

LECTURE AND COMMENTARY ON THE SOCIAL RESPONSIBILITY OF CORPORATE ENTITIES

THE SOCIAL RESPONSIBILITY OF BOARDS OF DIRECTORS AND STOCKHOLDERS IN CHARGE OF CONTROL TRANSACTIONS: IS THERE ANY “THERE” THERE?

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Thank you, Ehud, for that gracious introduction. I am honored and pleased to be with you at USC today.

I am aware that I speak to an audience that is comprised largely of students without a deep exposure to corporation law. Happily, I hope that the subject of my talk will be of some modest interest even to law students and professors not obsessed with the doctrinal nuances of corporation law. I have attempted to make my discussion accessible even to nonlawyers, but I have undoubtedly missed my mark at times.¹

In the main, though, I harbor hope that you will find my subject provocative. That subject centers on a hypothetical that raises some of the

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1. These remarks were delivered in a lecture at the University of Southern California Law School on January 22, 2002, and in a slightly different form at the Fifth Annual Fall Symposium of the Conference Board on October 31, 2001, which focused on the social responsibility of corporations. The author gratefully thanks Karlis P. Johnson, Andrew H. Lippstone, Esq., and Adam M. McLain, Esq. for their invaluable help; Professor Ehud Kamar for his kind invitation to visit the University of Southern California; and Professors Lynn Stout and Eric Talley for their thoughtful and provocative responses.

tough ethical choices that must be made by legislators and judges forging the Delaware corporation law. The hypothetical is designed to stimulate thought about the social role of the corporation in our society, and to raise questions about the extent to which corporation law can wish away the difficult moral choices that corporate boards and stockholders often face, simply by creating doctrinal boxes in which real-world moral concerns are thought to be of no relevance. At an even deeper level, the hypothetical presents a challenge to those scholars who have embraced an optimistic view of the extent to which Delaware corporation law protects the interests of rank-and-file employees and communities affected by the fate of American corporations. I have intentionally framed the hypothetical in vivid and somewhat moralistic terms, which tend to ignore certain complexities, but which also serve to highlight the theoretical and ethical tensions that are the core subject of this lecture.

Before describing the hypothetical, I pause briefly to set forth the basic normative debate the hypothetical amplifies.

It is, of course, trite to observe that American corporation law has long struggled with a fundamental question: what is the purpose of the corporation? Is the aim of the corporation simply to maximize the wealth of its current stockholders? Or is the corporate purpose broader, taking into account the interests of other contributors to corporate success, such as its employees, the communities in which its facilities operate, and the nation in which it is chartered?²

The predominant academic answer is that corporations exist primarily to generate stockholder wealth, and that the interests of other constituencies are incidental and subordinate to that primary concern.³ In this conception, the corporation is like other forms of privately held property: the stockholders who own its shares are seen as its owners, and the maximization of their wealth is the corporation's singular end. Former Chancellor, and now Professor, Bill Allen has aptly called this view the "property" model.⁴ Some evince such faith in the marketplace that they genuinely believe that a stockholder-focused approach will, in the long run, generate the greatest benefit for corporate employees and the societies in

2. In a forthcoming article with William T. Allen and Jack B. Jacobs, I also discuss this debate. See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. (forthcoming 2002).

3. A famous judicial decision adopting this viewpoint is *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

4. William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 264-65 (1992).

which corporations operate. This school is dubious about allowing corporate boards of directors to consider values other than the best interests of their current stockholders. In particular, its adherents have difficulty conceiving of a situation in which it could be appropriate for a corporate board to prevent stockholders from accepting a fully funded, premium-to-market tender offer for all the shares of the company, once the board has had the opportunity to develop a higher value opportunity.⁵

Another strain of thought, however, has deep roots as well, and might even be thought to have been predominant in the American business community for most of the latter half of the twentieth century.⁶ That strain sees the corporation as a societal institution, with responsibilities larger than the provision of large returns to its current stockholder base—a base that is often comprised largely of transient equity holders with no long-term stake in the fate of any particular corporation. In this conception, the corporate board of directors owes its duty to the corporation itself, rather than to the stockholders.⁷ In weighing the appropriate course of action, the board is entitled to think about the well-being of various interests vital to the corporation's *long-term* success as an economic entity.⁸ Allen has called this the "entity" model of the corporation.⁹

5. For examples of thinking along these lines, see Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 819–21 (1981). See also Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1046–50 (1982).

6. See Allen, *supra* note 4, at 270–72.

7. Articulate advocates of this perspective include Martin Lipton and Margaret M. Blair and Lynn A. Stout. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory Of Corporate Law*, 85 VA. L. REV. 247, 298–309 (1999); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 105–06 (1979); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 187–89 (1991); Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply To Professor Gilson*, 27 DEL. J. CORP. L. (forthcoming 2002).

8. In the academic literature, there is a vigorous debate over which school of thought is most likely to increase long-term wealth creation by corporations. For example, critics of the property model argue that it slights the economic value flowing from a system that permits the corporate board both to disregard the demands of its current stockholders for a one-time sale premium and to pursue a different strategy focused on long-term growth of the entity. Blair and Stout have articulated the following perspective:

How can rejecting a premium offer benefit the long-run interests of the present pool of shareholders if—as modern financial theory holds—today's lower market price reflects the best possible estimate of those shareholders' future returns under current management?

... the mediating hierarchy model predicts that shareholders benefit from granting directors discretion to favor other constituencies, because it suggests that shareholders' "long-run interest" should be interpreted to mean the long-run interests of all the shareholders who hold, have held, or will hold stock in the firm, including those original investors who bought their shares when the firm first went public. Opportunistically exploiting the firm-specific

There are many permutations to the property and entity schools of thought, but for today's purposes, this basic division suffices. One characteristic that both schools share is an ardent desire to wish away the basic conflict between their two visions. The stockholder-focused school thinks that in the end all stakeholders will be served by a rigorous, market-oriented approach that places an emphasis on the free flow of property—including corporations themselves—to those who will pay the highest price.¹⁰ The softhearted are kidding themselves if they think that the

investments of corporate stakeholders (say, violating employees' expectations of job security by moving the firm's manufacturing plants to Mexico) may well benefit, in both the short and the long run, those individuals who happen to hold shares in the corporation at the time the decision to move is made. If the firm's employees anticipated this sort of conduct *ex ante*, however, they might well have demanded higher wages—or been more reluctant to invest in firm-specific human capital—in earlier years.

The mediating hierarchy model thus lends intellectual content to the argument that treating directors as trustees charged with serving interests above and beyond those of shareholders in fact can be in shareholders' 'long-run interests,' because a shareholder decision to yield control rights over the firm to directors *ex ante*—that is, when the corporate coalition is first formed—can induce other participants in the team production process to make the kind of firm-specific investments necessary to reap a surplus from team production in the first place. Thus, a broad interpretation of the business judgment rule that permits directors to sacrifice shareholders' interests to those of other corporate constituencies "ties the hands" of shareholders in public corporations in a fashion that ultimately serves their interests as a class, as well as those of other members of the corporate coalition.

Blair & Stout, *supra* note 7, at 304–05. See generally Lipton & Rowe, *supra* note 7.

9. He has summarized this model thusly:

The second conception sees the corporation not as the private property of stockholders, but as a social institution. According to this view, the corporation is not strictly private; it is tinged with a public purpose. The corporation comes into being and continues as a legal entity only with governmental concurrence. The legal institutions of government grant a corporation its juridical personality, its characteristic limited liability, and its perpetual life. This conception sees this public facilitation as justified by the state's interest in promoting the general welfare. Thus, corporate purpose can be seen as including the advancement of the general welfare. The board of directors' duties extend beyond assuring investors a fair return, to include a duty of loyalty, in some sense, to all those interested in or affected by the corporation. This view could be labeled in a variety of ways: the managerialist conception, the institutionalist conception, or the social entity conception. All would be descriptive, since the corporation is seen as distinct from each of the individuals that happen to fill the social roles that its internal rules and culture define. The corporation itself is, in this view, capable of bearing legal *and* moral obligations. To law and economics scholars, who have been so influential in academic corporate law, this model is barely coherent and dangerously wrong.

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This social entity conception sees the purpose of the corporation as not individual but social. Surely contributors of capital (stockholders and bondholders) must be assured a rate of return sufficient to induce them to contribute their capital to the enterprise. But the corporation has other purposes of perhaps equal dignity: the satisfaction of consumer wants, the provision of meaningful employment opportunities, and the making of a contribution to the public life of its communities. Resolving the often-conflicting claims of these various corporate constituencies calls for judgment, indeed calls for wisdom, by the board of directors of the corporation. But in this view no single constituency's interest may significantly exclude others from fair consideration by the board. This view appears to have been the dominant view among business leaders for at least the last fifty years.

Allen, *supra* note 4, at 265, 271–72 (citations omitted).

10. Professor Mark Roe put this argument in clear terms recently, without necessarily embracing it:

interests of labor and communities ultimately will be served by quasi-protectionist measures taken by corporate boards.¹¹

Meanwhile, those who embrace the entity model believe that stockholders with diversified portfolios will benefit in the aggregate by emphasizing the long-term creation of wealth rather than the enabling of short-term stockholder profits through market transfers. Corporations generate wealth when they can obtain firm-specific investments from employees, creditors, and communities. If these constituencies believe that the value created by these firm-specific investments can be unfairly expropriated any time a majority of stockholders decides to sell the firm, they may reduce their own level of investment, to the detriment of overall

Shareholder wealth maximization is usually accepted as the appropriate goal in American business circles. The norm makes some uneasy, though: after all, why should shareholders, who usually are favored members of their society, prevail over, say, current employees, who usually are less favored?

The utilitarian justification is that this preference is the price paid for strong capital markets, and allocative efficiency and that these benefits are so powerful that they overwhelm the normative benefit of any distributional favoring of current employees over current shareholders. In the long run, the argument goes, employees and other stakeholders are overall better off with fluid and efficient capital markets, managers need a simple metric to follow, and both wealth and, in the end, fairness are maximized by shareholders being the corporation's residual beneficiary, with the other claimants getting what they want via contract with the corporation. Current employees might be made worse off in some industries, but employees overall will have more opportunities, higher salaries, and better working conditions. Furthermore, a stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own.

Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001). Professor Allen's recitation of this argument is similar:

The . . . rationale for the property model is that the model, and action consistent with it, maximizes wealth creation. This rationale asserts that the purpose of business corporations is the creation of wealth, nothing else. It asserts that business corporations are not formed to assist in self-realization through social interaction; they are not formed to create jobs or to provide tax revenues; they are not formed to endow university departments or to pursue knowledge. All of these other things—job creation, tax payments, research, and social interaction—desirable as they may be, are said to be side effects of the pursuit of profit for the residual owners of the firm. . . .

. . . This . . . argument for the legitimacy of the corporation as shareholder property is not premised on the conclusion that shareholders do "own" the corporation in any ultimate sense, only the premise that it can be better for all of us if we act as if they do.

Allen, *supra* note 4, at 269–70.

11. This argument is buttressed by the difficulty of policing director fidelity even when directors are supposed to act only in the interests of stockholders. By permitting directors to justify their actions by reference to more diffuse concerns, the (already challenging) judicial task of adjudicating fiduciary compliance arguably becomes impossible. See, e.g., Allen, et al., *supra* note 2, at 43–45; Committee on Corporate Laws, *Other Constituencies Statutes: Potential For Confusion*, 45 BUS. LAW. 2253, 2270 (1990) ("[A]ny articulation of a director's duties that extended them to other constituencies without primacy being accorded shareholder interests would diminish the ability of shareholders to monitor appropriately the conduct of directors."); Roe, *supra* note 10, at 2065.

wealth generation.¹² The entity school also notes that investors with diversified portfolios will not necessarily benefit from a legal regime that encourages mispriced, perhaps hubristic takeovers advantaging target stockholders at the expense of acquirers and the actual economic assets purchased. Because diversified investors are just as likely to hold stock in acquiring firms as in targets, bad deals are ultimately costly to them, too.¹³

These arguments are appealing because they make us feel better about whichever of the two models we tend to favor. Best of all, they provide courts and other decisionmakers with a way out of the basic conflict. If a board of directors can plausibly claim that a decision to reward employees with a pay raise now will pay off in long-term returns for the stockholders, the need for a choice between the property and entity models magically disappears.

The institution of the corporate board plays an important role in bridging (or papering over) this gap. After all, the stockholders elect the board. It therefore has legitimacy. To the extent that the stockholders disagree with the board's decision to acknowledge the interests of other constituencies, their remedy is a simple one theoretically, if a more difficult one in practice: they can elect another board.

Even though only the stockholders play a role in electing boards, some scholars who adopt the entity view that corporations have larger societal duties have also embraced the institution of the corporate board as a critical element in explaining the success of the corporate form. According to these scholars, the board acts as a "mediating hierarch" that balances the respective interests vital to the corporation's success.¹⁴ While not a perfect answer to the resolution of these competing interests, a properly motivated corporate board with a long-term view of the corporate interest is, these scholars argue, well-situated to attract and retain investments in the

12. See Blair & Stout, *supra* note 7, at 307. See also Lipton & Rosenblum, *supra* note 7, at 216–24.

13. See, e.g., Blair & Stout, *supra* note 7, at 272; Lipton & Rowe, *supra* note 7. See also James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 *BUFF. L. REV.* 249, 251, 256–57 (2001) (summarizing evidence that in his view supports the conclusion that many mega-mergers result in value destruction).

14. The leading article on the subject is Blair and Stout's *A Team Production Theory of Corporate Law*, *supra* note 7, at 271. By associating Blair and Stout with the entity model, I do not mean to obscure or minimize the nuances of their team production model of the corporation. Rather, I simply recognize that their view that corporations create value because they are able to extract valuable commitments of labor and capital from many sources, and that those sources must be treated with a modicum of fairness and respect if the corporate form is to be a successful tool for long-term wealth creation, is fairly identified with the entity model.

corporation from all the sources vital to economic success.¹⁵ The knowledge that there is a reputable group of individuals committed to the firm's success over time is viewed by them as a safeguard that engenders a degree of trust among employees, communities, and creditors sufficient to encourage them to make full-bodied investments in the firm.¹⁶

The Delaware corporation law has developed an approach to balancing the entity and property models in mergers and acquisitions transactions. Its approach gives boards of directors substantial leeway to act in what they perceive to be the best interests of the corporation as an entity, *whenever the company has not decided to engage in a change in control transaction.*¹⁷

Now, you might ask, what is a change in control transaction? It is most easily defined as a sale of the corporation for cash. This is considered an end-game transaction in which the corporation's stockholders are entitled to have the board seek the highest immediate value, to the exclusion of other considerations.

A change in control is also deemed to occur when a corporation without a controlling stockholder is merged with another company, with the corporation that results from the merger being controlled by a particular group or individual with the power to decide when the resulting company will be sold.¹⁸ Why? Because after such a transaction, the minority stockholders may only receive a control premium through the grace of the controlling stockholder. Thus, the transaction that leads to the transfer in control is thought to represent the current stockholders' last chance to receive a control premium. As a result, the board is charged with getting the highest immediate value in the deal, regardless of whether the transactional consideration is stock instead of cash.

15. Blair & Stout, *supra* note 7, *passim*.

16. *See id.* at 316–19.

17. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179–80 (Del. 1986). As a general matter, the *Revlon* case stands for the proposition that once a board of directors either decides to sell the company or engages in change of control transaction, it must act to secure the highest immediate value reasonably attainable. *See id.* at 182.

18. Under Delaware law, a stock-for-stock merger is not deemed a change in control invoking so-called “*Revlon* duties” (discussed *infra*) if the company whose stock is received in the merger is publicly traded and will not have a controlling stockholder after the merger. The two leading cases on this subject are *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150–51 (Del. 1990) and *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 46–48 (Del. 1994). These cases provide guidance as to the situations in which a board is subject to the duties articulated in *Revlon*.

In corporate law, the name for this “*Revlon*” duty—that is, the duty to get the highest price immediately available in a change in control transaction—is taken from the key case that articulated it: *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*¹⁹ When *Revlon* duties are invoked, the corporate board is operating in a context in which the property model predominates, because the board’s singular focus is on getting the best price for the current stockholders, regardless of the interests of other constituencies.²⁰ Put differently, once directors have entered the metaphorical world of *Revlon*, all of their actions must be judged against the sole objective of securing the best immediate value. As a practical matter, that means that the directors cannot give lock-ups or other preferences to one bidder if those preferences will have the effect of deterring a sale of the company at the best price.²¹ It also means that the directors cannot prefer one deal over another because they believe that a buyer offering, say, a ten percent lower price has a long-term business plan that is better for other corporate constituencies, such as the employees.²² In *Revlon*-land, the directors must take a materially higher price because the law considers there to be no “long term” for the corporation’s stockholders, and thus their interests as owners in maximizing their final return from their investment is regarded as legally paramount. Because of *Revlon*’s uni-dimensional focus, the standard cabins director flexibility more than any other. While Delaware courts still accord directors substantial leeway to determine how to fulfill their duty to get the best deal, at bottom the standard reduces the directors to faithful auctioneers.

By contrast, in other situations the entity model prevails. For example, assume a large public corporation engages in a stock-for-stock merger with another public corporation that is four times larger. A public stockholder owns neither, but the larger corporation’s management will in reality dominate the resulting entity. In that circumstance, the smaller corporation’s board need not decide that the merger is the best immediate value its stockholders can receive. Rather, they may consider whether the merger is the best way to maximize profits in the long term, because the smaller entity is not seen as disappearing in an end-game transaction, but continuing as part of a new entity.²³ Because no particular stockholders

19. 506 A.2d at 173.

20. *See id.*

21. *See id.* at 183–84.

22. *See id.* at 182.

23. This scenario roughly tracks the situation in *Arnold v. Society for Savings Bancorp., Inc.*, 650 A.2d 1270, 1289 (Del. 1994), in which such a merger was held not to trigger *Revlon* duties because no change of control had occurred. *See also* Bernard Black & Reiner Kraakman, *Delaware’s Takeover*

control that new entity, the smaller entity's stockholders can still receive a control premium in the future. Therefore, the courts give substantial deference to the board to decide whether to adopt this strategy and to reject other bids that might have a higher short-term value. Said a bit differently, the directors need not follow the stock market's or their investment banker's view of what they consider is the best deal; they can chart their own long-term course in good faith. In this context, the Delaware corporation law leans heavily toward the entity model. Important cases like *Paramount Communications, Inc. v. Time Inc.*²⁴ illustrate this tendency.

Let me now turn to the hypothetical, which purposely places stress on the concepts that the Delaware corporation law has used to reduce the tension between the property and entity conceptions of the corporation.²⁵ It hopefully raises provocative questions about the duties owed by corporate directors and stockholders, and the purpose of the corporation law. In particular, the hypothetical explores the extent to which the board of directors can genuinely act as a mediating institution that reconciles the property and entity models of the corporation.

The hypothetical addresses the duties of directors and stockholders in an end-game transaction involving the sale of the enterprise in a change of control transaction that implicates *Revlon* duties.

Let's start. Assume that James Trains is a publicly traded Delaware corporation that manufactures children's toys, that it started as a family-owned business, and that it went public some twenty-five years ago. James has plants in four different communities in the midwestern United States. Over the years, James has been generally profitable for its stockholders. At times, however, it has experienced some significant financial challenges. In order to help it through, each of the states in which James operates plants has provided the company with incentive financing packages and tax breaks that have enabled the company to survive tough times. The states have done so because they want to keep the plants open in their communities and because James' management is known for caring for its

Law: The Uncertain Search for Hidden Value, 96 NW. U. L. REV. 521, 543-44 (2002) (discussing this holding).

24. 571 A.2d 1140, 1140 (Del. 1990).

25. Several other states have, by statutory enactment of constituency statutes, explicitly empowered boards to act in accordance with the entity model, thus making a more definitive policy decision. See Lipton & Rowe, *supra* note 7, manuscript at 15-16 (noting that a majority of states have adopted constituency statutes). See also Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, CAL. L. REV. (forthcoming 2002) (noting strength of many states' anti-takeover statutes).

workers. For similar reasons, the federal government also has assisted James and other domestic manufacturers of toys, through efforts such as export assistance and negotiating to open foreign markets.

Importantly, by the beginning of the twenty-first century, the toy manufacturing business was consolidating. James was under increasing pressure to generate profits and to maintain the fair wage structure and strong environmental record that had earned it respect in the communities where it had operations. The company also faced some difficulty in manufacturing and marketing its toys efficiently, since it was smaller than many other industry players which could capitalize on economies of scale and other opportunities unavailable to James. Equally important, the company needed to invest in its plants and reduce its cost of capital, which was greater than that of larger concerns in the industry.

Looking to the future, the James board reluctantly concluded that it could not remain independent and hope for its operations to continue to thrive on a long-term basis. Rather, it decided that the company needed to combine with some other larger entity to secure its future. The board was hopeful that a favorable sale or merger could be realized, because the company's replica trains, trucks, and cars were well-regarded American staples of high quality. Its brand names alone were valuable.

Assume that the board used a high-quality investment bank to shop the company and that it came up with three financially attractive, all-cash bids.

The first was from All American Toys, a publicly traded corporation. All American Toys was a manufacturing concern four times the size of James. Descendants of its founders, the Washington family, controlled seventy-five percent of its voting stock through a family trust. Like James, All American Toys manufactured high-quality toys in American plants. Its workforce was well-paid and the company had a good reputation for keeping its folks employed even during tough times. Like James, All American Toys was respected in the communities in which it operated and had a good record of environmental compliance. Also, the company had a successful catalog and "e-tailing" business.

In connection with a sale, All American Toys indicated that its intention was to keep all of James' plants operational and to make the necessary capital investments to maintain their viability. Moreover, its pay structure was such that the James employees could make a transition to its payroll without personal pain. Some of James' higher-level administrative executives would lose their jobs, but its plant-level employees would be retained.

The All American Toys offer was a thirty-five percent premium over the highest price at which James had traded in the last three years.

James received two other all-cash, fully financed bids. Toys Of The World was one of the world's leading toy manufacturers. Although it had distribution facilities in the United States, most of its manufacturing operations were conducted abroad, in nations with weak environmental and labor protection laws. Sadly, Toys Of The World sometimes employed children of the developing world to manufacture toys for export to Western Europe and the United States. The principal value that Toys Of The World saw in James was in its name-brand toys, and it refused to make any promises that it would continue manufacturing in the United States.²⁶

The final bid was from Piggy Banks, Inc., which represented a group of financial investors. Piggy Banks proposed a leveraged buy-out ("LBO") that would result in James taking on a very heavy debt burden. Piggy Banks wanted to keep James' top management, but was committed to stringent cost reductions (read: job cuts) to ensure that it could repay the debt it had incurred to fund its highly leveraged tender offer.

Both Toys Of The World and Piggy Banks were willing to pay a forty percent premium to market, which was a five percent higher premium than the offer from All American Toys. By this time, James' bankers were satisfied that they had extracted the best bids they could get, at least until the board selected its favorite, in which case an additional round of (perhaps egotistic) bidding might ensue.

Assume that the James board is comprised of ten persons. Only two are full-time managers. Two are members of the James family, which still owned eighteen percent of the company's stock. The other six were independent directors, each of whom lived in a community in which James operated.

Imagine that the James board deliberated long and hard on which bid to select. They knew that the bidders were offering cash, not stock, and that the Piggy Bank and Toys Of The World offers were the highest and that both could pay. But it bothered them that a sale to either of the two would end the legacy of James on a sour note.

By contrast, the All American Toys bid seemed quite impressive. While the price was slightly lower, it was still at an attractive premium to market. Moreover, the board had looked at the James stockholder profile carefully. Aside from the James family holdings and the stock owned by

26. As I said, I am, in this and other respects, shamelessly stacking the deck.

employees, institutions that had bought the stock in the past three years primarily held the rest of the company's stock. For them, the All American bid was a premium to any price that James' stock had traded at during that period.

In addition, All American shared the same values that made James such a respected company. Indeed, All American was even going to keep the James name for use in connection with certain of its most established toys, something All American had successfully done in the past. Most importantly, All American had a solid business plan for building high-quality toys at a profit at domestic manufacturing plants with well-paid workers. Its catalogs and e-tailing efforts dovetailed nicely with sales of its products through more traditional retailers. Thus, a sale to All American seemed to be the fairest to the employees and communities whose efforts had contributed to the company's prosperity. It also seemed to be a good long-term economic move.

By contrast, the board feared that Piggy Bank's business model was a mess. The debt that Piggy Bank had taken on to finance its offer seemed untenably high. The board feared that Piggy Bank either would run the company into bankruptcy or would be forced to bust it up. Nothing about Piggy Bank seemed to bode well for the company's workforce. And of course, Toys Of The World's goal seemed to be clear: buy the value of the company's name brands, keep making them for a time in the current plants without any plan for refurbishment of those facilities, and eventually make them offshore at low cost in nations with bad reputations for labor protection. The directors found this distasteful.

The board counseled with its legal advisors, who told them they were in a straitjacket: they had to accept the highest bid. The board demurred: "Isn't there something else we can do?" "Well," said the counsel, "if All American weren't dominated by a controlling stockholder, you could have structured the deal as a stock-for-stock, non-change-of-control deal and tried to argue that the long-term value of the offer was higher. All American is willing to let our stockholders take stock rather than cash, but I fear that won't get us out of the legal box. All American is dominated by the Washington family's holdings and would be even after a merger with us. Thus, even a pure stock deal with All American would be considered a change in control. In that case, your duties would still be governed by the *Revlon* standard, and you would have to get the highest price."

At this point, the two James family representatives on the board got hacked off. "Damn it, we have the biggest stake in this company and we're

willing to take less to do the right thing. By God, the rest of you ought to be able to stand up and do the right thing, too.” The board rallied behind this view. The James board noted that privately held businesses are sold to less-than-the-highest bidders all the time, precisely because their owners feel that the lower bidders will treat employees better and maintain their companies’ legacies. Thought the board: “Who hasn’t heard of the owner of a local restaurant, drugstore, or car dealership selling out to his long-time manager rather than to a higher bid from an interloper? Or picking a particular chain to sell to because it treated its workers better than others? Why shouldn’t our stockholders have the opportunity to make the same choice?”

So the board stampedes their lawyer and signs up a merger agreement with All American Toys, giving the James stockholders a choice of cash or stock. It agrees to put the merger agreement to a prompt vote and in the meantime promises not to sign up another deal. It also gives All American a three and a half percent termination fee payable if the James stockholders vote no and accept another, higher-priced transaction within one year. Until the vote, the James board agrees to keep the company’s poison pill in place to prevent any tender offer by Piggy Bank or Toys Of The World.

Accept that the board fervently believes that its actions are in James’ best interest. Acknowledge that the board is well-advised of the material facts and has made a conscious choice. Recognize that eight of the ten directors have no financial self-interest that would lead them to favor All American and that the two remaining managers have golden parachutes, making the question of which bidder prevails less a matter of monetary self-interest than one of pride and concern for others.

The James board publicly announces its decision. It candidly admits that the deal is slightly less attractive in financial terms to its stockholders as an immediate matter than are the other two deals. Yet, the deal is at a fair price that is quite high. The board indicates that it will ask its stockholders to consider the interests of the employees and communities in deciding how to vote. “Isn’t a slightly lower price a small amount to pay for doing the right thing?” the board asks.²⁷

27. Is the five percent differential sufficiently narrow to be acceptable under the PRINCIPLES OF CORPORATE GOVERNANCE § 6.02(b)(2) (1994)? That section indicates that a board’s reaction to a tender offer may include “regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders.” *Id.*

The board is heartened in its struggle because it has the support of the James family and the employee holders, who between them control twenty-four percent of the stock. Another five percent is held by a socially responsible mutual fund. And twenty-three percent is held by various pension funds that are associated with labor unions and state government retirement plans. Combined with holdings of individuals who live in communities with James facilities, which make up another four percent, the board feels it can obtain a majority in favor of the merger.

But as soon as the proxy solicitation begins, lawsuits are filed seeking a preliminary injunction against the merger agreement and the board's use of the pill. Stockholder plaintiffs file several suits, and Piggy Bank and Toys Of The World file their own suits. The suits are all similar and make a simple point: the board has decided to sell the company. Thus, its duty is plain and singular: get the highest price. After all, doesn't *Revlon* say that the interests of other constituencies can be considered only if they are rationally related to furthering the interests of stockholders?²⁸ In a cash deal, the only interest the stockholders have is to get the most green. Indeed, Toys Of The World indicates that it will raise its bid to a forty-three and a half percent premium if the termination fee is struck down, but will not raise its bid if the fee is left in place.

Meanwhile, the James board is having more trouble than it thought with its proxy solicitation efforts. The socially responsible investment fund is not a problem. Its contracts with investors have been written flexibly enough so that it can choose a lower-priced deal when necessary in order to accomplish social objectives. But the state government pension funds are in a tizzy. They are used to arguing that boards should be open to offers and should accept the highest bids, and now they fear looking hypocritical or being sued for breach of fiduciary duty.²⁹ The state treasurer of a state

28. See *Revlon, Inc.*, 506 A.2d at 176. *Revlon* cut back on less restrictive language regarding other corporate constituencies in the Delaware Supreme Court's earlier decision in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985), which had permitted directors to consider "the impact on 'constituencies' other than shareholders (that is, creditors, customers, employees, and perhaps even the community generally)" in deciding whether a takeover offer was a threat. See also E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. PA. L. REV. 2179, 2184 (2001) ("Delaware's jurisprudence holds that the interests of stockholders are primary and may not be trumped by that of other constituencies, although those interests may be considered if congruent with the interests of the stockholders.").

29. See Lipton & Rosenblum, *supra* note 7, at 207 nn.59–60 (citing to federal statutory provisions and administrative guidance under the Employment Retirement Income Security Act of 1974 that suggests that trustees of ERISA plans will commit a breach of fiduciary duty if they do not tender into a high premium offer); Marleen A. O'Connor, *Organized Labor as Shareholder Activist: Building Coalitions to Promote Worker Capitalism*, 31 U. RICH. L. REV. 1345, 1358 n.49 (1997) (citing to

with a James facility within its borders has been more sympathetic, but has been told by lawyers to vote no on the All American deal.

The labor pension funds are also in disarray. James has been able to generate rank-and-file support for the All American deal. The pension fund trustees are unmoved, however, and are being advised by their lawyers that their fiduciary duties require action designed to extract the highest price. The fact that Piggy Bank and Toys Of The World kept their bids on the table and insisted that they might offer even more if the three and a half percent termination fee were struck down has put even more pressure on the funds to vote no.

The Chancellor holds a preliminary injunction hearing. How does it come out? Is the injunction issued? If the answer is no, does that mean that the court has acknowledged—per the entity model—that there are corporate values that extend beyond the interests of the current stockholder base? Can this result be justified under the current *Revlon* standard? Would the result be different if Toys of The World were unwilling to increase its bid if the termination fee were struck down? How big a spread can a board accept to advance other values?

If the answer is yes and the injunction is granted, does that mean that the stockholders and directors of public corporations do not have to face the same moral choices as the owners of small businesses do when they decide to sell and retire? If the corporation law is so stockholder-focused that public stockholders cannot be confronted with this moral dilemma, doesn't this suggest that models implying that corporate boards can act as mediating hierarchs on behalf of employees and communities have inherent limitations?

Likewise, if the state government and labor pension funds vote no, what does that say about them? Does it make sense for these interests to have social and political agendas that can—or must—be disregarded whenever these interests act in a fiduciary capacity as trustees over the stockholdings of others? Within the last two years, former Secretary of Labor Robert Reich has written a provocative column pointing out that several teachers' union-affiliated investment funds were actively lobbying European companies to undertake value-maximizing efforts that involved a diminution in the rights of their employees.³⁰ Even from a self-interested

federal authority warning pension fund trustees to consider asset value maximization instead of unrelated objectives, such as employment of beneficiaries).

30. Robert B. Reich, *Look Who Demands Profits Above All*, THE AMERICAN PROSPECT ONLINE, Sept. 1, 2000, at <http://www.prospect.org/webfeatures/2000/09/reich-r-09-01.html>. The reader

point of view, is it clear that a pension fund with diversified investments would be irrational in concluding that its own selfish long-term interests might be advanced by voting for the merger with All American Toys, because that might create the most long-term wealth creation in the United States?³¹

In the hypothetical, I have quite consciously structured the transactions as cash deals that would constitute change of control transactions invoking *Revlon* duties. I do so because it is an economic reality that corporations combine. The future of a business might necessarily involve its status as a division or part of a larger enterprise. This is part of the natural lifecycle of many firms. For those who prefer to avoid tough choices, it is nice to suppose that there is a critical economic distinction between stock-for-stock deals that don't invoke *Revlon* duties and deals that do.

I fully accept that the change of control test does serve a useful purpose in legal doctrine.³² In the real world, however, the ethical issues raised by these economically similar transactions are largely identical.

interested in the subject of labor unions as shareholder activists should consult Marleen A. O'Connor, *Organized Labor as Shareholder Activist: Building Coalitions to Promote Worker Capitalism*, *supra* note 29; Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998); and Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed to Make Shareholder Proposals?*, 73 WASH. L. REV. 41 (1998).

31. Each time I have given this address, I have emphasized that I rather starkly portrayed the facts, downplaying many subtle points that sophisticated readers will no doubt uncover for themselves. I have done so for rhetorical effect and for the more important substantive purpose of exposing some of the theoretical issues raised by the *Revlon* doctrine. In this regard, for example, I am aware that certain pension funds have been active in taking stands against child labor, a stand that could influence their view of the Toys Of The World bid. I also know that certain funds might vote in favor of the All American offer if they believed it was a better long-term value than the other bids. Nonetheless, those same funds might also argue as a matter of principle that the James board should not get to put its deal to a vote first, while stalling the other bids with a poison pill. A representative of a prominent public pension fund in fact told me that would likely be his institution's reaction to this scenario. Of course, if the other higher-priced bids could proceed at the same time, it seems likely that the lower All American bid would stand little chance of succeeding.

I am also aware that many readers will not find credible a scenario in which the James board could not get its investment banker to opine that the All American bid was somehow of equal or greater value to the other bids. I acknowledge that I have slighted some of these real world complexities so as to concentrate on more central doctrinal concerns.

32. See Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures In Stock-For-Stock Merger Agreements*, 56 BUS. LAW. 919, 931 (2001) (discussing the utility of the change in control test, which limits the applicability of *Revlon*). In that prior article, I explored some of the reasons stockholders might be frustrated by the failure of courts to extend *Revlon* to all merger transactions. See *id.* at 930. In this article, I look at the other side of that question, with an eye toward the concerns of other affected corporate constituencies, and I implicitly focus on whether the substantive corporate law can secure their interests.

After all, the hypothetical makes clear that the long-term fate of the bundle of economic assets that makes up James will hinge on which bidder is chosen. Those assets do not magically disappear in a cash deal any more than they do in a stock-for-stock deal that is not considered a change of control.³³ The extent to which those assets produce economic value in the future depends on the determination of who will own them in both cases.

The answer to the ethical issues posed by the hypothetical turns largely on one's belief about the role of the corporation. For those who believe that maximizing the returns of stockholders is the only aim of the corporation, the choice is clear. So much the better for those who believe that in the aggregate it will advance the overall well-being of society if assets flow freely to the highest payer.

For those who are less sanguine about the marketplace, the hypothetical probably inclines them to root for the James board. What's wrong with a disinterested board exercising classic business judgment in good faith? They haven't precluded a later bid; they've just asked the stockholders to make a moral judgment. Haven't the stockholders elected them to make decisions like this?

33. Blair and Stout take a generally optimistic view of corporation law, viewing it as largely consistent with their view that the mediating hierarch has discretion to favor other constituencies over the short-term interests of stockholders. The *Revlon* doctrine provides them with an analytical problem, however, because that doctrine focuses only on stockholder interests. Blair and Stout side-step this difficulty by stating that the "*Revlon* exception to the general rule may reflect an intuitive judicial recognition that when a firm 'goes private,' it abandons the mediating hierarchy approach in favor of a . . . principal-agent structure dominated by a controlling shareholder." Blair & Stout, *supra* note 7, at 309. The problem with this approach is that it avoids the reality that it is quite common for corporations to be sold. If the interests of other constituencies can be disregarded altogether when a sale occurs—that is, if the stockholders may expropriate value belonging to other constituencies—doesn't that limit the utility of the mediating hierarch concept as an explanation of those constituencies' willingness to make firm-specific investments?

Might that willingness be better explained by other factors? These could include characteristics of human nature that incline persons towards altruistic behavior, even where such behavior is not "rational" in purely economic terms. This is an explanation drawn from Blair and Stout themselves. See generally Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001) (contending that the behavioral phenomenon of internalized trust plays an important role in discouraging opportunistic behavior). For a laborer, a decision to do a good job might often be a highly personal one bound up in the complicated questions of self-identity that are at the core of human existence. Many workers doubtlessly believe that corporate boards and management are anything but fair, but remain committed to doing a good job for reasons of personal pride and morality. These laborers might also cooperate because they feel that they have few alternative choices and wish to remain employed. As for creditors, the detailed agreements they secure from corporations to protect their rights seem to diminish the implication that they rely on a mediating hierarch to protect them. Such contractual protections also increasingly safeguard top executives.

I have no intention of opining as to how the case would be decided. I do suggest, however, that the answer would shed light on the fundamental purpose of the corporation in our society. If the James board were permitted to proceed to the merger vote, the result would tend toward the entity model of the corporation. Similarly, if the state and labor investment funds were permitted to vote for the lower All American bid as a matter of fiduciary doctrine even if that bid promised somewhat lower returns over any short- or even long-term investment horizon, this would reflect the view that stockholders have moral as well as financial interests—an attitude identified with the entity model.

By contrast, if the court were to enjoin the All American merger before the vote, this would reflect a firm choice for the property model of the corporation. A grant of an injunction would also suggest inherent limits on the utility of the corporate board as a mediating hierarch for employees and communities in end-game transactions. If the residual claims of stockholders are so powerful in an end-game transaction that the mediating hierarch must subordinate the interests of other corporate constituencies entirely to the goal of extracting the highest sales price, how much protection does the institution of the board really provide to those constituents? Does the mediating hierarch emerge largely as a body that ensures that high-level managers—*as well as the stockholders*—are taken care of in end-game transactions through severance packages?³⁴

In the end, a choice for the strict application of the property model might simply render more vivid a reality that many clear-headed liberals already acknowledge, which is that institutions whose governing bodies are elected solely by the stockholders will, when conflicts become unavoidable, tend to act in ways that put the interests of those with the most clout at the forefront. This means that the interests of stockholders and high-level managers will come first. The practical consequence of that conclusion is to underscore that the protection of labor and the environment depends on legislation extracted through the larger political process. The rights and protections of other constituencies have always been primarily secured in that manner, rather than through the corporate law system or the voluntary good graces of those who control capital. This is not to say that corporate boards do not often act in ways that benefit employees and communities—they of course do so regularly. It is only to acknowledge

34. Anyone who has discussed the “social issues” critical to merger negotiations with experienced transactional lawyers recognizes that these issues often center on the fate of the company’s top managers after the combination. Off the record, transactional lawyers will admit that these issues sometimes loom larger than the economic terms of the merger exchange ratio.

that in the American corporate law system, there is no reason to expect that the interests of the stockholders and top managers will not predominate over those of labor and the community. After all, in the intra-corporate republic, only capital has the right to vote!³⁵

Let me close by emphasizing that you should not draw from my remarks any hint as to how I think the hypothetical case I have articulated should as a normative matter be decided. If you think you have a sense of my views in either regard, your understanding of my own leanings far exceeds my own. So-called liberals and conservatives can each, I venture, come up with arguments on both sides of the question of whether and, if so, how the substantive corporation law ought to address social issues like the ones raised here. And I do not presume to lecture you that there is a correct way to think about this hypothetical.

What I do wish you take away from this speech is a renewed commitment to the important responsibility that all of us who are engaged in the dynamic process of shaping corporation law have: to reflect deeply and continually on the purpose of the corporation in our society and the extent to which the instrument of corporation law itself can be used to advance that purpose. I hope I have in some small measure caused you to engage a little in that ongoing task today.

35. Fans of great rock and roll music will find this unsurprising. Eddie Cochran's saga of one alienated American youth's struggle with parental and employer authority captures the point succinctly: I'm gonna take two weeks, gonna have a fine vacation/I'm gonna take my problem to the United Nations/Well I called my congressman and he said, quote/"I'd love to help you, son, but you're too young to vote."

EDDIE COCHRAN, *Summertime Blues* (Liberty Records 1958).

