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Tyler: Tyler: Other Constituency Statutes

# Other Constituency Statutes\*

Richard B. Tyler\*\*

## I. INTRODUCTION

The takeover phenomenon of the 1980s resulted in a massive "releveraging" of American industry.<sup>1</sup> In addition to the profound impact on the companies directly involved and those that undertook drastic measures to avert being taken over, this "releveraging" has markedly affected groups outside the corporations involved, such as employees, suppliers, customers, and communities.<sup>2</sup> To meet the debt-service obligations flowing from leveraged buy-outs,

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1. Clifford L. Whitehill, *The American Law Institute Tentatively Approves Part VI of its Corporate Governance Project*, in NATIONAL LEGAL CENTER FOR THE PUBLIC INTEREST, THE AMERICAN LAW INSTITUTE CORPORATE GOVERNANCE PROJECT IN MID-PASSAGE: WHAT WILL IT MEAN TO YOU? 113, 120-22 (1991) (hereinafter "Whitehill"); Roberta S. Karmel, *Is It Time for a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 62 n.34 (1991); Deborah A. DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L.J. 517, 517 & n.4 (1988). The "releveraging" resulted from the use of non-investment grade ("junk") bonds and other debt and debt-like instruments to finance hostile takeovers in leveraged buy-outs ("LBOs"), as well as the use by companies, which feared that they might be targets of hostile takeovers, of similar devices to eliminate public shareholders in management buy-outs ("MBOs")—the "going private" phenomenon. For a good illustration, as well as a good read, see BRIAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE* (1990).

To be sure, a fair amount of scholarly opinion defended the high levels of debt as a mechanism to compel management to work harder in order to service the debt. See Karmel, *supra*, at 63 n.37.

2. Whitehill, *supra* note 1 at 123-24; James Lyons, *Conflicting Interests*, FORBES, Mar. 30, 1992, at 48; Jonathon R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173 (arguing that stakeholders are not, in fact, harmed by hostile takeovers, and that they are capable of protecting themselves contractually). *Contra*, John C. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986). See also *Deals and Misdeals: A Sampling of M&A Hits and Strikeouts in the 1980s*, MERGERS AND ACQUISITIONS, March/April 1990, at 100 (a review of the results of a decade's combinations).

many of which were financed with high-risk, noninvestment grade ("junk") bonds, companies "restructured"; employees lost their jobs,<sup>3</sup> older facilities were closed to the detriment of communities dependent on them,<sup>4</sup> existing bondholders found their claims downgraded or felt their security jeopardized,<sup>5</sup> and existing suppliers and customers found their relationships disrupted, if not dismantled entirely.<sup>6</sup> Existing federal law<sup>7</sup> sought to provide some protection for shareholders faced with deciding whether to tender, but nothing spoke directly to the concerns of these other groups; their concerns remained the focus of state law, such as statutory and common corporate law and the law of contract and fraudulent conveyance.

Unfortunately, neither state corporation laws nor the common law rules applicable to corporations addressed these issues. Most statutes simply said that

3. Annie B. Fisher, *Employees Left Holding the Bag*, FORTUNE, May 20, 1991, at 83; Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 45 & n.4 (1991). See also Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1003 nn.136 & 137 (1993). Perhaps an even more threatening development has been the extent to which acquirors have used employee pension funds to finance takeovers, and the resulting risk to retirees, both current and future. See, e.g., Christi Harlan, *LTV's Pension Liabilities Aren't Favored, Judge Says*, WALL ST. J., Sept. 16, 1991, at A3 (reporting that a federal judge had ruled that LTV's underfunded pension plan should not be accorded preferred status in a bankruptcy proceeding following a merger that involved assuming a substantial amount of debt, as well as using "excess" reserves in the pension fund). See also Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65; Jonathon M. Moses & Milo Geyelin, *RJR to Pay \$72.5 Million to Settle Suit*, WALL ST. J., Feb. 26, 1992, at B8 (reporting RJR's agreement to settle a class-action suit brought by former shareholders and employee stock-option holders who charged that the company failed to disclose takeover talks in the months preceding its LBO).

4. See Bainbridge, *supra* note 3, at 1004 & n.141; Joseph William Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 633-63 (1988). See also Arthur S. Hayes, *Companies Are Finding it Harder to Move Out of Town*, WALL ST. J., March 1, 1993, at B6, col. 1, mentioning, *inter alia*, a suit brought by the city of Ypsilanti against General Motors to block its planned closure of the Willow Run facility after the town had granted GM tax abatements in 1980. Although a trial court found for Ypsilanti, the Michigan Court of Appeals reversed. See *Ypsilanti v. General Motors Corp.*, 506 N.W.2d 1 (Mich. Ct. App. 1993).

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

In fact, the LBO phenomenon resulted in a massive shift of wealth from bondholders to shareholders. See, e.g., Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 206-09 (1988); ROBERT W. HAMILTON, CORPORATION FINANCE: CASES & MATERIALS 408-409 (2d ed. 1989) (recounting the downgrading of RJR Nabisco, Inc.'s outstanding bonds after its LBO).

6. Macey, *supra* note 2, at 173-174.

7. Williams Act, §§ 13(d)-(e), 14(d)-(f) of the Securities Exchange Act of 1934, codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988).

the business and affairs of the corporation would be managed by, or under the direction of, a board of directors<sup>8</sup> without specifying how the directors were to carry out their functions. This omission was left to common law.<sup>9</sup> The traditional obligations of directors, the duty of care<sup>10</sup> and the duty of loyalty,<sup>11</sup> supplemented by the business judgment rule,<sup>12</sup> run to the corporation and apply to all of the actions of the directors, including their response to takeover bids. Thus, in most jurisdictions, it was not clear that, in deciding how to respond to a takeover proposal, a board could consider the potential impact on constituencies outside the corporation. *Cheff v. Mathes*<sup>13</sup> did permit a board to justify a decision to buy out the interest of an unwanted shareholder because of concern for the interests of employees and the company's customers and suppliers, but that was a relatively unusual case.<sup>14</sup>

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8. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991); MO. REV. STAT. § 351.310 (1988) ("property and business"); MODEL BUSINESS CORPORATION ACT § 35 (1979) [hereinafter "MBCA"]; REVISED MODEL BUSINESS CORPORATION ACT § 8.01(B) (1984) [hereinafter "RMBCA"].

9. Some statutes, such as MBCA § 35 and RMBCA § 8.30, and statutes patterned after them (*e.g.*, IND. CODE ANN. § 23-1-35-1 (Burns 1989), based on § 8.30 of RMBCA) *did* specify directors' duties, but these specifications were generally patterned on the rules that evolved in the cases.

10. Usually phrased as the duty to act with that degree of care that would be exercised by a reasonable prudent person in a similar situation under similar circumstances. *See, e.g.*, *Boulicault v. Oriol Glass Co.*, 223 S.W. 423, 426 (Mo. 1920); MBCA § 35. ROBERT CHARLES CLARK, CORPORATE LAW § 3.4, at 123 (1986); PHILIP G. LOUIS, JR. & FRANK C. BROWN, 25 MISSOURI PRACTICE: BUSINESS ORGANIZATIONS § 24.3 (1993).

11. The duty of loyalty essentially addresses conflict of interest situations: directors owe their highest degree of loyalty to the corporation; they must not place themselves, or allow themselves to be placed, in a position in which their personal interests conflict with that of the corporation. *See generally* *Ramacciotti v. Joe Simpkins, Inc.*, 427 S.W.2d 425 (Mo. 1968); *Binz v. St. Louis Hide & Tallow Co.*, 378 S.W.2d 228 (Mo. Ct. App. 1964); CLARK, *supra* note 10, § 4.1 at 141; LOUIS & BROWN, *supra* note 10, § 24.4.

12. The business judgment rule says that when a matter is committed to the discretion of the board of directors, and the board, in good faith, exercises a business judgment, a court will not examine the merits of the decision, or second-guess the board. CLARK, *supra* note 10, § 3.4, at 123; LOUIS & BROWN, *supra* note 10, § 24.9. *See generally* *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Broski v. Jones*, 614 S.W.2d 300 (Mo. Ct. App. 1981).

13. 199 A.2d 548 (Del. 1964).

14. Other cases that appear to recognize the idea that corporations have responsibilities to groups in addition to shareholders include, *e.g.*, *Universal Leaf Tobacco Co. Inc. v. Congoleum Corp.*, 554 F.2d 1283 (4th Cir. 1977); *Herald Co. v. Seawall*, 472 F.2d 1081 (10th Cir. 1972); *Boyetown Burial Casket Co. v. Amedco, Inc.*, 407 F. Supp. 811 (E.D. Pa. 1976); *Elco Corp. v. Microdot, Inc.*, 360 F. Supp. 741 (D. Del. 1973); *Abramson v. Nytronics, Inc.*, 312 F. Supp. 519 (S.D.N.Y. 1970); *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968). *See generally* *Macey, supra* note 2, at 177-78.

Some states, like Delaware and Missouri, did elaborate on director's standards of

Then, in 1985, the Delaware Supreme Court decided *Smith v. Van Gorkom*<sup>15</sup> and imposed personal liability on a board of directors that had acceded too readily to a friendly merger proposal originally initiated by Van Gorkom, the autocratic chief executive officer of the company being acquired. The Delaware court refused to give the directors the benefit of the business judgment rule because, it held, their judgment was not informed.<sup>16</sup> The court imposed liability on the directors for the difference between the merger price and a "fair" price, and remanded for a determination of that amount; although it was ultimately settled, without an evidentiary hearing, for \$23.5 million,<sup>17</sup> it created a certain amount of consternation in boardrooms across the country.<sup>18</sup> It also allegedly contributed to a marked increase in the premiums for director's and officer's liability policies ("D&O policies").<sup>19</sup> Managements became more interested in

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behavior in their indemnification statutes. DEL. CODE ANN. tit. 8, § 145 (1991); MO. REV. STAT. § 351.355 (Supp. 1993). These provisions specify the circumstances under which officers and directors may be indemnified for claims brought against them as a result of their performance as directors and officers, and so prescribe standards of behavior in a back-handed fashion. But, essentially, these only require that the individual seeking indemnification have acted in good faith, and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation, if the action is brought by a third party. If the action is brought by or in the right of the corporation (e.g., a shareholder's derivative action), there is the added proviso that no indemnification may be made with regard to any claim as to which the person has been adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation, unless the court before which the action was brought determines that, notwithstanding the judgment of liability, it is fair and reasonable to indemnify that person.

15. 488 A.2d 858 (Del. 1985).

16. The board, all of whom had served on the target's board for several years and were familiar with the company's unsuccessful efforts to find a merger partner or otherwise extricate itself from a capital squeeze situation, had approved the proposed merger, which was not an arm's length transaction, on the basis of a two-hour meeting during which they heard a presentation from the CEO (who, recall, had instigated the transaction and suggested the price), but did not see the actual documents, or attempt to verify the adequacy of the price, "shop" the company, or take other action to give the appearance of independent bargaining.

17. Apparently, \$10 million was covered by insurance, \$10 million paid by the corporate purchaser or an affiliate, and the directors paid the rest. See LARRY D. SODERQUIST & A.A. SOMMER JR., *CORPORATIONS: CASES, MATERIALS AND PROBLEMS* 206 (3d ed. 1991).

18. See Laurie Baum, *The Job Nobody Wants*, BUS. WK., Sept 8, 1986, at 56; Mauro, *Liability in the Boardroom*, NATION'S BUS., May 1986, at 45-46. One response to this concern, now adopted in some 40 states, was to secure legislation permitting corporations to adopt provisions in their articles of incorporation limiting or eliminating directors' liability. See, e.g., CAL. CORP. CODE § 309(c) (West 1990); DEL. CODE ANN. tit. 8, § 102(b)(7) (1991); IND. CODE ANN. § 23-1-35-1(e) (Burns 1989); RMBCA § 8.30(d). That movement is beyond the scope of this Article.

19. SODERQUIST & SOMMER, *supra* note 17, at 207 n.20.

having a statutory basis to permit them to consider a broadened range of factors, particularly when responding to takeover proposals, and, with a little prompting from the Delaware Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>20</sup> "other constituency" statutes came into being. Such statutes arguably reflect a public policy of encouraging managers to consider the effects on groups in addition to shareholders in determining whether or not a particular action is in the best interests of the corporation. Of course, directors could only raise the argument that they were acting in the interests of some other constituency if the minutes of their deliberations reflected that such considerations actually were taken during the board's discussion of the proposed action, but that should pose no problem for boards of directors acting under the advice of experienced counsel.<sup>21</sup> Further urgency was provided as disappointed shareholders began bringing suits against directors who successfully resisted merger proposals.<sup>22</sup>

Of course, the push for antitakeover legislation was already well established—the earliest ("first generation") statutes dated from the late 1960s.<sup>23</sup> When these were struck down in *Edgar v. Mite Corp.*,<sup>24</sup> the proponents of this

Shortly after *Van Gorkom*, a director of the leading directors' liability insurer at Lloyd's of London said, "Any buyer who thinks the cost of his insurance will only double is a dreamer." Newport, *Protecting Directors Suddenly Gets Costly*, FORTUNE, Mar. 18, 1985, at 61. Two years after *Van Gorkom*, Korn/Ferry International estimated that the premiums for directors' liability insurance "went up more than 900 percent in just two years." Powell, *Is It Safe to Go Back in the Boardroom?*, NEWSWEEK, May 4, 1987, at 45, 46.

See also Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989), reporting that, in spite of all the attention the case received in the business community, it did not affect the market value of Delaware corporations. They also note that D&O insurance premiums increased more than twelvefold in the year the *Van Gorkom* decision was rendered, and that the common stock of firms writing D&O insurance rose significantly. *Id.* at 73. The authors suggest that insurers were able to increase premiums beyond the actuarial fair amount. *Id.* at 75.

20. 506 A.2d 173 (Del. 1986).

21. That is not to suggest that counsel would falsify minutes of meetings, but only to recognize that experienced counsel, being aware of the possibilities, would ensure that such considerations were actually raised, and reflected in the minutes of the board's deliberations. Then, the argument can be raised that particular action was taken in consideration of these other groups. Less experienced counsel might not take such precautions.

22. See, e.g., *Panther v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

23. See, e.g., Donald C. Langevoort, *State Tender-Offer Legislation: Interests, Effects, and Political Competency*, 62 CORNELL L. REV. 213 (1977); Mark A. Sargent, *On the Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689 (1981); Diane S. Wilner & Craig A. Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1 (1976).

24. 457 U.S. 624 (1982) (invalidating the Illinois first generation statute). Lower

legislation went back to the drawing board and continued tinkering with state laws. It was natural to think of adding consideration of other constituencies to the arsenal of weapons being forged to resist takeovers. Apparently permission for directors to consider other constituencies in the context of mergers and business combinations first appeared in the articles of incorporation of Control Data Corporation in 1978.<sup>25</sup> For once, the interests of management began to coincide with those of organized labor, which had become concerned at the job losses resulting from LBOs. This coalition began to lobby state legislatures for legislation permitting or requiring directors to take the interests of other constituencies into account in deciding how to respond to takeover proposals.<sup>26</sup> Large bondholders—institutional lenders—who saw the value of their senior bonds degraded by the insertion of large amounts of junior debt into the capital structures of their debtor corporations also began to demand some sort of protection, and other constituency statutes seemed like a possible avenue.<sup>27</sup>

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courts promptly relied on *Edgar* in striking similar statutes. See *National City Lines, Inc. v. LLC Corp.*, 687 F.2d 1122 (8th Cir. 1982) (invalidating Missouri's first generation statute).

25. See, e.g., Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121, 149 (1991); A.A. Sommer, *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 39 (1991).

26. See John C. Coffee Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Minimum Standards*, 8 CARDOZO L. REV. 759, 770 & n.28 (1987) (concluding that in New York, labor actively supported such legislation); Kenneth B. Davis Jr., *Epilogue: The Role of the Hostile Takeover and the Role of the States*, 1988 WIS. L. REV. 491, 493-497 (discussing Wisconsin antitakeover legislation); Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STETSON L. REV. 197, 220 (1991) (noting that the Pennsylvania Chamber of Commerce and the AFL-CIO co-sponsored the 1990 amendments to Pennsylvania's other constituency statute). Minow also notes that, by October 17, 1990, nearly one-third of Pennsylvania's publicly traded companies had opted out of at least some provisions of the bill; indeed, she says that over 61% of the Fortune 500 companies incorporated in Pennsylvania had opted out, as had over 56% of those included in the Standard & Poor 500. *Id.* See also John C. Coffee Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders, and Bust-ups*, 1988 WIS. L. REV. 435, 437 & n.8. But see Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 134-38 (1987) (report of her study of the adoption of antitakeover measures in Connecticut, in which she concluded that there was no broad-based coalition of stakeholders; rather, the legislation was special interest legislation enacted at the behest of the incumbent managers of certain powerful corporations).

27. See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989); James J. Hanks Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 116 (1991) (noting that many other constituencies—like creditors—may be protected by fraudulent conveyance statutes, as well as by contract, and noting that many lenders now include in loan documents provisions to deal with "event risks"); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate*

Several state legislatures responded by adopting other constituency statutes, permitting<sup>28</sup> or requiring<sup>29</sup> directors to consider the impact of a takeover on groups in addition to the shareholders; some specified particular groups,<sup>30</sup> whereas others phrased the permission more generally.<sup>31</sup> Some statutes took the approach of including such provisions in sections specifying the standards of directors' behavior in general;<sup>32</sup> most are applicable to directors' obligations in contexts other than takeovers.<sup>33</sup> Some statutes limit this consideration to responding to takeovers.<sup>34</sup>

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*Fiduciary Duties*, 21 STETSON L. REV. 23, 40 & n.35 (1991); McDaniel, *supra* note 25, at 125-26.

28. See e.g., FLA. STAT. ANN. § 607.0830(3) (West 1993); GA. CODE ANN. § 14-2-202(b)(5) (1990); HAW. REV. STAT. § 415-35(b) (Supp. 1992); IDAHO CODE § 30-1602 (Supp. 1993); 805 ILL. COMP. STAT. ANN. 8/85 (Smith-Hurd 1993); IND. CODE ANN. § 23-1-35-1(d),(f),(g) (Burns 1989); IOWA CODE § 491.101B (1993); KY. REV. STAT. ANN. § 271B.12-210(4) (Baldwin Supp. 1992); LA. REV. STAT. ANN. § 12:92(G)(2) (West Supp. 1991); ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 1993); MASS. GEN. LAWS ANN. ch. 156B § 65 (West 1992); MINN. STAT. ANN. § 302A .251(5) (West Supp. 1994); MISS. CODE ANN. § 79-4-8.30(d) (Supp. 1993); MO. REV. STAT. § 351.347(4) (Supp. 1993); NEB. REV. STAT. § 21-2055(1)(c) (Supp. 1990); N.J. STAT. ANN. § 14A:6-1(2), -14(4) (West Supp. 1993); N.M. STAT. ANN. § 53-11-35(D) (Michie Supp. 1992); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1994); OHIO REV. CODE ANN. § 1701.59(E) (Anderson 1992); OR. REV. STAT. § 60.357(5) (1993); PA. CONS. STAT. §§ 1711-1712, 1715-1717, 1721 (1993); R.I. GEN. LAWS § 7-5.2-8 (1992); S.D. CODIFIED LAWS ANN. § 47-33-4 (1991); TENN. CODE ANN. § 48-35-204 (1988); WIS. STAT. ANN. § 180.0827 (West 1992); WYO. STAT. § 17-16-830(e) (1977).

See Appendix, 21 STETSON L. REV. 279 (1991), for the texts of the statutes existing as of 1991.

29. CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1993).

30. E.g., *id.*; FLA. STAT. ANN. § 607.083(3) (West 1993); MO. REV. STAT. § 351.347 (Supp. 1993).

31. E.g., ARIZ. REV. STAT. ANN. § 10-1202 (Supp. 1993).

32. E.g., FLA. STAT. ANN. § 607.0830(3) (West 1993).

33. Bainbridge, *supra* note 3, at 986 n. 83, reports that only Connecticut, Iowa, Louisiana, Missouri, Oregon, Rhode Island, and Tennessee limit their nonshareholder constituency statutes' effect to corporate acquisitions. As indicated in notes 34 & 35, *infra*, the Missouri provision has been broadened to include *any* exercise of business judgment.

34. E.g., MO. REV. STAT. § 351.347 (as originally adopted in 1986) (amended 1989). This is also the approach taken by the American Law Institute. See ALI PRINCIPLES OF CORPORATE GOVERNANCE § 6.02(b)(2) (Proposed Final Draft, March 31, 1992).



Missouri's approach was initially limited to the takeover context.<sup>35</sup> In 1989, however, the scope was expanded to apply to *all* exercises of business judgment.<sup>36</sup> To date, there has been no judicial interpretation of this statute or any of the other similar statutes, and so the question remains whether these statutes have any significance at all. More generally, how should courts treat these sorts of statutes, which exist now in at least twenty-eight states?<sup>37</sup>

This Article will use the Missouri experience as a point of departure to consider what the legal effect of "other constituency" statutes might be. Recognizing that "other constituency" statutes were adopted along with other statutes clearly aimed at deterring unwanted takeovers, those other statutes will also be discussed. First, the Missouri law relating to corporate governance prior to the enactment of the package of Missouri legislation that includes the other constituency statute will be examined, including the legislative history of these statutes and the sources from which they seem to have been drawn. Next, this Article will consider whether, and to what extent, the changing nature of the corporate shareholder population should affect the interpretation of such statutes. This will require some digression into the "nexus of contracts" approach to corporate theory and some counter-arguments to this approach. The effect of these statutes on different classes of corporations—"close" to public—is then considered. The next area of inquiry treats some of the problems with these statutes: their permissive nature and their ambiguity. A distinction may be taken between "structural" and "operational" decisions, but both pose conflict of interest problems for directors. This raises questions as to the applicability of the business judgment rule and, hence, the other constituency statutes. Following that, this Article considers which constituencies merit consideration,

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35. MO. REV. STAT. § 351.347 (1986) read:

1. In exercising its business judgment concerning any acquisition proposal, as defined in subsection 2 of this section, the board of directors of the corporation may consider the following factors among others:

....

(4) Social, legal and economic effects on employees, suppliers, customers and others having similar relationships with the corporation, and the communities in which the corporation conducts its businesses;

....

3. Nothing in this section shall require any director or corporation to respond to any particular acquisition proposal.

36. In 1989, Subsection 3 was modified to read:

3. Nothing in this section shall require any director or corporation to respond to any particular acquisition proposal nor preclude directors, in exercising their business judgment in other contexts, from considering factors such as those enumerated in subsection 1 of this section.

MO. REV. STAT. § 351.347.3 (Supp. 1993). However, the title to this section remains, "Acquisition proposals, board may make recommendation."

37. See Appendix, 21 STETSON L. REV. 279 (1991).

and then looks to the various contexts—ranging from hostile takeover bids to routine business decisions—in which these statutes might come into play.

Returning to a supposed motive for adoption of these statutes, concern about imposing Draconian liability on boards of directors, this Article analyzes the possible effect of these statutes on director liability. This leads into a brief consideration of some possible rationales for imposing liability on directors, their interaction with statutes permitting corporations to indemnify officers and directors, and some possible alternative remedies. A consideration of the sorts of liabilities for which indemnification might be considered, and others for which it would not be appropriate, follows, leading to the question of how directors' liability might be limited, if that is desired. Finally, this Article concludes by noting that these statutes are so flawed that they should be repealed and suggests some other approaches to realigning the system of corporate governance.

## II. PRIOR MISSOURI LAW

Historically, Missouri statutes did not specify the standards of behavior expected of directors, at least not directly. Rather, the statute provided that the "property and business" of the corporation were to be "controlled and managed" by a board of directors.<sup>38</sup> The only express liability section in the statute imposed personal liability on directors who knowingly declared and paid a dividend other than as provided in the dividend statutes.<sup>39</sup>

The statutory provision for indemnification of directors,<sup>40</sup> which was similar to that of Delaware,<sup>41</sup> provided some guidance for directors. With regard to suits brought by outsiders against a person because of serving as a director, the statute permits indemnification if the director acted in good faith and in a manner the director reasonably believed to be in, or not opposed to, the best interests of the corporation—essentially a "good faith, reasonable belief" standard. When an action was brought by or on behalf of the corporation, a director could be indemnified according to the same standard, with the added proviso that no indemnification could be paid with respect to any claim for which the director was adjudged liable for negligence or misconduct unless the court determined that, in spite of the negligence or misconduct, the director was fairly and reasonably entitled to indemnification. This adds some element of care, or at least non-negligent behavior, to the good faith, reasonable belief standard in those cases in which suit is brought by or on behalf of the corporation. Also, the statute authorizes the corporation to purchase insurance on behalf of its

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38. MO. REV. STAT. § 351.310 (1986).

39. *Id.* § 351.345 (1986).

40. *Id.* § 351.355 (1986).

41. DEL. CODE ANN. tit. 8, § 145 (1991).

directors;<sup>42</sup> in that context, the insurance carriers may impose certain standards on directors' behavior. However, the statute also says that it is not exclusive,<sup>43</sup> so that a director could seek to contract for greater indemnification as a condition to accepting a directorship. Of course, a court might impose public policy limits on the extent to which indemnification in excess of that permitted by statute should be allowed, but it is unclear just when such limits would be invoked.<sup>44</sup>

Thus, based on the statutes, a director knew that he could incur liability if he knowingly declared a dividend other than as authorized by law, although that was qualified by permitting him to rely on financial information prepared by company officials whom he believed to be reliable. He knew that he should be indemnified for any action brought by anyone other than the corporation or someone suing on its behalf if he acted in good faith, and reasonably believed that the action was in the corporation's best interests. Even in the case of actions brought by or on behalf of the corporation, he could be indemnified if, in addition, he was not guilty of negligence or misconduct; even if his behavior did not meet that standard, a court might still allow indemnification. Misconduct is fairly easy to identify, but "negligence" is a somewhat slipperier concept. There is also considerable slack in the concept of "good faith," and "reasonable belief" is "soft" as well.

The real specification of standards of directors' behavior was the common law. Missouri courts tended to follow the common law of other states—initially Illinois, more recently Delaware. Consistent with that approach, the courts recognized duties of care and loyalty, and also recognized the business judgment rule as a complement to the duty of care. A director was expected to perform his functions with the degree of care that a reasonable person in a like situation would exercise under similar circumstances: a "reasonable, prudent director" standard.<sup>45</sup> The Missouri application of the business judgment rule is also quite traditional: when directors, in good faith and in the absence of fraud or self-dealing, exercise a business judgment, the courts will not examine the merits of that decision, unless the matter on which the directors acted was not one

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42. MO. REV. STAT. § 351.355(8).

43. *Id.* § 351.355(6).

44. Dicta in cases such as *Mooney v. Willys-Overland Motors, Inc.*, 204 F.2d 888 (3d Cir. 1953), suggested that Delaware courts might invalidate or refuse to enforce contracts inconsistent with the public policy reasons for allowing indemnification. *But see* *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339 (Del. 1983) (holding that a corporation may grant indemnification rights beyond those provided by statute); *Choate, Hall & Stewart v. SCA Serv., Inc.*, 495 N.E.2d 562 (Mass. App. Ct. 1986) (holding that contractual agreement obligating corporation to indemnify director for legal expenses was authorized under Delaware's nonexclusion provision, absent a finding that the director had violated any fiduciary duty owed to the corporation).

45. *Boulicault v. Oriel Glass Co.*, 223 S.W. 423, 426 (Mo. 1920).

committed to their discretion.<sup>46</sup> Although the Delaware court seems to have incorporated a standard of care into the "good faith" element,<sup>47</sup> the Missouri court has not yet done so explicitly.<sup>48</sup> The duty of loyalty runs to the corporation, and requires that the director avoid placing himself, or allowing himself to be placed, in a situation in which his personal interest conflicts with that of the corporation, *i.e.*, he must avoid conflicts of interest.<sup>49</sup> This is tempered, however, by the adoption, in 1983, of Missouri Revised Statute section 351.327 which, like section 144 of the Delaware Corporation Law, permits contracts between the corporation and interested officers or directors under specified circumstances.<sup>50</sup>

The difficulty in fleshing out these standards results from the relative paucity of cases decided in Missouri. Courts have been forced to look to decisions in other jurisdictions to resolve issues; not surprisingly, they have tended to look to Delaware, because of its comparatively rich body of case law. However, the decision in *Smith v. Van Gorkom*,<sup>51</sup> as well as others dealing with directors' responses to hostile takeover bids,<sup>52</sup> created concerns for corporate counsel. For example, the business judgment rule presumably applied to all aspects of directors' actions, including the response to takeover bids, at least insofar as the matter involves only the level of care required.<sup>53</sup> Nevertheless, the

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46. That is, if the matter was reserved for shareholder approval, a board's efforts to take action would be ineffective. Although there are no Missouri cases directly on point, two Delaware cases are illustrative. See *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 406 (Del. 1985); *Datapoint Corp. v. Plaza Sec. Co.*, 496 A.2d 1031, 1036 (Del. 1985). Moreover, the courts will conduct an antecedent inquiry into the directors' good faith and will determine whether fraud or self-dealing are present before conferring the protection of the business judgment rule. *Broski v. Jones*, 614 S.W.2d 300, 304 (Mo. Ct. App. 1981).

47. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

48. *LOUIS & BROWN*, *supra* note 10, § 24.3, at 536, notes the idea of due care involves some element of prudence, at least when the corporation in question is a financial institution. See *State ex rel. Moore v. State Bank*, 561 S.W.2d 722, 724 (Mo. Ct. App. 1978).

49. See *Chemical Dynamics, Inc. v. Newfeld*, 728 S.W.2d 590, 593 (Mo. Ct. App. 1987); *Binz v. St. Louis Hide & Tallow Co.*, 378 S.W.2d 228, 231 (Mo. Ct. App. 1964).

50. The transaction will be sustained if it is approved, after full disclosure of the details of the transaction and the conflict, by a majority of the disinterested directors (even though it be less than a quorum of the board), or by a majority of the shareholders, or if the court deems the transaction fair to the corporation as of the time it was approved. See DEL. GEN. CORP. L. § 144 (1993); MO. REV. STAT. § 357.327 (Supp. 1993).

51. 488 A.2d 858 (Del. 1985).

52. *E.g.*, *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1988); *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

53. *E.g.*, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). Of course, because tender offers raise serious conflict of interest issues for directors, courts are justified—required—in scrutinizing closely the directors' conduct to ensure that their

extent to which a director's business judgment could consider the effect of a particular action on constituencies other than shareholders was not clear, although there had been suggestions in some cases that such considerations were appropriate, as being in the long-term interests of the corporation.<sup>54</sup> Even then, however, the courts had given only limited consideration to the weight directors could accord to impacts on other constituencies. At least one influential court had said that consideration of other constituencies was permissible, so long as it did not detract from primary consideration of the interests of shareholders.<sup>55</sup>

These uncertainties lead to a search for legislation that might be more supportive of management, or at least provide the bases to argue that management's actions were proper.

### III. LEGISLATIVE HISTORY

Missouri has a long history of attempting to erect statutory takeover defense measures. The "first generation," the Missouri Takeover Bid Disclosure Act,<sup>56</sup> was held invalid under the Commerce Clause<sup>57</sup> following the Supreme Court's decision in *Edgar v. Mite Corp.*<sup>58</sup> The statute was amended in 1986<sup>59</sup> in an effort to eliminate the unconstitutional features, and has not been relitigated.

Meanwhile, in 1984, Senator Webster, then Majority Leader of the Missouri Senate, introduced Senate Bill 409, which amended several sections of the Business Corporation Act and added the Control Share Acquisition provision,<sup>60</sup> which provides that, unless a corporation "opts out" by a provision in its articles of incorporation, any acquisition of "control shares"<sup>61</sup> must be preauthorized by

action is not tainted by their self-interest, which would invoke the duty of loyalty and, hence, rule out the application of the business judgment rule.

54. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989); Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 168-170 (1991).

55. *Revlon*, 506 A.2d at 182.

56. MO. REV. STAT. §§ 409.500 - .566 (1978), adopted in 1978 Mo. Laws, S.B. 820. This was an addition to the Missouri Securities Act, and appears to have been patterned on the Illinois statutory scheme.

57. *National City Lines, Inc. v. LLC Corp.*, 687 F.2d 1122 (8th Cir. 1982).

58. 457 U.S. 624 (1982).

59. MO. REV. STAT. § 409.500 - .566 (1986).

60. MO. REV. STAT. § 351.407 (1986) (amended 1989).

61. MO. REV. STAT. § 351.015.(5) (Supp. 1993) provides:

"Control shares" means shares that, except for this chapter, would have voting power with respect to shares of an issuing public corporation that, when added to all other shares of the issuing public corporation owned by a person or in respect to which that person may exercise or direct the exercise of voting power, would entitle that person, immediately after acquisition of the shares, directly or indirectly, alone or as a part of a group, to exercise or direct the exercise of the voting power of the issuing public corporation in the

a vote of the shareholders of the target corporation or the control shares will have no voting rights. The bill specified procedures for obtaining the approval of the shareholders and gave dissenting shareholders appraisal rights. The bill was duly passed and signed by the governor.<sup>62</sup>

Then, in 1986, Senator Webster introduced Senate Bill 565.<sup>63</sup> As introduced, the bill was limited to amending the section of the Business Corporation Act relating to election and removal of directors.<sup>64</sup> Senate Bill 565

election of directors within any of the following ranges of voting power:

- (a) One-fifth or more but less than one-third of all voting power;
- (b) One-third or more but less than a majority of all voting power;
- (c) A majority or more of all voting power; . . .

MO. REV. STAT. § 351.015(4) (Supp. 1993) provides that "Control share acquisition" means the acquisition, directly or indirectly by any person of ownership of, or the power to direct the exercise of voting power with respect to, issued and outstanding control shares. . . ."

Finally, MO. REV. STAT. § 351.015(10) (Supp. 1993) defines "Issuing public corporation" to mean

[A] corporation incorporated under the laws of Missouri . . . that has: (a) One hundred or more shareholders; (b) Its principal place of business, its principal office, or substantial assets within Missouri; and (c) One of the following: [a] More than 10% of its shareholders resident in Missouri; [b] More than 10% of its shares owned by Missouri residents; or [c] 10,000 shareholders resident in Missouri. . . .

62. The effective date for the bill was June 13, 1984. In 1985, House Bill 117 attempted to extend § 351.407 to foreign corporations with substantial Missouri connections. The language was drawn so that only TWA qualified. That effort was held unconstitutional in *Icahn v. Blunt*, 612 F. Supp. 1400 (W.D. Mo. 1985), insofar as it applied to corporations not incorporated in Missouri. The case does not speak to the validity of § 351.407 as applied to Missouri corporations, but its validity is subject to challenge on the same basis as the federal court invalidated a voting-type "poison pill" in *Asarco, Inc. v. A Court*, 611 F. Supp. 468 (D.N.J. 1985) (applying New Jersey law)—it creates different voting rights among shares of the same class or series. *See also* *Ministar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985) and *Amalgamated Sugar Co. v. N.L. Indus., Inc.*, 644 F. Supp. 1229 (S.D.N.Y. 1986).

63. JOURNAL OF THE MISSOURI SENATE, 83rd Gen. Assembly, 2d Sess., 28 (1986).

64. MO. REV. STAT. § 351.315 (Supp. 1993). The amendment was to change subdivision 2 of that section, relating to removal of directors, to read:

*Unless otherwise specified in the articles of incorporation, [t]he entire board of directors may be removed, with or without cause, by a vote of the holders of a majority of the shares then entitled to vote at an election of directors. [emphasis added.]*

This would permit a corporation to provide, in its articles, that the board could be removed *only* for cause; it was thus part of the package of antitakeover reforms, because this would make it more difficult for successful bidders for control of the corporation to install directors of their own choosing immediately, and thus would serve as a deterrent to any attempt to acquire control of the corporation.

was referred to the Committee on Miscellaneous Bills, of which Senator Webster was a member.<sup>65</sup> After a hearing, that Committee reported the bill to the Senate, recommending that the bill "do pass".<sup>66</sup> At this time, the bill apparently still related only to the election and removal of directors.

Senator Webster next moved that Senate Bill 565, with Senate Substitute, be called from the Informal Calendar and again taken up for perfection.<sup>67</sup> The Senate Substitute significantly broadened the scope of Senate Bill 565 by adding a number of defenses against takeovers: it increased the types of stock that could be issued,<sup>68</sup> eliminated the statutory right of the holders of a given percentage of voting stock to call special meetings of the shareholders,<sup>69</sup> implicitly permitted the articles to provide for shares having multiple or fractional voting rights,<sup>70</sup> amended the provision on indemnification to include service on the board of an employment benefit plan,<sup>71</sup> added a provision on stock options and warrants,<sup>72</sup> and added the "other constituency" statute.<sup>73</sup> The fragmentary legislative history available in Missouri does not reveal the source of the Senate Substitute for Senate Bill 565; it apparently did not originate in the Committee on Miscellaneous Bills, for then it would have been designated as

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65. JOURNAL OF THE MISSOURI SENATE, *supra* note 64, at 97; OFFICIAL MANUAL, STATE OF MISSOURI 105 (1985-86).

66. JOURNAL OF THE MISSOURI SENATE, *supra* note 64, at 296.

67. *Id.* at 386.

68. MO. REV. STAT. § 351.180 (1986) was amended to make it possible to authorize "poison pill preferred" and other kinds of stock that had been developed to aid in fending off unwanted takeover bids.

69. See MO. REV. STAT. § 351.225 (1978). As amended, the section now provides that special meetings can be called by such persons as are specified in the articles of incorporation; formerly, the holders of one-fifth or more of the outstanding shares had the right to call a special meeting. This change makes it more difficult for a successful hostile takeover bidder to call a special meeting in order to replace the existing board of directors with directors of his own choosing; it thus operates to deter takeover efforts. See *id.* § 351.225 (1986).

70. MO. REV. STAT. §§ 351.180, .245.1 (1986). This would permit a corporation to authorize a class of preferred stock and give the board of directors the power to prescribe the relative rights of that class. Under that grant of authority, the board could create a class of preferred stock having multiple voting rights sufficient to outvote the outstanding common stock and place that class of preferred stock in friendly hands—like an employee benefit plan the trustees of which are members of or chosen by management. If sustained, such a class of stock would render a takeover impossible.

71. MO. REV. STAT. § 351.355 (1986).

72. MO. REV. STAT. § 351.182 (1986).

73. MO. REV. STAT. § 351.347 (1986). As initially adopted, § 351.347 related only to the board's exercise of its business judgment in the context of responding to acquisition proposals. See the title and the introductory language of the section:

"Acquisition proposals, board may make recommendation.—

1. In exercising its business judgment concerning any acquisition proposal . . . ."

"Committee Substitute." After the Substitute was adopted, perfected and printed, and passed, it moved rapidly through the House, and was signed by the Governor on May 6th.<sup>74</sup>

The Business Combination Act<sup>75</sup> was also adopted in 1986. This Act restricts combinations between certain Missouri corporations<sup>76</sup> and "interested shareholders,"<sup>77</sup> for a period of five years following the acquisition of the shares making one an interested shareholder unless the board of directors of the Missouri corporation approved the acquisition of the shares before the interested shareholder acquired them. It thus would preclude a hostile takeover from being completed for a period of five years following the date upon which the would-be acquirer obtains twenty percent of the shares.<sup>78</sup>

Finally, in 1989, Senator Webster sponsored Senate Bill 141, which modified several sections of the Corporation Act. As it emerged from the Conference Committee and finally passed, it eliminated mandatory cumulative voting for the election of directors, as mandated by the voters' amendment of Section 6 of Article XI of the Missouri Constitution, amended sections 351.407 and 351.459 (the Control Share Acquisition and Business Combination sections), and broadened section 351.347 to provide that the board could consider other constituencies in *any* exercise of its business judgment.<sup>79</sup>

About all that can be inferred from this limited sketch of legislative history is that the adoption of the "other constituency" statute was part of the anti-takeover "package" the legislature was putting in place. Indeed, the very heading of section 351.347—"Acquisition proposals, board may make recommendation"—affirms that conclusion. It also appears, in view of the haste with which the legislation was adopted and the circuitous route by which the "other constituency" provision was added, that there was no material discussion of that provision in either the legislative committee to which it was referred or on either floor of the legislature. Significantly, none of these bills was proposed

74. Status Report, June 27, 1986, p. 2.

75. MO. REV. STAT. § 351.459 (1986).

76. MO. REV. STAT. § 351.459.1(13) (1986) defines "resident domestic corporation" as a corporation organized in Missouri with 100 or more shareholders, its principal place of business, principal office, or substantial assets in Missouri, and one of the following: more than 10% of its shareholders resident in Missouri; more than 10% of its shares owned by Missouri residents; or, 10,000 shareholders resident in Missouri. MO. REV. STAT. § 351.459.4 (1986) then excludes corporations not subject to § 12 of the Securities Exchange Act of 1934 unless the articles otherwise provide.

77. MO. REV. STAT. § 351.459.1(10)(a) & (b) (1986) defines "interested shareholder" as someone who acquires 20% or more of the outstanding shares of a resident domestic corporation.

78. MO. REV. STAT. § 351.459.2 (Supp. 1993).

79. MO. REV. STAT. § 351.347.3 (Supp. 1993): "Nothing in this section shall require any director or corporation to respond to any particular acquisition proposal *nor preclude directors, in exercising their business judgment in other contexts, from considering factors such as those enumerated in subsection 1 of this section.*" [emphasis added].



by the Missouri Bar Association Committee on Corporation, Banking and Business Laws. Indeed, The Missouri Bar declined to take a position on Senate Bill 565, on the ground that it was "not within the scope" of the Bar's legislative activities.<sup>80</sup> Interestingly, the Bar members who made this recommendation to the governing board were not active members of the Missouri Bar Committee on Corporation, Banking and Business Law (as the Business Law Committee was known at the time), although that Committee had several subcommittees active in drafting possible legislation at that time, some of whom also served as legislative review consultants for The Missouri Bar. It is unclear who determined to refer the proposed legislation to those particular individuals. To be sure, the Missouri Bar—like other bar associations—is subject to many of the same sorts of public-choice pressures as is the legislature. It seems curious, then, that the proponents of this legislation chose to circumvent the usual routine for Bar-sponsored legislation; it tends to reinforce the suspicion that this is, indeed, special interest legislation, intended to foster the interests of management at the expense of the shareholders.

#### IV. SOURCES OF THE LEGISLATION

Missouri's Control Share Acquisition Act<sup>81</sup> and Business Combination Act,<sup>82</sup> in their present formats, both appear to have been drawn on their Indiana counterparts.<sup>83</sup> That is, the language of both statutes is almost identical. As the brief legislative history indicates,<sup>84</sup> however, the origins of the "other constituency" provisions are less clear. Commentators have pointed out that other constituency provisions originated in the articles of incorporation of companies concerned about being targets for takeover attempts.<sup>85</sup> And, it has been noted,<sup>86</sup> that in at least seventeen states, antitakeover legislation was adopted at the

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80. Telephone conversations with the Legislative Liaison of The Missouri Bar (October 26 and 29, 1991) (memorandum of conversation on file with author). When pressed, the Liaison indicated that there was strong feeling among some members of the Bar that the organization should only take positions on legislation relating to the administration of justice and the courts.

81. MO. REV. STAT. § 351.407 (Supp. 1993).

82. *Id.* § 351.459 (Supp. 1993).

83. IND. CODE ANN. §§ 23-1-42-5 to -9 (Burns 1989) and IND. CODE ANN. §§ 23-1-43-1 to -24 (Burns 1989), respectively.

84. See *supra* notes 56-79 and accompanying text.

85. See, e.g., Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1356 (1991); Sommer, *supra* note 25, at 39.

86. Jonathon R. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 469-70; Kenneth B. Davis, *Epilogue: The Role of the Hostile Takeover and the Role of the States*, 1988 WIS. L. REV. 491, 492 n.4 (enumerating 17 states in which this occurred); Romano, *supra* note 26, at 122-34 (focusing on the Connecticut statute).

behest of a single company with important local connections. There is scant direct evidence of such involvement in Missouri with respect to most of the anti-takeover legislation, although it is fairly clear that the 1985 attempt to broaden the Missouri Control Share Acquisition Act to include foreign corporations was pushed, and expedited through the legislature, on behalf of a single company.<sup>87</sup> Based on these circumstances, and the somewhat circuitous way in which these bills—especially the other constituency provision—were adopted,<sup>88</sup> it seems more probable than not that the legislation emanated from pro-management sources.

Many of the proponents of constituency statutes<sup>89</sup> are involved with the Business Roundtable, or otherwise represent large public corporations.<sup>90</sup> But,

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87. See *supra* note 62 and accompanying text. At least, the language of the amendment included only one corporation: TWA, which was then the target of a takeover bid from Carl Icahn. House Bill 117 extended the coverage of Missouri's Control Share Acquisition Act, MO. REV. STAT. § 351.575.2 (Supp. 1985) to "those foreign corporations that are common carriers that have benefitted from physical facilities financed by Missouri political subdivisions and that have over 7,500 employees in Missouri." Icahn v. Blunt, 612 F. Supp. 1400, 1406 (W.D. Mo. 1985). Counsel for defendants conceded that TWA was the only corporation known to meet those requirements. *Id.* at 1406 n.2.

The court sketched the approval of House Bill 117 as follows:

House Bill No. 117 (original H.B. No. 117) was prefiled on December 3, 1984. Original H.B. No. 117 was passed by the Missouri House on April 25, 1985. On May 6, 1985, original H.B. No. 117 was referred to the Senate Commerce Committee.

Beginning on May 29, 1985, legislative action on original H.B. No. 117 accelerated. On that day, original H.B. No. 117 emerged from the Senate Commerce Committee as Senate Committee Substitute for House Bill No. 117 (H.B. No. 117). The bill had gone from 35 words in the original H.B. No. 117 to over 1,600 words in H.B. No. 117. Later that day, the rules were suspended and H.B. No. 117 was read for the third time and passed by the Senate.

The next day, May 30, 1985, the Senate and House appointed a conference committee. After the conference committee reported later that day, the House and the Senate passed H.B. No. 117. Still later that day, the President Pro Tem of the Senate, the Speaker of the House and the Governor signed H.B. No. 117 and it became effective immediately.

*Id.* at 1405-06 (footnote omitted).

88. See *supra* notes 56-80 and accompanying text (legislative history sketch).

89. E.g., Charles Hansen, author of the article cited in note 85, *supra*, represented the Roundtable at the deliberations on the ALI Corporate Government Project.

90. E.g., Steven Wallman, whose article is cited *supra* note 54, is a partner in the Washington, D.C. office of the firm of Covington & Burling. Mr. Wallman was co-drafter of the first constituency statute enacted in Pennsylvania in 1983, and of the 1990 amendments to that statute.

The Business Roundtable, of course, consists primarily of attorneys who are "in house" counsel of public corporations. Minow, *supra* note 26, at 221-24. The Roundtable has shifted from a position of fostering accountability to shareholders to one

as Professors Klein and Coffee have pointed out,<sup>91</sup> virtually everything accomplished by the states' other constituency statutes could be done by amendment of the articles of incorporation. And, as noted earlier,<sup>92</sup> the first other constituency provisions originated in that fashion. Why, then, did the advocates of these provisions seek to include such provisions in the statutes—especially when one of the proponents suggested that the typical statute would have little or no effect on the decisions courts would reach?<sup>93</sup>

One possible explanation for this preference for statutory enactment rather than appropriate provisions in the articles of incorporation is that, for existing corporations, such provisions would have to be incorporated by an amendment to the articles, which would require a shareholder vote. However, if a statute is adopted that applies to all corporations except those that provide in their articles that the statutory limitation shall not apply to them, the shareholder vote can be avoided.<sup>94</sup> This has become more critical for corporate counsel because institutional shareholders, who must focus on large public corporations, are beginning to vote against management proposals—such as "staggered" boards and "poison pills"—that are seen as defensive devices.<sup>95</sup> Perhaps "opt-in" provisions are preferable because they permit the shareholders to decide whether they want to have "their" corporation include such a limitation on liability.<sup>96</sup>

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of Chief Executive Officer monarchy, Minow notes. *Id.* at 203. The Delaware courts also have retreated from some of their more pro-shareholder accountability holdings, like *Smith v. Van Gorkom*, after influential corporate lawyers suggested that corporations should consider incorporating elsewhere.

91. WILLIAM A. KLEIN & JOHN C. COFFEE JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 194 (5th ed. 1993).

92. See *supra* note 5 and accompanying text.

93. See Hansen, *supra* note 85, at 1375. Hansen concluded that these statutes should be considered primarily as a codification of the common law for jurisdictions that had not developed case law precedent without such a statute. See *id.*

94. That is, the statute would be an "opt-out" type, like present MO. REV. STAT. § 351.407 (Supp. 1993). An "opt-out" provision would apply a limitation to *all* corporations incorporated in Missouri except those that provided in the articles of incorporation that the statutory limitation should not apply to them. In contrast, an "opt-in" provision would permit corporations, by making appropriate provisions in their articles of incorporation, to limit or eliminate the liability of directors for actions taken in their capacities as directors except for situations involving a breach of the duty of loyalty or other fraudulent acts.

95. See Ralph C. Ferrara & Harry Zirlin, *The Institutional Investor and Corporate Ownership*, 19 SEC. REG. L.J. 341, 356, 358 (1992); Karmel, *supra* note 1, at 83.

96. Of course, as Professor Robert Lawless has noted in conversations with the author, to require an amendment to the Articles of Incorporation in effect turns the other constituency statutes on their heads, in that it permits one constituency—the shareholders—to determine whether or not other constituencies should have a place at the table.

## V. THE CHANGING SHAREHOLDER MIX

The traditional view has been that directors are to exercise their business judgment to the end of maximizing shareholder wealth.<sup>97</sup> Indeed, their obligations run primarily to the holders of common stock<sup>98</sup> who hold the residual interests in the corporation.<sup>99</sup> Because they are the residual claimants, they bear the highest degree of risk, and therefore have the most control (at least in theory). Shareholders elect boards of directors to manage the business and affairs of the corporation; over time, boards of directors have adopted various approaches to executive compensation—such as stock options and deferred compensation partly in an attempt to align the interests of managers more closely to those of the common stockholders.<sup>100</sup> The view that boards should look primarily to the interests of common stockholders still underlies many judicial opinions considering the responses of boards of directors to acquisition proposals.<sup>101</sup> It is also implicit in many of the criticisms of the recent takeover wave.<sup>102</sup>

However, many modern developments have tended to undercut this traditional view of the shareholders as the residual beneficiaries of the directors' management. The rise of special classes of stock—such as "poison pill preferred," super-voting stock, and "blank check" preferred—has attenuated the common shareholders' already limited role in management, because those classes are designed so that the holders can block acquisition proposals that are favored by most of the common shareholders.<sup>103</sup> Developments in "financial engineer-

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97. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (1919) ("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."); ALI PRINCIPLES OF CORPORATE GOVERNANCE, § 2.01(a) (Proposed Final Draft, March 31, 1992). Bainbridge, *supra* note 3, at 976-79, cites *Dodge* as a case rejecting board consideration of nonshareholder constituencies in an "operational" decision, but applying the business judgment rule to sustain most of what Henry Ford wanted to do—construct an expanded manufacturing facility. Bainbridge is consistent with others who quote the famous passage from *Dodge* to the effect that maximization of shareholder profit is the standard by which to measure directorial performance. All of us, however, tend to overlook the fact—not clearly articulated in the opinion—that *Dodge* also involved a variant of a freeze-out of the Dodge brothers by Henry Ford, the majority shareholder. The case is thus a precursor of cases like *Donahue v. Rodd Electrotype*, 328 N.E.2d 505 (Mass. 1975).

98. KLEIN & COFFEE, *supra* note 91, at 119-20, 126-28.

99. *Id.*

100. *Id.* at 172.

101. See, e.g., *Revlon, Inc., v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

102. Whitehill, *supra* note 1, at 113; Bainbridge, *supra* note 3, at 973.

103. Obviously, if such special classes are created by amendment of the company's articles of incorporation, such amendment will have to be approved by shareholders. Such amendments will be instigated by management, however, and in most cases can be

ing" have produced new financial products that "strip out" the claim on earnings from the claim on assets at liquidation, further diluting the classic concept of the roles of directors and shareholders.<sup>104</sup> Finally, the increase in institutional shareholdings in major corporations<sup>105</sup> marks a shift from individual investors, who may need more judicial protection against managerial overreaching, to sophisticated institutional investors who could, if they chose, protect themselves

approved by a mere majority of the outstanding voting shares. *Cf.* MO. REV. STAT. § 351.090 (Supp. 1993). The common shareholders, as a widely dispersed group, are in a poor position to organize to resist a proposal that is more in management's interest than in that of the shareholders, if they even recognize what is happening. Shareholders also suffer from "free rider" problems and "rational apathy." That is, it may be too expensive for an individual shareholder to inform himself adequately on a matter submitted for shareholder approval; small shareholders may choose to rely on the efforts of larger shareholders—institutions—to perform the research and vote appropriately. These shareholders are "free riders" on their efforts. For the same reasons, it is rational for them to be apathetic about matters presented to the shareholders: their holdings are too small to have any effect, anyway. Further, the statute permits the articles to give the *directors* the power to set the terms of preferred stock. MO. REV. STAT. § 351.180(1) (1986). This power has often been used to create "poison pill preferred."

104. For example, beginning in 1983, the Americus Shareowner Service Corporation (ASSC) has sponsored unit investment trusts, the Americus Trusts, for shares of selected firms listed on the New York Stock Exchange and the American Stock Exchange. These trusts provide investors with two new kinds of securities, known by their acronyms "Prime" (for Prescribed Right to Income and Maximum Equity) and "Score" (for Special Claim on Residual Equity). The owner of a share of IBM stock, for example, can deposit his share with ASSC, receiving in exchange one Prime and one Score. Then, the shareholder who is interested in current income can retain the Prime and sell the Score to an investor who is willing to speculate on a potentially high return at some time in the indefinite future. Thus, the introduction of Primes and Scores broadens investors' portfolio choices. Clearly, however, the investor is different from the ordinary holder of common stock. Although the holder of the Prime retains the right to direct the voting of the underlying stock, she has given up the residual claim on assets beyond the specified maximum. *See* S. Deshpande & V. Jog, *Primes and Scores: What They Are and How They Perform*, in *THE INVESTMENTS READER* 260 (Robert W. Kolb ed., 1991).

*See generally* CLIFFORD W. SMITH JR. & CHARLES W. SMITHSON, *THE HANDBOOK OF FINANCIAL ENGINEERING* (1990); Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1274 (1991).

105. Whitehill, *supra* note 1, at 119. In 1989, the average ownership of institutions of the equity of the top 100 corporations was 53.2%, and of the top 50 corporations was 50%. *Id.* Whitehill also states that it has been estimated that all institutional investors currently hold in excess of 45% of total equities in the United States. *Id.* He attributes the recent increase in takeovers, in part, to the increase in institutional shareholdings, with their short-term investment horizon. *Id.* (citing Brancato, *The Pivotal Role of Institutional Investors*, in *CAPITAL MARKETS: A SUMMARY OF ECONOMIC RESEARCH AT THE COLUMBIA INSTITUTIONAL INVESTORS PROJECT* 22 (1990)); Karmel, *supra* note 1, at 68-69.

through appropriate provisions in articles of incorporation, contractual provisions such as control puts,<sup>106</sup> by voting in corporate elections, or through a combination of these methods.<sup>107</sup> To what extent, if at all, should these changes in the nature of shareholders affect the interpretation of other constituency statutes? Before attempting to answer that, it is necessary to address some other emerging issues.

Some commentators<sup>108</sup> describe the corporation not as an entity, but as a "nexus of contracts." That is, the organization is viewed as a group of identifiable participants: investors, lenders, customers, suppliers, employees and managers. These participants negotiate an equilibrium position among themselves.<sup>109</sup> One implication from this view is that no single group of participants (e.g., the shareholders) has a natural right to view themselves as the owners of the firm. Thus, shareholders are not seen as "owners," but as suppliers—"renters"—of equity capital: they are the "residual claimants" who have special abilities to bear risk, which creditors, managers, and employees tend not to have. If we regard shareholders merely as residual claimants who have agreed to accept an uncertain future return because of their superior ability to bear risk, there is less basis to decide that they are entitled to control the firm. Perhaps other groups—managers or creditors—should share in control. Indeed, in many ways, these "other constituencies" are more directly affected than the

106. A "control put" is a contractual undertaking by the issuing corporation to repurchase the shares at a stipulated price in the event of a shift in control. Such undertakings have begun to appear in bond debentures and loan agreements. See Macey, *supra* note 27, at 39 n.31 & accompanying text; John C. Coffee Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1519-20 (1990).

107. See Robert Pozen, *How Fidelity Votes*, FIDELITY FOCUS, Fall 1993, at 24, noting that, in its role as an investment manager, Fidelity Management & Research Co. determines how to vote the funds' holdings in corporate elections, following guidelines established by the independent trustees of the Fidelity funds.

Of course, there are practical and legal problems inhibiting institutions' exercise of voting power. See, e.g., Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 152-163 (1988); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). For a different approach to resolving some of these issues, see George W. Dent Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881.

108. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. & ECON. 305 (1976); *Symposium on the Distribution of Power Among Corporate Managers, Shareholders and Directors*, 20 J. FIN. & ECON. 3 (1988). See also Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449 (1989).

109. This perspective is well set-out in JESSE H. CHOPER ET AL., *CASES AND MATERIALS ON CORPORATIONS* 28-30 (3d ed. 1989).

shareholders: a shareholder who is properly diversified is not affected by any particular takeover, because diversification eliminates the firm-specific risk of the investment, but other constituencies—managers and employees—contribute "human capital"—skills peculiar to the particular firm and not readily transportable—that is necessarily firm-specific.<sup>110</sup> In addition, many executive compensation devices (e.g., stock options) that are intended to align managers' interests more closely with those of shareholders have the ancillary effect of concentrating much of a manager's financial capital in the stock of the single firm by which she is employed.<sup>111</sup>

There is, however, an economic argument that voting rights should vest primarily in the residual claimants.<sup>112</sup> The residual claimants are uniquely interested in the firm's overall profitability, but incur high "agency costs" in attempting to monitor managers.<sup>113</sup> Creditors, managers, and employees are essentially fixed claimants, who are satisfied if their claims are repaid; they will tend to resist risky activities.<sup>114</sup> Because they have less interest in the overall performance of the firm, creditors and other fixed claimants can bargain for contractual protections and do not need representation on the board to monitor the firm's performance.<sup>115</sup> Only the residual owners lack the ability, at least in

110. Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 901, 905-917 (1993), Coffee, *supra* note 2, at 17.

There is also a generational issue: to which shareholders do directors owe their obligations, current shareholders or those who will be shareholders in the future? Also, note the potential divergences between the interests of long-term and those of short-term shareholders, many of whom may be arbitrageurs who have taken a substantial position in the stock of a company rumored to be a potential takeover target. These short-term shareholders are most interested in the premium over market price offered by the would-be acquiror, while long-term investors may have very different interests. See, e.g., Sommer, *supra* note 25, at 50.

111. Coffee, *supra*, note 2, at 18. See *infra* text accompanying notes 175-80.

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

113. See, e.g., Jensen & Meckling, *supra* note 108, at 308-09.

114. As Klein & Coffee point out, there is an inherent conflict of interest between the holders of fixed claims and the residual owners, which extends into operational decisions such as investment strategies. The holders of fixed claims, in order to ensure that their claims will be paid, will tend to favor "safe" investments, so long as they will generate sufficient cash flow to pay their fixed claims. A higher degree of risk benefits the residual claimants, who will tend to favor more risky ventures. KLEIN & COFFEE, *supra* note 91, at 226.

115. This, of course, is the reason for the protective covenants in bond indentures. *Id.* at 258. Managers may be able to secure "golden parachutes" in their employment contracts; in addition, top management is generally able to strongly influence the selection of directors. See MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* (1971); Myles L. Mace, *The President and the Board of Directors*, 50 HARV. BUS. REV. 37, 37-49 (Mar.-Apr. 1972). The recent difficulties at IBM and some other large corporations have

large corporations, to protect themselves contractually, and therefore need the protections of the statute and of the fiduciary obligations of officers and directors. Many of the managerial compensation plans in vogue today are designed to reduce the shareholders' agency costs by aligning managers' interests more closely to those of shareholders. Here, the other constituency statutes, by enabling managers to look after their own interests rather than those of the shareholders, work directly against these carefully-wrought schemes.

Expanding the range of constituents that the board may consider essentially eliminates any standard by which to evaluate director performance.<sup>116</sup> As will be discussed,<sup>117</sup> these statutes are riddled with ambiguities and questions. At least the old common law standards gave something to gauge a director's actions. The *Revlon* court said<sup>118</sup> that the directors owe their obligations to the corporation, which the court apparently equated to the interests of long-term shareholders. The court did say that the board could consider the impact on other constituencies, but that consideration had to be related to the interests of the shareholders.<sup>119</sup>

The "financial engineering" referred to previously<sup>120</sup> has been done externally, to a great extent, by creative investment bankers seeking to appeal to investors' differing appetites. Some of the hybrid securities used in leveraged buy-outs<sup>121</sup> and as takeover defenses<sup>122</sup> also reflect financial engineering notions,

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led to greater activism by institutional shareholders, who have forced changes at the top. See *infra* notes 121-23 and accompanying text. Unionized employees can seek plant closing provisions in their contracts, although that is more difficult. Recently, communities have begun to exact commitments from corporations in exchange for tax abatements. See Hayes, *supra* note 4, at 136, noting commitments Arlington, Texas got from General Motors in exchange for tax abatements granted for a 10-year period; GM apparently agreed to certain payments if they abandoned the plant within 5 years. The article also notes the lawsuit between Ypsilanti, Michigan, and General Motors over GM's plans to close the Willow Run assembly plant after securing tax relief from the community.

116. Despite their ambiguity, the standards set out *supra* text accompanying notes 41-53, are superior to the total negation of standards flowing from the consideration of other constituencies. See William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 420-24 (1990).

117. See *infra* text accompanying notes 132-49.

118. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181-82 (Del. 1986).

119. *Id.*

120. See *supra* note 105 and accompanying text.

121. *E.g.*, PIK Preferred (payment in kind preferred) in which the preferred dividend may be paid in additional shares of the preferred, at least for the first few years. Most of these instruments require that cash dividends be paid at some time in the future. Cf. HAMILTON, *supra* note 5, at 376 n.5.

122. *E.g.*, "poison-pill preferred"—special types of preferred stock issued by potential target corporations with rights that are designed specifically to make unwanted takeover



to be sure. Still, these hybrid or derivative products attain value because of the protections developed for the underlying securities—essentially common stock—from which they have been derived.<sup>123</sup> Hence, even these innovations support protections for the holders of the underlying securities.

It is easy to think of institutional investors as sophisticated investors who can look out for themselves. Of course, many institutional shareholders are the pension funds of ordinary working-class folks, or the vehicles for individuals seeking to save for retirement. Although the institutions can afford to, and many do, employ skilled investment analysts, these investors remain surrogates for their beneficial owners, and it is these beneficial owners who deserve protection.<sup>124</sup> Institutions could be more active in attempting to influence management, and some have.<sup>125</sup> The California Public Employees Retirement

attempts difficult or impossible. The unique feature of a poison pill is that it gives additional rights to shareholders when an aggressor makes a public tender offer for target shares, or acquires a specified percentage of target shares. The additional rights may be additional voting rights for shareholders other than the aggressor (a "voting" poison pill), or additional financial rights in the target (e.g., the right to acquire additional shares or indebtedness of the target at a bargain price if the pill is activated—a "flip-in" poison pill), or rights to buy aggressor shares at a bargain price in the event of a back-end merger between the target and the person whose tender offer originally triggered the poison pill (a "flip-over" pill). Generally, management can redeem the pill at a nominal price before the rights become vested; the pill is therefore a negotiating device. In that regard, MO. REV. STAT. § 351.459(5) (Supp. 1993), the "Business Combination" section, may have the effect of a poison pill. See ROBERT W. HAMILTON, *FUNDAMENTALS OF MODERN BUSINESS* § 17.13 (1989).

123. That is, if the underlying common stock cannot pay a dividend, then the SCORE, see *supra* note 104 and accompanying text, is worthless, and if the common stock loses its residual, liquidation value, then the PRIME is worthless. By the same token, PIK preferred depends on the company remaining viable so that it will someday be able to pay cash dividends, as promised. Thus, all these instruments depend on the underlying vitality of the residual claimants, the holders of the common stock.

124. Indeed, the SEC has directed pension fund managers to utilize their proxies for the benefit of plan participants. Ferrara & Zirlin, *supra* note 95, at 352 n.43 (citing Marcia Parker & Marlene Givant, *Executives Warned of Proxy Vote Liability*, PENSIONS & INVESTMENT AGE, May 18, 1987, at 1, 58).

125. Ferrara & Zirlin, *supra* note 95, at 356, note that professional portfolio managers have tended to oppose poison pill plans. Institutional investors take an active part in introducing shareholder proposals to eliminate poison pills, opt out of the takeover protection laws, and limit "golden parachute" arrangements. *Id.* at 358. See also Pozen, *supra* note 108, at 24, noting that Fidelity Investments has designated Fidelity Management & Research Co. to vote shares held by the various funds managed by Fidelity Investments at annual meetings of nearly 3,000 companies, following guidelines established by the independent trustees of Fidelity funds. The author notes that, although Fidelity funds usually support the positions recommended by management, they will withhold votes, or vote against, proposals likely to affect their stockholdings negatively, such as antitakeover devices. See also Michael Quint, *Teacher's Pension Fund Asks for Diverse Boards*, N.Y. TIMES, Oct. 6, 1993, at D6 (setting out guidelines issued by

System (CalPERS) has been particularly active; for example, it has introduced shareholder proposals to repeal "poison pills" and has voted against antitakeover amendments.<sup>126</sup> Not surprisingly, such institutional activism, and particularly proposals for proxy reform that would make it easier for shareholders to introduce matters for consideration and to communicate with each other, has elicited opposition from business groups such as the American Society of Corporate Secretaries, Inc. and the Business Roundtable.<sup>127</sup> Further, because of the size of their holdings, institutions can no longer avail themselves of the "Wall Street walk"—selling their shares and reinvesting in other securities—when they become dissatisfied; their sales would probably have a pronounced negative impact on the market. We come back, then, to the importance of the courts' looking to the interests of the shareholders, the long-term investors, in evaluating managers' conduct. Consideration of other constituencies conflicts with the shareholder's interests.

Further, it may be useful to classify corporations according to numbers of shareholders, and evaluate the impact of "other constituency" legislation on them separately. At one extreme, we have the closely held corporation, consisting of few shareholders, all of whom are acquainted, and all or most of whom have significant involvement in the corporation on a daily basis, usually in some sort of management capacity. Such corporations are unlikely to be able to take advantage of these provisions. Because of their size and greater risk, the constituencies with which they deal can ask for, and get, personal guarantees by

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Teacher's Insurance Annuity Association/College Retirement Equities Fund on how it would vote the \$52 billion of corporate stocks it holds); Michael Quint, *Pension Group Lists 50 Companies as Financial Laggards*, N.Y. TIMES, Oct. 8, 1993, at D3 (reporting a list of companies identified by the Council of Institutional Investors as performing poorly).

126. Ferrara & Zirlin, *supra* note 95, at 358 n.59 and accompanying text. See also Karmel, *supra* note 1, at 83 (recounting CalPERS's request to the SEC for a rulemaking project that proposed 48 changes in the proxy rules). More recently, United Shareholders Association has been organized as a Washington advocacy group on behalf of shareholders; this group subsequently supported the CalPERS petition, and filed its own request for comprehensive revisions. *Id.* at 83-84.

In the wake of bad times, even IBM has found it necessary to overhaul its board, creating a "governance" panel of outside directors—at least, in part, in response to criticisms from shareholders' groups. See Michael W. Miller, *IBM, Overhauling its Board, Will Create 'Governance' Panel of Outside Directors*, WALL ST. J., July 30, 1993, at A3.

See also Joan E. Rigdon, *Kodak Seeks Outsider To Be Chairman, CEO*, WALL ST. J., Aug. 9, 1993, at A3 (reporting that Kodak directors, in a special board meeting called by the "outside" directors, forced the Chief Executive Officer to step down); Joan E. Rigdon, *More Senior Executives Get Hired by the Board*, WALL ST. J., Aug. 18, 1993, at B1; Lilli Gordon, *New Deal for Shareholders*, WALL ST. J., Feb. 4, 1993, at A18; Paul Ingrassia, *Board Reform Replaces the LBO*, WALL ST. J., Oct. 30, 1992, at A14.

127. Karmel, *supra* note 1, at 84-85.

at least the major shareholders, and those interested in the firm are unlikely to be able to misappropriate assets belonging to others. Among the shareholders themselves, because of their closeness and small number, they are able to protect their own interests contractually. In the event a controlling group forces its will on a reluctant minority, there is also the possibility of a suit for breach of fiduciary duties *à la Donahue*,<sup>128</sup> or an action for judicial dissolution on the ground of oppression.<sup>129</sup>

At the other extreme are the mega-corporations such as IBM, AT&T, and RJR Nabisco. Here, the "contractarian"<sup>130</sup> view of the shareholder as a "renter of capital" who, incidentally, assumes some residual risk, is more tenable. In many cases, it seems doubtful if even the shareholder views himself as an "owner." Rather, he has "invested" his money in the hope that it will increase in value. He chose to hold stock rather than a bond because he hopes for a higher return than a bond will provide, especially in unsettled economic times when one must always consider the possibility of inflation. Still more remote as an "owner" of a corporation is the "indirect" shareholder, one who invests in a mutual fund or a pension or retirement plan that happens to have that particular stock in its portfolio. Is either group of shareholders, the "direct" or "indirect," a more compelling focus for judicial concern than the employees of a plant that will be shut down, or a customer who will lose a source of supply, or a bondholder who will find that the risk of her debt is magnified by the additional indebtedness undertaken to finance a buy-out?

Between these two extreme situations lies a vast middle area, in which there is, or probably should be, real ground for concern for the individual shareholders' welfare. Consider a corporation with 75 to 125 shareholders, most of whom are passive investors. Are they not entitled to something more than the economists' flippant, "If they're adequately diversified, they're protected from what happens to any one firm?"<sup>131</sup> Most of these shareholders have no real basis to be able to influence management to put their interests first; they are completely at the mercy of the controlling person or group. And, it's no answer to say that they shouldn't complain because they should have realized when they invested in this type of company that they might lack liquidity and be completely at the mercy of management. When people are getting together to organize a new business, they tend to be full of optimism and often are blind to potential pitfalls. People just are not as rational as the efficient market proponents think they should be. This group of shareholders seems to be the group most likely to be victimized by legislation like the other constituency statutes.

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128. See *supra* note 97.

129. See, e.g., MO. REV. STAT. § 351.494.2(b) (Supp. 1993). Of course, the new, optional close corporation sub-chapter, MO. REV. STAT. §§ 351.750-.935 (Supp. 1993), will permit precise tailoring of an electing corporation's governance rules to protect against such antics, if counsel for the organizers thinks of including them.

130. See *supra* notes 108-11 and accompanying text.

131. See *supra* note 110 and accompanying text.

## VI. PROBLEMS WITH THE STATUTES

Other constituency statutes are ambiguous and so affected with uncertainties as to virtually insure that they will wreak more havoc than they can possibly cure. A partial list of the problems would certainly include the areas mentioned below.

Most of the statutes, like Missouri's, are permissive, not mandatory.<sup>132</sup> Therefore, some have contended that the statutes should not be construed as creating a right of action in any of the enumerated categories.<sup>133</sup> However, only a few statutes specifically state that they do not create a right of action.<sup>134</sup> We are then left to wonder what courts in the other jurisdictions will do; only litigation will determine that. It seems unlikely that, if a member of one of the nonshareholder constituencies filed suit, a court would dismiss it out of hand.

The ambiguity in the statutes stems, in part, from the lack of guidance as to how the various factors are to be considered or the weights to be given them.<sup>135</sup> That is, directors are given no guidance on these matters, and more importantly, courts have no guidelines by which to review directors' action purportedly based upon consideration of other constituencies. Professor Bainbridge<sup>136</sup> contends that this reflects a conscious legislative determination to leave these issues to the discretion of the board of directors, subject to judicial review of the self-dealing aspects. But, considering the haste with which many of these statutes were adopted,<sup>137</sup> it is difficult to believe that the respective legislatures had any intent, other than to satisfy whatever special interest was pushing for the legislation. Of course, it would be appropriate to follow Professor Macey's suggestion<sup>138</sup> and construe the statute in a public-regarding manner, thus transforming statutes designed to benefit special interests (corporate management) into statutes that in fact serve the public interest.

Clearly some of the factors enumerated in these statutes<sup>139</sup> are factors that any board operating with due care would have to consider. Often, these factors would be determinative. That is fine when we are talking about structural decisions<sup>140</sup> but now Missouri's statute (like most of the others) applies to any

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132. *Contra* CONN. GEN. STAT. ANN. § 33-313(e) (West 1991).

133. Bainbridge, *supra* note 3, at 987.

134. GA. CODE ANN. § 14-2-202 (b)(5) (Harrison 1990); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1994); 15 PA. CONS. STAT. ANN. § 1717 (Supp. 1993).

135. *Cf.* Bainbridge, *supra* note 3, at 988.

136. *Id.* at 989-90.

137. *See supra* notes 74, 80 and accompanying text; *see Romano, supra* note 26, at 125-28.

138. Jonathon R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 267 (1986).

139. *E.g.*, the consideration being offered, or the possibility of illegality.

140. *See* Bainbridge, *supra* note 3, at 975, in which takeovers are defined as "structural decisions"—those that relate to changes in the ownership structure of the

exercise of the board's business judgment, including "operational" decisions.<sup>141</sup> Here, the effect of these statutes is less clear.<sup>142</sup>

For example, the statutes provide no guidance as to how a board, or a court, should accommodate conflicts between different constituencies. Consider a hypothetical chemical company, ABC Co., operating in Missouri and employing 500 workers in a small town. It is clearly the largest employer in the immediate area. But, it incurs considerable expense in meeting the requirements of United States environmental protection laws, and management recognizes that it also could save a substantial amount in labor costs by moving to the *maquiladora* zone in Mexico. The ABC shareholders would thus benefit in two ways by ABC's shutting down the Missouri plant and moving the operation to Mexico: Increased profits due to lower labor cost and no environmental protection expenses.<sup>143</sup> The 500 American employees will be hurt, as will the local community, by ABC's departure, but presumably 500 workers in Mexico will be working at good wages, and the Mexican community will "benefit" from another U.S. plant. The global environment may suffer, but the American environment will be relieved of an environmental threat, at least directly. Suppose that, on balance, the board of ABC decides to remain where it is, in order to continue to support the employees and the community, and to protect the global environment. Would the directors' concern for these other constituencies insulate them from liability to a shareholder? Even if the statute would protect the directors here, could a court summarily dismiss a shareholder suit brought against the directors challenging this decision? Or, conversely, if the ABC board determines to place the interests of shareholders first and move to Mexico, could members of the community or the employees recover in an action against the board?<sup>144</sup> Along the same line, because most of the statutes are permissive, not mandatory, a board may consider these factors, but need not do so. How is a board's decision not to consider some constituency to be judged? In the ABC hypothetical, suppose the board decided that, from the standpoint of employees,

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corporation.

141. *Id.* "Operational decisions" are all those necessary to run the firm on a continuing basis.

142. Professor Bainbridge argues that the business judgment rule should apply in operational decisions, and that, in consequence, the other constituency statutes will not change the legal regime in this area. *Id.* at 997-1002. As noted in the text, this is far from certain.

143. *Cf.* WILLIAM S. GREIDER, WHO WILL TELL THE PEOPLE: THE BETRAYAL OF AMERICAN DEMOCRACY 391-92 (1992).

144. Of course, one can construct a fairly sophisticated argument to the effect that the decision to keep the plant in Missouri, although it may depress profits somewhat (at least in the short term), is in the long-term best interests of the shareholders as well. Even if a court ultimately accepted this argument, it would justify summary dismissal of a shareholder's action.

the move was a "zero sum" game,<sup>145</sup> and therefore it didn't worry about the effect on employment. How should a court treat that determination?

Although the traditional common law rules do not necessarily provide greater certainty, at least they limit the number of possible groups that must be considered, or that may challenge a transaction. Directors remain accountable, to some degree, to shareholders. They cannot raise the specter of considering some other group as a defense to a challenge.

To attempt to interpret the statutes in a public-regarding way, as suggested by Macey, a court might determine that the ostensible goal of the statute was to ensure that directors consider the effect of their actions on all constituencies. In fact, the private interest was to protect incumbent managers from displacement or challenge by disappointed parties. Then, the court might decide that unless a board could demonstrate that its decision benefitted one of the constituencies without making any of the others worse off, the directors should be liable in damages to any of the groups who were adversely affected. That would, it seems, be to interpret the statute in a public-regarding manner.

Note that even an operational decision does pose conflict of interest, self-dealing, problems.<sup>146</sup> Directors, in theory, are elected by shareholders;<sup>147</sup> none of the other constituencies has any input on that decision. Therefore, directors' self-interest should lead them to favor the interests of shareholders over those of other constituencies, that is, the directors' decision to favor shareholders may be tainted by self-interest, the desire to retain their directorships and the perquisites that go with them. But, ordinarily the business judgment rule does not apply when the director's action is tainted by self-dealing. How, then, can we invoke the business judgment rule to insulate directors' consideration, or lack of consideration, of other constituencies?

If, as was suggested earlier, these statutes are motivated in part by the desire to protect directors from excessive liability, they do so only indirectly. Why not do so more directly, as some states have?<sup>148</sup> And, why do some states have both a provision permitting a corporation to limit directors' liability and a non-shareholder constituency statute?<sup>149</sup>

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145. *E.g.*, although one group of employees—the Americans—lose out, another group—those in Mexico—gain, and so society as a whole isn't hurt. (This ignores differing wage rates, but assuming that each plant meets the prevailing wage level of its locale for that type of employment, it is difficult to fault the company for that.)

146. Bainbridge, *supra* note 3, at 975-76.

147. Of course, Mace's studies indicated that this is largely a myth, and that directors are in fact usually selected by management. *See* MACE, *supra* note 115.

148. *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993) (permitting a corporation to include in its articles of incorporation a clause limiting the directors' exposure for breach of the duty of care). Although it is an opt-in statute, it does not provide for periodic renewal of that clause.

149. CONN. GEN. STAT. ANN. § 33-313 (d),(e) (West Supp. 1993); IND. CODE ANN. § 23-1-35-1(b), (e) (Burns 1989).

Moreover, it does not appear that a corporation could "opt out" of the coverage of the statute. By its terms, the statute applies to all corporations. There is no "unless the articles otherwise provide," nor must the corporation adopt a provision in its articles or by-laws to compel directors to consider these constituencies. Although the "nexus of contracts" school might argue that shareholders should be able to elect not to be covered by a particular statute, it is difficult to see a court giving effect to such a clause,<sup>150</sup> particularly when there is no tradition of modifying the rules like that and quite a long tradition of adhering to the statutorily-specified forms.

Another problem is that the statutes do not appear to reflect any conscious consideration of the fundamental policy issue: what groups should be considered in reaching these decisions?<sup>151</sup> And, if there are perceived dangers to groups external to the corporation who may require protection, is it appropriate, as a matter of public policy, to charge corporate directors, supposedly selected by the shareholders and therefore not a politically responsible group, with responsibility for providing that protection? Or, should those protections be provided by the state or some other outside body?

Finally, and most importantly, if the statute is given any effect at all, does it not negate any and all duties owed by directors? That is, could a board of directors insulate any action it wanted to take from suit simply by claiming, "We considered the impact on (one or more of the other constituencies, and based our decision on that?" To be sure, as Bainbridge indicates,<sup>152</sup> a court would want to examine the *bona fides* of the claimed consideration of other constituencies' interests, but it should not be difficult for reasonably competent corporate counsel to produce documentation, to reflect such consideration.

## VII. WHAT CONSTITUENCIES SHOULD BE PROTECTED?

Some of the problems with other constituency statutes arise from the concern that no one has thought carefully about which constituencies need protection.<sup>153</sup> The "laundry list" set out in the statutes sounds good, but expressly denies that it is exclusive.<sup>154</sup> The problem is bad enough when consideration of other constituencies is required only in connection with takeover bids; it is exacerbated when the scope of the statutes is extended to all exercises of business judgment. Which groups have relationships with the

150. Cf. authorities cited *supra* note 108.

151. Cf. Joseph William Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611 (1988). See *infra* text accompanying notes 152-53.

152. Bainbridge, *supra* note 3, at 998 & n.120.

153. See *supra* note 151 and accompanying text.

154. E.g., MO. REV. STAT. § 351.347.1(4) (Supp. 1993) permits consideration of these factors, *among others*: "Social, legal and economic effects on employees, suppliers, customers and others having similar relationships with the corporation, and the communities in which the corporation conducts its business . . . ."

corporation similar to those of employees, suppliers, and customers? And, how are each of these persons affected by the manifold variety of decisions boards of directors must make? The effects of different sorts of decisions on some of the groups likely to be impacted need to be considered.

### A. Shareholders

The traditional view has been that shareholders are the owners of the corporation, however their ownership has always been of a very attenuated variety, at least in all but the closest of corporations. Shareholders' participation in management is very indirect, through the election and removal of directors and approval of a limited number of extraordinary transactions, such as mergers, sales of all or substantially all of the assets, amendment of the articles of incorporation, or voluntary dissolution.<sup>155</sup> They accept an unspecified claim on current earnings in the hope of a substantial residual claim on the corporation upon dissolution.<sup>156</sup> In corporations owned by more than a very few shareholders, it is very difficult for the shareholders as a group to protect themselves contractually against management self-dealing or perfidy. That is the reason the concept of management's fiduciary duties arose, to minimize the "agency costs" of public ownership of firms.<sup>157</sup> The classic view, exemplified by the *Dodge* case,<sup>158</sup> makes managers' duties run exclusively to the corporation, representing the shareholders as a group. If other groups sought the protection of fiduciary duties, courts generally looked to their contract (their indenture) to see what protections they had provided for themselves; if there were none there, the creditor was out of luck.<sup>159</sup>

In considering the impacts of directors' decisions on shareholders, and others, it is useful to separate routine business decisions<sup>160</sup> from more fundamental transactions.<sup>161</sup> At one time,<sup>162</sup> fundamental changes required unanimous shareholder approval. As that proved unworkable, the law relaxed to permit such changes to be effectuated with majority (often super-majority) approval, but protected dissenting shareholders by granting them the right to have their

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155. MO. REV. STAT. §§ 351.090, .093, .315, .425, .464 (Supp. 1993).

156. KLEIN & COFFEE, *supra* note 91, at 273-74.

157. *Id.* at 172-73.

158. See *supra* note 97 and accompanying text.

159. See, e.g., *Aladdin Hotel Co. v. Bloom*, 200 F.2d 627 (8th Cir. 1953); *Elliott Assoc. v. J. Henry Schroder Bank & Trust Co.*, 838 F.2d 66 (2nd Cir. 1988). See Dale B. TAUKE, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholders' Rights*, 1 COLUM. BUS. L. REV. 1, 53-67, 131-132 (1989) (arguing against creation of a fiduciary duty towards bondholders).

160. See *supra* note 146 and accompanying text; Bainbridge, *supra* note 3, at 975.

161. See *supra* note 141 and accompanying text; Bainbridge, *supra* note 3, at 975.

162. HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 195, at 517 (1983).



shares repurchased by the corporation at a "fair" price—the so-called "appraisal remedy."<sup>163</sup>

Most of the discussion of other constituency statutes has focused on the role of these statutes in the context of takeover bids, generally hostile ones,<sup>164</sup> where managers may be tempted to resist even a bid that is beneficial to shareholders. This is the area in which directors' self-interest is most apt to conflict with the interests of shareholders and other constituencies, but similar concerns exist even in the context of negotiated transactions: the concern is that directors may be inclined to approve a merger that gives shareholders less than the best possible price, in consideration of extra benefits flowing to the directors, such as consulting contracts, guarantees of employment, or golden parachutes.<sup>165</sup> *Revlon's* holding that, once the decision has been made that the company is for sale, the role of the board changes to that of auctioneer, seeking the highest price for the shareholders, does not preclude a board from preferring a negotiated transaction at a price less than the maximum possible price to shareholders because of some side benefit flowing to them.<sup>166</sup> To be sure, in this context, too, the appraisal right offers some protection to the shareholders, although it is imperfect and costly to enforce.

In the case of hostile takeover bids, if a bid is successful, the shareholders will get a price substantially above that available in the market.<sup>167</sup> In a sense,

163. *E.g.*, MO. REV. STAT. § 351.405 (Supp. 1993).

164. In that regard, the article by Professor Bainbridge is an exception, although even he looks most extensively at the takeover context.

165. Bainbridge *supra* note 3, at 1010. *See* *Barr v. Wackman*, 329 N.E.2d 180 (N.Y. 1975) (after the boards of Talcott National Corp. and Gulf & Western had agreed in principle on G&W's acquisition of Talcott, the Talcott board approved a number of transactions made for the benefit of Talcott's inside directors and G&W, but not Talcott or its shareholders).

166. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (1986); *see also Barr*, 329 N.E.2d at 184, 188; Bainbridge, *supra* note 3, at 1010-11.

167. This was certainly true in the case of the hostile bids in the '80s, in which premiums of 50% and more above market price were paid to shareholders, and probably holds even in the area of negotiated mergers. When the merger is financed with high-yield bonds, as noted above (*see supra* note 5), previously outstanding bonds were often down-graded by the rating services, resulting in a substantial loss of capital value to the holders of those bonds. This, then, resulted in a transfer of value from the prior bondholders to the common stockholders. *See generally* *McDaniel, supra* note 5, at 206-09; *HAMILTON, supra* note 5, at 408 n.4.

Employees' investment in the firm, as noted previously (*supra* note 116 and accompanying text), is primarily in the form of "human capital"—skills they have developed over the years that are largely specific to the particular firm, and may not be as useful to other firms. Often, the employee is encouraged to develop these skills in exchange for wage increases, but often the employee has not been compensated in full for the higher skill level. In part, the employee has relied on the implicit promise of certain benefits that may be endangered if the firm is taken over and the employee discharged, or the pension fund used in part to finance the takeover. In that way, the

then, shareholders may be arrogating to themselves part of the firm-specific capital investment of others; mainly employees, but possibly creditors and others as well.<sup>168</sup> And, even in those cases in which management may be tempted to recommend a transaction that is at too low a price, a fully diversified shareholder is protected against this sort of firm-specific risk.<sup>169</sup>

When we turn to the area of operational decisions, other constituency statutes may represent a very fundamental change in corporate doctrine. Traditionally, shareholders have had little or no direct input on these sorts of decisions; they are the sorts of matters that are committed to directorial discretion under the statutory directive that "the property and business of a corporation shall be controlled and managed by a board of directors."<sup>170</sup> This gives the board virtually plenary power over the corporation. Under the conventional formulation of the business judgment rule, when the board in good faith, and in the absence of fraud, illegality, or self-dealing, exercises its business judgment, a court will not look behind the judgment and impose liability on the directors, even if the decision proves to have been erroneous.<sup>171</sup> In exercising its business judgment, the board is expected to consider the best interests of the corporation. This presumably includes the best interests of the shareholders, but does it permit the board to consider the impact on other constituencies? In a sense, extending the other constituency statutes to all board exercises of business judgment may suggest a legislative belief that a board could not consider the effect of a particular course of action on other constituencies.<sup>172</sup> Again, the permissive nature of the statutory language is troubling: they may consider these other constituencies, but they don't have to do so. Professor Bainbridge argues that these statutes do not change the rules in these areas of operational decisions,<sup>173</sup> but that seems unclear. Professor Bainbridge is correct, however, in his contention<sup>174</sup> that extra-judicial constraints eventually will limit managers'

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shareholders also expropriate some of the employees' human capital when the aggressor reduces work forces and/or benefits in order to satisfy the indebtedness incurred. See Coffee, *supra* note 2, at 11-12; O'Connor, *supra* note 110, at 905-17.

168. Coffee, *supra* note 2, at 11-12; Bainbridge *supra* note 3, at 1007-008. See also Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 206-09 (1988).

169. Coffee, *supra* note 2, at 19.

170. MO. REV. STAT. § 351.310 (1986). Other statutory formulations vary, but the effect is the same. See, e.g., MBCA § 35 ("[A]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors"); RMBCA § 8.01(b) (same).

171. CLARK, *supra* note 10, at 123, 124.

172. That is, the legislature must not have believed that the board could consider the impact on other constituencies under common law approaches because if it *had* believed such considerations to be already available there would be no need for the statutory authorization.

173. Bainbridge, *supra* note 3, at 1001.

174. *Id.* at 1000-01.

ability to serve their own interests in these operational decisions. Once it becomes clear that particular managers engage in that sort of behavior, either investors will replace them, or investors will shift their investments from that firm into firms that are more honestly managed. These same sorts of market constraints do not operate in the takeover context, however, because those are "final period problems".<sup>175</sup> If the transaction occurs, the firm ceases to exist, and those managers will not have to interact with other groups any longer.

### B. Managers

As Coffee<sup>176</sup> points out, managers are more vulnerable to loss in the context of takeovers, because they are less capable of diversifying their investments in the firm than are shareholders. A large part of managers' investment is firm-specific "human capital"—the particular skills that are required in that firm, but perhaps not transportable, such as the acceptance of lower current compensation in reliance on an implicit promise of continued employment and deferred benefits in retirement.<sup>177</sup> Further, compensation plans using company securities, stock options, and other incentives increase the concentration of managers' investments in the particular firm. Thus, when shareholders receive premium prices in hostile takeovers, it is quite likely that at least part of that premium represents a transfer of wealth from managers to shareholders.<sup>178</sup> Top managers have demonstrated their ability to negotiate for protection from this type of danger through such means as "golden parachutes."<sup>179</sup>

175. *Id.* at 1001.

176. Coffee, *supra* note 2, at 17-19.

177. Thus, there is an "implicit" contract between the manager and the corporation that is threatened in the takeover context. See *id.* at 23-24; Van Wezel Stone, *supra* note 3, at 48-53.

178. Coffee, *supra* note 2, at 23-24; Van Wezel Stone, *supra* note 3 at 48-53. This again is an illustration of the "implicit contract" theory: if the manager is discharged following a successful takeover bid, he may never receive the implicitly promised benefits. To that extent, wealth is transferred from the managers to shareholders. Of course, to the extent that managers own shares in the target corporation, they receive the same premium as the other shareholders, but it is unlikely to be equivalent to the "promised" benefits.

179. A "golden parachute" is a contractual undertaking by the company that, in the event of the occurrence of specified events (e.g., a hostile takeover), the manager will receive a generous severance payment. In the RJR Nabisco takeover, Ross Johnson, the former CEO of RJR, received a \$50 million golden parachute. See BURROUGH & HELYAR, *supra* note 1. In some cases, lower level employees have received "tin parachutes"—similar contracts, at lower severance payment levels—but this practice appears to be less widely used. See, e.g., Alison Leigh Cowan, *New Play: "Tin Parachutes,"* N.Y. TIMES, Mar. 19, 1987, at D1. See also Patrick J. Ryan, *Corporate Directors and the "Social Costs" of Takeovers—Reflections on the Tin Parachute*, 64 TUL. L. REV. 3 (1989).

But, a hostile takeover bid presents the essential conflict of interest situation for top management. They know that if a bid is successful, they probably will be replaced. The "inside directors" have a pronounced conflict of interest, which "taints" the judgment of the entire board, especially when "inside" directors constitute a majority of the board.<sup>180</sup> This justifies the most intense judicial scrutiny of management's actions in response to a takeover bid. And, because the business judgment rule typically does not apply in the case of self-dealing,<sup>181</sup> it is difficult to see how the other constituency statutes could be invoked here. It appears, though, that the legislatures thought they could apply. Commentators<sup>182</sup> have argued that hostile tender offers are the market's way of disciplining inept management, and insuring that assets are put to their highest and best use, and that therefore management should be passive in response to tender offers. The difficulty is that many of the takeover targets of the '80s were well-managed companies;<sup>183</sup> because some of the companies resulting from these

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180. Mace, *supra* note 115, at 43, reported that, in practice, directors were most often selected by top management, unless there was a significant shareholder group that was able to gain representation on the board. And, "outside" directors—those whose only affiliation with the corporation is service as a director—tend to be chosen from the ranks of high executives of other corporations, people who are very similar in background and outlook to the very managers they are supposed to be supervising. Further, chief executive officers are unlikely to ask persons whom they expect to be hostile to their (the CEO's) positions or actions. Thus, until relatively recently, one would expect the actions of a board of directors to be strongly influenced by the position of the inside directors. See *supra* notes 125-126 and accompanying text. Again, outside directors have full-time commitments to their primary employer, their own corporation; they cannot be expected to devote extensive amounts of time to their service on a board, and they do not have access to the detailed information that inside directors possess. See generally CHRISTOPHER D. STONE, *WHERE THE LAW ENDS* (1975); MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* (1971); RALPH NADER ET. AL., *TAMING THE GIANT CORPORATION* (1976). Thus, the conduct of the director defendants in *Smith v. Van Gorkom* may not have been as unusual as the chancery court suggested.

181. See *supra* note 12 and accompanying text.

182. Lucian A. Bebchek, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 28 (1982); Coffee, *supra* note 2, at 5.

183. See, e.g., Edward S. Herman & Louis Lowenstein, *The Efficiency Effects of Hostile Takeovers*, in KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF HOSTILE TAKEOVERS 217-220, 230-233 (John C. Coffee et. al., eds., 1988), reprinted in HAMILTON, *supra* note 5, at 974-79.

leveraged buy-outs have had to be reorganized again and again<sup>184</sup> successor management may not have been all that disciplined or efficient.

When we turn to operational decisions, managers are making those decisions now; it is difficult to see how managers as a group are affected. Presumably, they take their own interests into account in making those decisions. For them, the other constituency statutes offer a justification for whatever decision they want to make.<sup>185</sup>

### C. Other Employees

Ordinary employees may lose jobs when companies are taken over, or when companies restructure drastically in order to avoid a takeover.<sup>186</sup> However, that is by no means certain: even when a successful takeover restructures the target corporation, it does not necessarily mean that the operating elements will be withdrawn from production. Often, they will merely shift ownership and continue operations, although they may streamline their employment rosters to some extent in the process. Furthermore, employees are threatened quite as much by routine "operational" decisions such as closing a plant in the United States and moving production into a lower-cost developing country.<sup>187</sup> These sorts of decisions have traditionally lain within the province of the business judgment rule.

184. See, e.g., George Anders, *Playtex Goes Through Four Buy-outs Since 1985, Enriching Top Officers*, WALL ST. J., Dec. 17, 1991, at A1 (reporting that Playtex, Inc. had gone through four buy-outs since 1991); *Deals and Misdeals: A Sampling of M&A Hits and Strikeouts in the 1980s*, MERGERS & ACQUISITIONS, Mar./Apr. 1990, at 100, 102-03 (listing 9 failed LBO's as of that time). More recently, George Anders, *More 1980's LBOs Rush To Go Public*, WALL ST. J., Jan. 21, 1992, at C1, reported a number of former LBO companies that were taking advantage of a "bull" market for new issues to go public again. Apparently, Playtex is trying to get in on this action, too. See *Playtex FP Planning IPO To Raise \$243.3 Million*, WALL ST. J., November 11, 1993, at B6; Ann Newman *Playtex's IPO Will Value the Holdings of Current Owners at Over \$100 Million*, WALL ST. J., December 2, 1993, at C11.

185. See *supra* notes 151-52 and accompanying text.

186. See O'Connor, *supra* note 110, at 915-17; Bainbridge, *supra* note 3, at 1003-004 nn.136-40.

But see DALE A. OESTERLE, *THE LAW OF MERGERS, ACQUISITIONS, AND REORGANIZATIONS* 8 (1991), stating that, among 62 targets of hostile takeovers between 1984 and 1986, the total post takeover layoffs were about 26,000 people, or about 2.5% of the labor force of an average target firm. "These layoffs are noticeable for the target firm, but small in the context of the national economy. By comparison, General Electric cut its work force by over 100,000 between 1981 and 1987." Further, the article noted, post takeover layoffs disproportionately affect relatively high-level white collar employees, as hostile takeovers lead to reduction of headquarters employment. *Id.*

187. See *supra* notes 141-44 and accompanying text. See also OESTERLE, *supra* note 187, at 243-59.

Those employees covered by collective bargaining agreements may be able to negotiate for job security in the form of plant closing provisions in labor negotiations. Employees not covered by collective bargaining agreements, and not sufficiently high in the corporate structure to be able to obtain "golden" or even "tin" parachutes, may not be able to protect themselves by express contracts, and the "implicit" contract suggested elsewhere<sup>188</sup> may be of little help, or comfort. These employees also have made extensive firm-specific investments of human capital, in terms of specific skills that are more or less uniquely suited to a particular firm, which are jeopardized by these sorts of decisions. Additional dangers lie in adverse changes in retirement plans; these may be regulated to some degree by ERISA,<sup>189</sup> but the regulation is less than perfect.<sup>190</sup>

These sorts of matters have traditionally been relegated to the business judgment rule. The other constituency statute permits the board to consider these impacts in making its decisions, but provides scant guidance as to how to weight them, and does not require such consideration. They provide scant protection for those who most need them. It would be better to protect employees directly, through plant closing laws and other worker protection statutes.<sup>191</sup>

#### D. Creditors

As already noted, courts have generally held that directors do not owe fiduciary duties to creditors.<sup>192</sup> Rather, creditors are relegated to whatever remedies they have provided in their contracts. Long-term creditors have protected themselves through contractual arrangements, such as requiring specific levels of reserves, periodic amortization of the debt, requiring specified levels of shareholders' equity, or accelerating the full amount of the debt upon a sale of all or substantially all the borrower's assets.<sup>193</sup>

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188. See *supra* notes 178-80 and accompanying text.

189. The Employee Retirement Income Security Act of 1974, *codified as amended* at 29 U.S.C. §§ 1001-1461 (Supp. III 1991). See generally BRUCE ALLAN MILLER, EMPLOYEE BENEFITS: MERGERS AND ACQUISITIONS (1985).

190. See, e.g., Bainbridge, *supra* note 3, at 1003 n.138 (citing examples of the use of pension funds to finance leveraged buy-outs).

191. Bainbridge, *supra* note 3, at 1012 & n.165. Bainbridge cites Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect*, 60 N.C. L. REV. 1189, 1233 (1991), for the proposition that many of the managers who vigorously lobbied state legislatures for nonshareholder constituency statutes were equally vigorous in opposing these worker protection laws.

192. See *supra* note 159 and accompanying text. See also Tauke, *supra* note 159, at 53-67, 131-32 (defending the traditional contractual approach to bondholders' rights).

193. *Aladdin Hotel Co. v. Bloom*, 200 F.2d 627 (8th Cir. 1953); KLEIN & COFFEE, *supra* note 91, at 240-53; BAYLESS MANNING & JAMES J. HANKS, LEGAL CAPITAL 103-05

In spite of these protections, many long-term creditors were caught off guard by the leveraged buy-out ["LBO"] phenomenon of the 1980s. Even though much of the debt issued to accomplish these transactions was subordinated to existing long-term debt, the degree of leverage in many firms became so high as to materially increase the risk of default on all the debt, thus leading to a decline in the value of the existing debt.<sup>194</sup> In this way, at least some of the early LBOs probably did transfer wealth from existing creditors to shareholders. Toward the latter part of the wave of buy-outs, creditors began to guard against such transfers by strengthening the protections in their loan agreements, restricting overall debt levels, and accelerating the debt if leverage exceeded specified levels.<sup>195</sup>

Ordinary trade creditors may not be able to protect themselves contractually because they lack the bargaining power to obtain protective provisions. One selling expendable supplies to a manufacturing concern is very well aware that, should he seek to include protective provisions in the contract of sale, his customer will laugh in his face and buy from his competitor, unless his commodity is somehow unique. Vigilance is the trade creditor's protection:<sup>196</sup> monitor the debtor closely, and when danger signs appear, act immediately. Keeping open accounts fairly current is not absolute protection, but should limit the loss.

So, ordinary trade creditors are one of the prime candidates for protection by a nonshareholder constituency statute; long-term creditors can protect themselves generally by appropriate contractual provisions, provided courts will compel borrowers to honor their contractual commitments.<sup>197</sup> Unfortunately, the legislatures have not seen fit to provide any guidance for courts as to how to protect these groups in the wide variety of circumstances under which boards of directors exercise business judgment, and courts do not seem well equipped to develop such guidelines on their own. Nor do any specialized agencies seem better equipped.

### *E. Suppliers and Customers*

Logically, many suppliers will fall into the category of ordinary trade creditors, which were just considered. Here, however, we are concerned

(3d ed. 1990).

194. *E.g.*, *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989); HAMILTON, *supra* note 5, at 408-09 n.4 (discussing the downgrading of RJR Nabisco's pre-existing debt from investment grade ("A") to "junk" bonds ("Caa") as a result of the additional debt financing used to complete the merger).

195. *See* HAMILTON, *supra* note 5, at 409-10 n.6; Coffee, *supra* note 106, at 1519-20.

196. *See, e.g.*, MANNING & HANKS, *supra* note 193, at 98-101.

197. Remember, the court did not compel RJR to honor its implicit commitments not to change the risk to existing creditors by taking on huge amounts of subordinated debt. *See RJR Nabisco, Inc.*, 716 F. Supp. at 1518-25.

primarily with those suppliers and customers whose claim to protection derives from their unique ties to a particular corporation. In the case of suppliers, it may be because they have been induced to make substantial investments that are suited only to the particular corporation's operations. In a sense, they have a "firm-specific" investment in the corporation, not too different from that of employees and managers.<sup>198</sup> Customers may also have unique claims to protection because of heavy dependence on the corporation's product, making them vulnerable to the risk of opportunistic behavior by the particular corporation. Once again, these highly vulnerable individuals or firms can seek to protect themselves contractually, but may lack the bargaining power to succeed.

Other suppliers and customers—those who have other potential customers or sources of product, and so are not uniquely tied to the particular corporation—are less subject to opportunistic behavior, and thus have lower claims to protection. Their protection is to take their business elsewhere, provided only that there are functioning competitive markets to which they can turn.

But, even those firms that are uniquely dependent on a particular corporation inevitably face the risk that the corporation may fail, and they may lose their customer or their source of supply. Surely, the other constituency statute cannot reasonably mean that, should a board's exercise of business judgment be erroneous, so that the corporation fails, these uniquely dependent suppliers and customers have a claim against directors for not adequately considering the effect of the transaction on them. Recall the hypothetical situation of ABC Corp. considering a move of its manufacturing facility to the *maquiladora* zone of Mexico, in order to reduce labor and environmental protection costs.<sup>199</sup> It was noted above that U.S. workers would be damaged, whereas workers in Mexico would benefit; the impact on suppliers and customers is less certain. Suppliers of unique inputs may continue to sell to ABC, albeit at a slightly higher price because of transportation costs, or the supplier may lose out to other suppliers closer to the new location. Customers may in fact benefit, because ABC's lower production costs may permit ABC to sell the product more cheaply, in spite of higher transportation costs. (Of course, ABC could continue to charge the same price and reap a fatter profit margin—at least until another producer of ABC's product emerged to compete.) How is a court to evaluate the directors' decision to move, or not to move, under these circumstances? Under traditional analyses, the court would apply the business judgment rule, and exonerate the directors.

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198. That is, a corporation has chosen to organize its production across markets, by contract, rather than organizing within the firm, as by undertaking to manufacture the supplies within the firm. If the firm had chosen to organize within the firm, then the fiduciary obligations of the managers would run, in part, to the "supplier" element within the firm. Should the decision to organize across markets, contractually, lead to legal differences in regard to managers' fiduciary obligations? If the answer to the question is "no," then other constituency statutes should be interpreted to *require* managers to consider those constituencies.

199. See *supra* note 143 and accompanying text.



The addition of other constituencies expands the protection of the business judgment rule, rendering the directors' decision virtually impregnable to challenge.

Again, the legitimate claim these groups have is for protection against opportunistic behavior by the corporation. The ambiguous other constituency statutes, as presently constituted, do not provide a basis to do that.

### *F. Communities*

Here, "communities" is used in a generic sense, to include not just local cities and towns, but other levels—county, regional, state, or national—which may have interests affected by corporate action. The claim for protection here arises because the community (often, the immediate locality, but sometimes a broader region as well) may have made substantial investments in infrastructure—schools, roads, sewers and other public utilities, not to mention tax relief—in consideration for getting a major corporate facility to locate or remain within its boundaries. All of these investments, of course, are jeopardized if that facility relocates, whether because of a corporate combination or some other business decision (*e.g.*, ABC moves to Mexico).

Again, a community could bargain for contractual protections before undertaking such substantial investments, but as a practical matter that has been unlikely to occur because there was just too much competition for new industries.<sup>200</sup> Recently, a few states<sup>201</sup> have enacted laws requiring companies to compensate municipalities for financial inducements if they move out of town prematurely. In 1991, General Motors entered into a ten year contract with the town of Arlington, Texas, under which the town can seek to recover all the abated taxes if GM closed its plant within 5 years.<sup>202</sup>

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200. *But see* Hayes, *supra* note 4, at B6, reporting that many communities are demanding long-term commitments in return for tax abatements, low interest loans, and other financial inducements. The article goes on to note that states and communities are going to court also, reporting that New York state's commissioner of economic development was considering suing General Motors, which had announced plans to close a plant at North Tarrytown, NY, which would idle 3,400 workers. The town had granted GM tax abatements when it threatened to close the plant in 1980. The article also referred to a ruling by a trial judge in Michigan that blocked GM's plans to close a plant in Ypsilanti, MI. because, the court held, "GM had made an implied promise to stay put when it accepted Ypsilanti's inducement of \$13 million in tax abatements in 1984 and 1988." A similar claim was rejected in an action brought by the town of Norwood, Ohio, over a plant closing in 1987, however. Alas, the Michigan Court of Appeals reversed the trial court in the Ypsilanti case. *See Ypsilanti v. General Motors Corp.*, 506 N.W.2d 556 (Mich. Ct. App. 1993).

201. *See* LA. REV. STAT. ANN. § 51:1927 (West Supp. 1994); OHIO REV. CODE ANN. § 122.17 (Anderson 1992).

202. Hayes, *supra* note 4, at B6.

To some degree, communities may be protected by corporate inertia. When a corporation has a substantial investment in a locale, and many of its personnel have developed attachments to the area, there may be a tendency to remain unless there is a compelling reason for change. A threatened takeover, or financial reversals, could provide such compelling reasons.

The major point, however, is that other constituency provisions are, at best, an indirect effort to provide some protection to these interests. Indeed, they may be more harmful than helpful, for they may lull community leaders into complacency, thinking that more protection is afforded than in fact exists. If these concerns are legitimate, and they seem to be, it is far better to address them directly, as a few states have begun to do.<sup>203</sup>

### VIII. CONTEXTS

As noted above,<sup>204</sup> the original Missouri provision applied only in the takeover context; it has subsequently been modified so that, like many of the other statutes, it applies to any exercise of business judgment. The question then arises, in what contexts should other constituencies be considered? And, how does the context affect that consideration?

#### A. Hostile Takeovers

Certainly, a hostile takeover is drastic, so far as management is concerned, and for shareholders, who presumably receive a premium price for their shares. As to other possible constituencies, it is difficult to say, *a priori*, whether any particular takeover is good or bad. Even in the extreme case of a "bust-up" takeover, in which the successful acquirer sells off portions of the acquired company in order to repay part of the debt used to finance the acquisition, the assets sold are not necessarily removed from production. Rather, they are often sold to another group that expects to be able to manage the assets more efficiently. It is difficult to see how other constituencies, or society in general, are injured by such an eventuality.

Often, in an effort to reduce costs and to help reduce indebtedness, new management will reduce the labor force, to the detriment of current employees.<sup>205</sup> But, should the law compel managers to retain unneeded employees? It is possible that inefficient prior management had allowed the corporation to get "fat," either to enhance their own prestige and "perks," or for other reasons. Again, as noted,<sup>206</sup> organized employees can bargain for protections in this area, although more direct statutory protection, in the form of plant closing legislation,

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203. See *supra* note 202.

204. See *supra* note 73 and accompanying text.

205. See *supra* note 187 and accompanying text.

206. See *supra* note 187 and accompanying text.

is probably more efficient. Mid-level employees, who often are not organized, may not be able to protect themselves contractually; they are the group most likely to lose out on firm-specific human capital. Top managers have demonstrated their ability to protect themselves through golden parachutes.

In addition, regardless of what directors do or do not do, many natural events in the course of a business cycle can compel a corporation to seek to reduce labor charges by shrinking the employee base. Certainly courts would not compel directors to retain a bloated staff in periods of financial exigency. Should hostile takeovers be treated differently?

In the context of a hostile takeover, the bidder must believe the target is worth more than its current market valuation, and so is willing to pay some premium in order to acquire control. In the context of directors' responses to such offers, the central issue often becomes how that premium will be divided between shareholders and managers, after making due allowance for the contractual rights of creditors.<sup>207</sup> If the law introduces the interests of other constituencies into that calculus, it becomes enormously more complicated, while offering minimal, if any, offsetting benefits.<sup>208</sup> Indeed, whatever change is introduced is most likely to be pernicious, in that it vastly broadens the discretion granted management.<sup>209</sup>

### *B. Fundamental Changes*

One of the traditional areas of shareholder involvement is approval of fundamental changes: amendment of the articles of incorporation, approval of business combinations (in any of their myriad forms), and voluntary dissolution. Most also involve the board of directors, who generally formulate a proposal which is then referred to the shareholders for approval.<sup>210</sup> In each case, the shareholders will be involved, in that they must vote; in the business combinations area, a dissenting shareholder can also seek an appraisal of the value of his

207. Coffee, *supra* note 2, at 9, 66-71.

208. See, e.g., Carney, *supra* note 116, at 417-19.

209. *Id.*

210. In this respect, the Missouri statute is somewhat more flexible than many statutes, in that it permits proposals for many of these transactions to be submitted directly to shareholders without being filtered through the board. Compare, e.g., MO. REV. STAT. § 351.090.2(1) (Supp. 1993) (amendment of articles may be submitted directly to shareholders) with MBCA § 59 (requiring board to propose amendment and submit to shareholders). As a practical matter, in a corporation of any size, the shareholders are usually too diverse a group to be able to organize effectively to bring a proposal for a fundamental change before a meeting of shareholders, so that the board will almost always be involved. Of course, if there is a shareholder with a substantial percentage of the shares (as in the case of a partially successful tender offeror), that shareholder may have the means and desire to by-pass the board. On the other hand, often such an influential shareholder may well control the board and be able to get whatever she wants.

shares, and payment of that value upon surrender of the shares. If other constituencies are to be considered, it presumably will occur in the board's decision to propose the change. No one has yet proposed anything comparable to the dissenting shareholders' rights for other constituencies.

An amendment to the articles of incorporation represents a basic change in the relationships between and among the corporation, the state, and the shareholders (and among the shareholders *inter se*). If an amendment poses dangers to other constituencies, as some antitakeover amendments might, the logical agency to intervene and take corrective action would appear to be the state, rather than the directors who have been chosen by the shareholders alone. The state could impose procedural requirements for amendments<sup>211</sup> or could limit the kinds of amendments that might be tolerated.<sup>212</sup> And, some constituencies can protect themselves contractually, as noted above.<sup>213</sup> Involving these constituencies directly in the amendment process would represent a very fundamental shift in our perception of the corporation.

Business combinations—here, friendly, negotiated transactions, because hostile takeovers have already been addressed—will occur only if both sides consider the combination advantageous. At least, the managements involved will have to agree; there are mechanisms (*e.g.*, triangular mergers<sup>214</sup>) by which some of the affected shareholders can be by-passed, but even if their vote can be avoided, they will retain the dissenters' rights to appraisal. The directors' fiduciary obligations also provide some protection. Creditors and organized employees can seek contractual protections, again. But, as to other constituencies—communities, unorganized employees, trade creditors—they may be either helped or hurt, but it is impossible to determine, in the abstract, which it will be. Again, trying to include all these groups in the determination of particular combinations is likely to render the process so rigid as to preclude all combinations.

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211. *E.g.*, by requiring approval of affected constituencies.

212. The latter seems highly unlikely; it is difficult to envision the types of restrictions that might be imposed, and any effort to be exhaustive in enumerating restrictions would be so cumbersome as to be outright ludicrous.

213. *See supra* notes 187-204 and accompanying text.

214. To accomplish a triangular merger, the would-be acquiring corporation ("A Corp") creates a wholly-owned subsidiary, Asub, and places A shares in Asub. It then proposes to the target corporation ("T Co") that T Co merge into Asub in exchange for the A Corp shares held by Asub. The end result is that T Co becomes a wholly-owned subsidiary of A Corp, but the A Corp shareholders never got to vote on the proposal. (Of course, the T Co shareholders would have to vote.) *Caveat*: if the number of shares to be issued by A Corp exceeds by 20% the number previously available for trading, and A Corp shares are listed for trading on the New York Stock Exchange, *Exchange* rules may require that A Corp shareholders be allowed to vote, but most state corporation statutes do not.

Finally, voluntary dissolution is an extreme measure, unlikely to be undertaken except in the most unusual circumstances. There may be situations in which unscrupulous managers and shareholders can seize such an opportunity to appropriate assets and values properly belonging to one or more of the other constituencies, but they are hard to visualize.<sup>215</sup> Indeed, the statutory procedures governing the winding up of a corporation's business<sup>216</sup> are intended to protect most external parties. If dissolution is indeed in the best interests of the corporation, the standard for board action, it is difficult to conceive that a court would block the action in the interests of one of the other groups. Also, it is important to recall that dissolution does not necessarily mean that the assets will be withdrawn from production; often, they will merely change hands, to be operated by new managers.

### IX. LIMIT DIRECTORS' LIABILITIES?

One possible explanation for the adoption of other constituency statutes is that they are intended to limit directors' exposure to liability, by providing additional defenses directors can raise. But, while there has been a fair amount of anecdotal evidence about the difficulties getting and keeping good directors because of the fear of ruinous liability,<sup>217</sup> there is little valid empirical evidence of it.<sup>218</sup> If, indeed, premiums for directors' and officers' liability insurance premiums have increased,<sup>219</sup> how much of the increase was due to higher litigation costs, and how much to anticompetitive practices in the insurance industry?<sup>220</sup>

The litigation costs, both direct and indirect, associated with holding directors to a minimal standard of behavior do not contribute, directly,<sup>221</sup> to produce goods and services useful to society: they are a net loss to society, except insofar as the recipients of fees, are able to live at a higher standard of

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215. There are many cases, of course, in which managers or controlling shareholders have attempted to secure advantages denied to minority shareholders. *See, e.g.,* Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505 (Mass. 1975); Ellzey v. Fyr-Pruf, Inc., 376 So.2d 1328 (Miss. 1979). These are situations in which courts are beginning to find fiduciary duties owed by shareholders to one another, as well as the duties owed by directors and officers.

216. *E.g.,* MO. REV. STAT. § 351.462 -484 (Supp. 1993).

217. *See, e.g.,* William B. Glaberson & William J. Powell, *A Landmark Ruling that Puts Board Members in Peril*, BUS. WK., Mar. 18, 1985, at 57.

218. *See, e.g.,* SODERQUIST & SOMMER, *supra* note 17, at 206 & nn.17-19.

219. *See supra* note 19.

220. Under the McCarran-Ferguson Act, 15 U.S.C. § 1012 (1988), the business of insurance is not subject to the restrictions of the federal antitrust laws.

221. To be sure, to the extent that such litigation induces directors to manage the companies better, they do contribute to enhanced production. Such contributions are *very* indirect, however, and uncertain in amount. Again, is this game worth the candle?

living. But, the defensive costs of creating "paper trails" to demonstrate a proper level of directorial behavior are totally unproductive, along with the judicial time and resources consumed by these cases, which are necessarily "big" cases; if the plaintiffs can get past the routine motions to dismiss, they can go on for years. And, of course, the plaintiffs' costs, such as attorney's fees and discovery expenses, are not insubstantial. But, all these costs would be justified if the litigation did indeed lead directors—both those sued, and others who learn of the litigation—to behave with more circumspection in the future. Alas, it seems far more likely that directors are prompted to beseech their state legislatures for statutes limiting the amount for which they can be held liable,<sup>222</sup> all the while erecting facades to demonstrate how diligently they've performed. The other constituency statutes, by expressly countenancing directors' considerations of a host of other factors in the exercise of their business judgment, probably ease the directors' minds, whether or not they have any effect.

### *A. Purposes for Imposing Liability*

Once again, neither courts, legislatures, nor commentators have clearly stated a rationale for imposing liability on directors.<sup>223</sup> The usual reason for a damage award is to compensate the parties injured by someone's breach of a

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222. Thirty-six states have enacted statutes which limit or authorize corporations to limit liability of directors. ALASKA STAT. § 09.17.050(a) (Supp. 1993); ARIZ. REV. STAT. ANN. § 10-054.9 (1990); ARIZ. REV. STAT. ANN. § 10-1005.18 (1990); ARK. CODE ANN. § 4-27-202 (Michie 1990); COLO. REV. STAT. § 7-3-101.5(2)(a) (1986); CONN. GEN. STAT. ANN. § 33-290(c)(2) (West Supp. 1993); DEL. CODE ANN. tit. 8, § 102(b)(7) (1991); GA. CODE ANN. § 14-2-202(b)(4) (Harrison 1990); HAW. REV. STAT. § 415-48.5(a) (Supp. 1992); IDAHO CODE § 30-1-54(2) (Supp. 1993); IOWA CODE § 490.832 (1993); KAN. STAT. ANN. § 17-6002(b)(8) (Supp. 1993); KY. REV. STAT. ANN. § 271B.2-020(2)(b), (5)(d) (Michie/Bobbs-Merrill 1989); LA. REV. STAT. ANN. § 12:24(C)(4) (West Supp. 1994); MD. CORPS. & ASS'NS CODE ANN. § 2-405.2 (1993); MASS. GEN. LAWS ANN. ch. 156B, § 13(b)(1 1/2) (West 1992); MICH. COMP. LAWS ANN. § 450.1209(c) (West 1990); MINN. STAT. ANN. § 300.64 Subd. 4 (West Supp. 1994); MISS. CODE ANN. § 79-4-2.02.(b)(4) (Supp. 1993); MONT. CODE ANN. § 35-1-216(2)(d) (1993); NEV. REV. STAT. § 78.037.1 (1991); N.H. REV. STAT. ANN. § 292:2.V-a.(a) (Supp. 1993); N.J. REV. STAT. ANN. § 14A:2-7 (West Supp. 1993); N.M. STAT. ANN. § 53-7-28 (Michie Supp. 1993); N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1994); N.D. CENT. CODE § 10-19.1-50.5 (Supp. 1993); OKLA. STAT. ANN. tit. 18, § 1006.B.6 (West Supp. 1994); OR. REV. STAT. § 60.047(2)(d) (1993); R.I. GEN. LAWS § 7-1.1-48(6) (1992); S.C. CODE ANN. § 33-2-102 (Law. Co-op. 1990); S.D. CODIFIED LAWS ANN. § 47-2-58.8 (1991); TENN. CODE ANN. § 48-12-102(b)(3) (Supp. 1993); TEX. REV. CIV. STAT. ANN. art. 1302-7.06(3)(B) (West Supp. 1994); UTAH CODE ANN. § 16-10a-841(1) (Supp. 1993); VA. CODE ANN. § 13.1-692.1 (Michie 1993); WIS. STAT. ANN. § 180.0828 (West 1992); WYO. STAT. § 17-16-834(a) (1989).

223. *Elkind v. Liggett & Myers*, 635 F.2d 156 (2d Cir. 1980), a securities law case, comes as close as any to identifying a rationale for damage calculations under Rule 10b-5; unfortunately, there isn't a counterpart to *Elkind* in the state law area.

duty.<sup>224</sup> But, considering the massive damages imposed in recent cases,<sup>225</sup> even a very wealthy board of directors would be unable to satisfy them. Insurance is the only feasible vehicle for generating such sums.<sup>226</sup> Even these massive recoveries would result in recoveries of a few cents or a dollar or so per share to the shareholders of large corporations—slight incentive to bring the action, which would be further reduced by allowing other constituencies to share in the recovery.

Another rationale for imposing liability on directors is to induce a desired minimum level of performance. Although this explanation is more appealing than that just discussed, it does not seem to require imposition of massive, ruinous damages. This goal could be reached, even for affluent directors, by imposing a significant, but not disastrous, amount for which directors could be held personally liable.<sup>227</sup> One objection to this approach is that it may lead the director into a perverse cost-benefit analysis: if I goof off as a director, and get caught (and, what is the probability of getting caught?), I can be liable for up to \$X; is my freedom to goof off worth that much to me?<sup>228</sup> And, perhaps more realistically, if the limit is set too low, it may remove any incentive for the shareholders, as "private attorneys general," to bring actions against miscreant directors.

All states permit corporations to indemnify directors against liabilities to which they are exposed because of serving on a board of directors.<sup>229</sup> Permitting corporations to indemnify directors, or purchase D&O insurance policies for them, may reduce directors' incentives to perform at acceptable levels of behavior.<sup>230</sup> One approach might be to set some lower limit to the amount that

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224. See, e.g., DAN B. DOBBS, *LAW OF REMEDIES* 210 & n.17, 216-20 (2d ed. 1993).

225. E.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del 1985) (\$23.5 million). See *supra* notes 15-19 and accompanying text.

226. Of course, as noted *supra* note 17, insurance only paid part of the settlement in *Smith v. Van Gorkom*.

227. Indeed, many would argue that it is the possibility of being sued, even more than the exposure to damages, that bears on the sorts of people invited to serve on boards of directors. They view themselves as community leaders, and worry that being a named defendant is a blot on their reputations, even if they are ultimately exonerated.

228. Admittedly, this is a far-fetched hypothetical; it is doubtful that the sorts of people serving on boards of directors would be inclined to engage in this sort of calculus. Still, the possibility exists.

229. See, e.g., DEL. CODE ANN. tit. 8, § 145 (1991); MO. REV. STAT. § 351.355 (1986); MBCA § 5.

230. Cf. Item 510 of SEC Regulation S-K, requiring that a prospectus for a securities offering include a description of any indemnification provisions relating to directors, officers, and controlling persons of the registrant, and requiring that the following statement be included:

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers or persons controlling the registrant pursuant to the foregoing provisions, the registrant has been

may be indemnified—e.g., no indemnification for liabilities up to, say, \$500,000<sup>231</sup>—but insurance can be carried for liabilities exceeding that amount.

### *B. What sorts of liabilities?*

The principal obligations imposed on directors are a duty of care and a duty of loyalty. Most of the statutes permitting corporations to limit directors' liability permit limitations on liability for breach of the duty of care, but not for loyalty.<sup>232</sup> That division is probably appropriate, if corporations should be permitted to impose such limits at all.

Directors are required to act with the degree of care of a reasonable person in a like position under similar circumstances because of the need for them to exercise some minimal degree of care. At the same time, directors should feel free to take risks without undue fear of personal liability, because the shareholders, as the residual claimants, benefit the most from those risky ventures that pay off.<sup>233</sup> Professor Coffee<sup>234</sup> points out that there is a tendency for shareholders to be more risk-tolerant than managers, in part because managers' investment is more firm-specific; properly diversified investors are more willing to accept risks than are managers, whose human and financial capital may be wiped out if the risk does not pan out. As a result, a variety of compensation mechanisms have been devised to attempt to align managers' risk preferences more closely to those of shareholders.<sup>235</sup> Clearly, liability rules that are too strict undercut the effort to bring managers' risk preferences in line with those of shareholders. Perhaps the approach taken in *Francis v. United Jersey Bank*<sup>236</sup> is an appropriate standard: require directors to keep themselves informed, oversee managers

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informed that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is therefore unenforceable.

17 C.F.R. § 229.510 (1993).

This Item reflects the SEC's historic antipathy for indemnification provisions, based on their concern that it will decrease the directors' incentive to ensure accuracy of statements made in a registration statement. The SEC also, as a condition to "acceleration" of the effective date of the registration statement, a practical necessity in almost all public offerings, requires the issuer of the securities to enter into an undertaking, if there should be a claim for indemnification, to submit the question to a court of competent jurisdiction.

231. The number is, of course, arbitrary; it sounds like a lot to some, but probably not to Ross Perot. Perhaps a sliding scale, in relation to the individual's net worth, could be used. In any case, the minimum amount should be sufficient to get the director's attention, but not be ruinous.

232. E.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

233. See generally KLEIN & COFFEE, *supra* note 91, at 255-70.

234. Coffee, *supra* note 2, at 17-19.

235. *Id.* at 23-24; CLARK, *supra* note 10, § 6.2.1, at 201.

236. 392 A.2d 1233 (N.J. Super. Ct. Law Div. 1978), *aff'd*, 432 A.2d 814 (N.J. 1981).



closely, and challenge transactions that appear questionable. Failure to meet that standard should be punishable, but at a reasonable level.<sup>237</sup>

The duty of loyalty usually refers to conflict of interest situations.<sup>238</sup> As such, it is not appropriate to limit a director's liability for self-dealing, usurpation of corporate opportunities, or other breaches of the duty of loyalty. Indeed, those statutes that permit limitations on liability expressly exclude breaches of the duty of loyalty.<sup>239</sup> Also, most of the existing indemnification statutes also bar or limit indemnification in these types of situations.<sup>240</sup>

### C. How to limit?

A statutory limitation on directors' liability would be too inflexible to cover the myriad situations arising in corporate America. A figure that would deter an average individual might not dent the consciousness of a very wealthy person. Also, any formula approach runs the risk of attaining complexity akin to the Internal Revenue Code. Further, the contractarians<sup>241</sup> would argue that, in a particular corporation, the shareholders might be willing to impose a limit on director's liability in order to secure the services of particular individuals, or for other reasons. Perhaps an individual would be willing to serve for less, or no, compensation if she were allowed to engage in self-dealing; if shareholders are willing to accept this, perhaps they should be free to do so. Thus, the Delaware approach, of permitting a corporation to adopt a provision in its articles of incorporation imposing such a limit might be acceptable.

One risk inherent in this suggestion is that a Machiavellian promoter might organize a corporation, and include a limitation provision in the initial articles of incorporation, in order to avoid later having to submit an amendment adopting a limit to a shareholder vote. That could be overcome by requiring, in the state corporation act, that these sorts of limitation provisions be re-adopted periodically by shareholders, perhaps every five years or so.

## X. CONCLUSIONS

Given that other constituency statutes are so riddled with uncertainty as to be of little practical effect, why has there been so much pressure to adopt them? Surely the lawyers who drafted them are far too intelligent to believe they would

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237. *Id.* at 1242. To be sure, in *Francis*, full liability was imposed on the director's estate, without limitation, but the likely beneficiaries of that estate were the director's sons, who were the primary miscreants in a plan of fraud on business relations.

238. CLARK, *supra* note 10, § 4.1, at 141; KLEIN & COFFEE, *supra* note 91, at 163-69.

239. *E.g.*, DEL. CODE ANN. tit 8, § 102(b)(7) (1991).

240. *See supra* notes 40-43 and accompanying text.

241. *See supra* notes 108-11 and accompanying text.

in fact insulate their director clients from liability.<sup>242</sup> Indeed, all they could realistically have hoped for is an additional argument that directors could raise, if they were sued over some exercise of business judgment. In this area, as in many others,<sup>243</sup> it is in defendants' interests to delay, and disputes over effects on other constituencies can certainly extend litigation, even if they do not persuade a court to dismiss an action on preliminary motion.<sup>244</sup> The statutes thus have the potential to erect additional barriers to shareholders' ability to hold directors accountable for what they do or do not do.<sup>245</sup>

If the concern for excessive liability being imposed on directors is legitimate, the other constituency statutes are, at best, an imperfect, indirect reaction. It would be much better to provide limitations on liability directly, through legislation targeted at those areas in which limitations may be appropriate. Rather than adopt statutory limitations, applicable to all corporations, it would seem better to permit corporations to elect to adopt limits on their own directors' liability, and such limitations should be subject to shareholder approval. Ideally, they should be subject to periodic reapproval, perhaps every

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242. Bainbridge, *supra* note 3, at 1002 n.133 (saying that this was almost certainly the intent of the drafters, but at least some of the legislators had real concern for nonshareholder constituencies). Bainbridge cites back to his footnote 115, at 996, in which he quotes exchanges with some of the proponents of the Pennsylvania version, and cites to Charles J. Dangelo, Comment, *Community Effects as a Factor in Corporate Decisions Under Pennsylvania's New Business Corporation Law: Objective Evidence of a Subjective Process*, 28 DUQ. L. REV. 533, 536 (1990), for the notion that the legislation was intended to benefit shareholders as well as other constituencies, not to protect corporate management. At best, this reflects the thinking of those particular legislators; it says nothing at all about what the collective intent of the legislature as a whole may have been. Indeed, particularly in the area of state legislation, the term "legislative intent" is an oxymoron.

243. For example, in the antitrust field, it has been noted that, notwithstanding the possibility of treble damages, it could be financially worthwhile to fix prices even if one were caught. The use of the extra profits derived from the price fixing throughout the duration of the litigation, coupled with the courts' typical aversion to allowing interest to run on damages until the judgment has been entered, means that the defendant in fact profits, even if he later *does* have to pay treble damages. See Walter B. Erickson, *The Profitability of Violating the Antitrust Laws: Dissolution and Treble Damages in Private Antitrust Litigation*, 5 ANTITRUST L. & ECON. REV. 101 (1972).

244. As the law governing shareholder derivative actions is evolving, with the rise of special litigation committees and the developments in the demand requirement (see FED. R. CIV. P. 23.1, which has been the model for many state counterparts)—especially in Delaware and New York (*compare* Barr v. Wackman, 329 N.E.2d 180 (N.Y. 1975) with Aronson v. Lewis, 473 A.2d 805 (Del. 1984))—the deck is fairly well stacked in directors' favor without more.

245. Again, the growing strength of advocacy organizations like United Shareholders Association, coupled with the increased activism of at least some institutional investors, is tending to counteract this trend to some extent. See *supra* notes 125-27 and accompanying text. However, this activity may be too little, too late.

five years. If the opposite approach, of specifying a statutory limitation, is chosen, then shareholders should be able to "opt out" of the limits, although in view of the difficulty in organizing a diverse, disparate, scattered group of shareholders, that is far less desirable than using an "opt in" approach, with periodic reapproval.

Concurrently, it would be desirable to spell out standards of director behavior, rather along the lines of the Revised Model Business Corporation Act,<sup>246</sup> rather than leave these standards to the current case-by-case determination. The judicial approach might be satisfactory in a jurisdiction, like Delaware or New York, with a well developed body of case law, but in jurisdictions like Missouri with limited judicial interpretations, there is too much uncertainty. It becomes extremely difficult to advise clients with a high degree of confidence as to how to conduct themselves, and how to ensure that they will be protected against liability.

Of course, it is fruitless for a jurisdiction that wants to protect shareholders from managerial overreaching to have rules, either statutory or judicial, that are much more stringent than those of the most liberal jurisdiction. Under current interpretations, managers will simply incorporate in the more liberal jurisdiction, and do business in their "home" state as foreign corporations.<sup>247</sup> Additionally, corporate lobbyists are heard much more clearly in state capitals than in Washington; legislators anxious to attract industry to the state, in order to help fill the treasury's coffers, are unlikely to be too hard on corporations, lest they discourage someone from locating in the state, or lead a domestic corporation to flee to more friendly climes. It is the "race to the bottom" all over.<sup>248</sup> This again raises an argument for federal incorporation, at least of larger corporations, but that idea has already been rejected many times.<sup>249</sup>

Other constituency statutes are so filled with uncertainties and inconsistencies that they should be repealed. Alternatively, courts should recognize that the total elimination of any accountability of managers so conflicts with traditional notions of corporate governance that they should be voided. This could be done if courts would apply Professor Macey's analysis, and interpret the

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246. *E.g.*, RMBCA § 8.30.

247. *E.g.*, most of the large, publicly held corporations headquartered in Missouri—Anheuser-Busch, McDonnell-Douglas, and Monsanto—are incorporated elsewhere. The holding company controlling Anheuser-Busch is a Delaware corporation, although there is a domestic Anheuser-Busch Company; McDonnell-Douglas is a Maryland corporation; Monsanto is a Delaware corporation. *See* the PH-MOCORP database on Westlaw.

248. *See* the historical sketch in KLEIN & COFFEE, *supra* note 91, at 114-19. Under Commerce Clause interpretations, it is the law of the state of incorporation that determines the corporation's internal operations. *Id.* at 116 n.7.

249. *But see* Karmel, *supra* note 1, at 91-96. However, it must be acknowledged that Congressional personnel may not be immune from the blandishments of lobbyists either.

statutes in a public-regarding manner.<sup>250</sup> But, for the reasons mentioned in the paragraph just above, neither eventuality is likely to occur anytime soon. Perhaps the best hope is that the newly-active institutional shareholders and shareholders' advocacy groups can bring sufficient pressure to bear on managers to get a significant proportion of corporations to "opt out" of these sorts of statutes.<sup>251</sup>

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250. See *supra* notes 138-45 and accompanying text.

251. See Minow, *supra* note 26, at 220, in which the author notes that, by October 17, 1990—within months of the passage of the restrictive 1990 amendments to the Pennsylvania other constituency statute—nearly a third of Pennsylvania's publicly traded companies had opted out of at least portions of the statute. The author goes on to say that 61% of the Fortune 500 companies incorporated in Pennsylvania had opted out, as had over 56% of those included in the Standard & Poor 500.

