GOVERNING the CORPORATION

19th century U.S. statutory and case law assigned legal private property rights to a business’ owners: proprietors, partners, or corporation shareholders

Natural entity theory of corporate governance treats firm as a “corporate personality” originating in the contractual relations between private individuals

Purchase of corporate equity (stock) entitles a risk-taking shareholder to:

• dividends from future company profits
• capital gains by re-selling their shares in stock market
• “residual assets” if firm dissolves, after debtors paid off

Legal theory and courts were slow to develop alternative theories for employee rights & consumer protection
Shareholder Primacy


Corporations must conduct operations in best interests of shareholders “which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.”

Not required to promote social goals or moral values

ABA Model Business Corporation Act obligates a company’s board of directors to supervise its activities using norms of

• **Duty to manage**: monitor the senior mgmt’s performance
• **Duty of loyalty**: make decisions in company’s best interests
• **Duty of care**: obtain accurate information before acting
• **Business judgment rule**: board is not liable for outcomes of actions taken with independence, due care, and good faith
Management Power

During 20th century, dilution of stock ownership enabled top management to take *de facto* control of many large corporations (Berle & Means 1932)

Owner-management separation gave control over company assets & operations to executives often more motivated by power, prestige, job security than by shareholders’ short-term profit-maximization goals.

Management control via board elections

Although shareholders elect directors, top mgmt controls access to the proxy machinery needed to win:

- Recommend a hand-picked candidate slate
- Solicit proxy cards authorizing the execs to vote
- SEC rules permit firm to pay mgmt expenses
- Insurgents lack adequate campaign resources
Recent **institutional investor** revolts sought to make corporations more accountable to shareholders

Led by large public pension funds (CalPERS, TIAA-CREF) facing the exit-voice dilemma: dumping shares would depress prices for their pensioners

Force CEO ousters & policy reforms to boost company performances and thus raise share prices

- Publicize “hit list” of poorly performing companies
- Sponsor shareholder resolutions on annual proxy statements; e.g., minimum share-holding by directors
- “Relational investing” – pension fund managers directly cajole execs to take new strategic actions

Mixed successes in reforming some badly-run companies such as GM, USAir, IBM, Time Warner
Alternative Stakeholder Model

**Stakeholder theory**: corporations should be socially responsible institutions managed in the public interest. Many constituencies have interests other than profits.
Corporate Constituency Laws

During 1980s hostile takeover wave, 28 states enacted “corporate constituency” laws that seemed to broaden business judgment rule to act in good faith to serve “the best interests of the corporation.”

Statutes permit companies to consider how their response to an attempted takeover would likely affect the firm’s stakeholders, not just its shareholders.

**EXAMPLE** Acme Inc. is targeted for takeover by two raiders. Bustups wants to sell off Acme’s unprofitable plants and relocate others overseas. ReWorks is known for restructuring efforts that often turn troubled firms around. Bustups’ bid is $5/share higher than ReWorks’ offer.

What factors should Acme’s Board of Directors take into account in deciding which bid to take? Why?
Other People’s Money

Watch scenes from Other People’s Money (1991) starring Gregory Peck, Penelope Ann Miller, and Danny DeVito.

Larry “the Liquidator” Garfield tries a hostile takeover of Peck’s money-losing New England Wire & Cable Co. He wages a proxy fight to win control, but plans to sell-off the mill. If successful, Larry and his backers will reap big profits but the W&C employees will all be put out of work.

What are the conflicting stockholder & stakeholder interests depicted in this dramatization?

Is the treacherous W&C president correct to say “Everyone looks out for their own self-interest. What’s in it for me – isn’t that what it’s all about?”

Or should other moral principles than profit-maximization govern the corporation?

What would happen to capitalism if jobs and community welfare took precedence?