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SHAREHOLDER PRIMACY AND THE MORAL OBLIGATION OF DIRECTORS

Mark J. Loewenstein[*] *and Jay Geyer*[**]

ABSTRACT

One of the most written-about and important topics in corporate law is the fiduciary obligations of corporate directors. Increasingly, critics of American capitalism have urged that corporations, and implicitly, corporate directors, act in a more socially responsible fashion and thus eschew the notion that shareholder primacy is the exclusive guide to a director's fiduciary duty. Under this view, directors must consider the effect of their actions on "stakeholders" other than shareholders and be guided by morality—doing the right thing—when making business judgments.

When directors move away from shareholder primacy, however, decision-making becomes more difficult and problematic. This article analyzes the arguments that underpin a rejection of shareholder primacy, alternatives to shareholder primacy, and the utility of morality as a guide for directors making business judgments.

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INTRODUCTION

Corporate directors are under increasing pressure from outside of their corporations, and sometimes from their shareholders, to be more socially responsible.[1] What that pressure demands is not altogether clear, but assume, for now, that there is a general consensus as to what constitutes a socially responsible corporation. The conventional wisdom is that directors in a typical business corporation are free to act in a socially responsible fashion if they can justify it as a business judgment in the best interests of the corporation.[2] As long as that justification is provided, the courts are loathe to second-guess the directors, and almost never have, unless there was no rational basis for the chosen course of action.[3] Still, the directors' freedom of action is easier if the applicable law—the business corporation statute under which the corporation is

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1. MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 212 n.19 (1995).
2. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 663 (Del. Ch. 1988).
3. *Id.*

organized—includes an "other-constituency" provision.[4] This provision expressly allows directors to consider the impact of a potential course of action on constituencies other than the shareholders, including employees, consumers, suppliers, and the community or communities in which the corporation does business. A course of action can be justified even if it is not necessarily in the best interests of the corporation and its shareholders, if another constituency benefits or is harmed by an alternative course of action the directors might have chosen.[5] The recent advent of "benefit corporations" adds yet another layer to this inquiry; directors of a benefit corporation *must* take into account the impact of their chosen courses of action on the environment and society at large, as well as the "other constituencies" noted above.[6]

The justifications for unmooring directors from their traditional fiduciary duties to the corporation and its shareholders are many and varied. Some turn on the great wealth and power amassed by the modern corporation. Under this justification, corporations must, as a matter of necessity, act in a socially responsible fashion.[7] Other justifications focus more on the impact that corporations have on society: Its proponents reason that corporations must therefore act to preserve and enhance societal goals.[8] These and other arguments, described below, are, essentially, arguments by assertion: The proponents justify the result because it is the result that they want. What is lacking is an analysis explaining why and how *directors* should behave in the way that these critics want them to behave.

This article grapples with this fundamental question from three perspectives. First, we consider the developing scholarship on "stakeholder theory," an approach to corporate governance that holds that directors should consider the interests of persons and groups that are affected by, or that affect, a corporation. Second, we consider the moral autonomy of directors; should directors be free to consult their own moral and ethical principles in deciding corporate matters? The answers

4. Andrew Keay, *Stakeholder Theory in Corporate Law: Has it Got What it Takes?*, 9 RICH. J. GLOB. L. & BUS. 249, 249–50 (2010).

5. Andrew S. Gold, *Purposive Loyalty*, 74 WASH. & LEE L. REV. 881, 882 (2017).

6. Leo E. Strine, *Making it Easier for Directors to "Do the Right Thing"?*, 4 HARV. BUS. L. REV. 235, 245–46 (2014).

7. *See* BARNALI CHOUDHURY & MARTIN PETRIN, CORPORATE DUTIES TO THE PUBLIC 42–43 (2019).

8. Jeffrey Nesteruk, *Corporations, Shareholders, and Moral Choice: A New Perspective on Corporate Social Responsibility*, 58 UNIV. CIN. L. REV. 451, 453–54 (1989).

may seem obvious, but operationalizing these individual moral judgments in a way that can be captured by the law is difficult, if not impossible. We thus consider in this context the analogous issue of a lawyer's duty to zealously represent her client when such representation conflicts with a lawyer's personal moral judgment.

We then turn to a third rationale to justify a non-profit-maximizing approach to corporate governance, as set forth in Professor Joseph Heath's recent book, MORALITY, COMPETITION, AND THE FIRM.[9] Heath calls for a "market failures approach" to business ethics: When there is a market failure, managers may not exploit that failure and, instead, should seek to do the right thing.[10] A close analysis of this approach, however, suggests that it is more efficient to change the law to address market failures than to depend on the good will of corporate managers. Before concluding, we contrast these approaches to the corporate law that underpins the legitimacy of director conduct in the first instance; that is, the fiduciary relationship between the directors and the shareholders, beautifully articulated in *Blasius Industries, Inc. v. Atlas Corp*.[11] How do these principles inform directors as to how they might act in a socially responsible way? Prior to considering these alternative approaches to director decision-making, it is important to set out the conventional understanding and, probably, the predominant norm for director conduct, the idea of shareholder primacy as a guiding principle and a manifestation of the ideas expressed in *Blasius*.

I. SHAREHOLDER PRIMACY AND STAKEHOLDER THEORY

A. SHAREHOLDER PRIMACY

Shareholder primacy is the theory in corporate law that the fiduciary duty of directors obligates them to make decisions that promote shareholder wealth maximization.[12] Shareholders are the principals on whose behalf the firm is organized and are, at least in a sense, its owners. The idea of ownership, though controversial, rests on

9. *See generally* JOSEPH HEATH, MORALITY, COMPETITION, AND THE FIRM: THE MARKET FAILURES APPROACH TO BUSINESS ETHICS (2014).

10. *Id.* at 90.

11. 564 A.2d 651, 655 (Del. Ch. 1988).

12. D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277–78 (1998); *see also* Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1746 (2006).

the notion that under state corporate law, the shareholders elect the directors of the corporation and can enforce the directors' fiduciary duties through derivative litigation.[13] Consistent with the idea of ownership, early cases often refer to directors as trustees for the shareholders, implying that the directors managed property "owned" by their beneficiaries, the shareholders.[14] In contrast to the shareholders, other constituents of the firm, such as employees and suppliers, depend on contracts (explicit or implicit) to define their rights. Shareholders lack explicit contracts and, to realize a return on their investment, depend on the directors to maximize the value of the firm.[15]

The idea of shareholder ownership of the firm is controversial, or at least subject to challenge, because the traditional indicia of ownership are lacking. Technically, shareholders only own shares of stock, which ownership includes certain rights defined by statute, principally the right to elect directors, approve or veto fundamental corporate changes (for example, mergers, amendments to the articles of incorporation, dissolution), and receive the residual value of the firm on liquidation.[16] Scholars, who dispute the idea that shareholders own the corporation, note that shareholders lack control over the firm's assets and lack power to direct those who do, the directors.[17] In addition, as a practical matter, shareholders face considerable hurdles in electing directors beyond nominating the directors themselves.[18] In publicly held corporations, the directors use corporate resources to prepare and circulate proxy statements to solicit proxies for their own election.[19] Shareholders do not have access to these proxy statements (unless the bylaws so provide) and must bear the considerable expense of soliciting proxies themselves.[20]

The right to bring derivative litigation must also be considered in context. Just as it is difficult for shareholders to exercise their right to elect directors, it is also difficult for them to discipline directors through

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13. Bainbridge, *supra* note 12, at 1748.

14. *See* Paul Weitzel & Zachariah J. Rodgers, *Broad Shareholder Value and the Inevitable Role of Conscience*, 12 N.Y.U. J.L. & BUS. 35, 39 (2015); *see also* Gray v. President of Portland Bank, 3 Mass. 364, 378–79 (1807).

15. Weitzel & Rodgers, *supra* note 14, at 40.

16. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. UNIV. L. REV. 547, 564–65 (2003).

17. *Id.* at 574.

18. *Id.* at 569.

19. Bainbridge, *supra* note 12, at 1737–38.

20. *Id.* at 1735.

derivative litigation. Procedural hurdles,[21] the ability of directors to dismiss the litigation,[22] and the business judgment rule[23] all make derivative litigation difficult and expensive. Under the business judgment rule, courts do not review the business judgments of directors unless the directors were conflicted or utterly failed to inform themselves when they made their decision.[24] The shareholders who challenge directors' business judgments bear the burden of proving the conflict or breach of the duty of care.

Although directors still regard shareholders as the most important constituency, recently some directors have admitted that they factor other constituencies into their decision making.[25] These directors explain that strict shareholder primacy may discourage non-shareholder constituents from making the types of firm-specific investments that can be essential to a company's success.[26] For example, a board of directors can make the decision to maximize shareholder wealth by selling the firm to the highest bidder. Or, taking into consideration the effects of the acquisition on non-shareholder constituents such as managers and other employees, the board can choose to sell to a lower bidder who offers commitments to those groups. If employees and managers really believe that the board of directors will sell to the highest bidder and not take their interests into account, then managers and employees will not devote themselves to the firm.[27] Since an ex-ante policy of considering the effect of a sale on employees encourages firm-specific investment, it can be argued that it is consistent with shareholder primacy, that is, it is in the best interest of shareholders as a class over the long run.[28] However, in the short run, it affords directors discretion to refuse to maximize the wealth of the shareholders of a particular firm at a

21. Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 525 (1992).

22. *Id.* at 505.

23. In re Trados Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013).

24. *See id.*

25. Smith, *supra* note 12, at 290.

26. *See id.* at 282 (quoting David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* PROGRESSIVE CORPORATE LAW 1 (Lawrence E. Mitchell, ed., 1995)).

27. Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1197–98 (2002).

28. *Id.* at 1198.

particular time in order to protect the extra-contractual expectations of essential non-shareholder groups, as well.

The idea of shareholder primacy began to emerge in the nineteenth century. It grew in popularity during the 1930s, became widely accepted by the 1990s, and is considered, for the most part, the norm today.[29] The development of derivative litigation in the nineteenth century was an early indication that directors should operate the corporation in the interest of the shareholders.[30] For example, in *Gray v. President of Portland Bank,*[31] Justice Samuel Sewall reasoned that the firm was the trustee of the shareholders, and therefore, it could not act except for the benefit of existing shareholders, thus supporting the notion that shareholders were the sole beneficiaries of the firm.[32] In *Robinson v. Smith*,[33] a shareholder brought a suit against the firm because the company failed to pursue mining operations, which was the purpose for which it was incorporated, and subsequently the firm incurred a substantial loss.[34] The court found in favor of the shareholder and reasoned that directors willfully abused their duty of trust to the shareholders.[35]

29. In a highly publicized statement issued in August 2019, the Business Roundtable announced that the purpose of the corporation should be to benefit all stakeholders, not just shareholders. *See* Press Release, Business Roundtable Redefines the Purpose of a Corporation to Promote "An Economy That Serves All Americans" (August 19, 2019) (on file with author), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/599K-2P9L]. This statement, signed by 181 prominent CEOs, marked a stark departure from prior positions of the Business Roundtable, which previously had championed shareholder primacy. *Id.* Whether this shift in attitude will make a difference in board decision-making has been questioned. *See* Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *For Whom Corporate Leaders Bargain*, 93 S. CAL. L. REV. (forthcoming 2021) (manuscript at 2) (on file with authors), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3677155. The authors argue that corporate managers in states that had other-constituency statutes did not tend to protect non-shareholder constituencies in acquisitions but rather obtained gains for shareholders and themselves. *Id.*

30. Smith, *supra* note 12, at 304.

31. 3 Mass. 364 (1807).

32. *Id.* at 378–79; *see also* Lynn A. Stout, *On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)*, 36 SEATTLE UNIV. L. REV. 1169, 1174 (2013).

33. 3 Paige Ch. 222 (N.Y. Ch. 1832).

34. *Id.* at 223; *accord* Smith, *supra* note 12, at 308.

35. Smith, *supra* note 12, at 308 (quoting *Robinson*, 3 Paige Ch. at 222–23).

Because of the foundation laid by these cases, shareholder primacy theory began to gain universal acceptance. In 1919, the court in *Dodge v. Ford Motor Company*[36] endorsed the shareholder primacy norm explicitly by stating that "a business corporation is organized and carried on primarily for the profit of the stockholders."[37] The idea that directors should act in the interests of the shareholders follows almost logically from state corporate statutes, which delegate to shareholders (and only to shareholders) the power to elect directors.[38] Following the *Dodge* ruling, public companies began to solidify the idea of shareholder primacy in their corporate charters.[39]

In general, and building on this legal history, four groups helped propel the shareholder primacy theory into the central theory in corporate governance. First, academics seeking to answer the question "what is the purpose of the corporation," saw shareholder primacy as a logical answer.[40] Second, "activist" investors, who, for instance, urged a corporation's board to increase dividends or spinout unprofitable divisions or subsidiaries, helped create a culture in which shareholder primacy became the norm.[41] Indeed, these activist investors explicitly or

36. 170 N.W. 668 (Mich. 1919).

37. *Id.* at 684.

38. Leo Strine, the former Chief Justice of the Delaware Supreme Court and a leading scholar on corporate law, has repeatedly made the argument that corporate power is corporate purpose, meaning that because shareholders wield ultimate power within the corporation, the directors must (and do) operate the corporation to best serve them. *See, e.g.*, Leo E. Strine, Jr., *Corporate Power Is Corporate Purpose II: An Encouragement for Future Consideration From Professors Johnson and Millon*, 74 WASH. & LEE L. REV. 1165, 1166–68 (2017); Leo E. Strine, Jr., *Our Continuing Struggle With the Idea That For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 136 (2012); Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 768 (2015). Justice Strine does not argue that directors should ignore the interests of corporate constituencies counter to shareholders' interests, but instead argues that current law–by structure and design–precludes them from doing so and, in his experience, effectively so. *See id.*

39. Stout, *supra* note 27, at 1180.

40. *Id.* at 1174.

41. *See, e.g.*, James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation*, 95 N.C. L. REV. 19–20 (2016) (explaining how activist investors have used the leverage of large shareholdings and appraisal litigation to discipline corporate management.

implicitly threatened the tenure of corporate managers who failed to prioritize shareholder wealth. Third, policy entrepreneurs such as academics and business consultants, argued that to improve corporate governance, boards of directors must embrace shareholder primacy as the norm. Prominent among these academics was Milton Friedman, who argued in a widely read New York Times essay that the only purpose of a corporation was the pursuit of profit, a basic tenet of the shareholder primacy norm.[42] Fourth, CEOs and executives accepted shareholder primacy because it suggested that the obvious metric to determine the value of the corporation should be stock price, and stock price turned out to be something that was relatively easy for executives to manipulate, at least in the short run.[43]

By the early 1990s, shareholder primacy was a widely accepted theory, and, in a sense, was enshrined in the Internal Revenue Code in a 1993 provision.[44] Responding to popular concerns that executive compensation was excessive, Congress amended the tax code to limit the deductibility of executive compensation to $1,000,000 unless the excess compensation was performance-based.[45] To comply with this requirement, corporations typically granted executives qualified stock options, which were only valuable to the recipient if the stock price rose. Incentivizing corporate actors to maximize share price, of course, is consonant with the idea of shareholder primacy.

B. STAKEHOLDER THEORY

A growing body of scholarship promotes the idea that in decision-making, corporate directors should take into account the effect of their actions on the corporation's stakeholders. This includes, at the least, the corporation's employees, creditors, suppliers, and the communities in which the corporation has facilities, in addition to the corporation's shareholders. Stakeholder theory is thus in profound conflict with the idea of shareholder primacy.

Interestingly, the article accepts, without discussion, that the goal of the corporation is to maximize shareholder returns).

42. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, at SM17.

43. Stout, *supra* note 27, at 1176.

44. 26 U.S.C. § 162(m).

45. In 2017, § 162(m) was amended to remove the exception for performance-based pay. *Id.*

Advocated for many years, stakeholder theory is of great interest, especially in the current sociopolitical climate. One of the leading theorists, Professor R. Edward Freeman, has written extensively on the topic.[46] In STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH,[47] Freeman identifies the various stakeholders of a firm, which he defines generally as "any group or individual who can affect, or is affected by, the achievement of a corporation's purpose. Stakeholders include employees, customers, suppliers, stockholders, banks, environmentalists, government and other groups who can help or hurt the corporation."[48] The crux of his thesis is that corporations have not been managed with a view toward dealing with each of these stakeholders, and effective management requires that they do so.[49] In other words, the emphasis appears to be on increasing the corporation's long-term success. He argues that "if business organizations are to be successful in the current and future environment . . . executives must take multiple stakeholder groups into account."[50] Freeman's argument for a stakeholder philosophy starts from the presumption that globalization, increased competition, and other factors have increased the challenges facing corporate management; he argues that a stakeholder approach is the best way to successfully navigate these changes. But the idea that corporate management has not understood the importance of, for instance, maintaining a loyal workforce or supplier network to effectively compete in a global market seems, on its face, implausible.

Further, Freeman seeks to distinguish his approach to corporate management from the corporate social responsibility movement. He argues that advocates of the latter do not fully appreciate the importance of integrating social responsibility with managers' strategic thinking: "corporate social responsibility literature . . . has failed to indicate ways

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46. *See generally* R. EDWARD FREEMAN, J.S. HARRISON, A.C. WICKS, ET. AL., STAKEHOLDER THEORY: THE STATE OF THE ART (2010); STAKEHOLDERS (R. Edward Freeman & Robert A. Phillips, eds., 2010); Jacob Hörisch, R. Edward Freeman, and Stefan Schaltegger, *Applying Stakeholder Theory in Sustainability Management: Links, Similarities, Dissimilarities, and a Conceptual Framework*, 27 ORGS. & ENV'T 4 (May 27, 2014), https://doi.org/10.1177/1086026614535786.

47. R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (Cambridge Univ. Press 2010).

48. *Id.* at vi.

49. *Id.*

50. *Id.* at 52.

of integrating these concerns into the strategic systems of the corporation in a non-ad hoc fashion."[51] In other words, corporate social responsibility is only one aspect of the many internal and external challenges that managers face. Freeman concedes that dealing with outside stakeholders is voluntary,[52] but describes how negotiating with, say, a consumer group, is better than a "hardball" tactic of non-negotiating.[53] It appears that in the 30 years since Freeman published STRATEGIC MANAGEMENT, no distinction is currently recognized between those advocating greater corporate social responsibility and proponents of a stakeholder theory of corporate management.

In any case, unlike shareholder primacy, which has a well-accepted definition, the parameters of stakeholder theory vary from proponent to proponent. Some advocates for stakeholder theory argue that directors should consider all individuals and groups that are affected by corporate actions.[54] At its extreme, of course, the affected stakeholders are without limit under such a definition. A corporation that, for instance, manufactures airplanes and buys engines from an engine manufacturer has an effect on that supplier and its stakeholders, as well as on every company in the engine manufacturer's supply chain and their respective stakeholders. Weighing the effects of its decisions on such a large and far-flung supply chain may be a nearly impossible task. Stakeholder theorists readily suggest such an obligation but do not grapple with its practical implications.[55]

In addition to a diversity of views on who should be considered a stakeholder, stakeholder theorists propose various rationales to justify or support their theory:

> 1. Large corporations affect the lives of a broad range of individuals and have an outsized influence on the economy and the public interest.[56]

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51. *Id.* at 40.
52. *Id.* at 74.
53. *See id.* at 75–76.
54. Keay, *supra* note 4, at 256–57.
55. Spencer J. Hazan, Note, *Considering Stakeholders in M&A*, 16 N.Y.U. J.L. & BUS. 749, 755 (2020).
56. *See, e.g.*, ANNA BECKERS, ENFORCING CORPORATE SOCIAL RESPONSIBILITY CODES: ON GLOBAL SELF-REGULATION AND NATIONAL PRIVATE LAW 7 (Hart Publ'g Ltd. 2015).

> 2. Outside groups, in addition to shareholders, contribute to a corporation's capital and, therefore, "should have claims on a corporation's assets and earnings."[57]
>
> 3. Considering the various constituencies that contribute to a corporation's profitability benefits the corporation because these constituencies will be more loyal to the corporation.[58]
>
> 4. Because many groups and individuals who deal with or are affected by a corporation do not have explicit contracts, there is an implicit understanding that their interests will be considered by corporate decision makers.[59]
>
> 5. Stakeholder protection is a matter of recognizing the human rights of those stakeholders.[60]

However, none of these rationales are persuasive upon further interrogation. The following considers each in turn.

1. The Outsized Effect of Corporations

Assuming the truth of the assertion that corporate policy has an outsized effect on individuals and the economy, it does not necessarily follow that the corporation has to consider each stakeholder in its decision making. To the extent that stakeholders are individuals, they have political processes available to them to affect corporate behavior. If, for instance, the claim is that a corporation should provide paid parental leave for its employees, it is more efficient for citizens to lobby their elected officials to change the law than for employees of multiple corporations to lobby their employers for a new benefit. Such a law would presumably not disadvantage one employer over others, while a piecemeal approach to the problem would. Moreover, the interests of stakeholders often conflict; what benefits consumers, for instance lower

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57. *See, e.g.*, Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156, 1171 (1993).

58. *See, e.g.*, Keay, *supra* note 4, at 265; *see also* John Plender, *Giving People a Stake in the Future*, 31 LONG RANGE PLAN. 211, 215 (1998).

59. *See, e.g.*, Wai Shun Wilson Leung, *The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime That Recognizes Non-Shareholder Interests*, 30 COLUM. J.L. & SOC. PROBS. 589, 622 (1997).

60. *See, e.g.*, Robert Phillips, R. Edward Freeman & Andrew C. Wicks, *What Stakeholder Theory Is Not*, 13 BUS. ETHICS Q. 479, 494 (2003).

prices, adversely affects other stakeholders, such as shareholders and employees. A policy that benefits suppliers, for instance higher prices for inputs, disadvantages other stakeholders, such as consumers. There is no principled way to weigh these competing interests, and resolving them in any way other than what maximizes profits will adversely affect the corporation's ability to compete, which in the end disadvantages all stakeholders.

2. Contribution of Capital by Stakeholders

This claim about non-shareholders is specious at best. In relation to a corporation, "capital" is normally thought of as financial assets, tangible machinery, and equipment employed to produce goods and services.[61] In her article *Implications of the Stakeholder Model*, Professor Roberta Karmel notes that employees make a "financial contribution to the corporation . . . in the form of human capital"[62] and that communities provide capital in the form of "governmental services to the business and its employees."[63] Professor Karmel recognizes the shortcomings of this approach, writing, "it is difficult to weave any theory as to how [customers and suppliers] supply a corporation with capital unless they are providers of trade credit."[64] This observation reveals that the argument reduces to a rhetorical device and, like the "outsized effect" claim, cannot support its conclusion. Instead of providing capital, various stakeholders provide goods and services that the corporation needs to utilize the capital supplied by its equity and debt investors. In addition, many proponents of stakeholder theory would include the "environment" as a stakeholder.[65] Arguing that the environment provides capital is, of course, *absurd*. Individuals and entities that transact business with the corporation do so on terms that are agreeable to the parties. There is no reason to characterize the consideration provided by each of the corporation's counterparties as "capital." To do so would drain the term "capital" of any meaning.

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61. Marshall Hargrave, *Capital*, INVESTOPEDIA (March 26, 2020), http://www.investopedia.com/terms/c/capital.asp [https://perma.cc/BLN2-W7LW]. In order to qualify as capital, the goods must provide an ongoing service to the business to create wealth. *See id.*

62. Karmel, *supra* note 51, at 1171.

63. *Id.* at 1171–72.

64. *Id.* at 1172.

65. Keay, *supra* note 4, at 271.

3. The Corporation Benefits From Protecting Stakeholders

This is perhaps the weakest argument, because it is not a rationale at all. If a corporation would realize enhanced returns because, for instance, it weighed the effect of its employment policies on the productivity and loyalty of its work force, then it would do so under a profit maximization philosophy, and stakeholder theory would become redundant. There is also a paternalistic undertone to this argument, suggesting that corporate decision makers are not fully capable of determining what policies are most profitable. Further, and worse yet, the critics outside the corporation are more capable than the corporate managers. For example, some corporations provide on-site daycare for children of their employees. They do so not because the relevant decision makers are "good folks" who have their employees' best interests at heart, but rather because the policy enhances employee productivity and recruitment. For other employers, however, the increase in productivity would not justify the added expense, and recruitment is not a problem. If an employer were to provide a benefit and its competitors did not, that employer might be at a competitive disadvantage which, in turn, could adversely affect the very employees in question.

4. Implicit Understanding

It is inevitable, of course, that in making decisions, corporate actors consider the effect of their decisions on stakeholders that are most directly affected by those decisions. Deciding how to price the corporation's goods or services requires a predictive analysis of consumer response. For example, deciding whether to declare additional paid holidays for employees is often motivated by a belief that employees will respond favorably. Moreover, for each decision, directors must (and inevitably do) consider the effect on the firm's bottom line. So, at one level, the "implicit understanding" rationale does not support an argument that stakeholder theory is different from principles of traditional corporate governance. This rationale may have force, however, if the corporate decision makers are expected to consider the effect of their decisions on stakeholders who are indirectly affected. For instance, using the example from above, if a corporation is considering providing a free daycare facility on its premises for children of its employees, should (or must) the board consider the effect on

daycare providers in the community? Posing the question suggests two additional questions: How would they weigh the interests of the community daycare providers? And what is the source of the implicit agreement upon which the outside daycare providers rely under this rationale?

As to how the interest of the outside providers would be weighed, the answer is that there is no principled way to do so. Indeed, in terms of time, it is hard to justify the cost of making the attempt. And, as to the source of the implicit understanding, there is none. Basic contract doctrine suggests that an "implied" contract between two parties exists under two circumstances. The first is when the facts suggest that both parties intended that there be an agreement,[66] and the second is when, for various policy reasons, the law imposes a contractual (or quasi-contractual) obligation on a person.[67] The former arises when the words and actions of the parties support the inference that they intended to be bound to one another, although an explicit understanding is lacking. The latter relates to situations in which one party enriched another party and a court determines that it would be unjust if the benefited party did not compensate the benefit provider.[68] Neither circumstance is implicated in this rationale for the stakeholder theory.

5. Human Rights

The argument that the failure to consider the interest of a stakeholder violates the human rights of that stakeholder[69] is simply an argument by assertion. Rights do not emerge from thin air; they must have a basis in law, whether statutory, constitutional, or, at the least, natural law. That corporate stakeholders have a human right in relation

66. Will Kenton, *Implied Contract*, INVESTOPEDIA (Jan. 12, 2020), https://www.investopedia.com/terms/i/implied_contract.asp [https://perma.cc/PK8K-BJV3] ("An implied contract is a legally-binding obligation that derives from actions, conduct, or circumstances of one or more parties in an agreement.").

67. Will Kenton, *Quasi Contract*, INVESTOPEDIA (Aug. 29, 2020), https://www.investopedia.com/terms/q/quasi-contract.asp [https://perma.cc/SGX4-DGRL] ("It is created by a judge to correct a circumstance in which one party acquires something at the expense of the other. The contract aims to prevent one party from unfairly benefiting from the situation at the other party's expense.").

68. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 (AM. L. INST. 2011).

69. Keay, *supra* note 4, at 268.

to a corporation is a statement that is creative but lacking in explanatory power.

In short, there is no persuasive rationale supporting the theory that directors (and, indeed, other corporate actors) should consider the interests of all stakeholders when making business decisions. Moreover, as indicated above, the requirement they do so is without adequate guidance. Essentially, any such decision would not be subject to a meaningful review, and the decision makers would be unaccountable. By contrast, the theory of shareholder primacy is relatively easy to articulate and is easy for decision makers to implement. As a result, decision makers can be (and often are) held accountable.[70]

While stakeholder theory seems to lack a convincing rationale, its popularity may already be affecting corporate behavior. Professor Lisa Fairfax, in her article *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, suggests that stakeholder theory is shaping the way directors behave, a view shared by other theorists.[71] She concludes:

> In contrast to those who discount this shift, this Article argues that the rhetorical embrace of stakeholder rhetoric has important normative repercussions. Focusing on the intrinsic value of rhetoric as a persuasive and expressive device, this Article argues that such rhetoric reveals normative dissatisfaction with shareholder primacy that extends to both customers and employees as well as the business community and investors. Even if temporary, the rhetoric reveals some societal and investor discontent with the prevailing shareholder primacy principle.[72]

Even conceding, however, that the rhetoric is a "persuasive and expressive device," it is unclear that corporate actors have embraced stakeholder balancing as a norm of behavior.[73] Many instances which Fairfax cites as evidence would be far more persuasive if the corporation in question had proposed an amendment to its articles, embraced a

70. *See, e.g.*, *In re Nat'l Prescription Opiate Litig.*, No. 1:17-MD-2804, 2020 WL 425965, at *1 (N.D. Ohio Jan. 27, 2020).

71. Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 678 (2006).

72. *Id.* at 712.

73. *Cf. id.* at 690–98 (citing stakeholder rhetoric in corporate annual reports, codes of conduct, and business school curricula, as well as the creation of internal compliance and ethics infrastructures, as evidence of a normative shift).

stakeholder theory, or, better still, re-incorporated in a jurisdiction with an other-constituency statute. In other words, if a board of directors were committed to a stakeholder approach, its commitment would be more persuasive if the board disclosed its intentions in ways that the law readily affords.

If investors preferred a stakeholder philosophy, and, if boards of directors were operating under such a philosophy, we would expect boards to propose amendments to the articles of incorporation or bylaws that welcome shareholder proposals that further stakeholder concerns. That does not appear to be the case. Shareholders frequently present environmental and social proposals to be voted upon at the annual shareholders meeting pursuant to SEC Rule 14a-8.[74] As a general matter, the number of such proposals increases each year.[75] In 2017, for instance, shareholders submitted some 345 proposals related to environmental and social issues to public companies for presentation at shareholder meetings, which amounted to 56% of all shareholder proposals.[76] Also, in 2017, environmentally-related proposals had overall shareholder support of 20%. Proposals typically supported by known proxy advisory firms averaged between 23% and 42% shareholder support, while "other" proposals typically received 20% or less shareholder support.[77] Moreover, other companies, primarily in the technology and financial services sectors, have filed shareholder

74. 17 C.F.R. § 240.14a-8 (2011); *see also* Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983, 1027 (2020).

75. Holly J. Gregory, Rebecca Grapsas & Claire H. Holland, *Corporate Governance: United States*, 18 CORP. GOVERNANCE 252, 268 (2019); *A Look at Governance Shareholder Proposals in 2015*, INST. S'HOLDER SERVS. (2020), https://www.issgovernance.com/library/a-look-at-governance-shareholder-proposals-in-2015/ [https://perma.cc/RJ9B-B6NC].

76. Becky L. Jacobs, *Milton Friedman Has a Lot to Answer for: A Response to Joshua Fershee's "Long Live Director Primacy: Social Benefit Entities and the Downfall of Social Responsibility,"* 19 TRANSACTIONS 391, 400 (2017) (citing Ronald O. Mueller & Elizabeth Ising, *Shareholder Proposal Developments During the 2017 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 12, 2017), https://corpgov.law.harvard.edu/2017/07/12/shareholder-proposal-developments-during-the-2017-proxy-season/ [https://perma.cc/346F-C6BM]).

77. James R. Copland & Margaret M. O'Keefe, *Climate-Change Proposals Break Through*, PROXY MONITOR (2017), http://www.proxymonitor.org/Forms/2017Finding1.aspx [https://perma.cc/3AZ7-BER6]. Such "other" proposals included those seeking the appointment of independent directors with environmental expertise or linking executive compensation to sustainability metrics. *See id.*

proposals in recent years to close identified gender pay gaps.[78] Thus, the empirical evidence suggests that boards are not embracing an easy way to integrate stakeholder philosophy in their governance structure.[79]

C. THE TEAM PRODUCTION THEORY

In *A Team Production Theory of Corporate Law*,[80] Professors Margaret Blair and Lynn Stout argue for a team approach to corporate law; that is, the board of directors acts as a mediating institution that must divide profits among all who provide capital to the corporation. The division includes not only shareholders, but also employees, who provide human capital, managers, and others. This is thus a modified stakeholder theory, and purports to be both normative and descriptive. Their theory is that team production keeps shareholders and others from using firm-specific assets opportunistically. In their words:

> [B]y putting control over the firm's assets and outputs in the hands of the board (whose members are precluded by law from using that control for their own personal benefit), corporate law prevents shareholders, managers, and other team members from using such control to opportunistically expropriate rents from the team.[81]

The team production concept is that all of these parties who contribute "capital" do so on the implicit understanding that their

78. Gregory, Grapsas & Holland, *supra* note 75, at 269.

79. In *Social Responsibility Resolutions*, Scott Hirst argues that the low numbers of favorable votes for social responsibility resolutions may be distorted because of the voting by mutual funds, which own, in the aggregate, about 24% of the equity in U.S. corporations. 43 UNIV. IOWA J. CORP. L. 217, 220 (2018). Hirst suggests that polling data indicates that, on some issues (principally resolutions relating to disclosure of corporate political spending and shareholder approval of proposed political spending), investor preferences are not consistent with voting by those funds. *Id.* at 230. Funds are likely to vote against those resolutions, but if given the choice, investors would favor them. *Id.* As Hirst concedes, the polling data is somewhat suspect and, of course, mutual funds presumably vote their shares in the way that they believe is in the best interests of their investors. *Id.* at 233–34.

80. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 315–16 (1999).

81. Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 746 (1999).

contribution will be managed by the board of directors not only in the shareholders' interests, but in theirs as well.[82]

This notion–really an assumption–of an "implicit understanding" is convenient indeed, but lacking as a matter of fact and law. As a simple example, do managers, who have explicit contracts with the corporation, also have an implicit understanding that the board will manage the corporation in their interests, at least to some extent? What would be the basis for their understanding? However, even conceding that point, the authors lack a rubric for how the corporate profits would be divided. The authors suggest that "the returns to any particular corporate stakeholder from participating in the corporation will be determined not only by market forces, but by *political* forces."[83] This process is largely one of negotiation by the relevant stakeholder.

Interestingly, the authors note the share of corporate returns going to shareholders has increased (in the period before the publication of their article) and attribute this to market forces: To attract capital, shareholder returns had to increase and, at the same time, technological advances and lower rates of unionization weakened the hand of labor. We believe it is fair to say that both before and after the appearance of this article, management decisions were heavily influenced by market forces. Team production merely describes management's need to respond to market forces with respect to each input of production. Blair and Stout conclude their article with the observation that boards as

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82. Professor Stout has written extensively and critically about the shareholder primacy norm. She is of the view that there is no justification in law or economics to justify the norm. *See* Lynn A. Stout, *The Dumbest Business Idea Ever. The Myth of Maximizing Shareholder Value*, EVONOMICS (Mar. 15, 2016), http://evonomics.com/maximizing-shareholder-value-dumbest-idea/ [https://perma.cc/VCS7-7NH7]. Stout argues that corporate actors should satisfice:

> Satisficing has many advantages as a corporate decision-making strategy. Most obviously, it does not try to resolve conflicts among different shareholders by maximizing only the interests of the small subset who are most short-term, opportunistic, undiversified, and asocial. It allows managers instead to try to decently (but not perfectly) serve the interests of many different shareholders–including long-term shareholders; shareholders who want the company to be able to keep commitments to customers and employees; diversified shareholders who want to avoid damaging their other interests as investors, employees, and consumers; and prosocial shareholders who want the company to earn profits in a socially and environmentally responsible fashion.

Id.; *see also* Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 680–86 (2003).

83. *See* Blair & Stout, *supra* note 80, at 325 (emphasis added).

mediating hierarchies explains corporate law, but that the increasing rhetoric about shareholder primacy poses the threat that the law may change to enhance shareholder primacy, and that would be a bad thing.[84] With that, the article is both descriptive and normative.

While it is true that (some) employees make firm-specific investments of human capital in the firm, many do not, or the value of their human capital investment is limited. Some employees who do make significant investments of human capital in the firm could possibly be in a position to contract for these investments. Shareholders are always residual claimants, dependent on management's good faith for a return on their investment.

Thus, one major problem with the theory is to determine when to treat employees as "investors," and when to treat them as being adequately protected and compensated for their investment. For an extreme example, think about a CEO with a munificent contract; is she entitled to more? What about a software engineer with stock options? At the other extreme, how entitled are unskilled or semi-skilled factory workers? Why wouldn't corporate management compensate them for their contributions so as to encourage their productivity and loyalty, given that such outcomes are best for the profitability of the firm? If management fails to do so, it is acting inconsistently with its traditional fiduciary duties and can be held accountable on that basis. As to making that judgment, the courts have traditionally deferred to the board of directors under the umbrella of the business judgment rule.[85]

Blair & Stout cite several well-known corporate law cases as proof that the team production model describes the current state of corporate law.[86] We do not believe that the team production model is an accurate

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84. *Id.* at 326–27.

85. *See, e.g.*, Parnes v. Bally Ent. Corp., 722 A.2d 1243, 1246 (Del. 1999).

> The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Where, as here, there is no claim that enhanced judicial scrutiny is required because of the nature of the transaction, to survive a motion to dismiss, "a plaintiff must allege well pleaded facts to overcome the presumption."
>
> The presumptive validity of a business judgment is rebutted in those rare cases where the decision under attack is "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."

Id. (citations omitted).

86. *See* Blair & Stout, *supra* note 80, at 301–304.

description of corporate governance. For instance, after distinguishing *Dodge*, discussed above, as essentially a dispute between shareholders, Blair & Stout cite *Shlensky v. Wrigley*,[87] *Credit Lyonnaise Bank Nederland, N.V. v. Pathe Communications Corp.*,[88] *Cheff v. Mathes,*[89] and *Paramount Communications, Inc. v. Time, Inc.*[90] as examples of courts endorsing the role of boards as mediators among corporate constituencies (thereby rejecting shareholder primacy theory). While there is some support for that conclusion, when read objectively, the cases do not go nearly that far.

In *Shlensky*, the court sided with the directors of the Chicago National League Ball Club Inc., a Delaware corporation that owned and operated the Chicago Cubs.[91] The plaintiff challenged the directors to install lights and schedule night games, with a goal of increasing the profitability of the corporation.[92] The board refused, citing the adverse effect that night games would have on the neighborhood surrounding the ballpark.[93] The court sided with the directors in this derivative action, but Blair & Stout argued that the board was mediating between the shareholders and the residents in the community, who did not want night games in their neighborhood.[94] However, the court seemed to be persuaded by–or at least was unwilling to second guess–the directors' argument that the corporation was better off, in the long run, if the neighborhood remained stable and safe, which might not be the case if night games were regularly played there.[95] *Shlensky* is thus a classic example of a court deferring to the business judgment of an unconflicted board. To suggest that the board forwent a more profitable course of action merely to accommodate the community is just speculation and requires one to believe that the court was being dishonest when it wrote: "we are not satisfied that the motives assigned to Phillip K. Wrigley [the controlling shareholder], and through him to the other directors, are contrary to the best interests of the corporation and the stockholders."[96]

87. 237 N.E.2d 776, 781 (Ill. App. Ct. 1968).
88. No. Civ. A. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).
89. 199 A.2d 548, 554 (Del. 1964).
90. 571 A.2d 1140, 1150 (Del. 1989).
91. *Shlensky*, 237 N.E.2d at 781.
92. *Id.* at 777.
93. *Id.* at 778.
94. Blair & Stout, *supra* note 80, at 303.
95. *Shlensky*, 237 N.E.2d at 780.
96. *Id.*

Credit Lyonnaise, a second case cited by Blair & Stout, is even less helpful to their thesis. The Chancery Court opinion in *Credit Lyonnaise* included a footnote suggesting that when a corporation enters the zone of insolvency, the board of directors should consider the interests of creditors, not just shareholders.[97] Though clearly intended as a dictum, this notion is arguably consistent with Blair & Stout's thesis. But the *Credit Lyonnaise* dictum was rejected by the Delaware Supreme Court in its 2007 *North American Catholic Education Programming Foundation, Inc. v. Gheewalla* decision: "Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation."[98]

Blair & Stout also offer *Paramount Communications, Inc. v. Time Inc.* as an example of a Delaware court rejecting shareholder primacy.[99] The Delaware Supreme Court deferred to the Time board, which had rejected Paramount's generous offer for Time stock if Time would abandon a planned merger with Warner.[100] However, to the extent that this case is contrary to the theory of shareholder primacy (which is itself highly questionable), it has been recognized as an outlier in the Delaware jurisprudence attributable to its somewhat unique facts.[101] In addition, subsequent Delaware cases can only be understood as reflecting shareholder primacy.[102] And, importantly, the *Paramount v. Time* court did not indicate it was overruling its earlier decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[103] or the definitive language in *Revlon* affirming shareholder primacy: "A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the

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97. *Credit Lyonnaise Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. Civ. A. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

98. 930 A.2d 92, 103 (Del. 2007) (internal punctuation omitted).

99. Blair & Stout, *supra* note 80, at 309.

100. *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989)

101. *See* Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 46–47 (Del. 1994) (distinguishing Paramount Commc'ns, Inc. v. Time Inc. on its facts).

102. *See id.*; *see also* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 928 (Del. 2003); QVC Network, Inc. v. Paramount Commc'ns, Inc., 635 A.2d 1245, 1266 (Del. Ch. 1993).

103. 506 A.2d 173 (Del. 1986).

stockholders."[104] Blair & Stout seek to distinguish *Revlon* and its statement of shareholder primacy:

> On first inspection, this language appears to support shareholder primacy. Closer analysis suggests, however, that *Revlon* may in fact support the mediating hierarchy model. Although the *Revlon* opinion did not clarify what it meant to say that a company's "break-up" was "inevitable," in subsequent cases *Revlon* has been interpreted to apply "[w]hen a majority of a corporation's voting shares are [to be] acquired by a single person or entity, or by a cohesive group acting together." In other words, *Revlon* applies when a formerly publicly held corporation is about to become essentially a privately held firm. As noted earlier, in closely held firms subject to the control of a single shareholder or group of shareholders, directors enjoy relatively little independence and can no longer function effectively as mediating hierarchs. Thus the *Revlon* exception to the general rule may reflect an intuitive judicial recognition that when a firm "goes private," it abandons the mediating hierarchy approach in favor of a grand-design principal-agent structure dominated by a controlling shareholder.[105]

Blair & Stout's reading of *Revlon* is plausible, but forced, because *Revlon* applies not only when a firm goes private, but also when it is to be liquidated.[106] Blair & Stout essentially argue that the Delaware courts should not be taken at their word, but we see no reason not to do so. Those unconvinced by this analysis need look no further than the recent observations of the erstwhile Chief Justice of Delaware Supreme Court, Leo E. Strine, Jr., who dismissed the idea that courts, or at least the Delaware courts, do not mean what they say.[107]

II. THE MORAL JUDGMENT OF DIRECTORS

Since stakeholder theorists seek to reorient the decisional priorities of corporate directors, they might be satisfied with a norm that director

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104. *Id.* at 182.

105. Blair & Stout, *supra* note 80, at 309.

106. The Delaware Supreme Court made this clear in *Paramount Commc'ns Inc. v. QVC Network, Inc.*: "Accordingly, when a corporation undertakes a transaction which will cause: (a) a change in corporate control; or (b) a break-up of the corporate entity, the directors' obligation is to seek the best value reasonably available to the stockholders." 637 A.2d at 48.

107. Leo E. Strine, Jr., *Corporate Power Is Corporate Purpose I: Evidence from My Hometown* 4 (Univ. Pa. L. Sch. Inst. L. & Econ. Research Paper No. 16-34, 2017), https://ssrn.com/abstract=2906875.

actions should be informed by moral principles. What appears to be objectionable to stakeholder theorists about the shareholder primacy norm is that it has overtones of avarice and greed, and causes harm to third parties—clearly immoral impulses. Under this analysis, directors who are free to act morally will naturally consider the effect of their actions on the corporation's various stakeholders.

While stakeholder theorists typically do not cite such principles to support their theory, a broad concept of morality could support a norm that corporate directors must consider the effect of their actions on remote individuals and entities that do not have a direct stake in the corporation. Moreover, and aside from the views of stakeholder theorists, a norm that supports or requires that directors act ethically seems unassailable. However, such a norm is not easily operationalized, and thus not a viable legal alternative to shareholder primacy.[108]

Nearly all theories governing what actions are morally permissible fall into one of three families—consequentialism, deontology, or virtue ethics. To illustrate the problems with charging corporate directors and managers to simply act morally as an alternative to shareholder primacy, we need only discuss the first of these families of theories in significant detail. According to consequentialism, an action is right if and only if it produces the *right consequences*.[109] Consequentialist theories differ depending on which consequences are deemed relevant and what counts as a right configuration of consequences. One such theory, Act Utilitarianism, is most frequently interpreted as requiring that an action *maximize utility*.[110] "Utility" in this context typically denotes whatever

108. A note on terminology: The terms "ethics" and "morals" are sometimes understood to involve slightly different shades of meaning. For our purposes here, we will consider them interchangeable, although we will generally use "moral" and its variants throughout.

109. Stanford Encyclopedia of Phil., *Consequentialism* (2003) (rev. Jun. 3, 2019), https://plato.stanford.edu/entries/consequentialism/ [https://perma.cc/H9H5-B3QD].

110. Works by major figures in the development of Act Utilitarianism include JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION (Doubleday 1961) (1789); JOHN STUART MILL, UTILITARIANISM (Roger Crisp ed., Oxford University Press 1998) (1861); and HENRY SIDGWICK, THE METHODS OF ETHICS (London, Macmillan & Co. 1874). *See generally* Jeremy Bentham, *Principles of Morals and Legislation*, *in* THE MAKING OF MODERN LAW: LEGAL TREATISES, 1800-1926 (Clarendon Press, 1876); John Stuart Mill, *Utilitarianism*, *in* THE MAKING OF MODERN LAW: LEGAL TREATISES, 1800-1926 (Clarendon Press, 1876); Henry Sidgwick, *The Methods of Ethics*, *in* THE MAKING OF MODERN LAW: LEGAL TREATISES, 1800-1926 (Clarendon Press, 1876).

value makes people's lives better. Most Utilitarians are also Hedonists, meaning that they consider happiness to be the only thing that ultimately makes life better; or conversely worse, in the case of unhappiness. The most common articulation of Act Utilitarianism directs us to act in such a way that we create the greatest net balance of happiness over unhappiness. If Act Utilitarianism is interpreted as being concerned with *expected* happiness instead of *actual* happiness, then morally right actions will only be those that we have good reason to believe will create the greatest *probability-weighted* happiness.

Suppose a director believes that there is a 50% chance that the economy will slip into a recession in the next quarter. If it does, then pursuing a certain investment will predictably result in losses and, potentially, company-wide layoffs. In turn, this would create a *significant* net loss of happiness. Suppose on the other hand that the economy does not slip into a recession. Then, the same investment would result in higher profits and bonuses for a small number of employees, and no lay-offs, in turn, creating a *slight* net gain of happiness. Given that the probability assigned to the recession occurring is 50%, the utility-maximizing action would be to abstain from the investment. However, in a different probability distribution where the recession was extremely unlikely, pursuing the investment could be the utility-maximizing action.

Other consequentialist theories differ from Act Utilitarianism. As previously mentioned, one would countenance a different outcome by employing different consequences that matter morally other than happiness, or by using a decision rule other than maximization to determine the *right* consequences. For example, perhaps there are multiple good consequences that should be considered rather than only happiness, such as aesthetic value, truth, freedom, and so forth. Or perhaps rather than maximizing good consequences, it is enough to reach some minimally-adequate threshold of good consequences. Most consequentialists have been less attracted to these alternatives, as they tend to clutter and confound an otherwise very elegant moral theory that simply directs people to create the most happiness.

Act Utilitarianism applied straightforwardly to the world of corporate decision-making would have some surprising implications. For example, a corporate director attempting to maximize utility might decide that dissolving the corporation would create the greatest balance of happiness over unhappiness in the world. After all, according to Act

Utilitarianism, no one's happiness receives higher priority than anyone else's.[111] While shareholders might be very unhappy with the directors' decision, their happiness would count for no more than the happiness of, say, a worker somewhere in the corporation's global supply chain, an asthmatic person living in close proximity to air pollution generated by the corporation, or even a future person who is impacted by changes in the global climate for which the corporation is partly responsible.

Furthermore, there is a built-in restraint of sorts in Act Utilitarianism against extreme pursuit of profit because money has diminishing marginal utility. Each additional dollar gained increases one's happiness less than the previous dollar; $1,000 means much more to one living in poverty than to a millionaire. For this reason, increasing shareholder value when shareholders are already likely among the wealthier members of society is unlikely to be a utility-maximizing action. It would seem far better to redistribute those resources, at least in the short-term, to those for whom money has a higher value.

Nevertheless, there are theorists who view Act Utilitarianism as consistent with the pursuit of profit and who even offer Act Utilitarian theories of corporate governance.[112] Taking the long-run view, and paired with certain liberal views about the value of markets, pursuing profit can potentially be seen as utility maximizing. The current historic lows in global poverty are plausibly attributable to market liberalization in the developing world and the kind of Pareto improvements that market interactions enable.[113] Without the profit motive, these improvements would not have occurred. So, although individual market transactions might not seem to maximize utility, a market-based system in the aggregate plausibly does. Or, at least it seems to produce greater net happiness than any other alternative. If good results are only possible by allowing or encouraging the pursuit of profit, then a view like shareholder primacy might be given a consequentialist (or Act Utilitarian in particular) moral grounding.

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111. This feature of Act Utilitarianism is most famously attributed to Bentham as his dictum "everybody to count for one, nobody for more than one." *See* MILL, *supra* note 110, at 53.

112. *See, e.g.*, Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235, 239 (2002).

113. *Not Always with Us*, THE ECONOMIST (June 1, 2013), https://www.economist.com/briefing/2013/06/01/not-always-with-us [https://perma.cc/4M3V-RE8M].

This is the view taken by Professors Hansmann and Kraakman in a 2001 law review article arguing for shareholder primacy.[114] But the underlying consequentialist framework is open to different interpretations. One might also construct a stakeholder view out of consequentialist considerations. If "stakeholder" is interpreted broadly enough to include everyone (and everything) whose interests are potentially affected by the firm, then maximizing stakeholder interests amounts to the same thing as maximizing utility. Finally, Joseph Heath's market failures approach (discussed below) could also be grounded in consequentialism.[115] Taking the same idea that only well-functioning markets tend to maximize utility, Heath's approach could be viewed as a check on pursuing profits that coheres neatly with the general directive to maximize utility.

This leads to the first major problem with directing corporate directors and managers to simply *act morally*: moral theories do not often precisely apply themselves to the kinds of decisions directors face. As a result, they underdetermine which actions are morally permissible. Because of this, there is no way to legally operationalize a directive to simply act morally. Imagine there was broad agreement that Act Utilitarianism is the one true moral theory. Even if we say, "act morally, by which we mean *maximize utility*," this directive has been variously interpreted as implying everything from the wrongfulness of pursuing profit to the moral requirement to pursue profit. One corporate director might interpret "maximizing utility" to mean that the corporation should be dissolved, and another may understand it to mean that shareholder profit ought to be maximized. There simply is no useful guidance here at the generalized level of Act Utilitarianism, let alone at the even more generalized level of "act morally."

This leads to the second major problem with directing corporate directors to *act morally*: There is no consensus on which moral theory, or family of moral theories, is the correct one. Interpretations of Act Utilitarianism vary widely, but this is only one of many different moral theories, belonging to the family of consequentialism. If we turn to consequentialism's main rival family, deontology, we find a myriad of

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114. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001). This article illustrates the consequentialist moral theory through profit-maximizing shareholders by providing examples in the way of the "case of controlling shareholders ('controllers') who wish to maximize their financial returns." *Id.* at 460.

115. *See infra* Part IV.

other moral theories, each of which face the same problems of interpretation and application that plagued Act Utilitarianism.[116] Here though, a new problem presents itself. Even if we could agree on an interpretation and application of a certain theory to the actions of corporate directors—for example, suppose we agree that according to Act Utilitarianism, directors ought to maximize profit—why should we be confident that the *theory* itself is the correct theory.

Within the deontological family, there is Rights Theory, which articulates a constellation of rights, both positive (the right to speak freely) and negative (the right to not to be killed), and explains who possesses which rights, and in virtue of what, and how rights interact.[117] There is also Kantian Ethics, which distills our moral duties ultimately to what is known as the Categorical Imperative. Perhaps the most commonly cited formulation of the Categorical Imperative directs us to respect others by always treating them as ends, and never as mere means.[118] There is also Rossian Pluralism, which directs us to follow a number of *prima facie* duties, or standing moral obligations, to which we should adhere unless they conflict with other *prima facie* duties.[119] There is also Contractualism, which directs us to follow whichever moral rules would be agreed upon under certain idealized social-contract conditions.[120] And on, and on. Each theory branches, in turn, with different theorists defending different versions of each.

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116. If we move away from simply considering the consequences of actions and instead take on various deontological concepts like rights, duties, etc., we are no closer to determining who corporate directors ought to act. Do they have a duty to honor an implicit promise made to shareholders? (*See* Friedman, *supra* note 42.) Or, should they reduce profitability out of respect for the dignity of each stakeholder? Deontological theories give us no clearer account than Act Utilitarianism did.

117. For one account, see JUDITH JARVIS THOMSON, THE REALM OF RIGHTS (1990).

118. IMMANUEL KANT, THE METAPHYSIC OF ETHICS 42 (Rev. Henry Calderwood, LLD., 3rd. ed. 1871). The primary sources of Kant's ethics are the CRITIQUE OF PRACTICAL REASON, and the GROUNDWORK OF THE METAPHYSICS OF MORALS. *See generally* IMMANUEL KANT, CRITIQUE OF PRACTICAL REASON (Thomas Kingsmill Abbott, B.D., 4th ed. 1889). Contemporary defenders of Kantian Ethics include Christine Korsgaard and Allen Wood. *See* CHRISTINE KORSGAARD, CREATING THE KINGDOM OF ENDS 7 (Cambridge Univ. Press 1996). *See generally* ALLEN WOOD, KANTIAN ETHICS (Cambridge Univ. Press 2007).

119. *See* W.D. ROSS, THE RIGHT AND THE GOOD 3 (Oxford Univ. Press 1930).

120. Perhaps the best known defender of Contractualism is T.M. Scanlon. *See* WHAT WE OWE TO EACH OTHER 5 (Harvard Univ. Press 1998).

Then, there is the third whole family of moral theories, virtue ethics, which shifts the moral focus away from actions toward character. Virtue ethics directs people to exercise phronesis, or a kind of practical wisdom, as they strive to emulate the virtues of certain moral exemplars.[121] While this is a very abridged and incomplete survey of theories, it is surely enough to convince the reader of the merits of the second major problem with asking directors to simply *act morally*: there is nothing close to a consensus among moral theorists about what that would amount to.

Moreover, it does no good to instead appeal to something like conscience, if by "conscience" we simply mean the direct moral judgment of directors. In that case, telling directors to act in accordance with their conscience leads to the same problems as telling them to *act morally*. The verdicts of people's consciences vary as widely as the verdicts of various moral theories and their interpretations. For example, a director might be following her conscience when she votes to dissolve the corporation or when she pursues shareholder profit above all else. If, on the other hand, "conscience" involves not just a moral judgment, but something volitional that compels someone to either act or abstain from acting in a certain way, we believe that the current legal framework accounts for this. If a director *cannot* in good conscience maximize shareholder value for the firm, that director should resign. On the other hand, if their conscience, or the application of whichever moral theory they believe to be true, directs them to, say, sabotage or defraud their corporation, then even if that is in fact morally required, the law cannot condone such behavior. It may sometimes be the case that one is morally required to break the law–for example, to effect social change through civil disobedience, or because one lives under an immoral legal regime. Perhaps the corporation is engaged in activity so immoral (but legally protected) that merely resigning from one's position is morally insufficient. So be it. Doing the right thing may sometimes require the courage to face legal, even criminal, repercussions. The law simply cannot be tailored in such a way that it accommodates each discrete moral judgment, even if the judgment is correct.

Despite the aforementioned widespread disagreement among moral theorists, it would be a mistake to conclude that there are no shared

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121. Aristotle is the original and most famous virtue ethicist. Contemporary defenders include Alasdair MacIntyre and Linda Zagzebski. *See* ALASDAIR MACINTYRE, AFTER VIRTUE 10 (1985); LINDA ZAGZEBSKI, VIRTUES OF THE MIND 13 (1996).

judgments among theories. Although Kantian Ethics and Act Utilitarianism will disagree about why theft is wrong, both theories agree that it generally is wrong. Where there are such shared judgments, moral theories can provide a useful and operationalizable framework for legally prohibiting certain kinds of corporate bad behavior. In fact, if the theory of shareholder primacy is to have any plausibility as either an ethical or a legal theory, it must accommodate these minimal moral restraints. No moral theory would condone maximizing shareholder value *no matter what*.[122] And neither does the law allow maximizing shareholder value no matter what. Some corporate actions, though profitable, are not legal. So, although we think that it is too simplistic to say that the law ought to encourage directors to *behave morally*, we do think that in cases in which there is broad shared moral judgment, among moral theories or in public sentiment (the collective conscience, so to speak), that an action which is legal is nevertheless seriously wrong, this is some indication that a new legal prohibition may be required. The current legal framework might then be expanded to address any gaps between that framework and these shared moral judgments.[123]

A. THE SHARED MORAL JUDGMENT CONSTRAINT IN PRACTICE

The recurring controversy over prescription drug pricing provides a useful case in which the existence of a shared moral judgment against a legal corporate action provided a framework for new regulation.

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122. We reject shareholder primacy as an *ethical theory* for roughly these reasons, even though we think it is perhaps the best legal framework we have available at present. As an ethical theory, shareholder primacy would either say that directors have a moral duty to maximize shareholder value *no matter what*, or that they have a moral duty to maximize shareholder value *so long as it is morally permissible*. The first option faces obvious counterexamples. The second option is to make shareholder primacy vacuous as an ethical theory. Why, and under which circumstances, it is morally permissible to maximize shareholder value is exactly what we would want a moral theory to tell us, not something to be left as a placeholder. Jason Brennan and others offer similar criticisms of shareholder primacy as an ethical theory. Jason Brennan, *Review of "Morality Competition and the Firm: The Market Failures Approach to Business Ethics*,*"* 26 KENNEDY INST. ETHICS J. 1, 3–4 (2016).

123. Or, conversely, the legal framework might need to be attenuated if it prohibits corporate action about which there is broadly shared moral approval.

A recent prescription drug controversy, wherein pharmaceutical companies dramatically raised prices on certain drugs,[124] invites the claim that the corporate actors making these decisions are, at best, morally callous and, at worst, deeply immoral. While other instances of bad corporate behavior could be cited, the drug pricing controversy places the stakeholder philosophy in sharp relief. Mylan Laboratories, NV, which produced the EpiPen (an auto-injector for epinephrine, which reverses life-threatening allergic reactions) increased its price by 450%.[125] The ensuing controversy demonstrates that Mylan's decision makers did not weigh (or weighed inadequately) the effect of the decision on a core corporate constituency, Mylan's customers. Apparently, Mylan determined that a dramatic price increase, while it may reduce unit sales, would increase Mylan's profits. So, the decision, at least nominally, was consistent with the best interests of Mylan's shareholders.[126]

At the same time, the price increase was clearly very adverse to the interests of Mylan's customers, and if Mylan had adopted a stakeholder approach, it would have had to weigh those interests. Setting aside for now the issues raised with stakeholder theory, the EpiPen price increase seems to be a significant challenge to shareholder primacy, and hence, at least initially a point in favor of its rival. At least stakeholder theory has an explanation of why the EpiPen price increase was objectionable, and an explanation could ultimately figure into some sort of revision to the legal framework. If nothing corresponds to this explanation within shareholder primacy, then shareholder primacy might not be an ideal underpinning for the relevant legal framework.

There is a mechanism, however, within the existing shareholder primacy paradigm that could address the EpiPen controversy–the previously discussed constraint imposed by shared moral judgments. We

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124. ROBIN FELDMAN & EVAN FRONDORF, DRUG WARS: HOW BIG PHARMA RAISES PRICES AND KEEPS GENERICS OFF THE MARKET 16 (Cambridge Univ. Press 2017) ("Even after factoring in average discounts of 37 percent in 2015 for the drugs studied, list prices still increased anywhere from 22 percent to a whopping 442 percent from 2009 to 2015" (citing Robert Langreth, Michael Keller, & Christopher Cannon, *Decoding Big Pharma's Secret Drug Pricing Practices*, BLOOMBERG (Jun. 29, 2016), http://www.bloomberg.com/graphics/2016-drug-prices/ [https://perma.cc/R6NN-V63Y])).

125. *See id.*

126. While it is likely that in the case generally pricing decisions are not made by the board of directors, the discussion is relevant because the board could intervene or set a policy that would bind management.

already accept all kinds of legal checks on maximizing shareholder value. Companies cannot determine how to dispose of industrial waste, compensate employees, keep their books, or any number of other actions solely to maximize profit. The legal constraints already in place are, in many cases, grounded in common public moral sentiment or the shared judgment of many moral theories. The public outrage over the EpiPen controversy should act as a warning for potential modification of the existing legal paradigm.

Closer examination of the case reveals a couple of unusual features. First, given the presence of insurance and the ability of insurance companies to negotiate, was the effective price increase as high as it was reported? Second, why was it that a manufacturer of the device could profitably raise the price so much? In other words, to what extent should we look outside of the corporation for a solution to such a controversy?

The answer to these questions starts with the understanding that prescription drug pricing takes place in an unusual market.[127] First, many prescription drugs are under active patents, giving the manufacturer considerable pricing freedom. Nevertheless, it is important to note that even patented drug prices are often, and significantly, restrained by pressure from insurers and their affiliated "pharmaceutical benefit managers."[128] Second, and perhaps more importantly, federal law prohibits Medicare from negotiating with pharmaceutical companies over price, which greatly enhances the pricing control of the manufacturers.[129] Were the government able to negotiate over price, most analysts believe that the effect would be a downward pressure on prescription drug prices.[130] Third, federal law also prohibits the re-importation of prescription drugs.[131] Other countries can and do negotiate with U.S. pharmaceutical companies and are able to secure prescription drugs at a much lower price than U.S. consumers pay.[132] A

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127. Feldman, *supra* note 124, at 19 ("[A] mix of dysfunctional market dynamics, strong intellectual property protection, and regulation has led to the complicated, expensive situation we have in the United States.").

128. *Id.* at 15–16. In addition, "many pharmaceutical companies provide co-pay coupons or rebates directly to [consumers]," lowering their direct cost, although the consumer's insurer continues to bear the bulk of the cost. *Id.* at 17.

129. *Id.* at 18.

130. *Id.*

131. 21 C.F.R. § 203.10 (1999).

132. Feldman, *supra* note 124, at 5 ("[O]ne drug that costs less than $400 a year in some countries has a list price around $300,000 in the United States." (citing Bethany

more active import market would also place considerable downward pressure on drug prices.

Fourth, the barriers to entry to manufacture generic replacements for patented drugs (when the patent expires) are extremely high. The patent on epinephrine has expired, and the drug can be manufactured generically. However, the costs and time delays to achieve approval by the Food and Drug Administration to produce a competitor to the EpiPen are extraordinarily high.[133] For instance, in fiscal year 2014, the FDA received nearly 1,600 applications for approval of new generic drugs, but by the end of the fiscal year none had been approved.[134] Moreover, pharmaceutical companies have a host of tactics that they regularly employ to delay the introduction of generic substitutes to their patent-expiring drugs.[135] Finally, provisions of the Affordable Care Act (ACA) require insurance companies to provide coverage for prescription drugs, and a prescription drug coverage gap in Medicare Part D was closed.[136] These provisions dramatically increased the demand for prescription drugs, and the ACA did nothing to increase the supply or otherwise regulate pharmaceutical companies. In short, U.S. laws virtually guarantee that drug prices will be high relative to manufacturing cost. Trusting a theory of corporate governance to limit price increases seems misplaced.

All of this suggests that this case highlights flaws in the existing legal framework. How these flaws should be redressed is beyond the scope of this article. Perhaps various market failures should be corrected

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McLean, *The Valeant Meltdown and Wall Street's Major Drug Problem*, VANITY FAIR, June 5, 2016, www.vanityfair.com/news/2016/the-valeant-meltdown-and-wall-streets-major-drug-problem)).

133. *See* Jeremy A. Greene, Gerard Anderson & Joshua M. Sharfstein, *Role of the FDA in Affordability of Off-Patent Pharmaceuticals*, 315 J. AM. MED. ASS'N 461, 461 (2016).

134. Michael Hiltzik, *The FDA Can Single-Handedly Reduce Drug Price-Gouging. Why is It Waiting?*, L.A. TIMES (Jan. 5, 2016, 12:32 PM), http://www.latimes.com/business/hiltzik/la-fi-mh-the-fda-can-single-handedly-stop-20160105-column.html [https://perma.cc/7JQE-AFBK]. This is not an article, of course, to analyze the drug approval process in the United States, but this reality helps explain how such price increases can occur in an economy that depends on competition and free market principles. Regulation is supposed to act as a check against market failures, but in this instance, regulation is the cause of the market failure.

135. For an excellent analysis of these tactics, see Feldman, *supra* note 124, at 10.

136. Caitlin Owens, *Why Prescriptions Drugs Aren't Part of Obamacare*, MORNING CONSULT (Mar. 24, 2016, 3:10 PM), https://morningconsult.com/2016/03/24/why-prescription-drugs-arent-part-of-obamacare/ [https://perma.cc/PWG4-6Y8A].

in order to create a more competitive market for prescription drugs. Maybe the government should impose price controls on certain pharmaceutical products. For our purposes, the point is that these steps can all be taken within the existing shareholder primacy paradigm. As we argued earlier, no serious theory, moral or legal, would say that directors should maximize shareholder value *no matter what*. The existing legal paradigm can and does accommodate those cases in which common public sentiment and the shared moral judgment of various moral theories reject as immoral the directive to maximize profit. Perhaps these accommodations appear to be too piecemeal and ad hoc. Perhaps there is a superior paradigm that more elegantly matches the law to our shared moral judgments in a way that is both intuitive and operational. Perhaps. But, this superior alternative has yet to be articulated.

III. THE LAWYER'S DUTY TO ZEALOUSLY REPRESENT THE CLIENT: A COMPARATIVE APPROACH

Like directors, lawyers are fiduciaries for their clients, owing clients the same fiduciary duties that directors owe to their corporations. Indeed, the common understanding is that lawyers have a duty to "zealously" represent their clients. Much has been written on the lawyer's duty, including a rich literature on whether the lawyer may deviate from the duty of zealous representation.[137] This literature exists because lawyers, like directors, often face what might be termed as moral dilemmas. For instance, may a defense counsel, without the consent of the client, disclose to the plaintiff's lawyer that the latter is laboring under a misunderstanding of the law when the result of the disclosure will be that the defendant will likely have to increase a settlement offer?[138] Of course, disclosure under these circumstances is contrary to the notion of zealous representation and so must be justified on some basis. One could make a moral argument that disclosure is

137. MODEL RULES OF PRO. CONDUCT: Preamble & Scope (AM. BAR ASS'N 2019) ("As advocate, a lawyer zealously asserts the client's position under the rules of the adversary system."). *See, e.g.*, Friedman v. Dozorc, 312 N.W.2d 585, 606 (Mich. 1981) (noting that a "reasonableness" standard to judge a lawyer's advocacy would be "difficult to reconcile with the lawyer's obligation to represent his client's interests zealously. 'Zealous representation' contemplates that the lawyer will go to the limits for his client, representing him loyally, tenaciously and single-mindedly.").

138. *See* MODEL RULES OF PRO. CONDUCT r. 1.4 (AM. BAR ASS'N 2019).

appropriate because otherwise there will be a perversion of justice. But to make this argument, one must also define and cabin the basis for the exception. What sort of moral exceptions to zealous representation are appropriate?

Scholars grappling with this question have generated a plethora of explanations. For instance, Professor Tim Dare has argued that lawyers operate within a system designed to assure that society's institutions function properly and, in that context, the "role of the lawyer is to allow clients to avail themselves of rights allocated to them by social institutions."[139] But, Dare sees this as limiting the lawyer's role to acting with "mere-zeal," eschewing "hyper-zeal."[140] The line between the two is nuanced, but the conclusion is that the lawyer would be restrained from acting in the best interests of the client to the extent that those interests exceed that to which the client is "entitled." Therefore, in the disclosure hypothetical above, the lawyer could disclose to opposing counsel (to his client's detriment) the legal misunderstanding. Other scholars have similarly identified various theories to limit a lawyer's duty of loyalty to her client in order to further some moral objective.[141]

The fundamental shortcoming of these theories is they fail to grapple with the underlying question of why lawyers have a duty of zealous representation in the first instance. Logically, when one identifies what underlies the duty, one can more easily consider whether, and to what extent, exceptions to the duty may be made. In his article, *A Private Law Defense to the Ethic of Zeal*, Professor Charles Silver persuasively argues that a lawyer's duty to zealously represent a client is a simple application of traditional, well-established agency law principles.[142] Further, those principles do not allow the lawyer to act on ethical or moral concerns not otherwise embodied in the law without the client's consent. Why? As any fiduciary, the lawyer must act in the best interests of his client. The Model Rules of Professional Conduct, to a large extent, codify the common law fiduciary duties and, with certain limited exceptions, do not permit a lawyer to make disclosures or otherwise take actions that are contrary to the client's interests unless

139. Tim Dare, *Mere-Zeal, Hyper-Zeal, and the Ethical Obligations of Lawyers*, 7 LEGAL ETHICS 24, 32 (2004).

140. *See id.*

141. *See id.*

142. Charles Silver, *A Private Law Defense to the Ethic of Zeal* 8 (Univ. Tex. L. Pub. L. Rsch. Paper No. 638, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2728326.

the client gives informed consent.[143] It is beyond the scope of this article to further consider the theories that might or might not justify the duty of zealous representation. Rather, we will consider to what extent the robust version of the lawyer's duty of zealous representation may inform the way directors act.

In our view, the short answer is, like lawyers, directors have a robust duty to act in the best interest of the corporation that they serve. Their power to act and legitimacy emanates from their "contract" with their shareholders, and unless that contract contains exceptions, the shareholders' reasonable expectation that the directors will act in the best interests of the corporation. Importantly, the articles of incorporation or bylaws (or even a shareholder-approved resolution) can alter that expectation, but the absence of such a modification leaves the morally troubled director with little choice other than resignation, much like a lawyer who is troubled by a course of action that the client insists the lawyer pursue. In the disclosure hypothetical noted above—where opposing counsel is laboring under a misunderstanding of the law—the lawyer cannot make a disclosure because of the likely harm to her client; her only choice is to resign.[144]

Are there differences between a lawyer and a director that might give a director greater freedom to act in a way that may not be in the corporation's best interests? Directors are not technically agents of the shareholders, or for that matter, agents of the corporation; rather, the position of directors is *sui generis*.[145] While true, this observation begs the question, because even though directors are not agents, they are fiduciaries and the salient inquiries are the content and source of those duties. There is little dispute that directors owe duties of loyalty, care, and good faith.[146] Like a lawyer who must make a personal and moral decision of whether to represent a particular client, the critical point for a director is deciding whether to serve as a director. And, like a lawyer who is generally free to withdraw from a representation if continuing to do so is morally repugnant, the director is free to resign from her seat.

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143. MODEL RULES OF PRO. CONDUCT r. 1.6 (AM. BAR ASS'N 2019). The exception to this rule is narrow, including, but not limited to, that there would be imminent death or substantial bodily harm if the client's information is not disclosed. *Id.*

144. *See supra* note 137 and accompanying text.

145. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. LAW INST. 2006).

146. *See* In re Trados, Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013).

There is one salient difference between lawyers and directors worth considering. The lawyer faced with a moral dilemma, such as the disclosure hypothetical, can and should consult her client. The client, for any number of reasons, may decide that disclosure is appropriate and so notify the lawyer. A director of a publicly-held corporation does not have that luxury in most instances. While a board of directors can refer a matter to the shareholders for an advisory vote or a binding determination, this is an unusual and expensive procedure. Moreover, it is somewhat awkward: Shareholders have elected the directors to make the business decisions for the corporation and ought not to be called upon to do the directors' work.[147] Thus, directors are guided by the fiduciary obligations and work without the "safety net" that lawyers have in the form of consulting with and gaining the consent of clients.

Since directors cannot consult with the beneficiaries of their fiduciary duties, ought they be free to guess whether their shareholders would opt not to maximize profits in a particular circumstance? This, too, seems like an avoidance of a fiduciary duty. The director's duty is not to do what the majority of shareholders might think best, but rather to do what the director believes is in the corporation's best interests. This concept finds support in the doctrine that a majority of shareholders cannot ratify a transaction that constitutes corporate waste; only unanimous shareholder approval can do so.[148]

Although there may be circumstances in which maximizing profit clearly contradicts the director's moral judgment, and even our collective moral judgment, there does not seem to be any way to operationalize the notion that, in these circumstances, the director should follow her own moral judgment, other than to allow the director to resign under these circumstances. To legally condone directors knowingly frustrating the profitability of their firm would be equivalent, in our view, to condoning lawyers knowingly frustrating their clients' legal success.

IV. THE MARKET FAILURE THEORY

In his recent book, MORALITY, COMPETITION, AND THE FIRM, Professor Joseph Heath offers a fresh approach to the debate about

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147. Of course, it is a different matter if the directors have a conflict of interest, or the corporate statute mandates shareholder approval.

148. *See* Michelson v. Duncan, 407 A.2d 211, 219 (Del. 1979).

director decision-making.[149] He notes that stakeholder theorists do not adequately consider the importance of corporate law when arguing for stakeholder protections. If a firm's managers favor non-shareholder constituents and its competitors do not, it will experience lower profits and become a target for hostile takeover. Heath explains that adherence to a norm of corporate social responsibility "significantly complicate[s] the agency relationships" between managers and the corporation, and he points to state-owned enterprises ("SOEs") as proof. SOEs are unsuccessful from a profit perspective, and a social responsibility perspective as well,[150] because the managers have a multi-task problem. As there is "no common metric that can be used in a [triple bottom line][151] context for evaluating social and environmental performance relevant to other stakeholders . . . it is very difficult to see how any reform of corporate law designed to permit managers to pursue a [triple bottom line] agenda would not also open the door to rampant malfeasance."[152] Similarly, the fact that managers are accountable to more than one principal (Multi-Principal Problems) frees them from accountability to any principal. Heath also convincingly discusses the experience of SOEs in this regard.[153]

Heath responds to these deficiencies with his "market failure approach," which starts from the presumption that economies based on free markets are relatively efficient at allocating goods and services. This is because free markets generate accurate pricing of such goods and services. Efficient markets, however, depend on an accepted set of rules or norms binding on competitors in the marketplace. Heath suggests ten such rules, one of which is that competitors minimize negative externalities; costs associated with the goods or services they produce that are not factored into the price at which those goods and services are offered. The classic example is goods that are produced in a way that generates carbon emissions which, in turn, contribute to global warming. Unless that effect is somehow factored into the price, the price of the goods will not accurately reflect all production costs. Thus, the efficiency of the market is reduced. To counter this result and to ensure

149. *See generally* HEATH, *supra* note 9.

150. *Id.* at 55.

151. Triple bottom line means accounting for the social and environmental impact of a firm in addition to its financial results. *See id.* at 54, 61.

152. *Id.* at 61.

153. *See id.*

the efficient allocation of goods and services to address this "market failure," corporate managers have a moral obligation to act in a way that might not maximize profits, but will internalize the full cost of their product.

Heath presents an elegant and forceful argument, but one that is ultimately unsatisfying as an alternative to the existing shareholder primacy paradigm in corporate law. Just as a firm's attention to a triple bottom line will disadvantage it if its competitors are not similarly constrained, the market failure approach requires adherence by all competitors. Heath responds to this obvious shortcoming by suggesting ways this may be avoided, including legislation to allow firms to collude on non-productive forms of competition.[154] But this and other suggestions provide only theoretical ways that managers might behave consistently with the market failure approach. As a practical matter, how would managers have to behave in the absence of such legislation? Typically, managers look for and exploit competitive advantages; the market failure approach presents a rationale for them to avoid doing so, but not a convincing reason that they in fact will.

For this reason, we find Heath's market failure approach to be a welcome and promising addition to the ethical question of what the purpose of a corporation is and what obligations it places on directors and managers. However, we also find it is not a satisfying alternative to shareholder primacy as the operant legal paradigm. Indeed, Heath's approach is not too far off from a more ethically sophisticated understanding of shareholder primacy—that is, one like ours that acknowledges the need for ethical constraints on the underlying presumption of a profit motive. Heath's idea that corporate directors have a moral obligation to eschew decisions that create Pareto inefficiencies, for example by rent-seeking behavior, could be re-purposed under the existing framework by highlighting the need for additional regulation in exactly these sorts of circumstances. We imagine that there would be widespread, shared moral judgment that Pareto inefficient corporate behavior, like regulatory capture or monopolizing a market, is wrong or at least morally questionable. If that behavior is not legally prohibited, then the shared moral judgement constraint should be invoked, and new regulation crafted.

154. *See id.* at 34, 37.

V. DELAWARE LAW: THE *BLASIUS* CASE

In *Blasius Industries, Inc. v. Atlas Corp.*,[155] Chancellor William Allen, writing for the Delaware Chancery Court, identified the essence of the shareholder-director relationship which, if accepted, explains (and constrains) the directors' authority to act. In that case, the Atlas board of directors rejected a restructuring proposed by Blasius, one of its shareholders.[156] In response, and in order to realize its proposed restructuring, Blasius decided to obtain control of the Atlas board.[157] Blasius sought to persuade Atlas shareholders to consent to an expansion of the Atlas board and to the election of Blasius's nominees to the newly created positions.[158] The Atlas board moved swiftly to thwart the plan by amending its bylaws, expanding the size of the board, and adding its own nominees to the vacancies.[159] Blasius sued for an injunction and prevailed.[160]

In an incisive opinion, Chancellor Allen posed these facts in the starkest terms: He assumed that the Atlas board of directors was unconflicted, fully informed, and acted in good faith—the prerequisites that normally indicate a court will not interfere with the directors' judgment.[161] Allen added that he was "inclined to think [the *Blasius* restructuring proposal] was not . . . sound."[162] The issue, then, was whether, under such circumstances, the Atlas board could act "for the principal purpose of preventing the [shareholder] from electing a majority of new directors."[163] Chancellor Allen concluded that they could not, because the shareholders' statutory power to elect directors provides the directors' authority to act for the corporation: "[T]he shareholder franchise is the ideological underpinning upon which the *legitimacy* of directorial power rests."[164] In other words, the directors cannot interfere with the shareholder voting process because their legitimacy depends on it. In that respect, the corporate voting construct

155. 564 A.2d 651 (Del. Ch. 1988).
156. *Id.* at 657.
157. *Id.*
158. *Id.*
159. *Id.* at 654.
160. *Id.* at 663.
161. *Id.*
162. *Id.* at 663.
163. *Id.* at 658.
164. *Id.* at 659 (emphasis added).

is not unlike the political process; a candidate who, say, interferes with voters casting their ballots loses all legitimacy to represent them. It is hard to argue with Allen's analysis, which is grounded in both logic and Delaware's corporate statute.

For present purposes, then, the question is the extent this limitation on director power informs the ability of directors to act in other circumstances. Must directors act to further the interests of shareholders? A couple of points are worth noting. First, Chancellor Allen was untroubled by the lack of a formal principal-agent relationship between the shareholders and directors.[165] Indeed, he used those terms to describe the relationship. Second, applying traditional agency principles, the agent must act in the best interests of the principal. To the extent that courts defer to the business judgments of directors, they do so because courts lack the expertise that directors presumably have. But, those business judgments must be in the best interests of the corporation and, by extension, in the best interests of the shareholders.[166] A board decision that the shareholder can prove did not meet this standard will, like the decision of the Atlas board, be subject to injunction.[167]

CONCLUSION: DO WE NEED NEW NORMS?

In this article, we sought to establish whether and how the corporation should act in a more socially responsible fashion. If directors are to deviate from the norm that they are bound to act in the corporation's best interests, then what justifies that deviation? This article considers a range of possible justifications: stakeholder theory, the team production theory, individual moral judgment, and the market failure rationale. All are found wanting as alternatives to the existing legal paradigm that assumes that maximizing shareholder value is a legitimate aim of directors.

The existing shareholder primacy paradigm is only plausible if we allow the need for some moral constraints based on publicly widespread shared moral judgments. This constraint allows shareholder primacy to plausibly navigate cases like the EpiPen controversy, where the course that maximizes shareholder value seems immoral to too many stakeholders and observers. Besides the need for ethically informed

165. *Id.* at 660.
166. *Id.* at 663.
167. *Id.*

legal constraints on maximizing profit, it is also available to directors under the operant paradigm to resign in protest if their personal moral judgments conflict with maximizing shareholder value, analogous to how a lawyer may resign rather than zealously represent a client when that representation conflicts with her personal moral judgment. To legally operationalize the alternative, in which it is at a lawyer or a director's discretion to contradict their fiduciary duties, would be unacceptable given the lack of a serious alternative to the agency law principles that inform a lawyer's duty of zealous representation. Those principles underpin the leading Delaware case, *Blasius*, which clearly articulates the source of director authority and its limitations.

Those who wish to see a change in this status quo should do more than just argue why it is a good idea. Delaware law, which governs the majority of publicly held corporations (where the call for social responsibility is most intense and consequential) does not currently give directors that unbounded discretion. The real challenge for those seeking the change, then, is to persuade the Delaware legislature to change its law, perhaps by adding an other-constituency provision. While that seems unlikely, proponents of change might turn to benefit corporations. One of the authors of this article has written of the promise of this new option, which mandates that corporate directors factor into their decisions the interests and concerns of a wide range of stakeholders, including the environment and society at large.[168] The mere fact that the Delaware legislature has recently added provisions in its law allowing for the creation of benefit corporations (called "public benefit corporations" in Delaware) only strengthens the conclusion that the realm of traditional corporations remains profit maximization and shareholder primacy. It is even harder to argue now that the directors of a traditional Delaware corporation may take into account the effect of their decisions on non-shareholder constituencies, unless there are benefits that accrue to shareholders from such accounting.

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168. Mark J. Loewenstein, *Benefit Corporations: A Challenge to Corporate Governance,* 68 BUS. LAW. 1007, 1007 (2013).