Two Birds, One Stone: Achieving Corporate Social Responsibility Through the Shareholder-Primacy Norm

MARSHALL M. MAGARO*

The business corporation is an instrument through which capital is assembled for the activities of producing and distributing goods and services and making investments. Accordingly, a basic premise of corporation law is that a business corporation should have as its objective the conduct of such activities with a view to enhancing the corporation's profit and the gains of the corporation's owners, that is, the shareholders.[1]

-Melvin Aron Eisenberg

INTRODUCTION

The business firm is one of the most powerful entities in the world. In fact, "most people in the [Western world] are employed by firms, . . . most production takes place within firms, and . . . the efficiency of the whole economic system depends to a very considerable extent on what happens within these economic molecules."[2] Corporations are so powerful that "[n]o social program can rival the business sector when it comes to creating the jobs, wealth, and innovation that improve standards of living and social conditions over time."[3] Despite the massive power inherent in corporate America, each corporation is a self-sustaining entity whose success is contingent upon its ability to take advantage of an impersonal market that is part of a larger system.

While the benefits of corporate efficiency often reverberate throughout society, corporations are traditionally managed to satisfy the shareholders' interests, "simply because the shareholders own [the corporation]."[4] In fact, under modern corporate law the management of a corporation is primarily "divided among three groups: shareholders, directors, and officers."[5] Under this view, directors are trustees of the shareholders' property, and, therefore, have a duty, first and foremost, to increase shareholder wealth.[6]

---

* J.D. Candidate 2010, Indiana University Maurer School of Law – Bloomington; M.P.A., Indiana University School of Public and Environmental Affairs, 2007. I would like to thank Professors John Scanlan and Donna Nagy, as well as Notes and Comments Editors Lindsey Hemly and Samantha Uslan for their guidance, support, and critiques of this Note. Finally, I would like to thank my wife Lindsey for her love and support during this long process.

1. Melvin Aron Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 BUS. LAW. 1271, 1275 (1993).
2. R.H. COASE, THE FIRM, THE MARKET, AND THE LAW 6 (1988).
3. Michael E. Porter & Mark R. Kramer, *Strategy & Society*: *The Link Between Competitive Advantage and Corporate Social Responsibility*, HARV. BUS. REV., Dec. 2006, at 78, 83.
4. Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 288 (1998).
5. D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES 247 (2d ed. 2008).
6. *See* A. A. Berle, Jr., *For Whom Corporate Directors Are Trustees*: *A Note*, 45 HARV. L. REV. 1365 (1932).

While corporations are powerful machines capable of creating prodigious societal wealth, they can also run off course and cause great societal harm. Understandably, there is much concern about corporations' power to affect nonshareholder constituents. Some have argued that because so many parties are ultimately affected by management decisions, namely creditors, employees, customers, and the community at large, a fiduciary obligation arises between management and these nonshareholder constituents.[7]

Academics favoring shareholder supremacy have long decried imposing a managerial duty to consider a corporation's nonshareholder constituents in the corporate decision-making process.[8] Most notably, Nobel Laureate Milton Friedman intimated that "[f]ew trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their shareholders as possible. This [social responsibility] is a fundamentally subversive doctrine."[9] This view, however, ignores the idea that proper consideration of nonshareholder interests could lead to greater profitability and return to shareholders.

Several states have implemented statutes allowing directors to consider these nonshareholder constituents' interests in the corporate decision-making process. This Note proposes the passage of similar statutes in all states—requiring directors to consider all affected stakeholders' interests when such consideration could provide a demonstrable benefit to the corporation and its shareholders. The need for such statutes does not flow from a managerial duty to these particular nonshareholder constituents. Instead, these statutes are necessary because consideration of nonshareholder constituents' interests can lead to increased long-run profitability and shareholder wealth. This Note does not suggest that directors owe a fiduciary duty to any nonshareholder constituency group outside of those duties implied by contract because "[the] [s]erious pursuit of . . . constituency rights [and management's complimentary fiduciary duties], implies a radical . . . move toward a social corporation."[10] Furthermore, this Note does not claim that a failure to heed constituency groups' interests constitutes a breach of the duty of care sufficient to pierce the shield of the business-judgment rule. Instead, this Note argues that management must *consider* these nonshareholder interests to become fully informed and thereby satisfy the standards set forth in *Smith v. Van Gorkom*,[11] and section 8.31 of the Model Business Corporation Act.[12]

---

7. *See, e.g.*, Kent Greenfield, *Proposition: Saving the World with Corporate Law?*, 57 EMORY L.J. 948 (2008).

8. *See, e.g.*, MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962).

9. *Id.* at 133.

10. William W. Bratton, *Confronting the Ethical Case Against the Ethical Case for Constituency Rights*, 50 WASH. & LEE L. REV. 1449, 1463 (1993).

11. 488 A.2d 858 (Del. 1985) (suggesting that when a board of directors fails to avail itself of all information reasonably available to it and relevant to its decision, it has breached the duty of care owed to the shareholders. In analyzing whether such a breach has occurred, courts should look to the concept of gross negligence).

12. MODEL BUS. CORP. ACT § 8.31(a) (2009) (suggesting that a director is not liable unless the party asserting liability in a proceeding establishes that the challenged conduct consisted of or was the result of a sustained and systematic failure of the director to be informed about the

Part I will analyze to whom a board of directors owes a duty. After establishing that directors owe a duty solely to the corporation's shareholders, Part II will show that consideration of the nonshareholder constituents' interests can lead to increased social benefit while simultaneously increasing shareholder value. Part III will introduce nonshareholder-constituency statutes and argue that, for the shareholders' interests, the statutes should impose upon directors an obligation to consider, within reason, all constituents' interests so that directors can make fully informed decisions. In addition, Part III will propose sample language that state legislatures should consider when promulgating such statutes.

I. DUTY TO WHOM: THE BATTLE BETWEEN SHAREHOLDERS AND STAKEHOLDERS

The fiduciary obligation is a creature of trust law where the "literal meaning [of fiduciary]—faithfulness—correctly described the duty or responsibility owed by one who held title, but not ownership, to property of another, who lacked legal title but could, in equity, claim the benefits of ownership."[13] In a fiduciary relationship, the fiduciary "must be loyal to the interests of the [beneficiary]. The fiduciary's duties go beyond mere fairness and honesty; they oblige him to act to further the beneficiary's best interests. The fiduciary must avoid acts that put his interests in conflict with the beneficiary's."[14]

Corporate law scholars do not disagree that directors owe the corporation both a duty of care[15] and a duty of loyalty.[16] What is contested, however, is whose interests are encompassed by the word "corporation." In particular, scholars have been embroiled in a debate for the better part of the century over whether directors must exercise their fiduciary obligations solely for the benefit of shareholders or whether they should balance the interests of shareholders against those of employees, creditors, suppliers, customers, and society at large. The answer to this question may "significantly differ [depending upon] whether one considers the corporation strictly private or tinged with a public purpose."[17] Merrick Dodd initiated the debate over to whom a board of directors owes a fiduciary duty during the Great Depression. Writing for the *Harvard Law Review*, Professor Dodd commenced the now famous Berle-Dodd

business and affairs of the corporation, or other material failure of the director to discharge the oversight function).

13. Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. CORP. L. 333, 333 (2002).

14. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 882 (1988).

15. MODEL BUS. CORP. ACT § 8.30(a) ("Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the bests interests of the corporation.").

16. *See id.* § 8.60. According to the Model Business Corporation Act, directors must refrain from self-dealing transactions and serve the corporation's interests before they serve their own interests. *Id.* § 8.60(6). A self-dealing transaction is a transaction between a director or officer and the corporation. *Id.* § 8.60(1). Alternatively, it may be a transaction between a director's or officer's relative or spouse and the corporation. *Id.* § 8.60(5). While the duty of loyalty is a crucial component of corporate law, this Note focuses on the duty of care in the corporate decision-making context, not the duty of loyalty.

17. Walsh, *supra* note 13, at 335.

Debate[18] by arguing that mounting public opinion—advanced primarily by powerful people in powerful positions—which can ultimately lead to the creation of new laws, was "making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function."[19] According to Dodd, this mounting political pressure would gain legitimacy and influence political and legal theory.[20] If capitalism were to survive under this view, it must treat "the economic security of the worker as one of its obligations and [be] intelligently directed so as to attain that object."[21] As a result, Professor Dodd promoted a framework in which directors "serve as trustees for the interests of all corporate constituencies."[22]

Professor Adolfe Berle responded sharply to Professor Dodd's conjecture that capitalism will fail if it does not serve both a social and economic function.[23] Admitting that Professor Dodd's ideas were theoretically sound, Professor Berle noted that there was no room for them in practice.[24] According to Berle, the "view that business corporations exist for the sole purpose of making profits for their stockholders"[25] cannot be abandoned until "a clear and reasonably enforceable scheme of responsibilities to somebody else"[26] can be offered. Professor Berle substantiated his claim by declaring that we are an individualistic society and that our current societal structure can be maintained only through the "vigorous protection of private property."[27] Such private property, according to Berle, is split into two classes: active and passive.[28] As owners of "passive property,"[29] shareholders leave their property rights in the hands of corporate directors who take on a role similar to a trustee, and therefore, owe a duty of the utmost care and loyalty to the shareholders.[30] Fearful of what might happen if we were to allow for a social-economic absolutism of management, Berle argued that it is best for capitalism and industrialism to protect those interests that "we know [of], being no less swift to provide for the new interests as they successively appear."[31]

The coals ignited by Professors Dodd and Berle still burn bright today.[32] There is no general consensus among scholars as to whom directors owe their fiduciary duties.

---

18. *See* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

19. *Id.* at 1148.

20. *Id.*

21. *Id.* at 1152.

22. Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 30 (1996).

23. Berle, *supra* note 6.

24. *Id.* at 1367.

25. *Id*. at 1365 (quoting Dodd, *supra* note 18, at 1148).

26. *Id.* at 1367.

27. *Id.* at 1369.

28. *Id.* at 1369–70.

29. *Id.* at 1370.

30. *See id.*

31. *Id.* at 1372.

32. *Compare* Greenfield, *supra* note 7 (arguing that directors' duties should extend to all stakeholders, or "non-equity investors" in a corporation), *with* Van Der Weide, *supra* note 22, at 31 (arguing that imposing a fiduciary duty on directors to act in the best interests of all

Two key theories have emerged from the Berle-Dodd Debate's ashes: the shareholder wealth maximization theory and the stakeholder theory.

A. Shareholder Capitalism and Shareholder Wealth Maximization

Modern corporations are usually managed with the goal of satisfying the "best interests of the corporation."[33] While there are many competing views regarding the best definition of "corporation," the official commentary to Model Business Corporation Act section 8.30(a) has helped unify the viewpoints. The statute's commentary defines the "corporation" as a frame of reference encompassing "the shareholder body."[34] This shareholder-encompassing view is nothing new; in fact, directors have historically been charged with the task of maximizing shareholder wealth. The most famous common law articulation of this mandate comes from *Dodge v. Ford Motor Co.*[35]:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[36]

This shareholders-first view has withstood the test of time, with its effects only marginally limited. In the mid-1980s, the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.* held that a merger target's board of directors could consider the impact that a successful bid would have on constituents other than corporate shareholders.[37] In addition, the court held that when attempting to block a takeover attempt via tender offer, a corporation may implement various defensive tactics, even if such tactics unduly hinder the value of an individual stockholder's interest, so long as that stockholder's interest is adverse to the interests of the corporation and shareholder body.[38] The court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[39] was limited by the holding by ruling that a board in a hostile takeover context "may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stock shareholders."[40]

Two different ideas have been put forth for why this notion of shareholder primacy has been so adamantly defended by its proponents. First, shareholders are owners of

---

stakeholders would be "unfortunate").

33. 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) (1994).

34. MODEL BUS. CORP. ACT § 8.30 cmt. 1 (2009).

35. 170 N.W. 668 (Mich. 1919).

36. *Id.* at 684.

37. 493 A.2d 946, 955 (Del. 1985).

38. *See id.* at 955–56.

39. 506 A.2d 173 (Del. 1986).

40. *Id.* at 182. The court further articulated that once the decision to sell a company has been acknowledged, the "duty of the board . . . change[s] from the preservation of [the company] as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit." *Id.*

the corporation and therefore have a principal/agent relationship with the corporation's directors.[41] Second, shareholders are residual claimants of the corporation's surplus income, which is usually dispersed in the form of a dividend. These ideas are further developed in the paragraphs to come.

1. Shareholders as Owners of the Corporation

Shareholders are the owners of the corporation, and, as a result, the board of directors' fiduciary obligations flow to the shareholder body. When a shareholder purchases a share of a particular corporation's stock, he does not receive the usual bundle of rights that are inherent in the acquisition and ownership of property. For example, while the shareholder has total control over the stock itself, a shareholder cannot use the corporation exclusively for his own benefit, nor can he restrict usage of the corporation by other people. Rather, by purchasing a share of a corporation's equity, a shareholder receives an ownership interest proportionate to his original investment.[42] This interest entitles the shareholder to (1) the unequivocal right to transfer his interest in the corporation at any time; (2) the right to vote for directors, shareholder proposals, and major organic events; (3) the right to bring a derivative suit on the corporation's behalf; (4) the right to obtain certain information from the corporation; and (5) the right to receive dividends at the end of the quarter/year should the corporation decide to disburse them, as well as residual claim status following liquidation of the corporation.[43]

Scholars have advanced two arguments supporting the view that shareholders are owners of the corporation, even though shareholders do not receive the traditional property rights. First, shareholders, unlike traditional property owners, are granted limited immunity for the harms that may arise in the normal course of corporate business.[44] As a condition of this limited liability, shareholders give up the right to control and use the property, which is delegated to the directors and senior management of a corporation.[45] Under this view, it is incumbent upon directors to make decisions as agents of the shareholders with the goal of legally and ethically maximizing returns to the shareholders.

Second, Professor Adolf Berle has argued that property is split into two distinct classes: active and passive.[46] Berle argued that shareholders own *passive* property, which he defines as a "set of economic expectations evidenced by a stock certificate . . . representing an infinitesimal claim on massed industrial wealth and funneled income-stream."[47] As owners of *passive* property, shareholders are barred from exercising many ordinary property-ownership rights.[48] Therefore, under Berle's approach, the

---

41. *See* SMITH & WILLIAMS, *supra* note 5, at 501 (suggesting that directors serve the interests of a principal over their own interests).

42. *See* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 109 (4th ed. 2008).

43. *Id.*

44. *Id.* at 95.

45. *Id.* at 109.

46. Berle, *supra* note 6, at 1369–70.

47. *Id.* at 1370.

48. *See id.*

corporation's directors become trustees of the shareholders' interests,[49] empowered to use shareholder property to advance those interests.[50] This view aligns with Professor Friedman's intimation that:

> In a free-enterprise, private-property system, a corporate executive is an employe of the owners of the business. He has a direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. [51]

Therefore, under this argument, directors, as the owners' agents, owe a duty of care and loyalty to the shareholders—even though their ownership interests do not evince traditional property ownership.

2. Shareholders as Residual Claimants

The traditional view of the corporate form has undergone a shift, inspired in part by Nobel Laureate R. H. Coase's claim that the firm is a system of internal contracts.[52] The new paradigm that has recently developed among scholars is referred to as the "nexus of contracts."[53] Under this new interpretation of the corporate form, the corporation is viewed as a "complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy."[54] In other words, the corporation is "nothing more than a set of contractual arrangements among the various claimants to the products and earnings generated by the business."[55] In creating this web of contracts, "[a]ll corporate stakeholders—shareholders, creditors, employees, suppliers, customers, etc.—are assumed to have voluntarily entered into explicit or implicit 'contracts' [with the corporation] that define each party's rights and obligations."[56] Participation in this contractual scheme is voluntary,

---

49. *See id.*

50. *See* DeMott, *supra* note 14, at 880–81 (arguing that directors occupy a "trustee-*like*" position) (emphasis in original); *see also* Guth v. Loft Inc., 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders.").

51. Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32, 33.

52. *See* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937) (suggesting that this web of internal contracts exists because it is cheaper for these arrangements to occur internally than on the open market).

53. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989).

54. *Id.* at 1418.

55. Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1266 (1999).

56. Antony Page, *Has Corporate Law Failed? Addressing Proposals for Reform*, 107

and under contractual theory, "parties will only enter into contracts that they think will make them better off."[57]

Shareholders occupy a different segment within the "nexus of contracts" than other claimants.[58] Creditors, suppliers, and employees typically have contracted for fixed claims against the corporation in the form of debt repayment, secured transactions, and compensation schedules, respectively. Shareholders, conversely, have a residual claim on the profitability of the firm. The "gains and losses from abnormally good or bad performance are the lot of the shareholders."[59] Furthermore, the residual claims of the shareholders are completely subordinated to claims of the other constituents.[60] The argument then arises that, as those with a residual, uncertain claim on a corporation's income, "shareholders are the group with the appropriate incentives . . . to make discretionary decisions,"[61] as "every decision a corporation makes affects shareholders' wealth."[62] Because the shareholders claim this residual interest through their implicit contractual arrangement, it is incumbent upon management to pursue policies and programs that are ultimately beneficial to the corporation's and shareholders' long-term interests. Therefore, under this framework, management's fiduciary obligations "flow to shareholders because shareholders are the corporate constituency that values those duties most highly."[63]

B. The Stakeholder Theory

The stakeholder theory holds that management's fiduciary obligations flow not only to shareholders, but also to nonshareholder constituents whose interests are affected by corporate action. Opponents of shareholder capitalism favor the fair distribution of a corporation's wealth amongst all stakeholders.[64] The argument goes that "corporations, and therefore corporate law, are created in the interest of society as a whole."[65] "The heart of stakeholder theory is that corporations affect a variety of individuals and groups who have a 'stake' in the firm."[66] The corporation is an entity that "benefits from the fruits of those individuals and groups."[67] Therefore, "the corporation has a reciprocal duty to them."[68] Consequently, under the stakeholder theory, directors are understood to have broader obligations to balance the interests of shareholders with the interests and concerns of employees, creditors, suppliers, customers, the environment, the community, and society at large.

MICH. L. REV. 979, 984 (2009) (reviewing KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES (2006)).

57. *Id.*

58. *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403–04 (1983).

59. *Id.* at 403.

60. *See id.* at 404.

61. *Id.* at 403.

62. Macey, *supra* note 55, at 1273.

63. *Id.*

64. *See* Page, *supra* note 56, at 980.

65. Greenfield, *supra* note 7, at 962 (emphasis omitted).

66. Timothy L. Fort, *Corporate Constituency Statutes: A Dialectical Interpretation*, 15 J.L. & COM. 257, 263 (1995).

67. *Id.; see also* Greenfield, *supra* note 7, at 958.

68. Fort, *supra* note 66, at 263.

According to proponents of the stakeholder theory, corporations cannot help but fail in many ways. The separation of ownership and control fails to act as a buffer on management's power. Although shareholders implicitly consent to management's exercise of their traditional property rights when they purchase a corporate security, there is no real mechanism to prevent potential management abuses other than electing new proxies. Because of the lack of a check on management abuses, many academics argue that management has "every incentive to externalize costs onto those whose interests are not included in the firm's financial calculus—and the firm can do this by polluting the environment, selling shoddy products to one-time purchasers, raiding its employees' pension funds, or producing its goods in sweatshops."[69]

In addition, the stakeholders suffer more from managerial abuses than shareholders. Proponents argue that shareholders do not "bear the consequences of [corporate] abuse in any of the ways the traditional owner-employee metaphor suggests."[70] Furthermore, due to the relentless pursuit of shareholder wealth, which stakeholder theorists attribute to the shareholder-capitalism approach, corporate law inequitably "privilege[s] some stakeholders (shareholders) at the expense of others (for example employees)."[71] Stakeholder theorists further argue that while nonshareholder constituents receive greater protection from external regulatory measures—minimum wage laws, debtor-creditor laws, environmental regulations, and the like—such regulations are ineffective protection for stakeholder groups.[72] Moreover, unlike shareholders, stakeholder groups are unable to effectively bargain internally with a corporation to establish a contractual framework that is fair to both parties.[73]

Due to the vulnerabilities of nonshareholder constituents, their substantial investments of human capital, and their inability to seek protection through contracts or the courts, stakeholder theorists argue that these constituents, and not shareholders, are those most in need of consideration during the corporate decision-making process. Consequently, stakeholder theorists contend that directors owe the duties of care and loyalty to these constituents.

C. The Shareholders Emerge Victorious

Admittedly, both sides of the argument present compelling reasons as to why their champions should be the subject of management's fiduciary obligations. That said, the more compelling of the two propositions is that shareholders, as both owners and/or residual claimants, are more deserving of fiduciary protection.

---

69. Greenfield, *supra* note 7, at 959.

70. Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1416 (1993).

71. Greenfield, *supra* note 7, at 951.

72. *See* KENT GREENFIELD, THE FAILURE OF CORPORATE LAW 16 (2007) (arguing that the mechanisms available outside of corporate law—explicit contracts and governmental regulation—are "seriously imperfect").

73. *See, e.g.*, *id.*; Van Der Weide, *supra* note 22, at 41 (suggesting that stakeholder theorists argue, especially in employment situations, "unions do not adequately protect employees . . . and courts are reluctant to enforce specific provisions in contracts that guarantee employee job security").

1. Market Contracting and the Political Process

Under the nexus-of-contracts view, a shareholder has limited ability to contract directly with the corporation. Instead, a shareholder is left with an implicit contract that management will take the shareholder's investment and use it profitably. Implicit contracts, however, are not observable to third parties—such as courts.[74] As a result, "shareholders are more vulnerable to management misconduct than are nonshareholder constituencies, because shareholders lack meaningful access to many of the protective mechanisms of which nonshareholder constituencies may avail themselves."[75]

Compared to the shareholders, many nonshareholder constituents are able to enter into explicit contracts with the corporation, contracts which directors already have a duty to uphold and honor. For example, employees are able to explicitly contract for "wage compensation, pension benefits, other fringe benefits, and employment levels."[76] Furthermore, the presence of unions and collective action gives workers protection from any employer attempting to dishonor the workers' employment contracts.[77]

In addition, when creditors loan funds to a corporation, they can protect themselves contractually by requiring debtors to "maintain reserves, periodically amortize the debt, maintain shareholders' equity, and/or submit to acceleration of the debt upon the occurrence of . . . dangerous transactions."[78] Under state law, creditors are further protected when a corporation is at or nearing insolvency.[79] For example, creditor's claims usually subordinate the fixed claims of all other constituents.[80]

Finally, while communities do not necessarily contract explicitly with firms, they often make "substantial investments in infrastructure—schools, roads, sewers, and other public utilities, not to mention tax relief—in consideration for getting a major corporate facility to locate or remain within its boundaries."[81] Accordingly, if the corporation were to pack up and leave, the community could quickly lose most of its investment.[82] That said, state and local governments usually maintain the discretion to alter the terms of their contracts with large corporations.[83]

In addition to the nonshareholder constituents' ability to contract around perceived harm, these constituents have another avenue open to them that many shareholders do not—the political arena. If a corporation's actions run counter to the interests of a nonshareholder constituent—whether an employee, a creditor, a supplier, or a community—the affected party can access the political arena and "obtain redress from state and local government."[84] Political theory suggests that constituent groups—with considerable political power to wield—are able to "benefit themselves at the expense

---

74. Van Der Weide, *supra* note 22, at 41.
75. Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1445 (1993).
76. Van Der Weide, *supra* note 22, at 41.
77. *See id.* at 42.
78. *Id.* at 46.
79. *See, e.g.*, *id.* At 50.
80. *See id.*
81. Richard B. Tyler, *Other Constituency Statutes*, 59 MO. L. REV. 373, 414 (1994).
82. *Id.*
83. Van Der Weide, *supra* note 22, at 54.
84. *Id.*

of larger, loosely defined groups by extracting legal rules from lawmakers."[85] Unfortunately, shareholders fall in one of these "larger, loosely defined groups," and consequently have very little political voice. Therefore, shareholders do not have much influence in the political arena.

2. Residual Claimants

In addition to their inability to effectively contract with corporations, shareholders do not have a fixed claim against the corporation. Unlike employees, creditors, and suppliers, shareholders only receive what is left after the corporation has paid all fixed claims. If a corporation has a bad year, shareholders may not receive any return on their investment. Because shareholders maintain only a residual claim against the corporation, their interests are "most aligned with the health of the enterprise itself and . . . therefore [shareholders are] most likely to want to maximize the value of the firm over the long run."[86] Specifically, under the discounted cash flow model of valuation, the value of a shareholder's security is the discounted present value of all future cash flows.[87] Therefore, shareholders maintain an interest in the firm's long-run profitability. Those constituents who have a fixed claim are unlikely to care about managerial decision making as long as the corporation is able to satisfy their claims.

3. Other Arguments

"No one can serve two masters."[88] When directors must figure out not only what their duty to the corporation is, but also to whom it runs, "poorer decisions can be expected."[89] If management had a fiduciary obligation to many different nonshareholder constituents, there is a risk that the obligations to each party become effectively unenforceable. This concern can best be illustrated by the following example: suppose that one manager instructs a worker to make a spreadsheet, while another manager concomitantly suggests that the worker run the cash register. The worker is not necessarily constrained by either mandate and can, in effect, play the directors off of each other.[90] In the corporate world, this practice could lead to extremely poor corporate decisions, as management has no real accountability to anyone.

Furthermore, while stakeholder theorists argue that corporate law should be rewritten to allow directors discretion in determining how to reallocate wealth, "the reallocation of wealth is a function for which directors are not especially suited and one

---

85. Bainbridge, *supra* note 75, at 1444.

86. Page, *supra* note 56, at 990.

87. For a discussion on the discounted cash flow analysis, see Introduction to Discounted Cash Flow, http://news.morningstar.com/classroom2/course.asp?docId=145101&CN=COM &page=1.

88. *Matthew* 6:24 (New International Version).

89. The Committee on Corp. Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2269 (1990).

90. For a similar example, see Page, *supra* note 56.

beyond the general pale of their perceived mandate from society."[91] Such a function is best left to external regulation.

In addition, extending fiduciary protection to nonshareholder constituents will give them yet another avenue for the remediation of harm caused by corporate decisions. Because shareholders only have a claim on a corporation's residual income stream and no real ability to seek redress through the political process or contractual market, it makes perfect sense to make them the sole beneficiary of management's fiduciary obligations. Otherwise there is a real concern that investors—feeling disenfranchised by corporate law—will flee the equity markets, leaving corporations with marginal ability to accumulate additional capital.

Finally, because management has every incentive to externalize the costs of production on parties outside of the firm's "financial calculus,"[92] the argument that fiduciary duties should be extended to these external parties is extraordinarily weak. Corporations need satisfied customers, employees, creditors, and communities to remain a going concern. It is clear from the above arguments that "the preponderance of the evidence suggests that state corporation statutes ought to confine the fiduciary duties of corporate managers to shareholders."[93]

II. CORPORATE SOCIAL RESPONSIBILITY AND INCREASED PROFITABILITY

It is without question that corporations, as major players in society, are expected to "engage[] in open and free competition, without deception or fraud."[94] That said, even when a corporation has operated within the framework promoted by Professor Friedman, "[g]overnments, activists and the media have become adept at holding companies to account for the social consequences of their activities."[95] Activist organizations have become especially skillful at building public support in response to a particular social or environmental issue.[96] In addition, these groups can readily place extreme pressure on high-profile corporations to resolve a problem, even if the corporation is not the problem's main cause.[97] As a result, corporate social responsibility (CSR) "has emerged as an inescapable priority for business leaders in every country."[98]

While CSR is generally revered by most in society, opponents have sharply criticized the proposition that firms may use shareholder money pursuing projects unrelated to the business at hand. Professor Friedman argued that CSR "shows a fundamental misconception of the character and nature of a free economy."[99] Opponents of CSR further the shareholder primacy argument by suggesting that "there is one and only one social responsibility of business—to use its resources and engage

---

91. The Committee on Corp. Laws, *supra* note 89, at 2270.
92. Greenfield, *supra* note 7, at 959.
93. Van Der Weide, *supra* note 22, at 83.
94. FRIEDMAN, *supra* note 8, at 133.
95. Porter & Kramer, *supra* note 3, at 78.
96. *Id.* at 80.
97. *Id.*
98. *Id.* at 78.
99. FRIEDMAN, *supra* note 8, at 133.

in activities designed to increase its profits."[100] Because corporations are viewed as the embodiment of private arrangements, they are "incapable of having social or moral obligations much in the same way that inanimate objects are incapable of having these obligations."[101]

While these ideas lead us to question whether it is really possible for directors to grow a corporation by solely considering shareholder interests, research has shown that if directors take employee and consumer welfare into consideration, stockholder profits will increase in the long-run.[102] Workers who feel that they are treated fairly are "more productive, obey firm rules more often, and [are] more loyal to their employers."[103] Such considerations, therefore, have the propensity to lead to considerable long-term corporate profitability and shareholder gain.

But will corporations realize the same gains when they, in pursuit of their own long-term profitability, take on projects that will further other constituencies' interests? Adam Smith argued in *The Wealth of Nations* that businesses would act in a self-interested manner and that when a corporation seeks to promote its own interest, it would be "led by an invisible hand"[104] that will eventually lead the corporation to "promote an end which was no part of [its] intention,"[105] resulting in greater societal wealth. Smith further argued, however, that every corporation would seek the most advantageous employment of its readily available capital.[106] The corporation will act with its long-term advantage in mind, but considering its own advantage, it will "naturally or rather necessarily . . . prefer that employment which is most advantageous to the society."[107]

In 2003, Marc Orlitzky, Frank L. Schmidt, and Sara L. Rynes conducted a meta-analysis of fifty-two studies attempting to demonstrate a relationship between corporate social performance and corporate financial performance.[108] The study examined 33,878 different observations and concluded that "market forces generally do not penalize companies that [rank] high in corporate social performance; thus, managers can afford to be socially responsible."[109] As a result of these findings, one must ask, what types of corporate social initiatives lead to superior financial performance.

The remainder of this Part will examine actual examples of corporations that have tied their interests to nonshareholder constituents' interests, resulting in a considerable increase in both societal and shareholder wealth.

---

100. *Id.*

101. Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1273 (1982).

102. Dodd, *supra* note 18, at 1156.

103. GREENFIELD, *supra* note 72, at 144.

104. ADAM SMITH, THE WEALTH OF NATIONS, 572 (Edwin Cannan ed., Bantam Dell 2003) (1776).

105. *Id.*

106. *Id.* at 571–72.

107. *Id.* at 570.

108. *See* Marc Orlitzky, Frank L. Schmidt & Sara L. Rynes, *Corporate Social and Financial Performance: A Meta-Analysis*, 24 ORG. STUD. 403 (2003).

109. *Id.* at 426.

A. Nestlé's Milk District

In 1962, Nestlé saw great, untapped potential in the Indian milk market. As a result, it successfully obtained government permission to construct a dairy in the northern district of Moga.[110] When Nestlé first entered the region, poverty was severe and people were without many of the tools necessary for modern life.[111] "Nestlé came to Moga to build a business, not to engage in CSR. But Nestlé's value chain . . . depended on establishing local sources of milk from a large, diversified base of small farmers."[112] As a result, Nestlé began creating the necessary infrastructure in the region by constructing refrigerated dairies as collection points for milk; assisting local farmers by sending trucks to the myriad dairies to collect the milk; and hiring "veterinarians, nutritionists, agronomists, and quality assurance experts" to travel to the dairies.[113]

As a result of Nestlé's efforts to increase profitability, conditions in Moga have improved dramatically.[114] Cattle are far healthier because farmers have learned from the professionals how to properly care for their herd; infrastructure has increased substantially; all villages in the region have primary schools; and "Moga has five times the number of doctors as neighboring regions."[115] Furthermore, with the technological advances came higher-quality milk.[116] Nestlé, in turn, was able to pay a higher premium to the farmers for the upgraded quality.[117] "The increased purchasing power of local farmers has also greatly expanded the market for Nestlé's products, further supporting the firm's economic success."[118]

B. What Other Companies Are Doing

The Nestlé example demonstrates how a single company can integrate business and society by using its powers to not only increase profitability and ensure its longevity as a going concern but also positively change an entire region of the world. Nestlé, however, is not alone in the category of companies seeking increased returns through CSR.

Vail Resorts, Inc., a Colorado resort behemoth, has made considerable efforts to implement an energy conservation policy.[119] These efforts include offsetting one hundred percent of energy consumption by purchasing wind credits; offering incentives to employees who carpool to work; installing "low-flow faucets, showerheads, toilets, kitchen sprayers and water efficient laundry equipment"; and integrating "EPA EnergyStar™ rated appliances, electronics, and other service equipment."[120] In

---

110. Porter & Kramer, *supra* note 3, at 90.
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.*
116. *Id.*
117. *Id.*
118. *Id.*
119. Vail Resorts Mgmt. Co., Conserving Water & Energy, http://www.vailresorts.com/CORP/info/conserve-water-and-energy.aspx.
120. *Id.*

addition, Vail Resorts will be constructing the largest Leadership in Energy and Environmental Design certified project for resort use in North America.[121] These policies are touted by the company as "the right thing to do for the environment, our guests, our company and the community."[122]

In May of 2005, General Electric announced "Ecomagination"—a company-wide initiative geared at decreasing pollution from the production and use of its products. The initiative also doubled the research and development spending on cleaner technologies including "wind-power generation, diesel-electric hybrid locomotives, more-efficient aircraft engines and appliances, and advanced water-treatment systems."[123] According to Chief Executive Officer Jeffrey Immelt, Ecomagination is expected to generate revenues of twenty billion dollars a year.[124] In addition, Immelt projects that more than half of General Electric's total product revenue will come from Ecomagination by 2015.[125]

Finally, corporations have broken the mold entirely by adding a "social dimension to [their] value proposition, making social impact integral to the overall [corporate] strategy."[126] Consider, for example, Whole Foods Market, the Austin-based natural and organic grocer. Social issues are a key component of Whole Foods' entire business operation. Those in charge of sourcing and good procurement emphasize purchasing from local farmers on a store-by-store basis.[127] Cognizant that the construction of big-box structures, like supermarkets, consume great amounts of resources, the company ensures that new stores are constructed using a minimum of virgin raw materials.[128] Furthermore, Whole Foods recently purchased renewable wind-energy credits equal to one hundred percent of its electricity in a large-scale push to limit its ecological footprint.[129] Finally, vehicles powered by biodiesel are used to truck any spoiled produce or biodegradable waste to regional compost centers.[130] Whole Foods' desire to keep social issues at the heart of its business plan is a primary driver behind its ability to "command premium prices" and reap greater economic rewards that are passed on to its shareholders.[131]

The preceding examples demonstrate how enlightened corporate leaders responded to the calls of nonshareholder constituents by implementing social and environmental programs that have had a demonstrable effect on the corporation's profitability, have increased shareholder value, and have enhanced society and the communities where these firms operate. As more findings regarding the relationship between CSR and corporate financial performance disseminate to a broader audience, "managers may be

---

121. *See Vail Announces "Ever Vail" Green Neighborhood*, FREESKIER MAG., Mar. 7, 2007, http://www.evervail.com/pdfs/2007-03-05_VailResortsAnnouncesLargestGreenResort.pdf.

122. *Id.*

123. Greg Schneider, *GE Determined to Show More 'Ecomagination'; Program Sets Pollution Reduction Targets*, WASH. POST, May 10, 2005, at E02.

124. *Id.*

125. *Id.*

126. Porter & Kramer, *supra* note 3, at 89–90.

127. *Id.* at 90.

128. *Id.* at 90–91.

129. *Id.* at 90.

130. *Id.* at 91.

131. *Id.* at 90.

more likely to pursue [CSR] as part of their strategy for attaining high [corporate financial performance]."[132] However, only by revamping nonshareholder-constituency statutes will society be able to guarantee that even the most unscrupulous directors will consider the interests of the myriad stakeholders affected by a corporation's decisions when seeking to improve long-term profitability and shareholder value.

III. NONSHAREHOLDER-CONSTITUENCY STATUTES

Nonshareholder-constituency statutes gained popularity during the height of the 1980s hostile-takeover boom. Stakeholders, it was perceived, were the parties most affected by hostile takeovers and, therefore, needed additional protection from the corporate law. For example, during this time period, takeovers resulted in "extensive job losses, diminished security between creditors, suppliers, and corporations, and ruined customer relationships."[133] As a result of these losses to stakeholders, "members of the legal community began advocating an approach to corporate law that allowed for stakeholder consideration" in the decision-making process.[134] The result of this advocacy was the nonshareholder-constituency statute. "Generically speaking, constituency statutes purport to allow directors of public corporations to consider an expanded group of 'interests' when making decisions on behalf of the corporation or, more precisely, decisions concerning the course of the corporation's business."[135] Proponents of these statutes assert that "they exemplify an effective means to ensure that the many varying interests affected by a corporation are given a voice in directors' decisions."[136]

The Commonwealth of Pennsylvania adopted the first nonshareholder-constituency statute in 1983.[137] Since this initial move in 1983, an additional forty states have implemented similar statutes.[138] A preponderance of the states have incorporated statutes that are all-encompassing, meaning that they follow Pennsylvania's precedent that reads "[i]n discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate."[139] The purpose of the "may" language was to "make explicit directors' and executives' ability to consider stakeholder interests without obliging them to act contrary to shareholders' interests."[140]

---

132. Orlitzky et al., *supra* note 108, at 426.

133. Kathleen Hale, Note, *Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes*, 45 ARIZ. L. REV. 823, 831 (2003) (footnotes omitted).

134. *Id.* at 832.

135. Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 26 (1992).

136. Edward S. Adams & John H. Matheson, *A Statutory Model for Corporate Constituency Concerns*, 49 EMORY L.J. 1085, 1101 (2000).

137. *See* 15 PA. CONS. STAT. § 1715 (2002).

138. Hale, *supra* note 133, at 833; *see also id.* at 833 n.78 (listing all corporate constituency statutes).

139. 15 PA. CONS. STAT. § 1715 (a).

140. Hale, *supra* note 133, at 830.

Critics of these "may" statutes, however, argue that the statutes do nothing to protect the nonshareholder constituents' interests.[141] Because these statutes do not require directors to consider nonshareholder constituents' interests, and given that shareholders have the power to upend a corporate board by voting their proxies, directors have little incentive to consider these third-party interests.[142] In addition, critics argue that the statutes give no cause of action to any nonshareholder constituents and are therefore ineffective.[143]

Furthermore, proponents of the shareholder-primacy norm oppose the ratification of such nonshareholder-constituency statutes altogether. Opponents of these statutes argue that "if management is to consider the public and social interests of its actions, then it essentially becomes a public servant and as a public servant it becomes the subject of increasing public control."[144] Professor F.A. Hayek furthered this argument by stating:

> So long as the management has the one overriding duty of administering the resources under its control as trustees for the shareholders and for their benefit, its hands are largely tied; and it will have no arbitrary power to benefit this or that particular interest. But once the management of a big enterprise is . . . obliged to consider in its decisions whatever is regarded as the public or social interest . . . it gains indeed an uncontrollable power—a power which could not long be left in the hands of private managers but would inevitably be made the subject of increasing public control.[145]

Those siding with Professor Hayek also argue that these statutes extend a fiduciary duty to constituents who are otherwise undeserving and who have other remedial methods available to them through the legal system or the political system. Because the efficacy of current nonshareholder-constituency statutes has been met with such overt criticism and controversy, a different suggestion is warranted.

First, these statutes should require management to consider the interests of all stakeholders. While this charge may, at first blush, appear counter to the main thesis of this Note, a deeper examination demonstrates that the two ideas are very much in-line because the inclusion of these interests in corporate decision-making can increase shareholder wealth. "Imposing a multilateral fiduciary duty, however, is not the way to achieve corporate harmony."[146] Therefore, these statutes should be written to award no new rights to the nonshareholder constituents. Specifically, these statutes should include a nonabrogation of duty clause, as articulated in New York's nonshareholder-constituency statute[147] so that the legislature can make it profoundly clear that these statutes are written to enhance the corporation's value and profitability and realize greater returns for the corporation's shareholders.

These statutes should be written as follows:

---

141. LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 105 (2001).

142. *Id.*

143. *Id.*

144. Fort, *supra* note 66, at 291.

145. 3 F.A. HAYEK, LAW, LEGISLATION, LIBERTY, THE POLITICAL ORDER OF A FREE PEOPLE 82 (1979).

146. Van Der Weide, *supra* note 22, at 84.

147. *See* N.Y. BUS. CORP. LAW § 717(b) (2002).

In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation in consideration of the best interests of the corporation, and to the *extent that such consideration will provide a demonstrable return to the corporation and its shareholder body*, *shall* consider without limitation, (1) both the long-term and short-term interests of the corporation and its shareholders, and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following: (i) the prospects for potential growth, development, productivity, and profitability of the corporation; (ii) the corporation's current employees; (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare, or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation; (iv) the corporation's customers and creditors; (v) the communities within which the corporation operates; (vi) the environment; and (vii) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities, employment benefits, and otherwise to contribute to the communities in which it does business. Nothing in this paragraph shall create any duties owed by any director to any of the nonshareholder constituents mentioned herein, nor shall it abrogate any duty of the directors, either statutory or recognized by common law or court decisions.[148]

This sample language embodies Professor Kenneth Goodpaster's "strategic stakeholder" position.[149] Under this approach, management is permitted to consider the impact of its decisions on nonshareholder constituents only to the extent that the impact has consequences for long-term shareholder wealth maximization.[150] In addition, the breadth of the sample language is supported by the American Law Institute, which states that the "long-term well-being of the shareholders requires stable relationships with suppliers and customers and a cooperative relationship with the communities in which the corporation does business."[151]

These statutes should be written to compel directors to examine strategies that they ordinarily would not consider in the normal corporate decision-making process, but which nonetheless have the potential to create greater long-term corporate returns.[152] Because "information has costs,"[153] directors should only seek information regarding nonshareholder constituents that they "reasonably believe[] to be in the best interests of the corporation."[154] In other words, directors should consider the legitimacy of the stakeholder claims early in the decision-making process to determine whether or not the information is relevant to the decision at hand.[155] These statutes give shareholders

---

148. This hypothetical statutory language is based on both the New York and Pennsylvania nonshareholder-constituency statutes. *See id.*; 15 PA. CONS. STAT. § 1715(a) (2002).

149. *See* Kenneth E. Goodpaster, *Business Ethics and Stakeholder Analysis*, BUS. ETHICS. Q., Jan. 1991, at 53, 63.

150. *See id.*

151. AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 6.02(a) cmt. c(2) (Discussion Draft No. 2,1989).

152. Adams & Matheson, *supra* note 136, at 1109.

153. *In re* RJR Nabisco, Inc. S'holders Litig., Civ. A. No. 10389, 1989 WL 7036, at *19 (Del.Ch. Jan. 31, 1989).

154. MODEL BUS. CORP. ACT § 8.30(a) (2009).

155. *See* ROBERT PHILLIPS, STAKEHOLDER THEORY AND ORGANIZATIONAL ETHICS 120 (2003).

another arrow in their quiver under the *gross-negligence* standard set forth in *Smith v. Van Gorkom*.[156] If management fails to consider the outside constituents' interests when information is readily available and such consideration could lead to maximized shareholder wealth, these statutes would give shareholders an opportunity to attempt to pierce the business-judgment rule when the board is grossly negligent in discharging its duty to become fully informed before making a decision.

Revamped nonshareholder-constituency statutes are necessary because they could "promote corporate growth and vitality, which benefits shareholders in the long-term,"[157] and consequently contribute to an increase in societal wealth.

CONCLUSION

During much of the twentieth century, businesses operated under the notion that what was good for business was good for America. Over the past few decades, however, the world has changed, and so too has corporate sentiment. Now, there is overwhelming evidence that what is good for society is, in fact, good for business. While the prevailing norm is that directors conduct business to maximize profits and generate shareholder wealth, it is now crucial that directors examine nonshareholder constituents' interests to achieve these goals. After all, "a theory of strategic management . . . would appear significantly incomplete in failing to consider the potential impact of powerful constituencies that could help or hinder the achievement of the organization's strategic objectives."[158] This Note's proposed revamping of current corporate law, through nonshareholder-constituency statutes, ultimately kills two birds with one stone. Forcing corporate boards of directors to consider the outside constituents' interests in order to become fully informed in the decision-making process will result in the simultaneous increase in corporate social responsibility and increasing shareholder wealth.

---

156. 488 A.2d 858, 873 (Del. 1985).
157. Adams & Matheson, *supra* note 136, at 1109.
158. PHILLIPS, *supra* note 155, at 120–21.