily measured in terms of economic return over time. The interests of others in society (other stakeholders) are defined by their relationships to the corporation. The other stakeholders in the corporation are its employees, customers, suppliers, creditors, the communities where the corporation does business, and society as a whole.58

Interestingly, and in many cases even before the enactment of these constituency statutes, a number of corporations adopted internal social responsibility policies. Indeed, Professor Dodd in his classic article, For Whom Are Corporate Managers Trustees?,59 referred to Owen D. Young, an executive with General Electric Company. Young identified his responsibilities as running to the company’s shareholders, its employees, its customers, and the general public.60 In 1951, the chief executive officer of Standard Oil of New Jersey, Frank Abram, stated his view that corporations should be managed “to maintain an equitable and working balance among the claims of the

55. See supra note 5.
58. The Business Roundtable, Corporate Governance and American Competitiveness, 46 BUS. LAW. 241, 244 (1990).
59. See supra note 1.
60. AMERICAN BAR ASSOCIATION, COMMITTEE ON CORPORATE LAWS, Other Constituencies Statutes: Potential For Confusion, 45 BUS. LAW. 2253, 2254 (1990) [hereinafter ABA].
various directly interested groups — stockholders, employees, customers and the public at large." In 1978, Control Data Corporation adopted a charter amendment that clearly authorized directors to consider interests other than shareholders. Similarly, numerous other companies claim to adhere to corporate social responsibility policies specifically defined in terms of "stakeholders" or the "corporate constituency."

II. CASE LAW ADDRESSING CORPORATE SOCIAL RESPONSIBILITY

Before the advent of constituency statutes, the judiciary played an important role in defining the scope of corporate social responsibility. In the 1919 case of Dodge v. Ford Motor Co., the Supreme Court of Michigan endorsed the corporate law principle that the business corporation's primary concern was stockholder profit maximization and therefore clearly repudiated Henry Ford's discretionary powers to extend corporate profits to benefit employees and consumers rather than stockholders. In this case, Henry Ford proclaimed that future dividends would be limited to five percent monthly; the remaining profits would be used for business expansion "to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes." In rejecting Ford's stated desire, the court stated:

62. Sommer, supra note 12, at 39. The author reports that the Control Data amendment reads:
   The Board of Directors of the Corporation, when evaluating any offer of another party to (a) make a tender or exchange offer for any equity security of the Corporation, (b) merge or consolidate the Corporation with another corporation, or (c) purchase or otherwise acquire all or substantially all of the properties and assets of the Corporation, shall, in connection with the exercise of its judgment in determining what is in the best interests of the Corporation and its stockholders, give due consideration to all relevant factors, including without limitation the social and economic effects on the employees, customers, suppliers and other constituents of the Corporation and its subsidiaries and on the communities in which the Corporation and its subsidiaries operate or are located.

63. Orts, supra note 6, at 5.
64. 170 N.W. 668 (Mich. 1919).
65. Id. at 684.
66. Id. at 671. It appears though that Ford conceivably made this statement to not only justify his long term expansion plans which he intended to achieve by retaining most profits in the corporation rather than dispersing them through dividends, but to thwart his fears that the Dodge brothers, minority shareholders in Ford, would use their share of the dividends to start a competing business. Had Ford merely stated that the remaining profits would be used
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. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.67

Twenty-three years before the often cited *Dodge v. Ford Motor Co.*, a New York court, in *Steinway v. Steinway & Sons*,68 decided a challenge sounded by a discordant shareholder who claimed that management's corporate expenditures were *ultra vires*. Management had provided housing, a church, a school, a free library and a free bath to employees on land owned by the corporation.69 The court, although attempting to distinguish between direct and remote benefits, held that a corporation's conduct must be "reasonably tributary to the promotion of [the corporation's] ends, in a substantial, and not in a remote and fanciful, sense."70 The court then determined that these employee benefits were not *ultra vires* because, taken collectively, they were they were directly related to the corporation's legitimate goals.71 This case, despite the court's reference to direct benefits, clearly foreshadowed judicial acceptance of corporate long-term interests.

Similarly, other early cases upheld speculative actions that only indirectly benefited, if at all, the corporation. For example, in the 1922 case of *Armstrong Cork v. H.A. Meldrum Co.*,72 the defendant corporation, Armstrong, donated money to two local colleges arguing that such expenditures would accrue to Armstrong through a superior future employee base.73 The trial court held for Armstrong despite an absence of any direct corporate benefit. Likewise, in the 1937 case of

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67. *Id.* at 684.
68. 40 N.Y.S. 718 (Sup. Ct. 1896).
69. *Id.* at 719.
70. *Id.* at 721.
71. *Id.*
72. 285 F. 58 (W.D.N.Y. 1922).
73. *Id.* at 58-59.
Holst v. New York Stock Exchange, the New York appellate court affirmed the defendant corporation's workmen's compensation claim to an employee who suffered an injury while playing on the corporate soccer team. Although a corporate sponsored employee athletic team only speculatively benefited the corporation, the court nonetheless found that "the maintenance of the teams was a matter of business, not of charity or benevolence. The officials of a corporation may not extend largess from stockholders' money."

The 1939 case of Pepper v. Litton seemingly altered a director's fiduciary obligation of shareholder primacy, when the Supreme Court held that a director's "fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders." Because of its highly unusual facts, this case, however, is rarely cited as controlling authority for the proposition that directors have a general duty to creditors. Here, the defendant, Litton, was both a dominant stockholder and a creditor; Pepper was a creditor holding a corporate loan. In order to prevent Pepper from collecting on the loan, Litton caused the company to confess a judgment in his favor for salary claims extending back five years. The court's holding apparently is limited to these unique facts.

In 1953, the issue of a corporate contribution to a university was again addressed by the judiciary. The Supreme Court of New Jersey in A.P. Smith Manufacturing Co. v. Barlow, however, synthesized corporate social responsibilities with benefits to the corporation. Here, complaining shareholders asserted the defendant corporation's fifteen hundred dollar donation to Princeton University was ultra vires. The court specifically addressed corporate social responsibility when it stated, "modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate... such expenditures may likewise readily be justified as being for the benefit of the cor-

75. Id. at 256.
76. 308 U.S. 295 (1939).
77. Id. at 307 (citations omitted).
79. 308 U.S. at 297.
80. Id. at 298.
81. 98 A.2d 581 (N.J. 1953).
82. Id. at 582.
The court therefore conceded that although public corporations can not make corporate expenditures merely for humanitarian purposes, it can do so when such expenditures are in the interest of promoting long or short term benefits to the corporation. In an apparent relaxation of *Dodge v. Ford* and *A.P. Smith Manufacturing Co. v. Barlow*, an Illinois appellate court in *Shlensky v. Wrigley* affirmed the lower court’s dismissal of the complaint and applied the business judgment rule in deferring to the majority shareholder’s famous refusal to install lights in Wrigley Field. Shlensky, a minority shareholder in the Chicago Cubs baseball team, provided uncontested evidence that Wrigley was favoring nonshareholder interests in his decision. The court, instead of emphasizing a director’s obligation to maximize profits, immunized Wrigley’s decision from judicial review by adhering to the business judgment rule and found the plaintiff failed to sufficiently allege that Wrigley’s decision was “contrary to the best interests of the corporation and its stockholders.”

In 1969, the expansive view courts were affording corporate expenditures was arguably enlarged in *Kelly v. Bell*. In this case, plaintiff stockholders charged that the defendant corporation, U.S. Steel, had wasted corporate assets through an arrangement it had made with Allegheny County under which U.S. Steel paid approximately five million dollars annually to the county’s taxing authorities. The Delaware Chancery Court upheld the payments, finding that these expenditures advanced the interests of the corporation in that they aided the public welfare of the community in which U.S. Steel operated.

Although the judiciary in the 1970s appeared to recognize that

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83. Id. at 586.
84. Id. at 590.
86. The business judgment rule, although it varies according to the jurisdiction, states that courts will not permit shareholders to challenge the wisdom of director’s business decisions and will not impose liability as long as the directors: (1) were not subject to a conflict of interest, (2) adequately gathered information prior to making their decision, and (3) did not act wholly irrationally. *BLACK’S LAW DICTIONARY* 200 (6th ed. 1990).
87. Id. at 781. Undoubtedly, it was this court’s decision that led to the Cubs September collapse in the 1969 season that permitted the upstart Mets to capture the division title.
88. Id. at 777.
89. Id. at 782.
91. Id. at 64.
92. Id. at 64-65, 74.
corporations had duties beyond shareholders,\textsuperscript{93} in no cases did courts countenance "director action which favored one or more of the other constituencies at the expense of shareholders, and in no case were the statements of the court acknowledging such responsibilities a part of its holding."\textsuperscript{94} However, the notable effect that the takeover mania of the 1980s played on shareholders and nonshareholder constituencies again raised the specter of to whom directors owed fiduciaries duties and to what extent. A series of cases involving change of control expanded the duties of corporate directors faced with merger proposals.\textsuperscript{95}

In the 1985 case of \textit{Smith v. Van Gorkom},\textsuperscript{96} the Supreme Court of New Jersey "held that a board could be held liable for approving the sale of a company—even at a significant premium to the market price—if it hadn’t followed procedures such as obtaining an investment bank’s opinion that the transaction was fair."\textsuperscript{97} The court ruled that the directors’ duty of care is heightened during mergers.\textsuperscript{98} Here, the majority held the directors failed to exercise due care in approving the sale.\textsuperscript{99} The directors approved the sale in a meeting that lasted only two hours when no crisis or emergency existed which required an immediate decision; the directors did not request any time extension; the directors did not seek any other offers; there was little discussion regarding the offered price; and the directors pointedly failed to secure an independent appraisal report.\textsuperscript{100} Clearly, the directors’ decision was not immune under the business judgement rule and therefore the court appropriately intervened to protect the rights

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\textsuperscript{93.} See, e.g., Herald Co. v. Seawall, 472 F.2d 1081 (10th Cir. 1972). The court here held:
We have long since passed the stage in which stockholders, who merely invest capital and leave it wholly to management to make it fruitful, can make absolutely exclusive claim to all profits against those whose labor, skill, ability, judgment, and effort have made profits available.
\textit{Id.} at 1096.

\textsuperscript{94.} ABA, supra note 60, at 2257.

\textsuperscript{95.} See Richard B. Schmitt, \textit{Court Holds Directors to Higher Standards}, WALL ST. J., Nov. 1, 1993, at B6 (reporting that an October 1992 Delaware Supreme Court decision "reinforces and strengthens a series of rulings during the takeover boom of the 1980s that expanded the duties of corporate directors faced with merger proposals").

\textsuperscript{96.} 488 A.2d 858 (Del. 1985).

\textsuperscript{97.} \textit{Id.} at 893; see also Schmitt, supra note 95, at B6.

\textsuperscript{98.} Smith v. Van Gorkom, 488 A.2d at 873.

\textsuperscript{99.} \textit{Id.} at 893. The offer was for $55 per share as compared to the market price of $38 per share. \textit{Id.}

\textsuperscript{100.} \textit{Id.} at 873.
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Recent decisions reveal the degree to which a board of directors may regard nonshareholder constituencies in a takeover context. If a target corporation’s management employs defensive tactics to repel an acquiring corporation, the proper standard for judicial review is found in Unocal Corp. v. Mesa Petroleum Co. In this 1985 case, the Supreme Court of Delaware granted a board of directors great scope in defending against hostile bids and established a two-part test generally applicable in acquisition contexts. Defenses are permitted as long as (1) the takeover is seen as a reasonable threat to shareholders, and (2) the target’s defensive tactics are reasonably related to that threat. Because of the inherent danger that, by defeating a takeover, the board might be acting in its own interest rather than that of the corporation and its stockholders, the court shifted the burden of proof to the board of directors to establish this two prong test. Once the board satisfies its burden, the business judgment rule applies and the burden of proof shifts back to the plaintiff. Unocal also permits the board to consider nonshareholder constituencies in a takeover setting.

Once a target corporation has decided to sell the corporation, the standard of review is dictated by the 1986 case of Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. This case clearly limited directors’ ability to consider nonshareholder constituents. Under the standard enunciated in Revlon, at the point the decision to sell is conclusively determined, the duty of the board shifts “from the preservation of Revlon as a corporate entity to the maximization for the company’s value at a sale for the stockholders’ benefit.” Although the court in Revlon acknowledged that Unocal allows directors to consider nonshareholder constituencies, the court nevertheless limited these considerations by explaining that a “board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders.” Therefore, the court found in this takeover context, a breach of fiduciary duties by the cosmetic concern’s directors to its shareholders because the directors entered into a lock-up agreement with another corpora-

101. Id. at 889.
102. 493 A.2d 946 (Del. 1985).
103. Id. at 955.
104. 506 A.2d 173 (Del. 1986).
105. Id. at 182.
tion for the purpose of protecting the company's noteholders." 106

In the 1987 case of *Ivanhoe Partners v. Newmont Mining Corp.*, 107 the court stated that, in considering a takeover bid, "the board may under appropriate circumstances consider the inadequacy of the bid, the nature and timing of the offer, questions of illegality, the impact on constituencies other than shareholders, the risk of non-consummation, and their basic stockholder interests at stake." 108 In 1989, the court in *Mills Acquisition Co. v. MacMillan, Inc.*, 109 citing *Unocal, Revlon* and *Ivanhoe Partners*, included among factors to be considered in a takeover context, "the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests." 110 In 1989, the court in *TW Services, Inc. v. SWT Acquisition Corp.* 111 stated:

[D]irectors, in managing the business and affairs of the corporation, may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected, and thus directors in pursuit of long run corporate (and shareholder) value may be sensitive to the claims of other "corporate constituencies." 112

In the 1989 case of *Paramount Communications v. Time, Inc.*, 113 the Delaware Supreme Court plainly affirmed previous decisions that permitted directors to consider long-term corporate interests rather than merely short-term shareholder interest. In this case, Paramount launched a hostile bid for Time offering two hundred dollars per share for Time. 114 Time then recast its offer to Warner as an all cash proposition rather than the previously discussed stock swap. 115 Paramount subsequently sought a preliminary injunction restraining Time from purchasing the Warner stock. 116 Despite realizing that

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106. *Id.* at 182-84.
108. *Id.* at 1341-42.
110. *Id.* at 1282 n.29.
112. *Id.* at 92, 178.
113. 571 A.2d 1140 (Del. 1990).
114. *Id.* at 1142.
115. *Id.*
116. *Id.*
Time's stock price would most likely fail to trade in the two hundred dollar range following consummation of the merger with Warner, Time nevertheless rejected Paramount's offer.\textsuperscript{117}

In finding for Time, the court held that directors are not compelled to forsake a deliberately conceived corporate vision in exchange for short-term shareholder wealth maximization unless there is no basis to support the corporate plan.\textsuperscript{118} Given the breadth of language affirming the managerial discretion of directors, this case appears to confirm that directors may take into account the interests of other constituencies if in so doing the long-term interests of the corporation and its shareholders are served.\textsuperscript{119}

Recently, in the most important court decision involving a takeover since Time-Warner, the Delaware Chancery Court in \textit{QVC Network, Inc. v. Paramount Communications, Inc.}\textsuperscript{120} blocked the proposed 9.5 billion dollar friendly takeover of Paramount by Viacom, holding Paramount's board acted improperly in rejecting a higher 10.5 billion dollar bid by QVC Network.\textsuperscript{121} The Paramount-QVC-Viacom takeover battle represented the largest hostile control contest in years. In this case, a merger agreement with Viacom was entered into by the board of Paramount which included extensive lockup provisions. QVC then launched a hostile, higher-valued offer for Paramount, precipitating the litigation heard in the Delaware Chancery Court.

Chancellor Jack B. Jacobs of the Delaware Chancery Court, in a stinging rebuke to Paramount, found that Paramount directors breached their duty to shareholders by granting Viacom a "lockup" option valued at 428 million dollars that discouraged higher bids, and did not attempt to obtain enough information about the latest QVC bid.\textsuperscript{122} The court found that the actions of the board were inconsistent with the interests of shareholders.\textsuperscript{123} The court ruled that the Paramount-Viacom merger clearly involved a change of control and that a change of control represented the last chance for Paramount shareholders to obtain a control premium for their shares. The court found that, under these circumstances, Paramount's directors failed to meet their enhanced duties to maximize the best possible deal for

\begin{footnotes}
\footnote{117. Id. at 1153.}
\footnote{118. Id. at 1152.}
\footnote{119. See ABA, supra note 60, at 2260-61.}
\footnote{120. 635 A.2d 1245 (Del. Ch.), aff'd, 637 A.2d 34 (Del. 1993).}
\footnote{121. 635 A.2d at 1272.}
\footnote{122. Id. at 1270.}
\footnote{123. Id. at 1272.}
\end{footnotes}
Paramount shareholders.\textsuperscript{124}

This decision seemingly limits the scope of the \textit{Time-Warner} decision and expands the definition of what types of sales trigger enhanced \textit{Revlon} duties. The court has therefore reinterpreted the scope of \textit{Revlon} and \textit{Time-Warner}. It is no longer enough for directors to simply approve a friendly merger based on their business judgment that the proposal is a strategic merger that delivers more value in the long term.\textsuperscript{125}

III. CONSTITUENCY STATUTES

A. General Overview

In 1983, Pennsylvania became the first of approximately thirty states to enact a constituency statute authorizing directors to consider the interests of nonshareholder constituencies. Notably absent from this group of states, however, is Delaware, the state of incorporation for over forty percent of companies listed on the New York Stock Exchange and more than half of the Fortune 500.\textsuperscript{126} Several commentators in favor of corporate constituency statutes, point to our most formidable foreign competitors, Japan and Germany, as having corporate cultures, laws, and governance principles that embrace the corporate constituency concept to a greater degree than that contemplated by any of the state statutes.\textsuperscript{127} These commentators feel that constituency statutes harbor significant potential for American corporations to emulate these successful foreign corporate governance configurations.\textsuperscript{128} However, no competent empirical evidence has ever been presented to substantiate the claim that superior foreign corporate governance, if indeed it does exist in the long term, is because of (rather than in spite of) consideration for nonshareholder constituencies.

All constituency statutes embrace one or more of the following provisions:

1. The directors may consider [three states require] the interests of,
or the effects of their action on, various non-stockholder constituencies.
2. These constituencies may include employees, customers, creditors, suppliers, and communities in which the corporation has facilities.
3. The directors may consider the national and state economies and other community and societal considerations.
4. The directors may consider the long-term as well as the short-term interests of the corporation and its shareholders.
5. The directors may consider the possibility that the best interests of the corporation and its stockholders may best be served by remaining independent.
6. The directors may consider any other pertinent factor.
7. Officers may also be covered.¹²⁹

A simple reading of these statutes indicates they are intended to expand the permissible range of considerations for directors and officers with respect to their fiduciary duty of care when making business decisions.¹³⁰

All but three of the constituency statutes are permissive and, therefore, place great discretion or perhaps, indiscretion, in the board of directors. Under the permissive laws, directors need not consider nonshareholder constituencies in their decisions. These statutes do not mandate express constraints on the directors’ discretion in deciding whether to consider nonshareholder interests and, if they decide to do so, which constituency groups’ interests to consider. As a result, these statutes must not be interpreted as creating new fiduciary duties for directors extending to nonshareholder constituencies.¹³¹

The potential for these statutes to affect business decisions is substantial and clearly invades the shareholder primacy principle. Considering the inflammatory political climate in state legislatures, it is not surprising that legislators failed to provide significant guidance in these statutes for directors faced with business decisions impacting shareholders and nonshareholders.¹³² Similarly, courts are not afforded legislative guidance to aid judicial review of corporate decisions. Although these statutes arose in the wake of the takeover hysteria, most of them apply to all corporate decisions rather than merely being limited to takeovers.

Some states have strengthened their statutes by including a pre-

¹²⁹. ABA, supra note 60, at 2261.
¹³⁰. See generally, Orts, supra note 6, at 20.
¹³¹. See Bainbridge, supra note 31, at 987.
¹³². See Bainbridge, supra note 31, at 973.
sumption that the board’s decision is valid unless, after reasonable
investigation, it is established that the decision was not made in good
faith. One of these states, Indiana, seemingly evidenced the scope
and the aim of the statute by adding a statement that the directors
may weigh the identified considerations in the full discretion of the
directors and that the directors are not mandated to afford primary
consideration to any particular constituency or group. Another
state, Pennsylvania, amended its statute to include a provision that
relieves the board of any obligation “to regard any corporate interest
or interests of any particular group affected by such action as a domi-
nant or controlling interest or factor.” Pennsylvania, therefore, ap-
ppears to endorse a board determination that favors nonshareholders
over shareholders.

Three states, Arizona, Connecticut and Idaho, have enacted man-
datory constituency statutes. The Connecticut statute, for example,
requires directors of a public corporation registered under the Securi-
ties Exchange Act of 1934, in control-shifting circumstances, to take
into account other constituencies and matters. These mandatory stat-
utes provide or, in the very least, strongly suggest, that directors’
action favoring nonshareholders over shareholders will be protect-
ed.

Idaho and Arizona require directors to consider the long-
term as well as the short-term interests of the corporation and its
shareholders, including the possibility that these interests may be best
served by the continued independence of the corporation. The
Idaho statutes, however, are most likely limited to a change of control
or merger because they are included within the control share acquisi-
tion statute and a business combination statute. The Arizona statute
expressly limits a board’s consideration for nonshareholder constitu-
encies to takeovers.

The New York statute is unclear in that it includes a statement
directly conflicting with the accompanying legislative history. The

133. See, e.g., IND. CODE ANN. § 23-1-35-1(g) (West 1989); 15 PA. CONS. STAT. ANN. §
1715(d) (Supp. 1993).
134. IND. CODE ANN. § 23-1-35-1(g) (West 1989).
135. 15 PA. CONS. STAT. ANN. § 1715(d) (Supp. 1993).
136. See Hanks, supra note 78, at 104.
137. CONN. GEN. STAT. ANN. § 33-133(e) (West Supp. 1993).
138. ABA, supra note 60, at 2262.
139. IDAHO CODE § 30-1602, 30-1702 (Supp. 1993).
141. See supra notes 139, 140.
statement in the statute reads "[n]othing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions." However, the assembly memorandum in support of the legislation states:

This bill takes a further step. By amending section 717 [of the Business Corporation Law], this bill makes it clear that a corporate director's duty to a corporation encompasses more than a duty to maximize profits for shareholders but also includes consideration of such things as the corporation's long-term growth, its relationship to its employees, and its ties to the communities in which it operates.143

B. Legal Challenges to These Statutes

Because the first wave of anti-takeover statutes was declared unconstitutional by the Supreme Court144 and the second wave of statutes was found constitutional,145 the current constituency statutes will inevitably also be challenged. When this challenge occurs, the strongest arguments will be that these statutes (1) violate the dormant commerce clause, (2) are preempted by the Williams Act, and (3) violate the contracts clause.146 However, these statutes are most likely constitutional.147 First, the laws do not unduly burden interstate commerce. Second, the Supreme Court in CTS found that legislative history indicated that Congress did not intend the Williams Act to preempt state regulation that is not inconsistent. Third, not only did the CTS court state that a corporation was an artificial entity, the Supreme Court has also made clear that federalism principles and not a contracts theory of the corporation will prevail. Finally, although a federal constituency statute, which several commentators have called for, would certainly preempt conflicting state constituency statutes, at this time, no such federal law is in place.

142. N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1994).
143. Memorandum of the Assembly Rules Committee: Corporate Directors/Responsibilities, 1989 NEW YORK STATE LEGISLATIVE ANNUAL 137.
144. See supra note 46 and accompanying text.
145. See supra note 48 and accompanying text.
146. See Orts, supra note 6, at 15.
147. For an excellent analysis of the legal challenges to constituency statutes, see Orts, supra note 6, at 15-20.
IV. AN EVALUATION OF CONSTITUENCY STATUTES AND THEIR SCOPE

A. General Overview

Some commentators applaud constituency statutes as a vehicle to ensure that corporations conduct themselves in a socially responsible manner that rewards not only shareholders but other constituencies as well. These commentators embrace these statutes as a radical alteration of the corporate form leading to mandated corporate socialism. Conversely, others fear the impact of these statutes as the demise of the corporation and corporate law as we know it. These commentators interpret these statutes as altering the board’s fiduciary duties to extinguish the shareholder primacy principle. Some of these commentators suggest that these statutes are simply a method of transferring wealth from shareholders to nonshareholders. Their worries are compounded by those states that mandate, rather than merely permit, consideration of nonshareholders in business decisions.

As discussed below, neither viewpoint is completely accurate. Instead, these statutes, as they currently exist, do not force a corporation to conduct itself in a socially responsible manner. Nor will these statutes significantly transfer wealth from shareholder to nonshareholder. As such, these statutes do not signal the death of the corporation.

B. A Viable Threat to Shareholder Welfare

Constituency statutes do pose a viable threat to shareholder welfare and therefore could negatively impact financial markets and the economy. These statutes unfortunately promote unaccountability in incumbent management by widening the separation between ownership and control. Management, by claiming it was merely considering other constituencies, can hide behind these statutes to justify business decisions that benefit management and not shareholders. Indeed, in light of the pervasive conflicts of interest that endure between shareholders and management, it is clear that if any group within the corporation is in need of additional legal protection it is the shareholders.

148. See generally BERLE & MEANS, supra note 22.
149. See Macey, supra note 17, at 38.
Most importantly, burdening the corporation with substantial and ill-defined social responsibilities undermines the market to the detriment of investors and society generally, including the intended beneficiary constituencies.\textsuperscript{150} The largest long-run costs of a corporate law that emphasizes other constituencies would be imposed not just on shareholders, but on the general public through a less efficient allocation of resources and a less innovative and productive economy, as compared with the allocation of resources that now results from firms' profit seeking under the current legal regime.\textsuperscript{151}

C. Institutional Investors

Because institutional investors now own more than fifty percent of stock in the nation, their "leverage to bring delinquent managements and directors to task"\textsuperscript{152} is significant. Indeed, institutional investors are now actively promoting their interests in corporate decisionmaking.\textsuperscript{153} Some commentators believe that the rise of institutional owners may help bridge the relationship between shareholders and directors, yet claim it is a development not fully materialized.\textsuperscript{154} On the other hand, powerful institutions such as the California Public Employees Retirement System and the Teachers Insurance and Annuity Association College Retirement Equities Fund are plainly increasing pressure of corporations to consider their financial interests. For example, TIAA-CREF recently mailed 1500 copies of their policy statement\textsuperscript{155} on corporate governance to corporations throughout the

\textsuperscript{150} See George W. Dent, Jr., Toward Unifying Ownership and Control in the Public Corporation, 1989 Wisc. L. Rev. 881, 893-94 (1989) (suggesting that shareholders and taxpayers might prefer and prioritize divergent concepts of social responsibility and thereby injure the intended beneficiaries such as consumers and employees as well as investors).

Discussions of economic theory are beyond the scope of this paper. However, it appears likely that mandatory constituency statutes could decrease corporate profits and diminish corporate taxes. A diminishing of corporate taxes could then adversely affect the very social goals that constituency statutes seek to advance. The question then develops whether this adverse effect is offset by the benefits generated by offering nonshareholders consideration.

\textsuperscript{151} See DeBow & Lee, supra note 14, at 397.

\textsuperscript{152} Wharton, supra note 44, at 13605-06.

\textsuperscript{153} John Pound, Where Shareholder Activism Is Paramount, WALL ST. J., Dec. 7, 1993, at A16 (reporting that during the final quarter of 1993, the financial and corporate communities were riveted by sudden changes in direction that occurred at major American corporations and that these changes ensued precisely because large institutional shareholders exercised their voice, communicating their views directly to corporate boards).

\textsuperscript{154} See, e.g., Orts, supra note 6, at 55.

\textsuperscript{155} TEACHERS INSURANCE AND ANNUITY ASSOCIATION-COLLEGE RETIREMENT EQUITIES FUND, POLICY STATEMENT ON CORPORATE GOVERNANCE, (Sept. 30, 1993) (on file with author). "TIAA-CREF is a combination of an insurance company and investment company that
country. This policy statement both states TIAA-CREF's perspective on what it considers good corporate governance and identifies the voting guidelines TIAA-CREF will adhere to on certain proxy issues.\textsuperscript{156}

Despite some commentators’ claim that institutional investors are not yet flexing their muscles, Labor Secretary Robert B. Reich is apparently concerned enough about institutional investors demanding share price maximization to address a gathering of managers of the nation's largest pension funds in early October, 1993.\textsuperscript{157} Reich's message to these powerful investing managers was to consider "non-financial criteria that don't show up on a balance sheet and are hard to get your hands on."\textsuperscript{158} Recently, these institutions demanded better returns and pressured corporations to increase profits and stock prices even if the cost was the loss of thousands of jobs and a high unemployment rate.\textsuperscript{159} Many institutional shareholders accepted Mr. Reich's views as an addition to fundamental financial analysis, but not as a substitute.\textsuperscript{160} James E. Heard, president of Institutional Shareholders Services, a pension consulting firm, stated, "[o]f course, at the end of the day institutional investors are fiduciaries and have to care about return to shareholders."\textsuperscript{161}

Given institutional investors' enormous power and newly discovered capacity to influence corporate decisions, it will be interesting to see how these investors will permit or deny directors the ability to consider nonshareholder constituencies. The TIAA-CREF policy statement on corporate governance provides an excellent current model of what to expect from large investors. This policy statement immediately states that directors, although considering the long-term success of the corporation, should nevertheless closely adhere to the shareholder primacy principle. The TIAA-CREF paper states "[i]t is recognized that the primary responsibility of the board of directors is to foster the long-term success of the corporation consistent with its fiduciary responsibility to the shareholders."\textsuperscript{162} Clearly, institutional investors

\textsuperscript{156} Id.
\textsuperscript{158} Id.
\textsuperscript{159} Id.
\textsuperscript{160} Id.
\textsuperscript{161} Id.
\textsuperscript{162} See supra note 155, at 1.
are concerned that their interests, the interests of stockholders, be paramount.

Other key sections of the TIAA-CREF paper that are related to corporate social responsibility or constituency statutes are:

1. Any action which alters the fundamental relationship between shareholders and the board — such as an “anti-takeover” measure — should be submitted for prior shareholder approval even when it is not required by law.
2. Any action to adopt “super-majority” requirements which interfere with a shareholder’s right to elect directors and ratify corporate action will be opposed.
3. Changes in a corporation’s domicile should only be proposed for valid business reasons, and not to obtain protection against unfriendly takeovers.
4. TIAA-CREF opposes elimination or reduction (through a change in by-laws or state of incorporation) of the shareholders’ right to demand independent appraisal of the value of the holdings.
5. The board has a primary duty to exercise its fiduciary responsibility in the best interests of the corporation and its shareholders. This would include periodic review to ensure that corporate resources are used only for appropriate business purposes.
6. TIAA-CREF believes building long-term shareholder value is consistent with directors giving careful consideration to social responsibility issues and the common good of the community.\(^{163}\)

Clearly, TIAA-CREF is against corporate conduct that unilaterally denies shareholders the opportunity to consider accepting takeovers. Although TIAA-CREF specifically mentions social responsibility issues, it also limits such allusion by plainly stating that any long-term consideration must be consistent with the best interests of the shareholders. Therefore, it appears that to this institutional investor, the board is permitted to consider nonshareholders constituencies in their business decisions but not to the point of negatively impacting shareholder value.

D. Debt and Equity Financing Considerations

Corporations need to raise and maintain capital to compete in today’s global marketplace. Constituency statutes, if they indeed transfer wealth from shareholders to nonshareholder constituencies, increase

\(^{163}\) Id.
the cost of raising this capital. The effects of this additional cost could more than offset any nonshareholder gain secured by the statutes in both equity and debt markets.

For example, if a lender feels that a corporation will not maximize profit then the risk involved by extending the loan will increase. Concomitantly with this increased risk is an added premium to the interest rate charged for the loan. The cost of capital becomes more expensive when nonshareholders are afforded rights.

The difficulty in raising equity capital could be even more profound. Investors will need to factor into their decisions that their return will be less because profits will be diverted at any time to nonshareholders. New investors will therefore require a larger amount of stock in return for their capital infusion. Conflicts will develop between existing shareholders and the board over offering too much stock for the capital contribution as compared to the amount received by the existing shareholder at the time of his contribution.

Even if one believed that corporations should not only assist nonshareholder constituencies but that profits should eventually be diverted to the constituencies that are best served by corporate social responsibility, the inevitable consequence will be fewer profits to be diverted. The eventual result of a system where corporations significantly weigh and promote the interests of nonshareholder constituencies over shareholders will be a less efficient distribution of resources, a less innovative and fertile economy and an overall diminution of available capital for those groups that corporate constituency statutes were intended to benefit.

Additionally, even if constituency statutes reveal themselves over time to be legitimate tools to assist society welfare in general, then why are corporations discriminated against? Why are these statutes limited to corporations? Why not extend them to partnerships, trusts or sole proprietorships?

E. Interpreting Constituency Statutes

Although constituency statutes should survive legal scrutiny, the determination of their scope is still open to interpretation. Some

164. See generally Hanks, supra note 78, at 117.
165. See generally Millon, supra note 7, at 262.
166. See DeBow & Lee, supra note 14, at 407.
167. See Hanks, supra note 78, at 117.
168. See supra notes 144-47 and accompanying text.
Commentators offer theories that these statutes must be interpreted in the broadest sense so that nonshareholder constituencies' interests will dominate or, in the very least, be considered on an equal basis with shareholders. These commentators argue for this theory despite the plainly permissive nature of almost all the statutes.\textsuperscript{169} They evidently insist on expanding the statutory language based purely on social theories of wealth transference. Clearly, they are wrong.

Under a broad interpretation of these statutes, a board would be free to deny a substantial premium to shareholders in a takeover context, enforce takeover defenses, and justify their decisions based upon their concerns for other constituencies.\textsuperscript{170} Management would be virtually unaccountable to shareholders for their conduct, thereby denying a board's fiduciary duties. Additionally, because the statutes are permissive in nature, they create no fiduciary duties to these other constituencies. Consequently, it is specifically a broad statutory interpretation that poses the greatest danger.

If a broad interpretation of these statutes was intended, then a new fiduciary duty running to nonshareholder constituencies would have been included. However, none of these statutes expressly mandates a new fiduciary duty, nor do they grant other constituencies standing to enforce new rights. In fact, some statutes, notably New York's, explicitly deny nonshareholder standing. With regard to those statutes silent on the matter of standing, it is an implausible assertion that legislatures intended to afford such groups standing despite no competent evidence in either the statutory language or the accompanying legislative history.\textsuperscript{171} Without affording nonshareholders standing, other-constituency statutes will be unenforceable by the parties who have an interest in their enforcement.\textsuperscript{172} The power in these statutes, therefore, is not primarily exercised for the benefit of nonshareholder constituencies; instead, incumbent management is the beneficiary. These statutes help management grow another step removed from shareholders and regrettably even less accountable for their actions.

Indeed, some commentators argue that corporate managers helped in the passage of constituency statutes to protect their own interests rather than to aid nonshareholder constituencies. They wanted protection from takeovers and they wanted job stability. Any statute that

\textsuperscript{169} See Millon, supra note 11; see generally Mitchell, supra note 57.
\textsuperscript{170} See Bainbridge, supra note 31, at 980.
\textsuperscript{171} See Orts, supra note 6, at 47.
\textsuperscript{172} See Carter, supra note 4, at 502.
permits management to weigh the impact of their business decisions on other constituencies at the expense of shareholder interests enlarges management discretion because of the indeterminacy and instability of interest group preferences.\textsuperscript{173} It is precisely management though who would argue vehemently against changing the permissive nature of these statutes into mandatory provisions.\textsuperscript{174} Interestingly, many of the same directors who vigorously lobbied state legislators in favor of nonshareholder constituency statutes are equally vigorous in their opposition of plant closing laws and other worker protection statutes.\textsuperscript{175}

Therefore, a broad interpretation of the statutes accomplishes nothing except to vest more unbridled power in the hands of management. Accordingly, constituency statutes must be interpreted narrowly\textsuperscript{176} so that management remains accountable to shareholders for their decisions.

V. CONCLUSION

Legislatures need to address the question, “for whom are corporate managers trustees?” Because this question has not been conclusively answered, constituency statutes, as they exist today, do not serve any legitimate purpose. Under the current statutes, nonshareholders are denied standing to enforce these statutes, thereby effectively rendering the statutes impotent as to wealth transference from shareholder to nonshareholder constituencies.\textsuperscript{177} The true beneficiaries of these statutes as they currently read are incumbent management who have been provided another weapon in their potent arsenal to maintain and increase their control.

If legislatures intended to afford nonshareholder constituencies new rights under these constituency statutes for the purpose of wealth transference from shareholder to nonshareholder, they have clearly failed. However, even if these statutes did afford nonshareholder constituencies new rights, the net result to these nonshareholders may be social welfare loss rather than gain.

\begin{itemize}
\item \textsuperscript{173} See Carney, supra note 19, at 423.
\item \textsuperscript{174} See DeBow & Lee, supra note 14, at 400.
\item \textsuperscript{175} See Bainbridge, supra note 31, at 991.
\item \textsuperscript{176} See ABA, supra note 60, at 2269.
\item \textsuperscript{177} See Bainbridge, supra note 31, at 998.
\end{itemize}
A. How States Could Empower Nonshareholder Constituencies

If legislatures truly wish to accomplish corporate social responsibility through constituency statutes, then legislatures must: (1) expressly mandate consideration for nonshareholder constituencies; (2) encourage accountability of incumbent management; (3) alter the composition of the board of directors to include nonshareholders; and (4) enable nonshareholder constituencies access to remedies. The following is a model statute that achieves the goal of corporate social responsibility through the use of a corporate constituency statute.

MODEL CORPORATE CONSTITUENCY STATUTE

Board of Directors

(a) All corporate powers shall be exercised by or under authority of, and the business, property and affairs of a corporation shall be managed under the direction of, a board of directors except as may be otherwise provided in this chapter or the articles of incorporation. If any such provision is made in the articles of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the articles of incorporation. If any such powers and duties are conferred or imposed to any such person or persons by the articles of incorporation, such person or persons shall consider all the factors set forth in this article when performing those powers and duties.

(b) At least fifty percent of the board of directors shall be residents of this State. If the board of directors is not comprised of at least fifty percent State residents, the board may not function except to elect a new director or new directors who are residents of this State.

(c) Board membership shall be comprised of at least one member from each of the nonshareholder groups enumerated in subsection (g)(1). Each of the nonshareholder groups enumerated in subsection (g)(1) shall be represented in equal proportion to each other. The total membership of the board of directors by nonshareholder groups shall be fifty percent of the total membership of the board of directors.
These members shall not own any stock in the corporation.178

(d) Fifty percent of the total membership of the board of directors shall be elected by shareholder voting. Each of these elected members shall be stockholders in the corporation.

(e) The board of directors shall have authority to fix fees of directors, including reasonable allowance for expenses actually incurred in connection with their duties, unless otherwise provided in the bylaws.

(f) Executive compensation shall not be deferred and shall not be in excess of $1,000,000 per year. All executive compensation determinations shall be decided by a committee of outside directors.

Fifty percent or greater of all executive compensation shall be in the form of restricted performance stock and stock options granted at market price that cannot be repriced and shall be closely tied to corporate performance recognizing both short and long term goals.

(g) A director shall perform the director's duties as a director, including the director's duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In determining the best interests of the corporation, a director, in addition to considering the interests of the corporation's shareholders, shall consider all of the following factors:

1. The interests of or the effects upon the corporation's employees, customers, suppliers and creditors;

2. The economy of the state and the nation;

3. The impact of any action upon the communities and society in or near which the corporation has offices or operations;

4. The long-term as well as the short-term interests of the corpo-

178. Although beyond the scope of this article, legislatures should also include a mechanism in the statute to address the issue of who decides membership in the various nonshareholder constituencies.
ration and its shareholders, including, without limitation, the possibility that these interests may be best served by the continued independence of the corporation.

(h) In all corporate decisions, directors shall afford equal consideration to all nonshareholder groups enumerated in subsection (g)(1). The total consideration afforded nonshareholder groups shall be equal to that afforded shareholders. In the case of conflicting interests between nonshareholder groups, the interests of and the effects upon each group shall be given equal weight.

(i) The provisions of this statute shall be liberally construed as against the business judgment rule.

(j) This statute shall apply in every business decision and is not limited to a change of control context.

(k) In performing the director's duties, a director shall be entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:

(1) One or more officers or employees or the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) Counsel, public accountants, or other persons as to matters which the director reasonably believes to be within that person's professional or expert competence; or

(3) A committee of the board upon which the director does not serve, duly designated in accordance with a provision of the articles of incorporation or the bylaws, as to matters within its designated authority, which committee the director reasonably believes to merit confidence;

provided that the director shall not be considered to be acting in good faith if the director has or should have knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties in accordance with this subsection shall be presumed to have no liability by reason of being or having been a director of the corporation.

(l) Directors shall allocate ten percent of all corporate net profits
to charities within the communities in or near which the corporation
has offices or operations.

(m) Shareholders, employees, customers, suppliers and creditors
shall be permitted to bring derivative suits to challenge the actions of
the board of directors.

B. Commentary to the Model Statute

Traditionally, directors of a corporation could not without autho-
rization by the stockholders perform acts which involved fundamental
changes in the corporation, nor could they delegate their own discre-
tionary powers. In direct contrast to this traditional authorization, this
model statute requires directors to consider nonshareholder interests.
This statute empowers nonshareholder constituencies in the following
ways:

(1) Standing to Enforce Rights: this statute, because it is manda-
tory rather than permissive, expressly creates a new fiduciary duty
running from directors to nonshareholder constituencies. Further, each
of the enumerated nonshareholder groups now have standing to en-
force their rights.

(2) Constituency Enumeration: this statute specifically enumerates
that the corporation’s employees, customers, suppliers and creditors
are the nonshareholder constituencies that shall be afforded consider-
ation.

(3) Statutory Guidance: this statute delineates the scope of con-
sideration that should be afforded nonshareholder and shareholder
constituencies. Specifically, this statute provides for equal consider-
ation of nonshareholder interests to that of shareholder interests. It
provides that among nonshareholder groups, consideration will be
provided equally so that no one nonshareholder group is favored over
any other nonshareholder group. Guidance is also provided for the
judiciary by the instruction that the provisions of the statute are to be
construed liberally as against the business judgment rule.

(4) Application: this statute applies in every business decision
and is not limited to decisions involving a change of control of the
corporation.
(5) Foreign Corporate Governance Models: this statute draws upon certain elements found in foreign corporate models of governance. For example, this statute incorporates the "codetermination" corporate laws of Germany which mandate employee representation on second-tier supervisory boards of directors that oversee lower-tier managing boards. It also requires, as in England under the Companies Act, that directors must consider the interests of employees in their business decisions. Finally, this statute is reflective of the Japanese corporate governance model that is comprised of a coalition of stakeholders including suppliers, lenders, customers and shareholders.

(6) Board Membership: this statute requires that various constituencies be represented on the board of directors. It specifically delineates this representation by requiring that shareholders represent fifty percent of board membership and nonshareholder constituencies represent the remaining fifty percent.

This statute also requires that at least fifty percent of the board of directors shall be residents of the state. This requirement reflects the artificial entity theory of the corporation in that the corporate form is a creation of the state conferred on specified bodies for the public benefit. It exists at the sufferance of the state which should continue the appropriate role of conditioning its grant of a corporate charter on the receipt of some quid pro quo. Mandating that at least fifty percent of the board of directors shall be residents of the State helps insure the state’s receipt of that quid pro quo.

179. See Orts, supra note 6, at 15.
180. COMPANIES ACT 1980 § 46(1).
181. Section 309 states in pertinent part:

(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company’s employees in general, as well as the interests of its members.

(2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.

Id.; see also Orts, supra note 6, at 72.
182. See Orts, supra note 6, at 72. But see Andrew Pollack, Japanese, in a Painful Recession, Trim Industrial Research Outlays, N.Y. TIMES, Nov. 29, 1993, at A1 (reporting that Japan’s long-term competitiveness is currently threatened because Japanese companies are trimming spending on research and development due to Japan’s severe recession).
184. See supra note 14 and accompanying text.
(7) Charitable Contributions: this statute recognizes that social responsibility is best served by corporations taking an active role in contributing to the welfare of society. This ten percent corporate net profit allocation is specifically not predicated on the receipt of some discernable benefit to the corporation. Instead, this allocation reflects that corporations, as major profit centers, must contribute to society.

(8) Derivative Suits: this statute authorizes shareholders, employees, customers, suppliers and creditors to bring derivative suits to challenge the actions of a self-interested or entrenched board that was permitting insiders to damage the corporation. In recent years, many courts and legislatures throughout the United States tightened the standards to the filing of derivative suits. States should instead encourage legitimate derivative suites as a means to combat incompetent or unethical management.

(9) Management Accountability/Executive Compensation: this statute addresses unbridled managerial discretion, promotes accountability and recognizes that excessive executive compensation evidences corporate waste. This statute caps executive compensation at $1,000,000 per year and requires that it shall be in specified forms tied to the performance of the corporation. Executive compensation shall also not be deferred. Self-dealing is deterred by requiring that all executive compensation determinations be governed by a committee of outside directors.

By enacting this statute, state legislatures would truly empower
nonshareholder constituencies. The critical question, however, is should this statute or a similar statute be enacted or should the share-
holder primacy principle prevail.

C. The Shareholder Primacy Principle Must Prevail

The shareholder primacy principle must endure. To negate this principle would seriously impair debt and equity capital infusions and thereby negatively affect financial markets and the economy. Institutional investors provide the key to revitalizing this principle. Because they now wield enormous power, their influence, demands and desires will eventually dictate corporate social policy. The recent ruling in QVC Network begins to rejuvenate corporate law governance principles that owners of corporate property, the shareholders, possess significant rights. The Delaware Supreme Court affirmation of the lower court’s opinion restored some of the power shareholders lost under the Time-Warner decision. Professor Gregg Jarrell of Rochester’s Simon Business School states:

The court should rule that any merger is a sale, triggering the enhanced director duties that maximize shareholder value. This would put responsibility for making major corporate control decisions with shareholders. Directors’ roles should be relegated to overseeing the running of the going concern, which is where the protection of the business judgment rule makes perfect sense.

This decision is a victory for the shareholder primacy principle. Delaware, however, did not achieve corporate prominence by undermining management. The political forces that helped promulgate the Time-Warner decision might very well produce a reversal of the decision in QVC Network. Delaware’s state legislature could pass legislation that will essentially accomplish this aim and assault the shareholder primacy principle in favor of management.

190. See supra notes 120-24 and accompanying text.
193. Id.
D. The Proper Model of Corporate Social Responsibility

Corporations are entities created by state law. Therefore, reasonable state regulation of corporate governance should be permitted in recognition of the obligations corporations owe to the state and to society. A legitimate focus of state regulation is the encouragement of corporate consideration for nonshareholder constituencies. Consideration for nonshareholders, however, should not invalidate the shareholder primacy principle. Accordingly, states should not mandate that corporations consider nonshareholder constituencies in their business decisions. Further, states should be reticent to enact permissive state regulations in favor of nonshareholder constituencies that increase the separation between shareholder ownership and managerial control.

The proper model for corporate social responsibility finds that although corporations should be able to consider the interests of nonshareholder constituencies in every business decision, the fundamental basis of the shareholder primacy principle must prevail. Therefore, consideration for nonshareholder constituencies should be limited in that corporations should be required to prove that any negative impact on shareholders is merely incidental.

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