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The Divergence of Corporate Finance and Law In Corporate Governance

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I. INTRODUCTION

Early in American jurisprudence, Chief Justice John Marshall described a corporation as follows:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created.[1]

Modern corporate law allows the object of a corporation's creation to be any lawful purpose.[2] However, such lawful purpose must be for profit since, by definition, a business corporation is "for profit."[3]

In microeconomics and finance it is a tenet of the theory of the firm that firms are wealth maximizers.[4] The basic finance theory that managers should

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1. Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819).
2. *See* REVISED MODEL BUSINESS CORP. ACT § 3.01(a) (1984).
3. *Id.* § 1.40(4).
4. THOMAS E. COPELAND & J. FRED WESTON, FINANCIAL THEORY AND CORPORATE POLICY

maximize the value of the corporation by investing in all positive net present value projects serves the dual purpose of maximizing the value of the corporation and the wealth of the shareholders. However, managers may not take advantage of all positive net present value opportunities. Several explanations, such as price depression of equity issues[5] and agency costs,[6] have been offered for this phenomenon. In their 1984 article[7] *Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have*, Stewart C. Meyers and Nicholas S. Majluf created a model revealing that under certain conditions corporations may forego positive net present value projects, thereby failing to maximize the value of the corporation, if such projects require the corporation to issue new shares to finance them.[8] Myers and Majluf assume asymmetric information—that firm managers have inside information that investors do not have. Further, they assume that managers act in the best interest of old, passive shareholders, who do not rebalance their portfolios in response to the firm's actions.[9]

The central paradigm of corporate finance is that corporate managers maximize profits, which maximize the value of the corporation, which in turn maximizes shareholder wealth.[10] Recent developments in the law, however, are eroding this paradigm. The trend toward corporate social responsibility, changes in the object of the fiduciary obligations and the business judgment rule by the courts, and corporate constituency statutes that allow corporate managers to consider the interests of other stakeholders such as creditors, employees, and the community undermine the profit and value maximization assumptions of traditional corporate financial theory.

The law and corporate financial theory are diverging. Since corporations are jural persons and exist only in contemplation of the law, managers are constrained by the law. This Article examines the assumption that managers act in the best interest of old shareholders in making corporate investment

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18 (3d ed. 1988); HAL R. VARIAN, MICROECONOMIC ANALYSIS 23 (3d ed. 1992).

5. *See* Paul Asquith & David W. Mullins, Jr., *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61 (1986); Richard Kolodny & Diane R. Suhler, *Changes in Capital Structure, New Equity Issues, and Scale Effects*, 8 J. FIN. RES. 127 (1985); Ronald W. Masulis & Ashok N. Korwar, *Seasoned Equity Offerings: An Empirical Investigation*, 15 J. FIN. ECON. 91 (1986); Wayne H. Mikkelson & M. Megan Partch, *Valuation Effects of Security Offerings and the Issuance Process*, 15 J. FIN. ECON. 31 (1986).

6. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

7. Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

8. *Id.*

9. *Id.* at 188-89.

10. *See, e.g.*, COPELAND & WESTON, *supra* note 4, at 18, 401, 553, 667, 743; Ronald W. Masulis, *The Effects of Capital Structure Change on Security Prices*, 8 J. FIN. ECON. 139, 140 (1980); *cf.* Myers & Majluf, *supra* note 7, at 191.

decisions. The validity of this assumption is tested by an analysis of certain aspects of corporation law and its developments. Additionally, an analysis is made of the fiduciary duties owed under state corporation acts and court decisions, the business judgment rule, corporate social responsibility, and state corporate constituency statutes.

II. FINANCE AND THE LAW

This Part explores the divergence of corporate law and corporate financial theory beginning with the Berle and Dodd debate[11] and traces the development of the corporate constituency statutes and other legal constraints that restrict managers' decision-making processes.

A. Separation of Ownership and Control

Many of the problems encountered in corporate financial theory and corporate law are rooted in the separation of ownership and control.[12]

> Control has passed from ownership hands into the hands of management; management personnel is more highly specialized and selected for professional competence; its motivations are substantially different from those of the owner-capitalist; and its area of discretionary action and the character of the limitations that bound their area differ markedly from those relevant to the enterprises of an earlier capitalism.[13]

The nonprofit maximization theory in economic literature is largely associated with corporations in which ownership is separated from control.[14] Corporations are owned by shareholders who do not run them and run by managers who do not own them.[15] The depersonalization of the shareholders' relation to the corporation was explained by Berle and Means in the following terms:

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11. *See infra* notes 42-44 and accompanying text.

12. Berle and Means traced the evolution of modern corporate structure as it shifted from shareholder to management control. ADOLF A. AUGUSTUS BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119-40 (3d ed. 1968). In this article "control" means managerial authority and not the absence of a controlling shareholder or block of shareholders.

13. Edward S. Mason, *The Apologetics of "Managerialism,"* 31 J. BUS. 1, 1 (1958).

14. *See* F. M. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 32-33 (2d ed. 1980) (discussing the separation of ownership and control and its effects).

15. Ownership of a small percentage of a corporation's stock by managers does not undercut the analysis because managers still control property they do not own: the percentage of the corporation owned by shareholders other than management.

> The spiritual values that formerly went with ownership have been separated from it. Physical property capable of being shaped by its owner could bring to him direct satisfaction apart from the income it yielded in more concrete form. It represented an extension of his own personality. With the corporate revolution, this quality has been lost . . . .[16]

Shareholders no longer are owners in the traditional sense, but only are investors in corporate equity securities.[17] This limits the shareholder-investor's interest in the enterprise to capital appreciation and income.[18]

Whether a separation of ownership and control has occurred as maintained by Berle and Means and others is open to debate. The typical individual shareholder is simply an investor desirous of income and capital appreciation. Moreover, there is no separation of ownership and control in the vast majority of corporations that are family owned or closely held. The question of separation of ownership and control only arises regarding the relatively few, large public corporations. When interlocking directorates, acquisitions, institutional investors, and family blocks—including foundations—are considered, a relatively small group of individuals or institutions hold a controlling interest.[19] The real issue to be addressed is the level of activity undertaken by these controlling shareholders: Are they active enough that managers must accede to their wishes?

In their model Myers and Majluf assume that managers act in the best interest of the old shareholders, although they admit that they have no theory why.[20] One explanation for this assumption is that corporations are not as diversely held as hypothesized in managerialism theory. Old shareholders may have power because there exists a small group of shareholders—individuals, foundations, other corporations, or institutions—that hold a controlling interest in virtually every major publicly held corporation in the United States today. Institutional investors alone hold more than $6.5 trillion or approximately 53 percent of the country's equity.[21] Currently great institutional investors debate their proper role in corporate governance.[22]

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16. BERLE & MEANS, *supra* note 12, at 64-65.

17. *See* PHILLIP I. BLUMBERG, THE MEGACORPORATION IN AMERICAN SOCIETY: THE SCOPE OF CORPORATE POWER 11 (S. Prakash Sethi & Dow Votaw eds., 1975).

18. *See* J.A.C. Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 STAN. L. REV. 248, 271 (1969).

19. *See* FERDINAND LUNDBERG, THE RICH AND THE SUPER-RICH 814-24 (Bantam Books 1969).

20. Meyers & Majluf, *supra* note 7 at 189.

21. Sherry R. Sontag, *Investors Use Clout in the Corporate Government Battle*, NATL. L.J., Dec. 2, 1991 at 23.

22. *See* James A. White, *New York's Regan to Pensions: Hands Off*, WALL ST. J., Sept. 13, 1991 at C1. Edward V. Regan, the New York State comptroller and sole trustee of New York's public pension fund, is alarmed that pension funds, particularly the California Public Employees

Controlling shareholders elect the board of directors. Often, the controlling shareholders' representatives control the board. The controlling shareholders also give managers a free hand to operate within certain limits, one of which concerns the value of the controlling shareholders' stock.

This scenario would seem to support the Myers and Majluf assumption that managers act in the interest of the old shareholders, if by old shareholders they mean old controlling shareholders. It also raises the specter of minority shareholder oppression, which is the subject of a great number of corporate fiduciary and business judgment rule cases.[23] The following analysis takes both theories of control into account.

B. The Parting of the Ways

In the first part of the twentieth century, corporate financial theory and corporate law espoused a profit maximization paradigm. In microeconomics the theory of the firm is that firms are profit maximizers.[24] If competitive firms did not maximize profits, they would be inefficient; therefore, they would be forced out of business by the efficient firms.[25] Monopolists are presumed to be profit maximizers by virtue of their position.[26] Moreover, if the shareholders could directly run the corporation, they would opt for profit maximization and its corresponding cost minimization. Corporate financial theory further holds that maximizing profits maximizes firm value which in turn maximizes shareholder wealth.[27] The landmark case of *Dodge v. Ford Motor Co.*[28] was decided in 1919. In *Dodge* the court addressed whether a corporation organized for profit could divert its profits from the shareholders to society at-large. The court drew a distinction between "an incidental humanitarian expenditure of corporate funds for the benefit of the employees" and a general purpose plan to benefit humankind.[29] The court unequivocally stated:

Retirement System (CALPERS), may get involved in corporate governance issues that have nothing to do with providing benefits to retirees. He advocates a passive investor role. CALPERS and other institutional investors are advocating active participation in corporate governance.

23. *See, e.g.*, Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977).

24. Varian, *supra* note 4, at 25.

25. *Id.*

26. *Id.*

27. *See* COPELAND & WESTON, *supra* note 4, at 20, 401, 553, 667, 743.

28. 170 N.W. 668 (Mich. 1919).

29. *Id.* at 684.

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.
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> . . . [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 . . . .[30]

As corporations grew in size and complexity, ownership was separated from control, and the law evolved to reflect these changes in the structure of twentieth century American society.

Because a corporation can act only through agents, it must necessarily have the capacity to appoint them.[31] The officers and employees are the agents of the corporation[32] and owe their allegiance to the corporation, not to the directors.[33] However, corporate finance textbooks and articles continue to assert erroneously that managers are the agents of shareholders.[34]

The board of directors situation is unique. Although shareholders elect and may remove directors, the directors are not agents of the shareholders, and the shareholders are not principals. Directors are not agents of the corporation because of their statutory powers of management; they are not subject to control by anyone, which is a requirement of the principal-agent relationship.[35] The law of agency deals with the relationship between principal and agent, and because directors are neither principals nor agents, new law had to be created or old law modified to deal with the relationship between a director and the corporation.

1. The Fiduciary Relationship

Based on their analysis of a series of early corporation cases, Adolf Berle and Gardiner Means contend that

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30. *Id.*

31. W. EDWARD SELL, AGENCY § 16 (1975).

32. *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES §§ 219, 223-24 (3rd ed. 1983) (discussing officers as agents of corporations).

33. *See id.* at §§ 219-227 (discussing the duties of officers as agents of the corporation).

34. *See, e.g.*, COPELAND & WESTON, *supra* note 4, at 17; Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AEA Papers and Proceedings 323, 323 (May 1986); Jensen & Meckling, *supra* note 6, at 309.

35. *See* SELL, *supra* note 30, at § 24.

> all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears. . . . [T]he use of the power is subject to equitable limitation when the power has been exercised to the detriment of their interest, however absolute the grant of power may be in terms, and however correct the technical exercise of it may have been. . . . And that, in every case, corporate action must be twice tested: [F]irst, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a cestui que trust to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary.[36]

Berle and Means believed that corporate law, in substance, was a branch of the law of trusts.[37] The fiduciary concept in corporate law can be traced to the law of trusts.[38] Acknowledging, however, that this position was more theory than practice, Berle and Means stated: "In fact, if not in law, at the moment we are thrown back on the obvious conclusion that a stockholder's right lies in the expectation of fair dealing rather than in the ability to enforce a series of supposed legal claims."[39]

The position advocated by Berle and Means was previously adopted in Delaware when the Chancellor in *Bodell v. General Gas & Electric Corp.*[40] recognized that while "not trustees in the strict sense of the term, yet for convenience [directors] have often been described as such."[41]

In addition to the two traditional duties of care and loyalty from a fiduciary relationship, Delaware courts impose a third duty of obedience,[42] a subdivision of the duty of loyalty from an analytic standpoint. Justice Cardozo described the fiduciary duty in his now-famous quote: "Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[43] This is but the beginning of the problem, however, for as Justice Frankfurter aptly said, "[t]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary?"[44]

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36. BERLE & MEANS, *supra* note 12, at 220.

37. *Id.* at 242.

38. *Cf.* AUSTIN W. SCOTT, THE LAW OF TRUSTS §§ 170, 174 (4th ed. 1987) (discussing a trustee's duty of loyalty and duty of care).

39. BERLE & MEANS, *supra* note 12, at 243.

40. 132 A. 442 (Del. Ch. 1926), *aff'd*, 140 A. 264 (Del. 1927).

41. *Id.* at 466.

42. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1985); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).

43. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

44. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

This is the crux of the matter. To whom are corporate officers and directors fiduciaries?

This question was the topic of the debate between Adolf Berle and E. Merrick Dodd. Berle defended the traditional corporate financial theory that corporate management exercises its powers solely for the benefit of the shareholders.[45] Dodd argued for a broader exercise of corporate powers, contending that management should exercise its powers on behalf of a broader constituency. Moreover, Dodd argued that the corporate purpose extended beyond making a profit for shareholders.[46] The debate ended in 1954 when Berle capitulated by agreeing that the corporate trust extended to the entire community and was not solely for the benefit of shareholders.[47] Although the Berle-Dodd debate ended with Dodd's view prevailing, corporate financial theory still embraces Berle, and there are lingering elements of the debate in corporate law today.

Corporate statutes generally are consistent regarding to whom the fiduciary duty is owed; however, a few corporate statutes extend the duty to the corporation and the shareholders.[48] The Model Business Corporation Act imposes a fiduciary duty on officers and directors for the benefit of the corporation by providing, "A director shall discharge his duties as a director . . . in a manner he reasonably believes to be in the best interests of the corporation."[49] The drafters of the Model Act and state legislatures have taken the position that the duty is owed to the corporation and not to any particular constituent stakeholder group.[50]

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45. Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

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

47. ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954).

48. *See, e.g.*, S.C. CODE ANN. § 33-8-300(a) (3) (Law. Co-op. 1990); *see also* N.C. GEN. STAT. § 55-8-30 commentary (1990) (recognizing that the drafters deleted the language from the North Carolina Business Corporation Act that extended a fiduciary duty from directors to shareholders).

49. REVISED MODEL BUSINESS CORP. ACT § 8.30(a)(3) (1984); *see also* HENN & ALEXANDER, *supra* note 32, at § 232.

50. *But see* Childs v. RIC Group, 331 F. Supp. 1078, 1082 (N.D. Ga. 1970) (recognizing that under Georgia law a director holds inside information in trust for the shareholders), *aff'd per curiam*, 447 F.2d 1407 (5th Cir. 1971); Weatherby v. Weatherby Lumber Co., 492 P.2d 43, 45 (Idaho 1972) (construing the statutory fiduciary relation to the corporation to include shareholders); Dawson v. National Life Ins., Co., 157 N.W. 929, 937 (Iowa 1916) (concluding that a fiduciary relation exists between a managing officer and a stockholder with respect to the stockholder's shares); Sampson v. Hunt, 564 P.2d 489, 491 (Kan. 1977) (recognizing that under Kansas law the director of corporation owes a fiduciary duty to the other stockholders), Jacquith v. Mason, 156 N.W. 1041 (Neb. 1916). According to Henn and Alexander, these cases demonstrate the minority rule that a duty is owed to shareholders in insider trading cases. *See* HENN & ALEXANDER, *supra* note 32, at § 239 n.7.

The Berle-Dodd debate concerning whether the fiduciary duty runs to the shareholders is continued through a line of cases that typically involve insider trading and a purchase or sale of control.[51] Although couched in terms of fiduciary duties owed to shareholders, these cases can be explained as involving breaches of fiduciary duties owed to the corporation as a whole where the phrase "corporation as a whole" encompasses all intracorporate groups. Favoring one intracorporate group to the detriment of another is a breach of duty owed to the corporation as a whole.[52] Moreover, many of these cases involve discrimination among different groups of shareholders; therefore, it is only logical that the courts should speak of duties owed to the shareholders rather than the corporation. But even when courts extend the fiduciary duty to the shareholders, they do not limit it to them. For example, the directors of a financially troubled corporation owe a fiduciary duty to creditors[53] even though no duty is owed to creditors of a financially healthy corporation.[54]

The formulation of the fiduciary concept by the Delaware Supreme Court appears in *Guth v. Loft, Inc.*,[55] where the court stated that, although not technically trustees, directors "stand in a fiduciary relationship with the corporation and its stockholders."[56] The court imposed a duty of "undivided and unselfish loyalty to the corporation."[57] The subsequent discussion of fiduciary duty refers to the corporation and does not further mention the shareholders. Of course, the shareholders did not need mentioning because the case involved an appropriation of a corporate opportunity. One may speculate that shareholders were included because in 1939 the interests of the corporation and its owners were considered to be the same. *Guth* has been cited for the fiduciary concept by the Delaware courts ever since.[58]

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51. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1985); *see also* HENN & ALEXANDER, *supra* note 32, at § 241.

52. HENN & ALEXANDER, *supra* note 32, at § 240. There is a minority view that wealth transfers from other stakeholders, such as bondholders, are permitted. *See Revlon*, 506 A.2d at 182-84.

53. *See* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985); Pepper v. Litton, 308 U.S. 295, 307 (1939); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981), *cert. denied*, 455 U.S. 990 (1982); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108-09 (Del. Ch. Dec. 30, 1991).

54. *See* Simons v. Cogan, 542 A.2d 785, 788-91 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988).

55. 5 A.2d 503 (Del. 1939).

56. *Id.* at 510.

57. *Id.*

58. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993), *modified on reargument in part*, 630 A.2d 956 (Del. 1994); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1988).

The unresolved question was: What if there is a conflict between loyalty to the corporation and to the shareholders? Can undivided loyalty to the corporation be divided between the corporation and its shareholders if their interests diverge? The Delaware Supreme Court answered that question fifty years after *Guth* when it decided *Paramount Communications v. Time, Inc.*[59]

Paramount is of particular importance in this analysis. Justice Horsey distinguished the directors' duty regarding corporate value to the corporation as an entity and their duty to the shareholders. His opinion suggests that the fiduciary duty is owed to the corporate entity and not to the shareholders.[60]

Paramount distinguishes the stance taken by the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings*,[61] which expressly denied that other constituencies were owed a fiduciary duty by management except under certain conditions.[62] *Revlon* involved a hostile takeover by Pantry Pride. Revlon's board of directors engaged in defensive tactics to thwart that hostile takeover.[63] Moreover, the board acted to protect noteholders at the expense of the shareholders.[64] The notes were issued as a defensive measure. Hence, *Revlon* involves an intracorporate allocation of value. However, the court did not prohibit the board from considering constituencies other than the shareholders in stating that "while concern for various corporate constituencies is proper when addressing a takeover threat, that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders."[65] This concession by the Delaware Supreme Court is a step toward liberalization of the fiduciary concept, although, the court cited *Guth v. Loft, Inc.*[66] for the proposition that the fiduciary duty is owed "to the corporation and its shareholders."[67]

The concept of concern for other constituencies comes from *Unocal Corp. v. Mesa Petroleum Co.*[68] In *Unocal* Mesa argued that action by the Unocal directors in opposing its two-tier tender offer for Unocal stock was a violation of the fiduciary duty Unocal owed to its shareholders, including Mesa. The Delaware Supreme Court said that the board of directors legitimately could be concerned with "the impact [of the tender offer] on 'constituencies' other than shareholders (i.e. creditors, customers, employees, and perhaps even the

59. 571 A.2d 1140 (Del. 1989).
60. *See id.* at 1150.
61. 506 A.2d 173 (Del. 1985); *see Paramount*, 571 A.2d at 1150-51.
62. *See Revlon*, 506 A.2d at 176.
63. *See id.* at 175-79.
64. *See id.* at 182.
65. *Id.* at 176.
66. 5 A.2d 503, 510 (Del. 1939).
67. *Revlon*, 506 A.2d at 179.
68. 493 A.2d 946 (Del. 1985).

community generally)."[69] This language is similar to that of corporate constituency statutes of other states.[70]

Further, in *Revlon* the court declared that the initial duty of the board in the face of the takeover was to preserve the corporation as an entity. At this initial stage the board owed a duty to the corporate entity. After determining that the corporate entity could not be preserved, the board's duty shifted to maximizing the firm's value at a sale for the benefit of the shareholders.[71] The shareholders take priority only after the board's obligations to a corporation are fulfilled. Once a corporation goes on the auction block, the board's duty is to maximize shareholder value; the board's objective no longer is to protect or maintain the corporate enterprise, but to sell it to the highest bidder.[72]

Paramount Communications v. Time, Inc.[73] also involved a hostile takeover. Relying on *Revlon*, the plaintiff shareholders argued "that Time's board's decision to merge with Warner imposed a fiduciary duty to maximize immediate share value and not erect unreasonable barriers to further bids."[74] In rejecting this argument the court noted "that Time's board, in negotiating with Warner, [had not] made the dissolution or break-up of the corporate entity inevitable, as was the case in Revlon."[75] Therefore, the *Revlon* duty to maximize the company's value at a sale for the benefit of the shareholders was not triggered.[76]

The Court of Chancery in its opinion below posed the pivotal question, also of importance in this Article: "Under what circumstances must a board of directors abandon an in-place plan of corporate development in order to provide its shareholders with the option to elect and realize an immediate control premium?"[77] The Delaware Supreme Court responded by relying on a provision of the Delaware Code that vests corporate control and management in the board of directors[78] and by distinguishing *Revlon*. First, the duty to manage the business and affairs of the corporation imposed on directors under Delaware law includes a "conferred authority to set a corporate course of action, including time frame, *designed to enhance corporate profitability*."[79] Further, "the question of 'long-term' versus 'short-term' values is largely

69. *Id.* at 955.
70. *See infra* notes 108-11 and accompanying text.
71. *Revlon*, 506 A.2d at 181-82.
72. *Id.* at 182.
73. 571 A.2d 1140 (Del. 1989).
74. *Id.* at 1149.
75. *Id.* at 1150.
76. *Id.* at 1151.
77. *Id.* at 1149.
78. *See* DEL. CODE ANN. tit. 8, § 141(a) (1991).
79. *Time*, 571 A.2d at 1150 (emphasis added).

irrelevant because directors, generally, are obliged to chart a course for a corporation which is in *its best interests* without regard to a fixed investment horizon."[80]

Second, absent circumstances similar to those in *Revlon,* "a board of directors . . . is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[81] In light of these statements by the Delaware Supreme Court, managers who forego positive net present value projects and, thereby, fail to maximize the value of the corporation in the interests of the old shareholders violate their fiduciary duty to the corporation and could be held accountable under Delaware law.

Although *Time* directly involved a takeover, the extension of the director's fiduciary duties likely is not restricted to this context because of the broad reach of the language quoted above. This case is extremely important because of the status of Delaware corporate law in the field. The duty originally imposed for the benefit of the shareholders has been transferred to the corporation as a whole. If a fiduciary duty is owed to a corporation, a fiduciary duty is owed to all stakeholders composing that corporation. The shift from the shareholders to the corporation actually is a broadening of the scope of fiduciary beneficiaries rather than a narrowing. The assumption that managers act in the best interest of the old shareholders is losing its support in the law; indeed, in Delaware, it may be gone. As demonstrated above, the case law trend is toward finding a duty owed to the corporation as a whole.

2. *Business Judgment Rule*

The business judgment rule is a logical extension of the transference of the object of the fiduciary relationship from the shareholders to the corporation as a whole. Management is compelled to act in the best interests of the corporation. The business judgment rule applies not only to directors, but also to officers and controlling shareholders—collectively referred to as management.[82]

The Delaware Supreme Court states that the business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[83] The court mentions only the company and not the shareholders in its formulation of the rule.

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80. *Id.* (emphasis added).

81. *Id.* (footnote omitted).

82. HENN & ALEXANDER, *supra* note 32, at § 242.

83. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citing Kaplan v. Centex Corp., 284 A.2d 119 (Del. Ch. 1971); Robinson v. Pittsburgh Oil Refiner Corp., 126 A.46 (Del. Ch. 1924)).

Thus, in the Delaware courts the business judgment rule moved ahead of the fiduciary concept.

Delaware adopted a more stringent business judgment rule for takeover situations because of the "omnipresent specter" that the directors may be acting in their own best interests rather than the best interests of the corporation and its shareholders.[84] The *Unocal* court imposed an enhanced duty calling for an initial judicial determination before conferring the benefits of the business judgment rule.[85] In Delaware directors in a takeover situation must show that they had reasonable grounds to believe "that a danger to corporate policy and effectiveness existed because of another person's stock ownership."[86] The directors may satisfy this enhanced duty by exercising good faith and performing a reasonable investigation.[87] Approval of the board's actions by a majority of independent, outside directors is strong evidence that the duty was satisfied.[88]

Care must be taken in discussing the business judgment rule. The rule was created by courts for evidentiary purposes in cases involving alleged misconduct by management.[89] The business judgment rule is a standard of proof that creates a presumption that the board of directors acted in good faith and exercised due care to further the best interests of the corporation.[90] The purpose of the business judgment rule is to shield directors from liability in shareholders' suits attacking discretionary business decisions made by the directors.[91] Directors are protected even if the decisions turn out to be wrong, provided they acted in good faith and exercised due care.[92] Courts are reluctant to substitute their judgment for that of boards of directors because courts perceive the boards as possessing skills, information, and judgment not possessed by the courts.[93]

The business judgment rule protects only boards that act in good faith in accord with their duty of loyalty,[94] but only a duty of loyalty to the

84. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

85. *Id.*

86. *Id.* at 955 (citing Cheff v. Mathes, 199 A.2d 548 (Del. 1964)).

87. *Id.* (quoting *Cheff*, 199 A.2d at 555).

88. *Id.* (citing Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.)), *cert. denied*, 454 U.S. 1092 (1981); *Aronson*, 473 A.2d at 805; Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971).

89. *See* HENN & ALEXANDER, *supra* note 32, at § 242. *See generally* Bayless Manning, *The Business Judgment Rule in Overview*, 45 OHIO ST. L.J. 615 (1984) (summarizing the business judgment rule).

90. *See, e.g., Aronson,* 473 A.2d at 812.

91. BNS, Inc. v. Koppers Co., 683 F. Supp. 458, 474 n.32 (D. Del. 1988) (recognizing that the business judgment rule prevents courts from questioning decisions) (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1985)).

92. *See Cheff*, 199 A.2d at 554 (citing Kors v. Carey, 158 A.2d 236 (Del. Ch. 1960)).

93. Solash v. Telex Corp., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608 (Del. Ch. Jan. 19, 1988); Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979).

94. *See* HENN & ALEXANDER, *supra* note 32, at § 242 (discussing the business judgment

corporation, not to the shareholders. If the directors are disinterested, the court likely will deem them to have acted in good faith.[95] However, if the directors are not disinterested and are beneficiaries of the action, they will have breached their duty of loyalty, and the business judgment rule will not protect them.[96] If the plaintiff establishes that the board did not act in good faith or breached its duty of due care, the burden of proof shifts to the defendant directors to show that the transaction was entirely or intrinsically fair.[97]

When it was developed, the business judgment rule represented a shift in the judiciary's focus from shareholders to the corporate entity.[98] Fiduciary relationships have taken more than thirty years to catch up to the business judgment rule.

3. Social Responsibility and Third-Party Beneficiaries

The internal relationships between officers, shareholders, directors, and the corporation are governed by the law of agency, the fiduciary concept including the business judgment rule, and state corporation laws. Modern courts are reconsidering the relationship between the corporation and society.

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rule).

95. *See* Galef v. Alexander, 615 F.2d 51, 57-58 (2d Cir. 1980) (quoting United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917)); Beard v. Elster, 160 A.2d 731, 738-39 (Del. 1960); Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971).

96. *See Beard*, 160 A.2d at 737 (discussing Gottlieb v. Heyden Chem. Corp., 90 A.2d 660 (Del. 1952)); *Puma*, 283 A.2d at 695 (quoting David J. Greene & Co. v. Dunhill Int'l Inc., 249 A.2d 427 (Del. Ch. 1968)) (finding the directors disinterested); *see also, e.g.*, Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981); *Galef*, 615 F.2d at 57-58; Grynberg v. Farmer, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,683 (D. Colo. Oct. 8, 1980) (concluding that the directors on the Special Litigation Committee were interested).

97. Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) ("Once a plaintiff demonstrates that a director had an interest in the transaction at issue, the burden shifts to the director to prove that the transaction was fair and reasonable to the corporation.") (citing Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Daloisio v. Peninsula Land Co., 127 A.2d 885 (N.J. Super. Ct. App. Div. 1956)); *see also* Johnson v. Trueblood, 629 F.2d 287, 293 (3d Cir. 1980) ("At a minimum, the Delaware cases require that the plaintiff must show some sort of bad faith on the part of the defendant."), *cert. denied*, 450 U.S. 999 (1981); Eldridge v. Tymshare, Inc., 230 Cal. Rptr. 815, 820 (Ct. App. 1986) ("[The] plaintiff . . . must be able to make specific allegations of malfeasance or bad faith. Where an improper motive is claimed, plaintiff must allege that it was the sole or primary reason for the directors' actions." (citing *Johnson*, 629 F.2d at 287; Starbird v. Lane, 21 Cal. Rptr. 280 (Ct. App. 1962))).

98. *Cf.* Epstein v. Schenck, 35 N.Y.S.2d 969 (Sup. Ct. 1939) (concluding that under the circumstances "the court should not substitute its judgment for the judgment of the duly constituted [and disinterested] corporate management."); Walker v. Man, 253 N.Y.S. 458 (Sup. Ct. 1931) (requiring interested directors to explain their conduct).

The theory of corporate social responsibility is developing in the wake of concerns about the environment, product safety, and social justice.

The traditional view of corporate social responsibility[99] provides that corporations should make profits for their shareholders.[100] Nonetheless, constraints often have been placed on the means by which a corporation may reach this goal. However, the profit motive remains the ultimate legal purpose for which persons form corporations.

At common law, it is a tenet of sovereignty that when necessary for the common good a government may regulate the manner in which citizens use their private property.[101] As the Supreme Court stated:

> Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use; but, so long as he maintains the use, he must submit to the control.[102]

More recent cases require corporate directors to consider more than the interests of shareholders when making decisions. In 1953 the New Jersey Supreme Court reached a watershed in the law of corporate social responsibility with its opinion in *A.P. Smith Manufacturing Co. v. Barlow*.[103] A.P. Smith Manufacturing Company had contributed consistently to the local community and occasionally to a local college and a local university. In 1951 the board of directors adopted a resolution to contribute to Princeton Universi-

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99. *See generally* Melvin A. Eisenberg, *Corporate Legitimacy, Conduct, and Governance—Two Models of the Corporation*, 17 CREIGHTON L. REV. 1 (1983); David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979); Edwin M. Epstein, *Societal, Managerial, and Legal Perspectives on Corporate Social Responsibility—Product and Process*, 30 HASTINGS L.J. 1287 (1979); J.A.C. Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 STAN. L. REV. 248 (1969); R. Collin Mangrum, *In Search of a Paradigm of Corporate Social Responsibility*, 17 CREIGHTON L. REV. 21 (1983); Jerry L. Mashaw, *Corporate Social Responsibility: Comments on the Legal and Economic Context of a Continuing Debate*, 3 YALE L. & POL'Y REV. 114 (1984); Lewis D. Solomon & Kathleen J. Collins, *Humanistic Economics: A New Model for the Corporate Social Responsibility Debate*, 12 J. CORP. L. 331 (1987) (discussing theoretical aspects of corporate social responsibility).

100. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919); MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133-36 (1962) (discussing directors' responsibility to make profits for their shareholders).

101. *See* Munn v. Illinois, 94 U.S. 113, 125 (1876).

102. *Id.* at 126.

103. 98 A.2d 581 (N.J. 1953).

ty. The company justified its action by claiming that the donations were a sound investment and were made for a valid business purpose.[104] The court, picking up the thread of the common law as articulated in *Munn*, carried the proposition further, stating: "It seems to us that just as the conditions prevailing when corporations were originally created required that they serve public as well as private interests, modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate."[105]

Significantly, the court held not only that the gift had been made in the reasonable belief that it would advance the interests of the corporation, but also that the gift would benefit the public welfare and advance the interests of the corporation as a part of the community in which the gift operates.[106] The court carefully added that the charity in question was not a pet charity of the directors and that the gift was not made indiscriminately or in furtherance of personal, rather than corporate, ends.[107] Corporations were now authorized to further social welfare.

More recent cases espouse a social responsibility theory for corporations.[108] Nonetheless, social responsibility is constrained by reasonableness because the profit motive remains the driving force behind corporate existence.[109]

State legislatures also are taking an active role in the expansion of the scope of corporate fiduciary duties. Although Delaware has not, nearly one-half of the states have enacted corporate constituency statutes.[110] These

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104. *See id.* at 582-83.

105. *Id.* at 586.

106. *Id.* at 590.

107. *Id.* Apparently, the court would have reached a different result if the charity were a pet charity of the directors.

108. *See, e.g.*, Theodora Holding Corp. v. Henderson, 257 A.2d 398, 404 (Del. Ch. 1969) ("[U]nless corporations carry an increasing share of the burden of supporting charitable and educational causes [then] the business advantages now reposed in corporations by law may well prove to be unacceptable to the representatives of an aroused public.").

109. *See id.* at 405 (concluding that "the test to be applied in passing on the validity of a gift such as the one here in issue is that of reasonableness.").

110. *See* ARIZ. REV. STAT. ANN. § 10-1202 (Supp. 1993); CONN. GEN. STAT. ANN. § 33-313 (West Supp. 1994); FLA. STAT. ANN. § 607.0830 (West 1993); GA. CODE ANN. § 14-2-202 (1994); HAW. REV. STAT. § 415-35 (1993); IDAHO CODE § 30-1702 (Supp. 1994); ILL. REV. STAT. ANN. ch. 805, para. 5/8.85 (Smith-Hurd 1993); IND. CODE ANN. § 23-1-35-1 (Burns 1989); KY. REV. STAT. ANN. § 271B.12-210 (Michie Supp. 1992); LA. REV. STAT. ANN. § 12:92 (West 1969 & Supp. 1994); ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 1993); MINN. STAT. ANN. § 302A.251 (West 1985 & Supp. 1994); MO. ANN. STAT. § 351.347 (Vernon 1991); NEB. REV. STAT. § 21-2035 (1991); N.J. REV. STAT. § 14A:6-1 (1993); N.M. STAT. ANN. § 53-11-35 (Michie 1993); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1994); OHIO REV. CODE ANN. § 1701.59 (Anderson 1992); 15 PA. CONS. STAT. ANN. § 516 (Supp. 1994); TENN. CODE ANN. § 48-35-204 (1988); WIS. STAT. ANN. § 180.0827 (West 1992).

statutes appear to be legislative reactions to the takeover mania of the 1980s and the shift of holdings from the individual to institutional investors. A typical provision permits the board of directors to examine a number of factors when considering the best interests of the corporation.[111] These factors include not only shareholders, but to the extent deemed appropriate, employees, suppliers, customers, creditors, the community where the corporation is located, short- and long-term interests of the corporation, and all other pertinent factors.[112] Moreover, no one group or interest need be considered the dominant or controlling interest or factor.[113] Because most of these corporate constituency statutes are permissive, not mandatory, they vest great discretion in the board of directors. Five states restrict the constituency statutes to takeover situations[114] while the rest apply the statutes to all decisions of the board of directors. Three states require directors to consider other constituencies,[115] although the statutes apparently allow the board to decide how the other constituencies should be taken into consideration.

The corporate constituency statutes demonstrate that state legislatures intend directors to consider other constituent stakeholders in addition to shareholders when making decisions. Acting in the best interests of the corporation means more than simply acting in the interest of the shareholders. The interests of the corporation and its shareholders no longer are synonymous.

Business ethics scholars are pushing for an even broader extension of corporate social responsibility. The extended stakeholder theory seems to be dominant at the moment. Proponents urge adoption of this theory because it can be accomplished within the framework of managerial capitalism. Under this theory, ethically responsible management will consider other stakeholders in addition to shareholders when making decisions. This Article already has demonstrated that legislatures and courts impose this requirement. Business ethics scholars differ in their approach because they advocate a circle of stakeholders far broader than the corporation itself. For example, Professor R. Edward Freeman defines a stakeholder as "any group or individual who can affect or is affected by the achievement of the organization's objectives."[116]

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111. *See, e.g.*, FLA. STAT. ANN. § 607.0830(1)(c) (West 1993); GA. CODE ANN. § 14-2-202(b)(5) (1994).

112. *See, e.g.*, FLA. STAT. ANN. § 607.0830(3) (West 1993); GA. CODE ANN. § 14-2-202(b)(5) (1994).

113. *See, e.g.*, FLA. STAT. ANN. § 607.0830(3) (West 1993); GA. CODE ANN. § 14-2-202(b)(5) (1994); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1994).

114. *See* CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1994); KY. REV. STAT. ANN. § 271B.12-210 (Michie Supp. 1992); LA. REV. STAT. ANN. § 12:92(G) (West Supp. 1994); MO. ANN. STAT. § 351.347 (Vernon 1991); TENN. CODE ANN. § 48-35-204 (1988).

115. *See, e.g.*, CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1994).

116. R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 46

This could include employees, customers, the community, governments, and markets. Freeman's approach calls for an analysis of stakeholders' interests; some are immediate and others are remote. The degree to which each stakeholder group must or can be considered is not well-defined and appears to be highly subjective and variable depending on the situation.[117]

Professor Freeman also advocates a multifiduciary approach in which "the manager *must* act in the interests of the stakeholders in the organization."[118] This approach is particularly troublesome because the fiduciary relationship traditionally has been reserved for trust or trust-like relationships. The duty of undivided loyalty seems incompatible with a multifiduciary approach because loyalties may change with the situation. The stakeholder theory promoted by Kenneth E. Goodpaster retains the fiduciary relationship between managers and shareholders, but advocates an ethical, nonfiduciary relationship between managers and nonshareholder stakeholders.[119] Professor Goodpaster does not understand that the fiduciary relationship is between the managers and the corporation except in certain intracorporate disputes.[120] Thus, business ethics scholars and others would move the law even further from traditional financial theory and expand the spectrum of stakeholder constituency broader than the courts or legislatures have to date.

III. REMEDIES

If management violates its fiduciary duty to the corporation in favor of the shareholders, the law offers little in the way of meaningful remedies. The shareholder derivative suit is a strictly legal remedy. Other potential remedies are the proxy contest and the shareholder proposal, both of which are regulated by federal and state securities laws.

A shareholder derivative suit is a claim asserted by a shareholder on behalf of the corporation. In a shareholder derivative suit the law recognizes that corporate directors may not be acting in the best interests of the corporation when they refuse to assert the corporation's legal right to enforce the directors' fiduciary duty to the corporation. The purpose of the suit is to prevent abuse of authority by the board of directors.[121]

Two obstacles exist to the use of the derivative suit as a remedy. First, individuals allowed to bring the suit include shareholders who may have benefitted from the directors' breach of fiduciary duty to the corporation.

(1984).

117. *See id.* at 54-64.

118. *Id.* at 249.

119. Kenneth E. Goodpaster, *Business Ethics and Stakeholder Analysis*, 1 BUS. ETHICS Q. 53, 61-73 (1990-91).

120. *See* discussion *supra* part II.B.1.

121. *See* HENN & ALEXANDER, *supra* note 32, at § 358.

These shareholders are unlikely to bring a shareholder derivative suit that might be detrimental to them. The second obstacle is the courts' application of the business judgment rule to shareholder derivative suits. Under the business judgment rule, courts seldom will interfere with intracorporate decisions.[122]

Before bringing a shareholder derivative suit, federal[123] and state[124] procedural rules require the shareholder to demand formally that the board of directors pursue the legal right of the corporation. Failure to make such demand ordinarily results in dismissal. The demand requirement is excused only if it would be futile.[125] If demand is futile, the Delaware Supreme Court applies a two-prong test to determine whether the suit will be dismissed on motion of an independent committee of the board of directors. First, the court must ask whether the committee acted independently and in good faith after reasonable investigation. Second, the court must ask whether it would come to the same conclusion applying the court's independent judgment.[126]

The use of a shareholder derivative suit requires the participation of a shareholder and an independent director concerned with acting in the best interest of the corporation instead of the shareholders. The logical shareholder candidate would be an outsider who, recognizing that the shares were undervalued, would invest in order to bring the shareholder derivative suit. This type of candidate likely would be interested in taking over the corporation.

The second group of potential remedies consists of the proxy contest and the shareholder proposal. An insurgent shareholder may initiate a proxy contest in order to make changes in corporate policy. If successful, the proxy contest places the insurgent's nominees on the board of directors. Even if not successful, however, the board of directors may make proposed policy changes to ward off further attacks. A corporation is vulnerable to a proxy contest if (1) management owns little or no common stock, (2) the corporation is undervalued (asset value greater than market value of stock), (3) the corporation has a poor performance record such as low earnings or low dividends, or (4) the board of directors is not unified, providing potential allies on the board to the insurgent shareholder.

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122. *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917).

123. *See* FED. R. CIV. P. 23.1.

124. *See, e.g.*, DEL. CH. CT. R. 23.1.

125. *See* Aronson v. Lewis, 473 A.2d 805, 811-13 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981) (quoting Maldonado v. Flynn, 413 A.2d 1251, 1262 (Del. Ch. 1980)).

126. *Zapata*, 430 A.2d at 788-89.

Proxy contests are governed by regulations[127] promulgated under the Securities Exchange Act of 1934.[128] Because proxy contests are expensive,[129] the insurgent shareholder must ensure that the difference between the market value of the stock and the asset value, including unfinanced positive net present value projects, exceeds the costs of the proxy contest.

An alternative to a proxy contest is a shareholder proposal to invest in positive net present value projects. Shareholder proposals are governed by Rule 14a-8.[130] Rule 14a-8 provides that if a shareholder entitled to vote at a shareholder meeting wishes to make a proposal at the meeting, the shareholder must notify management in advance. Management is required to include the proposal in its proxy statement and form of proxy[131] unless it demonstrates that the proposal is within one of the exclusions in the regulations.[132] To be eligible to make a shareholder proposal the shareholder must have held for one year at least one percent or one thousand dollars in market value of the corporation's outstanding voting stock.[133]

A shareholder may solicit proxies as well as submit proposals. In 1987 the Securities and Exchange Commission eliminated a regulation that allowed a corporation to omit shareholder proposals from proxy materials if the proponent had delivered proxy materials to holders of more than twenty five percent of a class of the corporation's securities.[134] However, the corporation may omit the proposal if it concerns operations that account for less than five percent of the corporation's total assets, net earnings, and gross sales and if the subject of the proposal is not otherwise significantly related to the corporation's business.[135]

Shareholders must overcome two problems with a shareholder proposal. First, shareholders are disadvantaged compared to management because management has inside, nonpublic information concerning the true value of the corporation. Second, shareholders must be willing to act contrary to their own short-term best interests. Similar to the proxy contest and shareholder derivative suit, the shareholder proposal remedy requires an outsider with inside information.

Acting in the best interests of the shareholders instead of the corporation is not a high-risk violation of the law. While the law explicitly requires managers to act in the best interests of the corporation, the law does not

127. 17 C.F.R. § 240.14a (1994).
128. 15 U.S.C. §§ 78a-78*ll* (1988 & Supp. V 1993).
129. HENN & ALEXANDER, *supra* note 32, at § 196.
130. 17 C.F.R. § 240.14a-8 (1994).
131. *Id.* § 240.14a-8(a).
132. *Id.* § 240.14a-8(c).
133. *Id.* § 240.14a(8)(a)(1).
134. Exchange Act Release No. 25,217, 52 Fed. Reg. 48,977 (December 29, 1987).
135. 17 C.F.R. § 240.14a-8(c)(5) (1994).

provide an adequate remedy for breach of that fiduciary duty. The shareholder derivative suit, proxy contest, and shareholder proposal are not effective because they require actions by the very persons who may be the beneficiaries of the breach of fiduciary duty. Such legal remedies rely on outsiders with information concerning the updated values of foregone projects. To maximize the value of the corporation, these outsiders must be willing to invest in the corporation and endure expensive legal contests. If managers fail to maximize the value of the corporation by acting in the best interests of the old shareholders, the law of corporate governance does not provide an effective solution to the problem.

Effective remedies must be sought in the marketplace. Corporate managers who do not maximize the value of their corporation may become takeover targets. New management presumably will maximize the value of the firm to glean a return on its investment.

IV. CONCLUSION

Whether one takes the separation of ownership and control or the controlling shareholder view, the assumption that managers act in the best interests of the old shareholders is no longer supported by the law. The fiduciary concept has evolved in favor of the corporation as a whole and not any particular stakeholder group. The business judgment rule consistently has required a fiduciary duty to the corporation. However, recent developments in corporate social responsibility and corporate constituency statutes have broadened the number of stakeholders who may or must be considered; a narrow focus on the shareholders has not been maintained. Case law development is particularly important because case law develops in response to legislative action. Courts have upheld the acts of managers who have considered constituencies other than shareholders when making decisions.

If the law is a reflection of managerial action, it has changed dramatically since the days of the Berle-Dodd debate. Corporate financial theory has lagged behind these legal developments. Accordingly, the law and managerial action now may be at odds. Through ignorance of the law or in deliberate disregard of the law, managers act in the best interests of the shareholders to the detriment of the corporation. Unfortunately, remedies must be sought in the marketplace because the law provides little effective relief.