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Getting Real About Corporate Social Responsibility: A Reply to Professor Greenfield

Franklin A. Gevurtz
Pacific McGeorge School of Law

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Getting Real About Corporate Social Responsibility: A Reply to Professor Greenfield

Franklin A. Gevurtz^{*}

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^{*} Professor of Law, University of the Pacific, McGeorge School of Law. Visiting Professor of Law, University of California, Davis, School of Law.

INTRODUCTION

Life can seem unfair to law professors whose scholarship focuses on corporate law. We just do not get the same amount of attention as our colleagues who write about constitutional law or other such subjects whose social significance is more readily recognized by those outside of the field.¹ It is therefore only natural to respond by seeking ways in which our subject does indeed have great significance for society as a whole. For many corporate law scholars, this means arguing that corporate governance rules are a critical determinant of economic growth.² For other scholars, who are concerned about wealth distribution, the environment, or the like, this means arguing that corporate governance rules can be the tools to achieve so-called corporate social responsibility.³ In either case, it takes no behavioral experiments to recognize the danger that corporate law scholars might attribute an unrealistic degree of significance to corporate law rules.

With the goal of adding a reality check, I have chosen to respond to Professor Kent Greenfield's paper, "Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as a Regulatory Tool."⁴ In his paper, Professor Greenfield proposes three changes in American corporate governance rules: (1) relaxation of the norm that the goal of corporate management should be to maximize profits for the shareholders of the corporation (often referred to as either the shareholder primacy or profit maximization norm); (2) broadening the fiduciary duty of corporate directors and management to include an obligation to the corporation's employees; and (3) mandating inclusion of employee representatives on corporate boards. While none of these

¹ It could be worse. We could be writing about tax laws. See, e.g., William J. Turner, *Tax (and Lots of Other) Scholars Need Not Apply: The Changing Venue for Scholarship*, 50 J. LEGAL ED. 189 (2000).

² See, e.g., Tom Ginsburg, *Does Law Matter for Economic Development? Evidence from East Asia*, 34 L. & SOC'Y REV. 829 (2000).

³ See, e.g., Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as a Regulatory Tool*, 35 U.C. DAVIS L. REV. 581 (2002); Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705 (2002). These articles illustrate a certain irony in the so-called progressive approach to corporate law. At one point, scholarship, which many characterized as progressive, focused on protecting shareholders from corporate managers. See, e.g., William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974). Now, we find so-called progressive corporate law scholars seeking to give managers more discretion to consider the interests of other stakeholders at the possible expense of the shareholders. The irony is that this has occurred at a time when a greater percentage of ordinary Americans own stock.

⁴ Greenfield, *supra* note 3.

proposals is new, Professor Greenfield argues that behavioral science shows how these three changes can lead to an increase in employee wages and a decrease in income inequality in the United States. At the same time, Professor Greenfield strives mightily to argue upon the same basis that increased wages need not mean decreased corporate efficiency (insofar as increased income for workers will more than offset any decreased profit for the shareholders). Needless to say, there is room to question whether Professor Greenfield understates the extent of the tradeoff between regulatory policies directed toward increasing wages and the goal of economic efficiency. This, in turn, can lead back into the endless debate about the appropriate balance in our society between the goals of wealth maximization and wealth distribution. These issues, however, I leave to others. Instead, I am enough of an old-fashioned liberal (and a one-time dues paying union member) to buy into, at least for purposes of this reply, Professor Greenfield's normative value judgment as to the desirability of using legal intervention to raise workers' wages. My concern is whether corporate law provides a realistic means toward achieving this end.

In this reply, I will look at the three suggestions Professor Greenfield proposes. Part I of this reply will consider the impact of relaxing the corporate law norm that the purpose of a business corporation, and the goal of the company's management, should be to maximize profits for the shareholders. Part II will examine the impact of expanding the fiduciary duty of a corporation's directors and management to include an obligation toward the corporation's employees. Part III will address the impact of mandating employee representation on corporate boards. Finally, Part IV will suggest that reform of employment contract law might provide a more effective vehicle to achieve the ends Professor Greenfield espouses.

I. THE PRACTICAL IMPACT OF THE SHAREHOLDER PRIMACY NORM IN CORPORATE LAW

A. *The Legal Reality of the Shareholder Primacy Norm*

Professor Greenfield's paper is the latest, but no doubt not the last, volley in a long-standing academic debate regarding for whose benefit corporate directors should act.⁵ In many, if not most states, legislatures

⁵ See, e.g., E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); A.A. Berle, Jr., *For Whom Corporate Managers are Trustees: A Note*, 45 HARV.

some years ago seem to have resolved this debate in the direction Professor Greenfield favors. These legislatures amended corporation statutes to empower directors to consider the interests of various constituencies, including the employees, in making the board's decisions.⁶ In other jurisdictions, however, including Delaware, judicial authority continues to govern the issue. Professor Greenfield, not surprisingly, cites the classic case of *Dodge v. Ford Motor Co.*⁷ as the fountainhead of the corporate law rule that the ultimate objective of the directors of a business corporation must be to make profits for the shareholders. Actually, it is worth taking a closer look at the *Dodge* opinion, because it illustrates that this shareholder primacy norm in American corporate law has been more a matter of rhetoric than an enforceable legal obligation.

The Dodge brothers were minority shareholders in Ford Motor Co. Henry Ford owned a majority of the outstanding stock and apparently dominated the board. Ford Motor Co. at this time was unbelievably successful. The corporation had huge cash reserves and was making money hand over fist. The board was declaring a generous regular dividend and also had been declaring special dividends. The Dodge brothers sued after Henry Ford announced that the corporation would not pay any more special dividends, but, instead, would retain the extra earnings for expansion. *Dodge* is one of the rare cases in which a court found directors abused their discretion in refusing to declare dividends — largely based upon the fact that the corporation was making money faster than the directors could spend it on expansion, even if the board declared more dividends.

What is important about the case for present purposes is a side discussion the court undertook regarding the corporation's expansion plans. Statements by Henry Ford, both in and out of court, suggest that his reason for expanding the business was not to maximize profits, but rather, stemmed from his desire to implement his economic and social views. Specifically, Henry Ford expressed the view that the company should lower the price of its cars and expand its production, not to increase profits; but to enable more Americans to own a car and to provide employment for more persons.⁸ The court took a different view

L. REV. 1365 (1932).

⁶ See, e.g., American Bar Association Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990) (describing various statutes).

⁷ 170 N.W. 668 (1919).

⁸ Cynics might wonder whether Henry Ford actually cut the dividend because the

of the permissible goals of a business corporation. Such a corporation (as opposed to a corporation organized as a non-profit corporation) exists, the court explained, "primarily for the profit of the shareholders." The directors have great discretion in choosing the means toward that end, but the directors breach their duty if they act to change the end objective itself from profiting the shareholders to seeking to benefit others. Professor Greenfield quotes this part of the court's opinion as establishing the shareholder primacy or profit maximizing norm.

Yet, as significant as the *Dodge* opinion's statements about shareholder primacy would seem, these statements generally have figured far more prominently in academic debates than they have in the practical workings of corporate law. The reason is found in the court's actual holding. The court ordered the payment of a special dividend; but this was only because Ford Motor Co. had plenty of money both to expand and to pay the dividend. Critically, however, the court refused to block Ford's expansion plans, despite what the court had to say concerning Henry Ford's express motivations for those plans. The court felt that the expansion plans might serve a business purpose and refused to substitute the court's judgment for the business expertise of the directors.

The court's opinion in another classic case, *Shlensky v. Wrigley*,⁹ is similar. A minority shareholder in the corporation which operated the Chicago Cubs baseball team sued to compel the directors to install lights at Wrigley Field. The plaintiff alleged that the inability to play night baseball games at Wrigley Field lowered attendance and resulted in the corporation losing money. The plaintiff further alleged that the directors refused to install lights because the majority shareholder, Philip Wrigley, believed baseball is a daytime sport, and he was concerned about the possibly detrimental effect of night games on the surrounding neighborhood. The court dismissed the complaint as not stating a cause of action. In response to the plaintiff's allegations concerning Wrigley's motives, the court speculated that it might be in the corporation's best interest to look out for the neighborhood, because the company owned real estate there (the ballpark) and because patrons might not wish to attend games in a poor neighborhood.

Dodge brothers were using the money to start their own car company. Biographers of Henry Ford suggest, however, his statements were sincere. E.g., Allan NEVINS, *FORD: THE TIMES, THE MAN, THE COMPANY* 575 (1954). At this point in his life (before he got into fights with his employees), Henry Ford evidently had developed a certain grand view of his mission in life as the person to bring industrial prosperity to America.

⁹ 237 N.E.2d 776 (Ill. App. Ct. 1968).

The practical upshot of cases like *Dodge* and *Wrigley* is that, by and large, courts have not scrutinized business decisions to see whether directors sacrificed profit maximization to advance the interests of employees, creditors, customers, and the community. Instead, the courts almost invariably accept some rationale as to how the business decisions were in the long-range interest of the shareholders.¹⁰ Indeed, even in those few cases in which outspoken individuals (like Henry Ford or Philip Wrigley) might ignore legal advice and express "profit be damned" sentiments, courts seem willing to conjure up profit maximizing rationalizations for the directors' actions.

Interestingly enough, much of Professor Greenfield's paper reinforces the conclusion that the corporate law shareholder primacy norm is not a barrier to corporate boards increasing wages. Professor Greenfield goes to great lengths to show how increasing wages of lower level workers might potentially increase profits. Specifically, increasing wages for production workers might increase loyalty and productivity and thereby decrease the need to employ more middle managers to monitor lower level workers.¹¹ Indeed, *Dodge* suggests that courts, even without the behavioral studies cited by Professor Greenfield, will be quite accepting of the argument that being good to workers and increasing wages is in the long-range best interest of corporate profitability. In fact, courts have been very deferential to the corporation's directors in reviewing challenged employee compensation decisions — at least if the directors approving the compensation are not all in a conflict of interest as recipients themselves.¹² Hence, even if Professor Greenfield is completely wrong in his argument that corporations can increase wages and decrease other monitoring costs, this rationale is more than plausible enough to allow directors to raise wages without fear of liability.

¹⁰ See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989) (maintaining "Time culture" of journalistic integrity, in part, justified rejection of higher price bid for control of Time Inc.).

¹¹ The notion that higher wages and other steps to increase worker morale often might more than pay for themselves through increased productivity is hardly revolutionary. Indeed, Professor Greenfield is fairly conservative in his claim insofar as he only suggests that the increased income to production workers will be greater than the decreased profit to the shareholders. Yet, this is obviously not an exact science. Hence, there is certainly a substantial spectrum in which directors can argue plausibly that increasing wages would actually increase overall corporate profits — and who is to say they would be wrong?

¹² See, e.g., *Beard v. Elster*, 160 A.2d 731 (Del. 1960). Indeed, perhaps greater judicial scrutiny of compensation for senior corporate executives might do something to trim the gap between senior executive compensation and worker wages, about which Professor Greenfield complains.

B. Other Forces Producing Shareholder Primacy

Recognizing that cases like *Dodge* and *Wrigley* have made something of a marshmallow out of the shareholder primacy norm, at least as an enforceable rule of corporate law, Professor Greenfield argues that the judicial utterance of this norm still can have a psychological impact on the actions of corporate boards. Yet, there obviously is room to question whether the simple experiments Professor Greenfield discusses provide an accurate insight into the more complex forces at work in the corporate milieu.¹³ Indeed, once we open the door to the prospect that corporate boards may act consistently with a shareholder primacy norm despite the lack of any realistic enforcement, we must note that all sorts of non-legal forces could cause boards and managers to continue to act consistently with this norm even if courts or legislatures were to relax the formal rhetoric. The most obvious force at work is simply competitive market pressure. After all, a corporation which fails to keep costs (including labor costs) down can find itself losing market share to competing firms able to sell at lower prices.¹⁴ Also, failure to maximize profits for shareholders might place the corporation at a disadvantage in raising needed capital.¹⁵ Moreover, failure to maximize shareholder profits places management in danger of being displaced through a hostile takeover.¹⁶ There can be psychological forces at work as well. For

¹³ For example, one arguable flaw in these experiments is that evidently none of the participants actually had contributed anything of their own to the pot. Even when they were playing with real money, they were dividing up "found money;" i.e., no matter what they did, they were not going to be out any significant labor done or money they had earned before becoming involved with the experiment. Under these circumstances, it might be much easier to take a relaxed attitude toward driving a hard bargain and to change one's attitude when told of an obligation to a third party. (Of course, one might object that the concept of "found money" is not economically rational; but the whole point of these experiments is that people are not rational economic actors.) Moreover, one might well expect different results in a situation in which the relative size of each participant's reward assumes psychological importance as a measure of self-worth. The negotiation of professional athletes' contracts illustrates this phenomenon. In the case of those who contribute capital, obtaining a higher return on their investment often seems to be viewed as establishing self-worth by showing how smart the investor is.

¹⁴ See, e.g., Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 264 (1977).

¹⁵ *Id.* at 257.

¹⁶ E.g., Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967). Interestingly, the corporate takeover context is one in which the question of whether directors can sacrifice maximum gain for the shareholders in order to look out for the interests of other constituencies can have real bite. To illustrate why, suppose that the board of a corporation receives an offer to buy out all of the existing shareholders for cash. Further, suppose that this offer comes from a party who plans to engage in a leveraged buy-out which will decrease the credit worthiness, and hence the market value,

example, the profit maximization norm might be more of a reflection of American business ethos than a reaction to judicial pronouncements.¹⁷ In addition, not to sound completely cynical, but creating a work environment which requires more monitoring is in the interest of those who aspire to become managers rather than just workers.

The ultimate question thus becomes how significant is a virtually unenforced corporate law shareholder primacy norm, versus these other forces which can cause directors and managers to act in a way to maximize corporate profits at the possible expense of employee wages and working conditions. There are several ways one might attempt to tease out an empirical answer to this question. To begin with, because the shareholder primacy norm only applies to investor owned corporations, one might compare wages and working conditions in investor owned and non-profit corporations in the same industries. For example, how do wages and working conditions compare at Federal

of the corporation's bonds, thereby harming the company's existing creditors. See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989). Also, suppose that this buyer intends to restructure the company by laying off employees. Can the directors reject the offer because of its impact on creditors and employees? Notice, in this event, it would seem more difficult to conjure up ways in which protecting these other constituencies is in the long-run best interest of the existing shareholders, since, under the proposed deal, the existing shareholders are selling out.

In a couple of opinions, the Delaware Supreme Court addressed the question of whether directors breach their duty if they seek to prevent a corporate takeover in order to protect the interests of constituencies other than the shareholders. In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), the Delaware Supreme Court stated that, in deciding to oppose a takeover bid, the directors could consider the impact of the bid on constituencies other than the shareholders. This includes, according to the court, creditors, customers, employees, and "perhaps even the community generally." *Id.* at 955. Nine months later, however, in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), the same court rejected the directors' other constituencies rationale for favoring one takeover bid over another. The board argued that the favored bid protected the holders of certain promissory notes issued by the corporation better than did the disfavored bid. In rejecting this rationale, the court qualified the statement in *Unocal* about considering other constituencies. This is permissible, according to the *Revlon* opinion, only to the extent there are rationally related benefits accruing to the shareholders. In a situation, such as *Revlon*, in which the directors have decided to have the shareholders sell out for cash to one of two bidders in any event, there can be no such long-range shareholder benefit from considering the interests of other constituencies. Hence, the *Revlon* situation is one in which the shareholder primacy norm actually can have legal significance. Still, the *Revlon* situation is not that common. Outside of the *Revlon* situation, the Delaware Supreme Court has pretty well deferred to the board's imagination in finding long-range shareholder benefit from rejecting cash bids in favor of looking out for other interests. See *supra* note 10.

¹⁷ See, e.g., Mark J. Roe, *Political Preconditions to Separating Ownership from Control*, 53 STAN. L. REV. 539, 554 (2000) (observing that belief in shareholder profit maximization norm is widespread in American business circles).

Express versus the United States Post Office?¹⁸ Is there a significant difference in wages and working conditions between municipally owned power companies and investor owned power companies?¹⁹ What about in proprietary versus voluntary hospitals? Yet, even if the presence of shareholders has correlated with lower wages and poorer working conditions than found in entities without shareholders, this does not mean that a sense of fiduciary duty to the shareholders has caused the difference. For example, one of the pressures for maintaining profits for shareholders comes from the threat of takeovers.²⁰ Merely relaxing the shareholder primacy norm will not remove this threat.²¹ More fundamentally, the existence of a takeover threat may tell us something about American business ethos which goes well beyond legal norms. It shows that there are persons in the business world who wish to exercise control over corporations in order to increase profits, including perhaps by reducing labor costs. In other words, for every business person who feels that the pressure of reporting to public shareholders is a handicap in treating employees as well as the business person would like,²² there are plenty of other business persons with a different attitude toward their workers. Indeed, it is the closely held firm — where those in control commonly answer only to themselves as shareholders — which, as often as not, is the company paying minimum wages.

¹⁸ Where working conditions have become so stressed that some employees have "gone postal." For a discussion of labor strife at the United States Post Office, see Rick Brooks, *Blizzard of Grievances Joins a Sack of Woes at U.S. Postal Service*, WALL ST. J., June 22, 2001, at A1.

¹⁹ Anecdotal evidence in my region indicates that employee compensation at investor owned Pacific Gas and Electric Company may be somewhat higher than at Sacramento Municipal Power District.

²⁰ Indeed, Professor Greenfield points to a study indicating that the adoption of state anti-takeover legislation may have produced higher wages. Greenfield, *supra* note 3, at 579.

²¹ As noted earlier, only in a fairly limited set of circumstances can directors not consider the interests of other constituencies, such as employees, in deciding whether to oppose a takeover. Moreover, the mere fact that directors legally can oppose a tender offer based upon concerns for other constituencies does not mean that, as practical matter, directors can prevent a particular offer from succeeding. Hence, state anti-takeover statutes contain provisions seeking to make hostile takeovers difficult, which go well beyond allowing directors to consider the interests of other constituencies. See, e.g., FRANKLIN A. GEVURTZ, CORPORATION LAW § 7.3.3 (2000) (discussing types of state takeover legislation).

²² As was Professor Greenfield's experience at Levy Strauss & Co.

II. THE PRACTICAL IMPACT OF EXPANDING DIRECTORS' AND OFFICERS' FIDUCIARY DUTY ON ACHIEVING CORPORATE SOCIAL RESPONSIBILITY

Professor Greenfield goes beyond proposing an easing of the shareholder primacy norm — thereby *allowing* directors to consider the interests of employees without breaching the directors' duty *to the shareholders* — to propose, in addition, that directors and management should have a legally enforceable fiduciary duty *to the employees*. In suggesting such an expansion of the directors' fiduciary duty to encompass other stakeholders in the corporation, Professor Greenfield once again joins in a long-standing debate.²³ I shall not add to the length of this reply by going into the various arguments based on economic efficiency, or the nature of relational contracts, for or against extending a fiduciary duty beyond the residual claimants in the corporate enterprise (i.e. the shareholders). Instead, I wish to raise a concern that has not been the subject of as much focus in the existing literature and that is more attuned to the "practical impact of corporate law" theme of my reply. This concern goes to how, exactly, courts would apply a fiduciary duty of corporate directors and officers toward the corporation's employees.

A. A Look at the Enforcement of Fiduciary Duty in Corporate Law

As stated by Justice Frankfurter in a much-quoted line, to say that a person is a fiduciary only begins the analysis.²⁴ In the present context, to urge that directors and "management" have a fiduciary duty toward the corporation's employees simply opens the door to a host of further questions. One must ask who can enforce this duty, through what procedure, with what remedy, against whom, and, perhaps most importantly, what standard is the court to apply in deciding if the duty was breached. Let us focus for now on this last question. Professor Greenfield assumes that the standard the courts will apply in judging whether directors or management breached their fiduciary duty toward employees is the fairness test. However, the fairness test would generally not be the appropriate test to apply under accepted corporate law doctrine, even if courts were to expand the fiduciary duty of directors and officers in order to make employees also beneficiaries of

²³ See, e.g., Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991); Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121, 156-157 (1991).

²⁴ SEC v. Chenery Corp., 318 U.S. 80, 85 (1943).

the duty.

Broadly speaking, the fiduciary duty of corporate directors and officers breaks down into two more specific duties — a duty of care and a duty of loyalty.²⁵ Courts apply the fairness test when dealing with claims based upon an alleged breach of the directors' or officers' duty of loyalty; in other words, when the allegation is that the directors or officers put their own personal interests ahead of the interests of the corporation or its shareholders.²⁶ In a situation in which the directors or officers do not have a conflict with their own personal interests, then, as a general proposition, the duty involved is one of care. Here, if the claim is that a director or officer paid no attention to his or her responsibilities, courts typically analyze the alleged breach of the duty of care by applying principles familiar from the tort of negligence.²⁷ Courts apply the so-called business judgment rule to situations in which shareholders challenge decisions made (as opposed to inattention) by directors when the directors are not in a conflict of interest.²⁸

At least as a first approximation, it would appear that claims by employees against directors, even if directors owed a fiduciary duty to the employees, would implicate the duty of care rather than of loyalty. After all, setting salaries for employees other than the directors themselves, deciding about layoffs, and determining other possible employment policies, do not involve transactions between the corporation and the directors or transactions in which the directors have a material financial interest. Hence, these sorts of decisions, if made by the board, would trigger the business judgment rule.²⁹

²⁵ E.g., GEVURTZ, *supra* note 21 at 273.

²⁶ E.g., *Lewis v. S.L. & E., Inc.*, 629 F.2d 764 (2d Cir. 1980).

²⁷ See, e.g., *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981).

²⁸ E.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

²⁹ See, e.g., *Beard v. Elster*, 160 A.2d 731 (Del. Ch. 1960). While cases such as *Beard* involve complaints by shareholders that the level of compensation set by the board was too high, presumably the standard should be the same when reviewing complaints by employees that a disinterested board set their compensation too low.

Of course, most decisions impacting corporate employees — who to hire and fire, individual compensation levels, specific working conditions — typically are not made by the board of directors but instead are made by officers and middle managers. In this event, the business judgment rule would not be the applicable standard in dealing with a duty of care claim against corporate directors, since the business judgment rule applies only to decisions by directors, rather than to claims based upon the directors' inattention. See, e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). Still, prevailing in a claim based upon inattention would require the complaining employees to show that a reasonable person in the director's position would have been aware of whatever action the employees are complaining about. E.g., *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963). Unless the complained of action was egregious and widespread, such an inattention claim

The business judgment rule means different things to different courts.³⁰ To most courts, however, the business judgment rule serves to insulate the directors from liability for ordinary negligence in making business decisions. For example, in Delaware, directors are not liable for a business decision (so long as the decision does not involve a conflict of interest) unless they made the decision in bad faith or with gross negligence.³¹ Alternatively, other courts have interpreted the rule as limiting the court's ability to review the substantive reasonableness of the directors' decision (as opposed to the process by which the board reached the decision).³² At the extreme, some courts view the business judgment rule as placing beyond challenge pretty much any decision made by directors without a conflict of interest, no matter how ill-

likely will founder in a corporation with any substantial size, based upon the argument that directors can hardly be expected to know what is going on with every corporate employee. Compare *Graham* (directors could not be expected to be aware of price fixing by corporate employees), with *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) (director breached her duty of care to corporation's clients when she should have been aware that her two sons, who were running the corporation, were stealing company blind). Notice, incidentally, as a practical matter, conduct sufficiently egregious that the directors should have been aware of it often will involve illegal actions (such as violation of labor, civil rights, or health and safety laws). Yet, in that event, the law does not need to establish a fiduciary duty to the corporation's employees in order for the directors to have a duty to prevent the conduct. E.g., *Miller v. A.T.&T.*, 507 F.2d 759 (3d Cir. 1974). Suppose, however, an employee sues the officer or manager who made the decision prejudicing the employee. It is not entirely clear whether the business judgment rule applies to actions of corporate officers. Compare *Platt v. Richardson*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,786 (M.D. Pa. June 6, 1989), with *Massaro v. Vernitron Corp.*, 559 F. Supp. 1068 (D. Mass. 1983). There is little, if any, authority applying the rule to middle managers. GEVURTZ, *supra* note 21, at § 4.1.3e. One reason for the lack of authority clarifying the application of the business judgment rule below the directors' level is the lack of financial incentive to bring an action against officers or middle managers — which, one suspects, would be the reality facing employees as well as shareholders.

³⁰ E.g., Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion*, 67 S. CALIF. L. REV. 287 (1994).

³¹ E.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

³² E.g., *Auerbach v. Bennett*, 393 N.E.2d 994, (1979). See also AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 401(c). Professor Greenfield attaches great significance to the requirement of careful process imposed by cases such as *Van Gorkom*. *Van Gorkom* is a rare case, however, in imposing liability upon directors for insufficient care in gathering information before making a decision. Indeed, one suspects that the magnitude of the decision facing the board in *Van Gorkom* — selling out the entire company for \$55 per share — had something to do with the court's willingness to demand that the directors base their decision on more than a 20 minute oral presentation during a 2 hour meeting at which there was no valuation estimate of the company's stock and no one had bothered even to read the contract. This is a far cry from providing authority for the proposition that adoption of a fiduciary duty toward corporate employees would lead courts to require that corporate directors and management adopt more process than corporations currently follow in making decisions regarding corporate employees.

conceived the decision, so long as the directors thought their action was somehow in the best interest of the corporation.³³ Regardless of the precise approach courts follow, the bottom line is that remarkably few courts have found directors liable for breaching their duty of care in making a business decision.³⁴ As a result, the duty of care has provided the shareholders and the corporate entity little protection from the directors making decisions that are harmful to the interests of the shareholders or the corporate entity. Accordingly, it is difficult to see how making employees also the recipients of a duty of care, when enforcement of the duty is limited by the business judgment rule, is significantly going to improve decisions from the standpoint of the employees.

Indeed, the limited protection which the duty of care will create for employees is simply the flip side of the point made earlier as to how courts have taken the spine out of the shareholder primacy norm. Specifically, we saw earlier that courts have been highly deferential to directors when faced with complaints from shareholders that directors were sacrificing shareholder interests to advance the interests of employees, the community, or the like. Conversely, if directors had a fiduciary duty toward employees, the business judgment rule presumably would lead a court similarly to short-shrift any argument by an employee that the directors were sacrificing employee interests to advance the interests of the shareholders. This is particularly true insofar as directors would not even need to argue that they somehow advanced the employees' long-range interests by advancing the interests of the shareholders. After all, creating a fiduciary duty toward employees does not eliminate a duty of the directors toward the shareholders.

B. Why not the Fairness Test for Decisions Involving Corporate Employees?

Perhaps one might attempt to avoid application of the business judgment rule to decisions regarding corporate employees by conjuring up some sort of conflict on the part of the directors. Maybe some or all of the directors own stock in the corporation or receive compensation tied

³³ See, e.g., *Kamin v. American Express Company*, 383 N.Y.S.2d 807 (1976) (upholding an action of board of American Express, which cost company \$8 million in tax savings, and whose rationale was somehow to hide from stock market fact that directors had lost \$24 million in bad investment).

³⁴ The *Van Gorkom* decision discussed earlier received much notoriety because it was an exception to the typical result.

to corporate profitability. Needless to say, the stockholders elect the directors, and, as pointed out earlier, the threat of takeovers can make directors concerned about maximizing profits for the shareholders. Accordingly, an employee might argue that the directors are not disinterested in setting wages or taking other actions that might increase corporate profitability at the employees' expense. By and large, courts have disregarded analogous conflict of interest arguments when made by shareholders.³⁵

The reticence of courts to recognize more subtle conflicts of interest in claims brought by shareholders against corporate directors does not reflect a failure of judicial imagination. On the contrary, it stems from a practical problem with broadening the scope of situations in which the fairness test would apply. The fairness test entails a high degree of judicial scrutiny of the directors' action, with doubts resolved against the directors.³⁶ This sort of judicial interference with internal corporate decisions — entailing, as it does, expensive litigation and the introduction of significant uncertainty as to the validity of board decisions — is acceptable when the decisions triggering fairness review are the exception rather than the rule. Moreover, directors can minimize the need to cope with fairness review by abstaining from entering into transactions with their corporation,³⁷ or by seeking disinterested approval of those conflict of interest transactions the directors enter into.³⁸ Taking an expansive view of what constitutes a conflict of

³⁵ See, e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (holding that directors were disinterested in approving compensation for 47% shareholder and in deciding whether to bring lawsuit based upon this action, despite allegation that 47% shareholder had picked each director to be on board); *Kamin*, 383 N.Y.S.2d 807 (1976) (rejecting argument that because some directors' bonuses were tied to reported earnings, directors were in conflict of interest in seeking to increase corporation's reported earnings). A different situation is presented when there is a controlling shareholder who dominates the board. In this event, a transaction in which this shareholder obtains something from the corporation to the exclusion of the other shareholders presents a conflict of interest calling for fairness review. E.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

³⁶ See, e.g., *Lewis v. S.L. & E., Inc.*, 629 F.2d 764 (2d Cir. 1980); Charles Yablon, *On the Allocation of Burdens of Proof in Corporate Law: An Essay on Fairness and Fuzzy Sets*, 13 CARDOZO L. REV. 497 (1991).

³⁷ In this regard, it is worth noting that at one point during the evolution of corporate law, conflict of interest transactions were automatically voidable if any shareholder objected. E.g., Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

³⁸ Approval by disinterested directors or shareholders lowers the level of judicial scrutiny. See, e.g., *Marciano v. Nakash*, 535 A.2d 400 (Del. 1987). Authorities are divided as to what precisely this lower level of scrutiny entails. See, e.g., GEVURTZ, *supra* note 21, at §§ 4.2.3c, 4.2.4a.

interest, however, both increases the number of transactions that the court would deem to involve a conflict and decreases the possibility of disinterested approval of such transactions. The result ultimately can be to trigger strict fairness review for practically every decision of the board, with the consequence that one may as well move the boardroom into the courthouse. This discussion, in turn, illustrates a practical reason why courts would not wish to apply the fairness test to corporate dealings with employees — even if the directors had a fiduciary duty toward the company's employees. Specifically, application of the fairness test to every corporate decision involving employee wages, terminations, working conditions or anything else impacting employees could potentially envelop the corporation and the courts in intensive litigation of virtually every corporate action.

Not only would general application of the fairness test to corporate actions concerning employees be impractical, it also flies in the face of the essential nature and purpose of the fairness test. The fairness test is an exacting standard of judicial review, the purpose of which is to substitute for the lack of arms-length bargaining that results when those in control of the corporation have the corporation enter into a transaction with themselves.³⁹ This exacting scrutiny is based upon the recognition that when those in control of the company have the company enter into a transaction with themselves, there is no two-sided bargaining to protect the company. The fairness test provides a surrogate for this bargaining by empowering a disinterested party (the court) to ensure that the terms of a transaction between the corporation and those in control of the corporation match the arms-length deal the corporation would have made if doing business with one not in control of the company.⁴⁰ Given this basic rationale, it makes no sense to apply the fairness test to a transaction between the corporation and its non-controlling employees. By definition, this is an arms-length transaction and therefore is fair.⁴¹

By contrast, the sort of workplace fairness norms Professor Greenfield seeks to promote have nothing to do with the fairness test under corporate law. It is entirely plausible that employees will be happier and

³⁹ E.g., GEVURTZ, *supra* note 21, at §§ 4.2.1, 4.2.2.

⁴⁰ See, e.g., *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976). Accordingly, process and disclosure are typically less important in the fairness test than is convincing the court of the substantive merits of the transaction. E.g., GEVURTZ, *supra* note 21, at § 4.2.2.

⁴¹ This discussion of fairness is entirely consistent with the use of the test in the sort of intra-shareholder disputes which arise, for example, in a freeze-out merger. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). Once again, the test is designed to substitute a strict judicial review for the lack of arms-length bargaining in such a transaction.

more productive in a workplace with established procedures for employees to air grievances, some sort of due process prior to dismissal, evenhanded evaluations, promotions and raises, and other efforts to minimize the pernicious influence of office politics. This is why unions often negotiate for such terms; and even without labor contracts, companies commonly adopt formal personnel policies and procedures. All this, however, is very different from a judicial test directed at policing self-dealing.

III. THE PRACTICAL IMPACT OF EMPLOYEE REPRESENTATIVES ON CORPORATE BOARDS

The proposal that corporate boards include employee representatives involves a different type of corporate governance reform than the proposals to relax the shareholder primacy norm and to expand the beneficiaries of the directors' and management's fiduciary duty. Here, we are dealing with structural change, rather than altering liability rules. Accordingly, in this instance, we need not consider how courts enforce (or do not enforce) broad corporate law rules of conduct.⁴² Nevertheless, there is real world experience upon which to at least begin an assessment of the practical impact of employee representatives on corporate boards. This is because employee representation on corporate boards is an existing phenomenon in a number of nations, most notably Germany.⁴³

A critical determinant of the practical impact of employee representatives on corporate boards is the role of the board itself. As noted above, most decisions impacting corporate employees, certainly on a direct individual level, are made by corporate officers and middle managers. Hence, employee representatives on corporate boards may not be in a position to do much good for the corporation's employees unless the board takes an extraordinarily active role.⁴⁴ Unfortunately, the experience in Germany in this regard has not been promising. According to a recent article by Professor Mark Roe, the requirement of labor representation on the board of German corporations (so-called co-determination) has had the effect of decreasing the role of the board in

⁴² This is not to say that requiring employee representation on corporate boards might not create implementation questions.

⁴³ *E.g.*, Roe, *supra* note 17, at 567-68 (observing that German corporations must have half of their board members from labor). It is also worth noting that, from time to time, there have been union representatives on the boards of certain American corporations.

⁴⁴ Which presumably is why unions are more interested in negotiating for union representation on the shop floor than in the boardroom.

corporate governance.⁴⁵ German corporate boards meet infrequently and their information has been weak. Professor Roe attributes this weakening of the German corporate board to the desire of managers and large shareholders not to enhance the power of labor. This, in turn, illustrates a common problem with structural reform. Often, the reform leads to a new equilibrium in which both the goals of the reform have been frustrated and other undesirable impacts have occurred.

IV. WHY REFORM OF EMPLOYMENT LAW MIGHT PROVIDE A MORE EFFECTIVE MEANS OF ADVANCING THE INTERESTS OF CORPORATE EMPLOYEES

In suggesting that a better approach to corporate social responsibility in general, and employee wages and working conditions in particular, may lie in laws other than those dealing with corporate governance, one need not argue that corporate governance should be strictly a matter of private contract. Instead, one can point to simple practical concerns. For example, increasing employee bargaining power or raising the minimum wage could have more impact on employee wages than altering corporate governance rules.

Needless to say, there is not time in this reply to canvas all of labor and employment law to compare the effectiveness of reforms in these areas with the effectiveness of changes in corporate governance, as a means to improve wages and working conditions. Instead, it is sufficient to illustrate the point with one example. This is to compare the efficacy of liberalizing judicial interpretations of the implied covenant of good faith and fair dealing that exists as part of the employment contract between an employee and the corporation with extending the fiduciary duty of directors and management to include an obligation toward employees. To make this comparison, it is useful to return to the point made at the outset of the discussion on extending fiduciary duty. As stated there, such an action requires one to consider who should be liable to whom, through what procedure, with what remedy, and based upon what standard. An action against directors, officers, and middle managers for breach of a fiduciary duty they would owe to employees would give very different, and potentially worse, answers to these questions than would an action for breach of an implied covenant of good faith and fair dealing that is part of the employment contract between an employee and the corporation.

⁴⁵ Roe, *supra* note 17, at 568.

To begin with, the defendants in an action for breach of fiduciary duty would be the parties who breached the duty; in other words, the individual directors, officers or middle managers involved.⁴⁶ By contrast, the defendant in an action for breach of an implied covenant of good faith and fair dealing would be the corporate employer.⁴⁷ One suspects that attorneys for plaintiff employees would much rather sue the corporation than sue the individual directors or executives, at least in the widely held corporation. The corporation is likely to have deeper pockets to pay any judgment and will likely evoke less sympathy from a judge or jury than would an individual corporate official.

Of course, plaintiffs' tactical concerns do not answer why, from a policy standpoint, the corporation would be the better defendant in a suit brought by employees. In fact, there are several policy reasons why liability would be better placed on the corporation than on individual corporate officials. To begin with, by invoking the shareholder primacy norm as a source of the problem, Professor Greenfield appears to be concerned with actions toward employees undertaken to increase profits for the shareholders (as opposed, for example, based upon bigotry or lust for power). To the extent that the goal of the directors' or management's action was to achieve profits for the corporation and its shareholders, it seems just that the corporation or its shareholders pay any damages if the directors' or management's actions turn out to be wrongful. Indeed, given the prevalence of indemnity and insurance provisions covering corporate directors and officers,⁴⁸ one suspects the corporation will pay damages in the end anyway (including through higher insurance premiums). Allowing the suit to be against the corporation in the first instance would avoid the need to go through two proceedings in order for the corporation to end up paying.

Deterrence provides a possible countervailing consideration. If corporate directors and officials do not personally pay for mistreatment of employees will they be deterred from such conduct? Presumably, if the goal of the directors' or officials' actions was to increase corporate profits, then the prospect of corporate liability for damages should provide deterrence. If the directors or officials had some other personal motive, than they would seem to have breached their duty to the corporation and could be liable to indemnify the company.⁴⁹ Certainly

⁴⁶ See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

⁴⁷ See, e.g., *Fortune v. Nat'l Cash Register Co.*, 364 N.E.2d 1251 (Mass. 1977).

⁴⁸ See GEVURTZ, *supra* note 21, at § 4.4.

⁴⁹ See, e.g., *Stern v. General Electric Co.*, 924 F.2d 472, 478 n.8 (2d Cir. 1991) (equating

this would be true if the officials' conduct was illegal (as, for instance, constituting racial or sexual discrimination); in which event, the officials would face personal liability without the need to recognize a fiduciary duty toward employees.⁵⁰

Also, differences in the standard for imposing liability suggest that the breach of the covenant of good faith and fair dealing is a better way to deal with disputes between the corporation and employees. As explained above, the corporate law fairness test would not be the appropriate test to apply to disinterested decisions impacting employees. Instead, such decisions would invite application of the business judgment rule. In fact, courts would be tempted to water down their review of the decision under the business judgment rule even more than they have in suits brought by shareholders.⁵¹ The reason is simple. Courts would be concerned that otherwise directors could be whipsawed every time they make a decision — if stingy to employees, employees will sue; if generous to employees, shareholders will sue.⁵² By contrast, the contract law concept of an implied obligation of good faith and fair dealing, at least if liberally applied, appears much more attuned to the real issues in the employment context. Professor Greenfield is on the right track in stating that employment involves a long-term relational contract in which the express terms inevitably are incomplete. Yet, there is an asymmetry in these gaps for employer and employee (or, more broadly, for principal and agent). The principal is concerned that the agent exercise reasonable care in carrying out his or her responsibilities and not use his or her power over the principal's property or affairs in a way to advance the agent's own interests at the expense of the principal's. Hence, courts apply the principles of negligence or the business judgment rule to see that corporate directors and managers have exercised at least a modicum of care in running the enterprise and apply the fairness test to ensure that corporate contracts with directors and managers match the terms of an arms-length transaction. By

bad faith which would breach duty of care under business judgment rule with having improper purpose).

⁵⁰ See, e.g., GEVURTZ, *supra* note 21 at § 4.1.6.

⁵¹ If such further dilution is even possible.

⁵² Cf. American Bar Association, *supra* note 6, at 2270 (citing fear of such conflicting suits as reason not to adopt "other constituency" statutes). This discussion has focused on the conflict between claims by employees and claims by shareholders. In fact, there can be other conflicts as well. Actions favoring some employees can disfavor others (as in promotion decisions). Extension of the directors' and officers' fiduciary duty to benefit other stakeholders, such as creditors, customers, or the community, can multiply these potential conflicts exponentially.

contrast, the agent is more concerned with actions by the principal that exploit gaps in the contract in order to deprive the agent of the expected compensation for his or her performance. This might involve the treatment of individual employees (such as laying someone off right before a pension plan vests) or the treatment of groups of employees (such as raiding a pension plan to fund a leveraged buy-out). In either event, the implied covenant of good faith and fair dealing, properly construed, unlike the corporate law duties of care and loyalty, is designed to address such conduct.⁵³

CONCLUSION

As stated at a number of points throughout this reply, Professor Greenfield's paper is simply the latest volley in long-standing debates about relaxing the shareholder primacy norm, expanding the fiduciary duty of directors and officers to encompass an obligation to other stakeholders in the corporation, and including employee representatives on corporate boards. What Professor Greenfield's paper seeks to add to these debates is an attempt, through the use of behavioral studies, to show a potentially positive impact of such proposals. No doubt this is a worthwhile addition to scholarship, which, at least as of late, often has focused too much on economic models. In this reply, I too have sought to expand the factors taken into account in scholarship regarding these issues. My concern is that much of the literature on these issues, including Professor Greenfield's paper, fails to consider the limited practical impact of these various corporate law rules, particularly in light

⁵³ See, e.g., *Fortune v. Nat'l Cash Register Co.*, 364 N.E.2d 1251 (Mass. 1977) (dismissal of salesman in order to avoid paying commissions held to violate covenant of good faith and fair dealing). But see *Ingle v. Glamore Motor Sales, Inc.*, 535 N.E.2d 1311 (N.Y. 1989) (holding that at-will employment doctrine precluded claims by shareholder/employee who alleged that defendant terminated his employment in order to trigger unfavorable obligation to sell his stock). In fact, if there is an appropriate corporate law test, it might be the reasonable expectations test applied in some involuntary dissolution cases. See, e.g., *Matter of Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984) (holding that two minority shareholders were entitled to involuntary dissolution of corporation under New York's statute empowering court to grant dissolution for "oppression," when majority acted in way to defeat minority's reasonable expectation that all shareholders would benefit from their ownership through receipt of bonuses which constituted de facto dividends). Without belaboring the point, there can be other differences between the fiduciary duty and the good faith and fair dealing actions. For instance, a suit for breach of the implied covenant of good faith and fair dealing avoids the need to untangle the question of whether the appropriate action is a direct suit, or a derivative suit on behalf of the corporate entity — an issue which adds to the complexity of shareholder actions against directors for breach of fiduciary duty.

of the actual manner in which courts enforce such rules.