

## ENRONITIS: WHY GOOD CORPORATIONS GO BAD

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## I. INTRODUCTION

We begin with a proposed definition of Enronitis:

*Enronitis.* (n., neologism derived from Enron, a large company that went bankrupt amid allegations of market manipulation, phony accounting, looting, and other corporate misbehavior)

1. A malfunction of corporate governance in which top managers become extraordinarily wealthy while misleading shareholders, creditors, employees and the general public about the company's prospects and practices, eventually resulting in share price collapse, loss of jobs, and, in extreme cases, the corporation's bankruptcy. Thought to have

characterized a non-trivial portion of the American corporate economy in the “bubble economy” around the turn of the twenty-first century. Often accompanied by sudden collapse of the reputations of seemingly upstanding corporate citizens who turn out to have been routinely lying, not only to shareholders, but to their own board members, employees, tax authorities, etc.

The Enron problem is widely understood to be the result of too weak of a legal mandate supporting the share-centered paradigm of corporate law. Paradoxically, however, it is in fact the predictable result of too strong of a share-centered view of the public corporation; share-centered corporate law creates the very problems it is meant to police.<sup>1</sup> The single-valued profit maximization ethos of the share-centered corporation demands that managers teach themselves to exploit everyone around them. It is inevitable that some will learn this lesson so well that they will exploit even those for whose benefit they are supposed to be exploiting.

Corporate law demands that managers simultaneously be selfless servants and selfish masters. On the one hand, it directs managers to be faithful agents, setting aside their own interests entirely in order to act only on behalf of their principals, the shares. On the other hand, in the service of this extreme altruism, they must ruthlessly exploit everyone around them, projecting on to the shares an extreme selfishness that takes no account of any interests but the shares themselves. Having maximally exploited their fellow human corporate participants, managers are then expected to selflessly hand over their gains, ill and justly gotten, to the

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<sup>1</sup> Much confusion in our law results from the unfortunate fact that we use the same term to refer to public corporations and closely held ones. In closely held corporations, a controlling shareholder (or small group of shareholders) has most of the rights of an “owner” in the normal sense of the word; in public corporations, shareholders have such rights only in potential, and the potential is only as real as the takeover market is free, uninhibited and vibrant. This Article discusses only public corporations; most of its analytic framework is inapplicable to firms with human owners.

faceless legal abstraction of the fictional shareholder. Altruism and rationally self-interested exploitation are extreme and radically opposed positions, psychologically and politically. The managerial role is deeply unstable and unlikely to hold.

For managers, one easy resolution of these tensions is a simple, cynical selfishness in which managers see themselves as entitled, and perhaps even required, to exploit shareholders as ruthlessly as they understand the law to require them to exploit everyone else. Another likely resolution conveniently switches between market and fiduciary norms to allow managers to view themselves—in good faith—as underpaid and exploited even as they increase their pay to previously unheard of levels. Enronitis, thus, is the result of the very share-centered paradigm current reform seeks to strengthen.

The damage caused by the share-centered paradigm goes beyond the share-manager conflict, however. On the simplest level, the share-centered paradigm encourages managers to see their job as requiring them to ignore all political, moral and human values but one: profit. This view urges managers to see the world in purely instrumental terms. However, this makes managers, who perform their roles as we tell them to, into one-sided, anti-social outsiders to civil society. Citizens do not treat fellow citizens as mere strangers and tools. Our corporate law, paradoxically, tells managers that to be good managers they must be bad citizens.

Internally, the share-centered paradigm is just as self-destructive. Corporations succeed because they are not markets and do not follow market norms of behavior. Rather, they operate under fiduciary norms as a matter of law and team norms as a matter of sociology. However, the share-centered paradigm of corporate law teaches managers to treat employees as outsiders and tools to corporate ends with no intrinsic value. Just as managers are unlikely to learn simultaneously to be selfish maximizers and selfless altruists, they are unlikely to be simultaneously cooperative team players and self-interested defectors. Thus, the share-

centered view undermines the prerequisite to operating the firm in the interests of shareholders. Share-centeredness can both accentuate the pathologies of teams—especially the tendency to disregard the interests of non-team members in an excess of we/them competitiveness—and undermine the mutual solidarity that is vital to maintain the team's advantages.

A story about Enron's CEO Jeffrey Skilling epitomizes the problem so well it seems too good to be true:

As a [Harvard Business School] student, Jeffrey Skilling was asked what he would do if his company were producing a product that might cause harm—or even death—to the customers that used it. . . . Skilling replied, "I'd keep making and selling the product. My job as a businessman is to be a profit center and to maximize return to the shareholders. It's the government's job to step in if a product is dangerous."<sup>2</sup>

Skilling's statement foreshadows both the internal corporate law and external regulatory perversities of Enronitis. On the one hand, even as a student Skilling had fully internalized the share-centered view that role morality requires managers to ignore ordinary responsibility for their fellows in favor of pursuit of profit. On the other hand, the extraordinary distortions that view creates (even within its own narrow framework) are already apparent: how likely is it that murdering your customers could be profit maximizing?

What is needed is a new paradigm for understanding corporate law, one that emphasizes the collective, corporate nature of the public corporation without falling into the trap of assuming that easy professionalism can resolve difficult value choices. Corporations are governance structures as complex as any other and deserve to be analyzed as such. Reforms emanating from a new understanding of the public

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<sup>2</sup> PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON: EVERYONE'S GUIDE TO THE LARGEST BANKRUPTCY IN U.S. HISTORY 28 (2002).

corporation as polis are more likely to ameliorate the dangers of Enronitis and other corporate dysfunctions.

This Article proceeds as follows: Part II reviews a few of the recent scandals and some of the reforms proposed in response. Part III sets out the basic theoretical framework of the share-centered corporation and the fictional shareholder as applied to the problem of managerial incentives and loyalty: managers are directed to work for fictional shareholders who are, in turn, imagined to have no relationships with the rest of us. The law teaches managers to act as if they were fiduciaries for foreigners interested only in using us and our world, not as fellow citizens in a common enterprise. Instead of acting as the representatives of a major part of our collective governance system, they are told to treat us much as a not-too-benevolent colonial power might, as tools for a stranger's projects.

Part IV applies and expands this framework in the contexts of both internal corporate law and external regulatory law. First, corporate law creates an oasis of agency or fiduciary law using norms appropriate to co-adventurers, within a greater environment of disinterested arm's-length market relations. The fictional shareholder is an unsatisfactory partner or principal in the fiduciary oasis because it is incapable of the loyalty or mutuality such relationships demand. The usual attempt to rescue the special relationship with shares is a metaphor of ownership; because the fictional shareholders "own" the firm they are entitled to special consideration and rights as the end, rather than the means, of the corporate enterprise. This metaphor, however, is not powerful enough to do the work demanded of it in the share-centered corporation. Shares do not have enough of the usual attributes of ownership to plausibly appear (or demand treatment as) corporate ends. Moreover, even though shareholders are sometimes (and incorrectly) called "owners," they are simultaneously viewed as factors of production like all other means to corporate ends.

Second, managerial attempts to resolve the tensions of the share-centered view can lead to a series of corporate

malfunctions in addition to corporate betrayal of shareholders:

- corporate decisions to treat regulatory and criminal law as merely prudential, additional elements to be taken into calculation in making a profit-maximization decision;
- ever-increasing managerial pay; and
- distortions of the team spirit that drives corporations as sociological entities.

Part V briefly considers some of the proposed reforms intended to strengthen the share-centered framework. It concludes that, although they are likely to be helpful in preventing a repeat of the current scandals, any reform that leaves the basic incentive structure in place is likely to result in corporate managers finding new, creative, and unexpected routes to scandal.

Finally, Part VI outlines a new conceptual framework—corporation as polis—that would allow us to think of corporate managers as explicitly political participants in an explicitly political conflict over public values and private money. The dominant share-centered view seeks to pretend corporations are apolitical by claiming that values, safety, and citizenship are, as Skilling said, “the government’s job.”<sup>3</sup> Its historic opponent, benevolent managerialism, is equally obfuscatory, pretending that professional ethics will suffice to resolve genuine value conflicts. Corporation as polis, in contrast, seeks to frankly acknowledge the multiple value conflicts inherent in any corporate enterprise. By taking the corporation seriously as a locus of both value debate and interest group conflict over scarce resources, we will be better able to tie our most powerful economic engines to private wealth generation, social good, and the public interest.

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<sup>3</sup> *Id.*

## II. THE PROBLEM: CORPORATE FAILURE

We live in an age of corporate scandal. Publicly traded corporations are the core of our economy, essential building blocks of our society, and centers of our individual and collective lives. They provide nearly half of our non-governmental jobs<sup>4</sup> and probably account for an even larger portion of our GNP.<sup>5</sup> The largest operate on every continent;<sup>6</sup> a new form of empire on which “the sun never sets.”<sup>7</sup> We work for them, buy from them, listen to them, depend on them and glorify them. Yet we seem unable to control them satisfactorily. Our major corporations violate law and civility on a routine basis.

Often we sharply distinguish two types of corporate scandal. On the one hand are scandals of corporate law

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<sup>4</sup> Of the 110 million Americans employed by private industry in 1999, just under half were employed by enterprises with 500 or more employees. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 483 No. 716 (2002), *available at* <http://www.census.gov/prod/2003pubs/02statab/business.pdf> [hereinafter 2002 STATISTICAL ABSTRACT]. Although the abstract was silent on this point, it seems safe to assume that virtually all these large private employers are publicly traded corporations.

<sup>5</sup> Precisely what portion of the economy is comprised of publicly traded firms turns out to be surprisingly difficult to determine. That it is large is clear: total stock market capitalization on the New York Stock Exchange alone is roughly \$15 trillion. Press Release, New York Stock Exchange, Barclays Global Investors and the New York Stock Exchange Introduce New Exchange Traded Funds Based on NYSE Indexes (April 2, 2004), *available at* <http://www.nyse.com/press/1080904515942.html>. However, it is hard to find numbers comparable to the total economy. In 2002, corporate business as a whole (including closely-held private corporations) accounted for \$6.2 trillion, or about sixty percent of the \$10.4 trillion GDP that year. See BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COMMERCE, NAT'L INCOME AND PROD. ACCOUNTS tbls. 1.1.5 and 1.14, *available at* <http://www.bea.doc.gov/bea/dn/nipaweb/SelectTable.asp>.

<sup>6</sup> In 1999, non-bank multinational corporations alone accounted for roughly fifteen percent of our economy: 21.3 million U.S. jobs and gross U.S. product of \$1.8 trillion. Compare 2002 STATISTICAL ABSTRACT, *supra* note 4, at 497 No. 749 (multinationals) *with id.* at 393 No. 602 (stating that total non-farm U.S. employment was about 132 million in 2001) *and id.* at 834 No. 1320 (U.S. GDP in 1999 was \$9.2 trillion).

<sup>7</sup> JOHANN CHRISTOPH FRIEDRICH VON SCHILLER, DON CARLOS act 1, sc. 6.



proper, in which internal corporate law norms are violated. Generally, these involve managers who help themselves instead of the corporation, or help themselves at the expense of the corporation. In a familiar pattern, stock prices rise and then collapse based on information that later turns out to be false or distorted, managers get rich, the company goes bankrupt, employees lose their jobs and pensions, and customers and suppliers must struggle to pick up the pieces in disrupted markets. In the aftermath of the late 1990s stock market rise, one giant company after another (along with plenty of small ones) had stock price collapses, allegations of shady accounting or dishonest managers, questions raised about directors asleep at the wheel or managers paid enormous sums while profits disappeared.<sup>8</sup>

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<sup>8</sup> According to a General Accounting Office (“GAO,” now called the Government Accountability Office) study, 845 listed companies restated their financial results to correct previous material misrepresentations between January 1997 and June 2002. This is an extraordinary admission of wrongdoing by 9.95% of the total number of companies listed on the NYSE, Amex and NASDAQ. GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES, GAO 03-138, 15-18 (2002), available at [http://www.gao.gov/news\\_items/d03138.pdf](http://www.gao.gov/news_items/d03138.pdf) [hereinafter GENERAL ACCOUNTING OFFICE]. The GAO study period includes the dot-com boom as well as part of the clean-up period afterwards. Booms typically allow some companies to grow out of lies and make concealment of the remaining problems easier. Accordingly, it is safe to assume that the study understates the true extent of the problem. See John C. Coffee, *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403 (2002) (suggesting that restatements are an indication that earlier earnings management had gotten out of hand); see also GENERAL ACCOUNTING OFFICE, *supra*, at 43 (quoting Sept. 1998 speech by then-SEC Chair Arthur Levitt raising concerns about degeneration in quality of reported earnings).

Under the Securities and Exchange Act regimes, companies have affirmative obligations to disclose financial statements that are not materially misleading. For example, Section 11 of the Securities Act imposes liability for untrue statements of a material fact in a registration statement without any scienter requirement. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder make unlawful “any untrue statement of a material fact . . . in connection with the purchase or sale of any security.” Form 10-K requires various officers to certify that annual

The second, often more important, type are the regulatory scandals, in which corporations take actions that harm those around them in violation of regulatory law or societal norms that ought to restrain predatory or negligent behavior. These include corporations that produce dangerous products either without adequate testing or in the face of known safety concerns, such as asbestos, tobacco, l-tryptophan, ephedra, the Ford Pinto exploding gas tank, or SUVs. They include abuse of the environment by routine pollution in large or small scale, from global warming to low mileage, and environmental disasters classified as accidents, such as Bhopal or Exxon Valdez. They include human rights violations, such as Enron's alleged complicity in police suppression of dissidence in connection with its Dabhol project,<sup>9</sup> or Unocal's alleged benefitting from slave labor on its Yadana gas pipeline in Burma.<sup>10</sup> Of most importance to this Article, the regulatory scandals include numerous instances where corporate managers felt constrained to do things they knew were wrong because of their belief that they were obligated to pursue profit at all costs.

Corporate law scandals, my central focus here, are generally understood to be failures of the corporate profit

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reports contain no untrue statements of material fact or material omissions. Each of these and other disclosure obligations has various additional requirements before liability can be established, so the restatements reported in the GAO report are not admissions of legal liability. But there can be no question that each one reflects a failure to fulfill the intent of the law and a company's fiduciary obligation to deal with its shareholders honestly.

<sup>9</sup> See HUMAN RIGHTS WATCH, THE ENRON CORPORATION: CORPORATE COMPLICITY IN HUMAN RIGHTS VIOLATIONS 1 (1999) available at <http://www.hrw.org/reports/1999/enron/>. The Enron Dabhol project is discussed *infra* note 37.

<sup>10</sup> John Doe I v. Unocal Corp., Nos. 00-56603, 00-57197, 00-56628, 00-57195, 2002 WL 31063976, at \*1 (9th Cir. Sept. 18, 2002) (partially reversing the district court's dismissal of claims under the Alien Tort Claims Act arising from allegations that Unocal benefited from forced labor, murder, rape, and torture in constructing the Yadana gasline). See also HUMAN RIGHTS WATCH, WORLD REPORTS, available at <http://www.hrw.org/worldreport99/special/corporations.html> and <http://www.hrw.org/wr2k1/special/corporations3.html> (summarizing allegations).

norm, thought to occur when managers put their own gain ahead of the corporation's best interests. Regulatory scandals, in contrast, are generally understood as resulting from too strong a pursuit of profit, thought to occur when the corporation has put its profit ahead of law, morality, safety, the environment, or the social good.

The distinction between corporate law scandals and regulatory scandals is overdrawn. As we shall see, corporate law scandals stem from the same underlying weaknesses in corporate law and organization as regulatory scandals. Therefore, paradoxical though it may seem, corporate law reforms that seek to tame self-interested managers by increasing the power of the share-centered profit norm ultimately will exacerbate the problem rather than solve it. As managers teach themselves to treat the law, morality, and fellow citizens as mere costs of doing business, some will learn this lesson so well that they will exploit even those for whose benefit they are supposed to be exploiting.

#### A. Enron and Enronitis

Perhaps the best known of the turn of the century corporate law scandals is Enron.<sup>11</sup> In the 1990s, Enron was held up as a model of the new economy, deeply involved in the deregulatory agenda and symbolizing the efficiency of markets in enriching itself and those around it.<sup>12</sup> The

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<sup>11</sup> See, e.g., BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003); MIMI SWARTZ & SHERRON WATKINS, *POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON* (2003); ROBERT BRYCE, *PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON* (2003).

<sup>12</sup> See, e.g., MCLEAN & ELKIND, *supra* note 11; Malcolm Gladwell, *The Talent Myth: Are Smart People Overrated?*, *NEW YORKER*, July 22, 2002, at 28 (critiquing a McKinsey & Co. study concluding that Enron was a model of the new business built on the "war for talent" and an "open market for hiring"); RICHARD N. FORSTER & SARAH KAPLAN, *CREATIVE DESTRUCTION* 150 (2001) (celebrating the Enron system: "[w]e hire very smart people and we pay them more than they think they are worth"); GARY HAMEL, *LEADING THE REVOLUTION* (2000) (lauding Enron as a revolution in the way

nation's seventh-largest company by stock market capitalization, it was run by pillars of respectability, charitable and political leaders, and friends of the President.<sup>13</sup> Suddenly, seemingly overnight, it collapsed amid disclosures of off-balance sheet transactions that created hundreds of millions of dollars of reported income that apparently never existed in fact.<sup>14</sup> Its bankruptcy was the second largest in U.S. history,<sup>15</sup> taking with it 10,000 jobs and over \$1 billion in its employees' retirement savings.<sup>16</sup> In the last year before the collapse, meanwhile, its two senior managers sold Enron stock worth over \$150 million.<sup>17</sup>

Enron's economic innovations, praised one day in the business press, became headline examples of fraud and excess the next. Two years of investigations have led to a series of indictments, guilty pleas and multi-million dollar fines.<sup>18</sup> No doubt more will follow. As I write, the

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businesses are run); James Surowiecki, *Drexel 2.0*, NEW YORKER, Dec. 17, 2001, at 39.

<sup>13</sup> See, e.g., MCLEAN & ELKIND, *supra* note 11; Gladwell, *supra* note 12; FORSTER & KAPLAN, *supra* note 12; HAMEL, *supra* note 12.

<sup>14</sup> See, e.g., Rebecca Smith & John R. Emshwiller, *24 Days: Behind Enron's Demise—How Confusing Earnings Figures and a Fortuitous Break Helped the Journal Uncover the Fraud*, WALL ST. J., Aug. 8, 2003, at C1.

<sup>15</sup> Jeffrey Toobin, *Annals of Law: End Run at Enron*, NEW YORKER, Oct. 27, 2003, at 48.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* CEO Kenneth Lay managed to lose most of this money in Enron's collapse. See *id.* This does not change the fact that he had succeeded in paying himself this much in the first place. Moreover, he was encouraging other Enron employees to hold on to their stock even as he was selling his own. *Id.*

<sup>18</sup> Inter alia, CEO Kenneth Lay, famous for his political connections, was targeted for investigation and possible indictment. His successor, Jeffrey Skilling, was indicted in February 2003. CFO Andrew Fastow and his wife pled guilty to criminal charges, accepting ten year and six month prison sentences and a \$23 million forfeiture; three Merrill Lynch employees were indicted in connection with transactions that apparently allowed Enron to improve the appearance of its financial statements; Merrill Lynch settled criminal charges with an acknowledgment that its employees may have violated federal criminal law, former Enron treasurer Ben Glisan pleaded guilty to criminal charges for concealing Enron's losses in a "special purpose vehicle," and Citigroup and J.P. Morgan Chase

investigation has not reached all the top executives and prosecutors have said nothing public about the company's use of its political connections during its heyday or after.

If Exxon's Valdez,<sup>19</sup> Ford's Pinto,<sup>20</sup> the asbestos bankruptcies and the tobacco industry symbolize corporate

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accepted fines of roughly \$120 million and \$200 million in SEC civil proceedings for assisting Enron and another company in reporting borrowed funds as if they were earned income. See *United States v. Fastow*, Cr. No. H-02-0665 (S.D. Tex., filed Jan. 14, 2004), available at [http://news.findlaw.com/hdocs/docs/enron/usafastow11404\\_plea.pdf](http://news.findlaw.com/hdocs/docs/enron/usafastow11404_plea.pdf) (guilty plea agreement to one count of conspiracy to commit wire fraud and one count of conspiracy to commit wire and securities fraud, discussed in *Fastows Enter Guilty Pleas over Roles in Enron Financial Fraud*, 36 SEC. REG. & L. REP. 123 (Jan. 19, 2004)); Toobin, *supra* note 15 (incorrectly stating that, in the end, no crime may have been committed in a company characterized by a "culture of dishonesty"); *United States v. Bayly*, Cr. No. H-02-0665 (S.D. Tex., filed Oct. 31, 2002), available at <http://news.findlaw.com/hdocs/docs/enron/usbaylyetal91603ind.pdf> (indictment and settlement agreement with Merrill, Sept. 16-17, 2003); *United States v. Glisan*, Cr. No. H-02-0665 (S.D. Tex., filed on Sept. 10, 2003), available at <http://news.findlaw.com/hdocs/docs/enron/usglisan91003plea.pdf> (settlement agreement and statement); *In the Matter of Citigroup, Inc.*, SEC Admin. Proceeding No. 3-11192, 2003 SEC LEXIS 1778 (July 28, 2003), available at <http://news.findlaw.com/hdocs/docs/sec/seccti72803ord.html>; *SEC v. J.P. Morgan Chase*, Cr. No. H-03-38-77 (S.D. Tex., filed July 28, 2003), available at <http://news.findlaw.com/hdocs/docs/sec/secjpmorgan72803cmp.html>. On-line legal database Findlaw lists over twenty-five different complaints, reports, indictments and plea agreements as of February 2004. Enron has filed a 275-page complaint against several investment banks, alleging that they actively participated in its officers' use of special purpose entities to defraud the company and its shareholders. *Enron Corp. v. Citigroup Inc.*, Cr. No. B 01-16034 (S.D.N.Y., filed Sept. 24, 2003), available at <http://news.findlaw.com/hdocs/docs/enron/eciti92403advprcd.pdf>.

<sup>19</sup> The National Oceanic and Atmospheric Administration, which organized the Exxon Valdez clean-up effort and has monitored the damage for the last decade, has a website devoted to the spill at <http://response.restoration.noaa.gov/spotlight/spotlight.html>. A five-page bibliography of legal writings on the incident and its aftermath appears at [http://www.evostc.state.ak.us/pdf/biblio\\_legal.pdf](http://www.evostc.state.ak.us/pdf/biblio_legal.pdf).

<sup>20</sup> *Grimshaw v. Ford Motor Co.*, 174 Cal. Rptr. 348 (1981) (civil suit, reversing jury award of astronomical punitive damages); *State of Indiana v. Ford Motor Co.*, No. 11-431 (March 10, 1980) (criminal case); Gary T.

abuse of customers and other outsiders, Enron stands for the same lack of concern for corporate shareholders and employees. Other corporate law scandals followed the Enron model closely. In Tyco, for example, the company showed its willingness to go to extraordinary lengths to avoid its civic responsibilities, even reincorporating in a foreign tax haven to avoid corporate income taxes.<sup>21</sup> Its collapse was precipitated by the discovery that its CEO had been evading state sales taxes as well.<sup>22</sup> This disclosure was followed rapidly by allegations that top managers had been using corporate assets for personal expenses and that reported profits were non-existent. CEO Dennis Kozlowski was charged with stealing \$400 million from the company.<sup>23</sup> In Adelphia, the CEO and controlling shareholders are accused

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Schwartz, *The Myth of the Ford Pinto Case*, 43 RUTGERS L. REV. 1013 (1991); Mark Dowie, *Pinto Madness*, MOTHER JONES, Sept./Oct. 1977, at 18 (the muckraking article that created the scandal).

<sup>21</sup> Rahm Emanuel, *The Democrats Can Win on Taxes*, WALL ST. J., Oct. 15, 2003, at A20 (reporting that Tyco avoided \$400 million in U.S. taxes in three years by reincorporating in Bermuda).

<sup>22</sup> Mark Maremont & Jerry Markon, *Ex-Tyco Chief Evaded \$1 Million in Taxes on Art, Indictment Says*, WALL ST. J., June 5, 2002, at A1.

<sup>23</sup> Kozlowski and his CFO Mark Swartz are being criminally prosecuted in New York's Supreme Court for looting the company; Tyco is suing Kozlowski civilly to attempt to reclaim some of the lootings; and the SEC has brought an enforcement action. The defendants have denied wrongdoing. *People v. Kozlowski*, No. 5259/02 (N.Y. Sup. Ct., filed Sept. 12, 2002), available at <http://news.findlaw.com/hdocs/docs/tyco/nykozlowski91202ind.pdf>; *SEC v. Kozlowski*, No. 02 Civ. 7312 (S.D.N.Y., filed Sept. 12 2002), available at <http://news.findlaw.com/hdocs/docs/sec/uskozlowski91202cmp.pdf>. Videos, shown at the New York criminal trial, of his apartment with its famous company-paid \$6000 shower curtain and a \$2 million birthday party for his wife, have become internet smash hits. See, e.g., Kevin McCoy, *Jury Sees Kozlowski's Posh Digs Via Video*, USA TODAY, Nov. 26, 2003, at 2B. Kozlowski, like the central figures of so many recent scandals, had been a hero of the business press. A 1999 cover story in *Barron's* called him "the next Jack Welch." Jonathan R. Laing, *Tyco's Titan: How Dennis Kozlowski Is Creating a Lean, Profitable Giant*, BARRON'S, Apr. 12, 1999, at 27, 32. For a lengthy profile of Kozlowski, see James B. Stewart, *Where Did Tyco's Money Go?*, NEW YORKER, Feb. 17, 2003, at 132.

of looting the company for personal interests.<sup>24</sup> Nine billion dollars of WorldCom's reported profits turned out to be non-existent; the result of simple accounting fraud and manipulation known to many members of its internal accounting department,<sup>25</sup> although its top executives' \$100 million in gains was real enough.<sup>26</sup> HealthSouth allegedly cooked its books to the tune of \$2.7 billion.<sup>27</sup>

In other instances, corporate executives appeared to be bringing to life the old joke about trading a million-dollar cat for a million-dollar dog. Major telecommunications firms and internet start-ups sold "capacity" and bought essentially identical capacity back or sold expensive advertisements,

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<sup>24</sup> *In re Adelpia Communications Corp.*, No. 02-41729 (REG), 2004 WL 2186582, at \*1 (S.D.N.Y. Sept. 27, 2004) (detailing history of investigation and lawsuit).

<sup>25</sup> See Dennis Bereford, et al., *Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom, Inc.*, Mar. 31, 2003, available at <http://news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf> (describing false entries amounting to \$9 billion on WorldCom's books made, with little or no apparent attempt to achieve accuracy, and with the knowledge and at least passive acquiescence of numerous employees who cooperated because they feared for their jobs); Richard C. Breedan, *Restoring Trust: Report to the Hon. Jed Rakoff, U.S.D.Ct., S.D.N.Y., on Corporate Governance for the Future of MCI*, (Aug. 2003), available at <http://news.findlaw.com/hdocs/docs/worldcom/corpgov82603rpt.pdf> (describing what appeared to be the largest accounting fraud in history, characterizing it as a result of an absence of "checks and balances" on an "imperial" CEO and proposing a "blueprint for action").

<sup>26</sup> See Bereford et al., *supra* note 25; Breedan, *supra* note 25. Following the share-centered approach, Breedan describes \$400 million the company extended to Ebbers as "loans" from shareholders, although he and his readers are surely aware of the difference between corporate and shareholder assets. *Id.* at 2. He similarly describes other abuses of the company as abuses of "shareholder interests." *Id.* In accordance with this understanding of the problem, Breedan details a massive set of proposed reforms, which he accurately summarizes as an "important shift in power from the board to the shareholders." *Id.*

<sup>27</sup> See, e.g., Carrick Mollenkamp & Ann Davis, *HealthSouth Ex-CFO Helps Suit*, WALL ST. J., July 26, 2004, at C1 (describing CFO's statement of his role in \$2.7 billion accounting fraud); SEC v. HealthSouth Corp., 261 F. Supp. 2d, 1298, 1303 n.5 (N.D. Ala. 2003) (listing pending actions).

accepting as “payment in kind” equally expensive advertisements on their customers’ websites.<sup>28</sup> The companies reported the sale as income even though nothing of substance had happened, and, in the more egregious cases, even found ways to conceal the associated expense.<sup>29</sup>

The drama of these headline scandals should not hide from view the many other companies that overpaid their executives during the boom or re-stated earnings (or should have done so) after the bubble’s collapse.<sup>30</sup> While some of these companies may have been within the letter of the law, they nevertheless acted dishonestly. For example, scores of publicly traded firms granted executives stock options without reporting any associated expense. Although apparently legal, this accounting treatment is clearly dishonest, since it allows the company to give away value without reporting any expense.<sup>31</sup> Similarly, many publicly

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<sup>28</sup> See, e.g., Stewart Baker, *The Other Bubble*, WALL ST. J., July 17, 2003, at D8 (describing “capacity swaps” and similar gimmicks); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319 (S.D.N.Y. 2004) (describing Global Crossing’s alleged use of “capacity swaps” to create the misleading appearance of sales); Dennis K. Berman & Deborah Soloman, *Qwest May Settle SEC Swaps Case*, WALL ST. J., May 19, 2003, at A3 (describing twenty public companies’ use of “capacity swaps” to report large revenue gains that the SEC views as improper); Dennis K. Berman et al., *What’s Wrong*, WALL ST. J., Dec. 23, 2002, at A1 (describing examples of widespread use of “bogus swaps” and “round trip trades of advertising” near end of bubble).

<sup>29</sup> See, e.g., Berman et al., *supra* note 28 (describing how Global Crossing booked “sales” as revenue, but listed the other side of the swap as a “capital expense” which doesn’t show up in operating revenue).

<sup>30</sup> See, e.g., Michael B. Dorff, *Softening Pharaoh’s Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811 (2003) (describing excessive CEO compensation); Susan J. Stabile, *One for A, Two for B and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Employees*, 36 U. MICH. J.L. REFORM 115 (2002) (describing excessive CEO compensation); GENERAL ACCOUNTING OFFICE, *supra* note 8, at 108 (indicating that ten percent of publicly traded companies restated their earnings between Jan. 1997 and June 2002).

<sup>31</sup> The practice facially violates the general requirement of GAAP that the company’s books fairly present its financial condition and the Rule 10(b)(5) requirement that the company’s financial disclosures not be false



traded companies routinely report higher profits to the public than to the IRS. This practice of keeping double books, once thought to be patently dishonest, necessarily means that corporations are being less candid or honest in one or the other set of their books and in particular in their public disclosures. Any investor would surely consider a company's equivocation to be material information and would want to know whether the company is lying to the IRS or taxpayers or to its shareholders.<sup>32</sup>

or misleading. However, in 1999 a specific attempt to change GAAP to require disclosure of granted options as an expense was defeated after a highly publicized and politically charged debate. See, e.g., Matthew A. Melone, *United States Accounting Standards—Rules or Principles? The Devil Is Not in the Details*, 58 U. MIAMI L. REV. 1161, 1216-21 (2004). Arguably, this debate over the specific rule leads to the inference that, common sense notwithstanding, it is not (legally) misleading to take the position that the grant of stock options is not an expense to the company—even though the recipient ends up with value and the company's other shareholders lose an equal amount. As I write, it seems possible that the 2000 battle will be revisited and reversed.

<sup>32</sup> See, e.g., Alan Murray, *Inflated Profits in Corporate Books Is Half the Story*, WALL ST. J., July 2, 2002, at A4 (arguing that corporate tax returns should be public and that a single measure of corporate income should apply for both tax and securities disclosure purposes); David Cay Johnston, *Wall Street Firms Are Faulted in Report on Enron's Taxes*, N.Y. TIMES, Feb. 14, 2003, at C1 (reporting that Enron was able to simultaneously increase its publicly reported income and cut its taxable income by the use of complex tax shelters, and that "the use of tax shelters has become so widespread among the 10,000 largest corporations that their effective tax rate was just twenty percent in 1999, according to the IRS").

Note that the Internal Revenue Code already provides that large corporate shareholders may inspect corporate tax returns. I.R.C. § 6103(e)(1)(D)(iii) (2003) (providing that corporate tax returns are open to shareholders of record holding more than one percent of the corporation's outstanding stock). It is not clear why this provision is insufficient to make tax returns generally available to Wall Street analysts. One would expect that if companies regularly take a different position to the IRS than to the SEC, analysts would be interested in the former as well as the latter, and that large shareholders could make a side business of selling access to the returns. But perhaps analysts have not focused on the usefulness of tax returns or perhaps there is another aspect of the regulatory regime that I do not understand.

Anecdotal evidence testifies to the extent of the scandals. The companies involved have supplied enough “bad guys” to fill up at least two competing sets of playing cards imitating the military’s Iraq deck.<sup>33</sup> Indeed, by September 2002, *Business Week* thought it newsworthy that they had found six examples of “The Good CEO.”<sup>34</sup> Executive honesty was entering the ranks of “man bites dog.”

Enron exemplified an era. At its peak, it was celebrated as a new and better way of doing business, making shareholders and employees money by the bushel while increasing the efficiency of our energy markets to everyone’s benefit. Enron seemed to demonstrate the power of the market to overcome the inefficiencies of government regulation and internal corporate bureaucracy alike. In retrospect, its economic successes appear to have been mostly smoke and mirrors, with just enough reality to allow a handful of top managers to become seriously rich by lightening the pockets of consumers, shareholders, and employees alike. It is only slightly unfair, then, to name the general phenomenon after its one of its most flagrant practitioners.

Treating Enron as the symbolic center is also appropriate because Enron’s misbehavior was not restricted to corporate law violations. If Enron’s economic successes were mainly illusions, its successes in evading the regulatory power of government that was supposed to restrain its pursuit of profit unfortunately were all too real. Not only did Jeffrey Skilling leave “step[ping] in if a product is dangerous” to the

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It should also be noted that under some circumstances, differences in tax and GAAP accounting may require two sets of books. This of course does not make the *practice* any less deceptive, although it may suggest that the *practitioners* are not necessarily wrongdoers. There is no reason I am aware of that companies keeping two sets of books could not supply both sets side-by-side to their investors and the IRS.

<sup>33</sup> See, e.g., <http://shareholdersmostwanted.com> (“The original greedy executive card deck”); <http://www.thestackeddeck.com> (playing cards featuring “America’s least wanted” executives from thirty-four entities involved in scandals).

<sup>34</sup> Nanette Byrnes et al., *The Good CEO*, *BUS. WK.*, Sept. 23, 2002, at 80.

government, his firm excelled at convincing (or misleading) the government not to object to danger, either.

Thus, Enron was involved in classic regulatory corporate scandals—most famously, manipulating the California energy market in ways that appear to have cost Californians huge sums and former California Governor Gray Davis his job.<sup>35</sup> The Senate Committee on Governmental Affairs blamed regulatory failure, but it clearly saw the problem to be attributable as well to the other side: “what Committee staff for the majority found was an agency that was no match for a determined Enron.”<sup>36</sup> The report goes on to detail extensive, deliberate violation of clear rules and norms by Enron, including a possible \$1 billion transfer from ratepayers to Enron just before its bankruptcy, market manipulation, illegal trades and so on. Other investigators implicated Enron in other scandals, including major human rights violations abroad.<sup>37</sup>

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<sup>35</sup> See Rebecca Smith, *Schwarzenegger May Return to Energy-Deregulation Model*, WALL ST. J., Oct. 10, 2002, at A5.

<sup>36</sup> Committee Staff Investigation of FERC's Oversight of Enron Corp., Nov. 12, 2002, available at <http://news.findlaw.com/hdocs/docs/enron/111202fercmemo.pdf>. “Regulatory failure” of this type is entirely predictable. Corporations that are bent on breaking the law have stronger incentives and greater resources to do so than their regulators have to catch them. The question is why we endow institutions with anti-social incentives and resources, not why we cannot catch them later.

<sup>37</sup> See HUMAN RIGHTS WATCH, *supra* note 9, at 109 (reporting that villagers' opposition to Enron's \$3 billion gas-powered Dabhol electric power plant in the Indian state of Maharashtra was “met with serious, sometimes brutal human rights violations carried out on behalf of the state's and the company's interests”). Although most of the violence described in that report was by state actors, the report charges (1) that Enron “benefited directly from an official policy of suppressing dissent through misuse of the law, harassment of anti-Enron protest leaders and prominent environmental activists, and police practices ranging from arbitrary to brutal,” *id.* at 106-07; (2) that Enron “pa[id] the state forces that committed human rights violations [and] it provided other material support to these forces” including use of its helicopters, etc., *id.* at 106; and (3) that Enron “failed to act on credible allegations that its own contractors were engaged in criminal activity” *id.*, including “engag[ing] in a pattern of harassment, intimidation, and attacks on individuals opposed to the

Finally, Enron was famous for its political connections, which it used, possibly legally but clearly in violation of basic republican principles of a self-governing democracy, to win favors for itself and its favored politicians and, of course, to reduce the likelihood of the government “step[ping] in.”<sup>38</sup> The House Committee on Governance Reform minority staff reports that, “Enron Corporation was President George W. Bush’s number-one career patron. Since 1993, Enron and its employees gave the President \$736,800 in political and related contributions.”<sup>39</sup> Even without White House cooperation, that report was able to document at least 40 direct contacts between Enron and White House officials in 2001, over \$3 million spent on thirty-six outside registered lobbyists at fourteen lobbying firms and seventy-three contacts between the Army Secretary and Enron officials and other alleged close connections between the company and the upper reaches of the Bush Administration, including deep

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Dabhol Power project,” *id.* at 3, with Enron’s knowledge, *id.* at 110-11. The report also describes widespread allegations of corruption and financial impropriety in connection with the project, the largest electric power plant in the world, which was a centerpiece of a highly controversial energy privatization plan and a key issue in several hotly contested elections.

<sup>38</sup> MINORITY STAFF, HOUSE COMMITTEE ON GOVERNMENT REFORM 107th CONG., BUSH ADMINISTRATION CONTACTS WITH ENRON (May 2002), available at <http://www.democrats.house.reform.gov/documents/20040817122823-67561.pdf>. I have argued elsewhere that corporate interventions into our political debate, whether by (legal) lobbying, (constitutionally protected) direct communications to the electorate, or (illegal) contributions to candidates, should always be viewed as deeply problematic in a self-governing republic. Corporations, like government in classic liberal theory, can never be trusted fully to represent those for whom they purport to speak—all the more so since corporations are directed by both law and market to speak for the principle of profit maximization, not for any citizen. See generally, Daniel J.H. Greenwood, *Essential Speech: Why Corporate Speech Is Not Free*, 83 IOWA L. REV. 995 (1998), available at <http://www.law.utah.edu/greenwood/pdf/EssentialSpeech.pdf> [hereinafter *Essential Speech*].

<sup>39</sup> MINORITY STAFF, HOUSE COMM. ON GOV’T REFORM 107th CONG., BUSH ADMINISTRATION CONTACTS WITH ENRON (May 2002), available at <http://www.democrats.house.reform.gov/documents/20040817122823-67561.pdf>.

influence on the Vice-President's National Energy Policy Development Group.<sup>40</sup>

But the President was far from Enron's only protégé or patron. The last report the Enron Political Action Committee filed with the Federal Elections Commission is 967 pages long.<sup>41</sup> The FEC, of course, regulates only direct electoral intervention, not conventional lobbying, so this may be only the tip of the iceberg.

Enron, as Skilling's student-era quote foreshadows, was acting in the interests of profit, not the public. At least, one might so conclude from a different staff report created for Representative Henry Waxman (D-CA).<sup>42</sup> Some of the regulatory failure may yet turn out to be the crude result of pressure from Enron's friends in high places. More of the failure seems to have been the result of a climate of businesses-can-do-no-wrong that Enron, and other companies like it, helped to create and finance. As the Senate Committee staff reported, "Enron was very aggressive about using . . . the regulatory process to further its own strategic business goals and protect its own economic interests," and FERC and other regulators were unable to

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<sup>40</sup> *Id.* See also *In re Cheney*, 334 F.3d 1096 (D.C. Cir. 2003) (describing allegation that Enron CEO Kenneth Lay participated in non-public meetings of the NEPDG as if he were a member); *Walker v. Cheney*, 230 F. Supp. 2d 51 (D.D.C. 2002) (denying standing to comptroller general in case involving similar allegations).

<sup>41</sup> Enron Corp. Political Action Comm., Inc., July 21, 2001 Report of Receipts and Disbursements, available at <http://news.findlaw.com/hdcos/docs/enron/epacrpt072701.pdf>.

<sup>42</sup> MINORITY STAFF OF HOUSE COMM. ON GOV'T REFORM 107th CONG., REPORT ON HOW THE WHITE HOUSE ENERGY PLAN BENEFITED ENRON (Jan. 16, 2002), available at <http://www.democrats.reform.house.gov/documents/20040830154930-11712.pdf>; see also MINORITY STAFF OF HOUSE COMM. ON GOV'T REFORM 107th CONG., FACT SHEET: WHITE HOUSE ENERGY PLAN REFLECTS SEVEN OF EIGHT RECOMMENDATIONS IN ENRON MEMO (Jan 31, 2002), available at <http://www.democrats.reform.house.gov/documents/20040830150832-54097.pdf> (both detailing extensive and effective political lobbying by Enron).

redirect Enron's influence in socially useful directions.<sup>43</sup> Representative Waxman's staff prepared a thirteen-page listing of regulatory events that contributed to Enron's failure, nearly all of which are instances in which Enron successfully lobbied for a particular rule or result that later turned out not to be in the public interest (in the staff's assessment).<sup>44</sup> Although that report blames "lax regulation" for the problems, surely primary responsibility lies with the malefactor Enron rather than the government.

So we can add to the definition of Enronitis:

2. A malfunction of corporate governance in which corporations in the pursuit of profit, manipulate markets, deceive consumers, create unsafe or polluting conditions, lobby to change the regulations meant to keep them operating in socially productive ways, commit human rights violations abroad or otherwise act in anti-social, dangerous, or socially inefficient manners. Particularly referring to instances in which corporate actors justify the firm's anti-social behavior or anti-republican political interventions by appealing to the norm of profit maximization.

Corporate law, in its share-centered version, teaches that the sole responsibility of the corporate manager is to increase returns to shares. It is "the government's job to step in if a product is dangerous,"<sup>45</sup> but the firm, acting in the imagined interests of its fictional shareholders, views itself as justified in taking any possible action to deflect, distract or avoid the government. We have set the strong forces of the market at war with the weak ones of regulation.

Skilling's statement clearly epitomizes the share-centered view. Managers have one responsibility and one alone. On

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<sup>43</sup> COMMITTEE STAFF INVESTIGATION OF FERC'S OVERSIGHT OF ENRON CORP, *supra* note 36, at 7, 8.

<sup>44</sup> MINORITY STAFF, HOUSE COMM. ON GOV'T REFORM 107th CONG., FACT SHEET: HOW LAX REGULATION AND INADEQUATE OVERSIGHT CONTRIBUTED TO THE ENRON COLLAPSE (Feb. 7, 2002, revised June 4, 2002), *available at* <http://www.democrats.reform.house.gov/documents/20040830150815-39986.pdf>.

<sup>45</sup> FUSARO & MILLER, *supra* note 2, at 28.

this view, managers serve the market, and government makes the market serve the people. But markets are powerful and regulators generally are weak. If we tell our corporate managers that they should pursue profit by any means they can, they are likely to do it and get away with it.

## B. Reform, Regulation and Repression

In the wake of the 2000 stock market collapse, numerous corporate reform proposals have been made. While it appears that little will change in state corporate law on the books, practice is already different. Corporations are adding “independent” directors; the British norm of separating the CEO from the Chairman of the Board is receiving additional attention;<sup>46</sup> and companies are scrambling to adopt new and presumably more accurate accounting standards. At the Federal level, the Sarbanes-Oxley Act dramatically changes disclosure responsibilities and imposes new obligations on managers.<sup>47</sup> The stock exchanges have enacted some mandatory changes and urged others.<sup>48</sup> The accounting

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<sup>46</sup> See, e.g., CORPORATE LIBRARY, EXCLUSIVE SPECIAL REPORT ON CEO/CHAIRMAN SPLITS IN THE S&P 500, available at <http://www.thecorporatelibrary.com/Governance-Research/spotlight-topics/spotlight/boardsanddirectors/SplitChairs2004.html> (Mar. 2004) (chart detailing the relationships of current officials to the companies they head).

<sup>47</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (imposing many new requirements, including CEO certification as to the accuracy of disclosures. See, e.g., §§ 302, 906, 404).

<sup>48</sup> See, e.g., Final NYSE Corporate Governance Rules (approved Nov. 4, 2003) (to be codified at NYSE Listed Company Manual § 303A), available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> (requiring that shareholders be given the opportunity to vote on all equity-compensation plans; requiring listed companies to have a majority of independent directors; tightening the definition of independent director to exclude recently retired employees, certain professionals and certain interlocking board memberships; requiring non-management directors to meet without managers present; requiring independent nominating/corporate governance, compensation, and audit committees; setting minimum audit committee standards; requiring internal audit functions; requiring and setting standards for corporate governance

profession's self-regulatory body, the FASB, with solid political backing decisively rejected expensing stock option grants in 1994 on the multiple (and contradictory) grounds that (1) they are too difficult to value, (2) they are already fully disclosed, (3) they are not really expenses, and (4) expensing them would hurt reported profits. Subsequently it has discovered that the undoubted difficulties of valuation are not a reason to ignore stock option grants after all.<sup>49</sup> Many other proposals to increase the power, responsibility or independence of "gatekeepers" such as accountants, stock analysts, lawyers and the SEC are on the table.<sup>50</sup> It is even possible that reforms of the tax code or IRS procedures will prevent future instances of the IRS discovering and failing to act on misleading SEC disclosures, or will align tax and securities income accounting.<sup>51</sup>

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guidelines; requiring a code of business ethics; requiring certain disclosures and CEO certification of compliance; and authorizing NYSE sanctions for violation).

<sup>49</sup> See Financial Accounting Series: Share Based Payment, Amendment of FASB Statements No. 123 and 95 (proposed Mar. 31, 2004) (comment deadline June 30, 2004), available at [http://www.fasb.org/draft/ed\\_share-based\\_payment.pdf](http://www.fasb.org/draft/ed_share-based_payment.pdf). See also Cassell Bryan-Low, *S&P Sheds Light On Accounting For Pension Costs*, WALL ST. J., Oct. 24, 2002, at C1. Expensing stock option grants would have reduced the reported earnings of the S&P 500 by almost twenty percent in 2001-2002. *Id.*

<sup>50</sup> See, e.g., GEN. ACCOUNTING OFFICE, *supra* note 8, at 63 (advocating strengthening independence of gatekeepers); Coffee, *supra* note 8 (discussing gatekeeper failures); Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185 (2003) (discussing failures of lawyers as gatekeepers and proposing reforms to increase independent counselor role).

<sup>51</sup> See Johnston, *supra* note 32 (reporting that Enron took advantage of the differences between tax and accounting rules to report tax losses and accounting profits, and that when "an unnamed IRS appeals officer concluded that Enron's reports to shareholders 'fooled' both investors and securities regulators about its financial condition . . . [t]he IRS settled the audit issues in tax court, without any disclosure of the suspicions about Enron's financial statements").



These reforms are important, widely debated and even possibly still under-analyzed.<sup>52</sup> This Article, however, approaches the reforms from a more abstract or theoretical perspective.

To date, the Enronitis problem has been diagnosed as a disease of managers who are insufficiently attentive to the interests of shareholders.<sup>53</sup> The medicine has flowed from the diagnosis: the proposed remedies are intended to tie managers more closely to the needs of the stock market.<sup>54</sup> If the Enron problem is the result of too weak a legal mandate supporting the share-centered paradigm of corporate law, the law should step in to support that paradigm. There is much truth to this diagnosis, and the reforms may mitigate the symptoms, particularly in the short run. The reforms may well make directors more independent so that they can ensure that managers work for the market, shares may be allowed to vote on managerial equity compensation so that compensation plans will be more closely tied to the will of the

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<sup>52</sup> Although a recent Westlaw search on the Sarbanes-Oxley Act alone turned up 1990 hits in Westlaw's law journal database, first principles suggest that something must remain to be said.

<sup>53</sup> See, e.g., J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317 (2004) ("The scandals arose in large part out of a failure of managerial oversight. Officers and directors did not adequately protect the interests of the corporation.").

<sup>54</sup> See, e.g., Breedan, *supra* note 25, at 45-147 (making seventy-eight specific suggestions for corporate governance reform designed to empower shares of the former WorldCom, including embedding some in Articles that can only be changed with share consent; increasing shareholder access to the proxy contest system beyond SEC standards; increasing the frequency of director elections and allowing shareholders to nominate candidates directly with access to the company's proxy solicitation statement; increasing the independence of board members, board training and board ability to act independently of management; changing board compensation; creating a non-executive board chair; adding board term limits; limiting executive compensation over \$15 million or by stock option grants without share approval; increasing financial transparency and, by increasing dividend payouts and limiting anti-takeover provisions, increasing company dependence on the financial markets; and strengthening internal legal compliance controls).

market and accounting may become more transparent and disclosure more accurate to help the financial markets control managers.

Paradoxically, however, and less widely recognized, Enronitis is also the predictable result of too strong a share-centered view of the corporation. The profit maximization ethos of the conventional share-centered corporation demands that managers teach themselves to exploit everyone around them. It is inevitable that some will learn this lesson so well that they will exploit even those for whose benefit they are supposed to be exploiting. The more we reform to ensure that managers serve only the profit-maximization ethos, the more we can expect to see managers who will hunt for new ways to evade the reforms. The share-centered view of the corporation makes the corporation into a machine, efficiently promoting one value at the expense of all others, even when the humans involved would long ago have decided that the interests of the nation, individuals, the environment, legality or simple human decency should prevail.<sup>55</sup> The power of strong market incentives assures that, all too often, the pressures we are creating to act badly will overcome the will (and enforcement powers) to act in society's interests.<sup>56</sup>

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<sup>55</sup> I have discussed the corporation's inability to act like a citizen at greater length elsewhere. See generally Daniel J.H. Greenwood, *Delaware and Democracy: The Puzzle of Corporate Law*, at <http://www.law.utah.edu/greenwood/pdf/PuzzleofCorporateLaw.pdf> (May 14, 2003); Daniel J.H. Greenwood, *Lawrence Mitchell's Corporate Responsibility*, 12 LAW. & POL. BOOK REV. 201-04 (2002), available at <http://www.bsos.umd.edu/gvpt/lpbr/subpages/reviews/mitchellci.html> (book review); Greenwood, *Essential Speech*, *supra* note 38; Daniel J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996), available at <http://www.law.utah.edu/greenwood/pdf/FictionalShareholders.pdf> [hereinafter *Fictional Shareholders*]. For a powerful and accessible representation of the problem, see THE CORPORATION (Big Picture Media Corp. 2003), website at <http://www.thecorporation.com> (a documentary film that argues that corporations should be understood as psychopaths).

<sup>56</sup> The power of market incentives to press actors towards socially destructive action is widely noted. See, e.g., John C. Coffee, *Limited Options*, LEGAL AFF. 52 (Dec. 2003) (comparing perverse incentives that

### III. THE SHARE-CENTERED PARADIGM: MUTUALLY ASSURED EXPLOITATION

#### A. Shares, Not Shareholders

According to the share-centered view of the corporation, the corporation has only one legitimate goal: maximization of share value.<sup>57</sup> Standard terminology states that corporate directors and managers have a fiduciary obligation to act in the interests of the shareholders. In fact, however, the only interests that are considered are those of the *role* of a theoretical shareholder, not of the people who own shares.

It is a dangerous fiction to pretend that human shareholders are necessarily better off if their shares increase in price, regardless of the impact of the company's share-value maximizing behavior on other aspects of their lives. The phrase "maximization of shareholder value" misleadingly suggests that share prices are the only values

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created the Savings and Loans scandal to perverse incentives behind Enron); GEN. ACCOUNTING OFFICE, *supra* note 8, at 57 (describing perverse incentives to distort financial statements or overemphasize short-term results, including stock market reliance on quarterly results and executive compensation schemes). The terminology of "perverse," however, suggests that such incentives are anomalous and unusual. The best modern evolutionary theory suggests that "perverse" incentives are pervasive. *See, e.g.*, JOSHUA M. EPSTEIN & ROBERT AXTELL, *GROWING ARTIFICIAL SOCIETIES - SOCIAL SCIENCE FROM THE BOTTOM UP* 136-37 (1996) (describing the Sugarscape studies as showing that market-like structures result in attractive results under special circumstances and unattractive ones under many other plausible ones).

<sup>57</sup> The most famous judicial statement of the share-centered view is *Dodge v. Ford Motor Co.*, 170 N.W. 668, 683 (Mich. 1919) (opining that a business corporation may not be operated as a "semi-eleemosynary institution" serving the perceived public good of managers and majority shareholders even if it also generates extraordinary profits for shareholders). *See also* *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (holding that, once the corporation is up for sale, directors must act to maximize short-term share value regardless of other considerations, even in circumstances where shareholders clearly also have a large financial interest in bond values).

that human shareholders hold. But people have many interests, often conflicting, and few people will consider their interest in maximizing share value to be the most important of all their goals at all times.

The share-centered view of the corporation excludes all those other shareholder views. Corporations are directed to pursue their shareholders' interests only insofar as they are the interests of shareholders, not bond investors, employees, customers, consumers, neighbors, family members, citizens, carriers of particular cultures, or inhabitants of a limited earth with limited pollution absorption ability. Financial and non-financial interests shareholders might have outside their role in the firm are simply ignored.

Indeed, the share-centered view directs managers to limit their consideration still further. Shareholders investing according to modern portfolio theory are likely to be highly diversified and, as a result, their interests even as shareholders (of many companies) may diverge from the single goal of the share-centered corporation. If a firm increases its market share and profits at the expense of a competitor (with some benefits to consumers), a pure shareholder who owns shares of both firms will be worse off to the extent that consumers are better off. Only rarely do proponents of the share-centered view of the corporation suggest that corporate managers take into account this type of shareholder interest, perhaps because this shareholder interest in anti-competitive collusion is so obviously opposed to any social interest that might justify allowing publicly held corporations to limit themselves to considering share interests alone.<sup>58</sup>

The share-centered view, in short, models shareholders as if they were aliens, with no connection to the corporation, its participants, or their fellow citizens except as undiversified

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<sup>58</sup> For further discussion of the implications of taking a share-centered view seriously while acknowledging the actual reality of institutional shareholders, see Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991); Henry T.C. Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277 (1990).

stockholders. The shareholders of the share-centered corporation are not people but legal fictions, roles rather than realities. To emphasize the narrow view of shareholder interests taken by firms seeking to maximize share value, I will speak of share-centeredness, share value and share democracy rather than the more euphonious but seriously misleading term, “shareholder” interests.<sup>59</sup>

## B. From Share-Centeredness to Enronitis

In the conventional view, the legitimate function of corporate directors and managers is to work for the shares.<sup>60</sup> All other goals and participants in the firm should be considered as mere tools towards this end. In particular, professional managers acting as the share value norm directs them to should consider all firm participants (other than the shares) as outsiders, with respect to whom one should decide to cooperate, defect or exploit according to a rational analysis of which practice will maximize share value.

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<sup>59</sup> The difference between shares and shareholders is the central theme of Greenwood, *Fictional Shareholders*, *supra* note 55; it is also the key reason why I argue in Greenwood, *Essential Speech*, *supra* note 38, that corporations, as representatives of a legal fiction, are not appropriate holders of the rights of citizens; and a key reason why I argue that market processes are only imperfect and partial correctives to democratic failures. See Daniel J.H. Greenwood, *Beyond the Counter-Majoritarian Difficulty: Judicial Decision-Making in a Polynomic World*, 53 RUTGERS L. REV. 781 (2001), available at <http://www.law.utah.edu/greenwood/pdf/Rutgers.pdf> [hereinafter *Beyond the Counter-Majoritarian Difficulty*].

<sup>60</sup> How to do this is of course difficult and often controversial. In particular, long term and short term views will often conflict. With the exception of firms in the limited “Revlon Mode” (when the company’s sale or dissolution is inevitable, see *Revlon*, 506 A.2d 173), courts generally allow directors to choose freely between long and short-term share interests without fear of judicial second-guessing. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (“a board may reasonably consider the basic shareholder interests at stake including . . . short term speculators [and] the long term investors”); *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989) (“The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals.”).

Even when the decision is to cooperate, however, the relationship is basically exploitative. The only reason a manager acting in good faith as a professional dedicated to share value maximization would give anything to any corporate participant (other than the shares) is because he or she believes that doing so will result in more profits for the firm's shares.<sup>61</sup>

The share-centered view of the corporation, thus, directs managers to take an amoral, instrumental view of the relationships in which they are enmeshed. Under this view, all relationships are for an ulterior purpose, and when they cease to serve that purpose they should be abandoned. Indeed, the share-centered profit maximization view suggests that a manager who treats corporate participants in any other way is acting wrongfully, violating role morality and perhaps even the law (although the business judgment rule may make enforcement rather difficult).<sup>62</sup> For example, it is improper—a violation of role morality—to view employees or suppliers as members of a team to whom long term commitments have been made. Managers are expected to treat all of the firm's relationships as arm's-length bargaining between competitors.

The short trek from the conventional share-centered view of the managerial role to Enronitis is over-determined. Several independent aspects link the two. The central theme that ties together the routes to Enronitis is the paradox of the managerial role in a share-centered corporation.

Corporate law demands that managers simultaneously be selfless servants and selfish masters. On the one hand, it directs managers to be faithful agents, setting aside their own interests entirely in order to act only on behalf of their principals, the shares. But on the other hand, in the service

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<sup>61</sup> For further discussion of the role obligations of professionals, see Greenwood, *Beyond the Counter-Majoritarian Difficulty*, *supra* note 59.

<sup>62</sup> The business judgment rule "posits a powerful presumption . . . of protect[ion of] corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). Thus many actions that may be in breach of the director's duties will not be actionable.

of this extreme altruism, they must ruthlessly exploit everyone around them, projecting onto the shares an extreme selfishness that takes no account of any interests but the shares themselves, narrowly understood. Having maximally exploited their fellow human corporate participants, managers are then expected to selflessly hand over their gains, ill and justly gotten, to the faceless legal abstraction of the fictional shareholder. Altruism and rationally self-interested exploitation are extreme and radically opposed positions, psychologically and politically. The managerial role is deeply unstable and unlikely to hold.

### C. Selfish Shares

In acting altruistically towards the interests of their principals (the shares), the manager-agents are directed to ignore the actual human beings who own (often indirectly) the shares.<sup>63</sup> In reality, many publicly held shares are held by pension funds representing the very employees (and their predecessors) whom managers are directed to treat as arm's-length opponents in a competitive negotiating game. More generally, shareholders are the citizenry, or at least the richer half of it. Roughly half of the shares of publicly traded corporations are held by institutions<sup>64</sup> that, in turn, represent roughly the top half of the American income distribution.<sup>65</sup>

For most of these indirect shareholders, shareholdings are only a small portion of their wealth (most of which is their future earning capacity).<sup>66</sup> Thus, actions that are in their

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<sup>63</sup> See *supra*, Part II.B.

<sup>64</sup> See, e.g., MICHAEL USEEM, *INVESTOR CAPITALISM* (1996); JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM* (2000) (fiduciary institutions own about half of the publicly traded stock of U.S. corporations).

<sup>65</sup> See, e.g., EDWARD WOLFF, *TOP HEAVY 27* (2000); LAWRENCE MISHEL ET AL., *THE STATE OF WORKING AMERICA 2000/2001* (2001).

<sup>66</sup> Most shareholders hold very small amounts of stock directly or indirectly. See, e.g., WOLFF, *supra* note 65 (stating that in 1998, 48% of households owned stocks directly or indirectly, but the poorest 99% of households owned only about as much as the wealthiest 1%); MISHEL, *supra* note 65, at 260 tbl. 4.3 (indicating that median net worth, including

all assets and liabilities, for Americans was about \$60,700 in 1998); *id.* at tbl. 4.4 (indicating that median financial wealth was less than \$37,000); *id.* at tbl. 4.7 (while nearly half of Americans held equities in 1998, directly or indirectly, only 36.3% of households held more than \$5000 worth).

The very rich own most stock, and for those few individuals, equities are a major part of their wealth. See WOLFF, *supra* note 65 (stating that in 1998, almost half of all stock by value was held by the richest 1%, those with net worth over \$3.35 million. This number, however, does not include pension wealth, which is somewhat less skewed); Edward Wolff, *Recent Trends in Wealth Ownership, 1983-1998*, Jerome Levy Econ. Inst. of Bard Coll. Working Paper No. 300, tbl. 6 available at <http://www.levy.org>, (in 1998, the richest 1% held 49.4% of stocks and mutual funds, or 42.1% if retirement funds are included); MISHEL, *supra* note 65, at tbl. 4.9 (indicating that in 1998 households in the top 1.6% of incomes held roughly half of all publicly traded stock. Including indirectly held stock and pension plans, households in the top 8.5% held two-thirds of equities).

By lumping together the entire wealthiest 1% these numbers understate the true extent of inequality in stock holdings. Piketty & Saez's work on income indicates that, even within the upper classes, income is extremely skewed: about 42% of income is received by the top 10% of the household income distribution (fig. 1), but of the income received by that upper decile, about one-third goes to the top 1% (fig. 3 and fig. 15), about 40% of that is received by the top .1% (fig. 16) and about half of that is received by the top .01% (calculated from tbl. 1, fig. 4). Thomas Piketty & Emmanuel Saez, *Income Inequality in the US, 1913-1998*, Nat'l Bureau of Econ. Research Working Paper Series No. 8467, available at <http://www.nber.org/papers/w8467>. Even this may understate the true inequality of the income distribution, since Piketty & Saez's work is derived from income tax returns and the rich are more likely to have the sorts of income that are harder to define and capture in an income tax regime. Wealth is distributed far more unequally than income, and financial wealth is more concentrated than wealth generally. See e.g., Edward Wolff et al., *Household Wealth, Public Consumption and Economic Well-Being in the United States*, Jerome Levy Econ. Inst. at Bard Coll. Working Paper No. 386, available at <http://www.levy.org> (demonstrating that measured inequality increases when imputed income from wealth is added to standard income measures); Arthur B. Kennickell, *A Rolling Tide: Changes in the Distribution of Wealth in the U.S., 1989-2001*, Fed. Reserve Bd. Fin. & Econ. Discussion Series 2003, available at <http://www.federalreserve.gov/pubs/feds/2003/200324/200324abs.html> (indicating that in 2001 the richest 400 households controlled approximately 2% of U.S. financial and non-financial wealth, and that the richest 1%—those with a net worth exceeding \$5.8 million—controlled about one-third); MISHEL, *supra* note 65, at tbl. 4.1 (top 1% receive 16.6% of all income but hold 47.3% of financial assets). Thus, it is safe to assume



interests as a shareholder are likely often to be in conflict with other, more important, interests. If a firm increases share value by \$1 per share by compromising its environmental standards or reducing employee benefits, a shareholder holding 100 shares would lose value if she cares more than \$100 worth about the environmental damage or the benefits. Thus, maximization of share value may or may not maximize value to the human shareholders, depending on the relative importance of the individual shareholder's share value as opposed to his or her other relationships with the firm.

Even if maximization of share value were in a particular human shareholder's financial interests, real human beings have interests beyond their finances. Few real people are as disconnected from social relationships as the fiction that drives the share value maximization model. It is virtually inconceivable that the entire half of America that holds shares would agree on how to balance their desire for profits in the stock market, on the one hand, with their desires for the many political goods that may conflict with profit, on the other.

Although it may not be immediately obvious in market centered politics, eventually nearly every human value will conflict with profit, and nearly everyone will find some value that is more important than profit at some point. Thus:

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that the fractal character of inequality is even more extreme with respect to wealth, so that if half our financial wealth is held by the top 1%, the bulk of that is held by the top .1%, and so on. The great concentration of wealth in a small part of the population again suggests that most shareholders would find their shares to be a relatively small part of even their financial interests.

Moreover, even among the very rich, most income is from wages (suggesting, but not by any means demonstrating, that even for many of the extremely rich most wealth is in the form of job prospects). See Piketty & Saez, *supra*, at fig. 6 (indicating that in 1998, approximately 60% of the income of households in the top .1% of taxpayers was from salary. Note, however, that Piketty & Saez's figures may overstate the influence of salary income since they do not include capital gains in income and they appear to include stock grants as salary.

- Safety regulations (whether protecting the environment, consumers, employees or innocent bystanders) generally increase private costs to the hazard-creator, thereby reducing its profits, even as those regulations are reducing social costs. Fictional shareholders will always choose profits when they conflict with safety. No real person is that one-sided.
- Advertising increases demand for products, and therefore, usually, profits. But most human shareholders will be able to identify some product made by a publicly traded company that they wish the world had less of—violent movies, cigarettes, junk food, global warming gases, the music their kids listen to, direct mail, internet pornography and even shoddy plastic toys. Fictional shareholders will always attempt to increase demand even for unattractive products. This is not true for real citizens—even citizens inclined to leave the matter to the market.
- Particular companies may find foreign trade (or limits on it) profit enhancing. Their individual shareholders may find that position conflicts with other values they hold, even values as simple as whether the trading partners who are enriched (or impoverished) are countries or elites that should be our allies or enemies.
- Maximum profit often will require that a company pick up and abandon a particular locale (especially since, under the perverse American labor unionization rules, relocation is usually the easiest way to escape unionization and because American localism encourages localities to invite companies to jump ship as they compete in lowering effective enterprise taxation). Fictional shareholders interested only in the value of their shares will always applaud such moves in the name of profit. But human investors live in particular places, as do employees and other human beings associated with the corporation. Often, the human beings behind the fiction will share the needs of those particular people

in the forsaken places or will empathize with them. Real human investors often prefer more stability than profit maximization demands.

- Perhaps what is most significant for American politics as a whole is that maximum profit requires employees who are maximally flexible: the famous American flexible labor market. But that means that we must be willing to be at work rather than raising children or caring for parents; that we must be willing to move locations rather than build deeply rooted communities or multi-generational families; that we must be willing to put one or two careers ahead of marital depth. Largely, we Americans are willing to do those things (at least by comparison, for example, with the French). Even so, there is some limit to our flexibility. The share value maximization directive does not have such a limit.

Managers are required to ignore these human complexities, instead imagining their shareholders to be essentialized, fictionalized, one-dimensional investors with no commitments, values or relationships beyond the desire that their shares increase in value.<sup>67</sup> Thus, managers are directed to de-humanize even the one group they are not explicitly directed to treat as exploitable resources. Thinking of shareholders as if they were no more than shares—thin fictions interested in nothing but increasing the value of a particular stockholding at any cost despite other moral, political or even financial values—managers step out of relationship even with their alleged beneficiaries.

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<sup>67</sup> Indeed, managers are urged even to ignore the complexities of shareholders' investment role. A diversified shareholder is likely to have a different financial interest, even in the narrowest sense, than the undiversified fiction. A publicly traded company successfully seizing market share from another publicly traded company does nothing whatsoever for the finances of an index investor; what the stock of the one company gains, the stock of the other will lose. See Greenwood, *Fictional Shareholders*, *supra* note 55; Hu, *New Financial Products*, *supra* note 58; Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, *supra* note 58.

Surely everyone can find something that is profitable but nonetheless aesthetically, morally or politically unattractive. Maximum profit for given companies inevitably will require decisions that will conflict with particular values of individual investors. Shares as constructed by corporate law, in contrast, value nothing but increasing the present discounted value of their long-term cash flows (future dividends and final period payment).<sup>68</sup> These shares represent the selfish gene, the single-minded money maximizer of introductory economic theory, anti-social monomania, all taken to the logical extreme.<sup>69</sup> To shares and their fictional shareholders, the people, cultures, and ideas Americans value are just resources to be maximally exploited, never values in themselves. If these shares were people, Americans would ostracize them, lock them up, or even fight a Revolutionary War of Independence against them.

In the end, the fictional shareholder resembles nothing more than a classic imperialist oppressor. The fiction we have created treats us as if we were a colonized people—to be befriended, used, or discarded only according to the interests of the colonizing power. In this case, the colonizer is us and we are the colonized. Our needs and interests should count for more to us than mere means to the profit-maximization end. Managers serving in this imaginary role are serving no human being.

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<sup>68</sup> For an accessible summary of modern corporate finance theory, see KLEIN & COFFEE, *BUSINESS ORGANIZATIONS AND FINANCE* (West Group Publishing 1996).

<sup>69</sup> Compare THE CORPORATION, *supra* note 55 (arguing that corporations act like psychopaths), with Greenwood, *Fictional Shareholders*, *supra* note 55.

#### IV. APPLICATIONS: PERVERSE RESULTS

##### A. Market v. Agency: Strangers in the Bazaar or Fellow Citizens of the Republic

To better understand how decent Americans working in fine institutions can end up treating their fellow citizens as colonized aliens to be maximally exploited, or as mere means to the end of profit, let us step back to examine some unexpected aspects of the well-known legal norms by which we live. American law, and, more generally, American culture, present at least two radically different norms for treating others. Corporate law attempts to mediate the irreconcilable conflicts between them.

###### 1. Market

The market norm is deeply impersonal, individualistic and competitive. In the market, each person can expect to be able to buy or sell on the same terms as everyone else, without regard for personal relationships or individual characteristics. My money is as green is yours, and therefore all sumptuary laws, caste privileges, or guild restrictions are presumptively improper in a capitalist market. All that counts is the product that is offered for sale and the money that is offered to purchase it.

At the limit, a fully competitive market, such as our stock market, should be anonymous. Since personal characteristics, including even personal identity, are irrelevant and should not affect the bargains struck, there is no legitimate reason to know with whom you are doing business.

Of course, sometimes the product being sold is inseparable from the person selling it. For example, there is no way for me to sell my labor skills or expertise or team-building abilities anonymously. Yet even where anonymity is impossible, market norms seek to exclude personal relationships and personal characteristics to the extent possible, creating a notion of “merit” that is independent of

the personal characteristics of the market participant. For this reason, nepotism is illegal in the public sector and questionable if not disreputable in the private one. Discrimination that allows irrelevant personal or status characteristics to influence a market transaction is presumptively improper. The market should be not only color-blind but also blind to all irrelevant characteristics. In the market, only skills and cash count. The person carrying them should not.<sup>70</sup>

In short, the market is the world of Sir Henry Maine's contract, in which status and relationship have no place.<sup>71</sup> Similarly, it is the world of Burke's "sophisters, economists, and calculators" with no room for sentiment, tradition or "sensibility of principle, that chastity of honor which felt a stain like a wound, which inspired courage whilst it mitigated ferocity, which ennobled whatever it touched, and under which vice itself lost half its evil by losing all its grossness."<sup>72</sup>

Market norms are not only impersonal but also self-interested. In this sphere, it is acceptable and even commendable for persons with superior information to act on it to the detriment of their trading counterparts. If, for example, I recognize that a painting in the flea market is a Rembrandt, I am entitled to the coup of buying it for the price of a remnant. In the world of the market, people are imagined to be isolated monads, strangers interested only in getting ahead, with no interest in others except as instruments to their own good.<sup>73</sup>

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<sup>70</sup> I have elaborated this point elsewhere. See, e.g., Greenwood, *Fictional Shareholders*, *supra* note 55. This concept is far from original; rather, it is the core of the liberal market attack on medieval caste status and its Jim Crow successors.

<sup>71</sup> SIR HENRY SUMNER MAINE, *ANCIENT LAW: ITS CONNECTION WITH THE EARLY HISTORY OF SOCIETY AND ITS RELATION TO MODERN IDEAS* (E.P. Dutton 1954) (1878) (elaborating the status vs. contract distinction).

<sup>72</sup> EDMUND BURKE, *REFLECTIONS ON THE REVOLUTION IN FRANCE* 86 (Th. Mahoney, ed. 1955) (1790).

<sup>73</sup> This section summarizes views I expounded at length in Greenwood, *Beyond the Counter-Majoritarian Difficulty*, *supra* note 59.

## 2. Agency

In contrast, the agency norm is relationship- (and status-) based, altruistic and cooperative. Even abstractly, an agent cannot be imagined to be an isolated individual making contact with other people only to trade anonymously. Nor can the law of agency be imagined to be limited only to policing theft and deceit.

Rather, an agent exists only in relationship to the principal, as someone who has agreed to act for, and under the direction of, her principal. As the Restatement defines it, “[a]gency is the fiduciary relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.”<sup>74</sup>

Moreover, in contrast to the arm’s-length market relation, agency is a fiduciary relationship.<sup>75</sup> Agents are expected to set aside their own interests and work “solely for the benefit of the principal in all matters connected with [their] agency.”<sup>76</sup> While a market participant is expected to bargain hard and to profit maximize at the expense of his counterparty, by contrast, an agent “who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal.”<sup>77</sup>

If the market often seems to rely on an image of Robinson Crusoe-like individuals selling their products in an anonymous market, agency relies on more homely, communal pictures.<sup>78</sup> Here the metaphor becomes one of friends sharing, parents and children sacrificing for one

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<sup>74</sup> Restatement (Second) Agency, § 1(1) (1958).

<sup>75</sup> *Id.* § 13.

<sup>76</sup> *Id.* § 387.

<sup>77</sup> *Id.* § 388.

<sup>78</sup> DANIEL DEFOE, ROBINSON CRUSOE (Oxford University Press, Inc. 1999) (1719).

another, patriots working for the common good, or the Three Musketeers declaring "one for all and all for one."<sup>79</sup>

Far from anonymous, this sphere is intensely particular and intensely conscious of the differences between otherwise similar people. Relationships are all that count. The agent *must* treat different people differently. It would be grossly inappropriate for a mother to treat her child in the same manner she would treat an outsider; so too for a friend who treated a friend like a stranger, or a citizen who refused to distinguish between compatriots and aliens. In relationships, nepotism is not scandalous but required. Similarly, an agent must always distinguish between the principal for whom she is a fiduciary and selflessly works, and strangers, with whom she, or her principal, remains at market arm's-length. The market is a world of strangers ruled by disinterested justice blind to persons. Agency, in contrast, is a relationship closer to friendship in which persons are all-important. Self-interested rational maximizers have no place here.

### 3. Corporate Law's Mediation

Corporate law constructs the corporation as an oasis of agency in the market. In the market, employees are arm's-length contractors each pursuing their own self-interested good. Within the employment market, as contracting opposites, they and their employers are competitors, entitled (within the rules of a fair battle) to fight for themselves as hard as they are capable. But in the firm, they are agents, required to set aside their own interests to work for their principal, the firm itself. As Cardozo put it in *Meinhard v. Salmon*, copartners:

owe to one another . . . the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market

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<sup>79</sup> ALEXANDRE DUMAS, *THE THREE MUSKETEERS* (Jacques Le Clercq trans., Modern Library ed., Random House, Inc. 1999) (1844).



place. Not honesty alone but the punctilio of an honor the most sensitive. . . . Loyalty and comradeship are not so easily abjured.<sup>80</sup>

The agency rules and the market rules obviously conflict, and much of the interest of corporate law concerns the problems that result from the dual role of employees as simultaneously self-interested market capitalists and altruistic, selfless agents. We sign on as employees in the world of the self-interested, impersonal, arm's-length market, but once employed, switch to the altruistic fiduciary world of agency.

But the share value maximization principle disrupts the delicate balance (or churning conflict) of corporate law. It commands managers, in their role as selfless agents, to treat all their fellow agents according to the workaday norms of self-interested arm's-length conduct in a competitive market place while simultaneously demanding that both employees and managers act selflessly. As explicated below, this is an impossible task.

#### 4. Creating Cooperation: The Pre-conditions to Agency

In the long run, people learn to cooperate only with those who cooperate back. Only fools or romantic lovers will continue to selflessly sacrifice for someone once they realize that the object of their sacrifice will uninhibitedly take advantage of their selflessness as if they were arm's-length competitors.<sup>81</sup> Few people, however, fall in love with their

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<sup>80</sup> 249 N.Y. 458, 463-66 (1928). Although Cardozo in *Meinhard* is explicating the duties that "co-adventurers" (even the language is reminiscent of Dumas!) owe to each other, the case is an accurate, if flamboyant, description of the general duty that an agent owes to his or her principal, which is the duty that an employee owes the employer.

<sup>81</sup> The possibility, but fragility, of cooperation is a central theme of both game theory and evolutionary biology. See, e.g., ELLIOTT SOBER & DAVID SLOAN WILSON, UNTO OTHERS: THE EVOLUTION AND PSYCHOLOGY OF UNSELFISH BEHAVIOR 173 (2003) (arguing that "social norms function largely, though not entirely, to make human groups function as adaptive

employers. Therefore, to be successful, a firm must convince its employees to work for it (rather than for themselves) by convincing them that their sacrifices will generate responses in kind. Were they to figure out that the firm sees them purely instrumentally, employees treated by the firm at arm's-length would treat it in the same way, whatever the law may say about the obligations of agents. Thus, managers who openly treat firm members like arm's-length competitors destroy the plausibility of the agency role and violate their own duty to act in the best interest of the corporation.

Managers therefore live a lie. They must attempt to convince employees that the firm will respond to employee sacrifice with cooperation of its own, as if it saw them as partners in a common enterprise bound by mutual responsibilities of agency. While doing this, managers must always remember that their own fiduciary duty to the firm requires them to be prepared to sacrifice employee interests whenever a rational calculation indicates that defection will gain the firm more than cooperation. The image of mutuality they must project to employees always remains an illusion, because the share value maximization principle requires that employees, like all firm participants other than shares, be treated as mere means to the end of profit-maximization, as tools to be exploited rather than partners in a cooperative enterprise.

Managers constructing the firm as a tool to the end of share value maximization treat the people with whom they

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units" in the biological sense). Corporate law and economic theories of the firm, of course, have long assumed in a fairly unreflective manner that the black box of the firm is the relevant unit for selection in the market. Only those firms that successfully create an internal culture conducive to survival in the market will survive. *See, e.g.,* William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 *CORNELL L. REV.* 407, 418 (1989) (summarizing the mainstream view as "contract forms with the lowest costs survive"). The argument of this article can be understood, in part, as a claim that although an internal culture of cooperation is usually advantageous for the firm's survival in a market characterized by intense competition, corporate law drives the human actors in the firm away from the psychological underpinnings of altruism.

work as means, not ends. Because they see themselves as competitors with the people with whom they are working, they learn as part of their ordinary life to break ordinary social solidarity. Learning to exploit ruthlessly is surprisingly difficult. This we learned in the first wave of the 1980s leveraged buyout boom, when a generation of managers fought bitterly in opposition to the new dispensation of abandoning ordinary social norms in order to get extraordinarily rich.<sup>82</sup> But cynicism can be learned, and managers subjected to the powerful incentives of the share value maximization principle do eventually learn it. Successful managers learn to project solidarity while watching, always, for the chance to defect.

This training, however, surely creates cynics, not faithful agents. As a rule, one does not learn to be a saint by daily sinning.<sup>83</sup> A manager whose lived experience is a pretense of selflessness (with respect to employees, customers and business partners) covering real disinterested exploitation (on behalf of shares) is unlikely to suddenly see himself as “in a position in which thought of self was to be renounced, however hard the abnegation”<sup>84</sup> and voluntarily hand over these hard-won gains of competitive practice to his principal. If you can properly lie to your subordinates, why not lie to your superior as well? Learning to be a rational maximizer is simply incompatible with being a faithful, selfless agent.

In the end, the cynicism of the share value maximization view must eat itself alive. The principle commands managers to abandon the ordinary ties of human solidarity: to maximize profit, they must be prepared to sacrifice their co-workers, their suppliers, and even the cities or communities in which they operate. Successful managers

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<sup>82</sup> See generally, John C. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV 1, 98 (1986) (arguing that the market for corporate control forced CEOs to abrogate an implicit contract with middle managers).

<sup>83</sup> Cf. ARISTOTLE, *THE NICOMACHEAN ETHICS* 1103a (J.E.C. Weldon, D.D. trans., MacMillan & Co. 1912) (350 B.C.E.) (stating that habit creates character).

<sup>84</sup> *Meinhard*, 249 N.Y. at 468.

learn to live in a world in which there is no loyalty and all relationships are purely instrumental, lasting only so long as they remain mutually beneficial. Only the share relationship is said to be different. But there is no good explanation for why loyalty to shares should be real when loyalty to all people is illusory. The rootless, commitment-less, value-less manager is unlikely to suddenly become loyal, rooted and spiritual just because shares are at stake.

The share value maximization principle teaches managers that they are acting properly only if they treat the people around them as mere tools, to be used or discarded as needed to fulfill the firm's share value maximization ends. But if it is permissible, even required, to treat all the human participants in a firm as tools, why are shares different? Why not exploit them as well? This key route from share value maximization to Enronitis, then, is straightforwardly psychological. The profit principle is incompatible with the selfless sacrifice for shares that it demands.

## B. Corporate Finance and the Specialness of Shares

The psychological difficulty of maintaining an extreme lack of commitment in every aspect of professional life except with regard to shares, of treating every corporate participant but shares as a mere tool, and of competing at arm's-length with every corporate participant but shares, is compounded by the problem that managers are also taught that shares are identical to all other corporate participants from which they are supposed to be different. Modern corporate finance theory—part of every MBA curriculum—teaches that shares, like every other firm participant, are simply fungible inputs.<sup>85</sup> In particular, it implicitly contradicts naive

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<sup>85</sup> See, e.g., Armen A. Alehian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AMER. ECON. REV. 777 (1972) (claiming that it is a "delusion" that firms have authority over its inputs; rather, all firm decisions are made by "ordinary market contracting"); William W. Bratton, Jr., *The New Economic Theory of the Firm*, 41 STAN. L. REV. 1471, 1480 ("In a firm of bilateral contracts between free market actors, both parties possess equal power to contract someplace else.").

theories of shares as “owners” of the firm that might, were they plausible, give managers some justification for treating shares differently from other factors of production.

### 1. Shares as Factors of Production

Start with the *Dodge v. Ford* view that shares are different. In ordinary usage, the share-centered view of the firm is conflated with the claim that the corporation should maximize profit. Accounting conventions derive from and reinforce this view by treating benefits to shares as profit while the benefits to all other corporate participants are treated as costs (with the anomalous exception of stock option grants to employees). As the accountants portray the firm, payments to shares (i.e., dividends)—unlike payment to any other factor of production—do not reduce profits. Moreover—in stark contrast to the legal reality—accounting conventions portray shares as having the sole claim on whatever is left over after other firm claimants are paid (“shareholders’ equity”).

Corporate finance teaches that this picture is false in a way that resonates with the experience of any big company manager.<sup>86</sup> From the publicly traded firm’s perspective, capital is just another factor of production. Firms need to pay to obtain raw materials, they need to pay to obtain labor, and they need to pay to obtain capital. To buy (or rent) capital, they must pay either interest or dividends. On this view, dividends are an expense and sales of shares are simply a way of raising money, to a large extent fungible with other methods of raising capital (such as retained

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<sup>86</sup> I leave aside the problem of the former owner who takes the company public while remaining manager. It is a well-known problem that such managers are particularly apt to see the outside shareholders as, at best, arm’s-length suppliers to be exploited to the maximum possible degree. For managers who built the company and formerly owned it, the public shareholders are particularly likely to look like the purely fungible suppliers of a cheap commodity I describe in the text. *See, e.g.*, James Surowiecki, *Other People’s Money*, NEW YORKER, Feb. 9, 2004, at 26 (describing Hollinger CEO Conrad Black’s description of his shareholders’ role: “to hand over their money and keep their mouths shut”).

earnings or borrowing). Part of the job of the top managers of the firm is to obtain capital in the cheapest way possible, by shifting between retained earnings, bank borrowing, bonds and equity sales according to the relative pricing of those funding sources, in pursuit of the usual goal of maximizing the returns to the firm.

This view, which is common in corporate finance circles and is likely a daily part of most CFOs' decision-making process, conflicts at the most fundamental level with the share-centered view because it treats shares as a cost like all others. Just as all other inputs to the firm should be given as little as possible, so should shares. Indeed, for a manager who is accustomed to financing the firm in the cheapest way possible, offering gifts to shares may seem like a violation of the profit maximization principle itself.

From the perspective of corporate managers and the bankers who advise them, shares are essentially a way of raising capital, largely interchangeable with other ways of raising capital such as borrowing money or retaining earnings (i.e., paying the various factors of production of the firm less than the revenues from sale of their product). On this "nexus of contracts" view of the firm, shares are merely one role among many that make up the firm.<sup>87</sup>

To be sure, shareholders who purchase their shares in an IPO contribute cash and some risk bearing services, accepting returns that are closely tied to the success of the company.<sup>88</sup> But bond buyers also contribute cash to the firm, and the value and returns of junk bonds fluctuate in close connection with the fortunes of the company. Similarly, employees, especially if they have developed company based skills or commitments not easily marketable or transferable elsewhere, if they have significant retirement savings in the

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<sup>87</sup> See, e.g., Bratton, *supra* note 81, at 417 (stating that in the "nexus of contracts" theory of the firm, "hierarchy is irrelevant"); Lynn Stout, *Bad & Not So Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002) (clearly stating the argument that shareholders do not own public corporations).

<sup>88</sup> Of course, the actual shareholders at any given time are likely to have purchased their shares in the secondary market and thus they may not have contributed anything at all to the company.

company's stock, if they are compensated based on company-seniority, or if they are paid in part in options or stock, also find their fortunes closely tied to the company's and bear much of its risk. Indeed, whenever labor markets are not perfectly flexible, employees are likely to be the most closely tied to the company of all: unlike either shareholders or bondholders, they cannot diversify.

The largest source of investment capital in modern large firms is retained earnings, not share or bond issuance. If the firm is able to retain earnings, by definition it must be paying its various factors of production less than it is able to sell its product for. This suggests, however, that all the factors of production have contributed to the firm's retained surplus: not only have shares foregone dividends, but employees have foregone raises, creditors have foregone higher rates, citizen-taxpayers have foregone higher taxes, and customers have foregone lower prices.

On the corporate finance view of the firm as a nexus of contracts, there is no moral or economic reason to assume that one of these factors has a stronger claim on the surplus than the others. Neither the Marxist view that all value is contributed by the employees or the obverse claim, sometimes made in shareholder circles, that the shareholders are the sole source of profits, makes much sense. The corporate product is a joint effort of all the factors of production, each one of which is likely to be a but-for cause of the company's success.

Still, common sense suggests that shares usually will have the weakest economic claim to the corporate surplus on corporate finance or nexus of contracts views. Public shareholders, after all, are perfectly fungible providers of a perfectly fungible commodity (cash) in a quite competitive market. Of all the various contributors to the final corporate product, they are the most easily replaced. It is hard to see why an arm's-length contractor would ever pay them more than the market price.

If shares are just factors of production, the share value maximization norm implodes. That norm teaches managers to treat factors of production as tools to be exploited, or at

least given no more than necessary in arm's-length negotiation. Predictably, some managers will apply precisely the same logic to the shares themselves. What is sauce for the goose is sauce for the gander. If investors have agreed to buy shares that have no legal right to a dividend, why should they get one? To give them one would be a free gift, and the maximization principle teaches managers that they should not give gifts.

## 2. Managerial Agency in the Corporate Finance World

At this point, the situation gets even worse. If managers have learned to be maximizers, but reject the argument that they must sacrifice themselves for the shares, for whom will they maximize? The cynic's answer must be correct: share value maximization produces cynics, and cynics work only for themselves. All bonds of loyalty and mutual respect having been broken, nothing is left for managers but to maximize their own individual wealth before their retirement (or firing) date. This is the logic of corruption well known to students of failed governments: steal as much as possible before the next group of reformers (or aspiring corruptionists) push you out to do the same. For the cynic trained in share value maximization, even the only value permitted by that norm, the only loyalty left, will soon seem just a tool. The new rule will be to maximize share value only to the extent that it is useful for personal pocket lining.

Often, of course, increasing share value will be the best way for managers to line their own pockets. It is easier to take a big piece of pie when the pie is big and growing. Similarly, often the most cynical and instrumental of managers will find that it is instrumentally useful to create a quality product or have happy employees. However, there is no necessary connection. An illusion of a quality product will often do just as well as an actual one, particularly in the short term, and similarly, illusions of profits will often do



just as well for a while.<sup>89</sup> In the long run, of course, illusions tend to be exposed, but chances are excellent that top managers will be gone before the fictions are apparent even to their authors.

### 3. The Ownership Metaphor

If shares are not different because they make a contribution to the firm that is different in kind than other factors of production, perhaps they are entitled to be the special objects of managerial concern for another reason. The traditional claim is that the shares “own” the firm and therefore are entitled to have it be run for them. Unfortunately, the reason shares need the ownership metaphor to justify their claim to the corporate surplus is precisely because, unlike owners, they lack the power to take it on their own.

The ownership metaphor, meant to differentiate shares from other corporate roles, is deeply implausible. In a public firm, shareholders own their shares. But they have few of the legal rights of owners of the firm, do not act like firm owners and do not have the normal significance of owners in the firm as a sociological entity.<sup>90</sup>

An owner of a fee simple absolute in real estate or the holder of title to chattel has the rights (subject to general

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<sup>89</sup> See, e.g., *Kamin v. American Express*, 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976), in which corporate managers successfully defended their decision to characterize a transaction in a way which made the company appear more profitable although it in fact made the company's expenses rise (by increasing its tax liability). While one might imagine that a court might simply hold that the decision to pay taxes voluntarily is commendable and patriotic, in fact the court rested its decision solely on the astonishing rationale offered by management: deceiving investors was good for them.

<sup>90</sup> In their seminal study, Berle & Means recognized that the public shareholders are not owners in any normal sense, but then created decades of confusion by referring to them as “owners” nonetheless. See generally ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1991). See also Stout, *supra* note 87 (arguing that shareholders are not owners).

legal regulation such as zoning or environmental laws) to decide to what use her property shall be put, has the right to refuse to use it in profit-maximizing ways or even to destroy it. Neither a home-owner nor a closely-held business owner has any duty to anyone to act in a way that an economist would recognize as economically rational.

In contrast, shares have none of these rights with respect to public corporations (so long as the company remains public). Our system of corporate law and securities markets has no mechanism by which a majority of shareholders could direct (or authorize) the directors to change the use of the corporation's property, place another value ahead of share value maximization or even pursue profit in a particular way.<sup>91</sup> Rather, shares have only the rights to a pro rata share of any distributions the corporate board chooses to make, the right to vote for that board, and the right to approve or reject certain changes in their rights proposed by the board.

Not only do shares lack the rights of individual owners, they lack even most collective rights. In practice, board members are nominated by incumbent management and usually elected without opposition. On the rare occasions where opposition appears, the rules are anything but democratic: management's candidates have full access to corporate resources while opponents are financially on their own.<sup>92</sup> Even if they elect a board, shares have no right to have the board act according to the wishes of the majority of the shares or shareholders. Rather, board members have a fiduciary obligation to act in the best interests of the shares as constructed by the courts without regard for the expressed desires of the shareholders, and that duty is enforceable by even a single share.<sup>93</sup>

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<sup>91</sup> See Greenwood, *Fictional Shareholders*, *supra* note 55.

<sup>92</sup> See, e.g., *Levin v. Metro Goldwyn Mayer*, 264 F. Supp. 797 (S.D.N.Y. 1967) (upholding incumbent management's use of corporate funds to solicit proxies for its position in contested elections). Insurgents do have a right to access to (or use of) the shareholder list under Exchange Act Rule 14a-7 and state law provisions, such as N.Y.B.C.L. § 624.

<sup>93</sup> Any shareholder may bring a suit for breach of fiduciary duty. See, e.g., DEL. CODE ANN. tit. 8 § 327 (2004).

Only if all shares act with one voice do shares have the rights of owners. Accordingly, the one serious ownership right that public shareholders have is the potential to sell their shares to a single buyer, that is, to take the company private. But since the development of the poison pill and its statutory equivalents, shares no longer have the right even to sell the company unilaterally. Prior board approval is required for sale of all the shares just as it always was for sale of the company.<sup>94</sup>

Far from being owners, then, in the usual course shares are just another input into the firm. As we saw above, they are largely fungible with other financing sources. It is thus hard to see why they should get something that others do not.

Owners in a capitalist society justify their rights by their function. As holders of the right to decide how property should be used, they are potentially entrepreneurial decision-makers. If there is anything that the shareholders of a public firm are not, it is that. Indeed, the closest equivalent to the entrepreneur in the public firm is the top managers themselves, who are the ones to decide what risks to take. It is a short ideological step, and an almost inevitable psychological one, for managers who act like owners to begin to view themselves as the owners in fact. Again, the strain on the share-centered agency view of the managerial role, in which managers are supposed to set aside their own interests in favor of the shares, seems impossible to sustain.

#### 4. The Diversification Problem

Additional pressure on the share-centered view of managerial duty comes from another aspect of corporate finance. Shareholders in a modern publicly held firm typically are diversified portfolios, the interests of which are often contrary to the interests of individual firms in a competitive market. (Diversified portfolios do not benefit

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<sup>94</sup> See Martin Lipton, *Pills, Polls and Professors*, 69 U. CHI. L. REV. 1037 (2002) (inventor of the poison pill describes and defends it).

when a portfolio company out-competes another portfolio company, particularly if the competition results, as it is supposed to, in collateral benefit to non-publicly traded consumers.)

Moreover, while shareholders do not own the corporation in any meaningful sense, they do have most of the usual panoply of ownership rights with respect to their shares. Shareholders, that is, actually own shares. It is shares that they buy and sell—often with considerations other than the interests of the company represented by the shares they are trading. Every shareholder who buys or sells based on a view that the market has temporarily misvalued a firm's securities is acting in a way that is not congruent with the interests of the company itself.

Shareholders do not consistently act as if they have the interests of the company at heart. Purely fungible providers of a purely fungible commodity, inputs like every other corporate participant, lacking the usual attributes of entrepreneurship or ownership including legal rights to use and control the assets, dehumanized and deracinated by the market and the legal demands of best interest analysis, the shares don't look like the company or behave as if they had its interests at heart. No wonder it is difficult for company managers to maintain the fiction that the shares are the company.

### C. The Highly Paid Executive Problem

As is well known, top manager pay packages have soared in the last several decades, reaching astronomical levels previously enjoyed only by entrepreneurial owner/founders and their descendants.<sup>95</sup> By the logic of the share value

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<sup>95</sup> See, e.g., Piketty & Saez, *supra* note 66, at fig. 18 (showing that between 1970 and 1999, a period in which average U.S. salaries were virtually unchanged in real terms, the annual pay of the average CEO of the top 100 U.S. corporations increased from roughly \$1.25 million to almost \$40 million); *id.* at fig. 21 (showing that by 1998 the income share of the top .1% of American taxpaying households was almost as high as it was in the Roaring Twenties); *id.* at figs. 6-7 (showing that while in 1916 the top .1% received most of their income from capital, in 1998, they

maximization model, this high pay suggests that CEOs are more important and more deserving of high pay than ever before. For when CEOs are seen as outsiders—factors of production and arm's-length market participants who are to be negotiated with according to the norms of the marketplace—there are only two possibilities: any time they do not deserve to be fired, they deserve a raise. The reasoning is slightly paradoxical but psychologically clear.

Under the share value maximization principle, managers are directed to view themselves as selfless agents acting only on behalf of the shares. In their mission to maximize share value, they should treat all employees, including themselves, as mere means to that overriding end; they, like all corporate participants, are valued not for themselves or as ends or values in themselves but merely as tools to increase share value. Perversely, the view of managers as obligated to exploit themselves can lead to an enormous over-valuation of managers.

A profit maximizing firm treating employees purely instrumentally will always seek to pay employees less than they contribute to the firm. Managers act as fiduciaries for the firm. At the same time, they are employees and tools to the end of firm profit maximization. Thus, in their fiduciary roles, managers are directed to treat themselves in their employee role as tools.

As fiduciaries, the only reason that can justify managers' decision to pay any employee (including themselves) anything at all is that the employee contributes more to the firm than the pay. So if manager-fiduciaries are doing their jobs, they are paying manager-employees less than they are contributing to the firm.

But this basic pay principle works in both directions. In a market relationship, any party to the bargain is entitled to attempt to obtain full value for their contribution. At equilibrium, indeed, the price of each firm input (including managers) should equal its marginal contribution. So

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received 60% from wages: CEOs have overtaken the heirs of the robber barons as our economic elite).

manager-employees are entitled to demand they be paid their full contribution to the firm.

Combining the two roles, it follows that either managers are not doing their jobs, or they are paid less than they contribute to the firm. Put differently, either they should be fired, or they deserve a raise. Either the CEO is contributing more to the firm than he (rarely she) is taking from it, in which case the firm is exploiting him and he is fulfilling his fiduciary obligation (in his role as an agent of the firm) but clearly is entitled to demand a raise (in his personal capacity as a free-market free agent). Or, he is not pulling his weight, he is exploiting the firm, and he is not merely presumptively incompetent and overpaid, but also dishonest—in breach of his duty as an agent and a professional. In short, he should be fired summarily. The logical conclusion is simple: if the CEO does not deserve to be fired, he deserves to be paid more.

Presumably, ordinary processes of cognitive dissonance will prevent most CEOs from concluding that they deserve to be fired; instead, they will conclude that they deserve an ever-increasing share of the corporate pie. The same processes of cognitive dissonance will lead boards to the same conclusion: if they are not making a major mistake or even breaching their own fiduciary duty, then they have chosen a CEO who is contributing more than his pay. Either he (and the board which failed by hiring and retaining him) should be removed, or he deserves the raise he is requesting.

The model here is similar to but more dramatic than the well-understood way in which the reform of having CEO salaries set by independent committees employing independent consultants led to rapid increases in CEO salaries: any board that hires a mediocre manager to run its company is surely derelict in its duty. By the logic of cognitive dissonance, it follows that a board must believe that the CEO it employs is not mediocre. Otherwise it would be obliged to fire him. But if he is not mediocre, it would be insulting to pay him a mediocre salary. Similarly, in times of transition, offering a mediocre salary to the newcomer suggests that the board is seeking mediocrity, which would

be a dereliction of duty. Accordingly, board members who wish to believe that they are acting in good faith appear to have only three choices: pay the CEO an above average salary, fire the CEO, or resign. When all boards seek to pay their CEOs above average salaries, inflation is a highly predictable result.<sup>96</sup>

Thus, the share value maximization model invites CEOs, acting in good faith on behalf of the firm, to see themselves as underpaid. Simultaneously, it invites directors to see themselves as required to pay above-average salaries to top managers. At the same time again, it tells CEOs, in their personal capacities, that their personal interests are, and should be, opposed to the firm's interests. They are, after all, mere factors of production that the firm should exploit. But that also means that, as contracting parties, they are entitled to exploit the firm if they can get away with it. In most firms, I imagine, the former processes are enough to make CEOs rich beyond imagination. In a few, apparently including WorldCom and Enron, the latter encourages outright theft.

#### D. Share Centeredness Opposed to Team Spirit

The share value maximization ethos treats all the people with whom managers have day-to-day relations as competitive opponents. On this view—given its clearest academic representation in the metaphor of the firm as a “moment in the market”—the firm is imagined to be composed of self-interested market participants whose only interest in other human beings is to use them to maximize their own wealth. Perhaps it is an exaggeration to say that

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<sup>96</sup> See, e.g., THE CONFERENCE BOARD, COMM'N ON PUBLIC TRUST & PRIVATE ENTERPRISE, PART I, EXECUTIVE COMPENSATION (Sept. 17, 2002) at 6, 10, available at [http://www.conference-board.org/PDF\\_free/756.pdf](http://www.conference-board.org/PDF_free/756.pdf) (disapproving prior recommended practice of “benchmarking” CEO salaries due to ever rising compensation resulting from attempts to beat the average); Susan Stabile, *Viewing Executive Compensation Through a Partnership Lens*, 35 WAKE FOREST L. REV. 153, 173 (2000) (describing salary spiral resulting from independent salary consultants).

“in the groves of their academy, at the end of every vista, you see nothing but the gallows.”<sup>97</sup> But certainly in these groves, there are no office romances. Not even friendships.

Contrary to this individualist ideology of mutual exploitation, firms in fact have many team-like and communitarian aspects, and, indeed, successful firms generally are quite unlike moments in the market. While this is not the place to argue the point, if the key to success were to be market-like, firms would be out-competed by real markets, which are always more market-like than the most market-like firm.<sup>98</sup>

Most Americans spend a good part of their waking day at work. Workplaces, therefore, are likely to be major sources of our social lives, relationship building and communities. Not all capitalist labor is alienated, notwithstanding Marx, the share value maximization principle and the best efforts of many human resources departments.<sup>99</sup> Many of us make friends at work, see our fellow workers as team members

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<sup>97</sup> BURKE, *supra* note 72, at 113.

<sup>98</sup> See OSCAR WILLIAMSON, *ECONOMIC INSTITUTIONS OF CAPITALISM* 132, 137-40 (1985) (describing failure of high-powered incentives inside firms). Enron seems to have taken the idea of firm as market to unheard of lengths, with predictably poor results. See, e.g., BRYCE, *supra* note 11, at 129 (describing “rank and yank” systems’ effect on transforming cooperation into competition); Toobin, *supra* note 15 (similar analysis).

<sup>99</sup> Marx makes a distinction between the market and the workplace that, like the arm’s-length vs. agency distinction I make, emphasizes the differences between the two spheres. However, with his usual heavy handed irony, he describes the market sphere as “a very Eden of the innate rights of man. There alone rule Freedom, Equality, Property and Bentham” in order to emphasize that the rights of the market disappear in the working relationship, which he describes as unmitigated oppression, closely echoing Adam Smith’s discussion of pin making. KARL MARX, *CAPITAL* 195-6 (Modern Library ed., 1992) (1887); ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* (Modern Library ed., 1994) (1776) (describing how the division of labor that efficiently produces pins also diminishes the human capacity of the pin makers). Ultimately, both of Marx’s characterizations are not illuminating with respect to the modern workplace and labor market. For my purposes, the workplace has aspects of attractive human community not seen in Marx or Smith, and the most important aspect of the market is not the “innate rights of man” but that, for good and ill, it is impersonal.



engaged in a common enterprise, and identify with the common project as our own project. All this is natural, normal and usually for the best. Human beings are social animals who seem to seek out opportunities for community building.

Most often, team spirit and community are also helpful to the success of the firm. When people believe they are part of a team, they work harder, demand less in return and enjoy themselves more. Members of a team pull together for the common goal, setting aside individual egos and needs (at least outside of NBA basketball) in order to focus their cooperation in competing with the other side. Soldiers, perhaps the quintessential team members, risk their own lives to protect fellow team members (most personally, their squad members; more abstractly, their fellow countrymen). In risking their lives, they show the highest form of altruism within the team—no profit maximizer would ever be willing to give up life itself for someone else's benefit.

### 1. Team Competitiveness

At the same time, the internal altruism of the team is usually accompanied by intense competition with non-team members, generally seen as opponents in a zero-sum game. Soldiers and football players alike use their intra-group cooperation and altruism in order to attack the enemy, often dehumanized or devalued as those jerks on the other side of the stadium, or worse. Nationalists combine love of the nation with hatred, or at least intolerance, of non-nationals; patriots are willing to sacrifice for the good of the country, but understand that good to be in competition with the good of the neighbors. *We pull together in order to pull ahead of them.*

In the corporate world, team competitiveness is reflected in the war-like metaphors of salesmen and the takeover world—hostile takeovers, barbarians at the gate, white knights, scorched earth and poison pill defense—as well as the zero-sum games of market share competition and the

fundamental market rule of “exploit thy business partner” or take advantages when the opportunity offers.

## 2. Team Pathology

Team spirit is a good so powerful that team players with strong communities seem to live longer and healthier lives.<sup>100</sup> Yet it can easily become pathological: good citizenship easily moves from patriotism to nationalism to xenophobia or worse. Intra-group solidarity and mutual aid can often be accompanied by extreme disregard of larger norms or the claims and humanity of non-group members. In the corporate context, team pathology is common enough, manifesting itself in cheating and law violation. Corporate team members can become so concerned about winning for the team that they disregard external norms requiring solidarity with larger groups of people. Driven to win, corporate players begin to feel corporate solidarity justifies cheating customers, evading national taxes, regulatory schemes, or environmental laws. In short, teams play dirty.

Some observers have not discerned much team spirit at Enron itself. The “rank and yank” system of ranking all employees every six months and then firing the bottom fifteen percent led to a good deal of internal backstabbing and corruption.<sup>101</sup> Nevertheless, much of Enronitis, and corporate malfeasance at more typical firms, seems to relate to this pathology of competitive team spirit: outsiders don’t count; rules are made to be broken; winning is all that matters. One may disregard the interests of Californians, for example, because the mission is to promote the interests of Enron.

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<sup>100</sup> See, e.g., RICHARD WILKINSON, MIND THE GAP: HIERARCHIES, HEALTH AND HUMAN EVOLUTION 11-13 (2001) (reporting that social cohesion increases public health; increased inequality worsens health of lower status individuals while more equal societies have better health, largely because equality correlates with cohesion).

<sup>101</sup> See BRYCE, *supra* note 11, at 127-29.

### 3. In Praise of Teams

Human communities, the teams I referred to above, often couple extreme altruism and mutual concern within the group with a striking lack of concern or hostility to those outside the group. The two processes, altruism on the one hand and competitive hostility or arm's-length indifference on the other, seem tightly linked in our psychology. Many people have fond memories of war (or a peace movement) as a time when ordinary people came together in a common enterprise for the common good, escaping the alienating individuality of ordinary times, even though the common enterprise was little more than hostility to some other group.<sup>102</sup>

In the corporate context, forming the team is one of the key advantages of firms over markets. Markets price better, can incorporate more information than any plan, and have obvious and precise motivators. Firms generally blur and dull those mechanisms and incentives—for example, by unlinking pay from direct measures of productivity, quality, or demand for the individual's products.<sup>103</sup> Team spirit, with its solidarity and internal altruism as well as its fierce competitiveness towards outsiders, can be the tool that overcomes the inherent limitations of command and control market displacement, thereby allowing firms to out-compete spot markets.<sup>104</sup>

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<sup>102</sup> Wilkinson reports that civilian health improved in Britain during both World Wars, despite the economic shortages. WILKINSON, *supra* note 100, at 12.

<sup>103</sup> See generally WILLIAMSON, *supra* note 98; LAURENCE J. PETER & RAYMOND HULL, *THE PETER PRINCIPLE* (William Morrow & Co. 1969); HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996) (each describing aspects of problematic internal incentive structures of firms).

<sup>104</sup> R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937) (arguing that firms appear where there are cost advantages over other alternatives); Margaret Blair & Lynn Stout, *A Team Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (discussing cost advantages of teams).

#### 4. The Instability of Teams in the Share Value Maximization World

The importance of intra-group team spirit in corporate enterprise is no news: it is a commonplace element of managerial training. But the share value maximization principle puts a strange twist on team spirit. It teaches managers that the humans who work for the corporation are not its team but rather the opponents.

Managers who accept the commonplace idea that team spirit works and also accept that their job is to maximize share value are bound to live a double life. In order to maximize share value, they must convince their fellow employees that they are all in the game together, part of a common enterprise, and sacrificing for a common goal. But the game and the goal is to extract the most value out of the supposed team members and give it away to someone else, a fictional bystander not even present at the game. At the same time that managers are building team spirit, they are required to be looking around for opportunities to shaft their fellow team members.

The key advantage of team spirit for rational managers is that team players are not rational maximizers. Team members give towards the common goal without expecting precise compensation for every act. They are motivated not by self-interest but by community feeling—positive towards fellow community members and negative towards outsiders. But this very altruism opens them to exploitation by a supposed team member who is really an opponent. When someone is giving their all, they are particularly open to being taken all the way.

Managers, then, are caught in a double game. The share value maximization principle tells them that their real team is the shares. They are meant to compete with everyone else in order to win one for the shares. To serve their true masters, they must convince their fellow employees, customers and suppliers that they are all on the same team; that is, that they are engaged in a common enterprise for a common goal. Or, in other words, they must show that they, as managers, are not serving their true masters. Then, they

must betray the team. Surely only the most extreme of cynics can succeed in this role.

But a manager who has learned to betray those he or she works with every day, pretending to be their teammate while constantly seeking opportunities to exploit their communal good feeling, is a manager who has learned to be dishonest, a dissembler, a traitor to his small community, and a breaker of trust. Why, having betrayed his trust to the team that he works with every day, should he remain loyal to a fictional shareholder that doesn't even exist except as a legal abstraction or an investment portfolio?

The share value maximization scheme teaches managers to betray the people with whom they have relationships in order to serve their ultimate master. It should be no surprise that some learn this lesson well enough to betray the master as well. Double agents, in the end, work only for themselves.

In short, share value maximization teaches that the real team is the shares and their servants are the managers; but enterprise success depends on creating a team composed of employees and often customers and suppliers as well. The two team notions are incompatible. The latter requires mutual concern and trust. The former constructs members of the firm as opponents, to be treated somewhere between arm's-length according to the norms of the market, in which mutual concern is absent, and active competitive hostility, in a zero-sum game in which every gain for one side is a loss for the other. The one requires trust; the other bars it.

Enronitis is a predictable pathological result. The team breaks down into a one-on-one competition of every man to himself and the devil take the hindmost.<sup>105</sup> All that remains of the team spirit is the disregard of rules, the desire to win

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<sup>105</sup> Some commentators have argued that large gaps between CEO and ordinary employee salaries harm corporate spirit and therefore productivity. *See, e.g.,* Jay Lorsch, *CEO Pay*, 70 HARV. BUS. REV. 132 (1992) (large pay gaps highlight intra-group competition and weaken claims that all employees are on the same team).

at all costs, and the depersonalization of opponents, now understood as everyone.

## V. POLICING SHARE-CENTEREDNESS: THE REFORMS

Many of the proposed post-Enron reforms are steps in the right direction, although taken as a whole they seem unlikely to solve the problem. A few, however, may well accentuate the pathology, much as the independent compensation committee and tax-law insistence that salaries over \$1 million be performance-based worsened the problem of overpaid executives.<sup>106</sup>

### A. Disclosure

First, improved disclosure is a good thing, if not necessarily for the reasons usually given.

The prices of publicly traded stocks are related to the profits of the underlying corporation, but as anyone who followed the market on its way up and down in the last few years is aware, the connection can be very loose. Stock markets often price shares based on expected earnings (or on expected price gains resulting from expectations of expected earnings), placing greater weight on trends and patterns than on the current absolute numbers and increasing or decreasing stock prices disproportionately for changes in trends.<sup>107</sup> This provides cynical managers a great incentive to massage the numbers or even lie. A few well-timed

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<sup>106</sup> I.R.C. § 162(m) (2004). See also Stabile, *supra* note 30 (discussing excessive compensation); Ryan Miske, *Note: Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1680 (2004) (describing failed history of tax-code provisions as intended maximums became de facto minimums and tax-favored "performance based" pay became authorization for enormous stock-option grants); Susan Stabile, *Is There a Role for the Law in Policing Executive Compensation*, 72 ST. JOHN'S L. REV. 81 (1998) (policy analysis of relevant tax code provisions).

<sup>107</sup> See generally, ROBERT SHILLER, *IRRATIONAL EXUBERANCE* (2000) (describing excess volatility of stock markets, including trend chasing behavior).

disclosures can cause a terrific price increase (or avoid a decrease) and allow top managers, who are nearly always near the end of their employment, to cash out before the truth emerges.<sup>108</sup>

Moreover, even managers who have not succumbed to ultimate cynicism may convince themselves that they are doing their jobs by managing reported earnings. The share value maximization ideology perversely suggests that corporations ought to manage their disclosures in the way that maximizes market valuation of their securities, rather than in the way that most accurately reflects their underlying condition. If the goal is to increase the value of shares, and any means will do, why not deceive shareholders for their own good? (Of course, deception cannot be to the good of actual shareholders as a group, but it can effectively increase share price for some period of time, and the latter may be the more salient effect even to managers still trying to act as good-faith agents.<sup>109</sup>)

Much market behavior seems to be the result of this perverse incentive. Because the market is quite sensitive to changes in disclosure, companies find that they can affect stock price as much by manipulating disclosure as by the more difficult task of out-competing their competition. If reported earnings can be increased or reported debt decreased by changes in financing or reporting or strategic acquisitions, the share value maximization ideology suggests that managers ought to do so, even if there is no real economic justification for the action.

The basic problem is managing the company according to the whims and prejudices of the stock market; reforming accounting rules or forcing CEOs to swear that they have not lied will not change that. However, accounting anomalies make a bad problem worse. If companies can create reported earnings by “round trip” trades, they will waste social resources and distort their reported earnings by making

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<sup>108</sup> See, e.g., *supra* notes 17, 18, 23 and 26.

<sup>109</sup> See *Kamin v. American Express*, 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976).

those trades. If executive stock options have no effect on the company's reported financials, they will be used more. If accounting for merger rules allow the combined company to have higher reported earnings than did the parts of which it was made, companies will combine even when no efficiencies result.

The reforms, of course, will create new and sometimes odd market incentives. If stock options are reported as an expense at the time of issuance based on their Black-Scholes value, and companies then correct the accounting when they are actually cashed in, the effect may be to smooth earnings oddly. When stock prices are down, options will expire unused, and the company will be able to report "earnings" resulting from reversing the too-high estimate of the cost of the options. Marking to market periodically would lessen the jumps in earnings but not change the effect of generating "earnings" for no reason other than stock price drops.

Overall, surely honesty is better than deception. The fierce resistance to disclosing options suggests that executives, at least, believe that the market responds to the reported bottom line numbers rather than the underlying reality or even the total information publicly available (which these disclosure reforms will not change), and it seems most likely that they are right.<sup>110</sup>

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<sup>110</sup> See, e.g., Melone, *supra* note 31 (describing FASB attempts to mandate disclosure of stock based compensation as an expense and the accompanying political opposition). The current FASB rule, Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation (Oct. 1995), available at <http://www.fasb.org/pdf/fas123.pdf>, requires disclosure (in a footnote) of the Black-Scholes value of option granted, but does not require expensing. Thus, analysts have available all of the information necessary to recalculate profits with options expensed. Nonetheless, both sides appear to believe—contrary to the strictures of an efficient market—that expensing (or not) matters. Kevin Murphy, in contrast, has argued that both compensation committees and executives constantly value options at considerably less than their market value as predicted by the Black-Scholes formula. See Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 857-68 (2002). If Murphy is correct, the gap between private and public value would be another reason for executives to resist disclosure.



Moreover, the end-stages of Enronitis involve deliberate deception and outright fabrication. Reforms that seek to increase the independence of auditors, demand stronger audit committees, require rotation of audit partners, separate auditors from consultants, and the like, seem quite likely to catch more fraud and perhaps even limit some of the semi-bad faith game-playing. Increasing nominal criminal penalties seems less likely to have any effect. These reforms do not, however, change the underlying incentives to cheat, so we should expect that as we close up some obvious routes, clever cynics will find others.

More disclosure than is currently on the table might help even more. For example, apparently some public companies report one set of earnings to the SEC for public disclosure, showing high profits, and another different set of books to the Internal Revenue Service, showing low profits, for tax reasons, which the IRS does not make fully public.<sup>111</sup> Under this system, managers serving the share value maximization norm predictably will stretch accounting conventions as far as possible in both fora, with only the good faith of managers and the limited resources of the governmental agencies standing in the way of powerful incentives to outright fraud. Private market incentives to exaggerate are limited only by governmental enforcement.

Reversing the rule would reverse the incentives and produce better results. If the IRS revealed the numbers submitted to it, or if the SEC ruled that double bookkeeping is *prima facie* evidence of a fraud on the marketplace, companies might have some reason to seek a single set of numbers that accurately represented the economic functioning of the firm. Even if that is too optimistic, at a minimum managers would seek to present a single set of profit numbers defensible in both fora. Instead of pushing to the limits of the law, companies might seek to live by the spirit of at least one of the two systems.

Finally, disclosure is important well beyond the narrow conceptions of securities law. Markets often prevent profit-

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<sup>111</sup> See Johnston, *supra* note 32.

maximizing companies from acting in socially valuable ways even when consumers would be willing to pay private fees for public goods.<sup>112</sup> Thus, companies might well be able to charge higher prices for products with lower associated pollution or fewer social externalities. Not all consumers free ride all the time. But consumers are unlikely to decide voluntarily to contribute towards maintaining the commons if they cannot even tell if the higher price is associated with greater social responsibility. Companies required to disclose the pollution associated with a product on its label, or to explain the testing they have done or not done, or to detail the externalities associated with their processes, or to state the wages they pay in their factories abroad, might well find that the consumer markets would reward efforts to behave in more socially acceptable ways, especially if a securities-like private right of action gave companies and consumers some assurance that false disclosures stand a good chance of being quickly and punitively disclosed.

In short, corporate disclosure and transparency is important well beyond the stock market. Corporations are part of our collective governance structure. As citizens, we must know what they are up to if we are to intelligently evaluate how to control them—both externally through regulation and internally through corporate law and market processes. The stock market, consumer markets, and the general political process depend on full disclosure.<sup>113</sup>

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<sup>112</sup> See Coffee, *supra* note 56.

<sup>113</sup> For this reason, as well as the reasons discussed in Greenwood, *Essential Speech*, *supra* note 38, current doctrine regarding corporate constitutional rights is backwards. Corporations should no more be constitutionally protected from public view than should other governmental agencies. Rather than possessing a Fourth Amendment constitutional right against unreasonable searches and seizures that can be used to foil governmental regulation, corporations should be subject to a sunshine principle along the lines of the Freedom of Information Act. Compare, e.g., *Gulf, Colo. & S.F. Ry. v. Ellis*, 165 U.S. 150, 154 (1897) (granting corporation 4th Amendment rights against searches and seizures on the (clearly incorrect) ground that this is equivalent to protecting the rights of citizens whose interest the corporation purports to serve) with *Wheeling Steel Corp. v. Glander*, 337 U.S. 562, 576-81, 579 (1949) (Douglas, J., dissenting) and *Connecticut Gen. Life Ins. Co. v.*

## B. Independent Directors

There has been a good deal of discussion of continuing and accentuating the reforms of the last decade, primarily by increasing the number of independent directors (marginally tightening the definition of independence to exclude some former employees, contractual beneficiaries of the company or relatives who might be considered independent today) and by increasing the number of consultants used by audit, hiring and compensation committees.<sup>114</sup>

The model outlined in this essay suggests that these reforms are unlikely to work as expected. If independent directors and their consultants view themselves as working for the shares or fictional shareholders, they will simply increase the perversities of the share value maximization model. By demanding that managers conform to the model, they will accentuate its incoherence. Managers will be driven to exploit their corporate team members even more, thus leading former team members to see themselves instead as free agents. Top managers attempting selfless selfishness will sink into self-interested cynicism. Corporations attempting to maximize share value will still find that often the easiest way to do that is to show Wall Street what it wants to see, regardless of whether it is what otherwise would make business sense. Top managers will, after a brief slowdown during the current scandals, continue to increase their share of the take, as the ineluctable logic of Lake Wobegon drives consultants and independent directors to conclude that they must pay above-average employees above-average salaries, and the agency principle requires that they convince themselves that their overpaid executives are contributing ever more to the firm as they take more from it.

The reality is that most independent directors are not particularly independent, and that seems unlikely to change.

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Johnson, 303 U.S. 77, 83-90 (1938) (Black, J., dissenting) (both rejecting view that corporations should be entitled to constitutional protection against the citizenry or government).

<sup>114</sup> See *supra* text accompanying note 48.

For good reason, consultants and incumbent managers alike are likely to look for other CEOs.<sup>115</sup> No one else, after all, is likely to have the expertise to police managers. But CEOs sitting on each other's boards are unlikely to criticize their peers too stringently. In any event, even if they had the inclination, directors rarely have the time or information necessary for serious review of company managers (and this problem is likely to be even worse for directors who are not themselves senior managers elsewhere). Thus, directors, nominally independent or not, are not likely to stand in the way of any but the most egregious managerial abuses.

The point of this essay is that truly independent directors, if they are or view themselves as answerable to the portfolios or fictional shares, will just make the problems worse. Enronitis ends in betrayal of the shares, but it begins in share-centeredness itself. Increasing share-centeredness will not cure this disease.

## VI. RECONCEPTUALIZING CORPORATE LAW: MAKING SPACE FOR CITIZENS

A more effective reform program must begin by recognizing the perversity of the share value maximization model and offering an alternative ideology of corporate governance. But it cannot end there. The selfish share may be a legally constructed fiction, but the law and our stock market have given it enormous market power to enforce its fictionalized, constructed will. Directors and managers have only limited ability to unilaterally reject the demands of the share value centered model before the market, as currently regulated, will oust them. Moreover, the easiest reforms—shifting power from the market to managers or boards they effectively dominate—are more likely to empower the truly cynical among managers, the solo players who have lost all social constraints, than they are to create a more desirable

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<sup>115</sup> See, e.g., Lucian Arye Bebchuck et. al, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 771 (2002) (discussing social ties of directors to CEOs and likelihood of common interests); JAY WILLIAM LORSCH, *PAWNS OR POTENTATES* (1989) (discussing board room composition).

corporate ethos. If we free managers from shares, the most likely immediate result is that they will steal more freely.

#### A. Corporation as Polis: An Alternative Ideology of Corporate Governance

For a start, we need an alternative metaphor to the corporation as its shares, and a different explanation of the purpose and reality of public corporations. Hobbes proposed to end his war of all against all by characterizing the state as a corporation.<sup>116</sup> I propose to reverse the process, and recharacterize the corporation as a polis, a community of all its human affiliates, not the shares.

The advantages of the metaphor of the corporation as a quasi-municipality or quasi-state go well beyond the probability that it would induce law faculties to seek political theorists or moral philosophers rather than law-&-economists to staff their corporate law curriculum.

##### 1. Polis to Politicians

Principally, the polis metaphor, like earlier “managerialist” understandings of the public corporation, emphasizes the common enterprise of the various corporate participants. Corporate managers instead of conceiving of themselves as selfless, unsituated rational maximizers could rather see themselves as statesmen, promoting the common good of all corporate participants, and, in our multiple-sovereigned system, as participants in the American governance system required to promote the good of all citizens.

On this model, it is clear that the corporate team extends well beyond the shares. It would, therefore, offer a rationale

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<sup>116</sup> THOMAS HOBBS, *LEVIATHAN* 106-18 (Edwin Curley ed., Hackett Publishing Co., Inc. 1994) (1660) (describing commonwealth as “artificial . . . covenant”); THOMAS HOBBS, *ELEMENTS OF THE LAW* 167 (J.C.A. Gaskin ed., Oxford University Press 1994) (1640) (analogizing body politic to corporation). *Cf.* BURKE, *supra* note 72 (“Nations themselves are such corporations”).

for acting for the good of corporate participants as ends in themselves, rather than doing so simply because treating them in an apparently good way is the best way to extract more out of them. But given the vague limits to “corporate stakeholders” in a firm that, understood as a nexus of contracts and externalities, lacks determinate or firm boundaries, the polis metaphor offers a rationale for managers to consider the public good generally, even beyond the narrower interests of corporate participants.

This broader conception of the managerial/director role is not an unmitigated good. Statesmanship is difficult. Many aspirants to the title have been cynical charlatans or self-interested deluders (even self-deluders). No doubt many managers will be able to explain to their own satisfaction why the common good requires precisely their private good. Moreover, the public good is often controversial, and there is no reason whatsoever to think that unelected corporate managers, or directors nominally elected on a “one share, one vote” basis, will reflect in their views the divisions of the citizenry as a whole. Managerialism is a poor substitute for democracy. Still, unlike the reigning share-centered ideology, working for the good of all corporate participants does not require managers to take inconsistent positions, play cynical double games, or deliberately lull people into trusting them when they know they will be required to take advantage of whatever trust they achieve.

## 2. The Struggle Over Surplus

The corporation as polis also emphasizes the open-endedness of the struggle over corporate surplus. In this way, it is quite different from the older managerial views, which often seemed to conceal the possibility of conflicts within the corporation under a veneer of professionalism. The polis metaphor is meant to emphasize that there is no “scientific,” neutral, or professional objective solution to the problem faced by managers. The issues are value laden, not professional: what kind of society we wish to be or how to mediate our conflicting values, not efficient administration.

Share-centered models define profit as what is left over after all corporate factors other than shares have been paid, and insist that all those corporate factors be paid as little as possible. The corporation as polis matches economic reality more closely. In the polis model, corporations can out-compete markets only when the combined contributions of all the corporate factors of production (including labor as well as investment capital, whether in the form of debt, equity or retained earnings) produce more in cooperation than they would in market competition. That excess is the corporate surplus, and it is available to be given to any factor of production, none of which has an a priori exclusive claim to it.

On this understanding of corporate surplus, the surplus is called profit if it is retained by the corporation or paid out to shares. If it is paid out to bondholders, it is called attractive interest rates; if it is paid out to employees, it is called decent working conditions, good benefits, competitive wages/salary or hard-earned executive stock options; if it is paid out to consumers, it is called every day low pricing; to the government, taxes; to suppliers, high prices; to stockholders of other companies, investment bankers and lawyers, acquisition costs; to architects and builders, a landmark headquarters; to the eco-system, ecological responsibility. Like the apocryphal Aleut languages with thirty-five words for snow, we have many words for corporate surplus. For political and economic purposes, however, the distinctions are not as important as the commonality. This is money that is available for someone to take and no one "owns" it until the struggle to allocate it has concluded.

### 3. Politics, Not Administration

Third, the political metaphor emphasizes the political nature of the decisions that must be made. Corporations are not only about increasing share value. They are also about creating jobs for employees and suppliers, and those jobs consist not only of paychecks but also of quality of life and quality of work issues: relationships, individual

empowerment, self-improvement and education, health and safety, hours that allow for families, movement and stability in our various communities, support in sickness and old age and for dependents. Corporations also exist to beautify our cities, to provide products for consumers, to support charities, to enhance and not merely destroy our environment.

The share-centered view tells managers that these concerns are illegitimate except when they are illusions. Thus, on the share-centered view, corporate charity is improper unless it is really advertising designed to increase share returns rather than to accomplish a charitable purpose.<sup>117</sup> Working conditions, wages and retirement benefits are just costs to the corporation, justifiable only if they induce workers to work harder or stick around longer and that in turn increases returns to shares. Even abiding by the law is defensible mainly because it is instrumentally useful in maximizing profit. As Friedman famously put it, "the business of business is business."<sup>118</sup> All other values must be imposed forcibly on business by enforceable regulation.

In contrast, on the polis view, the inhuman and uncivil claims of selfish shares can easily be rejected inside the firm. Improving working conditions is a good thing because it is a good thing, not because it is a subterfuge to extract more out of employees. Managers who cause their corporations to contribute to social needs are fulfilling their roles as trustees for major accumulations of social wealth, not stealing from shares. To be sure, firms can do none of these things unless they generate enough income to cover the expenses, but

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<sup>117</sup> See, e.g., *A. P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581 (N.J. 1953) (upholding charitable contribution on ground that it is really self-interested).

<sup>118</sup> Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., Sept 13, 1970, at 32 ("There is only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game").



there is a difference between a constraint and a goal.<sup>119</sup> The share-centered vision has the world backwards. Far from all of us existing to make shares worth more, the only reason a decent capitalist society allows some shareholders to become indecently rich is because the market is a critical part of improving working conditions and fulfilling social needs. Those are not the means, they are the ends; it is not us who are the tools but the shares.

### B. The Democratic Deficit in Corporate Governance

Finally, the view of corporation as polis places front and center the democratic deficit of our current corporate governance system. Externally, corporate governance law largely comes from Delaware. It is not even formally approved by the citizens whom it governs, few of whom vote in Delaware. Internally, corporations are governed by managers who are answerable to boards elected, formally at least, by shares on a basis of dollar proportionality. This is, in political terms, a “herrendemocracy” in which the “herren”—the elite group that adopts democratic norms among its own members while exploiting non-voting inhabitants—are not even people but dollars.<sup>120</sup>

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<sup>119</sup> Indeed, sometimes working to make the world better can also redound to private profit. Bruce D. Butterfield, *Test by Fire: The Story of Malden Mills*, BOSTON GLOBE, Sept. 8, 1996, at A1 (recounting that after 1995 fire, Malden Mills decided to retain all employees during rebuilding). Although Malden Mills stated that its decision was not based on profit-maximization calculations, it appears to have redounded to the benefit of the company, as sales of its Polartec soared and the unionized plant was strike-free. One shouldn't over emphasize this point: Malden Mills has since filed for bankruptcy. See Marianne Jennings, *Smart Money*, WASH. POST, Aug. 25, 2002, at B7 (interview with CEO and owner Aaron Feuerstein in which he denies that bankruptcy was related to fire and aftermath). Curiously, even though Malden Mills is closely held, at least one business ethicist claimed that Feuerstein's decision to retain his employees was unethical because it violated the profit maximization principle (and without offering any evidence that in fact the costs to the firm did exceed the benefits). *Id.*

<sup>120</sup> I have discussed the varieties of democratic governance at greater length in Greenwood, *Beyond the Counter-Majoritarian Difficulty*, *supra*

Managers who are expected to manage on behalf of the entire corporation and possibly the public at large, not just its shares, ought to be answerable to the entire corporation and the public at large, not just its shares.

Bringing the public at large into the corporate governance system may be the easier part. First, it requires ending the bizarre choice of law regime under which managers (with share approval) get to choose the corporate law that will govern them. Instead, we should have a genuinely federalist system, in which different states govern corporations under their jurisdiction in substantially different ways—and no state purports to govern corporations that exist primarily outside its borders. Corporations should be governed by the law of the states in which they operate; if the laws appear to cause conflicting regulation, trans-jurisdictional (i.e., national or multi-national) corporations should create legally separate subsidiaries to hold assets in different states, as European corporations have long done.

Second, corporate boards should include board members whose portfolio is specifically to represent the public and to promote the interest of the public at large—understood as citizens rather than shareholders, consumers or employees—and who are selected, directly or indirectly, by the public or its representatives.

Third, the fiduciary duty of board members should be clarified to be a duty to the corporation as a whole, understood to include all the people whom it affects, and not (as in the more extreme versions of the share-centered ideology) as a mere duty to shares or fictional shareholders.

In order for this broader duty to function as something more than a defense to shareholders' derivative actions, it must be enforceable by someone other than representatives of the shares—perhaps a public official, if staffing can be found, or perhaps private attorneys general. The courts, no

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note 59; Daniel J.H. Greenwood, *Akhnai*, 1997 UTAH L. REV. 309 (1997), available at <http://www.law.utah.edu/greenwood/pdf/Akhnai.pdf>; Daniel J.H. Greenwood, *Beyond Dworkin's Dominions: Investments, Memberships, The Tree of Life and the Abortion Question*, 72 TEXAS L. REV. 559 (1994), available at <http://www.law.utah.edu/greenwood/pdf/Dworkin.pdf>.

doubt, will continue to emphasize good faith, procedural safeguards and lack of direct personal conflicts of interest, permitting boards great discretion under the business judgment rule. Given the current leniency of judicial review of board action, I do not think that the more amorphous duties of a trustee for the corporation as polis would generate radically different judicially imposed limitations on firm behavior. Rather, its advantage is that it seems likely to put a significantly different cast on the deliberations of directors attempting to act in good faith, without much affecting those who are not.

Finally, corporate intervention into the general political debate ought to be restricted. As I have argued elsewhere, corporations, particularly when they are governed in accordance with the share value maximization model, are not legitimate participants in democratic debate.<sup>121</sup> At a minimum, direct corporate intervention into campaigns should be restricted well beyond historical norms or the limits of current Supreme Court doctrine.<sup>122</sup> More broadly, we need to find effective ways of limiting corporate lobbying or placing it under the control of all the citizens concerned, not merely managers and their purported beneficiaries the fictional shareholders.

Indeed, the image of corporations as polis emphasizes that in general corporations ought to be seen as on the state side of the great liberal divide between state and society. We need to be protected from them far more than they need protection from our collective will. Current constitutional law, which for over a century has granted corporations the rights of citizens against governmental agencies, is precisely backwards. Instead, citizens ought to have rights against these government-like entities. And we should be as unrestrained in using other governmental entities to regulate them as we are in using state law to regulate

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<sup>121</sup> See generally, Greenwood, *Essential Speech*, *supra* note 38.

<sup>122</sup> See Adam Winkler, *The Corporation in Election Law*, 32 LOY. L.A. L. REV. 1243 (1999) (describing election law's treatment of corporations).

municipal corporations or federal law to regulate administrative agencies.<sup>123</sup>

Representing more defined corporate constituencies inside the firm is a more difficult problem and I have only preliminary thoughts on it. The model of the corporation I have used, like the nexus of contracts model from which it borrows, tends to blur the edges of the corporation: this firm is anything but firm. Are consumers, or suppliers, or municipal hosts, members of the corporate team or not? For purposes of corporate governance, and in light of the unexpected results likely from radical changes, I am inclined to take the conservative position that such people, although undoubtedly dependent on the firm and necessary for its success, probably should be classified as members of the public at large and represented as discussed above.

In contrast, employees who spend significant parts of their waking lives working for and at the corporation must have some form of representation in the corporate governance structure if the team or polis concept is to be anything other than yet another cynical tool to delude marks into thinking they are being befriended rather than taken for another ride. For all its problems, democracy remains a far superior alternative to autocracy, kleptocracy or Enronitis. In 1776 we rejected Parliament's claim to virtually represent the American colonies. The claims of public corporations to represent the public—or even the corporate team—while granting the vote only to shares are even weaker.

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<sup>123</sup> See generally, Greenwood, *Fictional Shareholders*, *supra* note 55 (arguing, inter alia, that corporations are not citizens that require protection from the state but rather state-like entities from which citizens need to be protected); Adolf A. Berle, Jr., *Constitutional Limitations on Corporate Activity—Protections of Personal Rights from Invasion Through Economic Power*, 100 U. PA. L. REV. 933, 942-53 (1952) (arguing that the state action doctrine does or should not apply to corporations: "The emerging principle appears to be that the corporation, itself a creation of the state, is as subject to constitutional limitations which limit action as is the state itself").