Major Changes Lead Us Back To Basics

(A Response to the Symposium on My Treatise)

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I am flattered and humbled by this conference, and profoundly grateful to the organizers and sponsors—Professor Hillary Sale, the Journal of Corporation Law, and the University of Iowa—as well as to the contributors and participants. For me, an author reflecting on a labor of love produced nearly twenty years ago, the papers and the discussions have been uniquely instructive and stimulating.

The conference itself has prompted me to try to identify the major trends in legal doctrine, legal scholarship, business practice, and academic culture that have occurred since my treatise was written. Indeed, I will use this occasion to propose some candidates under each of these four headings. But the papers and the discussions have caused me to marvel about one mildly surprising aspect of recent corporate law scholarship—the continued interest in, and rich development of, views about the most basic issues of corporate purpose and the objects of directors’ and officers’ duties. My main purpose here will be to venture a restatement of my own views about these fundamental issues.

TWENTY YEARS: SO WHAT WERE THE BIG CHANGES?

Upon returning to corporate law teaching after my abnormally long run in an all-consuming deanship (followed by a generous sabbatical), I am struck by the fact that so much is essentially the same. There are new cases and statutory provisions to cover, but most of the doctrines, issues, and policy arguments seem astonishingly constant. At first I thought this must be a psychological illusion, facilitated by the fact that I did manage to read key opinions and law review articles in the field throughout my deanship, even though I did not teach. But closer analysis confirmed the high degree of continuity.

Yet there are also important differences between then and now, and they are crucial subjects of reflection for a scholar writing (or revising) a treatise today. I offer some candidates for the major trends, in the hope that doing so will stimulate others to suggest amendments, alternatives, and additions.

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1. This response paper tracks remarks made at the symposium. Because my main objectives are to flatter the contributors and offer some high level observations about the topics of their papers, I have taken the liberty of eschewing footnote citations to sources documenting the trends and developments referred to in the paper. They are all quite familiar to corporate law scholars.
Since I finished writing the treatise, there have been at least five important trends in the law that would demand significant attention in a new edition.

The first, and perhaps the most obvious, is the rich development and elaboration in Delaware case law of doctrines relating to hostile takeovers and defenses against them. My book dealt briefly with *Unocal*, which had just been decided, but later cases—from *Revlon* and the two *Paramount* decisions through *Unitrin* and beyond—have created a canonical set of authorities and concepts with which all corporate lawyers and law students must be familiar. Somewhat ironically, during the 1990s the acquisition landscape changed rather markedly away from hostile bids toward negotiated acquisitions, with a consequent shift in lawyerly worries toward issues like the validity of deal protections. Thus, the canon of takeover-related cases is now ripe for succinct, disciplined, and thematic treatment in treatises and casebooks, as opposed to the lavish but already anachronistic fascination with the cases and formulas that is so tempting to professors looking for dramatic tension in a sometimes tedious course. Fortunately for teachers, investor aggression against companies has more recently taken new and interesting forms. For example, the rise of hedge funds and other activist investors willing to threaten or launch proxy contests to elect board members who will pursue their preferred objectives will likely generate both noteworthy judicial rulings and a range of scholarly opinions about the underlying policy issues, such as the apparent conflicts among sets of shareholders and the problems they pose for directors trying to fulfill their fiduciary duties.

A second large-scale legal development is the wave of corporate governance changes resulting from the Sarbanes-Oxley Act of 2002 and related phenomena like new listing requirements and the rise of corporate governance rating agencies. My perception, based in part on service as a director of several large public companies, is that for about three years these changes dwarfed takeover and M&A-related issues in terms of the time, money, and worry demanded of corporate managements and boards. Casebooks and hornbooks seem not to have fully reflected the importance of these changes, but that may change when the small but important subset of good law review articles on SOX-related changes has been digested. Don Langevoort’s wonderful contribution to this symposium shows that at least some leading scholars have a firm grasp on what is most important about these changes. (And he rightly identifies the part of my treatise—the passages dealing with the duty of care as a duty to maintain monitoring systems—that most needs to be updated to reflect them.)

A third major change is the rise of Limited Liability Companies and other business forms that are more attractive to owners of closely held businesses than the traditional close corporation. Although many of the basic and recurring problems of resolving conflicts and adapting fiduciary principles to the special context of closely held businesses will remain to be addressed, both by planners and courts, a modern treatise should have a chapter on LLCs and the like, not on “close corporations.”

A fourth large-scale trend is the federalization of much corporate law litigation. The rise of securities fraud class actions, and the unanticipated morphing of such actions in response to the strictures of the Private Securities Litigation Reform Act of 1995, is an important reality of corporate law practice, as is the growing role of the SEC and the Department of Justice in addressing major accounting scandals. Fortunately, dealing with
such developments in a new treatise would be a rather straightforward matter of adding new sections or a new chapter, and making liberal use of the insights of scholars like Merritt Fox and Bob Thompson, both of whom, in their contributions to this symposium, demonstrate their insightful appreciation of this big trend.

A fifth, more recent trend is the sharp rise in regulatory concern about executive compensation. This trend is itself interesting to analyze in the context of the more general continuing evolution of Delaware case law that elaborates doctrine about the role and responsibilities of directors. My thin chapter on executive compensation needs a major remodeling and expansion, with significant attention given to the Disney litigation, investor activism, and possible SEC rule making.

As suggested, this “top five” list of major changes could be contested or amended. In any event, there are many other developments during the last two decades that qualify as important and worth discussing in a corporate law treatise. Among them are developments in director liability, gatekeeper liability, criminal law as applied to corporate actors, the role of general counsel, the difference in application of legal rules to officers as opposed to directors, social reporting and social responsibility resolutions, and foreign corporate law systems.

Trends in Scholarship

As I see it, there are at least three major lines of scholarship in the last two decades that should have their main themes reflected in a revised treatise.

The first is scholarship about competition among jurisdictions for corporate charters and comparative influence, and the related literature about the likelihood and extent of convergence of legal regimes governing corporations, both domestically and internationally. My sympathies in this area are with Henry Hansmann and Reinier Kraakman, but, as with so much else in debates about corporate law, what is most needed is good empirical evidence. Interestingly, there is now useful empirical work relevant to the debates, and some would have to be presented–succinctly and clearly, but usefully–in a new treatise.

A second scholarly trend was the continued development of contractualist accounts of the corporate form, and analyses of their limits. Mike Klausner’s perceptive presentation to this group is a fine example.

A third major scholarly trend is the continued production—or, more accurately, the surprising efflorescence–of scholarly writing about the purposes of corporations and the normatively desirable definition and allocation of powers and duties among shareholders, directors, and officers (such as the CEO). A striking majority of the contributions to this symposium either fit into this third category or have important consequences for the debates within it. Since it is in this category that I would like to venture some observations, I will return to their differing views in the second half of these remarks.

Trends in Business Practice

There are many trends in the business world that will eventually affect the evolution of corporate law and that ought to affect positive and normative analyses by corporate law scholars. Two such trends seem especially important to me.

The first trend concerns changes in stock ownership patterns. When I wrote
Corporate Law, the long term rise of institutional investors (measured, for example, by the percentage of all corporate stock held by financial intermediaries as opposed to individuals) and the long term spread of stock ownership (measured, for example, by the percentage of adults who have direct or indirect ownership of stocks) were recognized phenomena. (Indeed, much of my pre-treatise scholarship about financial institutions was based on fascination with these trends.) Scholars had begun to analyze and ponder the potentially great role of institutional investors in corporate governance.

What is now apparent, but was not obvious at the time, is that the trends have continued. The percentage of all stock held by institutions continued to grow, and the percentage of all adults with direct or indirect share ownership has also continued to grow. Moreover, certain subtypes of organizational investors have flourished in more recent times: private equity firms, venture capital firms, hedge funds, and the like. Interestingly, they are quite different in their funding sources from the older, classic examples of stock-investing financial intermediaries like mutual funds and pension plans, which aggregate the interests of numerous investors of often modest means.

As an apparent consequence of this difference, the hedge funds and their organizational investor cousins—the elite institutional investors, as I like to call them—tend to behave differently toward portfolio companies. They have displayed more activism, and/or a different kind of activism, toward company managers. The implications for the judicial elaboration of directors’ fiduciary duties and other aspects of corporate law have yet to be worked out. In my opinion, corporate law scholars have an historic opportunity to help shape the path of the law through this new and bewildering forest.

The second key trend in the business world has been the change in corporate capital structures, as a result of the financial innovations so well chronicled by Frank Partnoy and others. Like the change in stock ownership patterns and the rise of activist organizational investors, it poses problems for the law’s efforts to define and rank the beneficiaries of directorial duties, and to define the proper content of such duties.

Trends in the Academy

I cannot resist noting two other trends since publication of my treatise: the rise of sophisticated empirical scholarship (done by law professors as well as financial economists) bearing on policy debates in corporate law, and the substantial increase in the number of prominent women scholars of corporate law. In my view, both developments are extremely welcome, and have had important consequences. For example, my experience as long serving trustee of TIAA (and as a member and past chair of its corporate governance committee) convinces me that academically produced empirical work about the negative impact of classified boards on shareholder wealth has emboldened institutional investors to initiate or support resolutions calling for annual elections of all directors, and that these resolutions, which typically receive high votes,

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2. According to data reported on the New York Stock Exchange website, in 1952 about 6 percent of U.S. adults had direct or indirect shareholdings. In 1985, when the treatise was near completion, the figure was 28%; in 2002, it was 42%, or 84 million individuals. As the label “indirect” indicates, however, many of their shares are held by institutions, such as mutual funds and pension plans. Institutions now hold about half of publicly traded stock.
have eventually led to significant (though not overwhelming) change. The positive impact of women scholars is a subject about which I have various speculations, but I will leave them for another day.

TURNING AND TUSSLING IN THE WIDENING GYRE: PHILOSOPHICAL DEBATES ABOUT CORPORATE PURPOSE AND PARTICIPANTS’ ROLES

As noted earlier, a major trend in legal scholarship since the publication of my treatise has been the elaboration and defense of differing viewpoints about the purposes of corporations and the proper allocation of powers and duties among their constituents. This symposium dramatically illustrates the trend.

The continuum of diverse viewpoints is well represented. In his remarks, my esteemed colleague Lucian Bebchuk displayed his usual acuity and persistence in arguing the case for shareholder empowerment: in a myriad of ways, he believes, the law governing U.S. corporations should make it easier for shareholders to replace boards of directors, hold them to account, and set the basic rules of the game. Henry Hansmann’s article reaffirms and updates his argument (made with Reinier Kraakman) for the ascendancy of the shareholder primacy model, which affirms that boards of directors have fiduciary duties to enhance shareholder wealth, but which, as a strictly logical matter, need not entail so much shareholder empowerment as Lucian desires. Steve Bainbridge, were he here, would lead the charge for director primacy, which is in apparent tension with the Bebchuk view but is not incompatible with the Hansmann and Kraakman view. Ethan Stone presented an analytical project on the fiduciary duties of directors. A seat placed cleverly to the right of even the strongest director primacy view has been created by Charles O’Kelley, whose intriguing paper advocates a new perspective on the CEO’s properly powerful role as a large firm’s version of the entrepreneur. Frank Partnoy, who is acutely aware of the capital market’s creation of new and complex securities since the publication of my treatise, makes the case, in effect, for broadening the shareholder primacy model to a security holder primacy model, along with such arresting ideas as a sliding scale model of fiduciary duties that is similar to, but broader than, the notions developed in the “vicinity of insolvency” cases of recent years.

As we have come to expect, Margaret Blair and Lynn Stout expertly represent and advance a much broader stakeholder model and the conception of the board as mediator among stakeholders and, consequently, as protector of specific investments in business firms. Lisa Fairfax, in her intriguing piece, points to the literature on the impact of rhetoric on behavior, and thus offers reason to believe that the stakeholder model can have some positive reality and room for growth. Jill Fisch offers a thoughtful perspective on why empirical work should go beyond searching for the effects of regulatory policy on shareholder wealth. Her basic viewpoint does not necessarily entail a stakeholder model of directors’ duties, but it does push toward a stakeholder model for assessing the state’s total regulatory impact on corporations.

I will offer three observations about this extraordinary array of scholarly viewpoints about fundamental issues in corporate law.

First, in many respects, the scholarly debate does not echo issues that preoccupy corporate managers and directors or the lawyers and judges who interact with them. This is most true of the fundamental divide, that between shareholder primacy models and
stakeholder models. Unless my experience in serving as director of public companies and conferring with many other directors is wildly unrepresentative, it does not appear that corporate boards ever struggle with the issue. Directors and officers simply assume or state that the main effort is to maximize shareholder value, and that other groups must be kept happy enough to achieve this goal. Talk of good corporate citizenship is common on websites promoting a company’s charitable giving and other activities within the local community, but the tenor of board meetings and quarterly conference calls with the investment community—both of which occupy vast portions of managers’ mental space—is strikingly different. Granted, this observation does not imply that we academics, who are paid to take the long view and ponder key assumptions, should disengage from our inquiries into the subject. But it does raise questions about why the world is as it is, and it should help define the perspective in which we view the academic debate.

My second observation may help to explain the first. Properly formulated and qualified, the traditional shareholder primacy model is only modestly (though really, and perhaps importantly) different from a stakeholder model.

This point requires elaboration. In a memorable formulation of the debate,3 Bill Allen described two models of the corporation: a property conception of the corporation—sometimes called the traditional view—in which the corporation’s purpose is to increase its owners’ (i.e., shareholders’) wealth, and the directors’ duty is to maximize shareholder wealth; and a conception of the corporation as a social institution, in which the corporation’s purpose is to promote the general welfare and directors have a duty of loyalty to all constituencies interested in or affected by the corporation. Something like this dichotomy informs the writing of many scholars who deal with the fundamental issues. In my view, though, it wrongly conflates or combines two very different issues by proceeding as if “corporate purpose” and “directors’ duties” go together and should share a similar world view.

I can make this point more clearly by proposing what I will call Clark’s Restatement of the Traditional View. It expands or qualifies points made in my treatise (see § 16.2), and has several components:

1. It is not usually helpful to speak of a corporation’s “purpose.” Policymakers should consider the total impact of corporations on social welfare,4 and in doing so should consider their effects on all affected constituencies. But they should consider directors’ duties as a separate issue.

2. In general, elected legislators (not corporate boards) are the actors who should attempt to structure laws so as to optimize the total impact of corporations on human welfare. Doing so will involve many guesses and many kinds of laws.

3. A for-profit corporation’s directors have a fiduciary duty to maximize shareholder value, subject to several important constraints (items a, b, and c below) and important caveats (items d and e):

   a. Directors may and should cause their corporation to obey the law, even when the risk of detection and punishment seems low.

4. In this respect, I strongly support the position developed by Jill Fisch in her paper.
(b) Directors may and should cause their corporation to meet all of its legal obligations to non-shareholder constituencies, such as creditors, employees, suppliers, customers, taxing authorities, and so forth.

Since legal obligations may be created in a staggering variety of ways—by contracts, common law, statutes, regulations, rulings, case law interpretations, and so forth—the scope and impact of this often unstated caveat to the shareholder primacy viewpoint are enormous. A major segment of my treatise, § 1.4, was designed to elaborate this simple but critical point and drive it home to law students who, understandably in view of their lack of exposure to the multitudes of rules confining corporations, often proceed to talk about corporate purpose and directors’ duties as if they didn’t exist. Subsequent experience with academic debates have made me wonder if many of us ever escape the mental compartmentalization exhibited by new students of corporate law.

(c) Directors should cause their corporation to respond to market, social, and normative forces in such a way as to keep non-shareholder constituencies optimally involved in the corporation’s business.

For example, directors may properly consider the problem of protecting the firm from loss of “specific investments,” and such considerations may lead them to grant conditions and benefits to employees that go beyond those legally required, so long as they judge that such actions are likely to enhance shareholder value. Similar considerations may properly lead them to cause the corporation to act as a “good citizen” when anticipating or responding to community groups. Since such decisions are genuinely matters of judgment rather than decisions to fulfill reasonably clear and fixed legal obligations, directors ought to be protected by the business judgment rule when making them.

(d) Directors may cause their corporation to engage in charitable giving (which is authorized in all states).

(e) Directors may cause their corporation to cease participating in clearly and seriously unethical actions (e.g., genocide, apartheid), even when continuing them is profit maximizing and not clearly illegal under applicable law.

This caveat may be called the “matters of conscience” exception. Perhaps not all traditionalists would agree with including it, since it is hard to define and risks being over-expanded, but they should.

Each and every element of this Restatement calls for explanation, justification, and refinement, which cannot be ventured here. I note only a few points. Proposition 3, along with its constraints and caveats, is presented as a normative aspiration that may approximate the state of the law in key jurisdictions like Delaware. It probably conflicts with, and thus rejects, the constituency statutes adopted by many other states. A more important point for present purposes is that this full-form Proposition 3 might not seem to differ obviously or greatly in its practical operation from the Blair and Stout model of a stakeholder-oriented board. One might therefore question the point of continuing to begin a framing of directorial duties by referring to fiduciary duties to enhance shareholder value. Given all the caveats and constraints (especially “c”), what difference does it make? Why might this restated and properly qualified view of shareholder primacy be a better formulation of directorial duties than a pure stakeholder view?
The usual answers, developed in my treatise (at § 16.2.1) and to which I still subscribe, are two. (1) It promotes better monitoring of the performance of corporate directors and officers, since it is easier to judge whether the managers of a particular entity are promoting a more or less objective unitary goal than to judge whether they are optimally promoting multiple and hard-to-compare interests. (Similarly, this aspect of the case for fiduciary duties to shareholders also helps to explain and justify giving voting rights in director elections only to shareholders.) Yes, the caveats and constraints, along with more practical problems, mean that monitoring performance is very difficult and imperfect, but not as much as when there is no unitary benchmark. (2) Focusing boards on shareholder interests locates public policy-making about corporations—which policy-making should and does include concern for all constituents affected by corporations—in a better place than the boardroom, namely, in elected legislatures.

Granted, these reasons can be contested in many ways, such as by the activist’s claim that public policy-making is imperfect and afflicted by biases, so it is socially wise to diversify its placement in a variety of settings outside legislatures. In the end, choosing one model of directorial duties over another is a matter of judgment—or the upshot of a kind of natural selection in business history.

My third observation is that the phenomena most likely to create, in the real world of practice and judicial law making, serious interest in, and controversy about, the proper legal role and duties of directors are the trends on the investor side: the rise of elite institutional investors like activist hedge funds and the growth of complex financial instruments highlighted by Frank Partnoy. More and more, these developments are presenting boards and managers with challenges that are often perceived as creating a need to choose one kind of shareholder or investor interest over another.

Consider a real and prototypical case. A private equity fund buys stock, threatens a proxy contest, and demands a large share buyback program framed as a self tender offer (which of course will yield the fund and others a premium price—shared greenmail, one might say). Institutional investors like mutual funds, who would like to stay invested in the company but not suffer from the company’s paying a large premium to outgoing shareholders, oppose the buyback as a bad idea. The board of directors must decide what to do, thereby choosing sides, and ideally will fit its choice into an articulated conception of its fiduciary duties. At some point courts are likely to be called upon to evaluate the articulated conception of this board or similarly situated ones. The law of fiduciary duties may be fought over, rethought, and spelled out in extremely interesting new ways to deal with intra-shareholder and intra-security-holder conflicts. Astute corporate law scholars will have a chance to propose the definitive analysis and the ideal solution.

And perhaps these future legal and scholarly developments will be ripe for inclusion in a new edition of my treatise.