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# CORPORATE GOVERNANCE AND BANKRUPTCY

*Daniel J.H. Greenwood\**

## ABSTRACT

*Ordinary corporate law invests enormous authority in corporate leaders, largely without accountability either to those they govern or to the judiciary, in defiance of much of what we know about effective governance procedure. Instead, we rely on the markets in which the corporation participates as the primary check on incumbent officials. Regardless of whether relying on markets is sufficient in the ordinary course, corporate insolvency is the markets' verdict that incumbent management has failed. Accordingly, in bankruptcy and insolvency more generally, the law ought to abandon its ordinary deference to the corporate powers that be and instead impose standard good governance rules. Failed incumbents should be replaced and those governed should have political voice, not merely market exit rights.*

## INTRODUCTION

How does or should corporate governance change in insolvency or its vicinity? The special problems of bankruptcy emerge only by comparison with governance outside of the bankruptcy regime. Accordingly, this Article summarizes the ordinary course from the perspective of corporate law's formal governance rules and more broadly in light of the actual workings of the finance markets. Then, it suggests a few implications this background may have for bankruptcy and corporate law as well as some of the specific proposals discussed in the *Brooklyn Journal of Corporate, Financial & Commercial Law's* Spring 2018 Symposium on "The Market for Corporate Control in the Zone of Insolvency."

In short, American law reflects no consensus on the proper goals of corporate law. Instead, corporate law is largely procedural, providing a framework for deciding these issues rather than resolutions. The framework, however, is neither neutral nor the product of reasoned debate about the proper functioning of corporate governance in our self-governing, mixed economy democracy. On the contrary, corporate law is strongly tilted in favor of empowering incumbent officeholders, without much regard to how they use, or abuse, that power except in the most extreme circumstances. Accordingly, to evaluate both the rules of ordinary corporate law and the special problems of insolvency, we need to step outside the

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legal frameworks and think more broadly about the social goals this area of the law ought to promote.

Ordinarily, corporate law struggles with a series of difficult trade-offs. In bankruptcy, some of these conflicts become easier to resolve. In a market economy, solvency is the minimum measure of success—never sufficient but always necessary—for a private corporation. When incumbent officeholders and their shareholder electors have failed to achieve even this lowest measure of the public interest, arguments for stacking the deck in favor of incumbent wealth and power lose much of their power.

Market economies progress in significant part by Schumpeter's "creative destruction."<sup>1</sup> Bureaucratic business corporations, like other institutions, tend to be inflexible and unable to change rapidly. It is hard to change the way a firm does business when it is staffed largely by people who succeeded under the old way. Therefore, much as biological evolution is driven by the extinction of highly successful species closely adapted to ecosystems that no longer exist, economic progress is often marked by the failures of once important businesses. Economies that stop this process end up trapped in old ways of doing business that no longer make sense—burning coal or oil, for example, because changing to more modern and efficient fuels would require too much disruption of the existing energy, transportation and housing industries. It should never be the goal of insolvency law to excessively slow this critical process.

On the other hand, preservation of existing institutional structures is always attractive: institutions are easy to destroy and hard to replace. When a business, especially a relatively large one, closes down, the collateral damage may be quite serious. Jobs, working relationships, products and supply chains are never fungible. Employees who lose their jobs are likely to find it difficult to find similar replacements, especially if they have spent significant time developing firm-specific skills such as knowing the strengths and weaknesses of teammates or production systems. Similarly, customers and suppliers, whether individuals or other businesses, will inevitably lose time and money finding alternatives, and presumably the alternatives they do find will often be second bests (otherwise, why did they not switch earlier?). Multiplier effects mean that neighbors and unrelated businesses and their employees are likely to suffer as well: former employees are likely to be forced to change their spending patterns, uproot and move families, sell homes, and so on.

In light of the difficulties that abrupt change causes for ordinary citizens and the economy as a whole, even when change is necessary, it makes sense for bankruptcy to lean against the tendency of markets to view the past as

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1. Capitalism is an evolutionary process "that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* 82–83 (1994).

irrelevant, to constantly sweep away old methods of production, and to refuse to give any weight to sunk costs. Markets are radically innovative and constantly revolutionizing; the law can safely be somewhat conservative.

Accordingly, it is often appropriate for the law to seek to avoid liquidation of insolvent firms. Especially at the bottom of the business cycle, it is often difficult to tell whether insolvency is the result of obsolescence, incompetence or just bad luck. It is always possible, even likely, that a failing firm can be preserved, avoiding dislocation and misery, with relatively modest reforms.

That preservationist anti-market logic, however, does not apply to preserving the wealth or power of incumbent managers and shareholders. There is no reason to assume that the administrators and electors who ran an institution into insolvency are the right ones to reform and restore it.<sup>2</sup> On the contrary, the default is that failed managers and leaders ought to be replaced. To be sure, there is no guarantee that the replacement will be better. Nonetheless, past failure is not a good predictor of future success.

Ordinary corporate governance rules are extraordinarily deferential to incumbent office holders. Yet, since corporate governance is centrally about managing people—governance—the ordinary lessons of political theory largely apply. Power corrupts. Voting is the best way to assure that citizens are treated as partners in a collective project, rather than colonial subjects to be exploited, benevolently or otherwise, for someone else's benefit. Corporate law's incumbent protection should be suspect on its face.

The usual defense of corporate law's extraordinary grant of power to corporate elites is that markets will take care of problems. Firms run by incompetent or corrupt managers will not do well in consumer and labor markets, and the stock market will notice. Dropping share prices will lead directors to fire the malefactors. Alternatively, if they do not, more attentive investors will buy up the shares and associated votes necessary to replace

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2. The same, of course, is true of institutional creditors (bank lenders and bond holders). Both the bond market and banks are in the business of helping savers to invest small amounts in many different firms, thus transforming the unpredictable business risk of particular companies into a more predictable statistical risk. They are paid interest to assume this risk, much as an insurance company—also in the business of diversifying away risk—is paid premiums to compensate for the risks it assumes. When the risk they were paid to assume actually occurs, the law should generally be seeking to force them to accept the consequences of the agreement they made rather than relieving them from it.

The social function of these lenders is to transform savings into investment capital. If they invest in poorly run companies or fail to properly assess risk, they have not done their job. Accordingly, incompetent lenders generally should be left to the tender mercies of the market, not allowed to rewrite their obligations retrospectively. (The macro-economic problems caused by bank runs and bond market panics may counsel against relying overmuch on inherently unstable financial markets. However, here as well, protections against "contagion" should be focused on savers, on the model of the FDIC's deposit insurance, rather than incumbent financial intermediaries as in the bank bailouts of the last financial crisis).

directors and, ultimately, managers. If these finance-based mechanisms fail, the firm will succumb to the evolutionary pressures of competitive supplier, labor or consumer markets.

When the firm is insolvent, this defense no longer applies. Insolvency is a failure in a business carried on for profit. Consequently, the corporate law regime has failed. Corporate incumbents have demonstrated their inability to operate the firm successfully; boards have failed to replace them; and the stock market has failed to replace them. Similarly, the firm's failure demonstrates its inability to read and respond to the price signals of the competitive markets in which it must outbid others for sales, talent and physical and financial inputs.

Accordingly, insolvency law ought to abandon ordinary corporate law deference. Insolvency calls not for a strengthening of the authority of Wall Street but for countervailing powers and answerability to those dependent on and—ideally—benefiting from corporate law.

Part I summarizes at some length ordinary corporate law, outside of insolvency, emphasizing its deference to incumbent corporate officials. Part II seeks to discern goals of corporate law from the ordinary workings, finding instead that corporate law structures a struggle over corporate surplus in aid of top management and investors and to the detriment of other corporate participants. Part III briefly sets out some implications for insolvency. Edward Janger and Adam Levitin, in their article, *One Dollar, One Vote: Mark-to-Market Governance in Bankruptcy*, justify their policy proposals on inferences from normative principles they see as embedded in ordinary corporate law;<sup>3</sup> I contest both the embeddedness of the principles and their applicability in insolvency. Instead, insolvency means that the empirical-economic premises underlying conventional corporate law have been falsified.

In insolvency, the law ought to take a different direction. In sharp contrast to conventional corporate law, insolvency law should be hospitable to alternative theories of governance—including the lessons we learn from conventional democratic and republican theory. Here, at least, we should take seriously republican lessons of countervailing and separated powers, liberal demands for fundamental individual rights and due process constraints on arbitrary power, the democratic teachings of answerability to the ruled, and, above all else, the ancient rejection of corruption. The goal of corporate leaders must be the good of the whole, not the private enrichment of themselves or financial market participants.

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3. Edward J. Janger & Adam J. Levitin, *One Dollar, One Vote: Mark-to-Market Governance in Bankruptcy*, 104 IOWA L. REV. (forthcoming 2019).

## I. THE ORDINARY COURSE

The basic paradigm of corporate governance outside of bankruptcy is a study in stark contrasts. On the one hand, corporate law grants corporate elites with largely unreviewable authority and control over corporate decision making, without regard to opinions or requirements of input from others.<sup>4</sup> On the other hand, executives serve at the pleasure of their boards,<sup>5</sup> and while a successful chief executive officer (CEO) has de facto power to fill the board with supporters, loyalty cannot be guaranteed. Similarly, boards are elected by vote of the shares and shares are freely bought and sold, suggesting that, at least with respect to publicly traded companies, nominally powerful boards are actually subject to the whims of febrile financial markets.<sup>6</sup> Yet, most of the time, shareholders can be counted on to follow the “Wall Street Rule”—if you are unhappy with incumbent managers, then sell your stock to someone who likes them better—so that the usual shareholder vote looks more like a Saddam Hussein-era plebiscite than a contested election. To be sure, from time to time an outsider seeks to buy enough shares (and votes) to count, but corporate law grants managers enormous power to resist, including the nearly always effective poison pill.<sup>7</sup> In the end, the incumbents must be convinced to surrender.

Perhaps most confoundingly, conventional wisdom, routinely repeated by the business press, business schools, opinion makers and courts, is that corporations are obliged to maximize profits and boards ought to place shareholder profit above other goals. In contrast, however, standard corporate finance, as taught to our business elites for at least half a century, preaches that debt and equity are largely interchangeable<sup>8</sup> and that firms

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4. The business judgment rule, much like rational basis review in constitutional law, Chevron deference in administrative law or comity in international law, limits judicial review of board and managerial decisions in nearly all circumstances, barring conflicts of interest. *See, e.g.,* *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (under business judgment rule, a court presumes “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 was taken in the best interests of the company”).

5. DEL. CODE ANN. tit. 8, § 141(a) (2010) (vesting power to operate corporation in board).

6. *See generally* Robert J. Shiller, *Causes of Changing Financial Market Volatility* 1–32 (Proceedings - Economic Policy Symposium - Jackson Hole, Federal Reserve Bank of Kansas City, 1988) (discussing volatility in financial markets that cannot be explained by changes in available information); Hyman Minsky, *Stabilizing an Unstable Economy* (Hyman P. Minsky Archive, Paper 144, 1986), [http://digitalcommons.bard.edu/hm\\_archive/144](http://digitalcommons.bard.edu/hm_archive/144) (contending that stable markets lead to risk taking which leads to instability).

7. *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1348 (Del. 1985) (upholding poison pill).

8. That bonds and stock are largely interchangeable is the underpinning of the Modigliani and Miller independence propositions, taught to every beginning finance student, that the value of a firm, under “perfect” capital markets and without taxes, is independent of whether it is financed by debt or equity, and that under similar conditions investors should be indifferent as to whether corporate surplus is paid out as dividends, interest or reinvested in the firm. *See, e.g.,* IVO WELCH, *CORPORATE FINANCE: AN INTRODUCTION* 578 (2009); Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 262 (1958); Franco Modigliani & Merton Miller, *Corporate Income Taxes and The Cost of Capital: A Correction*, 53 AM. ECON. REV. 433 (1963).

ought to seek to minimize—not maximize—their cost of capital, as if the goal were to reduce rather than increase profit. Similarly, standard micro-economic theory teaches that in a competitive market any firm that does not minimize such costs will be forced out of business by lower cost competitors; no firm in a fully competitive market could possibly pay out dividends.

Moreover, profit maximization is distinctly contrary to the actual interests of most shareholders.<sup>9</sup> The human ones are likely to have far larger financial and emotional commitments to other roles—as citizens, consumers, producers, family members—that routinely will make conflicting claims. Most simply, nearly all of us have larger investments in our jobs, and our children’s future, than in the stock market. The institutional shareholders are diversified, so that they should be entirely indifferent to attempts by one publicly traded firm to compete with another; what they win in one pocket, they lose from the other. Instead, large scale investors are fundamentally invested in the system. They ought to recognize that their primary financial interest is mass affluence: Profit depends on companies’ ability to sell, which, in turn, requires customers, and for an investor invested in the broad swathes of the economy, customers are employees. Redistributing corporate gains to shareholders, in the medium run, simply leads to classic demand-deficit recession, as underpaid employees have trouble buying what they produce.

Even if it could be made consistent, the profit maximization faith has little support in the law. A century ago, corporate law statutes abandoned any attempt to restrict corporate form to socially useful purposes. Today, they consistently permit a corporation to be formed for any legal purpose and grant the board near plenary power to pursue corporate interests as the board perceives them, with no reference to profit at all.

In short, we live in a system that largely authorizes corporate elites to do as they please. Courts combine extraordinary judicial deference with

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9. The fictional shareholders for whose profit firms purportedly should be operated are implicitly described as if they have no interests other than their shares. This picture is highly implausible. An investor holding both shares and bonds of the same company might prefer the interests of its bonds over its shares. *See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 185 (Del. 1986) (barring corporate directors from considering interests of bondholders, despite evidence that bondholders and shareholders were largely the same entities). Diversified shareholders will have a greater interest in publicly traded firms than any particular firm, while traders may be more interested in price volatility than in the firm’s success. *See generally* Daniel J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996) [hereinafter Greenwood, *Fictional Shareholders*]. Ordinary middle-class citizen investors are likely to have far more interest in the overall success of the economy, employee prosperity, and consumer prices than in the price of any particular share. *Id.* Moreover, traders using modern derivatives can easily profit from the firm’s losses as well as its gains, or separate their vote from their economic interest. *See* Henry Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) (describing mechanisms by which stock market players can control corporate votes without the associated economic risk of shareholding).

hortatory demands to focus on profit, backed up by markets that, themselves, ordinarily easily tolerate inadequate performance but sporadically become harshly unforgiving.

In this Part I, I address a few of the principles of corporate law and its associated culture most relevant to insolvency and the bankruptcy regime. The central theme is the incoherence of the profit-maximization norm, both sociologically and as applied by the courts.

### A. THE MYSTERY OF PROFIT

The conventional wisdom, repeated in news articles, accounting and Master of Business Administration (MBA) classes, popular films, and judicial dicta, is that business corporations should and do maximize profits.<sup>10</sup> Unfortunately, the profit maximization norm is both confused and indefensible; there is no reason to think that a moral commitment to greed will lead to good results. Indeed, as Enron dramatically demonstrated, there is no reason to think that a commitment to profit maximization will even lead to profits; often it simply leads to fraud.<sup>11</sup>

If a business can sell its product or services for more than it must pay for its various human, physical and financial inputs, it generates an economic surplus. Some uses of that surplus are considered to be out of profits: payments of dividends for financial capital, purchases of other companies, or large-scale investment in physical capital for expansion. Others *reduce* accounting profits. For example, accountants will view the corporation's profits as lower if management uses its surplus to reduce the prices charged to corporate consumers<sup>12</sup> or increases payments (through

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10. See, e.g., WALL STREET (20th Century Fox 1987) (film clip available at <https://www.americanrhetoric.com/MovieSpeeches/moviespeechwallstreet.html>) (Gordon Gekko speech, "Greed is good").

11. Enron management was famously so focused on stock price that its stock ticker was displayed throughout the headquarters. See, e.g., Mimi Swartz, *How Enron Blew It*, TEXAS MONTHLY (Nov. 2001), <https://www.texasmonthly.com/the-culture/how-enron-blew-it/>. It seems highly likely that this focus led directly to its tolerance for sharp trading, misleading disclosures and outright fraud. See Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, COLUM. BUS. L. REV. 773, 775 (2004) (the profit maximization norm requires that managers learn to be cynics in order to betray their teammate employees; predictably, they also betray anonymous investors). For discussions of Enron, see generally, e.g., BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (Portfolio; Reprint edition, 2013); NANCY RAPOPORT ET AL., *ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER* 72–74, 125, 130, 287, 159, 163 (2009) (summarizing Enron's massively misleading accounting and use of stock options that gave executives strong incentives to increase share price; greed and opportunism are expected in corporate leadership but got out of hand at Enron; stock price was a powerful motivator; Enron's deceptions led to low cost of capital; Enron employee said "our job was to take advantage of the law to make as much money as we can;" top management conveyed impression that key objective was to book paper profits).

12. *Dodge v. Ford*, 170 N.W. 668 (Mich. 1919), discussed below, suggests that such a distribution of profit would be improper if not done with the goal of increasing shareholder dividends.

higher prices or greater consumption quantities) to corporate inputs in the forms of wages or salary for labor, rents for land, taxes for government services or interest for financial capital.

The distinctions between payments that reduce profits, and ones that do not, often reflect the recipient: in general, payments to equity investors are considered to be made out of profits, while payments to any other corporate participant are viewed as reducing profit. However, this distinction is often easily manipulated, in part because the various corporate roles are often held by the same people.<sup>13</sup> For one well-known example, bondholders and stockholders are, in general, the same diversified investment funds. Even when they are not, issuers and investors alike can readily substitute one for the other. In each case, anonymous savers aggregated through the financial markets provide funds to the firm in return for more or less predictable periodic payments subject to periodic renegotiation. The specific terms differ. But, as Modigliani and Miller famously demonstrated over half a century ago, and every finance student learns, the two forms are close enough to be substitutes in many cases, allowing firm managers and investors to substitute bonds (interest on which reduces profits) for stock (dividends on which do not) or vice versa.<sup>14</sup>

Similarly, a partnership reports payments to its key personnel as distributions of profits, while a corporation reports the same payments as wage and salary expenses reducing profit—unless the payments are in the form of dividends (or, during the go-go years of the ‘90s and ‘00s, out-of-the-money stock option grants), in which case they cease being expenses and no longer reduce profits.

Again, if a corporation’s control parties wish to make charitable contributions, the corporation may make the contributions itself, or it may distribute dividends to its shareholders, or it may increase executive compensation and they may make the contributions.<sup>15</sup> But these similar

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13. Prior to check-the-box income taxation for closely held corporations, *see* Treas. Reg. § 301.7701-2(b) (1996), closely held corporations routinely sought to recharacterize corporate surplus in order to avoid reporting taxable corporate profit.

14. That bonds and stock are largely interchangeable is the underpinning of the Modigliani and Miller independence propositions, taught to every beginning finance student, that the value of a firm, under “perfect” capital markets and without taxes, is independent of whether it is financed by debt or equity, and that under similar conditions investors should be indifferent as to whether corporate surplus is paid out as dividends, interest or reinvested in the firm. *See, e.g.,* IVO WELCH, *CORPORATE FINANCE: AN INTRODUCTION* 578 (2009); Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 *AM. ECON. REV.* 261 (1958); Franco Modigliani & Merton Miller, *Corporate Income Taxes and The Cost of Capital: A Correction*, 53 *AM. ECON. REV.* 433 (1963).

15. DEL. CODE ANN. tit. 8, § 122(9) (2010) (permitting corporation to make charitable donations). *See, e.g.,* Kahn v. Sullivan, 594 A.2d 48, 59–61 (Del. 1991) (approving settlement of derivative action challenging Occidental Petroleum’s financing of an art museum in honor of its CEO on the ground that board’s decision would be protected by business judgment rule); Theodora Holding Corp. v. Henderson, 257 A.2d 398, 405 (Del. Ch. 1969) (holding that Delaware corporations may make “reasonable” charitable contributions). While the duty of loyalty bars

behaviors are treated differently by law and accounting: the corporate contribution and increased executive compensation reduce the firm's profits and taxes, while dividends to allow shareholder contributions do not.

Accounting and legal conventions also do not track economic reality in other areas. Indeed, often a company that does not replace its plant before it becomes obsolete, abandons research and development, or does not spend on quality control will show an immediate increase in reported profit as its expenses decline. But as a matter of economic reality, by failing to make investments necessary to make its sales sustainable, the firm is disinvesting. In effect, it is eating its seed corn. The current "profits" are not economic surplus at all.

Similarly, any costs that the firm is legally permitted to avoid will not reduce accounting profits—even though from a social perspective they clearly reduce the social surplus, if any, produced by the firm. For example, the costs of production of oil include cleanup costs of spills, political instability and war in the Middle East, particulate pollution and associated disease in areas with heavy usage, global climate change from carbon emissions, and the social costs of building automobile rather than transit and pedestrian infrastructure (including the high cost of urban housing resulting from excess demand for the few areas served by transit). Few of these costs are legal obligations of oil producing or consuming firms and therefore they are not reflected in accounting profits.

Finally, even when a corporation has accounting profits in a particular accounting period, it is not required to distribute them to shareholders.<sup>16</sup> Stock market participants often assume that undistributed profits will eventually accrue to shareholders' benefit—they will be reinvested and produce larger profits later and at some point, those profits will lead to larger dividends or a final distribution if the company is sold. In the real world, this assumption often fails. Indeed, since competitive markets tend to force prices to marginal cost and the marginal cost of a dividend is zero, firms in competitive markets generally will have no choice but to distribute surplus to consumers (as lower prices) rather than to shareholders (as dividends). Even in less competitive markets, investments may not have the anticipated returns, or, as we have seen, management may decide to distribute any retained surplus to other corporate participants.

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executives from operating a firm for their personal advantage and executive compensation therefore ought to be in proportion to the executive's service, the courts are remarkably deferential to board decisions. *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697, 779 (Del. Ch. 2005) (reviewing high compensation for failed executive under deferential standard).

16. See *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1142 (Del. 1989); see *infra* note 26.

## B. THE PROFIT GOAL

Profit maximization, thus, conveys a general sense that corporations ought to be run in the interests of shareholders rather than other participants, but is highly ambiguous in its details. Indeed, short-term shareholder profit and long-term corporate success are rarely congruent. A firm that seeks to maximize accounting profits by minimizing expenses such as quality control, advertising, or legal compliance, or makes a routine practice of squeezing employees or suppliers, or deceiving customers, is highly likely to injure, not improve, its profits over the firm's life expectancy. The lesson of Enron may well be that true economic success, like happiness, is most likely to come to those who do not seek it directly.<sup>17</sup>

Ambiguities aside, the conventional wisdom is clear: managers are expected to profit-maximize at the expense of nearly every other value. Perhaps the most famous statement of this view is found in *Dodge v. Ford*.<sup>18</sup> The *Dodge* court, after reiterating the deference courts owe to the decisions of corporate boards, famously stated:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes. . . . [I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others . . . .<sup>19</sup>

While the court permitted Ford to continue reducing its prices below what the market would bear, the court said it was allowing Ford to do so only because expanding the business was likely to ultimately benefit the shareholders—not because the interests of customers or employees (as understood by Ford's board) were entitled to any consideration. Indeed, the court notes approvingly, as evidence that the board was properly pursuing the interests of shareholders, that the company was able to fund its expansion entirely on the backs of shareholders and ordinary employees—shareholders received their regular dividend and “the very considerable

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17. VIKTOR FRANKL, *MAN'S SEARCH FOR MEANING* (1959) (arguing that meaning and other directedness, not self-preservation, was the best route to survival in the concentration camps); see generally Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, COLUM. BUS. L. REV. 773 (2004) (arguing that pursuit of profit leads to cynical managers, which, in turn is antithetical to profit).

18. *Dodge v. Ford*, 170 N.W. 668, 684 (Mich. 1919) (maintaining that corporate customers and employees have no interests that corporate board may consider independent of shareholder profit).

19. *Id.*

salaries paid to Mr. Ford and to certain executive officers and employees were not diminished.”<sup>20</sup>

On this view, employees and customers are merely tools for the benefit of the shareholders, not ends in themselves. The company may act in their interests, as its board perceives them, only if so acting is a means to the end of shareholder profit. A fortiori, customer or employee views as to their interests or desires are entitled to no weight whatsoever.

To be sure, *Dodge* itself is an outlier.<sup>21</sup> The statutes explicitly contradict *Dodge*, stating that a business corporation may be formed for any legal purpose, without reference to shareholder profit,<sup>22</sup> and explicitly granting every corporation, “the same powers as an individual to do all things necessary or convenient to carry out its business and affairs,”<sup>23</sup> including using its funds for matters that clearly do not increase shareholder returns in any narrow sense, such as making “donations for the public welfare or for charitable, scientific or educational purposes” or “in aid of governmental authority.”<sup>24</sup> Moreover, cases ordinarily are far more deferential to managers and directors, even when managers obviously are not primarily concerned with short-term shareholder returns.<sup>25</sup>

Still, *Dodge* accurately reflects a widespread view that businesses *ought* to be managed solely to maximize profit, or (somewhat different) shareholder returns, even if the courts will not enforce this duty—that, as Milton Friedman perversely contended, the only social responsibility of business is profits<sup>26</sup> and managers ought to set aside all other concerns, including the welfare of employees, consumers, the environment or even the capitalist market system itself. Even the most deferential judicial opinions tend to repeat the shareholder profit goal while declaring it effectively unenforceable in court.

Thus, for example, in *Paramount v. Time*,<sup>27</sup> a much more typical case, the Delaware Supreme Court offered hortatory support for the profit maximization goal, even while rendering the board’s duty unenforceable in the courts. As in *Dodge*, board members testified to goals other than maximum profit, including preserving what insiders referred to as “Time

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20. *Id.*

21. Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 166 (2008).

22. *See, e.g.*, DEL. CODE ANN. tit. 8, § 101 (2010) (“A corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purposes . . .”).

23. Model Bus. Corp. Act § 3.02 (1969) (AM. BAR ASS’N, amended 1973).

24. Model Bus. Corp. Act §§ 302 (m), (n) (1969) (AM. BAR ASS’N, amended 1973). *Accord* DEL. CODE ANN. tit. 8, §§ 122(9), (12) (2010).

25. *See infra* pp. 11–13.

26. Milton Friedman, *A Friedman Doctrine – The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, at SM17.

27. *Paramount Commc’ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1142 (Del. 1989) (holding that Time’s board’s plan to merge with Warner was subject only to deferential review under the business judgment rule).

Culture” or “separation of church and state” (the separation of editorial and advertising staff) in order to maintain the “journalistic integrity” of Time Magazine.<sup>28</sup> Here, however, the court does not criticize these statements of purpose or even subject them to any critical analysis.<sup>29</sup> Instead, the *Time* court declared:

[The] broad mandate [of 8 Del.C. § 141(a)] includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. . . . [D]irectors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon. Second, [when *Revlon* is inapplicable] a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term . . . . The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals.<sup>30</sup>

Time’s directors, accordingly, were required to “promote the corporation’s interests,” which the court seems to view as interchangeable with “enhanc[ing] corporate profitability.” But they were not required to provide any evidence that their plans would have these results and explicitly were not required to “maximize shareholder value in the short term.” Rather, the court effectively grants the board near total autonomy to define the corporate “interest.”

First, the board has complete control over timing and need not even pretend to believe that its plans will maximize share value in any defined time frame or relative to any identified alternative.<sup>31</sup> On the contrary, the court affirmatively held that a board is entitled to set the time frame in which it seeks profits. But as Lewis Carroll’s White Queen taught us, when a manager offers jam every other day, it can mean that “the rule is jam tomorrow and jam yesterday—but never jam to-day.”<sup>32</sup> The power to defer is the power to deny; the court’s obeisance to profit maximization is entirely precatory.

Moreover, it is commonplace that short-term profit often conflicts with long-term success. Success depends on loyal and trusting employees and

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28. See, e.g., *Paramount Commc’ns Inc. v. Time Inc.*, 1989 WL 79880, at \*4 (Del. Ch. A.2d July 14, 1989) (noting that “transcendent goal” of the Time board included “a desire to maintain . . . what management and the board regarded as distinctive and important ‘Time culture’ [including a] distinctive structure that is intended to protect journalistic integrity from pressures from the business side of the enterprise”).

29. A more critical court might have questioned the testimony that the corporate purpose of the publisher of *People Magazine* and *Sports Illustrated* was to maintain “journalistic integrity” or that this goal explained the planned merger. See, e.g., *Time*, WL 79880, at \*7. In any event, the court’s recitation of the lengthy course of negotiations presented ample circumstantial evidence that executive prerogatives and empire building were far more salient drivers of the transaction.

30. *Time*, 571 A.2d at 1150, 1154.

31. *Id.* at 1153 (stating the board, not court, should determine what is a “better” deal for firm).

32. LEWIS CARROLL, *ALICE’S ADVENTURES IN WONDERLAND AND THROUGH THE LOOKING GLASS* 174 (Oxford World’s Classics 2009) (ebook).

customers, and, of course, a surrounding culture that encourages citizens to expect that they will be treated properly.<sup>33</sup> That kind of trust is hard to build and easy to destroy. Accordingly, *any* arguably socially useful decision is defensible as long-term profit maximization. The court acknowledges this reality, appropriately refusing to require a board to limit its considerations to profit in any narrow sense—it may, for example, take “*Time Culture*” as one of its goals. In short, the consequence of the *Time* holding is that boards may freely determine and change the corporate purpose so long as they appropriately invoke the requisite pieties and avoid “*Revlon mode*”<sup>34</sup> or self-interested actions that would eliminate the protections of the business judgment rule.

The legal reality of the holding is that *Time* was entitled to ignore shareholder returns to further a purported goal of preserving of an ill-defined “culture.” If this is all that is required of corporate boards, the case law parallels the statutory language: business corporations may be operated for any lawful purpose—ranging from creating good jobs or a quality product, satisfying (or creating) consumer desires for quasi-addictive nicotine or sugar, improving the national quality of life and/or profit, not doing evil, to preserving rain forests.

Still, the Delaware Supreme Court recapitulates and reinforces the widespread view that the highest goal of the board is “corporate profitability.”<sup>35</sup> Even as it allows deviations on the flimsiest of rationales, the court adds its voice to legitimize the social constraints on boards: rhetorically, if not mandatorily, their job is to consider profit, not social good.

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33. The literature on the economic importance of trust is vast. For examples, *see, e.g.*, Samuel Bowles & Sandra Polanía-Reyes, *Economic Incentives and Social Preferences: Substitutes or Complements?*, 50(2) J. ECON. LITERATURE 368 (2012); Edward L. Glaeser et al., *Measuring Trust*, 155(3) Q. J. ECON 811, 811(2000); Dani Rodrik, *Institutions for High Quality Growth: What They Are and How to Acquire Them* (NBER Working Paper No. 7540, 2000); Rafael La Porta et al., *Trust in Large Organizations*, (Nat’l Bureau of Econ. Research, Working Paper No. 5864, 1996), available at <http://www.nber.org/papers/w5864.pdf>; FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 5 (1996); *see generally* RODERICK M. KRAMER & TOM R. TYLER, TRUST IN ORGANIZATIONS: FRONTIERS OF THEORY AND RESEARCH (1995); Mark S. Granovetter, *The Strength of Weak Ties*, 78 AM. J. SOC. 1360 (1973).

34. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (stating that when company is for sale or sale or breakup has become inevitable (so-called “*Revlon Mode*”), board has an enforceable duty to disregard other goals in favor of share price maximization). In *Revlon*, an earlier transaction had exchanged shares for bonds; the court makes clear that the board was not permitted to consider the actual financial interests of actual shareholders which also held bonds. Rather, in *Revlon Mode*, the board must consider only the purely fictional interests of shareholders as shareholders, pretending that they have no other interests, financial or otherwise, in the firm or the broader economy.

35. *See Paramount Commc’ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1989).

### C. CORPORATE PURPOSE WITHIN THE PROFIT-SEEKING PARADIGM: SELF-COLONIZATION

Managers (and their critics) largely argue about specific strategies within this profit-seeking paradigm. Within particular companies, managers may seek specific solutions to specific problems—for example, by seeking to improve morale or to integrate new technologies, make legacy systems work together, or use financial engineering to improve reported earnings and, presumably, stock price. Those solutions, however, are no more ends in themselves than is employee well-being or customer satisfaction. Within the profit maximization framework, management is supposed to make its goal profit maximization. Organizing the firm efficiently to produce a useful product, improving morale, or contributing towards making America great are fine intermediate aims if they lead to profit. However, if instead profit requires ending a favorite project, exploiting customer trust, or even dissolving the firm, managers are expected to be prepared to abandon their prior commitments at any time. Indeed, the pursuit of profit seems to justify managers' use of firm resources to reduce the firm's contribution towards the public fisc, such as paying investors via tax-deductible interest instead of after-tax dividends. It may even shift profits to tax havens or injure the American economy by shifting production to jurisdictions with relaxed controls on pollution or safety, anti-union measures, or simply lower wages.

Corporate law is similarly conflicted about the roles and responsibilities of employees, especially top managers. As the *Time* case illustrates, courts defer almost completely to boards of directors, allowing them near plenary power over the firm.<sup>36</sup> Boards, in turn, routinely delegate their power to the

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36. Judicial review is effectively limited to a handful of circumstances. In the ordinary course, the board's decisions are protected by the business judgment rule, allowing the board to make arguably wrong and even negligent decisions without fear of a court "substitut[ing] its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Unocal Corp v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). The business judgment rule does not apply in a handful of narrowly defined situations. First, actual self-enrichment at the expense of the corporation, which is reviewed as a breach of the duty of loyalty. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (holding that conflict of interest and self-dealing transactions between a corporation and its top managers or directors are not void but will be reviewed for "entire fairness" and upheld only if they provide fair value to the corporation). Second, change of control transactions, where the board is presumed to have a conflict of interest leading to heightened scrutiny. *See Mesa Petroleum Co.*, 493 A.2d, at 956 (mandating elevated standard of review for defensive measures). Third, when the board causes or permits the corporation to violate the law, courts may review less deferentially. *See Miller v. Am. Tel. & Tel. Co.*, 507 F.2d 759, 762 (3d Cir. 1974) (applying NY law). However, even massive fraud does not automatically lead to judicial intervention. *See, e.g., Stone v. Ritter*, 911 A.2d 362, 369, 372 (Del. 2006) (holding directors to a "good faith" standard, i.e., that they must have minimal mechanisms in place to discover illegality, although the mechanisms need not be effective). Finally, if the board puts the company up for sale, or sale or dissolution becomes inevitable, the *Revlon* doctrine states that the board's duty changes to maximizing the return to shares in the particular transaction. *MacAndrews & Forbes Holdings, Inc.*, 506 A.2d, at 182.

firm's CEO and other top employees, retaining only the power to hire and fire and set pay for those at the very top. All employees, from the CEO on down, are subject to the ordinary agency rule that servants may be discharged at will, even in violation of employment contracts.<sup>37</sup> For employees below the level of the CEO, that power of discharge ordinarily is vested in their immediate superior. Accordingly, no employee is in a good position to criticize the firm leadership, play the role of a loyal opposition or otherwise decline to be a "team player" going along with top management's plans. The firm is organized internally as a sort of dictatorship with the board in the role of tribunes empowered to periodically review the dictator's actions and, if they so determine, remove him.<sup>38</sup>

The CEO, or the CEO and directors, may be dictators, but they are a peculiar type of dictator. Law and social pressures alike agree that both board members and managers owe a fiduciary duty of loyalty to the firm. They are expected to work for the firm, not themselves. Managers, even top managers who are founders or large shareholders, remain employees of the corporation and thus, like all employees, are its servants. In turn, a servant is obligated to work for the master's benefit, setting aside any conflicting interests the servant may have.<sup>39</sup>

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37. The U.S. norm is that non-unionized employees below the top executive level are "at will" and may be terminated at any time. Unionized and civil service employees sometimes have greater rights. Top executives typically have employment contracts. However, the firm may still sever the employment relationship for any reason; the only effect of the contract is to give the wrongfully terminated manager a claim for money damages.

38. If the top managers also control a voting majority of the stock, no one in the system has the ability to question or challenge their actions. See Kara Swisher, *A Wise Man Leaves Facebook*, N.Y. TIMES (Sept. 27, 2018), <https://www.nytimes.com/2018/09/27/opinion/facebook-instagram-systrom.html> (describing Facebook CEO Mark Zuckerberg's reluctance to allow dissent); Evan Osnos, *Can Mark Zuckerberg Fix Facebook Before It Breaks Democracy*, THE NEW YORKER (Sept. 17, 2018), <https://www.newyorker.com/magazine/2018/09/17/can-mark-zuckerberg-fix-facebook-before-it-breaks-democracy> (similar). Even when managers do not have controlling blocks of stock, the "Wall Street Rule" (that shareholders who are unhappy with current management's actions should sell their stock) and the basic Berle and Means passivity of dispersed shareholders assure that nearly all of the time, current shareholders will support incumbents. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *MODERN CORPORATION IN PRIVATE PROPERTY* (1932) (arguing that shareholders no longer had the control rights of owners in public corporations). For further discussion, see generally William W. Bratton, Jr., *The Modern Corporation and Private Property Revisited: Gardiner Means and the Administered Price*, UNIV. PA., INST. FOR LAW & ECON. RES. PAPER NO. 18–29 (Sept. 5, 2018); Dalia Tsuk Mitchell, *From Pluralism to Individualism: Berle and Means and 20th Century American Legal Thought*, 30(1) L. AND SOC. INQUIRY 179 (2005); Greenwood, *Fictional Shareholders*, *supra* note 9.

39. See, e.g., RESTATEMENT OF AGENCY 3D, § 8.01 GENERAL FIDUCIARY PRINCIPLE (AM. LAW. INST. 2006) ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship"); RESTATEMENT OF AGENCY 3D, § 8.05 USE OF PRINCIPAL'S PROPERTY (AM. LAW. INST. 2006) ("An agent has a duty (1) not to use property of the principal for the agent's own purposes . . . ."); *Meinhard v. Salmon*, 164 N.E. 545, 546, 548 (N.Y. 1928) ("A trustee is held to something stricter than the morals of the market place. . . .

Management is granted great power and directed to use it in the “interests of the corporation,” loosely understood as “corporate profitability.” Corporate profits, in turn, require selling the company’s services or products for more than the cost of production. This is another way of saying that the firm must seek to take as much as possible while giving as little as possible to consumers, suppliers, lenders, employees and society’s tax collectors. The profit motive requires the firm to treat its constituents, the very people who make it possible, as if they were outsiders, colonial subjects rather than citizens, to be exploited for the benefits they can provide.

At the same time, the duty of loyalty requires managers, while extracting the most they can from those they deal with on a daily basis, to themselves abandon any notion of personal profit.<sup>40</sup> They must be entirely selfless in their profit-seeking selfishness—true colonial administrators abjuring personal corruption in order to serve the greater cause. Except that the cause is not the glory of the motherland, but instead mere profit for anonymous stock market players.

#### D. THE CYNICISM OF PROFIT

To accomplish their designated profit-maximizing task, managers must treat their co-workers and firm customers with deep cynicism. The only way to get maximum cooperation and productivity from employees is to persuade them that they are part of a common enterprise; similarly, customers must be convinced that the company is not simply seeking to rob them. It is no surprise then, that managers like to call employees “associates” or “partners” as if they were equals rather than subordinates, or that they repeat aphorisms, such as “the customer is always right,” even while being quite certain of the contrary. Profit maximization requires that customer or employee-centered concerns be an illusion and a lie, much as the logic of colonialism inevitably demonstrates the “white man’s burden” or the “*mission civilisatrice*” to be simply more sophisticated extraction methods, pleasanter and probably more profitable than the violence of the Belgian Congo (but no more aimed at the interests of the colonial subjects). A profit-maximizing company treats its participants and customers well only to the extent that it expects that good treatment will enable it to extract more from them. Under profit-maximization norms, employees and

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Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation.”)

40. RESTATEMENT THIRD OF AGENCY, § 8.01 GENERAL FIDUCIARY PRINCIPLE (AM. LAW. INST. 2006); RESTATEMENT THIRD OF AGENCY, § 8.05 USE OF PRINCIPAL’S PROPERTY (AM. LAW. INST. 2006); *Salmon*, 164 N.E. at 548.

customers are not part of the team but opponents—every penny that they receive is a penny that reduces profits.<sup>41</sup>

Employees of a firm work together to produce the firm's products or services. It might seem, then, that they should be paid as participants in a joint enterprise, sharing in the benefits they have jointly created.<sup>42</sup> Such explanations of pay appear from time to time in the academic literature.<sup>43</sup> But the corporate law analysis is different. Under our business law, employees are agents (servants) of the firm and therefore, as a matter of law, what they produce belongs to the firm.<sup>44</sup> Since what they produce does not belong to them, it cannot be the justification for their pay.

Similarly, workers in a capitalist society are expected to look out for their own interests; they produce social benefits indirectly by directly pursuing personal wealth.<sup>45</sup> But as a legal matter, corporate employees, from the lowest paid to the CEO, are servants of the corporation, bound to set aside their own interest and act on behalf of the firm. Therefore, they cannot defend their pay on the Lockean grounds that they made it by combining their labor or effort or intelligence with raw materials,<sup>46</sup> or by George Washington Plunkitt's classic line: "I seen my opportunities and I took 'em."<sup>47</sup> Either of these conventional entrepreneurial positions would be clearly improper.<sup>48</sup>

41. See, e.g., DANIEL J.H. GREENWOOD, TEAM SPIRIT: DOING BAD THINGS IN THE CAUSE OF GOOD, in THE RANGE OF EVIL: MULTIDISCIPLINARY STUDIES IN HUMAN WICKEDNESS 5 (William A. Myers, ed., INTERDISCIPLINARY PRESS, 2006); Daniel J.H. Greenwood, *Discussing Corporate Misbehavior: The Conflicting Norms of Market, Agency, Profit and Loyalty*, 70 BROOK. L. REV. 1213, 1235 (2005).

42. See, e.g., JOHN LOCKE, SECOND TREATISE OF CIVIL GOVERNMENT ch 5, para. 27 (Thomas Peardon, ed. 1952 at 17) (1690) (arguing that since each man owns his own labor, when he mixes it with natural matter, it becomes his property).

43. See generally OLIVER WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM (1998) (arguing for shareholder supremacy on ground that employees would find democratic control difficult); see, e.g., Margaret Blain & Lynn Stout, *Team Production Theory of Corporate Law*, 85 VA. L. REV. 248, 263 (1999) (arguing that firms create hierarchy to overcome the difficulties of determining individual contributions to the firm product).

44. See, e.g., RESTATEMENT THIRD OF AGENCY, § 8.02 MATERIAL BENEFIT ARISING OUT OF POSITION (AM. LAW. INST. 2006); *Speck v. N.C. Dairy Found., Inc.*, 319 S.E.2d 139, 144 (N.C. 1984) (holding that employee's non-patentable invention belonged to employer in absence of contract to contrary).

45. ADAM SMITH, WEALTH OF NATIONS Book I, Ch. II (1776) ("It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. . . . Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens.").

46. LOCKE, *supra* note 42.

47. WILLIAM RIORDAN, PLUNKITT OF TAMMANY HALL: A SERIES OF VERY PLAIN TALKS ON VERY PRACTICAL POLITICS, DELIVERED BY EX-SENATOR GEORGE WASHINGTON PLUNKITT, THE TAMMANY PHILOSOPHER, FROM HIS ROSTRUM, THE NEW YORK COUNTY COURT-HOUSE BOOTBLACK STAND 3 (1905) (reissued 1963).

48. The product of an employee's labor belongs to the employer, not the employee. Similarly, the agent's duty of loyalty bars the agent from acting in pure self-interest. See, e.g., *Unocal Corp v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985).

Instead, managers justify pay for their subordinates and themselves on the ground that the pay is necessary to attract and retain them, or is calculated to lead them to work harder or more competently. Pay is not defended by pointing out that employees are “We the People,” so that employee pay is the same as social good, the reason why “Governments are instituted among men”<sup>49</sup> and indeed, one of the primary reasons why corporations are legal in the first place. Instead, pay is seen as, in effect, an investment expected to lead to more profit for the firm. For this reason, courts, prior to the Employee Retirement Income Security Act of 1974 (ERISA), consistently had trouble understanding the concept of a pension as deferred compensation. Since the pensioner was no longer contributing to the firm, courts saw the pension as unnecessary to induce work and therefore a gift lacking the consideration necessary to make it a contractual obligation.<sup>50</sup>

Indeed, the received wisdom appears to be that we must offer those at the very top ever larger pay (and ever lower taxes) in order to motivate them to do their jobs. Even the Delaware Chancery Court has stated that directors ought to hold stock in the companies they supervise in order to improve their “incentives.”<sup>51</sup> This view reflects an astonishing lack of confidence in the professionalism of the professionals who operate institutions that are among our most important. If they cannot be trusted to act responsibly unless they have “skin in the game,”<sup>52</sup> then presumably judges like Chancellor Strine, for whom such material rewards would be corruption, cannot be trusted either. And if directors must have such “skin” because they are acting solely out of self-interest, why would anyone expect them to not cheat or steal for personal benefit, given the generally low level of safeguards and the high potential rewards?

Increased wages at the top are said to improve incentives. For most other employees, higher wages are perceived differently: in the conventional view, increased wages are an inflationary threat that might reduce incentives to work, so they should be fought by raising interest rates and weakening unions. Were we to take the opposite view—that the purpose of profits is to entice, at the lowest possible price, finance capital so that we can maximize the number of good jobs—we might well get higher growth (as we did in the years following the Second World War), because we would have a broader base of affluent consumers. A mass consumer base would reduce the likelihood of demand-deficit (or “savings glut”)

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49. U.S. CONST. pmbl.; THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776).

50. See generally JAMES WOOTEN, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY (2004).

51. See, e.g., *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at \*10, 10 n. 47 (Del. Ch. Aug. 18, 2006) (citing academic articles contending that directors will not have “incentives” to do their duty without equity holdings).

52. *Id.* at 10.

recessions, since the middle class saves relatively little. At the same time, such a middle-class led economy would probably have fewer problems with inflation. The middle class is more likely to demand the sorts of goods and services that we know how to produce cheaply and in scale, in contrast to upper-class demand for “Veblen goods.”<sup>53</sup> Effective middle-class demand for housing leads to higher employment and better housing; demand for the largest house on the fanciest beach or the highest building in Manhattan just drives prices upward.<sup>54</sup>

Even conservative theorist Edmund Burke, denouncing the French Revolution, saw the affluence of a population as a chief test of the success of government.<sup>55</sup> Corporate law, and the conventional wisdom it reflects, beg to disagree. In the world of corporate law, ordinary Americans are, as it were, colonial subjects, tools to an end that is not their own—someone else’s profit. In short, our own interests and values—even those of us who own shares—are irrelevant.

Fundamentally, however, the profit goal puts managers in an awkward and cynical position. To succeed, a corporation must outcompete markets that, as Ronald Coase pointed out, perform for free the managerial functions of information assimilation and direction.<sup>56</sup> Corporations have two principal mechanisms to do this: centralized planning by command and control hierarchies, or cooperation and team spirit. The former is generally acknowledged to be inefficient, if only because superiors must rely on subordinates to supply information and to carry out orders.<sup>57</sup> Accordingly, successful managers routinely appeal to cooperation and group competition to convince employees to sacrifice—or at least work hard—for the corporation team.

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53. Veblen goods are luxuries for which demand rises as prices increase. The name is a reference to Veblen’s theory of conspicuous consumption, which contends that most consumption beyond subsistence levels is for the purpose of demonstrating status. See THORSTEIN VEBLEN, *THE THEORY OF THE LEISURE CLASS: AN ECONOMIC STUDY IN THE EVOLUTION OF INSTITUTIONS* 75–76 (1899). When demand is based on pursuit of status, the item or service is valuable only because it is not available to the masses.

54. As income and wealth are redistributed upward, status-marker goods such as the highest high rise, the best seats in the ballpark, or the most elite prep school are subject to massive inflation since, by definition, it’s not possible to create more without destroying the scarcity that is the source of their value. See generally THOMAS H. FRANK, *THE WINNER-TAKE-ALL SOCIETY: WHY THE FEW AT THE TOP GET SO MUCH MORE THAN THE REST OF US* (1996).

55. EDMUND BURKE, *REFLECTIONS ON THE REVOLUTION IN FRANCE* 146, 148 (The Liberal Arts Press, Inc. 1955) (“Among the standards upon which the effects of government on any country are to be estimated, I must consider the state of its population as not the least certain. No country in which population flourishes and is in progressive improvement can be under a very mischievous government. . . . The wealth of a country is another, and no contemptible, standard by which we may judge whether, on the whole, a government be protecting or destructive.”).

56. Ronald Coase, *The Nature of the Firm*, 401 *ECONOMICA* 386–405 (1937).

57. For an early example of this commonplace observation, see LEO TOLSTOY, *WAR AND PEACE* Book 9, Ch. 1 (1867).

But even while managers are trying to convince employees to be team players, the profit maximization norm simultaneously requires managers to remember that the same employees are costs to the corporation to be minimized whenever possible. They, or we, are not the goal of the firm but its opposition, not its citizens but its subjects. Managers, then, are expected to be double agents, as ready to betray a team as to build it. Perhaps as a result, one has the impression that many firms have promotion policies which, intentionally or otherwise, select for a degree of ruthless self-interest.<sup>58</sup> Presumably, pay-driven, self-interested, competitive individuals are less likely to develop the genuine relationships with co-workers that might make betrayal harder, and therefore are more likely to succeed in this intensely cynical game.

### E. FROM CYNICS TO SELFLESS SAINTS

Cynicism, however, is only the first part of the story. As noted above, corporate leaders, as fiduciaries, are barred from betraying their co-workers for their own benefit.<sup>59</sup> Rather, having faked loyalty in order to extract effort from their co-workers, the self-interested cynics must convert to selfless saints, acting with “the punctilio of an honor the most sensitive,” voluntarily to turn over their ill-gotten gains to the anonymous institutional investors of the stock market.<sup>60</sup>

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58. It is difficult to know how one would verify or falsify this impression. But anecdotes certainly support it. Consider a completely arbitrary list including the recent rash of scandals involving executives apparently coercing subordinates into sex, from Harvey Weinstein to American Apparel’s Dov Charney. See, e.g., Hadley Freeman, *American Apparel founder Dov Charney: ‘Sleeping with people you work with is unavoidable’*, THE GUARDIAN (Sept. 10, 2017), <https://www.theguardian.com/lifeandstyle/2017/sep/10/american-apparel-dov-charney-sexual-harassment>; see generally MICHAEL LEWIS, *LIAR’S POKER* (W. W. Norton & Company; Reprint edition, 2010) (noting examples of repeated stories of difficult-to-deal-with executives); Mike Isaac, *Uber Founder Travis Kalanick Resigns as C.E.O.*, N.Y. TIMES (June 21, 2017), <https://www.nytimes.com/2017/06/21/technology/uber-ceo-travis-kalanick.html> (explaining the forced departure of Uber’s Kalanick after sexual harassment allegations); Andrew Ross Sorkin, *This Tyco Videotape Has Been Edited for Content*, N.Y. TIMES (Oct. 28, 2003), <https://www.nytimes.com/2003/10/28/business/this-tyco-videotape-has-been-edited-for-content.html> (noting the extraordinary outright fraud in executive suites uncovered in each downturn, epitomized by Tyko’s Dennis Kozlowski’s ice sculpture of a urinating David); Alan Deutschman, *Is Your Boss a Psychopath?*, FAST CO. (July 1, 2005), <https://www.fastcompany.com/53247/your-boss-psychopath> (noting the infamous restructuring tactics of “Chainsaw Al” Dunlap). Or, for a more traditional version of power corrupting, consider Angelo Mozilo’s combination of political bribery and mass exploitation of vulnerable borrowers at Countrywide Financial. See Connie Bruck, *Angelo’s Ashes*, THE NEW YORKER, June 29, 2009, <https://www.newyorker.com/magazine/2009/06/29/angelos-ashes>.

59. See *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (“Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty.”).

60. *Id.* In Justice Cardozo’s memorable language, fiduciaries—partners in the *Meinhard* case, but corporate directors and top executives as well—are “held to something stricter than the morals of the market place . . . [They serve] in a position in which thought of self [is] to be renounced, however hard the abnegation.” *Id.* at 546, 548.

I say “voluntarily” advisedly. Shareholders have no legal entitlement to a dividend. Rather, they rely on the normative expectation that directors and managers are supposed to declare them, enforced by constant repetition in schools, the press and relevant social circles.

Beyond this social norm sits little. Shareholders ordinarily cannot invoke the power of the courts to demand a dividend; legally, the defining characteristic of a dividend is that it is not a contractual right until the board declares it.<sup>61</sup> Courts guard the autonomy of directors to determine the time frame in which to pursue profit or to turn over corporate funds to shareholders.<sup>62</sup>

As a result, as a practical matter, the only coercive power that shareholders have to force a dividend is the so-called market for corporate control—the possibility that stock market participants (shareholders and non-shareholders alike) will bid down the stock price to the point where a prospective buyer will find it attractive to purchase enough shares to vote out the incumbent directors. This has not been much of a threat since the mid-1990s: incumbent directors are entitled to use the funds and powers of the corporation to repel insurgents, including by methods such as staggered boards and poison pills that make it nearly impossible for any outsider to accumulate a control block of stock without managerial consent.<sup>63</sup>

What is left is moral suasion. Directors give corporate surplus to investors (via dividends or stock buybacks) because they think it is what they are supposed to do, not because anyone can force them to do it. It remains an open question to what extent or for how long this normative expectation will be able to overcome the powerful forces aligned against it. Will top managers who have risen to their position by betraying their colleagues consistently accept a moral obligation to share their gains with anonymous investors, or will they increasingly find ways to divert corporate profits to themselves?

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61. See, e.g., DEL. CODE ANN. tit. 8, § 170 (2010) (specifying conditions under which directors “may” declare a dividend); *Gabelli & Co., Inc. v. Liggett Group Inc.*, 479 A.2d 276, 280 (Del. 1984) (“It is settled law in this State that the declaration and payment of a dividend rests in the discretion of the corporation’s board of directors in the exercise of its business judgment [and courts will intervene only in cases of fraud or oppression].”).

62. *Paramount Commc’ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 (Del. 1989), discussed *infra* note 26.

63. *Versata Enter., Inc. v. Selectica, Inc.*, 5 A.3d 586, 604 (Del. 2010) (upholding combination of staggered board and poison pill as not “preclusive” even though it made hostile takeover virtually impossible in short term); *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361, 1376 (Del. 1995) (upholding “just say no” defense by holding that directors may “protect its stockholders from offers that do not reflect the long-term value of the corporation under its present management plan . . . [and may] properly employ[ ] a poison pill as a proportionate defensive response to protect its stockholders from a ‘low ball’ [offer].”); *Unocal Corp v. Mesa Petroleum Co.*, 493 A.2d 946, 955–56 (Del. 1985) (setting out standard of review for defensive measures).

### F. ABSOLUTISTS RUNNING SCARED

In short, in the ordinary course, corporate managers—the CEO and subordinates—have near total discretion, virtually exempt from judicial review. The near universal practice of a single bureaucratic hierarchy culminating in a CEO, all of whose subordinates serve at his pleasure, ensures that top management will be largely unfettered by meaningful countervailing powers within the bureaucracy. Therefore, while the board has real power to replace the CEO, it lacks the basic internal information to exercise that power sensibly. Flying blind, it usually must depend on information from the CEO himself, subordinates willing to put their own careers at risk by defying the boss, or outsiders such as market analysts. The CEO retains a degree of authority that would have pleased King James. Meanwhile, insecure and dependent subordinates, as every student of political theory since Aristotle has understood, make the likelihood that CEO or board can receive honest advice or accurate information vanishingly small.

Nonetheless, managers and boards alike often run scared, acting less like all-powerful sovereigns with unlimited power to silence and exclude dissidents, than like slaves to the latest market fashions. The CEO serves at the pleasure of the board;<sup>64</sup> the board is elected by the stockholders' meeting, typically on a basis of one vote per share,<sup>65</sup> and shares (with their votes) are freely bought and sold<sup>66</sup> at prices that reflect some combination of speculation regarding future corporate payouts, so-called control premia, and speculation regarding future stock market returns.

Ultimate control, thus, rests in the stock market, which at any time could drive the price of a vote down to the point where an active investor would find it attractive to purchase control of the board. The consumer and producer markets may be similarly harsh taskmasters, at least to the extent that the firm is subject to competitive pressures there. However, most corporations with publicly traded stock can be expected to have some monopoly power or similar protection from consumer market forces. Competitive markets drive prices down to marginal cost; any firm that paid dividends would have marginal cost and prices that are higher than its competitors and would be driven out of business. There would be little reason for a passive investor to buy stock in a firm that is not expected to ever declare a dividend, so investors in the public market, if they are not entirely irrational, must believe that the firm has a way to escape the competitive dynamic.

To the extent that ultimate control rests in the stock market, it remains as fraught as the conflicts between discretion and fiduciary duty or the

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64. DEL. CODE ANN. tit. 8, § 141 (2010).

65. DEL. CODE ANN. tit. 8, § 211(b).

66. DEL. CODE ANN. tit. 8, § 202(a).

various contradictory understandings of the profit imperative. Indeed, the stock market fractally reproduces the conflicts we have seen already. Stock markets simultaneously take far longer and shorter-term perspectives than any human being: investment portfolios, having no life cycle or anticipated death, can invest for the longest possible term, but they attract customers based on short term performance and ever shorter-term trading. A primary function of the stock market and the portfolios that dominate it is diversification to eliminate firm-specific risk. A market made of portfolios should ignore most of the diversifiable risks that are the central issues of management, yet it moves in stampedes. Since any individual trader can profit hugely by trading on information before others know it, traders collectively make the stock market into a rapid aggregator of information. Yet, actual stock price movements are often driven by fads and fashions and self-referential inferences about its own behavior.<sup>67</sup>

### G. CONFLICTS BETWEEN FINANCIAL AND OPERATIONAL MANAGERS (“SHAREHOLDERS” VS. MANAGERS)

Conventional wisdom refers to an “agency cost” problem, that corporate managers might not be perfect representatives of shareholder interests. The problem is misnamed and poorly theorized. Managers (but not directors) are agents of the corporation, but neither managers nor directors nor even the corporation are agents of shareholders.<sup>68</sup>

Shareholders themselves are largely institutional.<sup>69</sup> Debates about whether “owners” should have more control than “managers” are really about which set of managers ought to run the firm. There are several

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67. On the self-referential or otherwise meaninglessness of many stock market price changes, see, e.g., ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 239 (3d ed. 2015); J. Bradford De Long et al., *The Size and Incidence of the Losses from Noise Trading*, 44 J. FIN. 681 (1989); Robert Shiller, *Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?*, 71 AM. ECON. REV. 421 (1981).

68. Indeed, were shareholders to treat the corporation as if it were their agent, the courts would conclude that the firm is not a corporation at all, and “pierce the veil” to deny shareholders the key privilege of corporate law: entity (so-called “limited”) liability. See, e.g., *Berkey v. Third Ave. Ry. Co.* 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.) (“Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent.”).

69. The Tax Policy Center estimated that in 2015, about 21% of the US stock market, measured by capitalization, was held by households directly (i.e., not via mutual funds) in taxable or non-taxable accounts. Steven M. Rosenthal & Lydia S. Austin, *Tax Policy Center, The Dwindling Taxable Share of U.S. Corporate Stock*, TAX POLICY CENTER, 927 T. 2 (2016), <https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000790-The-Dwindling-Taxable-Share-of-U.S.-Corporate-Stock.pdf>. These numbers appear to include non-publicly traded stock, which likely increases the proportion of non-institutional shareholders. The bulk of these individual holdings are probably controlled by a tiny group of ultra-wealthy investors, and it is highly likely that most of it is professionally managed. The remainder of the market is owned and controlled by institutions: largely pension funds, but also mutual funds, hedge funds, insurance companies, endowments, and the like. *Id.* Almost a quarter is held by foreigners, again primarily institutions. *Id.*

reasons to think that shareholder managers will generally do a worse job: first, expertise and experience, second, information and independence, and third, fiduciary duty and fundamental commitments.

Shareholder-managers are trained to spot and trade on market inefficiencies or to rebalance investment portfolios.<sup>70</sup> This is not obviously relevant to operating a firm. On the contrary, modern investors are trained to think about the risk and return of a portfolio of passive investments—not about motivating large numbers of employees or ensuring that the bureaucratic processes of information aggregation, planning and hierarchal control lead to producing useful services that can be sold for more than their cost of production.

Trading is transactional, short-term, and zero-sum: the past is no predictor of the future, the counterparty is often anonymous and almost always replaceable, and every dollar one trader makes is a dollar another lost. For a trader, future prices are all that matters. The past is useful only to the extent that it predicts the future and, especially to the extent that prices already reflect existing information, often meaningless or threatens to be misleading. For a trader, emotional commitments to a project or an individual are merely sunk costs to be removed from consciousness, however difficult the abnegation of ordinary modes of thinking.

These skills and habits are almost diametrically opposed to those of a good institution builder; institutions, unlike markets, are always tied to their own past, always path dependent, always dependent on long-term commitments and relationships. The idea that traders will be better at running companies than insiders with relevant skill and knowledge defies the most basic logic of the division of labor.

Second, shareholder-managers tend to be tightly tied to the stock market, if only because most portfolio managers, including active investors such as hedge fund managers, are regularly and routinely evaluated by comparison to stock market returns. Fail to beat the index, lose your job. Since operating firms can only succeed by being different from the finance markets,<sup>71</sup> tying firm decisions closely to stock price is doomed to fail. As Enron showed, a firm trying to duplicate the finance markets internally is likely to end up with the worst aspects of both systems.<sup>72</sup>

Moreover, most proposals to shift power to shareholders will actually shift power to the entire stock market. Prices are not set by shareholders but by the finance market as a whole—buyers, sellers, holders, and those who

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70. See generally JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* (2006).

71. Coase, *supra* note 56, at 393.

72. See generally, e.g., BETHANY MCLEAN AND PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2013); NANCY RAPOPORT & JEFFREY VAN NIEL, *ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER* (2009).

decide to buy bonds instead. Making hostile takeovers easier or tying managerial incentives more tightly to stock prices empowers prices, not votes. Moreover, professional shareholders usually are prepared to sell at the right price at any time (and may even have fiduciary obligations to their own institutions or investors to do so). So even shareholder powers that are actually restricted only to current holders of the company's stock—such as the right to vote for directors, say on pay, or authority to nominate directors or make precatory or binding proposals without prior board consent—also tend to empower the financial markets rather than affiliates of the particular firm. If the right, or a particular exercise of it, is salient enough, the shareholder base will shift to those who value it, without regard to any ongoing commitment to or connection with the firm. Non-shareholders are always potential shareholders at the right price.

The financial markets, especially the institutional sector governed by the teachings of modern corporate finance and legal fiduciary obligations based on it, have fundamentally different commitments than any firm. The primary function of financial markets is to match investors and savers with different time and risk preferences: to allow firms, which need long term funds to invest in particular, risky projects to use money from savers who fear risk and want to be able to regain the use of their money independent of the firm's needs. On the one hand, the markets aggregate numerous small investments to create the large sums that firms need. On the other hand, they split the large, illiquid, long term investments that firms make into small, transferable pieces, so that individual contributors can diversify their own portfolios, eliminating the risk of any particular project, and can exit when they wish without regard for the firm's investment horizons.

A portfolio investor can shift the portfolio from one industry to another, or one country to another, or one time frame to another, by a simple phone call to a broker. Even the longest-term investor is essentially short-term in that it need not have any ongoing commitment to any liquid investment: for even a momentary profit, it may decide to sell a thirty-year bond or a permanent equity investment and buy over-night paper. Its own time frame—a pension, for example, is a permanent investor—need not have any connection to the time frame of its investments—short-term commercial paper, for example.

In contrast, the real capital investments of a firm are necessarily bounded by time and place. An operating corporation, unlike a financial investor, must commit to particular projects in particular places run by particular people using particular skills and equipment.

To be sure, a corporation may finance long term real capital with short-term borrowing regularly rolled over (or the reverse), even if this leaves it more subject to possible downturns in the financial markets. Similarly, corporate managers remake firms all the time—GE moves in and out of finance as its primary activity; the American Can Company transforms

itself into a financial conglomerate called Primerica and then is absorbed into and later spun off by Citigroup; and Amazon moves from selling books to providing the infrastructure for everyone selling on the internet.

Yet, the distinction remains. Financial investors can change time frame or physical location at a moment's notice, moving funds from the Australian stock market (permanent financing) to the Norwegian overnight loan market with almost no costs. In contrast, transforming a business takes time. Moving physical plants often requires abandoning physical capital before it is worn out. Changing places or projects requires destroying and rebuilding teams of employees, sacrificing the often-significant value of experienced people who know how to work with each other. A firm must be firmly solid; the whole point of a financial market is that it is liquid.

Fiduciary duty and loyalties lead to the same result. Corporate managers are expected to work for the firm. Shareholder managers are not. It is perfectly acceptable—legally and ideologically—for a shareholder to explicitly harm the long-term interests of the firm for the short-term interests of the shareholder (at least if there are no minority shareholders injured in the process). Thus, it is not surprising that hedge fund and private equity managers, who operate as super-CEOs supervising the CEOs of the operating companies their funds own, yet legally are representatives of a shareholder rather than operating company fiduciaries, pay themselves far more than the operating executives.<sup>73</sup> Private equity fund manager Steven Schwartzman received almost \$800 million in 2015.<sup>74</sup> Top hedge fund managers have received pay of over a billion dollars in a single year.<sup>75</sup> Even the *Disney* court might have been troubled had these been corporate fiduciaries.<sup>76</sup>

The upshot is that portfolio investors—shareholders and bondholders—inhabit a fundamentally different world than any firm manager. Portfolio investors need not concern themselves overmuch with particular projects,

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73. See generally Daniel J.H. Greenwood, *Looting: The Puzzle of Private Equity*, 3 BROOK. J. CORP., FIN. & COM. L. 89 (2008) [hereinafter Greenwood, *Puzzle of Private Equity*].

74. See Benn Protess & Michael Corkery, *Just How Much Do the Top Private Equity Earners Make?*, N.Y. TIMES (Dec. 10, 2016), <https://www.nytimes.com/2016/12/10/business/dealbook/just-how-much-do-the-top-private-equity-earners-make.html> (noting that most of this pay was in the form of “carried interest” or earnings on his own investments in the firm’s funds, rather than salary).

75. See, e.g., Nathan Vardi, *The 25 Highest-Earning Hedge Fund Managers and Traders*, FORBES (Apr. 17, 2018, 9:48 AM), <https://www.forbes.com/sites/nathanvardi/2018/04/17/the-25-highest-earning-hedge-fund-managers-and-traders-3/#75d5b2e53596>.

76. *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697, 779 (Del. Ch. 2005) (upholding Disney’s payment of \$140 million to its failed CEO). The statement in the text is probably incorrect, however, if the executives receive their payouts in their shareholder role, as many founders and long-term executives do. I am aware of no case holding that an otherwise legal payout to shareholders—that is, out of surplus or profit, see Del. Code Ann. tit. 8, § 170 (2010), and without making the corporation insolvent, see Model Bus. Corp. Act § 6.40(c) (1969) (AM. BAR ASS’N, amended 1973)—is a potential violation of a board’s fiduciary duty just because a large part of the payout goes to a shareholder with an executive or controlling role in the firm.

technologies, places, teams or even political systems, because they can diversify by separating their investments into many little bits in many projects and places. They can transform long term investments into short term ones and vice versa. Any single investment has only a limited impact on the portfolio as whole. This is not the world of operating companies. Each time that Boeing designs a new generation of planes, or Intel a new generation of processors, it places the company's future existence at risk. Financial investors always have the option of eliminating most of that risk by diversification—buying small amounts of multiple securities instead of placing all their eggs into one basket. The concerns of financial market investors, thus, are radically different from those of operating companies.

Similarly, operating companies must worry about competition. Most publicly traded corporations operate in oligopolistic consumer and producer markets, where prices can be set well above marginal and even average cost. Nonetheless, sales and profits may easily be lost to competitors. Similarly, advertising to seize market share from competitors is a major part of the business strategy of most oligopolistic businesses.

In contrast, portfolio investors have a radically different interest: so long as all the major operating players are publicly traded, they can hold shares in all of them. Thus, they should be entirely indifferent when one firm wins market share from another; the increased market share of the winning firm will be balanced out in the financial portfolio by the losses of the loser. However, portfolio investors cannot own shares in human consumers or employees. Therefore, they have a strong interest in avoiding inter-company competition that might reduce prices or increase wages, even if an individual company in which they hold shares suffers as a result. Shareholder oriented managers, or managers of diversified institutional shareholders, have a strong interest in suppressing competition and far less interest in any particular firm's success.

In short, portfolio investors and corporate managers should have different risk tolerance, different time frames, different commitments to specific projects, and different views of the benefits and dangers of competition. Any manager trying to manage on behalf of stock market investors faces an intractable conflict between the interests of the institution and its shareholders.

## **H. CONFLICTING GOALS NEAR INSOLVENCY**

Of course, the conflict gets far worse near insolvency. Shareholders have unlimited financial upside but limited downside, since their expected dividends and stock price can go up as high as the firm's profits but cannot ever go below zero whatever the firm's losses. Once the firm's equity value reaches zero, further firm losses must be borne by other firm participants such as lenders, employees or other creditors. Thus, shareholders may be able to profit from gambles that clearly have negative expected returns,

especially if they can invest in multiple firms making similar gambles. The winners will more than compensate for the limited losses they suffer from the losers. For this reason, Delaware extends additional protections to creditors in insolvency, allowing them to bring derivative actions demanding the firm be operated in their ultimate interest.<sup>77</sup>

But this is only an extreme version of the universal reality that diversified shareholders profit when companies, in the aggregate, take excessive risk. Corporate law always protects shareholders from the full downside of corporate bets, which will be borne by others. Increasing competitive efficiency is difficult, but it only takes position or power to shift uncompensated risk to other corporate participants. Accordingly, diversified shareholders with serious control over companies likely will operate them in a riskier manner than other participants, both because shareholders bear less of the risk of failure than other participants and because shareholders may be able to profit from potential firms' losses via their other investments.

Finally, we make an intrinsically difficult task still more difficult by confusing ourselves. Shareholders are often thought of as "owners" of the corporation. But owners don't need outside help to seize the proceeds of their property; they just take their rents. Shareholder profit maximization theory demands that managers pay shareholders corporate funds (as dividends or otherwise) which shareholders have no legal right or power to take for themselves.<sup>78</sup> Similarly, the shareholder-centered view contends that firms "ought" to turn profits over to shareholders, but ordinary corporate finance teaches that equity sales are simply a source of funding, largely fungible with borrowing or retained earnings. On this view, managers learn to treat shares as input that, like any input, ought to be cost-minimized in the pursuit of efficiency and profit. Rather than owners, shares are simply another exploitable resource for the firm's profit.

To add to the confusion, it is common to claim that shares are the residual risk bearers in a corporation—and that this justifies giving them voting authority because it means that they have interests aligned with the firms. This is wrong on two levels. First, shares manifestly are not the residual risk bearers outside of liquidation. Firms routinely cut employment long before they cut dividends. If the function of shareholders in the firm is

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77. *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (rejecting 'zone of insolvency' analysis; even when a corporation is close to insolvency, directors' duty is to "exercise[e] their business judgment in the best interests of the corporation for its shareholders," but allowing creditors to assert derivative claim for breach of directors' fiduciary duty to corporation when corporation is insolvent); *cf.* *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. CIV. A. 12150, 1991 WL 277613, at \*36 n.55 (Del. Ch. Dec. 30, 1991) (explaining "curious" incentives near insolvency).

78. Only directors, not shareholders, may declare a dividend. DEL. CODE ANN. tit. 8, § 170 (2010).

to absorb and eliminate firm specific risk, in practice they are not performing.

Second, even to the extent that shareholders do bear firm risk, that would simply mean that they are insurers. Like other insurers, financial investors can more easily diversify than other firm participants, and thus can eliminate certain forms of firm specific risk.<sup>79</sup> Insurance is a worthy and useful service. But in no other context would we expect insurers to control the insured or assume that their interests are aligned with the insured's. On the contrary; insurers are highly regulated precisely because they are always in conflict with their insureds and have strong incentives to not provide the risk-bearing services which they contractually assumed. This is obviously true of the stock market as well. Portfolios are diversified, timeless, skillless and placeless—precisely the opposite of all other firm participants, and extraordinarily poor proxies for the public good. Hedging and empty voting are merely the most visible manifestations of the fundamental disconnect between the interests of equity investors and the rest of us in firm success.<sup>80</sup>

### I. CORPORATE LAW SUMMARIZED

In summary, we can characterize publicly traded corporations outside of bankruptcy as quasi-autonomous self-governing units. While the general view in the business schools and business press is that business corporations are formed and operated for the purpose of shareholder profit, the law does not require this goal. Instead, most corporation statutes explicitly state that a business corporation “has the purpose of engaging in any lawful business”<sup>81</sup> and explicitly permit the corporation's board to use its funds to support a variety of activities with no obvious connection to shareholder profit, including to “make donations for the public welfare or for charitable, scientific or educational purposes.”<sup>82</sup> Similarly, while the courts routinely exhort the profit-maximization goal, they have also left enforcing and even

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79. For these purposes, bondholders, shareholders and large or syndicated bank lenders seem interchangeable—all are diversified finance sources.

80. See generally Henry Hu & Bernard Black, *supra* note 9 (describing mechanisms by which stock market players can control corporate votes without the associated economic risk of shareholding). Note that empty voting—votes without economic exposure—is simply the *reductio* of ordinary diversified shareholding. The point of diversification is to reduce the shareholder's exposure to firm specific risk, which is another way of saying that the shareholder's interest and the firm's will never be aligned. See Greenwood, *Fictional Shareholders*, *supra* note 9, at 1071.

81. Model Bus. Corp. Act § 3.01(a) (1969) (AM. BAR ASS'N, amended 1973) (“Every corporation incorporated under this Act has the purpose of engaging in any lawful business”); *cf.* DEL. CODE ANN. tit. 8, § 101(b) (2010) (“A corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purposes”).

82. DEL. CODE ANN. tit. 8, § 122(9) (2010); *cf.* Model Bus. Corp. Act §§ 3.01(a)(13), (a)(14) (1969) (AM. BAR ASS'N, amended 1973) (“to make donations for the public welfare or for charitable, scientific or educational purposes; to transact any lawful business that will aid governmental policy”).

defining it entirely to the discretion of the board in all but the most extraordinary circumstances.<sup>83</sup>

Historically, corporate status was regarded as a special privilege granted only for special, public, purposes.<sup>84</sup> This notion has long since disappeared from the statutes. However, widespread alternative views track the historical rationale: corporations ought to be operated to produce useful products and services at a fair price (the “consumer” view) or to provide good jobs (the “producer” view).

Under both the older special privilege view and the modern consumer and producer views, a democratically answerable legal system presumably grants corporations the privileges of autonomy and legal personality in the expectation that they will serve the public good. Properly guided market incentives can lead to prosperity and other social goods. On the other hand, untethered pursuit of profit is not necessarily in the public interest. In particular, firms often find it narrowly profitable to violate regulatory rules meant to ensure that businesses internalize their costs, do not impose pollution or safety hazards on others, and treat employees and customers honestly. Indeed, with the increasing importance of lobbying and the rise of corporate-funded electioneering, businesses often perceive profit in seeking to eliminate those laws, even where the long term consequences may be devastating to the industry or the country generally.<sup>85</sup> Thus, the American automobile industry has long and influentially opposed health insurance reform despite the extraordinarily competitive burden employer-funded insurance places on companies with older or retired workforces in an international market where foreign production does not incur such costs. Similarly, parts of the fossil fuel industry have actively sought taxpayer subsidies of fossil fuels and to slow the adoption of alternatives<sup>86</sup>—despite the potentially disastrous consequences of global climate change, including the fallout from the collapse of peasant farming in the Mid-East and elsewhere. Similarly, the stock market generally appears favorably impressed by reductions in taxes on the profits or upper-class incomes, even if the consequence is degradation of public services and infrastructure

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83. See, e.g., *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989), discussed *supra* pp. 11–13; *Gabelli & Co., Inc. v. Liggett Group Inc.*, 479 A.2d 276 (Del. 1984), discussed *supra* note 61; *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697, 779 (Del. Ch. 2005).

84. See, e.g., MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1780–1860* (HARVARD UNIV. PRESS 1977).

85. See, e.g., *Citizens United v. Fed. Election Comm'n*, 558 U.S. 310, 365 (2010) (upholding corporate campaign contributions).

86. See, e.g., Ian Johnston, *Exxon Mobil: Oil and gas giant 'misled' the public about climate change, say Harvard experts*, INDEPENDENT (Aug. 23, 2017, 1:00 PM), <https://www.independent.co.uk/environment/exxonmobil-climate-change-oil-gas-fossil-fuels-global-warming-harvard-a7908541.html>.

necessary for a successful economy or the impoverishment of the customers whose demand keeps a capitalist economy thriving.

Current law leaves the choice of corporate goals, like the choice of the means to those goals, to the almost unfettered discretion of incumbent directors and managers. The only effective judicial limit is the fiduciary rule that managers and directors may not treat corporate property as their own. Even that rule, however, is quite limited, as shown by judicial willingness to uphold virtually any compensation agreement so long as directors are willing to state that insider pay is for the benefit of the firm.<sup>87</sup>

Institutionally, managers are appointed by and serve at the will of directors, and directors are usually elected by shareholders on the plutocratic basis of one share one vote. Since shares, and therefore votes, are freely bought and sold, this means that, ultimately, the corporation's managers answer to the stock market. In practice, managers, formally or informally, control the nomination process for director candidates and stock market investors are more likely to sell shares than vote against incumbents. Therefore, corporate elections tend to be overwhelmingly in support of the incumbents; barring crisis, usually managers have effective control of their own supervisors.

Even when shareholders do assert their control powers—usually by selling their shares to an investor that buys a control bloc of votes—the result is simply to shift power from internal corporate managers to external financial market managers. The system remains one of managers supervising managers, with strong incentives to follow the fads and interests of the financial markets.

The only effective limit on managerial discretion, then, is markets. The stock market may drive the stock price down or up. Of course, stock price movements have no direct impact on the firm outside the unusual circumstance that the firm wishes to sell new stock.<sup>88</sup> Managers holding stock or options, or simply ideologically committed to shareholder primacy, may take these stock price movements as critical information influencing their decisions; while such behavior clearly meets traditional understandings of corruption, lack of professionalism and even breach of

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87. See *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697, 779 (Del. Ch. 2005).

88. Price movement in the secondary market reflect stock investors selling to each other; the firm is not involved in these transactions and receives no benefit when the stock price goes up or loss when the price goes down. Ordinarily, then, the company should be able to continue business as usual regardless of what happens in the stock market. There is one important exception. If the company is highly dependent on continual market confidence, for example if it is using short term borrowing to finance illiquid investments, a drop in stock price may signal to other market players, such as lenders, the possibility of a run. In this case, the stock price drop can do serious damage to the company. Matt Taibbi has argued that such a loss of lender confidence precipitated by a stock price drop in highly leveraged companies led to the demise of both Bear Stearns and Lehman. See Matt Taibbi, *Wall Street's Naked Swindle*, ROLLING STONE (Apr. 5, 2010, 8:09 PM ET), <https://www.rollingstone.com/politics/politics-news/wall-streets-naked-swindle-194908/>.

the duty of loyalty, modern courts and public opinion appear to see it as entirely appropriate.

Other markets in which the firm participates (supplier, labor, consumer) will affect the firm more directly. If firm managers are unable to obtain the resources the firm needs at a price lower than it can sell its goods or services, then it will run an economic loss and, ultimately, become insolvent.

## II. THE IRRELEVANCE OF CORPORATE LAW'S GOALS

Can we then say something about the goals of ordinary corporate law that ought to determine the rules in insolvency? I do not believe that we can say much.

To be sure, in a democratic republic all legitimate law ultimately ought to serve the public, but the very grant of autonomy to corporate managers means that our legislatures have, rightly or wrongly, concluded that we are better off letting managers decide the details.

Crude popularizers of Adam Smith's invisible hand imply, not very convincingly, that financial, consumer, and labor markets as well as the managers' own financial interests will lead managers to act in the public interest.<sup>89</sup> Alternatively, they contend that managers should not be guided by their own self-interest, which as Smith himself pointed out, will often lead them to sloth or profit at the expense of the institutions they operate,<sup>90</sup> but should pursue profit for the firm or its anonymous, ever-changing investors—even if that means setting aside their own political values, senses of right and wrong, loyalty to co-workers or customers, or even commitment to the firm itself. More sophisticated students of mixed economies may conclude that direct attempts to control corporate decision making are likely to succumb to information overload, bureaucratic ossification, or the temptations of corruption. Adjusting market rules so that

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89. Adam Smith himself argued that businessmen were likely to work against the public interest if they could. SMITH, *supra* note 45, at Book I, ch. X (“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices”).

90. SMITH, *supra* note 45, at Book V, ch. I (“The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnership frequently watch over their own”). Edmund Burke, prosecuting the impeachment of Warren Hastings as Governor General of the East Asia Company, famously denounced as corruption the fact that company officials became rich as the East Asia Company languished and its Indian subjects starved. *See, e.g.,* Julie Murray, *Company Rules: Burke, Hastings, and the Specter of the Modern Liberal State*, 41 EIGHTEENTH-CENTURY STUDIES 1, 55, 59–61, 63 (2007), available at [www.jstor.org/stable/30053748](http://www.jstor.org/stable/30053748) (describing Burke's critique of the “corruption of Hastings's public self by his ungovernable private passions and interests” as part of his larger attack on the feudal aspects of corporate charters, the “despotism . . . invariably attend[ing] the drive to private wealth,” and the subordination of individuals to the company's leaders and its collective “*esprit de corps*”).

market incentives press disparate and competing decisionmakers in socially useful directions may be more likely to succeed, especially when we disagree about the best route to progress. Others contend that the power of corporations is so great and the profit incentive so often ill-directed that managers ought consciously to use their discretion in ways that are not obviously sociopathic—to avoid, for example, promoting cancer or global warming even if the company’s narrow profit motive counsels the opposite.

Corporate law in the modern era is, as we have seen, largely agnostic on this debate. Corporations are largely free to seek their own path within the limits of extant regulatory law and their ability to lobby for its change.<sup>91</sup> Indeed, as discussed above, the law is quite clear that corporations may allocate any surplus they generate in almost any way that the firm’s decision makers determine, responding to the political and market power of the various firm constituencies and their own consciences.<sup>92</sup> If competition requires or a firm facing less-than-perfect competition chooses, it may give the surplus to consumers in the form of lower prices. But, if the firm is able to overcome the pressures of consumer market competition, it may also give its surplus to employees as higher wages, to suppliers as higher prices, to landlords as rents, to bondholders as interest, or to the people as taxes. If none of those participants have sufficient market power to demand the surplus, managers and directors are authorized, but never required, to distribute it as dividends to shareholders. In each case, outside observers rarely will be able to tell whether the payment was a compelled response to market forces, poor bargaining over a surplus to cooperation (i.e., economic rents) or a purely voluntary gift.<sup>93</sup>

Managers need not elect to organize as a business corporation and need not have publicly traded shares if they do so elect. But so long as they retain the publicly traded form, shares are entitled to vote for the corporation’s board of directors, and those shares, with their votes, are freely bought and sold.

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91. The Supreme Court has held that the First Amendment protects management’s ability to use corporate resources to lobby for changes in regulatory law, whether they would free the company to follow the logic of sociopathic profit seeking or free managers from it. *See* *Citizens United v. Fed. Election Comm’n*, 558 U.S. 310, 324 (2010) (overturning, on free speech grounds, limitations on corporate managers’ spending other people’s money to influence political debate and elections); Daniel J.H. Greenwood, *Person, State or Not: The Place of Business Corporations in Our Constitutional Order*, 87 *COL. L. REV.* 351, 404–06 (2016) (arguing that this modern form of Lochnerism is as problematic as the original); Daniel J.H. Greenwood, *Essential Speech: Why Corporate Speech Is Not Free*, 83 *IOWA L. REV.* 995, 1050 n. 144 (1998) (corporate fiduciaries will not make the political tradeoffs between competing goals that citizens must).

92. *DEL. CODE ANN.* tit. 8, § 141 (2010) (corporation to be managed by its directors).

93. Ordinarily, sunk costs, such as the payments initial shareholders make in an IPO, earn no returns in a competitive market, so dividends usually should be understood as voluntary gifts rather than payments for services received. Standard accounting agrees. It considers dividends distributions of profit rather than payments to factors of production. The gift understanding, however, conflicts with claims that shareholders have a right to demand payment or that corporations should take shareholder profits as their primary goal.

In modern financial markets, portfolio investors can acquire those votes without any deep commitment to the firm. Indeed, in most cases they must do so: while corporate managers have nearly unreviewable discretion, many portfolio managers would be in violation of law if they failed to diversify the portfolios they manage.<sup>94</sup> By buying shares of multiple firms, the portfolio replaces the risk of particular managerial failures or successes with average risk, much as insurance replaces the financial risk of particular accidents with the cost of the average accident.

A fully diversified portfolio has as its primary interest ensuring that returns go to publicly traded companies and not to non-traded employees or individual consumers; it cares little about which firm extracts surplus from the non-traded citizens. In this sense, a diversified shareholder's interests are almost precisely *opposite* those of the citizenry, even if it itself is not managed on behalf of, for example, a foreign royal family or the as yet unborn citizens of a foreign state.<sup>95</sup> In short, we have no particular reason to think that diversified institutional investors will act in the interest of any particular firm they hold stock in, let alone the American public.

What we are left with, then, is this: corporate law structures a struggle over corporate surplus. Absent unions, the struggle is tilted against employees from the beginning, since financial capital is inherently more mobile and more able to refuse services if not paid what it demands. It again tilts the field by giving shareholders, but not employees, votes for the board of directors, making it easier for investors to demand that directors, and through them managers, serve their interests. The dominant ideology of the last generation has tilted the field still more, by teaching managers that they ought to bargain as the united representative of all investors against individual employees (rather than as the representative of labor hiring capital as needed, or as a neutral technocratic elite managing on behalf of an amorphous common interest).<sup>96</sup> Similarly, the near demise of anti-trust law has tilted the field towards capital and against consumers as increasingly

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94. See, e.g., 29 U.S.C § 1104(a)(C) (2012) (ERISA trustee's fiduciary duty to diversify). Most mutual fund managers are under a similar contractual duty.

95. See, e.g., *About PIF*, PUB. INV. FUND, <https://www.pif.gov.sa/en/Pages/AboutPIF.aspx> (last visited Oct. 31, 2018) (describing Public Investment Fund of Saudi Arabia, one of the best-known sovereign wealth funds). The Norwegian Government Pension Fund Global holds 1.4% of listed securities worldwide, including almost \$250 billion in US equities. *Holdings as at 31.12.2017*, NORGE BANK INV. MANAGEMENT (last visited Oct. 29, 2018), <https://www.nbim.no/en/the-fund/holdings/holdings-as-at-31.12.2017/>.

96. Compare Margaret Blair and Lynn Stout, *Team Production Theory of Corporate Law*, 85 VA. L. REV. 248, 327 (1999) (arguing that managers ought to view themselves as mediators between different claimants), with HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 239 (1996) (claiming that the apparently greater efficiency of business corporations is due to their having a single, measurable, goal of profit instead of a more amorphous public interest).

large companies have increasing oligopolistic power and are less constrained by competitive consumer, employee or supplier markets.<sup>97</sup>

Nonetheless, while the law and ideology strengthen some corporate participants and weaken others, it does not impose any particular priority on claimants. If employees have particular market power or bureaucratic influence, they may seize the bulk of the corporation's surplus in the form of high pay (as in the investment banks or some technology companies) or high rates of employment (as was the case for some "featherbedded" companies in the past). For example, Bear Stearns' bankers took large paychecks from the firm even as its stock price plunged;<sup>98</sup> Google's parent company, Alphabet, pays no dividends, suggesting that the profits from its extraordinary market dominance are flowing elsewhere, at least in part to its highly paid engineers and upper-level executives and their favorite projects.<sup>99</sup> If consumers have sufficient power or the anti-trust authorities do their job, the corporate surplus may be entirely devoted to price reductions, leaving the firm with minimal accounting profits and shareholders with little or no returns. Historically, the airline industry has made no profits; Amazon has given much of its surplus to consumers in the form of lower prices and below-cost shipping and used much of the rest to expand its business, in effect passing its surplus out to additional employees, including both poorly-paid warehouse fulfillment workers and others more generously compensated.<sup>100</sup>

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97. See ROBERT BORK, *THE ANTITRUST PARADOX* (1978) (arguing that anti-trust law should abandon its historic focus on restricting the size and political influence of powerful corporations and instead focus merely on predicted effects on consumer prices). Bork's theory, influential in both the courts and the administrative agencies, combined with economic models that focus on short-term effects in the consumer markets, ignore labor markets, and assume away long-term burdens on innovation, growth and competition, led to a dramatic drop in anti-trust enforcement in the long Reagan era.

98. Bear Stearns executives received more in pay during the 2004–06 period than the final sale price of the company in 2008. Joann S. Lublin, *Credit Crisis: The Response: For Top Bear Executives, 'Paltry' Exit Packages*, WALL ST. J. (Mar. 19, 2008).

99. See, e.g., Jared Cummins, *Why Google Doesn't Pay a Dividend*, DIVIDEND.COM (Sept. 29, 2014), <http://www.dividend.com/how-to-invest/why-google-goog-doesnt-pay-a-dividend/> (reporting that Google's parent company spends large sums on R&D and purchases of other companies).

100. See, e.g., Jon Markman, *The Amazon Era: No Profits, No Problem*, FORBES (May 23, 2017, 9:57 AM), <https://www.forbes.com/sites/jonmarkman/2017/05/23/the-amazon-era-no-profits-no-problem/#13789f8f437a> (reporting that Amazon and several other companies have been very attractive to the stock market while rarely reporting accounting profits); Adam Levin-Weinberg, *Is Amazon.com's Retail Business Actually Profitable? (It's Complicated)*, THE MOTLEY FOOL (Apr. 14, 2018, 2:10 PM), <https://www.fool.com/investing/2018/04/14/is-amazon-com-retail-business-actually-profitable.aspx> (reporting that Amazon had accounting profits of \$3 billion in 2017, but it also vested stock grants to employees worth \$10 billion, only \$4.2 billion of which was recorded as a compensation expense).

### III. IMPLICATIONS IN INSOLVENCY

Bankruptcy, as the papers in this Symposium make clear, both continues the fundamental conflict and adds new manifestations. In insolvency, creditors—and the markets—have more “voice” than shareholders and markets do in a more routine situation. This makes the problems with shareholder voting—of both the free riding and the conflicts of interest types—more immediate; votes are less likely to be pro-forma ratification of the workings of the established powers-that-be than when the establishment has not already demonstrated its incompetence.

#### A. THE WRONG VALUES

Janger and Levitin base their call for reform on two values they find in bankruptcy law: retaining control in the residual claimant and equality of claimants.<sup>101</sup> As an outsider to bankruptcy law, I would have assumed the ultimate goal of bankruptcy to be keeping the American job machine running smoothly. The two values that Janger and Levitin identify seem to be distinctly secondary—and not even necessarily present.

As to the first value, the claim that the residual claimant ought to control the enterprise needs to be carefully theorized. It should be taken not as a first principle but as a crude rule of thumb likely to mislead in many circumstances.

Outside of bankruptcy, corporations function perfectly well without any residual claimant: managers have nearly complete discretion to give surpluses to or impose losses on nearly any corporate participant. There is no rule that any particular claimant be paid before others. It is perfectly permissible, for instance, to take on junior debt that reduces the likelihood that senior debt will be paid in full.<sup>102</sup> Similarly, a firm may pay a dividend knowing that it will be unable to pay future bond obligations unless it massively reduces its payroll or has reasonably good luck in the consumer market; the only restriction is that managers plausibly expect to be able to impose the costs on those other claimants and the dividend payment does not actually make the firm insolvent.<sup>103</sup>

It is sometimes said that shareholders are the residual claimant in a solvent firm because all other claims are defined by contract,<sup>104</sup> but this is an illusion at best.<sup>105</sup> Contracts are always open for renegotiation, even

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101. Janger & Levitin, *supra* note 3, at 43–44.

102. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1508 (S.D.N.Y. 1989).

103. DEL. CODE. ANN. tit. 8, § 174 (2010) (barring dividends that would make corporation insolvent); see *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 99–101 (Del. 2007) (emphasizing autonomy of board even close to insolvency).

104. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 67 (1991).

105. See, e.g., Bernard Black, *Corporate Law and Residual Claimants* 24–31 (Stan. L. Sch. John M. Olin. Program in Law and Econ., Working Paper No. 217, 2001),

when they appear to be long term.<sup>106</sup> This may be more or less explicit. Employees nearly all serve at will, meaning that the firm's managers can fire them, hire more, or change salaries at any time. Loans are typically written in rigid language, but usually lenders and borrowers seek to manage debt so it is regularly rolled over (short-term paper), callable and pre-payable at regular intervals, or laddered so that at any given time some is open to renegotiation. Long term supply and purchase contracts are routinely renegotiated as conditions change even when they have apparently fixed terms. In the real world, firms routinely attempt to impose unexpected losses on employees, suppliers and customers long before they reduce shareholder dividends, and the same is true of unexpected gains. Indeed, even the most casual empiricism suggests that employees are far more likely to be the residual claimant than shareholders. Dividends are far more stable than profits or payroll.

More importantly, the heavy legal thumb on the scale to favor shareholders in the competition for corporate surplus has proven a mistake. Since the 1980s, the share of economic wealth going to investors and top managers has soared, leaving ordinary Americans with little or no benefit from a half century of economic growth. Average salaries for men with average education, for example, are unchanged after inflation, while for men with only a high school education they have actually dropped. Women have vastly increased the number of hours they work for pay (without a commensurate decrease in unpaid work in caretaking and home maintenance), but the net result for American households in the middle 80% has been only to maintain, not increase, their real financial income. Meanwhile, this troubling and unjust increase in inequality is associated with a parallel slowdown in economic growth. While not all economists agree, it seems probable that with middle class income stagnant for close to a generation and an increasing share taken up by price increases in housing, healthcare and (for the fortunate) higher education, we have less of the middle-class consumer consumption that once drove the American economy's growth.<sup>107</sup>

Rawls<sup>108</sup> contended that inequality could be justified if it made the worst off materially better off, ignoring Veblen's point that at some

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[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1528437](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1528437) (noting that many corporate participants are residual claimants); MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 202–34 (1995) (describing employees as residual claimants).

106. Cf. HANSMANN, *supra* note 96, at 27 (pointing out the risks of long term contracting and opportunistic behavior).

107. See generally JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY (HARVEST/HBJ 1964) (arguing that recessions are generally caused by a failure of demand); THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (2014) (documenting rise of inequality and concentration of wealth).

108. JOHN RAWLS, A THEORY OF JUSTICE 65–68 (1971) (describing “difference principle”).

relatively low level of income, absolute material wealth is less important than relative wealth.<sup>109</sup> But Rawls' implicit economics—his assumption, similar to trickle-down Reaganomics, that increased inequality leads to increased economic growth making even the worst off financially wealthier eventually proved wrong.<sup>110</sup> We traded off the absolute well-being of 80 or 90% of our compatriots in order to make a few far richer.

At this point, it should be clear that corporate law ought to be pushing in the opposite direction, not to help investors and top managers seize the corporate surplus but to force them to share it with employees and other corporate participants. If there ever was a principled argument for corporate law that assists the wealthy in upward redistribution of wealth and income, it no longer applies. As this Article illustrates, shareholders lack any moral, legal or economic claim to the surplus that corporations create; in competitive markets it ought to go, instead, to those who create it or consumers. More generally, the upward redistribution of wealth and income of the last several decades has failed to encourage economic growth or democracy. We need, instead, to find new ways to strengthen the internal corporate bargaining and market power of employees, consumers and other ordinary non-financial corporate participants. Current market rules make it too easy for managerial incumbents in alliance with financial markets to seize a disproportionate share of the corporate surplus; we need to revise those rules to allow a fairer competition.

In bankruptcy, unlike during the ordinary course, the law does impose formal priority rules (although in practice negotiated resolutions are possible only by varying them). But those rules should not be treated as absolute values rather than legal formalities. Outside of bankruptcy, we expect corporate claimants to continually struggle over allocation of corporate surplus and, as we have seen, the arguments for the law assisting shareholders are weak, at best. In insolvency, the arguments for assuring the

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109. See generally THORNSTEIN VEBLÉN, *THE THEORY OF THE LEISURE CLASS* 24 (B. W. Huebsch, 1912) (“The possession of wealth conveys honor; it is an invidious distinction.”).

110. Rawls' difference principle holds that inequality is justified to the extent that it makes the worst off better off. RAWLS, *supra* note 106, at 65–68. Rawls assumes that extreme equality would lower the economic well-being of the worst off, by destroying incentives (much as the Laffer Curve contends that extremely high taxation would stifle economic activity and therefore tax receipts). But that tradeoff is not our reality. Today, it seems far more likely that increased equality would increase both the absolute wealth of the worst off and economic growth for all, by shifting demand to the middle and lower middle class (who consume basically all their income), from the uber-rich, who are more likely to pursue power or honor with smaller multiplier effects. Veblen argues that beyond subsistence, people pursue wealth because it is a marker of honor. VEBLÉN, *supra* note 109, at 74. Honor is inherently a zero-sum game: I can only have more if you have less. Thus, even leaving aside demand-driven economic growth, to the extent that Veblen is right to understand wealth as the pursuit of relative status rather than the accumulation of possessions for their own sake, Rawls' difference principle demands—contrary to Rawls' own interpretation—fairly extreme equality. Increased inequality in relative status always makes the worst off worse off, not better off.

victory of incumbent management and finance over other corporate participants are weaker still.

In particular, there is no a priori reason to believe that the legally defined junior financial claimant is more aligned with the needs of the economy, or the firm, than the groups Janger and Levitin identify as “excessively long”—employees and contracting parties that may prefer the firm’s existence to maximization of current value. To be sure, maximization of current value will often be completely contrary to longer term interests or continued corporate existence. But the social interest is more likely to be aligned with the long-term interests than the short-term interests.

In other words, the judgment that other groups are “excessively” long seems wrong. On the contrary, in most cases, survival of the institution is exactly what bankruptcy should be aiming for. Institutions are difficult to create and costly to dismantle. If they can be reformed to be viable, even with considerable loss of financial value, that is likely to be better for participants and the economy as a whole than liquidation.<sup>111</sup> To make the same point in more conventional economic terms: the residual claimants, those whose interests are most aligned with the institution and society, are highly likely to be exactly those that Janger and Levitin label “excessively long.” They are the least likely to be diversified and the most likely to be dependent on the specific characteristics of the firm: employees with firm specific skills, in particular, are at risk of losing the entire value of their investment if the firm fails, with no opportunity to reduce their losses through diversification. They are the ones with the most to lose and, perversely, the ones to whom bankruptcy law gives the least bargaining power. Their lack of diversification and peculiar connection to the firm also means that they have the most to gain from successful reorganization, at least if the reorganization does not exclude them. Financial investors, whether holding equity or debt, normally diversify in order to limit downside risks, but this necessarily means that they also limit their upside. The undiversified employees, as well as customers or suppliers with no ready alternative business partners, are far more exposed to the particular firm.

As to the second value Janger and Levitin identify, equality of claimants,<sup>112</sup> it is questionable whether such a value even exists in ordinary corporate law. Before *Moran*, one could have argued that the poison pill violated the most basic principle of corporate law, that shares of the same series have the same entitlement to corporate returns.<sup>113</sup> The poison pill

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111. This reasoning does not apply to sufficiently small-scale businesses. If no institution is at stake, it may well be best to speed “creative destruction” along by encouraging dissolution.

112. Janger & Levitin, *supra* note 3.

113. *See, e.g.*, *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407, 408 (S.D.N.Y. 1985) (overturning poison pill on ground that special preferred stock failed to preserve uniform voting rights for entire series of shares).

clearly discriminated. Yet it was upheld almost without dissent.<sup>114</sup> Similarly, all markets insist on one price, but also violate the principle as often as they uphold it.

Equality is always a value. However, the equality that has a prima facie claim to validity is equality of persons, not equality of dollars or claims. If equality of dollar claims leads to further empowering large institutional creditors relative to individual employees, it is the wrong kind of equality. Instead, we should be looking for solutions that make it more likely that useful institutions will survive and less likely that investors will be willing to finance, whether by equity or debt, and participate in raids that create investor profit by using up the company's accumulated reputation and good will, by defaulting on implicit contracts with consumers, suppliers or employees, by restructuring to reduce taxes or obligations relating to past operations such as pensions or polluted manufacturing sites, or simply by squeezing corporate participants. Equality of claims does not, at least on its face, promote this goal.

## **B. TOWARD BETTER VALUES**

Stepping back to consider the broader goals of corporate law suggests a different direction for future work. Corporate law is a form of constitutional law, setting out the officers who will govern the firm, the extent and limits of their authority, the degree to which they are answerable to other firm participants, courts and the financial markets, and the limits—or, lack of limits—on their powers.

Notably, corporate constitutional law lacks any conceptions of due process, individual rights, or separation of powers within the firm. Employees lack even the first right of citizens, the right to have their good taken as the good of the whole. Corporate law treats them not as citizens but subjects: while directors are urged to act in the interests of the firm, those interests ordinarily do not include the preferences, goals, interests or values of the people who make up the firm.

The doctrine of employment at will is parallel, in the political sphere, to a regime's right to summarily exile dissidents and the disaffected; generally considered to be a clear mark of tyranny. Without a right to continued membership in the firm, employees are entirely dependent on the good will of their superiors. Even if the firm follows bureaucratic process, there can be no dissent, no loyal opposition, and, indeed, nothing resembling the legal rights protected by due process that citizens depend upon for personal freedom.

Similarly, corporate governance as we know it seems doomed to replicate the failures of the court-centered aristocracies that we fought to

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<sup>114</sup> See *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985) (upholding poison pill).

eliminate in the political sphere. Even the best of decisionmakers make mistakes (and hierarchal systems rarely promote the best). Multiple points of view reduce the likelihood of major error. Yet, corporate governance lacks the basic structure necessary to produce a public opinion that might check or guide the absolute power at the top of their hierarchy. Employees serve at the will of their superiors; critics of the boss keep their critiques to themselves or get fired.

Boards of directors are the nominal bosses of the CEO, yet there too, “team players” are prized above all. Open disagreement means, inevitably, that either the critic or the CEO will resign; there is no room for a loyal opposition. Without independent access to information in the firm or a countervailing bureaucratic power, boards are generally poorly positioned to act except in crisis, and when they do act, as a practical matter they can do little other than replace the CEO—and even in hiring chief executives, they predictably and routinely fail. Decision makers trained to be yes-men, surrounded by other yes-men, are deprived of the debate and criticism necessary for sound decisions.

Insolvency is a sign that conventional corporate law has failed even within its own limited terms. Accordingly, it is an appropriate moment to pull back and consider broad reforms which we might hesitate, for good Burkean reasons,<sup>115</sup> to impose on more successful institutions.

As a start, we might begin by treating corporate governance as governance. Governors ought to govern in the interests of all those they govern, not just a subset defined by wealth. Similarly, the corporate good and the corporate interest should mean something more than merely promoting the financial interests of investors that have failed in their jobs of monitoring or allocating capital. Rather than defining the corporate interest as “paying the senior creditors the most possible,” we ought to redefine a genuine public interest—seeking to assure that the reorganized firm is managed, during and after insolvency, to maximize the good of the maximum number of affected individuals. That means, at a minimum, seeking to preserve jobs and useful goods and services wherever possible, even at the cost of requiring financial investors to accept the losses for which they were paid interest or dividends.

Preserving the institution, to the extent that it can satisfy consumer desires and provide decent jobs, ought always to be a goal of reorganization. But there is no reason to protect failed incumbent leaders or investors that have failed in their assigned role of assuring that corporations serve the public interest.

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115. See generally BURKE, *supra* note 55 (urging caution in “cashiering” even moderately successful governors).

Ordinary corporate law has not escaped its feudal origins.<sup>116</sup> The crisis of insolvency is a clear mark of the failure of the corporate law feudal model of officeholders answerable only to accumulated wealth (and largely independent even of that), and governing without the constraints of due process, individual rights, or countervailing institutions. Accordingly, insolvency law should reject the ordinary corporate norms, not attempt to continue in their failed path.

In large corporate bankruptcies, the normal course ought to include: (1) replacing incumbent management; (2) giving strong preference in reorganization to the interests of undiversified participants, especially employees and pensioners, over those of investors and creditors that could have protected themselves by diversification; (3) granting additional voting rights to additional parties, especially employees; (4) creating countervailing institutions such as a voting public representative to speak, like the Lorax,<sup>117</sup> for affected outsiders; (5) creating fora for internal debate and protection for critics of incumbent management; and (6) in liquidation, giving employees some form of priority over debt creditors in liquidation, including future expectations, such as a preferred claim for an additional year of pay.

While detailed proposals are beyond the scope of this Article, the principles that should guide reform are clear. First, genuine financial distress is a strong indicator that incumbents have failed to manage the company appropriately. In the ordinary course, reorganization will mean that shareholders and debtholders are going to have to accept write-downs on their claims. Often, employees will lose their jobs or be forced to accept reductions in pay or benefits, even if guaranteed by contract or collective bargaining agreement. Since managers and directors are fiduciaries for the firm, they should not be permitted to profit from injuries to the firm participants. Even leaving aside issues of competence, if others are going to have to take losses, those in charge should be near the head of the line.

Reversing the presumption of deference to incumbent managers is especially important because of the phenomenon of strategic filings. Sometimes managers cause firms to enter bankruptcy not because of pressing financial distress but to avoid contractual and other obligations that they no longer perceive as in the firm's interest. For example, a firm may have had a generous pension plan in an era when large, stable employment was a priority. Later, automation or outsourcing may make employee turnover less of an issue. Pensions for retired employees are a current cost with no current benefit (pensioners have no way of reclaiming work they did), so a firm that does not mind developing a reputation for renegeing on

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116. See generally Daniel J.H. Greenwood, *Neofeudalism: The Surprising Foundations of Corporate Constitutional Rights*, 2017 U. ILL. L. REV. 163 (2017).

117. DR. SEUSS, THE LORAX (1971) ("I speak for the trees, for the trees have no tongues.").

deals, may find it attractive to attempt to avoid pension obligations. Bankruptcy may allow the firm to reject these obligations or to avoid collective bargaining agreements, and then to redistribute the savings to other firm participants. Bankruptcy law should hold such redistributions presumptively improper.

There may be good reason to retain incumbent managers, particularly if it appears that the firm's failure is the result of bad luck rather than bad planning for inevitable business cycles, or if the firm's future success requires specialized knowledge unlikely to be found in outside managers. But these will be exceptions. The rule should be that management is replaced, just as the rule is that shareholders will be replaced. They have failed in their decision making and oversight functions, respectively, and someone else should be given a chance.

Second, bankruptcy reorganization ought to prioritize the interests of undiversified participants such as employees. One major function of diversified financial investors is insurance: to accept and diversify away firm-specific risk. In standard accounts of corporate finance, this risk is the primary service for which investors are paid. We ought to take that commitment seriously. If investors have been paid to accept risk, they ought to accept it rather than deflect it on to employees and other less diversified firm participants.

Third, in insolvency, parties that have no voice in ordinary corporate law should be given votes. Employees, pensioners, and (to the extent that the firm lacks direct market competitors) suppliers and customers have a special relationship with the particular institution—parallel to the special connection that citizens have with their own country—that is different from the more transactional relationship that diversified financial investors have. Since the existence and future of the firm is more important to them, and they are more likely to lose irreparable relationships if it closes down, they should have more influence in reorganization. This can mean a voice in determining new management, voting rights for the board of directors or on a plan of reorganization, even grants of equity to compensate for lost security of tenure.

Relatedly, reorganized firms, even more than ones that have never failed, need to escape the information and decision failures caused by leaders with no critics. Leaders need to hear diverse and critical voices, not just affirmations of their god-like power. Firms, therefore, need to have alternative pathways for employees and customers to express dissatisfaction with the powers that be—at a minimum, an ombudsmen's office able to accept complaints and act upon them separate from and without fear of pressure from the ordinary hierarchy.

Critical thinking, however, is impossible in the face of overweening power. An employee subject to firing at any time, like a customer dependent on the company's service, is in no position to voice objections or

even to question obvious mistakes. Messengers are blamed often enough that ordinary people will decide, instead, to put up with what they can and quit on their own terms when they cannot. The institution, however, needs voice, not exit. When dissidents disappear, the incumbents are even less likely to see the errors in their way. Consequently, reorganization ought to include the basics of due process—some right for subordinates to demand something resembling a fair hearing prior to discipline, and some obligation for superiors to accept critique and disagreement.

Finally, often a firm that enters insolvency is already too far gone for salvation. At the beginning of the internet age, Sears had capacities that Amazon could only dream of; Sears had been in the business of fulfillment by mail for a century. By the time Sears filed for bankruptcy, however, those capacities were gone. So, too, was its highly valuable reputation for quality household tools and appliances, milked by years of managers more interested in short-term returns than in long-term investment. It may well be too late to return to what could have been had the company taken a different path a decade or two ago.

When liquidation is the only alternative, insolvency law ought to protect employees far more than is customary today. Giving employees a protected, high priority, claim reflecting at least part of the value they lose in liquidation would change the dynamics of intra-firm negotiations for the better. Before insolvency, it would change the incentives of managers and their financial masters, especially in firms dominated by unified financial industry shareholders, such as private equity firms or hedge funds.

Under ordinary corporate law, shareholders owe no fiduciary duty to the firm. Some shareholders, then, will find ways to profit at the expense of the firm, by various variations on eating its seed corn.<sup>118</sup> Shareholders, for example, may demand that a firm reduce investment in developing improved versions of the product, keeping stores and infrastructure up to date, maintaining or improving quality controls, recruiting, training and retaining employees, or maintaining morale. Reducing such expenditures leaves more money, in the short run, available for distribution to shareholders. The better run a firm is, the more valuable its accumulated expertise and reputation, the more lucrative this destruction will be to shareholders. But it destroys the company. For the rest of us, the loss is far greater than the shareholder's gain.

To the extent that employees have a legally enforceable claim on the future of the company—such as a claim for lost pay in the event of liquidation or termination—they will be able to resist such tactics even before insolvency, and financial players will have less incentive to strip and

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118. See generally Greenwood, *Puzzle of Private Equity*, *supra* note 73 (discussing shareholder profit at company's expense).

abandon our most successful firms. That is the direction we need to press insolvency law, and, indeed, even ordinary corporate law.

## **CONCLUSION**

Our corporate law is in a low-visibility crisis, failing its central missions of providing good jobs for ordinary people producing useful goods and services in a sustainable fashion. Caught between rising inequality and rising seas, our existing institutions are too often failing to meet the challenge of “promot[ing] the general Welfare.”<sup>119</sup>

Insolvency indicates that a corporation has failed even on the narrowest of measures. Rather than reinforcing the unsuccessful incumbent elite and the structures that led to the firm’s inability to meet its responsibilities, the law should take the crisis as an opportunity to reform and rebuild, replacing the feudal remnants of corporate law’s property-based authoritarianism with more democratic and republican models of governance.

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119. U.S. CONST. pmbl.