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CORPORATE LEGITIMACY, CONDUCT, AND GOVERNANCE—TWO MODELS OF THE CORPORATION*

MELVIN ARON EISENBERG**

The large publicly held corporation is one of the dominant social institutions of our time. Over the last fifty years, a sharpened perception of the significance of this institution has given rise to extended discussion of its legitimacy, conduct, and governance. To place this discussion in perspective, and to analyze the major questions involved, I shall develop and compare two competing models of the large publicly held corporation [hereinafter simply "the corporation"] which I shall call the Political Model and the Economic Model.1 Each Model can be thought of as a structure consisting of five closely linked cells housing positions on five fundamental issues of corporate governance. These issues are:

First. What is the fundamental nature of the corporation as an institution within a larger society?

Second. How is the power of the corporation legitimated?

Third. What should be the objective and what should be the conduct of the corporation?

Fourth. What should be the role of management in the corporation?

Fifth. What should be the role and the composition of the corporation's board of directors?

Although, as will be seen, the two Models diverge in almost every respect, they rest on a common empirical foundation. This is, that the American economy is a corporate system, in the sense that control of the economic factors of production and distribution is vested largely in the hands of privately appointed corporate managers. By virtue of this control, and the dominant position of a

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1. These Models are idealized in the sense that alternative economic and political models could be constructed, but I believe they fairly reflect the major relevant currents of thought.
relatively small number of corporations in many markets, these privately appointed managers are able to determine, within varying limits, such fundamental social matters as the rate and direction of capital investment, technological innovation, and product differentiation. By the same token, these managers play a critical role in the lives of those who contribute capital to the corporation and such other groups as the corporation's employees, consumers, and neighbors.

This common empirical foundation underlies the first issue each Model must confront: What is the fundamental nature of the corporation as an institution within a larger society?

For the Political Model, the answer is that the corporation is essentially a political institution, and the groups it most directly affects are its constituencies. That position makes up the first cell of this Model. It leads naturally to the second. Since the corporation is a political institution, and since it is embedded in a democratic state, under the Political Model the corporation's legitimacy depends upon the extent to which it is governed by principles appropriate to a democratic state. This, in turn, is said to entail democratic participation in decisionmaking processes by salient constituency groups through direct or representative voting. Thus the political scientist Robert Dahl refers to the idea "that power can be legitimate—can be considered as acceptable authority—only if it issues from fully democratic processes." Given this idea, Dahl views the corporation as a principality lacking legitimacy. "In a society that sought to arrange authority according to [democratic] criteria," he says, "these new principalities would be an anomaly. Although the power wielded by their rulers can be obfuscated by the dreams of opulence they create, it cannot . . . be rationally justified. . . . In a rational society . . . [people] would see an economic enterprise as a kind of association of all those who are affected by its activities. . . . [W]hy should people who own shares be given the privilege of citizenship in the government of the firm when citizenship is denied to . . . employees and customers . . . and the general public. . . ."

This brings us to the third issue—what should be the objective (or objectives) and what should be the conduct of the corporation? In the Political Model the corporation is characterized as having a number of objectives, just as it has a number of constituencies—indeed, as having an objective for each constituency. Accordingly, it has an objective of making profits for the shareholder constitu-

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3. Id. at 116, 123. See also id. at 64, 125-40.
ency, an objective of providing work and good wages and working conditions for its labor constituency, an objective of providing reasonably priced, safe, and well-made products for its consumer constituency, an objective of good citizenship toward its neighbor constituency, and so on. Correspondingly, the conduct of the corporation should be shaped so as to attain these various objectives.

This view of corporate objectives and conduct leads to a resolution of the fourth issue—what should be the role of management in the corporation? Given the premise that the corporation has a number of constituencies and objectives, it follows under the Political Model that the role of management is to mediate among the various constituencies and objectives, perhaps placing more weight on one than the other, perhaps not, but in any event giving weight to all.

The fifth and final issue is the composition and role of the board of directors. Given the content of the first four cells, it follows under the Political Model that the corporation should be controlled by a board composed of representatives of salient constituency groups, and that the board's role is to ensure that the corporation fairly meets the objectives of these groups. This idea is reflected in the so-called "codetermination" model, in which workers control a significant number of board seats. Dahl goes further, and advocates the Yugoslavian structure, in which the workers are given control of the board. A more common variant in the American literature is that all identifiable constituencies should have seats on the board.

To summarize, under the Political Model the corporation is a political institution whose constituencies are the groups it affects most directly; the corporation is legitimated only if its processes turn on democratic participation by those constituency groups; the corporation has a number of objectives, roughly one for each group; the role of management is to mediate among these objectives; the board should be composed of, or at least include, representatives from the corporation's constituency groups; and the board's role is to ensure that the objectives of those groups are being fairly met.

This Model is attractive, if not seductive. Given its premises, it holds together intellectually. However, those who endorse this

4. Id. at 130-40. This suggestion seems both peculiar and inconsistent with Dahl's analysis. It is peculiar, because it assumes not only that institutions can be transplanted like kidneys, but that such transplants can be made between radically different creatures. It is inconsistent with Dahl's analysis, because it excludes the participation of such relevant constituency groups as shareholders, creditors, customers, and the general public.
Model often seem not to realize that the positions in the first two cells, concerning the corporation's institutional nature and legitimacy, rest not on functional analysis, but only on deduction from postulates of questionable power. The position that the corporation is a political institution, to be governed in accordance with political principles, does not rest on analysis of the special nature of the corporate institution compared to other nongovernmental institutions. Rather, it rests simply on a deduction from the postulate that all political institutions should be governed by political principles, and that any institution that makes decisions of major importance to society is a political institution. This postulate, however, ignores or trivializes critical differences between the official and the unofficial—between that which is state and that which is not.

Similarly, the position of the Political Model on the legitimacy of the corporation rests on the conception that the legitimacy of an institution depends on whether it conforms to some a priori principle. Given this conception, it is then postulated that in a democratic society, legitimacy depends on the principle that all persons affected by an institution have a right to participate in its control—unless, perhaps, it can be demonstrated that there is highly differential competency among those persons, or that the transaction costs of universal participation would be too substantial. This interpretation of legitimacy, however, departs from a more widely accepted conception under which the legitimacy of an institution depends on its popular acceptance, so that legitimacy is an empirical rather than a deductive phenomenon. Under that conception, the legitimacy of an institution may be based, for example, on a popular belief that the institution produces desirable outcomes.5

Recall, in this context, the passage from Dahl referred to earlier. "Although the power wielded by [corporate] rulers can be obfuscated by the dreams of opulence they create, it cannot . . . be rationally justified." Dahl has loaded the argument by using the term "dreams." Suppose that instead of talking about dreams of opulence we talk about national wealth. And suppose further it is popularly believed that placing control over corporate resources in the hands of institutions that are run on managerial rather than democratic principles produces considerably more national wealth, spread throughout the society, than would other constitutive arrangements. Such a system would not necessarily lack legitimacy as an empirical matter simply because its processes are not

democratic. If running a national economic system through Process X is thought to produce more national wealth than running it through Process Y, and the relative social costs of Process X are not excessive, Process X could be accorded legitimacy on the basis of the manner in which it filled basic human needs. The corporation is certainly not the only crucial social institution in a democratic society that is legitimated on grounds other than democratic principles. Think, for example, of the university. Indeed, the presence of legitimating grounds other than democratic principles are only to be expected, if it is accepted that legitimacy is an empirical rather than a deductive phenomenon and that the democratic principles appropriate to the conduct of the state may be inappropriate to other social institutions.

Once it is understood that the propositions embodied in the first two cells of the Political Model rest not on functional analysis, but simply on questionable postulates, we are in a position to develop the alternative Economic Model. The initial cells of this Model assume that the corporation is an economic institution, and that, as an empirical matter, the corporate system is legitimated on three major bases. The first is a belief that placing control of the factors of production and distribution in the hands of privately appointed corporate managers, who are accountable for their performance and who act in the interest and subject to the ultimate control of those who own the corporation, achieves a more efficient utilization of economic resources than that achievable under alternative economic systems. The second is a belief that corporate managers are in fact accountable for their performance. The third is a belief that the shareholders, as the owners of the corporation, have the ultimate right to control it. This right is often challenged on the grounds that share-ownership is frequently short-lived and is almost invariably derivative, since shareholders typically purchase and sell stock on the market rather than contributing funds directly to the corporation's capital. It is hard to make sense of this position. It might as soon be said that a middleman has less right in his inventory than does a manufacturer, or that a person who buys a house has less right to its control than a person who builds one. There are other problems with the concept of ultimate shareholder control—not least, whether the shareholders are interested in exerting control. For present purposes, however, it is sufficient to point out that in our society control solely by virtue of ownership—hands-on or hands-off—is a fully legitimating principle, and that managing the corporation in the interest of the shareholders is socially desirable, in that their interest coincides with the social interest in efficiency.
Let us turn now to the third cell—the objective and the conduct of the corporation. Under the Political Model the corporation has a number of objectives. Under the Economic Model, however, the corporation has a single objective—conducting business activities with a view to corporate profit and shareholder gain. I shall refer to this as the economic objective. This objective does not mean that the corporation must relentlessly maximize profit on every occasion. Every human institution, including the corporation, is a social institution. The corporation's conduct in pursuit of the economic objective therefore must be constrained by social imperatives and may be qualified by social needs. To put this differently, the corporation's pursuit of the economic objective should be conducted within the channels laid down by social norms.

Both the economic objective and its limits are reflected in section 2.01 of Tentative Draft No. 1 of the American Law Institute's Principles of Corporate Governance and Structure: Restatement and Recommendations:6

[T]he objective of the business corporation is to conduct business activities with a view to corporate profit and shareholder gain, except that, even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business

(a) is obliged, to the same extent as a natural person, to act within the boundaries set by law,
(b) may properly take into account ethical principles that are generally recognized as relevant to the conduct of business, and
(c) may devote resources, within reasonable limits, to public welfare, humanitarian, educational, and philanthropic purposes.

Often, of course—probably in the vast bulk of cases—there is no conflict between the economic objective and social norms. The economic objective does not compel the corporation to favor short-run over long-run profitability; on the contrary, long-run profitability is at the core of that objective. An orientation toward lawful and ethical activity will normally further the economic objective, even if it involves short-run economic costs, because it is likely to produce long-run economic gains or avoid long-run losses. Simi-
larly, activity that benefits the public may be based on the prospect of long-run gain to the corporation, and in such cases too the activity will fall within the economic objective. This is true even if the activity will generate profits to an entire industry, rather than just to the corporation, provided the corporate decisionmaker rationally believes that the corporation's share of the industry's gains is likely to exceed the corporation's costs. Nevertheless, there will be instances when adherence to social goals or imperatives are neither designed nor likely to enhance corporate profit and shareholder gain. Three principles govern the effect of social norms on corporate conduct in such cases.

1. The boundaries set by law. The first of these principles is that even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business, is obliged to the same extent as a natural person to act within the boundaries set by law. This principle is embodied in section 2.01(a) of the Principles of Corporate Governance and is exemplified by Illustrations 7 and 8 to that section:

7. Corporation F is a publicly held corporation with annual earnings in the range of $3-5 million. F hopes to be awarded a supply contract by P, a large publicly held corporation. The anticipated profits on the contract are $5 million over a two-year period. A vice-president of P has approached O, the relevant corporate decisionmaker of F, with the suggestion that if F pays the vice-president $20,000, he will guarantee that F will be awarded the contract. O knows such a payment would be illegal, but correctly regards the risk of detection as extremely small. After carefully weighing that risk and the consequences of detection, O causes F to pay the $20,000. F's action involves a departure from the principle stated in § 2.01(a)....

8. Corporation G owns and operates fifteen plants which were traditionally non-union. For the last several years Union U has been attempting to organize G's workers, and has successfully organized three of G's plants. G adopts a strategy of refusing to bargain at the three plants which U organized, and harassing workers belonging to U

9. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 6, § 2.01(a), at 17.
at G's other twelve plants. Although the relevant corporate decisionmaker, W, has been informed by counsel that in counsel's opinion the proposed conduct would violate the National Labor Relations Act, W correctly believes that a long time will elapse before sanctions are imposed, and that the profit from this conduct will far exceed the cost of possible sanctions. G's action involves a departure from the principles stated in § 2.01(a). . . .

The concept that a corporation ought to act within the boundaries set by law might seem self-evident. Unfortunately, it is not. Some persons take the position that a corporation is free to decide whether to obey a given legal rule on the basis of a kind of cost-benefit analysis, in which probable corporate gains are weighed against probable social costs, measured by the dollar liability imposed for engaging in such conduct, or probable corporate losses, measured by dollar liability discounted for likelihood of detection. A recent matter involving Citicorp, one of the country's two largest banking corporations, is worth considering. In February 1982, the New York Times reported that after a three-year investigation, the SEC's enforcement staff had concluded that between 1973 and 1980 Citicorp had shifted at least 46 million dollars in currency-transaction profits from the bank's branches in Europe, where the transactions occurred but taxes are high, to branches in the Bahamas, where taxes are much lower. The staff also concluded that these shifts were purposely concealed from the European authorities; were effected through such means as disguising transactions, keeping two sets of books, and even falsifying books; and involved extensive violations of local law. Faced with this report, the SEC voted 3-1 not to bring a civil action against Citicorp. This result may be defensible: even if the staff's conclusions were correct, Citicorp's activities would not necessarily run afoul of either the principle of compliance with law, which is directed largely at domestic law, or the Securities Acts,

10. Id. § 2.01(a), at 26-27. Illustrations 7 and 8 both conclude: "[A]s to the legal obligations of [the decisionmaker], see § 4.01(c)." Section 4.01(c) provides that "[T]he duty of care . . . encompasses the obligation of a director or officer to make reasonable efforts to cause his corporation to perform its duty under § 2.01(a) to obey the law." Id. § 4.01(c), at 141. Under § 7.06(b), the defendant can offset damages under § 4.01(c) by establishing gains to the corporation that arose out of the same transaction, unless recognition of such an offset would frustrate an authoritatively established public policy. Id. § 7.06(b), at 378-79.

13. The Comment to § 2.01(a) states that the Draft does not address questions relating to the effect of the law of countries other than the United States.
which are directed principally at disclosure. However, the decision apparently did not rest solely on these considerations. According to the Times, SEC staff officials, including the chief of the enforcement division, contended that Citicorp's management "made a reasonable and standard business judgment" by taking the "most profitable course," despite the knowledge that it was probably unlawful and risked sanctions. Similarly, one of the commissioners reportedly argued that Citicorp had acted properly by measuring the risk of getting caught against the potential profits to be gained by the currency transactions. "I think that evaluating the risk is within a business judgment," he is said to have maintained.

The approach apparently embraced by the SEC on this matter is premised on a false view of the citizen's duty in a democratic state. Risk of liability is not a ticket that can be purchased for the privilege of engaging in legally wrongful conduct. A legislature or a court may, within limits, utilize a cost-benefit analysis in determining whether a certain type of conduct should be deemed legally wrongful. Once that determination has been made, however, the resulting legal rule normally represents a community decision that the conduct is wrongful as such. Violations cannot then be morally or socially justified on the ground that in a particular case the violator's financial gains would outweigh either its financial losses or general social losses.

Given the corporation's obligation to act within the boundaries set by law, how should the extent of that obligation be measured? The corporation's obligation to obey law is based on the social norm of obedience to law, and is therefore no different than the obligation of an individual. Accordingly, the corporation is obliged to act within the boundaries set by the law to the same extent as a natural person—no less, but no more. For example, noncompliance with law may be justified under the principle of necessity in extraordinary situations where compliance would inflict substantial harm on third parties, and noncompliance would not. Similarly, the norm of obedience to law usually is deemed counterbalanced where, under appropriate conditions, a rule is violated openly for the purpose of testing its validity. Noncompliance with law may also be justified under the concept of desuetude where a departure from a legal rule is explicitly condoned by both popular morality and relevant government authorities. Again,

while a breach of contract may violate the moral norm that promises should be kept, it is not clear that the obligation of contract is separately supported by the norm of obedience to law.

2. Ethical principles generally recognized as relevant to the conduct of business. The principle that a corporation must act within the boundaries set by law goes a long way toward ensuring that corporations act like responsible citizens. This is particularly so because, as stressed in the Comment to section 2.01 of the Principles of Corporate Governance, in determining what boundaries are set by law “the corporation should not rest simply on past precedents or an unduly literal reading of statutes and regulations, but should give weight to all the considerations that the courts would deem right to take into account in their determinations, including relevant principles, policies, and legislative purpose.” 16 In some cases, however, a given line of conduct, although not required by law, is suggested by ethical principles. Often no special rule of corporate conduct is needed in such cases, because ethical principles converge with the economic objective. This situation is exemplified by Illustrations 1 and 2 to section 2.01:

1. Corporation A is a publicly held corporation with annual earnings in the range of $2-3 million. A has entered into a contract that is unenforceable against it under the Statute of Frauds. Performance of the contract will involve a loss of $70,000. A performs the contract, because the relevant corporate decisionmaker . . . makes a judgment . . . that the loss is likely to be exceeded by long-run profits from preserving confidence in A’s willingness to honor its commitments. A’s action does not involve a departure from the economic objective.

2. Corporation B is a publicly held corporation with annual earnings in the range of $6-8 million. E, a long-time middle-manager of B, is forced to retire because of serious injuries sustained in an automobile accident. B has a pension plan covering E, but the plan was installed only recently, and E’s benefits are only 30% vested. B purchases an annuity for E at a cost of $50,000, to bring E’s retirement income up to a liveable amount, because the relevant corporate decisionmaker . . . [concludes] that the cost of the annuity will be exceeded by long-run profits from increasing the morale of B’s remaining employees. B’s action does not involve a departure from the economic

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Nevertheless, in some cases ethical principles and the economic objective will diverge. In such cases, a corporate manager is no less morally obliged than any other citizen to take generally recognized ethical principles into account. However, because corporate officials deal with other people's money, they may properly take ethical principles into account only where those principles are generally recognized as relevant to the conduct of business. Furthermore, because there is so much imprecision in defining and applying the ethical principles generally recognized as relevant to the conduct of business, it would be impracticable to oblige corporations to follow such principles as a matter of corporate law. Accordingly, corporations should be permitted but not required to take such principles into account. This concept is embodied in section 2.01(b) of the Principles of Corporate Governance, and exemplified in Illustrations 11-13 to that section:

11. The facts being otherwise as stated in Illustration 1, A is about to be dissolved. A nevertheless honors the contract because generally recognized ethical principles indicate that seriously made business promises should normally be kept even if there is a technical excuse for nonperformance. A's action can be justified under § 2.01(b).

12. The facts being otherwise as stated in Illustration 11, A does not honor the contract. A's action can be justified under the first clause of § 2.01.

13. J corporation is a publicly held corporation engaged in the operation of a chain of small moderately priced restaurants. A 40% controlling stock interest in J is held by S. On S's death her stock passes to her grandson, T. J converts all of its restaurants to strictly vegetarian menus, because under T's principles it is improper to eat meat or fish, although it is admitted that the conversion will reduce J's profits on both a long-run and a short-run basis. J's action involves a departure from the principles stated in § 2.01, because T's beliefs are not generally recognized as ethical principles relevant to the conduct of business. . . .

What principles are generally recognized as relevant to the conduct of business may vary somewhat according to the business. For example, special policy considerations may attach to the con-

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17. Principles of Corporate Governance, supra note 6, § 2.01, at 21-22.
18. Id. § 2.01(b), at 17.
19. See p. 110 supra.
20. Principles of Corporate Governance, supra note 6, § 2.01, at 30-31.
duct of a newspaper business. An index to whether a corporate
decisionmaker may properly take account of a given ethical prin-
iple is whether doing so would be likely to violate the fair expecta-
tions of the corporation's shareholders taken as a group.

3. Public welfare, humanitarian, educational, and philan-
thropic purposes. It can be plausibly argued that the social inter-
est is best served by allowing managers to depart from the
economic objective only when the departures are either compelled
by law or clearly sanctioned by generally recognized ethical prin-
ciples. On balance, however, considerations of social policy support
a third principle governing the effect of social norms on corporate
conduct: The corporation should be permitted to devote resources,
within reasonable limits, for public welfare, humanitarian, educa-
tional, and philanthropic purposes, even if corporate profit and
shareholder gain are not thereby enhanced. One major reason
for this principle is that because corporations occupy a central po-
sition in the economic structure, their cooperation in furthering de-
clared social policies is often critical to the success of such policies.
A primary example is corporate activity which, although techni-
cally not required by statute, is in furtherance of the policy under-
lying a statute—for example, activity designed to combat
discrimination in employment or to preserve the environment.
Such cooperation cannot feasibly be required, since by hypothesis
it goes beyond the corporation's legal obligation. Certainly, how-
ever, it should be permitted and indeed encouraged where it is in
aid of the statutory design. Similarly, major social institutions, in-
cluding the corporation, should be permitted and indeed en-
couraged to engage in humane behavior even where the behavior
is not required by generally recognized ethical principles. Finally,
our social system favors diversity and decentralization in educa-
tional and philanthropic activity, and those objectives would be
difficult to achieve unless corporations, which control a great share
of our national resources, were permitted to devote a portion of
their resources to those ends.

A rule permitting corporations to use resources for public wel-
fare, humanitarian, educational, and philanthropic purposes is also

21. See Kelly v. Bell, 266 A.2d 878, 879 (Del. 1970); Theodora Holding Corp. v.
Henderson, 257 A.2d 398, 405 (Del. Ch. 1969); Sorensen v. Chicago, B. & Q. R. Co., 12
402 (1958); MODEL BUSINESS CORPORATION ACT § 4(m) (1971) ("Each corporation
shall have power . . . to make donations for the public welfare or for charitable,
scientific or educational purposes").
supportable on administrative grounds. The use of corporate resources to further such purposes is often motivated by the economic objective. For example, a donation to public television may be made for reasons comparable to those for sponsoring a commercial, and a contribution to local Red Cross or Community Chest activities may be made for reasons of employee well-being and morale. In many cases, however, the expected dollar benefit of such activity is extremely difficult to measure. It is therefore desirable to permit a reasonable zone of flexibility in which corporate resources can be used in this manner without an explicit showing of likely dollar benefits.

However, because of the great imprecision in determining what constitutes public welfare, humanitarian, educational, and philanthropic purposes, the possible lack of an intrinsic connection between such purposes and the corporation's business, and the lack of inherent limits on the extent to which corporate resources may be used in this manner, if corporate action is justified solely on the ground that it furthers such purposes, it must be subject not merely to the usual test of business judgment, but to the more demanding limit of reasonableness. What is reasonable in this context, as in others, depends on the circumstances of the particular case. The two principal factors that should be considered are the customary level at which resources are devoted to such purposes among comparable corporations in proportion to earnings and assets, and the strength of the nexus between the use of corporate resources and the corporation's business. Of course, extreme conditions, such as threats to national security, may justify activity beyond that which would be reasonable under normal conditions.

Both the general principle and its limits are embodied in section 2.01(c) of the Principles of Corporate Governance, and exemplified in Illustrations 22 and 16 to that section:

22. P Corporation is a large publicly held corporation engaged in the manufacture of powerful computers, with annual earnings of $60-70 million. P has been negotiating with a North African country for the sale of three computers. Negotiations were essentially complete, and a con-

22. In Union Pacific R.R. v. Trustees, Inc., 8 Utah 2d 101, 329 P.2d 398 (1958), the court held that corporations have authority to make "contributions of reasonable amounts to selected charitable, scientific, religious or educational institutions, if they appear reasonably designed to assure a present or foreseeable future benefit to the corporation." Id. at 107, 329 P.2d at 402 (emphasis added). In Sorensen v. Chicago B. & Q. R. Co. 112 Neb. 248, 199 N.W. 534 (1924), the court stated: "We see no reason why a railroad corporation may not, to a reasonable extent, donate funds or services to aid in good works." Id. at 256, 199 N.W. at 537 (emphasis added).

23. Principles of Corporate Governance, supra note 6, § 2.01(c), at 17.
tract ready to sign, when the President announced that within the next two weeks he would adopt an executive order prohibiting the shipment of certain high-technology products to that country, because its conduct was highly inimical to the United States and threatened the stability of the entire area. The President also announced that the prohibition would not be applied to contracts made before the order became effective, but urged voluntary compliance as of the date of the announcement. It was clear that when the executive order became effective it would apply to P's computers. P estimates that the sale would have generated earnings of $6 million, and that short- and long-term costs entailed by completing the sale would not have been significant. P nevertheless decides not to sign the contract, because its officials believe that sale of the computers would contravene a strong and clearly announced national policy. P's action does not involve a departure from the principles stated in §2.01, since it can be justified under §2.01(c). Although the amount of forgone income is high, it is reasonable under the circumstances.

16. M corporation is a publicly held cement producer with assets of approximately $125 million and annual earnings in the range of $13-15 million. All of M's facilities are located in the western United States, and the nature of the cement business is such that M cannot practicably make sales outside that region. On the basis of philanthropic considerations, M donates $3.1 million to a prominent New York art museum for the purchase of an old master. M's action involves a departure from the principles stated in §2.01. A contribution equal to approximately 20% of M's annual earnings for a use that lacks any meaningful nexus to M's business is not reasonable under §2.01(c). The contribution cannot be justified under [the economic objective], since it is not motivated by profit considerations, and given the nature of M's business (and assuming no additional relevant facts) there would be no rational basis for concluding that the contribution would increase either short- or long-term profitability in more than a marginal manner.

This brings us to the last two cells of the Economic Model—the role of management, and the function and composition of the board. The role of management is easily dealt with. Given the Economic Model's stance on the objective and conduct of the corporation, management's role is to achieve the economic objective

24. Id. § 2.01, at 37-38.
25. Id. at 34-35.
while adhering to law, to generally accepted ethical principles, and to standards of humane and responsible behavior.

Resolution of issues concerning the composition and the role of the board also follows from the Economic Model's stance on earlier issues. The Economic Model assumes, as principles of legitimacy, that (1) privately appointed managers who are accountable for their performance, and who act in the interest and subject to the ultimate control of those who own the corporation, will achieve a more efficient utilization of economic resources than that achievable under alternative economic systems; (2) corporate managers are under the ultimate control of the shareholders; and (3) corporate managers are in fact accountable for their performance—accountable principally for efficiency, but also for loyalty and law-abidingness. Given these principles of legitimation, the legal system may and even must insist on some institution of accountability for managerial performance that is external to the managers themselves.

One such institution would be direct review of managerial performance by the body of shareholders. In the modern corporation, however, this body cannot be relied upon to conduct the kind of scrutiny required, because of its disparate and shifting nature and the complexity of modern management issues.

A second such institution would be the market. Potentially, three types of market mechanisms are relevant.

The first such mechanism consists of the commodity markets in which the corporation operates, with their attendant sanction of business failure. This mechanism, however, is inadequate to the purpose, since a large publicly held corporation can often remain in business for a protracted period of time even with minimal returns, or may earn acceptable returns only because it is coasting on programs put into place by prior managers.

The second relevant market mechanism is the capital market: Inefficient managerial performance will increase the cost of equity capital by decreasing the price at which the corporation's equity capital sells. However, a corporation with a large cash flow may be able to meet its capital needs for a long period of time through internal and even external financing—even though its profits are lower than good management would produce.

The third relevant market mechanism is the market for corporate control: If the corporation's assets are utilized inefficiently, its shares may sell at a price low enough to tempt outsiders to acquire control through a takeover. The takeover mechanism, however, also provides excessive leeway for managerial inefficiency. For
one thing, outsiders often experience a time-lag in ascertaining lack of managerial efficiency. For another, the transaction costs imposed by the inherent mechanics of takeover bids and the requirements of relevant statutes are very high. Furthermore, inefficient managers can often protect their positions through invocation of a wide array of defensive techniques whose costs are borne by the shareholders.

Finally, since self-interested transactions are typically not sufficiently material in dollar terms to have a significant impact on share prices, market mechanisms, even if fully effective in holding corporate management accountable for efficiency, are unlikely to be effective in regulating managerial conflicts of interest. Such conflicts have public as well as private consequences. Even when they are economically immaterial they tend to sap the public's confidence, and therefore willingness to participate, in capital markets.

A constraint beyond the market is therefore required as a check on managerial efficiency, as well as on conflicts of interest. The board, which is already charged with the duty of monitoring or overseeing management, is the natural institution in which to vest this critical function. It is compact and cohesive, devoted to the interests of the enterprise, knowledgeable in business affairs generally and the corporation's affairs in particular, capable of being made independent of executive control, and responsible directly to the shareholders. Until recently, the received legal model of the corporation provided that the primary function of the board was to manage the business of the corporation. It is clear today, however, that the business of a large publicly held corporation can only be managed by fulltime senior executives. The primary function of the board should therefore be to select those senior executives, and then monitor or oversee their conduct—primarily to determine whether they are managing the business in a manner which is efficient, but also to determine whether conflict-of-interest transactions are fair, and whether the corporation is being managed in a manner that is consistent with law, generally recognized ethical principles, and standards of humane and responsible behavior.

Given this function, the composition of the board should be such as to ensure that it will be capable of overseeing the performance of the senior executives in an objective manner. To this end, the law should provide that the boards of large publicly held corporations—those with, say, 2,000 or more shareholders and at least $100 million in assets—include at least a majority of directors who are independent of the senior executives—who are, for example,
not employees of the corporation, relatives of the senior executives, major suppliers to the corporation, corporate counsel, or the corporation's investment bankers. This requirement should be complemented by provisions requiring that such corporations have nominating committees to strengthen the board's independence and audit committees to strengthen the board's monitoring capacity, and that those committees should be composed entirely of directors who are independent of the senior executives.

CONCLUSION

The choice between the Economic and Political Models rests in part on a choice between postulates concerning the nature and legitimacy of the corporation. To some extent, that choice must be intuitive. The postulates of the Economic Model, however, seem to better reflect accepted conceptions of institutional competence and legitimacy than do those of the Political Model. Moreover, the Economic Model has several important functional advantages over the Political Model.

First, managing the corporation in the interest of the shareholders is desirable on the ground that the shareholders' interest coincides with the social interest in efficiency.

Second, the Political Model is unlikely to be workable in the United States. Under modern conditions, corporations must regularly make huge new capital investments. The funds for these investments typically cannot be generated through internal profits alone. Accordingly, many corporations must seek periodic infusions of capital in the equity markets. It is questionable, in this country, whether such funds would be forthcoming to corporations controlled by groups whose interest in corporate profitability is either diluted, as in the case of labor, or virtually nonexistent, as in the case of consumers.26

Third, the Economic Model provides for managerial accountability, while the Political Model does not. Under the latter Model the corporation has a number of objectives, and the role of man-

26. For example, while it is not easy to evaluate the Yugoslavian system of employee management, recent reports suggest that Yugoslavian corporations distribute surplus to the employees rather than reinvesting it, and that investment in Yugoslavia is in a chaotic state. Sirc, The Yugoslav Debt and Socialist Self-Management, Wall St. J., Oct. 13, 1982, at 29, col. 3; Yugoslavia without Tito is Torn Economically by Rivalries Among Its 8 Autonomous Regions, Wall St. J., July 5, 1983, at 44, col. 1. Similarly, Milovan Djilas recently commented, “Worker self-management is completely artificial; it is really part of the ruling structure, part of the party’s political activity. Self-management cannot be very efficient because it’s part of the ruling structure.” Bray, A Conversation with Yugoslavia’s Milovan Djilas, Wall St. J., Oct. 20, 1981, at 23, col. 3.
agement is to mediate among them. It is therefore virtually impos-
sible to hold management to meaningful account under this Model,
because the amount of weight that should be given to any one ob-
jective must necessarily be a matter of discretion. In contrast,
under the Economic Model a meaningful although admittedly gen-
eralized objective is set for measuring management performance.

Finally, in comparing the two Models it must be borne in mind
that voting is not the only mode for expressing the needs and legiti-
mate concerns of groups whose interests are affected by the cor-
poration. Denying these groups a voting right is therefore not
equivalent to denying them a voice. On the contrary, nonvoting
modes of participation, such as markets, negotiation, and consulta-
tion, are often more responsive to those needs and concerns than
voting would be. Thus as a practical matter the shareholder voice,
expressed through the vote, interacts with the voices of commer-
cial and investment bankers, expressed through the market for
credit and the mechanisms of creditor supervision; of consumers,
expressed through the commodity markets and the institutions of
consumer protection; of labor, expressed through the labor market
and collective bargaining; and of the community, expressed
through legal regulation and generally recognized ethical
principles.27

The task ahead is to ensure that large publicly held corpora-
tions do not depart from the Economic Model in fundamental
ways. Historically, the corporate statutes permitted two such de-
partures: They provided that the board should manage the busi-
ness of the corporation, rather than requiring it to monitor or
oversee management, and they failed to require a board and com-
mittee structure that could be relied upon to hold executives ac-
countable. If the integrity and legitimacy of the Economic
Models—and therefore of the corporate system—are to be main-
tained, these deficiencies must be corrected, by recognizing that
the senior executives manage the business of the corporation, re-
quiring the board to oversee the executives' conduct of the busi-
ness, and providing that the board and its key overview
committees be composed in a manner which makes it likely that
this oversight will be objectively performed. The law has begun
moving, albeit very slowly, in this direction, and many corpora-
tions have already adopted such a structure. Others, however, de-
part from a system of real accountability. Until the law requires
corporate managers to be accountable to an objective body, these

27. I owe parts of this passage to Alfred Conard.
departures from the Economic Model will make the Political Model much harder to resist.