

# CORPORATE FIDUCIARY PRINCIPLES FOR THE POST-CONTRACTARIAN ERA

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## I. INTRODUCTION

[Y]ou cannot abandon emphasis on “the view that business corporations exist for the sole purpose of making profits for their stockholders” until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.<sup>1</sup>

The impact of the law and economics movement on legal scholarship, legal analysis, and, ultimately, on the rules under which our society operates is substantial. The proponents of this movement (“Contractarians”) articulate their positions skillfully and apply their principles broadly

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

across the entire spectrum of our laws,<sup>2</sup> including, of course, the area of corporate law.<sup>3</sup> Their goal is to convince the rest of us that their rules and principles are worthy of the imprimatur of society.

Regarding the fiduciary duties owed by corporate managers to the corporation and its investors, it was entirely predictable that the Contractarians advocate that society should have no corporate fiduciary principles. Rather, the Contractarians argue that we are better off if society stays out of the entire matter and leaves private parties (i.e., corporate managers and investors) free to contract as they see fit regarding fiduciary duties.

While the arguments of the Contractarians may be appealing and certainly the debate generated by them is enlightening,<sup>4</sup> the Contractarians will lose and, indeed, probably already have lost their bid for the elimination of all mandatory corporate fiduciary principles.<sup>5</sup> For good reasons, society is not about to relieve corporate managers of all their fiduciary responsibilities.<sup>6</sup>

2. The law and economics movement analyzes nearly all aspects of law. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (4th ed. 1992); A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* (2d ed. 1989).

The foundation works for the Contractarian position include, or are explained in, Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Steven N. S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (1983); Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); Eugene F. Fama & Michael C. Jensen, *The Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

3. See RICHARD A. POSNER & KENNETH E. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* (1980); ROBERTA ROMANO, *FOUNDATIONS OF CORPORATE LAW* (1993); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) [hereinafter EASTERBROOK & FISCHEL, *ECONOMIC STRUCTURE*]; Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99 (1989); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989) [hereinafter Easterbrook & Fischel, *The Corporate Contract*].

4. In what is something of an overstatement but nonetheless generally correct, Kornhauser says that the revolution in corporate law sparked by the Contractarians has "transformed not only our understanding of the law, but the law itself . . ." Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449 (1989).

5. Even scholars who do not accept fully the Contractarian view may consider it premature to declare that the Contractarians lost in their bid to eliminate all mandatory fiduciary duties. See, e.g., Thomas L. Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Value*, 69 N.C. L. REV. 273, 288 (1991) (referring to "the demise of the fiduciary principle in corporate governance"). Nonetheless, as more fully articulated herein, society will continue to require some significant level of fiduciary duties for corporate managers for the foreseeable future.

Interestingly, in this regard, Professor DeMott found that fiduciary duties actually may still be expanding into new areas. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 909 ("commercial franchises, distributorship relationships, a bank's relationship with its borrowers and its depositors, and the relationship between holders of executive and nonexecutive interests in oil and gas estates").

6. Articles expressing the varying degrees of disagreement with the Contractarian position include Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the*

Society's attention, therefore, should be refocused away from the question of whether all mandatory corporate fiduciary duties ought to be eliminated, a matter that seems to be essentially settled, and onto the matter of the appropriate shape of corporate managers' fiduciary duties.<sup>7</sup> In refocusing, however, we should impound the considerable wisdom we are able to garner from the Contractarians, while at the same time we must respect the widely shared societal values that led to the defeat of the Contractarians' bid to eliminate all mandatory fiduciary duties.

The Contractarians argue persuasively the benefits of the capitalistic system and the integrally related pursuit of economic efficiency.<sup>8</sup> Our society considers appealing the personal autonomy generated by the pursuit of economic efficiency and the fact that the system moves society generally in the direction of a maximization of total utility.<sup>9</sup> Perhaps in this era, which shortly follows the massive and spectacular debacle of communism, one is even more appreciative of the values that underlie and result from the pursuit of economic efficiency.

At the same time, society is uncomfortable with the unfettered pursuit of economic efficiency as envisioned by the Contractarians. We are uneasy with the apparent greed and self-interest that seem to fuel the system and the lack of grace and kindness that the Contractarians are willing to accept. We are concerned about "losers" and repulsed in extreme cases by the results of the allocation of resources solely to those who can pay the most for them. We also doubt the essential factual assumptions that are necessary to support the Contractarians' position regarding fiduciary duties.

The purpose of this Article is to propose, explain, and defend broad and unifying principles<sup>10</sup> to guide the development of fiduciary duties of

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*Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990); Douglas M. Branson, *Assault on Another Citadel: Attempts To Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375 (1988); DeMott, *supra* note 5, at 915-23; Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Hazen, *supra* note 5; John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on Judicial Role*, 89 COLUM. L. REV. 1618 (1989) [hereinafter Coffee, *Essay*]; John C. Coffee, Jr., *No Exit? Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988) [hereinafter Coffee, *No Exit*].

7. This is not to imply that all debates about the shape of corporate fiduciary duties were suspended during the debate regarding elimination of mandatory fiduciary duties. Indeed, many of the articles cited in the immediately preceding footnote deal in varying degrees with the appropriate shape of mandatory fiduciary duties. See, e.g., Eisenberg, *supra* note 6.

8. See *infra* notes 13-15 and accompanying text (defining "economic efficiency").

9. See *infra* notes 19-29 and accompanying text (discussing the moral justifications offered for the pursuit of economic efficiency).

10. Some commentators express a similar view regarding the need for broadly applied principles. See, e.g., John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1547-48 (stating that "a narrow preoccupation with

corporate managers<sup>11</sup> in the post-Contractarian period. These principles are based on Pareto criteria,<sup>12</sup> which are demonstrably appealing to society and provide workable and morally attractive bases for a development of corporate fiduciary rules. Thus, while the proposed principles sound not unfamiliar, one should not underestimate the significant changes in the present law of corporate fiduciary duties that would be wrought by a broad application of the proposed principles.

Although the major thrust of this Article deals with traditional, broadly formulated corporate fiduciary duties, duties that have most usually been developed through court decisions, the principles are intended to have a more expansive application. Specifically, the principles are proposed as appropriate guides not only for courts applying generalized fiduciary standards but also for legislatures enacting specific laws dealing with corporate managers' fiduciary obligations. Indeed, some of the implementations of the principles exceed the capabilities of courts and thus require legislative action.

In order to illuminate these principles, part II of this Article reviews the debate between the Contractarians and those opposed to the Contractarians' position ("Regulators") and proposes an explanation as to why it is entirely appropriate that the Contractarians lost their attempt to eliminate all mandatory fiduciary duties. Part III offers observations concerning corporate managers and the other corporate constituencies affected by the actions of corporate managers and focuses specifically on how these parties act as rational maximizers. Part IV describes and defends the suggested fiduciary principles. In part V, the principles are applied to familiar corporate problems to demonstrate the sensibleness of these proposals and the extent of the changes they effect.

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fiduciary duties has long been the hobgoblin of law professors"). Coffee recognizes the need for a "fuller normative theory." *Id.*

11. This Article is limited in the discussion of corporate fiduciary duties to the standards applicable to "managers," which include the traditional groups of officers and directors but exclude owners. Owners may make corporate "management" decisions, when, for example, they vote to approve a merger, and, under traditional corporate law, certain actions of majority stockholders have been subjected to scrutiny under fiduciary principles. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (involving a fiduciary duty imposed on a majority stockholder voting on affiliated merger); *Swinney v. Keebler Co.*, 329 F. Supp. 216 (D.C. 1971), *rev'd*, 480 F.2d 573 (4th Cir. 1973) (involving a fiduciary duty imposed on a majority stockholder selling majority block of voting stock). Notwithstanding, out of practical necessity, the discussion in this Article is limited to fiduciary duties as applied to "managers," although much of what is proposed in this piece would seem applicable to stockholders' management decisions, especially when the decisions are undertaken by a majority or controlling stockholder.

12. Pareto criteria, more specifically the concept of Pareto superiority, is defined and discussed in the discussion accompanying note 56 *infra*.

## II. THE DEBATE: OF FACTS AND VALUES

The Contractarians champion economic efficiency as a goal. Although definitions may differ,<sup>13</sup> economic efficiency generally denotes a pattern of resource allocation in which resources are allocated to the party willing to pay most for a particular resource.<sup>14</sup> Attaining economic efficiency, therefore, requires that the parties be permitted to trade unfettered by governmental or other restraints. Without such unfettered trading, resources cannot move into the hands of the party who is willing to pay the most for the resources and who, accordingly, is assumed to be the most efficient user of the resources.<sup>15</sup>

Applying these concepts to corporate fiduciary duties,<sup>16</sup> Contractarians view managers as sellers of fiduciary protections and corporations and their stockholders as buyers of fiduciary protections. Thus, an economically efficient allocation of corporate fiduciary duties is achieved only through free bargaining between corporate managers and corporations (or the corporation's stockholders) regarding the existence and terms of managers' fiduciary obligations. The mandatory imposition of fiduciary duties on corporate managers is seen as inconsistent with achieving economic efficiency, since it limits free bargaining between the parties.<sup>17</sup>

This line of thinking, however, generally does not lead the Contractarians to reject some governmental role in the formulation of fiduciary duties but, instead, leads them to favor state-promulgated fiduciary standards as default provisions. The now-familiar argument in this regard is based on economy. If, over time, most corporate stockholders and managers, unfettered by governmental rules, select certain fiduciary duties as a part of their contract, utilization of those fiduciary duties as default provisions is economical, since the parties and society are spared the expenses of negotiating and drafting the fiduciary duties.<sup>18</sup> If particular

13. For a discussion of other definitions of economic efficiency, see Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 512 (1980).

14. See POSNER, *supra* note 2, at 11-15.

15. Posner characterizes the permissibility of voluntary exchanges as a "basic economic principle" and discusses its integral role in achieving economic efficiency. POSNER, *supra* note 2, at 9-15.

16. For an overview of the Contractarian position on corporate fiduciary duties, see Butler, *supra* note 3.

17. In arguing that managers and investors should be left free to determine the extent, if any, of managers' fiduciary duties, Easterbrook and Fischel state, "[J]ust as there is no right amount of paint in a car, there is no right relation among managers, investors, and other corporate participants." Easterbrook & Fischel, *The Corporate Contract*, *supra* note 3, at 1428.

18. See, e.g., *id.* at 1433, 1444-45. More specifically, Contractarians argue that society should enact corporate law that "fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance." *Id.* at 1445. In another piece, Professor Fischel states that "optimal fiduciary duties should approximate the bargain that investors and managers would reach if transaction costs were zero." Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982). Judge Posner suggests that implied consent may be inferred "by try-

stockholders and managers enter into a contract that expressly overrides the default provisions, of course the Contractarians would give effect to the override provisions.

Contractarians, when called upon to provide a moral justification for their position, concede the instrumental nature of economic efficiency and, accordingly, defend their position by reference to other, more fundamental values.<sup>19</sup> One such defense is based on utilitarian notions<sup>20</sup> and proposes that the pursuit of economic efficiency will lead in the direction of maximum total utility (happiness).<sup>21</sup> Unfettered rights of the parties to effect voluntary trades that each considers in his or her best interests, by definition, must increase the total utility of the trading parties.<sup>22</sup> Utilitarianism, however, has been subjected to significant criticisms over the years<sup>23</sup> and has led to alternative justifications for pursuing economic efficiency.<sup>24</sup>

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ing to answer the hypothetical question whether, if transaction costs were zero, the affected parties would have agreed . . . ." Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 494 (1980).

19. Thus, for example, Posner defends his own concept of efficiency, which he views as wealth maximization, as a concept that, if pursued, "will produce an ethically attractive combination of happiness, of rights (to liberty and property), and of sharing with less fortunate members of society." Posner, *supra* note 18, at 487. See also Coleman, *supra* note 13, at 528-30. Both Calabresi and Dworkin have observed that wealth maximization as a goal must be considered only instrumental. Guido Calabresi, *An Exchange: About Law and Economics; A Letter to Ronald Dworkin*, 8 HOFSTRA L. REV. 553, 556 (1980); Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191 (1980).

20. The works of Jeremy Bentham and John Stuart Mill provided the foundations for utilitarianism. See JEREMY BENTHAM, *PRINCIPLES OF MORALS AND LEGISLATION* (1789); JOHN STUART MILL, *UTILITARIANISM* (1863). For modern discussions of utilitarianism, see J.J.C. SMART & B. WILLIAMS, *UTILITARIANISM* (1973); H.L.A. Hart, *Between Utility and Rights*, 79 COLUM. L. REV. 828 (1979).

21. See Coleman, *supra* note 13, at 510. Professor Stone describes the pursuit of wealth maximization as a "crude sort of utilitarianism." Christopher D. Stone, *Corporate Social Responsibility: What It Might Mean, If It Were Really To Matter*, 71 IOWA L. REV. 557, 570 (1986).

The pursuit of economic efficiency, certainly if defined as Pareto criteria, has been viewed as promoting the utilitarian goal of maximizing total utility. Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103 (1979); Posner, *supra* note 18, at 491-92 (describing Pareto superiority as having a "utilitarian premise").

22. Obviously, this still leaves the problems of externalities or adverse effects on non-trading parties.

23. Coleman summarizes these criticisms as "those which do not question the consequentialist character of utilitarianism" (e.g., criticisms based on the uncertainty of "whose utilities or preferences should count and which of a person's preferences should count; " criticisms based on distributive considerations; and criticisms based on the "interpersonal-utility comparison problem"), as well as those criticisms that do question the consequentialist character of utilitarianism (e.g., the criticism "that utilitarianism is an impoverished moral theory, incapable of accounting for the full range of moral obligation and right action"). Coleman, *supra* note 13, at 511. Related to the latter, Judge Posner observed, "The fact that one person has a greater capacity for pleasure than another is not a very good reason for a forced transfer of wealth from the second to the first." POSNER, *supra* note 2, at 12. Hart recognizes that utilitarianism "ignores . . . the moral importance of the separateness of persons." Hart, *supra* note

Maximization of personal autonomy is offered as one such justification for the pursuit of economic efficiency. Market transactions and the pursuit of economic efficiency are morally justified, proponents argue, if they are the result of freely given consent. Such consent to transactions ensures autonomy, which is valued for its own sake and without regard to its relationship to total happiness or utility.<sup>25</sup> This line of argument is based on Kantian traditions<sup>26</sup> and proffered in different settings by scholars including Robert Nozick<sup>27</sup> and Richard Epstein.<sup>28</sup> Judge Posner also employs consent and promotion of personal autonomy in his defense of the pursuit of wealth maximization.<sup>29</sup>

Notwithstanding the arguments of the Contractarians, and even though they may have won a skirmish or two in the area of corporate fiduciary duties, society, for sound reasons that are articulated by Regulators, is not about to give up on its longstanding<sup>30</sup> commitment to protect shareholders through the imposition of fiduciary duties.<sup>31</sup> Indeed, in considering this matter, one must be careful not to overestimate or misinterpret the Contractarian "victories."

At least some of the Contractarian "victories" may be more reflective of a discrete game of power politics than of any shift in public values. For example, a number of state legislatures, including my home state of Kentucky, passed a typical and apparently Contractarian statute that permits corporations to adopt an article of incorporation limiting directors' liability for monetary damages to instances involving bad faith or intentional misconduct.<sup>32</sup> The

20, at 831. Professor Dworkin states, harshly, that "utilitarianism, as a general theory of either value or justice, is false and its present unpopularity is well-deserved." Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191, 216 (1980).

24. For an excellent comparison of utilitarianism and Kantianism, the two moral theories most prevalently employed in the moral justification for capitalism and, more specifically, the pursuit of economic efficiency, see JEFFERIE G. MURPHY & JULES L. COLEMAN, *PHILOSOPHY OF LAW* 70-82 (1990).

25. For a discussion and criticism of this line of reasoning, see Coleman, *supra* note 13, at 531-40.

26. For a compact, but elegant description of Kantianism, see MURPHY & COLEMAN, *supra* note 24, at 75-82. Separately, Murphy has written extensively about Kant. J. MURPHY, *KANT: THE PHILOSOPHY OF RIGHT* (1970).

27. See ROBERT NOZICK, *ANARCHY, STATE AND UTOPIA* (1974).

28. See Richard A. Epstein, *Causation and Corrective Justice: A Reply to Two Critics*, 8 J. LEGAL STUD. 477, 487-88 (1979). Professor Epstein uses the advance of individual autonomy as a basis to support the legitimacy of the employment-at-will doctrine. Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 951 (1984) [hereinafter Epstein, *In Defense*].

29. See Posner, *supra* note 18.

30. In her work, Frankel reports that corporate fiduciary duties "originated with the formation of . . . corporations . . ." Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

31. This view may not be shared by all Regulators. See, e.g., Hazen, *supra* 3 note 5, at 275 (stating that his article "examines the demise of the fiduciary principle in corporate governance").

32. KY. REV. STAT. ANN. §§ 271B.2-020(d) (Baldwin 1994). The Kentucky provision, which is based roughly on the 1994 Revised Model Business Corporation Act (RMBCA), RMBCA § 2.02(b)(4) (1994), permits the articles of incorporation to limit monetary recovery against

Kentucky statute, however, was passed in a busy legislative session and was buried in the adoption of the Revised Model Business Corporation Act (RMBCA). The entire adoption process was dominated by corporate managers and their agents. While, over time, one is able glean societal values through legislation and court-made rules (indeed, later in this Article court and legislative rules are relied on heavily as an indication of societal values), one statute passed in such an atmosphere may be somewhat less persuasive of any widely held Contractarian values.

Additionally, even the statutes that appear to opt for some Contractarian philosophy often retain a decidedly Regulator approach. Referring again, for example, to corporate statutes that permit limiting directors' liability by an amendment to a corporation's articles of incorporation, directors under those statutes are still subject to a baseline fiduciary standard that cannot be avoided by contract. Also, the statutes often do not apply to officers.<sup>33</sup>

In looking at statutory developments, one finds that the RMBCA actually increases the mandatory protection for stockholders by expanding the coverage of appraisal rights to include certain amendments to corporations' articles of incorporation.<sup>34</sup> Prior to the adoption of the RMBCA, most state statutes did not grant appraisal rights to stockholders whose rights were affected by amendments to a company's articles of incorporation,<sup>35</sup> notwithstanding the existence of notorious examples in which such amendments were used as vehicles to expropriate the wealth of preferred stockholders.<sup>36</sup> The RMBCA deals with this by mandatorily imposing appraisal

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directors to "acts or omissions not in good faith or which involve intentional misconduct." Section 2.02(b)(4), however, uses the terms "intentional misconduct" as the extent of the right to limit monetary recovery against directors.

33. In Kentucky, for example, the right to limit liability applies only to directors (i.e., officers' liability cannot be limited by a company's articles of incorporation) and does not include permission to eliminate or limit a director's liability for conflict transactions, a breach of good faith, intentional misconduct, knowing violations of the law, or transactions where "the director derived an improper personal benefit." KY. REV. STAT. ANN. § 271B.2-02(2)(d) (Baldwin 1994).

34. The RMBCA grants appraisal rights in the case of amendments that "materially and adversely" affect certain of the stockholders' rights, including preferential rights, redemption rights, preemptive rights, or voting rights. RMBCA § 13.02(a)(4) (1994).

35. The Model Business Corporation Act, for example, limited the availability of appraisal rights to mergers, consolidations, and sales of substantially all of a corporation's assets other than in the regular course of business. MBCA § 80 (1991).

36. See, e.g., *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (Del. D. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944); *Goldman v. Postal Tel., Inc.*, 52 F. Supp. 763 (Del. D. 1943).

The unfairness visited on preferred stockholders in single-company recapitalization cases generally attracted a lot of attention in earlier times. See, e.g., E. Merrick Dodd, Jr., *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780 (1942); Norman D. Lattin, *A Primer on Fundamental Corporate Changes*, 1 W. RES. L. REV. 3 (1949); Arno C. Becht, *Corporate Charter Amendments: Issues of Prior Stock and the Alteration of Dividend Rates*, 50 COLUM. L. REV. 900 (1950) [hereinafter Becht, *Charter Amendments*]; Arno C. Becht, *Changes in the Interests of Classes of Stockholders by Corporate Charter Amendments Reducing Capital and*

rights on such transactions, a resolution that obviously is inconsistent with the Contractarian philosophy.

Finally and more generally, some commentators have observed an increase in society's general affinity for fiduciary duties. In a 1988 article, Deborah DeMott reminds us that, in recent years, courts have been willing to expand fiduciary protections into new areas,<sup>37</sup> and, in an earlier piece, Tamar Frankel opines that "[t]he twentieth century is witnessing an unprecedented expansion and development of the fiduciary law."<sup>38</sup>

Society continues to endorse the Regulators' view of corporate fiduciary duties for two reasons. First, the position of the Regulators better reflects the facts; second, the values that underlie the Regulators' positions are more closely aligned with society's shared values.

The facts as imagined by the Contractarians<sup>39</sup> are that no significant market failures exist<sup>40</sup> and, thus, the parties (i.e., investors and managers) are able to effect the trades necessary to reach economic efficiency regarding fiduciary duties. Alternatively, Contractarians imagine that even if significant market failures do exist, no substitute system of resource allocation (legally mandated rules, for example) is more efficient than the free market, even with its flaws.<sup>41</sup> Contractarians also are less likely than

*Altering Redemption, Liquidation and Sinking Fund Provisions*, 36 CORNELL L.Q. 1 (1950) [hereinafter Becht, *Classes of Stockholders*].

Not surprisingly, the most perceptive of the more modern works is by Brudney, and his piece contains many of his observations about market failures and bargaining inequities among investors and managers. See Victor Brudney, *Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445 (1973).

37. DeMott, *supra* note 5, at 909.

38. Frankel, *supra* note 30, at 796.

39. See Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, 43 TORONTO L.J. 315, 327 (1993) (describing the factual assumptions underpinning the Contractarian position).

40. See, e.g., Easterbrook & Fischel, *The Corporate Contract*, *supra* note 3, at 1430 ("Investors . . . can participate or go elsewhere. . . . [Entrepreneurs or managers] cannot force investors to pay more than what the resulting investment instruments are worth; there are too many other places to put one's money."). The authors also note that "prices quickly and accurately reflect public information about firms." *Id.* at 1431. The authors also state that "[i]t turns out to be hard to find any interesting item that does not have an influence on price." *Id.* at 1432. Easterbrook and Fischel also argue that the market works to protect ignorant and unsophisticated investors through, in part, the influence of professional traders on the market price. *Id.* at 1435. The authors concede that market failures may exist in midstream adjustments of corporate governance provisions. *Id.* at 1442-44. Contractarians also do not necessarily reject the possibility of opportunistic conduct by management. See, e.g., Butler, *supra* note 3, at 119 ("[T]he market mechanisms may be inadequate to deal with last-period, or one-time, divergences when the agent rationally concludes that the benefits of the one-time use of discretion is worth whatever penalties may be forthcoming in the employment market for the agent's services.").

A thoughtful and interesting piece regarding market efficiency, which contains an outstanding survey of the literature in the area, is Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992).

41. See Easterbrook & Fischel, *The Corporate Contract*, *supra* note 3, at 1432 ("[I]t does not matter if markets are not perfectly efficient, unless some other societal institution does

Regulators to imagine that private arrangements between the parties have significant third-party effects.<sup>42</sup>

Regulators, on the other hand, dispute the existence of the factual underpinning of the Contractarian position<sup>43</sup> and argue that significant market failures<sup>44</sup> are typically present in the process of contracting for fiduciary duties. Concerning bargaining by the stockholders who first purchase from the issuer, Regulators opine that such investors are often scattered, unsophisticated, and rationally ignorant regarding the fiduciary duties for which they are "contracting."<sup>45</sup> Although in a public offering underwriters conceivably could act on behalf of such shareholders to evaluate and properly price contractual fiduciary duties, Regulators generally argue that underwriters have an interest in overpricing securities to investors in order to garner repeat business from the issuer. Thus, the fear is that underwriters will underprice any initial contractual limitations of fiduciary duties.<sup>46</sup>

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better at evaluating the likely effects of corporate governance devices. The prices will be more informative than the next best alternative, which is all anyone can demand of any device."). Coase expressed this idea earlier. See Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

42. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 3, at 1429-30 ("The corporation's choice of governance mechanisms does not create substantial third-party effects—that is, does not injure persons who are not voluntary participants in the venture.").

43. For a list of the underlying assumptions of the Contractarian position, see Daniels, *supra* note 39, at 327.

44. Market failures exist when parties are impeded in their trading to the extent that resources cannot flow to those who are willing to pay the most for them. Hazen says that "market failure may occur when transactions do not result from meaningful consent of both parties." Hazen, *supra* note 5, at 276. Coleman defines market failure as "the failure of agents acting on purely individually maximizing strategies to secure a Pareto optimal or collectively rational outcome." Jules L. Coleman, *Afterward: The Rational Choice Approach to Legal Rules*, 65 CHI.-KENT L. REV. 177, 179 (1989). Without using the specific term, Brudney appears to consider market failure as the inability to "effect Pareto superiority or maximize efficiency." Brudney, *supra* note 6, at 1411.

45. See, e.g., Brudney, *supra* note 6, at 1420 ("[I]nvestors in large publicly held corporations have little or no ability to choose or negotiate the terms of management with original owners who go public or with corporate management."); Eisenberg, *supra* note 6, at 1521 ("It is no more likely that buyers in an initial public offering would know of variations in core fiduciary and structural rules than that buyers of insurance policies will know the fine print in their policies."); Hazen, *supra* note 5, at 300 ("Consent is no more meaningful in a firm that is about to go public than it is in a firm that is already publicly held."). Bebchuk, however, considers the potential for abuse less in instances of initial sales of securities by corporations than in midstream corrections. Bebchuk, *supra* note 6.

46. See, e.g., Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1183 (1990); Eisenberg, *supra* note 6, at 1518-19; William W. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 89 DUKE L.J. 92, 156 (1989); Dale B. Tauske, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, COLUM. BUS. L. REV. 1, 22-26 (1989).

Regulators are even more pessimistic about the “bargaining” that goes on if fiduciary duties are contractually limited in midstream.<sup>47</sup> Here Regulators argue that the proxy machinery typically activated to amend fiduciary duties does not ensure any meaningful bargaining. Again, stockholders generally are scattered, rationally ignorant, unsophisticated, and powerless to defend against detrimental changes in fiduciary rules effected in midstream. Mechanistically and economically, shareholders are unable to protect themselves. Regulators are similarly pessimistic that other factors, such as the market for corporate control,<sup>48</sup> will adequately protect corporate stockholders subjected to midstream adjustments in their contract.<sup>49</sup>

While proving market failures is necessarily difficult,<sup>50</sup> the Regulators generally have the more accurate view of the facts, and the plausibility of this view explains, at least partially, why society is unwilling to accept the Contractarians’ demand for the elimination of all mandatory corporate fiduciary duties.

Certainly my own experiences and observations, both as a transactional attorney and a law professor, support a conclusion that market failures are not trivial. For example, the very cases from which I teach my courses in Corporations and Corporate Finance involve numerous examples of situations that are best interpreted as market failures, cases with facts that make it impossible to find that the parties bargained for, priced, and allocated the risks to which they were later subjected. Examples in-

47. Contractarians admit this is their toughest case. See, e.g., Easterbrook & Fischel, *The Corporate Contract*, *supra* note 3, at 1442-44. On a theoretical level, however, I fail to see the difficulty for Contractarians. The obvious theoretical answer is that the market discounts the initial price of the investment to reflect the risk of a midstream adjustment. Assumedly, the reason Easterbrook and Fischel do not make that argument is because they believe that there is a market failure respecting this term.

But to argue *ex ante* consent and payment for assuming the risk of a midstream adjustment seems less of a stretch than arguing, for example, that citizens consent to a negligence-based tort recovery system by accepting *ex ante* compensation. Such compensation, it is argued, is a result of the relatively lower operational costs of the system, which, it is assumed, would be consented to *ex ante* even by those who later may be denied recovery that they would have received under a strict liability system. See Posner, *supra* note 18, at 492-96.

48. Contractarians argue the therapeutic value of the market for corporate control. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-74 (1981); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965). Applied here, the argument would run as follows: If management constructs fiduciary duties that are unfair vis-à-vis shareholders, the market value of the stock will go down, which will make the company subject to a hostile takeover. This threat keeps managers from charging too much for their services (in this case, in the form of reduced fiduciary duties).

49. Brudney finds that neither the market for managers nor the market for securities does much to overcome the bargaining defects. See Brudney, *supra* note 6, at 1420-47. Eisenberg explores a broader array of market forces and concludes that the forces do not eliminate the need for certain mandatory fiduciary principles. See Eisenberg, *supra* note 6, at 1488-1514.

50. I concede as, I trust, does the other side of the debate, the correctness of Coffee’s statement that “[m]arket failures are easier to predict than prove.” Coffee, *supra* note 10, at 1511.

clude voluntary recapitalizations in which preferred shareholders are effectively forced to surrender or exchange their arrearage or other valuable contractual rights for less than fair consideration,<sup>51</sup> freezeouts of minority shareholders at less than the fair market value of their stock,<sup>52</sup> situations in which investors' value is devastated by the sale of the company to a corporate looter,<sup>53</sup> and highly leveraged transactions that dramatically decrease the value of investors' securities.<sup>54</sup> All of these cases involve instances in which it is probable that investors, due to market failures, did not bargain for, accept, or receive *ex ante* compensation for the risks of the particular occurrences or transactions.

Contractarians also are out of line with the Regulators and society on the matter of values. Generally, as concerns corporate managers' obligations to stockholders, Regulators and society are attracted by Pareto concepts, while Contractarians are attracted by the concept of Kaldor-Hicks efficiency.<sup>55</sup> This difference reflects fundamentally disparate views regarding the treatment of losers in transactions.

Any move (or decision) is Pareto superior if no one is made worse off and at least one person is made better off by the move.<sup>56</sup> On the other hand, a move is Kaldor-Hicks efficient even if there are losers, so long as the winners in the move could compensate the losers, whether or not such

51. Cases involving the elimination of preferred arrearage include *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (Del. D. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944); *Western Foundry Co. v. Wicker*, 85 N.E.2d 722 (Ill. 1949); *State v. Bechtel*, 31 N.W.2d 853 (Iowa 1948), *cert. denied*, 337 U.S. 918 (1949); *Dratz v. Occidental Hotel Co.*, 39 N.W.2d 341 (Mich. 1949); *Wessel v. Guantanamo Sugar Co.*, 35 A.2d 215 (N.J. Ch.), *aff'd*, 39 A.2d 431 (N.J. 1944); *Buckley v. Cuban Am. Sugar Co.*, 19 A.2d 820 (N.J. Ch. 1940); *Bove v. Community Hotel Corp. of Newport, R.I.*, 249 A.2d 89 (R.I. 1969). Much has been written on this matter, although most pieces are somewhat older. See, e.g., Arno C. Becht, *Alterations of Accrued Dividends: I*, 49 MICH. L. REV. 363, 565 (1951); E. Merrick Dodd, *Accrued Dividends in Delaware Corporations—From Vested Rights to Mirage*, 57 HARV. L. REV. 894 (1944); E.R. Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1 (1942). Professor Brudney's piece on this matter is outstanding. See Brudney, *supra* note 36.

52. Examples of cases in which minority stockholders complained of unfairness in a freezeout situation include *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), and *Berkowitz v. Power/Mate Corp.*, 342 A.2d 566 (N.J. Super. Ct. Ch. Div. 1975). One of the most egregious examples of mistreatment of minority stockholders in a freezeout is *Matteson v. Ziebarth*, 242 P.2d 1025 (Wash. 1952).

53. *Swinney v. Keebler Co.*, 329 F. Supp. 216 (D.C. 1971), *rev'd*, 480 F.2d 573 (4th Cir. 1973), is an interesting case involving a sale to a corporate looter, although the suit was brought on behalf of creditors (debentureholders), rather than minority stockholders.

54. See *infra* notes 139-45 and accompanying discussion. Coffee renders an especially enlightening account of the market failures that affected bondholders in the 1980s. See Coffee, *supra* note 10, at 1505-15.

55. Some Contractarians advocate the goal of wealth maximization. See, e.g., Posner, *supra* note 18, at 487. In any event, the fundamental point is that individual losers seem to be of little concern to Contractarians.

56. MURPHY & COLEMAN, *supra* note 24, at 182-85. Pareto criteria are discussed more extensively in Jules L. Coleman, *Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law*, 68 CAL. L. REV. 221 (1980).

compensation in fact occurs.<sup>57</sup> Thus, Pareto concepts, as a measure of managers' fiduciary duties to stockholders, reflect a strong concern for individual losers and, in fact, ensure the absence of losers, while Kaldor-Hicks concepts, as a measure of corporate managers' fiduciary duties, do not ensure the absence of losers.

Society is concerned about individual losers in corporate transactions and thus attracted to Pareto concepts.<sup>58</sup> This is the reason, for example, that both courts and legislatures have generated rules requiring minority stockholders in an affiliated merger to receive fair consideration for their stock. Although managers and the majority stockholders may effect the "move" (i.e., the merger), the intrinsic fairness test is designed to provide the minority stockholders with a "fair price" in the merger,<sup>59</sup> and statutory appraisal rights permit dissatisfied stockholders the option of demanding cash equal to the "fair value" of their stock.<sup>60</sup>

Society's attraction to Pareto concepts also is evidenced by the way courts and legislatures deal with the claims of preferred stockholders in single-company recapitalizations,<sup>61</sup> although, admittedly, the poor analyses and sloppy crafting in many of the court decisions make this evidence less persuasive than it should be.<sup>62</sup> Nonetheless, courts, acting under their common law powers, generally recognize limits on the concessions that preferred stockholders can be asked (or forced) to make in single-company recapitalizations and state that such recapitalizations cannot be effected if the terms of the transaction are "unfair," "grossly unfair," or amount to "constructive fraud."<sup>63</sup> These cases (most of which are older) reflect, therefore, the gen-

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57. MURPHY & COLEMAN, *supra* note 24, at 186.

58. McDaniel observes that economists do not care "about losses to individuals. . . . Judges do care about individual losses." Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 243 (1988). Society's aversion to transactions generating individual losers leads Professor Coffee to conclude that the takeovers may not remain "politically viable" unless constituency losses are eliminated. Coffee, *supra* note 10, at 1548.

59. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

60. Legislatures have enacted appraisal statutes to ensure that stockholders receive "fair value" in mergers and other corporate reorganizations. See, e.g., RMBCA §§ 13.01-.03 (1994).

61. Single-company recapitalizations are situations in which the rights of stockholders are altered by some corporate action, most typically by a merger with a shell company or amendments to the company's articles of incorporation.

62. Critical comment includes Becht, *Charter Amendments*, *supra* note 36; Becht, *Classes of Stockholders*, *supra* note 36; E. Merrick Dodd, *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780 (1942); Elvin R. Latty, *Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares*, 19 U. CHI. L. REV. 759 (1952); Comment, *A Standard of Fairness for Compensating Preferred Shareholders in Corporate Recapitalizations*, 33 U. CHI. L. REV. 97 (1965); Rutheford B. Campbell, Jr., *Voluntary Recapitalizations, Fairness, and Rule 10b-5: Life Along the Trail of Santa Fe*, 66 KY. L.J. 267 (1977).

63. *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418, 422 (Del. D. 1944) (employing the terminology "so unfair as to amount to constructive fraud" and "gross unfairness," although the analysis looks more like a fairness analysis under the old Delaware block approach); *Barrett v. Denver Tramway Corp.* 53 F. Supp. 198 (Del. D. 1943), *aff'd*, 146 F.2d 701 (3d Cir.

eral concern that preferred stockholders not be made losers (or at least significant losers) in recapitalizations.

Legislative action on the matter is even clearer. Single-company recapitalizations structured as mergers normally generate statutory appraisal rights, although, generally until relatively recently, recapitalizations effected through amendments to the company's articles of incorporation did not trigger appraisal rights.<sup>64</sup> The RMBCA, however, closes this gap by also providing for appraisal rights when preferred stockholders are subjected to amendments that "materially and adversely" affect stockholders' rights.<sup>65</sup> Appraisal rights, which are designed to prevent losers, or at least limit the amount of the losses, are, therefore, now broadly available under the RMBCA to protect preferred stockholders in a single-company recapitalization.

The position of the Contractarians leads to a quite different analysis and result. Thus, for example, in an affiliated merger, the Contractarians would argue that society should, from the beginning, impose no mandatory fiduciary constraint on such situations but should, instead, rely on a market solution. Even if the affiliated merger causes a loss for the minority stockholders, the Contractarians are apparently confident and morally satisfied that the market will correct this in future transactions either by future stock purchasers' requiring a higher return to pay them for this risk or by the inclusion in the future stockholders' contracts of a term that prohibits affiliated mergers or limits affiliated mergers to situations that are not harmful to minority stockholders.

The Contractarian solution, of course, is based on a series of assumptions about which some may disagree. As examples, the Contractarians would ask us to believe that all (most?) markets would immediately (before too long?) adjust to the newly discovered risk and impound that risk in the price of all (most?) future sales of the particular investment contract. Obviously, some may be unwilling to accept these factual assumptions.

More to the point of this part of the discussion, however, is the fact that even if the market is as efficient as the Contractarians assume, society and the Regulators are concerned about the first case.<sup>66</sup> First investors,

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1944) (referring to "constructive fraud," "bad faith," and "gross unfairness"); *Bove v. Community Hotel Corp. of Newport, Rhode Island*, 249 A.2d 89 (R.I. 1969) (refusing to select standard since the recapitalization met even the most rigorous standard of fairness).

In other instances, however, courts have indicated that no fiduciary or equitable rules are implicated by single-company recapitalizations. See *Goldman v. Postal Tel., Inc.*, 52 F. Supp. 763 (Del. D. 1948); *Franzblau v. Capital Sec. Co.*, 64 F.2d 744 (N.J. 1949).

64. MBCA § 80 (1991).

65. RMBCA § 13.02(4) (1994).

66. See, e.g., *McDaniel*, *supra* note 58, at 243 (arguing that individual investors who suffer losses from wrongful management decisions are entitled to compensation regardless of the aggregate behavior of the market). For an interesting and thoughtful consideration of the "first

those who are the minority stockholders or preferred stockholders subjected to the affiliated merger or the recapitalization, should not be turned into cannon fodder for future generations of investors. The fact that the market may correct future situations says nothing about the unfairness or fairness of the first case. The Regulators and society share the view that it is unfair for managers and other constituencies to subject stockholders to wealth-diminishing moves, unless it is demonstrable that stockholders were paid to take the risk of such transactions.<sup>67</sup>

The general uneasiness over the unrestrained pursuit of economic efficiency is based on more than just a concern for uncompensated losers, however. The unrestrained pursuit of economic efficiency may also be troubling because it arguably is fueled by some of the least attractive characteristics of the human spirit. Euphemisms such as "rational maximizer" and "utility-seeking individual,"<sup>68</sup> accordingly, may be viewed by some as a thin mask for greed and selfishness,<sup>69</sup> characteristics that we insist that our children reject, or at least temper substantially, as part of the early maturation process.

The pursuit of economic efficiency also will at times lead to resource allocations that are shocking. For example, Posner bravely provides a hypothetical situation in which a poor child will be a dwarf unless he gets an expensive pituitary extract.<sup>70</sup> The child of rich parents, however, will grow to a normal height without the extract, but by obtaining the extract the rich parents can ensure that their child will grow a few extra inches above normal. Since the rich child's parents can pay for the extract, he gets the drug, and the poor child, who clearly has the greater need, is denied the extract. While such an alloca-

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case" problem, see Ronald Dworkin, *Why Efficiency?*, 8 HOFSTRA L. REV. 563, 584-90 (1983).

67. This last statement, that wealth-diminishing moves should be permitted if there is payment for taking the risk of such moves, opens up a significant line of consideration that will be dealt with later but that needs to be explained here, at least briefly.

Regulators concede the appropriateness of, or at least have not objected to, a contract between shareholders and managers defining to some extent management's fiduciary duties owed to shareholders. See, e.g., Eisenberg, *supra* note 6, at 1463-80; Coffee, *Essay, supra* note 6. For example, Regulators would be unlikely to argue that redemption provisions in preferred shareholders' contracts should be considered unenforceable as inconsistent with management's fiduciary duty to shareholders. The exercise of a redemption privilege, however, is contrary to the best interests of the preferred stockholders who are subjected to the redemption. If interest rates go down and, as a result, a preferred share of stock would be worth more (but for the redemption provision), the preferred shareholders would be better off if management announced that they never intended to call the stock. The reason Regulators would not require management to forego the exercise of the redemption right is that the preferred shareholders have contracted for and are being paid to take the risk of redemption. In other words, it is permissible for managers to act contrary to the best interests of shareholders by redeeming stock because the parties consented to the redemption. These ideas are developed more fully later.

68. This euphemism is used by Posner, *supra* note 18, at 497.

69. Disagreement exists on this point. See, e.g., POSNER, *supra* note 2, at 4 ("[S]elf-interest should not be confused with selfishness.").

70. *Id.* at 13.

tion may be efficient under Posner's definition, the result is unsatisfactory to most of us.<sup>71</sup>

Rules that promote unfettered pursuit of economic efficiency are rules of the jungle. Just as the jungle produces beauty and a diverse array of strong and healthy vegetation and wildlife, pursuit of economic efficiency produces a diverse array of strong economic units that operate efficiently. Notwithstanding the beauty of the jungle, however, most are unable to watch, without at least some degree of squeamishness, a lion catch and devour a sickly fawn. We understand that the fawn is weak and possibly genetically imperfect and that allowing the lion to have its way with the fawn may ultimately make the entire race stronger and better competitors. However, our instincts are to try to make the fawn well rather than to allow the lion to make a meal of this pitiful and delicate creature. Values other than the preservation of the jungle—values such as fairness, compassion, and decency—come into play and may cause us to intercede on behalf of the fawn.

The trick for society is to impound the wisdom of the Contractarians and gain the benefits of enhanced economic efficiency<sup>72</sup> while, at the same time, to soften the hard edges of capitalism by injecting widely held values of society.<sup>73</sup> The failure of the law and economics movement to accomplish,

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71. Posner's answers to this are brief, stating only that he makes no attempt "to defend efficiency as the only worthwhile criterion of social choice." *Id.* Most interestingly, in the previous edition of his book, Posner opines that the limitations of economic efficiency as an ethical criterion are "perhaps not serious ones, as such examples [as the pituitary extract case] are very rare." RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 13 (3d ed. 1986). That statement is quite curious. So long as dollars are distributed unevenly in society and the marginal value of dollars decreases as one acquires more dollars, a large percentage of all purchases by the rich will generate less utility for the rich than would have been generated if the goods that were the subject of the purchase had been allocated to a poor person. The point is that although the extremeness of Posner's example may appear to him to be a "very rare" situation, the broader version of the problem is nearly ubiquitous.

72. Regulators readily concede that economic efficiency is worth pursuing. They agree that value is created by allowing parties the right to enter into contracts that they consider mutually beneficial. They do not deny that the increased total utility and autonomy resulting from such transactions are worthy goals for society. For example, Professor Eisenberg states:

It is a general principle of law that a bargain should normally be enforced according to its terms, without regard to whether it is reasonable or fair. One reason for this principle is that bargains have social utility because they create joint value through trade. Another reason is that a fully informed party is normally the best judge of his own utility or interest and, therefore, of the value to him of a bargained-for performance.

Eisenberg, *supra* note 6, at 1463.

73. This position may not be inconsistent with the view of the Contractarians, who do not necessarily reject the importance of values other than economic efficiency. In fact, some economists argue that economic analyses should be entirely value-neutral. The articulated aim of these economists is "to determine which sort of rules or policies would be efficient in the abstract." This type of analysis says "nothing about the types of policies governments should impose . . . ." Coleman, *supra* note 13, at 549. As examples of this positive approach, Coleman cites A. Mitchell Polinsky, *Private Versus Public Enforcement of Fines*, 9 J. LEGAL

or, indeed, even to attempt this task is at the heart of the reason society rejects Contractarian views regarding corporate fiduciary duties.

### III. CORPORATE CONSTITUENCIES AS RATIONAL MAXIMIZERS

The success or failure of a corporation affects many constituencies, including persons investing money in the corporation ("money investors," generally stockholders and creditors), persons investing human capital in the corporation ("human capital investors," generally employees, including corporate managers such as senior officers and directors), and more remote constituencies ("remote constituencies," such as suppliers and the community). It is helpful at this point to describe briefly the constituencies, to outline in the most general terms how certain of those constituencies act, assuming they are rational maximizers, and to offer an observation regarding the complications caused by remote constituencies.

Money investors in a corporation are normally easy to identify and include, depending on the capital structure of the particular corporation, common shareholders, preferred shareholders, debentureholders, bondholders, noteholders, and general unsecured creditors.<sup>74</sup> Although each of these groups has different rights, they also exhibit striking similarities. All have invested money in the corporation in the hope of earning a return on their investment, and all depend to a large degree on the skills of managers to provide them with a return on their money. Interestingly, however, under the law as it presently stands, corporate managers owe fiduciary duties only to common and preferred stockholders.

Human capital investors,<sup>75</sup> as stated above, include directors, officers and employees, all persons contributing services to the corporation in return

STUD. 105 (1980); A. Mitchell Polinsky, *Probabilistic Compensation Criteria*, 86 Q.J. ECON. 407 (1972); Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1 (1980).

More typically and more genuinely, Contractarians defend strongly the value of promoting economic efficiency. They view the pursuit of economic efficiency as a morally justifiable endeavor and thus advocate that "governments should intervene in human affairs or rearrange socio-political and legal institutions to promote efficiency." Coleman, *supra* note 13, at 549.

In any event, the fact that Contractarians and economists value economic efficiency and desire to enhance utility and autonomy does not necessarily mean that they do not recognize the significance of other values. To quote one of the champions of the law and economics movement, Judge Posner: "[Economics] does [not] answer the ultimate question of whether an efficient allocation of resources would be socially or ethically desirable." POSNER, *supra* note 2, at 14. In his other writings, however, Posner does deal with the question of whether an efficient allocation of resources is ethically desirable; he concludes it is. See Posner, *supra* note 18; Posner, *supra* note 21.

74. Of course, the rights of debentureholders, bondholders, noteholders, and general unsecured trade creditors will vary from corporation to corporation and, even within a single corporation, may break down into various classes or "series" that have different rights and obligations.

75. Under "human capital investors," I include "managers" (i.e., directors and officers) as a part of "employees." Therefore, I lump together in "employees" everyone from the most menial laborer to the chief executive officer.

for compensation and thus having a palpable interest in the future of the corporation. With regard to the investment in the corporation by employees, a body of scholarship argues that employees make human capital investments in the firms for which they work. One of the more compelling of these arguments posits that employees during the early years of their employment underprice their services to the firm in return for the implied promise that during the employees' last years of employment the firm will repay the employees for this investment of firm-specific human capital and, accordingly, pay the employee wages above the fair market value of such late career services.<sup>76</sup>

Assuming that the money investors and human capital investors are rational maximizers, they share an interest in maximizing the value of the corporation. All other matters being unchanged, these constituencies normally benefit from any move that increases the total value of the corporation. Thus, for example, if the corporation invests in a new machine or a new division or purchases a new subsidiary and the investment is profitable, all money investors and human capital investors should benefit from the purchase.<sup>77</sup> This leads to the rather simple, but important, conclusion that all of these constituencies, as rational maximizers, want managers to manage the corporation in a way that maximizes the overall value of the corporation.

On the other hand, as rational maximizers, each of the constituencies (and, indeed, each of the individual money investors and human capital investors) wants to appropriate for itself as much of the corporate value as possible. Thus, for example, rationally maximizing common shareholders desire a leveraged buyout of "their" company if they are thereby able to expropriate value from other constituencies, such as preferred shareholders, creditors, and employees. This claim of expropriation, of course, is

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Some commentators draw sharp distinctions between managers and employees regarding the need for fiduciary protections. Professor Coffee, for example, believes that managers are especially vulnerable to expropriation in takeovers. John C. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 73-86 (1986) (analyzing the problem of losing deferred compensation after a takeover). Professor O'Connor, on the other hand, opines that employees are much more vulnerable to expropriation. Maureen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty To Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1212-23 (1991).

Anyone considering directors as rational maximizers should read James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROBS. 83 (1985).

76. These theories are well explained by Katherine Van Wezel Stone in *Policing Employment Contracts Within the Nexus-of-Contracts Firm*, 43 U. TORONTO L.J. 353, 363-69 (1993) [hereinafter Stone, *Policing*]; Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON. L. REV. 45, 48-53 (1991) [hereinafter Stone, *Employees as Stakeholders*]; and O'Connor, *supra* note 75, at 1205-07.

77. The value of the residual claimants' investment increases because their income stream increases; the value of the fixed claimants' investment increases because their fixed stream of earnings becomes less risky.

at the heart of many of the classic corporate fiduciary cases, including those involving voluntary recapitalization that changes the rights of preferred shareholders,<sup>78</sup> leveraged buyouts that reduce the value of the corporation's debt instruments,<sup>79</sup> and the intra-constituency expropriation that occurs when, for example, majority common shareholders effect an affiliated merger at a price below the fair value of the affiliate.<sup>80</sup>

Managers, for two somewhat different reasons, are in a unique position in all of this. First, as rational maximizers, managers' first instinct is to garner as much as possible of the corporate value directly for themselves. Once managers have attained for themselves as much corporate value as is possible, their next desire is to appropriate value for the benefit of common stockholders. The reason managers attempt to promote the interest of common stockholders is that common stockholders appoint managers, a factor which makes it in managers' self-interest to please common stockholders. Everyone understands that stockholders' "appointment" of managers is somewhat indirect, but, for the purposes of this Article, the point is simple: as rational maximizers, managers would rather allocate value to common shareholders than allocate value to preferred shareholders, creditors, or employees.

The uniqueness of the managers' position is also a result of the fact that nearly no transaction that affects the absolute or relative wealth of investors can be accomplished without the involvement of at least some of the corporate managers. In many instances, for example, statutes require the approval of directors before such transactions affecting wealth can be accomplished. Obvious examples of this include dividend decisions, mergers, sales of assets, and recapitalizations accomplished by amendments to the articles of incorporation. Even in transactions structured to bypass managers, such as a tender for the majority of the outstanding common stock of a company, managers typically take steps that impact the outcome of the transaction. The most obvious, of course, are defensive tactics that managers may initiate to fight an unsolicited tender.

Finally, remote constituencies include groups whose well-being is integrally tied to the corporation's success and extends to groups that are so remote that corporate actions affect them only in a marginal or theoretical way. If one imagines, for example, a corporation with \$100 million in assets that is forced into bankruptcy and liquidation by a stupid management decision, the identification of remote constituencies becomes easier. Remote constituencies such as the bankrupt corporations suppliers and their constituencies (employees, suppliers, managers, investors, etc. of the suppliers) are harmed by the loss of the customer and, in an extreme case, could be devastated by the loss, depending on the percentages of the

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78. See *supra* notes 61-63 and accompanying text.

79. See discussion *infra* part V.B.

80. See *supra* notes 59-60 and accompanying text.

suppliers' business that the corporation represented. The community in which the business was located also suffers as a result. The nation as a whole suffers from the loss of a competitive unit. Indeed, the entire global economy may suffer, but, of course, at this point the harm becomes nearly or actually theoretical, and here the problem of breadth becomes most apparent.

The breadth of the protection of fiduciary principles must necessarily be limited by a perimeter. Although a number of commentators have argued for expansion of the present perimeter, which now encompasses only equity investors, little discussion has been generated regarding the appropriate outer limits of fiduciary protection for remote constituencies.

#### IV. PRINCIPLES AND IMPLEMENTATION

##### A. *Society's Fiduciary Principles*

The shape of corporate managers' fiduciary obligations should be determined by three principles. The first principle ("Principle Requiring Corporate Value Maximization") is that managers are obligated to maximize the value of the corporation. One should note that this principle is not that managers must maximize the value of shareholders' interests in the corporation, an application which may approximate the present fiduciary rule.<sup>81</sup> Instead, the Principle Requiring Corporate Value Maximization requires that managers' obligations be measured by reference to the corporation as a whole and not by reference to a single component of the corporation, such as the interests of the stockholders.

The second principle ("Principle Prohibiting Wealth Transfers") is that managers are obligated to refrain from effecting or facilitating inter-constituency or intra-constituency "wealth transfers," unless the losing investors have consented to the risk of the particular wealth transfer.<sup>82</sup> A "wealth transfer" is a redistribution of corporate wealth or value from one group (or person) to another group (or person). The Principle Prohibiting Wealth Transfers prohibits managers from taking action that, for example, transfers wealth from creditors to common stockholders or transfers wealth from common stockholders to managers themselves. These are examples of inter-constituency wealth transfers. The Principle Prohibiting

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81. Dean Robert Clark states that "from the traditional legal viewpoint, a corporation's directors and officers have a fiduciary duty to maximize shareholder wealth, subject to numerous duties to meet specific obligations to other groups affected by the corporation." ROBERT C. CLARK, *CORPORATE LAW* 678 (1986).

82. For purposes of this Article, "consent" is assumed to exist if the risk of the event is to some degree impounded on price. I leave for another day the question of whether such a definition of "consent" is well founded in moral theory, a subject that is explored and debated in the following articles: Posner, *supra* note 18; Coleman, *supra* note 13, at 531-40; and Dworkin, *supra* note 66, at 574-79.

Wealth Transfers also prohibits wealth transfers among members of a single constituency (intra-constituency), such as wealth transfers to majority common stockholders from minority common stockholders. These moves are permitted, however, if the parties subjected to the wealth transfer consented *ex ante* to the move.

The proper relationship between the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers requires that managers presented with a move that is wealth-enhancing but that also effects a wealth transfer must, to the extent possible, eliminate the wealth transfer and then make the move. Thus, managers cannot defend against a charge that they failed to make a wealth-maximizing move by claiming that the move also involved a wealth transfer, unless managers show that it was impossible to eliminate the wealth transfer.

The Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers are founded on Pareto criteria, since the principles together require managers to make all Pareto superior moves.<sup>83</sup> Furthermore, the relationship between the principles, as described in this section, requires management to make all Kaldor-Hicks efficient moves<sup>84</sup> and then turn the move into a Pareto superior move by arranging compensation from the winners to the losers. Although this sounds somewhat esoteric and mechanistically complicated, in real life these compensation payments typically should be easy for management to effect.<sup>85</sup>

The third principle ("Principle Permitting Gain Allocation") is that managers are free in their discretion to allocate among constituencies gains from transactions, except that managers cannot allocate such gains to themselves. This third principle is likely to be the most controversial and problematic of the three. On the one hand, some may argue that managers should be allowed, as an incentive, to participate in the value created in wealth-enhancing moves. Others may argue with equal vigor the unfairness of permitting managers to allocate all of a particular corporate gain to a favored constituent, such as common shareholders.

These three principles are meant to provide guidance for courts operating under traditional, general fiduciary standards, whether the standards are based on statutory or common law, and for legislatures enacting statutes related to

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83. A move is Pareto superior if no one is made worse off by the move and at least one person is made better off. See MURPHY & COLEMAN, *supra* note 24, at 182-85.

84. A move is Kaldor-Hicks efficient even if there are losers so long as the winners in the move could compensate the losers in the move, whether or not such compensation in fact occurs. See MURPHY & COLEMAN, *supra* note 24, at 186.

85. Morey W. McDaniel has opined similarly. Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121, 134 n.43 ("[M]anagers, acting as agents for all participants, can arrange cheaply, if not costlessly, for the necessary side payments."). McDaniel's fine works cited in this Article generally reflect views consistent with my own and helped crystalize my thinking regarding the fiduciary principle that I propose.

the fiduciary duties of managers. The reasons offered in support of the principles should be equally compelling to legislatures considering statutes dealing with managers' fiduciary duties and to courts interpreting managers' fiduciary obligations under broad standards. Further, as will be shown, a rational pursuit of the principles requires both judicial and legislative involvement, since as a result of legal process and practical considerations, a particular societal rulemaker (the legislature, for example) may be superior in a certain instance to another societal rulemaker (courts, for example).<sup>86</sup>

### B. *The Mandatory Application of the Three Principles*

Part II of this Article dealt with the matter of whether society should eliminate all mandated fiduciary duties for corporate managers and concluded that all such mandatory fiduciary duties should not be eliminated.

A similar, but more complex, matter must now be considered in light of the three principles of fiduciary duties proposed. Specifically, the following questions need to be answered. First, should the proposed principles be mandatory in whole, or in part? Second, if only a part of the principles are considered mandatory, how should society's decisionmakers determine which parts of the duties are mandatory and which parts may be limited by the parties?

As will be explained, the three fiduciary principles proposed are generally supported by values widely shared in society and are otherwise good principles.<sup>87</sup> As a result, the mandatory imposition of the whole of the principles on corporate managers and corporate constituencies would seem appropriate. An apparent problem with such an all-inclusive mandatory imposition of the principles, however, is that instances arise in which investors and corporate managers for legitimate reasons desire to construct an investment arrangement that is inconsistent with one of the principles and in which they are fully capable of evaluating and pricing the investment arrangement.<sup>88</sup>

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86. Neither the proposed principles nor this Article generally (at least to any significant extent) deal with the standards of care or allocations of the burdens of proof that are appropriate when investors claim that managers' violations of the proposed principles entitle them to some *ex post* settlement. With regard to such matters, however, the business judgment, proportionality, and intrinsic fairness tests, at least in a mechanistic matter, will continue to work well.

Thus, if investors claim that a decision of managers to purchase assets, defend against a hostile takeover, or effect an affiliated merger violates the Principle Requiring Corporate Value Maximization or violates the Principle Prohibiting Wealth Transfers, courts could (but would not be required by the proposed principles to) continue to use the business judgment, proportionality, and intrinsic fairness tests to establish managers' standards of conduct and obligations regarding the burdens of proof.

87. See discussion *infra* parts IV.D., IV.E., V.

88. In economic terms, to prohibit such parties from agreeing to the desired terms would be inefficient. Regulators do not generally dispute that economic efficiency is valuable. See *supra* note 72 and accompanying text.

As a way of explaining this dilemma, consider circumstances surrounding the construction and exercise of a redemption provision in a preferred stock contract.<sup>89</sup> The exercise of a redemption privilege is contrary to the best interests of the preferred stockholders who are subjected to the redemption, since if interest rates go down and, as a result, a preferred share of stock is worth more (but for the redemption provision), the preferred shareholders are better off if the corporate managers do not call the stock. Managers' exercise of a right of redemption, therefore, is a move that involves a transfer of wealth away from the preferred stockholders.

The reason managers should not be, and under today's fiduciary rules are not, required to forego the exercise of the redemption right is that the preferred stockholders contracted for and are paid to take the risk of redemption. In other words, preferred stockholders consented *ex ante* to the redemption,<sup>90</sup> and no third-party effects are apparent in the situation. This leads to the obvious, but highly generalized, conclusion that, at a minimum, any right to opt out of any part of the proposed fiduciary principles should be predicated on a clear demonstration of consent.

Regulators proffer different formulas to deal with the matter of when parties should be permitted to opt out of portions of mandatory fiduciary principles,<sup>91</sup> and Professor John Coffee's treatment of this matter is most attractive. While Professor Coffee (and, indeed, all of the Regulators) seeks to preserve the value of economic efficiency by permitting consenting parties to enter into arrangements that advance their own interests, assuming, of course, that no overriding third-party effects are present, he makes the fundamental, and thus predictable, Regulators' point out that "informational asymmetries and collective action problems [create] reason to doubt the market's ability to price" terms affecting fiduciary duties. Professor Coffee doubts the probability, in other words, of satisfactory levels of bargaining regarding the opting out of fiduciary duties.<sup>92</sup>

In addition to doubts regarding the adequacy of bargaining, the idea that investors would, at least in broad terms, opt out of the protection of the fiduciary principles proposed here is counterintuitive. If investors en-

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89. Although this problem does not involve an actual violation of the Principle Prohibiting Wealth Transfers, since the principle as stated permits the parties to consent to wealth transfers, it nonetheless provides a good example of the relationship between consent and the mandatory nature of the principles.

90. It is interesting to relate this example to Posner's use of consent and *ex ante* compensation in his discussion of the moral justification for the pursuit of wealth maximization by society. See Posner, *supra* note 18.

91. Two of the most extensive treatments of this are in Eisenberg, *supra* note 6, and Coffee, *Essay, supra* note 6. More generally, see Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Brudney, *supra* note 6.

92. Eisenberg also recognizes the value of permitting parties to contract in their own perceived best interests, and he attempts to protect that right in the corporate governance area, but his formula is more rigid than that of Professor Coffee's. See Eisenberg, *supra* note 6.

tirely opted out of the principle Requiring Corporate Value Maximization and the principle Prohibiting Wealth Transfers, for example, they would be saying to managers: “Here is my money for you to manage, but you are not required to try to increase the value of my investment, and it is permissible for you to give part of the value of my investment to other investors.” The facial absurdity of such an arrangement makes it highly unlikely that investors would knowingly consent to such an investment arrangement.

Generally, Professor Coffee proposes opt-out rules designed in part to ensure that any opting out involves a meaningful *ex ante* consent of the parties. Professor Coffee would require courts to find that any deviation from state-prescribed fiduciary duties is “accurately priced,” to ensure that “shareholders have been compensated” for the additional risk they assume by the altered fiduciary standards. Thus, he proposes that opting out should be predicated on a finding that the opt-out provision is “sufficiently specific and limited in its application that the parties reasonably could appreciate its likely impact. . . .”<sup>93</sup> Professor Coffee also retains a baseline mandatory duty that is not subject to any opting out. In his case, he proposes “good faith” as that standard.<sup>94</sup> All of this provides an attractive model for permissible opting out of the proposed principles, although my own view differs somewhat from Professor Coffee’s.

The Principle Requiring Corporate Value Maximization should be considered a mandatory rule, except that the parties should be permitted to consent to any level of care for managers down to, but not including, gross negligence. Two reasons support limiting the right to opt out at this level of care. First, an investor’s agreeing to a lower standard of care is so implausible as to make any claim of consent highly suspect. Such an agreement lowering the standard of care to gross negligence (or lower) would mean that the investor turns his or her money over to the corporate manager with the understanding that the manager may manage the money in a grossly negligent (or more culpable) manner. When one considers the informational asymmetries and collective action problems described by Professor Coffee, society should be unwilling to infer that investors opted for such an arrangement.

The second reason that opting out of the Principle Requiring Corporate Value Maximization should be limited at the gross negligence level is that lower standards of care facilitate the under-management of corporate assets to an unwarranted degree. As a general matter, Contractarians are correct to insist that assets, including corporate assets, should be moved into the hands of productive managers, and any rule that permits manag-

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93. Coffee, *Essay, supra* note 6, at 1665. Alternatively, Professor Coffee requires that the provision represent “the substitution of an adequate alternative procedure that the parties reasonably could believe would better serve their interests.” *Id.*

94. *Id.*

ers to manage corporate assets at the gross negligence level or lower is inconsistent with that goal.<sup>95</sup>

The prohibition of managers' effecting or facilitating wealth transfers, which is the heart of the Principle Prohibiting Wealth Transfers, is specifically made subject to the right of the investors to consent to the risk of the wealth transfer. Thus the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers are, to differing degrees, made subject to opting out through *ex ante* consent.

Following the lead of Professor Coffee, courts should be most reluctant to infer that investors consented to changes in the applicability of the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers and should require managers to overcome a strong burden against such opting out. Certainly, Professor Coffee is correct that such opting out must, at a minimum, be predicated on clear and specific language dealing with the particular matter. Thus, general language normally should be insufficient to opt out.

Admittedly, this approach will require some common law definition over time, but, in the interim, the pressures are just where they should be. Managers and other constituencies that stand to benefit from underpriced opting out terms should be provided with strong incentives to make certain that any opting out of the principles is clearly and specifically articulated and subjected to meaningful process and, thus, properly priced. Exposing managers and such constituencies to the risk that opting out will be ineffective is the best possible incentive for proper pricing.

Relatedly, one should not forget that managers control the process by which such opting out terms are constructed, implemented, and priced. Managers or their agents typically bear responsibility for drafting the opt-out provisions, and typically managers establish the process through which the corporation or the corporate constituencies "consent" to the opt-out provisions. Thus, saddling managers with the responsibility for eliminating market failures in this process is an efficient allocation of responsibility.

Finally, the Principle Permitting Gain Allocation should be considered entirely a default rule. The pressures in this situation are reversed from those at work in the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers. An agreement by managers and common stockholders to forego the benefit of the Principle Permitting Gain Allocation and to share corporate gains with other constituencies

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95. In an economic sense, of course, an efficient allocation of fiduciary duties may occur if owners and managers agree on a grossly negligent (or lower) standard of fiduciary care. On the other hand, such an arrangement can have third-party effects, since others in society may be willing to pay something to avoid such a waste of valuable societal assets. In any event, as described above, such an "agreement" between an owner and managers seems so unlikely that it is explainable only as a failure by the owner to understand the terms of the arrangement.

raises no concern that informational asymmetries and collective action problems make the level of bargaining suspect. Managers and stockholders, the constituencies that may be disadvantaged by the rebargaining of the default rule, are capable of protecting themselves by bargaining.

### C. *Breadth of the Principles—Remote Constituencies*

While it is not difficult to imagine that remote constituencies can be harmed significantly by the actions of managers and that society may be sympathetically inclined to provide protections for such groups,<sup>96</sup> courts would face insuperable complexity if they attempted under general fiduciary standards to apply the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers for the protection of remote constituencies. Suppose, for example, that courts interpreted managers' general fiduciary obligations in a manner that made the Principle Prohibiting Wealth Transfers protective of remote constituencies. In such a case, corporate managers would be unable to switch to a more efficient supplier of raw materials, since the move would not result in a Pareto superior state. The move would produce a loser, the abandoned supplier. Prohibiting a switch by the corporation to a more efficient supplier, however, is so antithetical to economic efficiency that no one seems willing to suggest its appropriateness. Such a rule would also so handcuff management that the corporation would be brought to a grinding halt. Management cannot run a corporation without adversely affecting someone. Not only is the idea silly, but also normatively it would be impossible for managers to implement.<sup>97</sup>

Finally, enforcing the principles on behalf of remote constituencies would generate impossible problems for courts. For example, consider the claims of communities and their inhabitants harmed by plant closings. Identifying, calculating, and managing the thousands of independent and vastly differing claims that would be generated are clearly beyond any reasonable capability of courts.

To conclude, however, that remote constituencies should have no general, court-enforced fiduciary right to the protection of the Principle Prohibiting Wealth Transfers says nothing about whether we should permit such constituencies to enforce the Principle Requiring Corporate Value Maximization, the obligation that managers maximize the value of the corpo-

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96. Professors Shleifer and Summers render a compelling description of the impact of a plant closing on remote constituencies. See Andrei Shleifer & Lawrence H. Summers, *The Effect of Takeover Activity on Corporate Research and Development*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33-54 (Alan J. Auerbach ed., 1988).

97. This, of course, is merely a restatement of the often voiced criticism of Pareto standards: that Pareto criteria are nearly useless in the real world because it is impossible to avoid losers in transactions. See MURPHY & COLEMAN, *supra* note 24, at 186; POSNER, *supra* note 2, at 14.

ration. Assume, for example that managers make a huge and exceedingly stupid investment that materially reduces the overall value of the corporation. If the community in which the company is located or the corporation's suppliers suffer as a result of the loss, one may be pressed to explain just why members of the community or the supplier should not be able to initiate a derivative suit on behalf of the corporation. This question is more difficult than the question of whether an inefficient supplier should be protected.

Ultimately, however, courts acting under a general fiduciary standard should deny remote constituencies the right to enforce the proposed principles, including the Principle Requiring Corporate Value Maximization. As will be described later, money investors and human capital investors should all have the right to enforce the obligation to maximize the value of the corporation. Permitting these broad groups such enforcement rights provides sufficient incentive to ensure that managers live up to their obligation to maximize the value of the corporation. Permitting a broad range of additional plaintiffs, such as remote constituencies, to enforce the Principle Requiring Corporate Value Maximization would likely add to agency costs without a corresponding increase in the quality of managers.

The harshness of this position, which is that managers should have no general, court-enforced fiduciary duties to remote constituencies, should not be overlooked, however. Certainly one feels sorry for a community, suppliers, and constituencies who, through no fault of their own, are adversely affected by the mismanagement of corporation. To make matters worse, by excluding remote constituencies from generalized fiduciary protection, managers, acting on behalf of the money investors and human capital investors, are not only permitted, but also required, to take every possible advantage of these remote constituencies. The obligation to increase the value of the "corporation," which now consists of the money investors and the human capital investors only, compels managers to make every possible move that shifts wealth from any remote constituency to money investors and human capital investors.

The proper response to these concerns requires legislative consideration. Thus, while it would be impossible or inappropriate for courts acting under general fiduciary standards to protect remote constituencies from losses of wealth that are caused by management decisions or mismanagement, a legislature could choose to deal statutorily with such losses. For example, a legislature could pass a plant closing bill that would require a six-month notice to the community before a plant could close. As another example, a legislature could require companies to pay closing fees to communities affected by closings. Each of these examples represents an attempt to deal *ex ante* with the losses of remote constituencies—losses that are caused by the pursuit of wealth maximization for investors and

that are impossible for courts to process and remedy under general fiduciary standards.

Each of these solutions is subject to criticism, of course. Contractarians would naturally claim that such laws are economically inefficient, and certainly such remedies represent inexact compensation for losses suffered by the remote constituencies. Nonetheless, legislatures could conclude that economic efficiency is trumped by other values and that an *ex ante* compensation schedule, while inexact, is the best society can do in the situation. In fact, a legislature may conclude that uncompensated losses visited on communities in such cases are unacceptable.

The point here is not to endorse these or any such measures, and the Article purposefully avoids any such endorsement. Instead, the point is that the concerns of society for remote constituencies can only be implemented through legislative action. If legislatures were to conclude that remote constituencies are deserving of protection from such losses, then clearly articulated *ex ante* rules that can be priced by the market may be attractive solutions, even if such solutions are necessarily imperfect.

*D. A Defense of the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers*

The Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers are based on Pareto criteria, which are demonstrably attractive to society. Accordingly, while the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers can be defended on numerous grounds, the principles rest most comfortably on broadly shared societal values.<sup>98</sup> Although one is able to find cases and statutes that are inconsistent with the principles (and, indeed, part of the purpose of this Article is to deal with these inconsistencies), the fact that legislatures and courts persistently return to these fundamental principles reflects a widely held view that it is inappropriate for corporate managers to fail to maximize the value of the corporation or engage in inter-constituency or intra-constituency wealth transfers.

Manifestations of society's commitment to these principles are easy to find.<sup>99</sup> For example, the obligation of corporate managers to maximize the value of the corporation has an obvious and strong family resemblance to the long-standing rule that corporate managers must operate corporations

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98. Like Judge Calabresi, I generally am willing to pursue "goals that are apparently adhered to by most people in society, even if with no great consistency." Calabresi, *supra* note 19, at 556.

99. The examples in this section are intended to be more general and thus are primarily limited to money investors. In part V.C., human capital investors are considered specifically and, at that point, arguments are offered for the view that manifested societal values support the extension of the principles to human capital investors.

in the best interests of the owners of corporations.<sup>100</sup> While over the years society has imposed certain limitations on these obligations and disagreements have at times erupted about the standards of care to which we hold various managers, no court or legislature has seriously considered abandoning this fundamental obligation.

The Principle Requiring Corporate Value Maximization is, perhaps, even more closely related to the right to bring a derivative action in order to remedy harms to the corporation from mismanagement. Although derivative actions normally can be pursued only by shareholders,<sup>101</sup> any recovery becomes a corporate asset and thus is available for claims of any constituency, including creditors and employees. Courts, in fact, have gone to some lengths to ensure that constituencies other than common stockholders are the beneficiaries of derivative actions.<sup>102</sup> The availability of these derivative rights is consistent with an obligation for corporate managers to maximize the total value of the corporation.

The Principle Requiring Corporate Value Maximization is also related to the bankruptcy rights of the constituencies. If a corporation is subjected to a bankruptcy proceeding, the trustee is required to gather all corporate assets, including any causes of action that the corporation may have. Thus, if managers have breached their fiduciary duties by not maximizing the value of the corporation for the owners, that claim passes to the trustee, who enforces it against managers. As in a derivative suit, the recovery from this claim becomes an asset of the bankrupt estate, which asset is then available to satisfy the claims of all claimants according to bankruptcy law.<sup>103</sup>

Society's aversion to corporate wealth transfers, an aversion which undergirds the second principle, is similarly visible through court deci-

100. CLARK, *supra* note 81, at 678 (1986) ("[F]rom the traditional legal viewpoint, a corporation's directors and officers have a fiduciary duty to maximize shareholder wealth . . ."); *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir.), *rev'd*, 481 U.S. 69 (1986) (Judge Posner states that a director's obligation is "stockholder wealth maximization.").

101. *See, e.g.*, RMBCA § 7.40(a) (1994). *But see* WILLIAM CARY & MELVIN A. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 936 & n.3 (1988) (stating that "a creditor . . . ordinarily has no right to bring a derivative action" but then stating in footnote three that "the rule is not entirely clear").

102. Courts have developed derivative suit rules that protect creditors. For example, courts have been most reluctant to permit a pro rata recovery in a derivative action but, instead, have concluded that the full corporate loss must be awarded to the corporation. *See* HARRY G. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS* § 373 (2d ed. 1970). One court explained the basis for the rule as follows:

One of the reasons why courts of equity have not allowed direct proportionate recoveries in stockholders' derivative suits has been that the recovery is an asset of the corporation, and its creditors have first claim upon it; and that to award such recovery direct to the stockholders leaving any creditors unpaid, would be fraudulent as to them.

*Liken v. Shaffer*, 64 F. Supp. 432, 441 (Iowa N.D. 1946).

103. *See generally* DANIEL R. COWANS, *II BANKRUPTCY LAW AND PRACTICE* 169-72 (6th ed. 1994).

sions and statutes. As examples, statutes that limit the payment of dividends to the amount of a company's earned surplus<sup>104</sup> and the rules that prohibit an insolvent corporation from paying dividends<sup>105</sup> are designed to control the transfer of wealth from creditors to shareholders. Fraudulent conveyance statutes,<sup>106</sup> the "fairness" limitation imposed on the rebargaining of rights under old Chapter 10 reorganizations,<sup>107</sup> and the limitations imposed by the Trust Indenture Act on rebargaining the terms of a qualified indenture<sup>108</sup> are other examples of legislative rules that are (or were) designed to limit expropriation of creditors' wealth.

The rules of society also protect preferred stockholders from the expropriation of their wealth by other constituencies. As was described in part II, courts, through the exercise of their general fiduciary powers, and legislatures, through the enactment of appraisal statutes, impose limitations on the concessions that can be extracted from preferred stockholders in single-company recapitalizations.<sup>109</sup>

Similarly, common law and statutes limit wealth transfers within a single constituency. Thus, as was previously discussed, minority common stockholders involved in an affiliated merger are protected against expropriation by the terms of the intrinsic fairness test and appraisal rights.<sup>110</sup>

Over the years, therefore, society has affirmed its commitment to manager obligations' to maximize the value of the corporation and refrain from wealth transfers. Admittedly, society has not always treated these matters with consistent rules and remedies, and thus, for example, today the black letter law is that managers owe no generalized fiduciary duties to a large portion of money investors (i.e., creditors) or to human capital

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104. See, e.g., MBCA § 45 (1991) (limiting payment of dividends to the amount of "earned surplus"). Even the RMBCA §§ 6.40 and 1.40(6) contain a similar, although significantly less restrictive, provision.

105. See, e.g., RMBCA § 6.40(c)(1) (1994).

106. See, e.g., UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 652 (1984); see generally Robert C. Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977). For an outstanding piece dealing with the problems of fraudulent conveyancing in the context of highly leveraged transactions, see Emily L. Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449 (1988).

107. Prior to the *Bankruptcy Act Reform Act* of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-1330 (1978)), bondholders in a Chapter X reorganization were protected by the absolute priority rule, which required that the consideration they received in the reorganization be "fair and equitable." See, e.g., Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 570-91 (1950). Although the 1978 Act changed the standard, it retained a limitation for the protection of bondholders. For an excellent discussion of this, see Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1828-29 (1992).

108. Security Trust Indenture Act of 1939, 15 U.S.C. § 77 (1994) (providing that an indenture cannot, unless unanimous permission is granted, permit a rebargaining of the right to receive principal or interest, except that interest may be postponed for up to three years by approval of 75% of the principal amount).

109. See *supra* notes 61-65 and accompanying text.

110. See *supra* notes 59-60 and accompanying text.

investors. Nonetheless, society at a more fundamental level has been unwilling to subject creditors and human capital investors to unfettered bargaining and has imposed significant protections for the benefit of such groups.

A second reason to pursue the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers is that they render good results. The principles protect legitimate expectations of investors, encourage maximum utilization of assets, promote fairness, and soften the hard edges of capitalism.

Regarding the expectations of investors, it is admittedly difficult to prove that those who invest money or human capital in a corporation price their investment based upon a *subjective* expectation that the managers of the corporation will operate the corporation in a way that maximizes its value and that the managers will refrain from subjecting the investors to wealth expropriations. Nonetheless, most investors appear to harbor essentially those expectations.<sup>111</sup> Returning to a point made earlier in this Article, contrary expectations would mean investors are saying to managers: "Here is my investment for you to manage. I do not expect you to try to increase the value of my investment, and you may give to any other investor part or all of the value of my investment." It is hard to imagine that risk-averse investors would select such an investment arrangement.<sup>112</sup>

The principles also encourage the productive utilization of assets since, for example, the principles prohibit corporate managers from significantly mismanaging corporate assets. Contractarians, of course, disputing the value of such a rule, claim that society should deploy assets in economically efficient ways and that economic efficiency is best achieved without mandatory rules.

In this regard, however, an economically inefficient allocation occurs only to the extent that the mandatorily imposed terms differ from the bargain that investors would strike with managers if contracting costs were zero. As discussed above, that fully informed investors would ever broadly elect out of the principles is not clear. In any event, even if the mandatorily imposed terms are different from those particular parties may choose, the only impact of imposing mandatory fiduciary duties on managers is that managers must sell (but will receive compensation for providing) more fiduciary duties than they otherwise would like and investors

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111. Some may argue that certain of today's investors, such as employees and creditors, have been so abused by managers over the years that investors expect only the most aggressive and selfish conduct from managers. If, in fact, this is the case, society should be concerned.

112. Subjective expectations, of course, can be altered by more complete information, and thus one may be uneasy in defending a particular fiduciary formula by reference to such ephemeral expectations. As described earlier, however, informational asymmetries, contracting difficulties, and the nearly bizarre nature of the resulting arrangements among the parties should make one most suspicious of claims that investors accepted and priced no, or insignificant, fiduciary protections from managers.

must buy (and will have to pay for) more duties than they otherwise would like. This result involves no major compromise either to economic efficiency or one's exercise of his or her personal autonomy and, in light of contracting difficulties among the parties, seems to be a sensible way to reduce the risk of undermanagement of corporate assets.

Finally, the Principle Prohibiting Wealth Transfers is supported by considerations of fairness and by the need to eliminate indecent managerial incentives and to soften the hard edges of capitalism, all of which can best be understood in light of today's situation. Today, fiduciary rules generally require managers to act only in the best interests of stockholders and not in the best interests of other constituencies.<sup>113</sup> As a result, managers are now permitted, and as rational maximizers have an economic incentive, to expropriate the wealth of employees and creditors in order to benefit shareholders and themselves.<sup>114</sup> Thus, in today's world, the incentive for managers is to lurk about, attempting to create or find and then exploit market imperfections and thus expropriate the wealth of disadvantaged creditors and employees.<sup>115</sup> In short, managers today have an economic incentive to create losers. The economic drubbing of bondholders, who were subjected to unanticipated highly leveraged transactions in the 1980s and, from years gone by, preferred shareholders, who were subjected to unanticipated managerial conduct and recapitalizations, are examples of such actions by managers.

Implicit in all of these discussions is the notion that the instrumental goal of economic efficiency and the more fundamental goals of maximization of utility or personal autonomy are not the only goals worth pursuing by society. Fairness and decency must be accommodated and promoted by society and, in the cases of the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers, those values predominate over any minor compromises in efficiency, utility, or autonomy generated by the principles.<sup>116</sup>

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113. See generally CLARK, *supra* note 81 (directors and officers have a fiduciary duty to maximize shareholder wealth); *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir.), *rev'd*, 481 U.S. 69 (1986) (directors' obligation is "stockholder wealth maximization").

114. Obviously, managers have an economic incentive to expropriate the wealth of non-stockholders (and others). Regarding today's legal rules, it is an interesting question whether managers are free to expropriate nonstockholder value for themselves or are required by their fiduciary obligations to stockholders to turn over all such expropriations to stockholders.

115. The suggestion of the Contractarians to eliminate all fiduciary protections leaves the economic incentives unchanged, since in all events managers have economic incentives to create and exploit market failures for the benefit of themselves and voting stockholders. If, under a Contractarian regime, managers were to opt out of their fiduciary duties to stockholders, then managers' ability to construct and exploit market failures in furtherance of wealth transfers favorable to themselves and voting stockholders would be unconstrained by legal criteria.

116. Most of us, assumedly, reject the notion that any single value or goal must drive all decisions but, instead, believe that more than one value is worth promoting. This point is made by Murphy and Coleman as they contrast utilitarianism and Kantianism: "[B]oth traditions do . . . seem highly plausible to most of us. We are inclined to think that each has an important

Other arguments against principles one and two are also unpersuasive. For instance, it is unpersuasive to argue that the principles, which will expand fiduciary protections to constituencies beyond stockholders, will subject managers to the impossible task of serving two masters.<sup>117</sup> In the first place, managers already serve multiple masters, including majority common shareholders, minority common shareholders, and preferred shareholders. As any student of corporate finance knows, those constituencies can have diametrically opposed interests. Second, a requirement that a fiduciary make allocative decisions is neither unmanageable nor unfair. Society constantly requires this of fiduciaries (and others), and the most obvious example of a fiduciary entrusted with allocative tasks is a judge. Managers (or judges) do, of course, need sensible and intelligible allocative rules, which, it is hoped, are offered in this Article.

Some may argue that the prohibition against wealth transfers discourages beneficial acquisitions, an argument best explained by the following example. Assume that the present value of X Co.'s assets is \$100 and the value is split evenly between creditors and common stockholders. X Co. purchases an operating subsidiary for \$20 and pays for the purchase by issuing new debt. Because managers are able to utilize the new assets efficiently, the move increases the total value of X Co.'s assets to \$140 (this includes the pre-existing value of the X Co. and the newly acquired subsidiary, plus \$20 in synergy resulting from the purchase), but the increased leverage reduces the value of the old creditors' interest to \$40 (i.e., the stockholders' value increases to \$80, but the old creditors' value decreases to \$40; the value of the new debt is assumed to be \$20). The move is value-maximizing, as demonstrated by the increased market price of the X Co.'s assets after the acquisition and, accordingly, should be encouraged. The problem, however, is that the move involves a wealth

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perspective to offer on ethics, even if we are unsure of just how to integrate them both into one coherent overall moral vision." MURPHY & COLEMAN, *supra* note 24, at 79.

For example, many of us may believe that one's exercise of personal autonomy may entitle him or her to burn a building that he or she owns. Perhaps the act is a form of protest against an unjust war; perhaps the owner simply feels the building is too ugly to continue standing. If, however, the building contains a Van Gogh painting or the only copy of an unpublished Mozart sonata, which, let us assume, the owner is unwilling to sell at any price but intends to burn with the building, some may conclude that society has a right in such a case to intervene to prevent the owner from burning his or her building or the art work. Perhaps one may base such a restraint on utilitarian notions and conclude that the utility to the owner generated by burning the building and its contents is less than the loss of utility to society from the destruction of such a treasure. Perhaps we articulate the reasons for protecting art treasures differently, and perhaps we even conclude (I would not) that personal autonomy trumps in this case and that the owner may burn the building and the painting. The point is, however, that most of us in looking at the problem would not fail to see that values other than personal autonomy must at least be considered in arriving at a solution to the question.

117. Thomas R. Hurst & Larry J. McGuinness, *The Corporation, The Bondholder and Fiduciary Duties*, 10 J.L. & COM. 187, 205 (1991).

transfer and thus apparently violates the Principle Prohibiting Wealth Transfers.

The proposed principles deal with this dilemma by a requirement that managers make all value-enhancing moves, such as acquiring the subsidiary, if it is possible to avoid the wealth transfer by side payments or other realignments among the investors. Stated otherwise, the requirement is that managers must make all moves that are Kaldor-Hicks efficient and then turn those moves into Pareto superior moves (to the extent that the moves are not already Pareto superior).

This requirement is especially attractive, since managers usually are in a perfect position to turn a Kaldor-Hicks efficient move into a Pareto superior move with little or no cost.<sup>118</sup> For example, in our hypothetical case, managers can easily eliminate the wealth transfer by increasing the interest rate on the old debt sufficiently to pay the creditors for the added risk resulting from the additional leverage.<sup>119</sup>

One final argument against the principles, specifically the Principle Prohibiting Wealth Transfers, is worth considering. Some argue that it would be unfair to stockholders now to extend to other constituencies pro-

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118. See, e.g., McDaniel, *supra* note 85, at 134 n.43 (“[M]anagers, acting as agents for all participants, can arrange cheaply, if not costlessly, for the necessary side payments.”).

119. Managers faced with a prohibition against wealth transfers but nonetheless acting as rational maximizers normally would seem inclined to acquire the subsidiary described in the text, even if managers were not legally required to do so. Managers’ self-interest prompts them to please common stockholders, because managers are appointed by common stockholders. Since stockholders would not be pleased if they were denied participation in the acquisition of the subsidiary, managers would take steps to complete the acquisition, which, in the face of a prohibition against wealth transfers, would require managers to eliminate the transfer of wealth away from creditors.

In certain instances, however, the interests of managers are aligned with creditors instead of common stockholders, see, e.g., Coffee, *supra* note 10, at 1519-21, necessitating an affirmative duty on managers that they convert a Kaldor-Hicks efficient move into a Pareto superior move instead of resisting the wealth-enhancing move on the grounds that the move also involves a wealth transfer. Consider, for example, a highly leveraged bid for a target, which bid may be wealth-enhancing as a total matter but at the same time, because of the new leverage, may depress the total value of the target’s public debt. If managers were not required to convert a Kaldor-Hicks efficient move into a Pareto superior move, managers might, in their own self-interest, resist such a bid, since the successful bid may cost managers their jobs. See Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 948-50 (1993) (pointing out that both managers and creditors may oppose a takeover, although managers oppose the takeover because of the potential loss of their jobs, while creditors oppose only the additional leverage).

Not only have commentators argued that at times managers’ interests parallel interests of creditors, but also commentators have argued that managers’ undiversified human capital investment in the corporation generates in managers a risk aversion that is more like that of creditors and thus less in line with the level of risk aversion of the common stockholders. As a result, managers may be disinclined to take on the additional debt in our hypothetical or to make the more risky investment, even if the investment increases the total value of the corporation. Regarding the risk aversion of managers, see Alison G. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1977-78); Reiner H. Kraakman, *Corporate Liability Strategies and the Cost of Legal Controls*, 93 YALE L.J. 857 (1994).

tection from wealth transfers, since it would involve a midstream correction that robs stockholders of part of the value of their bargain.<sup>120</sup> In essence, the argument is that stockholders have, through higher interest rates or other favorable terms, paid for the right to engage in wealth transfers and now to deny them that right would be unjust.

This argument fails definitionally, however. If, in fact, the risk of the wealth-diminishing move were priced at the time the investment was sold by the company, the Principle Prohibiting Wealth Transfers would not prohibit the move, since the Principle Prohibiting Wealth Transfers prohibits moves that diminish an investor's wealth only if the losing group of investors did not consent, and thus were not paid, to assume the risk of such a transaction. As a result, enforcing the Principle Prohibiting Wealth Transfers would prohibit only the exploitation of an unpriced risk or, stated alternatively, the exploitation of a market failure. This, then, eliminates any claim that imposing a prohibition against wealth transfers would result in a windfall for constituencies such as bondholders.

#### E. *A Defense of the Principle Permitting Gain Allocation*

The third proposed principle of corporate fiduciary duties is that managers are to be free to allocate gains in their discretion among corporate constituencies, except that management may not allocate to themselves. Of the principles proposed, this principle is the most problematic as a matter of theory and may be the most controversial politically.<sup>121</sup>

Unlike the situation with the Principle Requiring Corporate Value Maximization and Principle Prohibiting Wealth Transfers, broad manifestations of societal support for the idea of allowing managers to allocate corporate gains in their sole discretion (except to themselves) are difficult to find. In fact, little authority of any sort is available regarding the appropriate allocation of gains among corporate constituencies.<sup>122</sup>

Even at the intra-constituency level, one finds conflicting signals regarding the allocation of gains.<sup>123</sup> For example, regarding the allocation of gains among common stockholders, appraisal statutes, although a bit ambiguous, seem to permit majority stockholders to grab all corporate gains

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120. Hurst & McGuinness, *supra* note 117, at 202-04.

121. See McDaniel, *supra* note 85, at 136 (recognizing the potential for controversy in rules governing the allocation of gains).

122. McDaniel says that *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), "suggests that stockholders must share in any division of net gains and further that any benefits received by other stakeholders must be 'rationally related' to the benefits received by stockholders." *Id.* at 135-36.

123. This is not to imply that the same rule regarding the discretion to allocate gain should apply at the intra-constituency level as applies at the inter-constituency level. Different considerations may exist in the two situations. A discussion of the obligation to share gains at the intra-constituency level is beyond the scope of this Article and accordingly left for another day.

for themselves in mergers and other transactions involving organic corporate changes.<sup>124</sup> On the other hand, one finds support in case law for some obligation to share gains at the intra-constituency level. In *Levin v. The Great Western Sugar Co.*,<sup>125</sup> for example, the Third Circuit held that in an affiliated merger the minority shareholders "are entitled to a proportionate benefit in the merged corporation."<sup>126</sup> Similarly, near the end of the long and tortured trail of *Mills v. Electric Auto-Lite Co.*,<sup>127</sup> the Seventh Circuit, in constructing a remedy for a proxy violation in an affiliated merger case, also indicated that majority shareholders would not be permitted to grab all the synergy in an affiliated merger.

While it is difficult to base the Principle Permitting Gain Allocation on societal manifestations, a rule allowing managers discretion to allocate gains is supported on other grounds. First of all, such a rule is relatively efficient, since the complexities of allocative formulas make them impossible, or at least cost-prohibitive, for managers to apply in the real world.

Assume, for example, that the applicable allocation formula requires that gains be allocated among investors according to each investor's pro rata investment in the corporation.<sup>128</sup> Each management decision, in that case, would have to be preceded by a determination of the present values of all investments of each constituency, a measure of the anticipated gain, an estimation of the way the gain will fall among the various constituencies, and, finally, if the gain falls disproportionately, the steps can be taken to allocate the gain on a pro rata basis. Such requirements are unworkable for managers.<sup>129</sup>

Even allocative formulas that appear simple and manageable contain substantial complexities. For example, one rule that may be attractive to

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124. Under the MBCA, stockholders dissenting from the terms of a merger, for example, were entitled to receive "fair value" for their stock, but such fair value excluded "any appreciation or depreciation in anticipation of such corporate action unless such exclusion would be inequitable." MBCA § 81(a)(3) (1991). The RMBCA uses essentially the same language. RMBCA § 13.01(3) (1994).

125. 406 F.2d 1112 (3d Cir. 1969).

126. *Id.* at 1117.

127. 552 F.2d 1239 (7th Cir.), *cert. denied*, 434 U.S. 922, *reh'g denied*, 434 U.S. 1002 (1977).

128. McDaniel, whose work is both admirable and compelling, suggests a requirement that gains be shared with bondholders, although he states that "[a]n equal division of gain between bondholders and stockholders per dollar invested would lack a rational basis because a firm's stock is relatively more risky than its bonds." See McDaniel, *supra* note 58, at 257. He suggests a permissive allocation of gains to other constituencies. See McDaniel, *supra* note 85, at 136.

129. Requiring managers to allocate gains according to such a formula is much more complex than requiring managers to avoid wealth transfers. For example, moves by managers that decrease the value of creditors' investments in the company can be identified by reference to the market, either an external and active market or an inferred market. McDaniel also finds that a determination "of Pareto efficiency between bondholders and stockholders is a far simpler task" than allocating gains between the two constituencies. He believes that the "stock market and bond market provide ready answers" to the question of whether a move was Pareto superior. McDaniel, *supra* note 58, at 257.

some and that sounds simple to apply is a rule that requires all gains to be allocated to common stockholders. This apparently simple formula, however, contains significant application difficulties for managers. Again, an example is helpful.

Assume that managers operating under such an allocative formula purchase a new machine that adds substantially to the profit of the company. Although any net profits or earned surplus generated from the investment is allocated to the common stockholders, the increased earnings also increase (at least to some degree) the value of the investments of the fixed claimants. This increased value for the fixed claimants results from the fact that those parts of the earnings stream servicing the company's preferred stock and debt become safer, an effect that increases the present value of those parts of income streams. A portion of the gain from the investment, therefore, is allocated (albeit without specific action by the managers) to constituencies other than the common stockholders.

For management to take steps to ensure that all gains from all such transactions are allocated only to common stockholders would be difficult, and thus costly, or perhaps impossible. Literally, each management decision would have to be evaluated to determine whether there is gain, and then steps would have to be taken to make sure that only shareholders recognized gain. The complexity and costs of such decisionmaking are apparent and would be stifling to the efficient management of the corporation.

Nonetheless, the idea of allocating all or nearly all of corporate gains to junior equity is attractive.<sup>130</sup> First, such a result approximates the manifested expectations of the parties. Common stockholders, as residual claimants, expect and generally contract (although perhaps imperfectly) to receive nearly all corporate gains; that is the essence of their arrangement with the corporation and its other constituencies. As a corollary, fixed claimants agree to receive only the very limited gains that result from changes in the capitalization rate applicable to their fixed stream of earnings, changes which most typically result from a general shift in interest rates or an increase in the safety of the portion of the company's income stream against which they have claims.<sup>131</sup>

The second reason for allocating all, or nearly all, gains to common stockholders is that it encourages moves that are economically efficient

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130. The proposal of permitting managers to allocate gains is based to a significant degree on inferred consent. I am prepared to infer that fixed claimants manifest only the most limited expectations to share in corporate gains. By selecting an investment with a fixed return, such investors consent not to share in corporate gains, at least not to any significant degree. Regarding consent as a moral justification, see generally Posner, *supra* note 18.

131. McDaniel disagrees. Because "in bad times stakeholders must share in the losses," he reasons that "in good times stakeholders should be able to share in the gains." McDaniel *supra* note 85, at 135.

and thus usually beneficial to society.<sup>132</sup> Corporate transactions typically require the approval either of common stockholders or the corporate managers who were appointed by common stockholders and thus want to please common stockholders. Allocating gains to stockholders encourages stockholders and managers, acting as rational maximizers, to undertake profitable, and thus efficient, transactions.<sup>133</sup>

If one is convinced that allocating most, or all, corporate gains to common stockholders is sound but that mandatory allocation formulas are unworkable, then permitting managers discretion regarding the allocation of gains becomes attractive. The reason is that managers, as rational maximizers acting without an imposed standard, will be inclined to allocate nearly all corporate gains to common stockholders (assuming always that managers cannot allocate such gains to themselves). They will effect such an allocation in order to please common stockholders, who appoint them as managers. At the same time, managers are unlikely to engage in inefficient tactics to take every gain for stockholders but, instead, are likely to permit a certain amount of efficient slippage. Thus, in the example above involving the gain to fixed claimants from a profitable investment, managers would be unlikely to pursue such small gains on behalf of stockholders but would, instead, allow such gains to go to fixed claimants.

Managers, therefore, should be left unconstrained regarding the allocation of corporate gains, except they should be prohibited to allocate gains to themselves. Such managerial discretion avoids costly and essentially unworkable rules and results in an attractive allocation of corporate gains.<sup>134</sup>

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132. Obviously, such transactions are also encouraged by the Principle Requiring Corporate Value Maximization, which requires managers to make all moves that increase the value of the corporation. See Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 710 (1982).

133. The greatest incentive for value-maximizing transactions, of course, would come if the respective decisionmaker were allowed to keep all the gain. This proposition leads to the notion that managers should be able to keep all corporate gains, an idea I reject because it conflicts so fundamentally with the fiduciary concept.

134. No reason exists to fear that managers generally will allocate inappropriate amounts of gain to constituencies other than common stockholders, although such fears have been voiced. See McDaniel, *supra* note 85, at 136.

The point made by commentators, that the interests of managers are often more aligned with creditors than stockholders, does not lead to a conclusion that unfettered managers will allocate gains to bondholders. While such an alignment of interests may affect investment decisions (managers and creditors tend to be more risk-averse than shareholders, and thus managers may make investment decisions more agreeable to bondholders than stockholders) and decisions regarding defensive tactics (managers and creditors may consider it to be in their best interests to resist highly leveraged acquisitions of the company, even if the acquisition is in the best interests of stockholders), such ephemeral alignments provide no incentives for managers to allocate gains to bondholders, for example. See *generally supra* notes 125-27 and accompanying text.

## V. APPLICATION OF THE PRINCIPLES TO SELECTED MATTERS

### A. Introduction

The general defense of the proposed fiduciary principles in part IV of this Article left untreated numerous issues regarding the specific applications of the principles to particular investors or situations. While discussing all such issues is impossible, it is appropriate to deal with some of the more important or instructive applications of the principles. Such particularized discussions permit a better explanation of the reasoning underlying the expansion of the principles to the specific constituency or situation and demonstrate, it is hoped, the beneficial effects of the principles. The discussions also will show that a full implementation of the principles by society requires both legislative and court involvement.

### B. Creditors

Presently, managers owe no fiduciary duties to creditors of corporations.<sup>135</sup> This rule continues in nearly all situations and jurisdictions, even though some contrary authority has been generated over the years,<sup>136</sup> and

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135. The rule is long-standing that creditors generally have no right to enforce directly management's fiduciary obligations. See, e.g., HENRY W. BALLANTINE, CORPORATIONS 184 (rev. ed. 1946) ("Creditors have no direct right of action against directors or officers for mismanagement . . . by the better view."). Examples of cases supporting this position include *Nuclear Corp. of Am. v. Hale*, 355 F. Supp. 193 (Tex. N.D. 1973); *Skinner v. Hulsey*, 138 So. 769 (Fla. 1931); *Confick v. Houston Civic Opera Ass'n*, 99 S.W.2d 382, 385 (Tex. 1936) ("Directors are not personally liable to creditors for mismanagement, or for waste of assets except on proof of the commission of such fraud."); *Equitable Life & Cas. Ins. Co. v. Inland Printing Co.*, 484 P.2d 162 (Utah 1971); *Anderson v. Bundy*, 171 S.E. 501 (Va. 1933); *Wheeling Kitchen Equip. Co. v. R. & R. Sewing Center, Inc.*, 179 S.E.2d 587 (W. Va. 1971); *Inter-Ocean Cas. Co. v. Lecony Smokeless Fuel Co.*, 17 S.E.2d 51 (W. Va. 1941). See also the cases cited in RALPH J. BAKER & WILLIAM L. CARY, CASES AND MATERIALS ON CORPORATIONS 610 (3d ed. 1959).

Similarly, creditors generally have not been permitted to enforce fiduciary claims against management derivatively in the right of the corporation. See, e.g., RMBCA § 7.41(a) (1994) (predicating the right to institute a derivative suit on one's having been a "shareholder of the corporation when the transaction complained of occurred"). A similar position is taken in AMERICAN LAW INSTITUTE, II PRINCIPLES OF CORPORATE GOVERNANCE § 7.02 (1994). Again, this is a long-standing general rule. See BALLANTINE, *supra*, at 351.

Courts have used various reasons for not extending fiduciary protection to creditors, reasons including that management is not a trustee for creditors, *Skinner*, 138 So. at 770 ("It is difficult to perceive upon what principle a director of a corporation can be considered a trustee of its creditors."); *Whitfield v. Kern*, 192 A. 48, 55 (N.J. 1937) (stating that management is not the agent for creditors).

136. See, e.g., *Swinney v. Keebler Corp.*, 329 F. Supp. 216 (D.S.C. 1971). *Swinney* is one of the most intriguing, and the most overlooked, of the cases indicating that corporate managers owe fiduciary duties to creditors. Although the Fourth Circuit reversed the lower court's holding that creditors could recover for the breach of fiduciary duties, *Swinney v. Keebler Corp.*, 480 F.2d 573 (4th Cir. 1973), the reversal was based on the appellate court's determination that the fiduciary had acted reasonably in the circumstances. The appellate court did not reject the right of creditors to enforce fiduciary obligations and stated that "if the sell-

even though some commentators have argued vigorously in favor of expanding the protection of fiduciary duties to include creditors,<sup>137</sup> a line of argument that appears to have intensified recently.<sup>138</sup>

To a large extent, this heightened interest in creditors is due to the numerous<sup>139</sup> and widely publicized<sup>140</sup> highly leveraged acquisitions of the 1980s. It seems uncontested that as a result of these transactions bondholders lost many millions of dollars.<sup>141</sup> In the RJR Nabisco acquisition

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ers of control are in a position to foresee the likelihood of fraud on the corporation, including its creditors . . . or on the remaining stockholders, at the hands of the transferee, their fiduciary duty imposes a positive duty to investigate. . . ." *Id.* at 578 (citations omitted). Other cases indicating that creditors may be owed some sort of fiduciary duty include *Pepper v. Litton*, 308 U.S. 295 (1939); *United States v. AT&T*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd mem. sub nom. Maryland v. United States*, 460 U.S. 1001 (1983); *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981); *Western Producers Coop. v. Great Western United Corp.*, 613 P.2d 873 (Colo. 1980); *Steinberg v. Blaine*, 17 S.W.2d 286, 288 (Ark. 1929); *Johnson v. Coleman*, 20 S.W.2d 186 (Ark. 1929); *Anthony v. Jeffress*, 90 S.E. 414 (N.C. 1916); *W. H. Elliot & Sons Co. v. Gotthardt*, 305 F.2d 544 (1st Cir. 1962); *Goodwin v. Whitener*, 138 S.E.2d 232 (N.C. 1964); *Ford Motor Credit Co. v. Minges*, 473 F.2d 918 (4th Cir. 1973) (applying North Carolina law); *Underwood v. Stafford*, 155 S.E.2d 211 (N.C. 1967). Clearly, however, the substantial majority rule is that creditors are owed no fiduciary duties. *See, e.g., Pittsburgh Terminal Corp. v. Baltimore & O.R.R. Co.*, 680 F.2d 933, 941 (3d Cir.), *cert. denied*, 459 U.S. 1056 (1982); *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133 (Del. 1975). Professor Mitchell correctly states that "scholars supporting expanded bondholder rights do not have a great deal of law supporting them." Mitchell, *supra* note 46, at 1169 n.11.

137. *See* Rutheford B. Campbell Jr., *Limited Liability for Corporate Shareholders: Myth or Matter-of-Fact*, 63 KY. L.J. 23, 55-71 (1975).

138. *See generally* Albert H. Barkey, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 CREIGHTON L. REV. 47 (1986); William W. Bratton Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92; Hurst & McGuinness, *supra* note 117; Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986); McDaniel, *supra* note 58; Mitchell, *supra* note 46. The thinking in this area has been helped by works on closely related subjects. *See, e.g.,* James J. Hanks, *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991); Kahan & Klausner, *supra* note 119; McDaniel, *supra* note 85 (arguing for the use of Pareto concepts in interpreting constituency statutes); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

139. Two authors report that more than 230 companies were involved in "event risk" transactions between 1984 and 1989. Hurst & McGuinness, *supra* note 117, at 190 n.14. The authors defined "event risk" transactions as "corporate activity which results in a downgrading of the credit rating of corporate debt obligations." This includes leveraged buyouts. *Id.* at n.15. Two other authors report that from 1984 through 1988, the bonds of 183 companies "lost value as a result of mergers, acquisitions or leveraged buyouts." Kahan & Klausner, *supra* note 119, at 933 n.2.

140. Probably the most famous of the cases continues to be the RJR Nabisco acquisition. *See* Deborah A. DeMott, *Introduction—The Biggest Deal Ever*, 1989 DUKE L.J. 1.

141. Kahan & Klausner, *supra* note 119, at 933 ("[L]everaged acquisitions and recapitalizations transformed blue-chip bonds valued in the tens of billions of dollars into speculative-grade 'junk'."); Hurst & McGuinness, *supra* note 117, at 187-91. McDaniel refers to the losses of bondholders as "possibly the largest expropriation of investors in American business history." MacDaniel, *supra* note 58, at 206. At least some commentators characterize these

alone, for example, estimates are that bondholders lost \$40 million following the announcement of the acquisition.<sup>142</sup> Interestingly, stockholders gained,<sup>143</sup> studies indicate,<sup>144</sup> even more than bondholders lost.<sup>145</sup>

The lack of fiduciary protection for creditors is especially curious when considered in light of the societal manifestations that creditors should be protected from harmful actions at the hands of common stockholders and corporate managers. Some of these societal manifestations were described in part IV of this Article and include limitations on dividend payments, prohibition of fraudulent conveyances, bankruptcy rules, and limitations imposed by the Trust Indenture Act.<sup>146</sup> As argued more generally in part IV, the societal values reflected by such manifestations support an expansion of generalized fiduciary protections to creditors.

Applying the fiduciary principles of this Article for the protection of creditors not only will be consistent with such manifested values of society but also will eliminate an indefensible distinction between money investors who purchase equity instruments (stockholders) and money investors who purchase debt instruments (creditors). Considered at any level, creditors' claims for fiduciary protection are at least as strong as stockholders'.<sup>147</sup>

transactions as wealth transfers. See, e.g., McDaniel, *supra* note 85, at 124; Coffee, *supra* note 10, at 1498.

142. James Sterngold, *Kohlberg Leads Latest Nabisco Bids*, N.Y. TIMES, Nov. 30, 1988, at D1; see generally DeMott, *supra* note 146.

143. Bernard Black & Joseph A. Grundfest, *Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986: \$162 Billion Is a Lot of Money*, J. APPLIED CORP. FIN. 5 (Spr. 1988) (estimating that stockholder wealth increased \$162 billion during the period as a result of takeovers); see also Greg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 51-53 (1988) (citing studies regarding shareholder gains in takeovers).

144. See the results of studies reported in Kahn & Klausner, *supra* note 119, at 940 ("Studies show that the gains to shareholders from both hostile and friendly acquisitions, on average, far exceed losses to bondholders."); see also Coffee, *supra* note 10, at 1515-1521.

145. In economic terms, this result should not be surprising since the result indicates that common stockholders were able to expropriate value from other constituencies and appropriate some or all of the value of efficiency gains generated by the transaction.

146. See *supra* notes 104-08 and accompanying text.

147. The similarity in the positions of debtholders and equityholders was recognized years ago by scholars. See ADOLPH A. BERLE, JR., *STUDIES IN THE LAW OF CORPORATION FINANCE* 156 (1928); Jerome Frank, *Adolph A. Berle's The Modern Corporation and Private Property*, 42 YALE L.J. 989, 992 (1933) (book review); ARTHUR S. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 166-67 (5th ed. 1953).

More recently, Easterbrook and Fischel opined regarding the similarity of debt and equity. See Frank H. Easterbrook & Daniel F. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 274 n.8 (1986) (noting "no fundamental difference between debt and equity claims from an economic perspective"); see also William H. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 114-16; Campbell, *supra* note 137, at 64-67; McDaniel, *supra* note 58, at 218-21. Professor Mitchell seems to agree that bondholders and stockholders are generally in similar circumstances, but he would shape fiduciary obligations to bondholders as a function of whether the situation involves a "vertical relationship" or a "horizontal relationship." Mitchell, *supra* note 46, at

First, creditors' relationships with the corporation are fundamentally the same as stockholders. Creditors, like stockholders, invest value and depend on management for their return. Managers' actions that reduce the value of the corporation as a whole hurt creditors in the same fashion that such actions hurt shareholders. In some instances, the harm to creditors or shareholders may be so slight as to seem only theoretical; at other times, the harm may completely eliminate the investment of the creditors or stockholders.

Similarly, at the bargaining stage, the abilities of investors to protect themselves by negotiating and pricing risks are essentially the same, whether they purchase debt instruments or equity instruments from the corporation. Debt and equity are sold in the same types of transactions. Both can be privately placed and sold publicly in underwritten transactions.<sup>148</sup> In underwritten offerings, the players and the pressures are essentially the same in debt and equity offerings. The underwriter in each situation has the same incentive (or lack of incentive) to bargain hard and price aggressively.<sup>149</sup> Indenture trustees, everyone concedes, are uninvolved in the bargaining and pricing process of debt,<sup>150</sup> and thus their presence in no way eliminates the need for fiduciary protections.

All of this indicates, then, that the risk of market failures, which is, as previously suggested, one reason society continues to enforce fiduciary duties in favor of stockholders, is at least as great for creditors as for stockholders.<sup>151</sup>

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1180-89. *But see* Hurst & McGuinness, *supra* note 117, at 191-92 (outlining the "investment theory," but opining that "the legitimate expectations of the two groups of security holders differ significantly").

148. On average, one may assume that those purchasing debt from issuers in private transactions are better able to protect themselves through bargaining than are those who purchase debt from issuers in public offerings. Typically, such private purchasers have more access to information, have more at stake, and are more sophisticated than are public purchasers. *See* Brudney, *supra* note 106, at 1830-31. Brudney points out, however, that not all private purchasers of debt are on equal footing. *See* Brudney, *supra* note 107, 1830 n.20. The same, of course, is true with regard to purchasers of publicly issued and privately issued equity. McDaniel argues that one of the important changes in the bond market in recent years is the "significant participation by individual investors. The bond market no longer is (if it ever was) the exclusive domain of institutional investors able to fend for themselves." McDaniel, *supra* note 138, at 415.

149. *See* Mitchell, *supra* note 46, at 1183; Bratton, *supra* note 147, at 156 (dealing with debt offerings); *see also* Eisenberg, *supra* note 6, at 1518-19 (dealing with equity issues).

150. *See, e.g.*, Brudney, *supra* note 107, at 1830-31; Mitchell, *supra* note 46, at 1183; McDaniel, *supra* note 138, at 429-31.

151. *See* William W. Batton, *The Economics and Jurisprudence of Convertible Bonds*, 84 WIS. L. REV. 667, 715 (1984) (discussing the inability of bond purchasers to protect themselves through the bargaining process); Brudney, *supra* note 107, at 1830 & n.20 (discussing the especially disadvantaged position of purchasers of publicly issued debt and citing authority for the argument that "the substantial erosion of protective covenants in publicly issued bonds after 1970 was not readily appreciated by investors or digested by the market until debtors made that erosion apparent in the mid-1980s"); Mitchell, *supra* note 46, at 1181-86 (discussing the structural bases for market failures in the sale of debt instruments). *But see* Kahn & Klaus-

The need of creditors for broad fiduciary protections is not sufficiently ameliorated by any alignment of interests between themselves and managers. As previously noted,<sup>152</sup> some commentators have observed that managers and creditors share certain common interests in the management of the corporation<sup>153</sup> and, thus, that managers, by pursuing their own self-interest will protect the interests of creditors.<sup>154</sup> The argument is made, for example, that managers' investment policies may be more aligned with creditors' interests, since both have limited, but prior, claims against the corporation's earnings and thus favor a conservative investment policy for the corporation.<sup>155</sup> Relatedly, commentators have observed that managers and creditors share an interest in avoiding a hostile, highly leveraged takeover.<sup>156</sup> Thus, one may argue that, as a result of this alignment of interests, creditors need less fiduciary protection.

The alignment in the interests of managers and creditors is less than complete, however.<sup>157</sup> Thus, even conceding that managers and creditors share similar interests in the investment policies and defensive tactics, managers otherwise usually retain an economic interest in moves that transfer wealth from creditors to voting stockholders and themselves. Viewed somewhat differently, the fact that corporate managers in constructing an investment policy or in evaluating and defending against a hostile, highly leveraged takeover may, in their own self-interest, eschew wealth-maximizing transactions and also transfer wealth from stockholders to themselves, and thus inadvertently also transfer wealth to creditors, means only that we should protect stockholders from such activity under fiduciary principles. Such anticipated responses by managers in those situations is not a basis for abandoning creditors, since many opportuni-

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ner, *supra* note 119, at 981 ("Our findings are inconsistent with those commentators who claim that bondholders cannot obtain effective contractual protection."); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 182 (Purchasers of fixed corporate claims "will . . . adjust the price they pay for their fixed claims to compensate themselves for the prospect that shareholders will make subsequent wealth transfers."); Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, 43 TORONTO L.J. 315, 344-45 (1993) (finding that creditors are adequately protected by the market and their ability to bargain).

152. See *supra* note 119 and accompanying text.

153. See, e.g., Macey, *supra* note 151, at 182.

154. See, e.g., McDaniel, *supra* note 138, at 433-34.

155. Regarding the risk aversion of managers, see Allison G. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 785 n.141 (1978); cf. Reinier H. Kraakman, *Corporate Liability Strategies and the Cost of Legal Controls*, 93 YALE L.J. 857, 862-64 (1984).

Jensen and Meckling liken managers' salary claims to a quasi-debt. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 353-54 (1976).

156. Coffee, *supra* note 10, at 1519-21.

157. See *supra* note 119 and accompanying text.

ties also exist for managers to engage in wealth transfers away from creditors.

Commentators have also pointed out that the competition in the financial markets diminishes the need to extend generalized fiduciary protections to creditors. The argument is that the incentive to cause wealth transfers away from creditors is diminished by the costs of such transactions to the other constituencies, such as stockholders. Thus, if the managers and stockholders expropriate the creditors' value, the next creditors will have to be paid to take the risk of a repeat of the expropriation. This risk results in a higher interest rate on future debt offerings and thus increases the cost of capital for the corporation.<sup>158</sup>

Another way that some commentators have explained this matter is by arguing that the company is able to sell an original debt offering without either protective covenants or a commensurately higher interest rate by posting a "bond" backed by the company's "reputational capital." The "promise" supported by the bond is that the company will not take certain action (effecting a highly leveraged transaction, for example), even though there is no express prohibition of the action in the indenture. If the company takes the particular action, it will accordingly violate the terms of the bond and thus forfeit its reputational capital.<sup>159</sup>

Two points must be made about this argument. First, even if one is convinced that corporations do post a reputational bond, Karl Llewellyn's analysis from years ago has proven correct.<sup>160</sup> Corporations are quite willing to sacrifice the bond if the stakes are high enough, as has been the case with leveraged buyouts.<sup>161</sup> The reputational bonds, therefore, are at best only partial protections.<sup>162</sup>

Second, the forfeiture of a corporation's reputational bond in no way compensates the party who was harmed as a result of the company's failure to live up to its implied promise. Thus, although the unanticipated

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158. McDaniel, *supra*, note 138, at 434 ("A company with a reputation for hurting its bondholders will find it more difficult to sell bonds in the future.").

159. For descriptions of this argument, see Hurst & McGuinness, *supra* note 117, at 197; McDaniel, *supra* note 58, at 238. See also John Kose & David C. Nachman, *Risky Debt, Investment Incentives and Reputation in a Sequential Equilibrium*, 40 J. FIN. 863, 876 (1985); Ileen Malitz, *On Financial Contracting: The Determinants of Bond Covenants*, 1986 15 FIN. MGMT. 18, 24-25.

160. Karl N. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704, 722 (1931).

161. With regard to the recent highly leveraged transactions and the impact on bondholders, Professor Coffee concluded: "[H]aving convinced bondholders to delete most negative covenants for reasons that seem plausibly in their mutual self-interest, managements have exploited that trust when faced with shareholder pressures that might otherwise result in their ouster." Coffee, *supra* note 10, at 1515.

162. Both Hurst and McGuinness, and McDaniel agree. See Hurst & McGuinness, *supra* note 117, at 198 (It "appears that the bondholders' reliance on the reputational capital of major corporations . . . was misplaced."); McDaniel, *supra* note 58, at 238 ("When covenants are incomplete and the company is in extremis, reputation does not fill the gap.").

highly leveraged transaction may increase the company's cost of debt in future deals, none of that additional expense goes to the existing creditors subjected to a wealth transfer as a result of the highly leveraged transaction. The surrender of the reputational bond fails to pay the original creditors for any harm that they suffer.

Paradoxically, instead of protecting creditors, market pressures, most specifically the market for corporate control, actually exacerbate the vulnerability of creditors and thus make the case for fiduciary protection of creditors even more compelling than the case for fiduciary protections of stockholders.

The therapeutic value of the market for corporate control has been much heralded.<sup>163</sup> The fundamental idea is that if management operates inefficiently, a hostile bidder will purchase all the stock of the company, kick out the inefficient management, and reap the financial benefits of providing better management for the assets of the target company. Thus, the fear of the hostile takeover and management's potential loss of employment encourages management to operate in a way that maximizes the value of the interests of the stockholders.<sup>164</sup> This pressure seems to diminish any need for mandatory fiduciary duties imposed by law.

Unfortunately for creditors, just as the market for corporate control puts pressure on management to manage the corporation in a way that maximizes the value of the interests of the stockholders, the competition for corporate control puts pressure on management to *minimize* the value of creditors' investment by making all possible wealth transfers from creditors to stockholders. The pressure on management is to maximize the value of the interests of stockholders from all sources.

Unless management acts to expropriate for stockholders as much of creditors' investment as is economically possible, a hostile bidder may buy all the common stock of the company, install its own managers, expropriate creditors' value, and reap the financial benefit of its expropriation. To avoid the threat of this hostile takeover, management must deliver to stockholders all value from all sources, including expropriation. If managers are rational maximizers, they will act to expropriate creditors' value in all situations where such action is economically possible.

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163. Commentators have made strong claims about the pervasiveness of the benefits of the market for corporate control. For example, to counter the late Professor Cary's argument that the states are in a "race for the bottom" in which they each compete for corporate charters by minimizing investor protection, see William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 88 *YALE L.J.* 663 (1974), some commentators argued that the competition for corporate control neutralizes the harmful impact of such competition, see Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUD.* 251 (1977).

164. Easterbrook & Fischel, *supra* note 48, at 1169-74 (1981); Kahan & Klausner, *supra* note 138, at 944; Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 *J. POL. ECON.* 110, 113 (1965).

All of this creates the worst possible situation. It is capitalism at its worst, in essence creating a market for market failures. Management, as rational maximizers, will construct market failures, situations in which creditors are fooled about the risk they assume and thus not paid to take the risk. Then, as rational maximizers, management will exploit the situation by expropriating the creditors' value and if they fail to exploit the situation, a hostile bidder may do so after it acquires the company and fires the managers.

Finally, no mechanistic or structural impediments prevent the extension of fiduciary protection to creditors. Derivative suits, for example, will work well for creditors enforcing their general fiduciary rights.<sup>165</sup> In fact, extending derivative rights to creditors will eliminate a long-standing anomaly in derivative actions.<sup>166</sup>

Although today corporate managers owe fiduciary duties only to shareholders, a derivative action against a manager for a breach of the manager's fiduciary duty is brought in the right of the corporation, and any recovery is paid to the corporation and is for the benefit of all investors, including creditors.<sup>167</sup> This remedy is obviously inconsistent with the underlying duty of managers to shareholders only. This duty, if enforced in a conceptually consistent way, would lead only to a direct right in shareholders to pursue a remedy as an individual or as part of a class action.

A derivative suit, however, works conceptually well under the proposed principles. A derivative action could be initiated by any investor, and any recovery would be paid to the corporation, with the rights of the investors to the recovery determined by contract and fiduciary duties.

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165. Dean Prunty's work on the origins of the derivative suit lends support for the appropriateness of permitting creditors to enforce rights through a derivative action. See Bert S. Prunty, *The Shareholders Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. REV. 980, 992, 994 (1957) ("[T]he origin of the derivative suit . . . lies in judicial recognition of a new wrong or maladjustment for which pre-existing legal procedures proved more or less inadequate." The derivative suit "was born and nurtured as a corrective for managerial abuse in economic units which by their nature deprived some participants of an effective voice in their administration.").

Professors Coffee and Schwartz, however, argue against permitting creditors to institute derivative suits on the grounds that such a change would chill socially useful risk taking. See John C. Coffee & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 313 n.277 (1981).

166. As previously discussed, creditors presently have no right to enforce claims through derivative actions. See *supra* notes 135-38 and accompanying text.

167. In administering derivative suits, courts have developed rules that protect creditors. See *supra* note 102 and accompanying text.

### C. Employees

The expansion of fiduciary principles to protect employees can be justified on the basis of widely shared societal values, but the matter is complex and the debate is emotionally charged.

Predictably, the Contractarians argue against fiduciary duties for employees by claiming that society is better off allowing employees and corporations to work out their own arrangements regarding fiduciary duties and other terms of the employment contract.<sup>168</sup> They imagine that employees are able to protect themselves by bargaining with their employers. Contractarians seem to consider the terms of an employment contract the "routine stuff of ordinary life" that employees are able to manage.<sup>169</sup> Consent of the parties, therefore, eliminates any claim of unfairness, so the argument goes.<sup>170</sup>

The Contractarians also argue that firms have a strong economic interest in treating employees fairly.<sup>171</sup> Unfair treatment of employees imposes costs on the corporation, since, for example, to fire unfairly a productive employee costs the firm a good employee, creates morale problems for remaining workers,<sup>172</sup> and makes recruitment of future workers more difficult.<sup>173</sup> Corporations, it is argued, attempt to avoid these costs by treating employees fairly,<sup>174</sup> and this self-imposed aspect lessens the need for any state-imposed, mandatory protections for employees.<sup>175</sup>

168. Presenting this position powerfully, Professor Epstein imagines as facts employees with the capability to understand employment arrangements ("we are dealing with the routine stuff of ordinary life; people who are competent enough to marry, vote, and pray are not unable to protect themselves in their day-to-day business transactions") and who, in fact, generally understand their employment arrangements ("nor is there any reason to believe that such contracts are marred by misapprehensions, since employers and employees know the footing on which they have contracted"). Epstein, *In Defense*, *supra* note 28, at 954-55. Such facts, of course, are essential to the Contractarians' position. See Daniels, *supra* note 39, at 327.

169. Epstein, *In Defense*, *supra* note 28, at 954. Professor Macey is less assertive factually, although he arrives at the same result. He concludes that employees do make investments in firms and are subject to expropriation but that, nonetheless, matters are best left to private arrangements. Macey, *supra* note 157, at 176, 188-92, 200-01.

170. Epstein, *In Defense*, *supra* note 28, at 953-55.

171. This is the same argument proffered regarding the expropriation of creditors' value. Specifically, Contractarians argue that the corporation will not expropriate creditors' value because it raises the corporation's future cost of capital. See *supra* notes 158-62 and accompanying text.

172. See, e.g., Clive Bull, *The Existence of Self-Enforcing Implicit Contracts*, 102 Q.J. OF ECON. 147, 149-54 (1987).

173. Macey, *supra* note 151, at 192 ("employer's need to maintain its reputation in the community and to attract new workers in the future will tend to discourage exploitation"); Epstein, *In Defense*, *supra* note 28, at 967-68, 970, 974.

174. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 259-61 (1985); William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 405-12 (1990); Costas Azariadis & Joseph E. Stiglitz, *Implicit Contracts and Fixed Price Equilibria*, 98 Q.J. ECON. 1, 15-19 (Supp. 1983).

175. For a description of these arguments, see Daniels, *supra* note 39, at 336-40.

The Regulators, on the other hand, predictably dispute the factual underpinnings of the Contractarians' position. In part, the Regulators' view of employees is shaped by a theory that scholars have developed and that likens employees to money investors in the corporation. Proponents of this theory argue that employees, instead of investing money in the corporation, which is the case with stockholders and creditors, invest their own human capital in the corporation<sup>176</sup> and have legitimate expectations of a return on their investments.<sup>177</sup>

The factual assumptions of this scholarship are that employees during the early years of employment by their firms are paid at levels below their opportunity wages and their marginal productivity.<sup>178</sup> Employees are willing to accept these lower wages because of an implied promise of job security and wages greater than their marginal productivity during the latter part of the employees' careers. This "implicit contract" between employees and their employers benefits the companies in the early years of employment and protects workers during the later years of their employment.<sup>179</sup>

These scholars argue, however, that a real risk exists that the employers will opportunistically breach the implicit contract. An employer (i.e., the corporation or, more appropriately, the other constituencies of the corporation, such as common stockholders) acting as a rational maximizer may find it to be in furtherance of its own economic interest not to live up to the implied promise of job security and wages above the employee's marginal productivity.<sup>180</sup> These arguments are perhaps most powerfully made in the context of corporate takeovers, where commentators contend

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176. See, e.g., Joseph W. Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 621 (1988); Clyde W. Summers, *Labor Law as the Century Turns: A Changing of the Guard*, 67 NEB. L. REV. 7, 15-16 (1988); David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 234-35 (1991).

177. Recent scholarship arguing that employee investments of human capital necessitate extra-contractual protection for the investing employees includes Stone, *Employees as Stakeholders*, *supra* note 76, at 48 ("[E]mployees' interests should be protected from major corporate restructuring decisions that threaten to expropriate those investments."), and O'Connor, *supra* note 75.

178. See, e.g., GARY S. BECKER, HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS WITH SPECIAL REFERENCE TO EDUCATION 129-30 (1993); MASAHIKO AOKI, THE CO-OPERATIVE GAME THEORY OF THE FIRM 14 (3d ed. 1984); Bull, *supra* note 172, at 658. For a graphic illustration of this theory, see Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure and Relocation*, 136 U. PA. L. REV. 1349, 1362 (1988).

179. The theory is well explained by Stone in *Policing*, *supra* note 76, at 363-69; Stone, *Employees as Stakeholders*, *supra* note 76, at 48-53. See also O'Connor, *supra* note 75, at 1205-07.

180. For descriptions of these risks, see Stone, *Policing*, *supra* note 76, at 369; Stone, *Employees as Stakeholders*, *supra* note 76, at 52; and O'Connor, *supra* note 75, at 1208-10. Interestingly, Judge Posner offers a similar analysis as an economic explanation for age discrimination laws. See POSNER, *supra* note 2, at 339.

that the human capital investments of employees have been routinely expropriated.<sup>181</sup>

If one accepts the theory that employees make an "investment" in the firm<sup>182</sup> and thus have some legitimate expectation to a return on that investment, the similarities between the human capital investors and money investors become striking, and the arguments to extend fiduciary protections to employees become stronger. Like the investments of stockholders and creditors, employees' investments can be lost if, to use an extreme but obvious example, mismanagement leads to the business failure of the corporation. The value of employees' investments in the corporation also can be lost through wealth transfers when, for example, the corporation (perhaps following a change in control through a takeover) opportunistically breaches its implied contracts to pay older employees at a rate above their marginal productivity.

Also, as was true in the case of creditors, the pressure created by the market for corporate control generates incentives for managers to expropriate the human capital investments of employees.<sup>183</sup> Thus, if managers do not engage in the opportunistic breach of the implicit contracts with employees, corporate raiders may acquire the company in a hostile bid, change managers, and reap the benefits of their own opportunistic breach of the employees' implicit contracts. Managers, as rational maximizers, will act to avoid the threat of the raiders by effecting their own preemptive opportunistic breach of the employees' implicit contracts.

Although the implicit contract theory may well be an acceptable approximation of reality, the theory, in any event, is a compelling metaphor for society's general concern for employees' well-being. Employees have palpable interests in the corporation,<sup>184</sup> in its efficient management, and in

181. See Shleifer & Summers, *supra* note 96. Oliver Hart, however, after suggesting that such a line of argument may justify defensive tactics by management, finds the entire argument difficult to sort out. He finds it difficult to determine whether the high wages of employees before a takeover are a function of past service or "the result of managerial slack or the price management has paid for an easy life." He fears, as a result, the throttling of "efficiency-enhancing bids." Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. TORONTO. L.J. 299, 312 (1993).

182. Not all scholars accept the fact that employees invest in the firm by underpricing their services during part of their careers. See, e.g., Boyan Jovanovic, *Job Matching and the Theory of Turnover*, 87 J. POL. ECON. 972, 973 (1979). Even advocates of protection for employees concede that the empirical evidence is inconclusive on this matter. See Stone, *Employees as Stakeholders*, *supra* note 76.

183. See Stone, *Employees as Stakeholders*, *supra* note 76, at 64-74.

184. Not surprisingly, a similar view is expressed by Professor Clyde Summers:

[E]mployees who provide the labor [for corporations] are as much members of that enterprise as the shareholders who provide the capital. Indeed, the employees may have made a greater investment in the enterprise by their years of services, may have much less ability to withdraw, and may have a greater stake in the future of the enterprise than many of the stockholders.

Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potential*, 4. J. OF COMP. CORP. L. & SCI. REG. 155, 170 (1982). Aoki similarly states that

not being excluded from future participation in the corporation. Mismanagement can significantly and adversely affect the interests of employees. Other constituencies often can gain (or limit losses) by replacing employees. Whether or not one classifies that as the expropriation of an investment of human capital through a breach of the corporation's implicit contract with employees, sympathy for displaced workers and rules and mechanisms that provide relief for such workers are consistent with society's clear and persistent manifestations of concern for the well-being of employees.<sup>185</sup>

All of this, however, does not eliminate the need for the Regulators (and society) to deal with the claim of the Contractarians that employees are able to protect themselves through negotiating the explicit and implicit terms of employment contracts. In that regard, Regulators claim that market failures are sufficiently significant to justify the imposition of mandatory terms, such as fiduciary duties, on the parties. One argument is that bounded rationality makes it impossible to construct a contract that will cover all contingencies.<sup>186</sup> Such extensive and detailed contracts, commentators argue, are cost-prohibitive,<sup>187</sup> and employees do not have sufficient information to assess the risks they face in their employment. Claims also are made that employees are too unsophisticated to protect themselves through bargaining.<sup>188</sup> Finally, some argue that, at least in certain instances, present law makes agreements for future payments of invested human capital unenforceable.<sup>189</sup>

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"employees form an integral part of the firm for which they work to a far greater extent than shareholders." AOKI, *supra* note 178. It has also been pointed out that harm to employees of firms may have significant, indirect adverse impacts on other groups. See, e.g., Peter E. Millspaugh, *Plant Closings and the Prospects for a Judicial Response*, 8 J. CORP. L. 483, 484-86 (1983).

185. See *infra* notes 204-10 and accompanying text.

186. See, e.g., John C. Coffee Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, WIS. L. REV. 435, 448 (1988); Hart, *supra* note 181, at 303 (noting that it is "hard to write a contract that specifically rules out all the possible bad actions that management might undertake"). Not all agree that this is a basis for interfering with free contracting. Professor Williamson, for example, concedes the inability to anticipate all possible conditions but argues that the market will adjust in the next case. Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1197-1202 (1984).

187. O'Connor, *supra* note 75, at 1241.

188. See Duncan Kennedy, *Distributive and Paternalistic Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 630 (1982).

189. For example, Professor Stone makes the point that a collective bargaining agreement in which X corporation agrees to pay all employees the fair value of their human capital investment in the event that they are terminated without cause would be unenforceable against a firm that acquired the assets of X and may be unenforceable against a firm that acquired X in a statutory merger. See Katherine Van Wezel Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 U. CHI. L. REV. 73, 102-11 (1988); Stone, *Employees as Stakeholders*, *supra* note 76, at 62.

The Regulators also discount the Contractarian argument that employees attain protection as a result of the firm's desire to protect its reputation as a good and fair employer. Regulators consider the firm's interest in ensuring its reputation as a good employer to be a weak protection for employees<sup>190</sup> and, in support of their position, are able to point to statistics indicating that employees are often subjected to unjustified discipline and dismissal.<sup>191</sup>

Commentators also point out that employees, unlike money investors, are unable to limit their risks through diversification.<sup>192</sup> Modern portfolio theory demonstrates that money investors are able to reduce their economic risk by holding a diversified portfolio of investments.<sup>193</sup> Commentators argue that this option is not open to employees' human capital investment because that investment is by definition undiversified.

The overarching argument of Regulators (and one that is, at least to some extent, inextricably entwined with other Regulator arguments), however, is that the bargaining power between the parties is unequal. The lonely worker, in the view of the Regulators, is grossly overmatched when bargaining with a giant corporation (or even a local hardware store) for terms of employment.<sup>194</sup>

The theoretical soundness of this last line of argument is, not surprisingly, hotly contested by Contractarians, who point out that imposing mandatory terms in the employment relationship in no way relieves the bargaining mismatch.<sup>195</sup> Thus, Contractarians argue that if society requires a particular term in an employment contract and the term is expensive to the corporation, the corporation will respond by otherwise reducing the benefits offered to the employee.<sup>196</sup>

190. Carl Shapiro & Joseph E. Stiglitz, *Equilibrium Unemployment as a Worker Discipline Device*, 74 AM. ECON. REV. 433, 442 (1984); Stone, *Policing*, *supra* note 76, at 371; Clyde W. Summers, *Individual Protection Against Unjust Dismissal: Time for a Statute*, 62 VA. L. REV. 481, 520 (1976); Lawrence E. Blades, *Employment at Will v. Individual Freedom: On Limiting the Abusive Exercise of Employer Power*, 67 COLUM. L. REV. 1404, 1412-13 (1967); Clive Bull, *The Existence of Self-Enforcing Implicit Contracts*, 102 Q.J. ECON. 147, 148 (1987); Shleifer & Summers, *supra* note 96, at 39; Stone, *Employees as Stakeholders*, *supra* note 76, at 55 ("[I]n large and widely dispersed labor markets, reputational factors are often inadequate to the task" of protecting against opportunistic breaches).

191. For some interesting evidence regarding abusive employer conduct, see Summers, *supra* note 184, at 507, 532 (citing an American Association of Arbitrators study that shows more than one-half of discharge cases resulted in employee reinstatement and reports the arbitration of "tens of thousands of discipline cases, finding nearly half to be instances of injustice").

192. See, e.g., Coffee, *supra* note 75, at 78-79.

193. For a description of modern portfolio theory, see RICHARD A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS, 42-46, 48-54, 115-31 (1969).

194. Such a picture is painted, for example, in Summer, *supra* note 184; Lawrence E. Blades, *Employment at Will v. Individual Freedom: On Limiting the Abusive Exercise of Employer Power*, 67 COLUM. L. REV. 1404, 1404-10 (1967).

195. See, e.g., Macey, *supra* note 138, at 37-38 (1991).

196. See generally POSNER, *supra* note 2, at 101-05. Applied to the area of fundamental corporate change, for example, rules designed to protect stakeholders merely "rearrange" the relationships, suggests Macey. Macey, *supra* note 151, at 180.

While corporate managers presently owe no fiduciary duty to employees, extending the protection of the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers to employees is consistent with society's manifest concern for employees. Society has persistently treated labor differently from other economic inputs and has been unwilling to subject employees to the risks of an unrestrained pursuit of economic efficiency. Thus, at a general level, society has not left employers and employees free to contract as they see fit but, instead, has imposed mandatory provisions on their otherwise private arrangements.

Manifestations of the mandatory provisions are many and include the obvious examples of minimum wage laws,<sup>197</sup> health and safety rules,<sup>198</sup> and child labor laws.<sup>199</sup> These examples of special, mandatory terms imposed on the contractual arrangements between employers and employees reflect society's view that the market is not sufficient protection for employees who "bargain" for the terms of their employment and that in this area the value derived from the pursuit of economic efficiency must at times be subordinated to other values important to society.

Other laws express, perhaps even more closely, values that support extending general fiduciary protections to employees. Various legislatures, for example, have passed laws that protect the health coverage of certain terminated employees,<sup>200</sup> require notice before plant closings,<sup>201</sup> and even require severance pay in certain cases.<sup>202</sup> All of these laws seem designed to soften the fall of employees who lose their jobs as a result of expropriation, mismanagement, or otherwise.<sup>203</sup>

Although extending to employees the protection of the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers is sound policy and consistent with the general manifestations of societal values, problems appear when the principles are enforced by courts under general fiduciary standards. Practical considerations and legal process concerns must be considered carefully in evaluating the most effective method of implementing the principles.

With regard to the Principle Requiring Corporate Value Maximization, permitting employees to enforce this obligation against managers is sensible

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197. 29 U.S.C.A. § 201 (West 1994).

198. *Id.* § 651.

199. *Id.* § 212.

200. *E.g.*, CONN. GEN. STAT. § 31-0 (1994).

201. 1988 Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-09 (1994).

202. HAW. REV. STAT. §§ 394B-9 to -10 (Supp. 1994); ME. REV. STAT. ANN. tit 26, § 625-B (West 1994).

203. Professor Stone refers to "the widely held intuition" regarding the unfairness of laying off "employees who have substantial seniority without some form of warning, severance pay, and pension protection." Stone, *Employees as Stakeholders*, *supra* note 76, at 52.

and creates no particular problems. As described above, employees' interests in the corporation can be damaged by actions that diminish the value of the corporation, and employees seem to have at least as legitimate a claim to institute remedial derivative suits as have stockholders or creditors. A derivative suit is the correct vehicle to permit employees to enforce the obligation of managers to maximize the value of the corporation, since any recovery becomes corporate property and is distributed to constituencies in a manner that protects their initial investment expectations.

With regard to the Principle Prohibiting Wealth Transfers, however, courts would face insurmountable practical and legal process problems were they to attempt under general fiduciary standards to protect employees from wealth transfers, including the expropriation of human capital. Take as an example claims by 2,000 employees terminated after their company is acquired in a takeover. Each employee would have a separate claim under the implied contract theory that he or she had made individual human capital investments that had not been repaid. To evaluate these claims, a court in each of the 2,000 cases would have to determine whether each employee had underpriced his or her services, the period of time during which the services had been underpriced, the amount during each pay period of such underpricing, and the amount of any payback by the corporation with respect to the employee's investment. Obviously, that would be a staggering and exceedingly costly<sup>204</sup> undertaking by courts and an entirely unworkable solution.<sup>205</sup>

Such difficulties, however, should not lead society to abandon its attempts to protect employees against such wealth transfers but, instead, should cause society to consider a legislative response. Unlike courts, legislatures are capable of constructing specific, administrable, and priceable solutions for expropriation of employees' wealth.

Notwithstanding that, purposefully, no solutions are suggested by this Article for the problem of the expropriation of employee human capital, the following observations are offered. Preliminarily, one recognizes that the remedy of choice for employees who are terminated and thus lose their human capital investments is a mandatory reinstatement to their old jobs. Mandatory reinstatement, however, is too drastic a remedy. Thus, while it has been argued that employment should be maintained "when

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204. Regarding the difficulties of calculating the value of human capital investment by employees, see Stone, *Employees as Stakeholders*, *supra* note 76, at 50-51. Perhaps an even more pessimistic picture of evaluation difficulties is disclosed as Professor Stone attempts to fashion a "tin parachute" pay provision that approximates an appropriate payout for the loss of employees' human capital investment in the firm. *Id.* at 59-60. Professor Macey concludes that it would be difficult to calculate and award appropriate specific capital to dismissed employees. Macey, *supra* note 151, at 193.

205. Professor Epstein uses a similar argument in support of the employment-at-will doctrine and against a rule requiring cause for dismissal of employees. Epstein, *In Defense*, *supra* note 28, at 953.

production declines temporarily,"<sup>206</sup> commentators otherwise do not argue in favor of mandatory reinstatement but, instead, propose a monetary settlement of claims as the appropriate response.<sup>207</sup> Mandatory reinstatement is simply too costly in terms of lost economic efficiency to be a viable remedy in this area.<sup>208</sup>

A monetary remedy in the form of a payment similar to severance pay also is attractive because of its theoretical consistency with the implicit contract theory, a theory which, either as an approximation of reality or as a metaphor, is appealing. Under the implicit contract theory, employees' investments of human capital seem not to entitle them to lifetime jobs but, instead, to an economic return on their investments.

Accordingly, were society acting through its legislature to determine that employees need protection from expropriation of their human capital investments, a statute requiring employers to provide employees with some predetermined "severance pay" as compensation for the employees' human capital investment, although a second-best solution from the employees' perspective, would be manageable by the market and should (although I doubt this is true) be only mildly objectionable to Contractarians. An example will help illuminate this.

Assume that Congress decides that the implicit contract theory has validity and that employees' investments are not properly protected by the market and thus necessitate protection from expropriation. Congress by law could require employers to pay all employees who are terminated without cause termination benefits equal to a stated percentage of their annual salary, the percentage dependent on how long they had been with the company. Contractarians (and employers) would object, of course, but if the market for employees is operating efficiently (an argument that Contractarians proffer in support of the need for no mandatory protection of employees), the result of the law will be to lower wages in the early stages of employees' careers because of the contingent liability for terminated employees.<sup>209</sup>

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206. O'Connor, *supra* note 75, at 1207. A similar view is expressed in Edward N. Gamber, *Long-Term Risk-Sharing Wage Contracts in an Economy Subject to Permanent and Temporary Shocks*, 6 J. LAB. ECON. 83, 84 (1988).

207. Larry Samuelson, *Implicit Contracts with Heterogeneous Labor*, 3 J. LAB. ECON. 70, 87 (1985).

208. One commentator sympathetic to the claim of expropriation of human capital investments nonetheless rejects solutions that would make firms "reluctant to reduce their work forces . . . for legitimate, market-driven reasons . . ." The author fears that it would "deprive troubled firms of flexibility to restructure their costs, thereby hastening firm failure." Stone, *Employees as Stakeholders*, *supra* note 76, at 62. The author fears that it would "deprive troubled firms of flexibility to restructure their costs, thereby hastening firm failure." *Id.*

209. Contractarians, for example, argue that imposing mandatory terms will not change the level of benefits to employees, only the form of the compensation. See *supra* note 295 and accompanying text.

To reemphasize, mandatory severance pay for employees terminated without cause is not offered substantively as a solution to expropriation of human capital investment.<sup>210</sup> Instead, the solution is offered only as an example of the method the legislature could use in approaching the problem. Any solution, however, must be one that the market can price and courts can administer efficiently or, better yet, be one that is so clear that courts will rarely become involved in enforcement.

#### D. Revlon Duties

The application of the Principle Requiring Corporate Value Maximization eliminates the nonsensical distinction that courts make between corporate managers' so-called *Revlon* duties and their duties when *Revlon* is not implicated.

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>211</sup> the Supreme Court of Delaware held that in a takeover situation, once the target is up for sale, the duty of the target's managers changes "from the preservation of . . . [the target] as a corporate entity to the maximization of the . . . [target's] value at a sale for the stockholders' benefit."<sup>212</sup> One negative implication of this rule is that when the company is not up for sale and thus the special *Revlon* duties do not apply,<sup>213</sup> managers may engage in tactics to protect the "corporate bastion" even, it seems, if such actions are less than value-maximizing.

Permitting managers to protect the corporate bastion by engaging in moves that are not wealth-maximizing is unsound, since such a rule enables managers to undermanage corporate assets and throttle the flow of those assets to their more efficient use. As discussed earlier, managers as rational maximizers sometimes have a strong self-interest in undermanaging

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210. One may argue against ensuring payment in full of the present value of an employee's human capital investment on the grounds that it would create perverse incentives and a moral hazard, since employees protected by such rights "might be tempted to shirk in order to provoke a staff reduction." Stone, *Employees as Stakeholders*, *supra* note 76, at 60. The argument is unpersuasive, however, if employees' claims are limited to the present value of their "firm specific capital." Such a limitation on recovery is not only consistent with the implied contract theory but also would seem to reduce significantly an employee's incentive to cause a staff reduction, since if employees shirk, they risk losing the income stream from their future employment, which is the same risk that is thought to inspire all workers.

211. 506 A.2d 173 (Del. 1986).

212. The court went on to state: "The directors' role changed from defenders of the corporate bastion to auctioneers, charged with getting the best price for the stockholders at a sale of the company." *Id.* at 182.

213. Not surprisingly, the Delaware courts have been forced to deal with the question of when the *Revlon* duties become applicable. *Mills Acquisition Co. v. MacMillian, Inc.*, 559 A.2d 1261 (Del. 1989); *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989); *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994) (all indicating that *Revlon* duties attach not only when the target is faced with a bust-up but also when the target is faced with a change in control).

corporate assets,<sup>214</sup> and this interest is perhaps seen most vividly when the corporation is faced with an unsolicited takeover bid. In such a case, managers want to protect their jobs, even if the offering price of an unfriendly bidder reflects the bidder's confidence that it can deploy the corporate assets more efficiently than existing managers can.<sup>215</sup>

The proposed principles help eliminate such undesirable results and, in addition, provide clearer guidance regarding managers' fiduciary duties. Accordingly, if hit with an unsolicited takeover bid, the target's managers operating under the proposed principles have the same duties they had the instant before the bid, which are duties to maximize the value of the target corporation and avoid transfers of wealth. In such circumstances, the first decision of the target's managers is to determine whether the unsolicited bid maximizes the value of the target. If a higher bid is possible or alternative uses for the assets (including the managers' continued management of the assets) are more efficient, the target's managers should resist the bid. If, on the other hand, the bid maximizes the value of the target's assets, managers should take steps to facilitate the acquisition by the bidder, provided that the bid does not expropriate the value of any of the target's money investors.<sup>216</sup> Managers, however, may not resist the bid on the basis of expropriation of money investors' value unless managers are unable to restructure the bid in a way that eliminates the expropriation. In that regard, courts should be most suspicious of claims by managers that such restructuring is impossible, since the bidder should be indifferent as to the recipient of its payment for the target.

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214. See *supra* note 156 and accompanying text.

215. At least two other arguments support elimination of any special *Revlon* duties. First, investors harbor legitimate expectations that managers will act at all times to maximize the value of the corporation. See *supra* text accompanying notes 103-10. Additionally, an economic argument supports elimination of special *Revlon* duties through the broad application of the Principle Requiring Corporate Value Maximization. Already, courts (and thus litigants and their attorneys) have spent significant resources litigating the question of whether facts support the application of the special *Revlon* duties. See, e.g., *Mills Acquisition Co.*, 559 A.2d at 1261; *Paramount Communications, Inc.*, 571 A.2d at 1140; *QVC Network*, 637 A.2d at 34. The expenses of dealing with these issues, both at the stage where managers make decisions and at the litigation stage, would be eliminated by the broad application of the Principle Requiring Corporate Value Maximization.

216. As with the application of the Principle Requiring Corporate Value Maximization, the application of the Principle Prohibiting Wealth Transfers in such situations would facilitate clarity. For example, in *Revlon*, the court stated that in responding to an unsolicited bid, consideration of the interests of corporate constituencies other than stockholders "may be permissible," but apparently only in instances where such actions "are rationally related [to] benefits accruing to the stockholders." 506 A.2d at 182. The court then stated: "However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder." *Id.* Obviously, such language is confusing but seems to indicate that when the corporation is sold, the fiduciary duty of managers is to expropriate as much wealth from nonstockholders as possible.

One should notice again, however, how unprotected these principles leave employees in potential wealth transfer situations, including takeovers. As described earlier, practical and legal process considerations make it impossible for courts acting under general fiduciary standards to extend the protection of the Principle Prohibiting Wealth Transfers to employees. If, therefore, society concludes that employees are vulnerable to expropriation of their human capital investment and merit protection in that regard, legislatures (instead of courts) must provide the appropriate remedies.

### *E. Valuation of Minority Interests in Affiliated Mergers*

The Principle Prohibiting Wealth Transfers should have a beneficial and clarifying impact on the valuation of minority interests in affiliated mergers.

Problems in this area may begin when a corporation (Parent) acquires a substantial majority, say seventy percent, of the common stock of a previously independent company (Subsidiary), which, after Parent's acquisition, continues to have thirty percent of its common stock held publicly. The response of an efficient market to Parent's acquisition may be to decrease the per share price of the minority interest,<sup>217</sup> in part, at least, due to the perceived risk that Parent will acquire minority's interest in Subsidiary in an unfairly priced transaction.<sup>218</sup>

Subsequently, Parent may in fact complete the absorption of Subsidiary by, for example, merging Subsidiary into Parent. In such a second-step transaction, however, minority stockholders are protected by the intrinsic fairness test, which requires an evaluation of whether the minority stockholders received a "fair price" in the acquisition,<sup>219</sup> and by an appraisal statute, which ensures that dissenting stockholders received "fair value" for their stock.<sup>220</sup>

If, however, "fair price" or "fair value" is calculated by reference to the market price of the minority shares,<sup>221</sup> the expropriation of minority

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217. Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact on Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 478 (1990); J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 5 (1977).

218. Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1073, 1099 (1983); Theodore N. Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485, 489 (1982-83); Carole B. Silver, *Fair Dealing Comes of Age in the Regulation of Going Private Transactions*, 9 J. CORP. L. 385, 396 (1983-84).

219. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

220. See, e.g., RMBCA § 12.01(3) and 13.02 (1994).

221. Cases involving valuation of minority interests in a corporation include *Kalabogias v. Georgiou*, 627 N.E.2d 51, 57 (Ill. 1993); *Dermody v. Sticco*, 465 A.2d 948, 951 (N.J. 1983); *Weinberger v. UOP, Inc.*, 426 A.2d 1333, 1356 (Del. 1981); *Citron v. E.I. Du Pont de Ne-*

stockholders' value, which started with Parent's original acquisition of the seventy percent interest in Subsidiary, is complete. The loss suffered by minority stockholders as a result of the threat that Parent would force an unfair merger on Subsidiary is then impounded in "fair price" or "fair value" through the use of market price as a basis of calculation.

The broad application of the Principle Prohibiting Wealth Transfers will ameliorate these problems at all levels. Thus, when Parent first acquires its seventy percent interest in Subsidiary, the adverse impact on the market price of minority's shares should be reduced if the market can be convinced that the Principle Protecting Wealth Transfers will protect the minority from a subsequent transaction that expropriates a part of their wealth. Similarly, minority interests are protected at the second step of the acquisition by utilizing a calculus of "fair price" or "fair value" that eliminates any market discount resulting from risk of a wealth-transferring transaction. Specifically, in that regard, minority stockholders subjected to an affiliated merger should receive an amount equal to the present value of their proportionate share of Subsidiary's projected stream of corporate earnings, assuming that, at all times in the future, managers would maximize the value of the corporation and would not engage in wealth transfers detrimental to the interests of the minority stockholders.

*F. Consent to a Non-Pareto Move: Failure To Pay Noncumulative Preferred Dividends and Other Related Matters*

An interesting and instructive problem is presented by the old dividend credit cases.<sup>222</sup> Although the circumstances that generated these cases are less than usual in today's world, the cases nonetheless are an apt vehicle to consider how courts should deal with the claim that a constituency protected by the Principle Protecting Wealth Transfers agreed to assume the risk of a non-Pareto move by managers.

The dividend credit cases, which caused considerable interest in the corporate world years ago,<sup>223</sup> arose when corporations sold noncumulative preferred stock and then refused to pay dividends on the stock. In such

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mours & Co., 584 A.2d 490, 507 (Del. 1990); *In re Valuation of Common Stock of Libby, McNeil & Libby*, 406 A.2d 54, 61 (Me. 1979).

222. See *Sanders v. Cuba R.R. Co.*, 120 A.2d 849 (N.J. 1956); *Agnew v. American Ice Co.*, 61 A.2d 154 (N.J. Super. Ct. Ch. Div. 1948); *Day v. United States Cast Iron Pipe & Foundry Co.*, 123 A. 546, *aff'd*, 126 A. 302 (N.J. 1924) (the court was equally divided). Other courts rejected the dividend credit rule. See *Wabash Ry. Co. v. Barclay*, 280 U.S. 197 (1930); *Guttman v. Illinois Cent. R.R. Co.*, 189 F.2d. 927 (2d Cir. 1951), *cert. denied*, 342 U.S. 867 (1952).

223. See Adolph A. Berle, Jr., *Noncumulative Preferred Stock*, 23 COLUM. L. REV. 358 (1923); Norman D. Lattin, *Noncumulative Preferred Stock*, 25 ILL. L. REV. 148 (1930); Alexander H. Frey, *The Distribution of Corporate Dividends*, 89 U. PA. L. REV. 735 (1941); Note, *Dividend Rights of Noncumulative Preferred Stock*, 61 YALE L.J. 245 (1952); Note, *Right of Noncumulative Preferred Stockholders to Back Dividends Earned but Unpaid*, 74 U. PA. L. REV. 605 (1926).

situations, preferred stockholders claimed unfairness, since the foregone dividends decreased the value of their investments and accrued to the benefit of the residual claimants (i.e., the common stockholders), who, of course, elected the managers that determined the dividend policy.<sup>224</sup>

Pleaded under Principle Prohibiting Wealth Transfers, preferred stockholders claim that the decision not to pay preferred dividends violates managers' fiduciary duties since it generates a wealth transfer detrimental to preferred stockholders. Managers and common stockholders, on the other hand, can claim that, even if the decision not to pay preferred dividends decreases the wealth of preferred stockholders, the preferred stockholders consent and are paid to take the risk that managers might pass over preferred dividends. Since, under the Principle Prohibiting Wealth Transfers, managers may make a wealth-decreasing move if the harmed constituency, the preferred stockholders in this case, consent to the risk of the move and are paid to take the risk, the issue seems joined.

In resolving the question of whether preferred stockholders consented to the nonpayment of dividends, courts should rely heavily on the proper allocation of the burdens of proof, as outlined in part IV.B. Thus, for the reasons stated in that section, once the preferred stockholders establish that the determination not to pay their dividends decreases the value of their investment, managers should bear the heavy burden of establishing that the preferred stockholders consented to the risk of such a nonpayment of dividends.

The actual content of the dividend credit rule is worth examining as an example of the type of rules that may be sensible in such cases. The rule provides that, prior to the payment of any dividends to common stockholders, noncumulative preferred dividends that are passed over must be paid to preferred stockholders for those years in which the corporation has earnings sufficient to cover the preferred dividends.<sup>225</sup> For at least two reasons, the dividend credit rule is an attractive resolution of the question of whether the failure to pay such preferred dividends violates managers' fiduciary duties.

First, the rule represents a reasonable approximation of the deal to which the parties consented at the market price. It seems reasonable that

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224. An interesting twist on this is *Baron v. Allied Artists Pictures Corp.*, 337 A.2d 653 (Del. 1975), *appeal dismissed*, 365 A.2d 136 (Del. 1976), in which the company's articles of incorporation gave to preferred stockholders the right to elect a majority of the company's board of directors in the event of the failure to pay preferred dividends. Under this provision, the preferred stockholders gained control of the company's board of directors and thereafter refused to eliminate the dividend arrearage necessary to meet the threshold for their required relinquishment of their election rights. Suing for relief, the common stockholders alleged that the company had sufficient funds available to permit payment of the arrearage. The proper analysis of this case is the same as the analysis proffered generally in this section.

225. For a good statement of the dividend credit rule (as well as a statement of the contrary rule), see *Day*, 126 A. at 304-05.

the parties thought (and thus impounded in the price of the preferred stock) that managers would pay the preferred dividends if the corporation were in a position to do so, and the existence of earnings may be a good indication that the company was able to pay preferred dividends.

Second, such a rule provides an incentive for better bargaining and thus enhanced economic efficiency in future deals. The dividend credit rule encourages the most efficient party, which is the corporation acting through its managers, to provide better information to the future investors purchasing noncumulative preferred stock, and it encourages better bargaining mechanisms and structures when the company undertakes the sale of such preferred stock to investors. The dividend credit rule will encourage the corporation to draft clear language regarding the rights of preferred stockholders to dividends and to call these terms to the attention of preferred stockholders. Without such action, the corporation cannot be sure of the validity of the consent of preferred stockholders to the relinquishment of their dividend rights in the event dividends are not paid.

In numerous other situations the question of an investor's consent to a wealth transfer may arise. Obvious examples include managers' decisions to redeem preferred stock,<sup>226</sup> make distributions to common stockholders (either in the form of dividends or through repurchases),<sup>227</sup> or defer paying off the arrearage on preferred stock.<sup>228</sup> Similarly, if a particular constituency claims that managers' decision to make an unusually risky investment<sup>229</sup> or to add significantly to the company's debt<sup>230</sup> resulted in a wealth transfer detrimental to the particular constituency, managers may be able to defend on the basis of consent to the transaction.

In all of these cases, the analysis of the courts should be the same. If an investor is able to demonstrate that managers' action decreased the value of his or her investment, the burden falls on managers to demonstrate consent. In ultimately resolving the particular case, courts should interpret situations and promulgate specific rules that approximate the most likely understanding of the parties and promote future economic efficiencies.

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226. Managers' decision to redeem stock typically is detrimental to the interests of preferred stockholders. See *supra* notes 89-90 and accompanying text.

227. Senior money investors such as preferred stockholders and creditors (and, for that matter, employees) can be harmed by dividends and repurchases of common stock that increase the risk that the company will be unable to meet its obligations to such senior investors.

228. Preferred stockholders whose dividends are in arrears will benefit by the rapid or immediate elimination of the arrearage. Any delay in elimination of the arrearage, therefore, is contrary to the best interests of preferred stockholders.

229. Numerous commentators have noted the different investment objectives of fixed investors and residual investors and the fact that an investment that maximizes the value of the corporation may nonetheless reduce the wealth of fixed investors, who have no right to participate in earnings above their fixed, contractual amount. See, e.g., Hurst & McGuinnis, *supra* note 117, at 195.

230. See discussion *supra* part V.B. (especially notes 139-45 and accompanying text).

### G. Constituency Statutes

At first look, one may consider constituency statutes<sup>231</sup> to be consistent with the principles of this Article. Viewed more critically, however, constituency statutes turn out to be antithetical to the proposed fiduciary principles, since the statutes make it easier for managers to undermanage corporate assets and engage in wealth transfers to themselves or favored constituencies.

Constituency statutes have been enacted in more than one-half of the states<sup>232</sup> and, although the substance of the statutes varies from state to state, the core of the statutes is similar.<sup>233</sup> Generally, the statutes permit managers<sup>234</sup> in certain instances, most usually in dealing with takeovers,<sup>235</sup> to consider the interests of constituencies other than stockholders. The statutes, with few exceptions,<sup>236</sup> however, are discretionary, which means that managers may, but are not required to, consider the interests of the other constituencies. The failure by managers to consider the interests of other constituencies therefore creates no managerial liability for such action.<sup>237</sup>

Managers acting as rational maximizers and faced with a corporate decision have two interests.<sup>238</sup> First, managers want to maximize their own wealth or utility; second, and this interest is clearly secondary to the first, managers want to maximize the wealth or utility of voting stockholders, since voting stockholders appoint managers. Managers, at least as rational maximizers, are essentially indifferent about the welfare of the other corporate constituencies.<sup>239</sup>

231. Regarding constituency statutes, see James J. Hanks, *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988); Alexander C. Gavis, *A Framework for Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. PA. L. REV. 1451 (1990).

232. In a 1991 article, Professor O'Connor lists the states having constituency statutes. O'Connor, *supra* note 75, at 1229 n.288. In the same year, Hanks put the number of states adopting constituency statutes at 28. James J. Hanks, *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 103 (1991).

233. See Hanks, *supra* note 232, for a description of the variations among states.

234. Constituency statutes protect directors, and some, but not all, cover the actions of officers as well. *Id.* at 105.

235. O'Connor, *supra* note 75, at 1194; Hanks, *supra* note 232, at 106.

236. Connecticut's constituency statute is mandatory. CONN. GEN. STAT. § 33-313(e) (West 1994).

237. Stone, *Employees as Stakeholders*, *supra* note 76, at 70.

238. See *supra* text accompanying notes 75-77.

239. This is not entirely accurate, of course, since it is possible that the mistreatment of another constituency may harm the interests of managers or voting stockholders. For example, an expropriation of creditors' wealth may raise the subsequent cost of capital to the corporation, which would be contrary to the interests of managers and voting stockholders.

Because of their discretionary nature, constituency statutes change none of this.<sup>240</sup> The incentives of managers after the passage of constituency statutes are exactly the same as the incentives before the statutes; as rational maximizers, managers still want first to promote their own interests and then to promote the interests of voting stockholders; they still are indifferent about the interests of other constituencies. The statutes provide managers as rational maximizers no additional incentives to maximize the value of the corporation or abstain from wealth transfers from disfavored constituencies to favored constituencies.

Constituency statutes should not be considered neutral, however, since such statutes provide an obfuscation opportunity that facilitates managerial moves that are inconsistent with the Principle Requiring Corporate Value Maximization and the Principle Prohibiting Wealth Transfers. Thus, managers in pursuit of their own self-interest of ensuring the continuation of their positions, salaries, and perquisites may, for example, resist a value-maximizing takeover that threatens their jobs and, under constituency statutes, may attempt to justify their resistance on the basis of potential harms to creditors, employees, or the community. Managers as value maximizers will attempt to hide behind constituency statutes, and courts, if they take the statutes seriously, will have difficulty in concluding that defensive tactics are inconsistent with the apparently broad latitude granted managers under constituency statutory norms.<sup>241</sup>

One way out of this problem is proposed by McDaniel, whose views are similar to many of my own.<sup>242</sup> McDaniel argues that constituency statutes should not be interpreted to permit managers to exercise unfettered discretion regarding the amount and type of deference that they may accord constituencies other than stockholders but, instead, that any action taken by manager under the authority of constituency statutes should be limited by an obligation to maximize corporate value and avoid wealth

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240. Even commentators who share a view that fiduciary duties need to be liberalized are less than consistent in their views regarding the efficacy of constituency statutes. Stone, *Employees as Stakeholders*, *supra* note 76, at 71, 72 ([S]tatutes have at least "symbolic value"; "despite their weaknesses, the nonshareholder constituency statutes may nonetheless have value."); O'Connor, *supra* note 75, at 1260 ("Although these statutes have not been tested in the courts, they are a potential source of protection to displaced workers."); McDaniel, *supra* note 85, at 161 (Statutes are valuable if interpreted with "Pareto efficiency as the economic goal."). For contrary and more negative views about constituency statutes, see Hanks, *supra* note 232; Macey, *supra* note 138.

241. Professor Macey makes this argument directly. Macey, *supra* note 138, at 32 ("[V]irtually any management decision, no matter how arbitrary, can be rationalized on the grounds that it benefits some constituency . . .") (emphasis added). Hanks makes the point somewhat more indirectly. Hanks, *supra* note 232, at 113-15 (emphasizing the absence of standards and the difficulty of monitoring).

242. See McDaniel, *supra* note 85; McDaniel, *supra* note 58.

transfers.<sup>243</sup> Thus, under McDaniel's proposal, managers could not take any action to protect a constituency if that action either failed to maximize the value of the corporation or resulted in a wealth transfer.

Certainly if constituency statutes must exist, McDaniel's solution is attractive. Nonetheless, even as interpreted by McDaniel, constituency statutes are a decidedly incomplete remedy. Obviously, constituency statutes are often limited to managers' actions in takeover situations, while as indicated in this Article, questions regarding fiduciary duties arise in many and varied situations. Stated more broadly, the matter of fiduciary duties should be addressed directly and more inclusively and not through a statute that deals by indirection with only a part of a problem. The better solution (and one with which McDaniel would likely agree at least in part) is to eliminate the constituency statutes and adopt broadly the principles proposed in this Article.

## VI. CONCLUSION

The bid of the Contractarians to eliminate all mandatory fiduciary duties fails principally because the values underlying their position are inconsistent with the widely shared values of society. Notwithstanding, no one should be so foolhardy as to argue that the Contractarians' pursuit of economic efficiency is without any moral justification or support in society generally, since the pursuit of economic efficiency leads in the direction of increased total utility and personal autonomy, conditions that are morally and popularly attractive.

Thus, while most concede the value in the pursuit of economic efficiency, society nonetheless finds the harsh edges of capitalism to be distasteful and other values to be important and worth pursuing. In short, economic efficiency is a worthy goal but clearly not the only worthy goal for society and not a goal that can be pursued without costs.

A world dominated by the pursuit of economic efficiency is often lacking in grace and kindness, those wonderful human qualities that society in its finer moments finds so attractive. In the Contractarians' world, greed seems at times to be considered a virtue, and the only answer for individual disappointments is to make a better contract next time.

Society, albeit somewhat imperfectly, demands more of itself in the area of corporate fiduciary principles. We are demonstrably concerned about corporate managers' actions that create losers by decreasing the value of corporations or expropriating the investments of corporate constituencies.

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243. McDaniel, *supra* note 85, at 121-39. McDaniel also argues that constituency statutes should be interpreted to require that any gains "awarded to stakeholders must bear a reasonable relationship to the benefits received by stockholders." *Id.* at 136.

Our rules set standards that are higher than the basest conduct of the unfettered market.

Pareto criteria represent worthy principles that encapsulate widely shared values of society and thus provide attractive guidance for the formulation of our corporate fiduciary principles in the post-Contractarian era.