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Moral Money
Corporate Governance

Remembering what comes first is more important than ever

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The objective of a business to seek gains is trumped by a duty to follow the law

Leo Strine MARCH 27 2020

Lost in the debate over whether corporations should put the interests of their stockholders first, or give equal weight to all their stockholders, is this important first principle of corporate law: our society only charters corporations to do lawful business by lawful means. This principle means that the natural objective of a for-profit business to seek gains is trumped by a duty to honour society's legitimate expectations and not engage in unlawful activity in the pursuit of profit.

And it also means that corporations, like the human beings whose laws authorised their creation, must respond when our government calls on us to follow public health guidance, to help alleviate a genuine national crisis, and to put the best interests of our fellow Americans ahead of our self-interest.

Of most immediate relevance is this consequence of the duty of corporations to follow the law: the corporation's obligations to its workers, its regular contractors, service providers, and lenders, and others with a legal and ethical claim to being paid comes above its duty to stockholders. Corporate leaders have the discretion to use their business judgment to best enable the corporation to weather this unprecedented storm, to honour its duties to those who have made the deepest commitment to the company's success (that is, its employees), and to secure the solvency and long-term health of the business.

This principle also limits the ability of short-term stockholders to jump the queue. Stockholders demanding a dividend, for example, in a situation where the company might soon not be able to meet its payroll, are poorly positioned to exert real leverage. This is because the law gives corporate leaders room to make keeping the business in a condition where it can pay its bills and function profitably for years to come the top priority.

At this sensitive moment, business leaders must act on this first principle of corporate law. But, others with economic power — notably institutional investors — must act with a corresponding responsibility. It will harm ordinary diversified investors if hedge funds exploit the current vulnerability of a public company to hurt its long-term viability. It will harm American investors if plaintiffs' lawyers seek fees by suing over technical issues that companies will all face due to the national emergency.

And corporations themselves need to temper their approach to competition. They need to realise, for example, that a transaction that was priced in very different circumstances might still make fundamental economic sense, but under terms, or at a later time, that take into account the effect of something that neither company could have reasonably anticipated. Put simply, opportunism now is rightly seen as war profiteering.

The good news is that corporate law gives our business leaders the right to resist dodgy demands, and to honour the legitimate expectations of their employees, creditors, and of our nation. Let's support them in doing so.

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