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COMMENTS ON BAINBRIDGE AND KENNEDY**Margaret Blair***

Thank you for inviting me to participate in this interesting and challenging conference. As a “fallen-away” Catholic, as my mother used to say, I’m sure that I have no authority to be here discussing Catholic Social Teaching, although perhaps I have redeemed myself somewhat by reconnecting with my Christian roots through a Congregationalist church in Arlington Va., and by serving on the board of trustees of the Woodstock Theological Center, a Jesuit think tank affiliated with Georgetown University.

My main source of authority for being on this panel is that I am an economist with a special interest in corporate governance, and I am currently teaching corporations law at Georgetown Law Center while I try to reinvent myself as a law professor.

Let me say first that I very much enjoyed reading both of these papers. I found Professor Kennedy’s paper to be an especially helpful exposition of what Catholic social teaching has to say – and doesn’t have to say – about contemporary corporations. As for Professor Bainbridge’s paper, I always enjoy reading Steve’s work because of the breadth and depth of knowledge he brings to his writing, and because I am keenly interested in most of the same things that he is interested in. I also always find his work a little frustrating, and this paper was no exception. As I read his work, I often find that I agree with him at every step of the way, until he draws his conclusions. And then I just shake my head and wonder how we could both look at the same facts, and use the same tools of analysis, and yet reach such different conclusions.

Putting on my economist’s hat, I want to start out by saying that I think both Professor Bainbridge and Professor Kennedy have it partly right and partly wrong in their perceptions of the degree to which the predictions of economic theory are in conflict with Catholic Social Teaching. They are right that the basic model of human behavior that serves as the starting point for *economic* analysis is much more individualistic and self-centered than the human beings of Catholic social teaching, who are, as Professor Kennedy says, “social by nature.” Professor Bainbridge focuses on the idea from Christian doctrine that mankind is “fallen”, and thus seems to accept the economist’s grim view of human beings as ruthlessly self-centered, and, apparently, fundamentally incapable of being trustworthy. So he buys into the logic of economic models which say that economic activity must be organized in ways that assume that participants will only respond to financial or economic incentives.

But I think economics is not so totally dismal a science as Professor Bainbridge believes. In the last few decades, a number of economists have been reassessing the behavioral assumptions behind their models and studying the institutional arrangements that people create that may help to evoke behavior from economic actors that, with some predictability, can be counted on to be trustworthy and other-regarding, rather than always calculating and selfish. So I want to give an

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economic account of corporations that I think is much more consistent with Catholic social teaching than is Professor Bainbridge's.

In work I have done jointly with Professor Lynn Stout, we argue that corporations are formed as a way to solve the contracting problem that people run into when they attempt to work together in teams. "Team" production is production that involves complex, specialized inputs by a number of people. Team production is further characterized by the fact that the output from the team production process is nonseparable, which is an economist's term that means the output is more than just the sum of the inputs, and cannot be neatly divided up according to who was responsible for what part of the output.

If one uses a purely economic analysis, team production presents significant contracting problems. The rational, but self-centered team members know that they will produce more if they work together, but the process of working together is too complex for them to be able to write clear, enforceable, ex ante contracts specifying what each team member is supposed to contribute. Some contribute ideas or certain kinds of expertise. Some provide financial capital, with or without expertise. Some contribute physical labor. Some provide marketing expertise. Some may contribute several different kinds of inputs. But these things are difficult to specify in advance. Team members also have a problem if they try to specify in advance who is supposed to get what in return for their inputs. Under any ex ante sharing rule, team members will have an incentive to shirk because they will get the same agreed-upon share whether they work hard or not. They also have a problem if they try to divide up the output later, because then they are likely to get into feuds over who gets what, and, indeed, may waste all the surplus value they created in squabbling over the division of the pie.

Professor Stout and I argue that the corporate organizational form provides a special solution to this contracting problem. When a corporation is formed, the law creates a separate legal person to be the "owner" of all the assets used in production. As team members contribute assets, or skills, or effort, those inputs immediately become assets of the corporation. The participants cannot decide, unilaterally, to pull their contribution back out. The corporation, and not the shareholders, nor any other participant, also owns the output, at least until it is sold and the proceeds paid out to team members.

Importantly, the law requires that when a corporation is formed, a board of directors must be created to make decisions for this separate legal person. And all the participants in the enterprise agree to yield control over the joint enterprise to this board of directors. Thus they create a human community that is organized hierarchically, with ultimate decision-making authority resting with the board of directors. By forming this organization, and yielding control rights to the board, the team members help to bond their mutual commitment to each other to cooperate with each other, and not to try to "hold up" the enterprise by threatening to withdraw the inputs that they provided.

Under this theory of the corporation, the law delineates a zone, within which decisions are made by the internal hierarchy, and courts generally decline to get involved in settling disputes over allocation of resources within this zone or in otherwise second-guessing the judgment of directors within that zone. The reluctance of the courts to get involved in decisions which should

be made by the internal hierarchy is called “the business judgment rule.” The law thus creates the opportunity for corporate executives and directors to be, as Professor Kennedy suggests “not merely the stewards of financial resources, but stewards of other common goods as well.” The law thus appeals to directors to be “statesmen”, or at least to have the virtues Russell Kirk attributes to statesmen

What corporate law creates is something which, to my understanding, looks very much like Steve Bainbridge’s Option B, despite the fact that he says Option B would be worse than what he says is current law. Current law, Steve claims, requires corporations to “maximize value for shareholders.” I find very little evidence that current law actually requires this, but, even if it were a requirement technically, the business judgment rule means that the courts refuse to enforce this requirement. In fact, *current law gives directors of corporations reviewable discretion to make tradeoffs among the corporate team members*. There is plenty of room within the law as it currently exists for directors to decide to make contributions to local charities, for example, or give employees raises, or even increase pension payments to retired employees. If shareholders challenge such actions as not consistent with share value maximization, courts will generally give directors the benefit of the doubt, and will only review the actions of directors if the shareholders make a case that the directors were acting in a self-interested way, or were wasting corporate assets.

Now I admit that it’s a bit cheeky of me to sit here and tell Professor Bainbridge what the law is, since he is a well-known and respected corporate scholar and author of a casebook used in many law schools. But I find his claims that the law requires maximization of share value just completely inconsistent with what I know of the way corporate law works in practice. So let me give some examples of why I am bold enough to challenge Steve’s conclusions on this point.

First of all, there are no statutory mandates in any state to “maximize shareholder wealth.” A subset of legal professionals and academics tried some years ago to get the American Law Institute (ALI) to say that that is what corporate law should be, but the ultimate recommendations in the ALI’s Principles of Corporate Governance pulled back from this kind of extreme statement.

Secondly, Steve relies heavily in his paper on the opinion of the courts in two key cases for his conclusion that corporate law requires “maximization” of shareholder value. The first is the old and familiar case of *Dodge v. Ford*, in which the Michigan Supreme Court in 1919 famously said that “A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.”¹

This case does not prove what Bainbridge claims of it. First of all, in the same paragraph in which the above cited sentences appear, the court also concedes that it is acceptable for corporations to expend some resources for charitable or humanitarian purposes or to provide extra

¹ 170 N.W. 668, 684 (Mich. 1919).

benefits for employees.² Secondly, the court clearly states that the business corporation is organized “primarily for the profit of stockholders” not “exclusively” for that purpose.³

Most importantly, the underlying dispute in the case of *Dodge v. Ford* is really a minority oppression problem. Henry Ford had used his controlling interest in the corporation to make decisions designed to deprive the Dodge brothers of receiving any benefits from their minority position in the company. Ford argues to the court that he wants to use the profits generated by the company to expand the business and raise wages and lower the prices of his cars. Ford was an eccentric character and his reasons may have been exactly what he said they were. But my guess is that he gave these reasons because he thought that the court might be more sympathetic to this rationale for not paying dividends than it would be for what is widely believed by economic and legal historians to be his *real* reason for not paying dividends. The real reason was that Ford knew that the Dodge brothers wanted to get their share of the value of Ford Motor Company back out of the company so they could use the funds to establish their own automobile manufacturing company that would compete with Ford. And so he quit paying dividends on the shares so that the shares would have no value to anyone if the Dodge brothers tried to sell them.

The legal issue in the case was whether the court would compel the company to pay dividends. Professor Bainbridge knows full well that, except perhaps in other minority oppression cases, the Delaware courts have been extremely reluctant to compel a company to pay dividends. Any decision about whether or not to pay dividends is regarded by the courts as exactly the kind of internal allocation decision that the courts do not want to get involved in. In other words, if Kirk Kerkorian had tried to seek a court order compelling Chrysler to pay out more in dividends a few years ago, he almost certainly would have lost. Kerkorian had to use other devices to try to persuade Chrysler to increase its dividends.

The second case Bainbridge relies on is the more modern case of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁴ which considered the appropriateness of certain actions by Revlon directors as they tried to fight off a hostile takeover. In that case, the Delaware Supreme court famously said: “when Pantry Pride increased its offer to \$50 per share and then to \$53, it became apparent to all that the break-up of the company was inevitable. The Revlon board’s authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board *had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company’s value at sale for the stockholders’ benefit.*”⁵

This is one of the very few instances that I know of in which courts have said anything about “maximizing” anything for anybody (Chancellor Allen’s comments in *Katz v. Oak*

² *Id.*

³ *Id.*

⁴ 506 A.2d 173 (Del. 1986).

⁵ *Id.* at 182.

*Industries*⁶ representing one other example). Yet, here, in the very same sentence that the court says the board's duty is the maximization of value for stockholders' benefit, it also said that this duty was the *exception* not the rule. The duty had "changed" in the court's word, under the exceptional circumstances in which existing shareholders were going to be bought out and thereby eliminated from any future involvement in the company. It had changed from the preservation of Revlon as a corporate entity, which the court apparently believes is the duty of directors in ordinary circumstances, to getting the highest price they could get for shareholders. For shareholders this was the "end game". They would have no further future involvement with the company, so the directors' duty was to get the best deal for them.

This case surely should not be cited for the proposition that in ordinary times, directors must always maximize share value to the exclusion of other goals. In fact, other cases, both before and after *Revlon* make it clear that, except in these "end game" situations, directors have a duty to set a strategic plan for the future of a company, and that it is the directors' prerogative to determine what that plan is, and what the timetable is for pursuing the plan (*Paramount Communications v. Time*⁷), and that, even in the face of a hostile takeover proposal, the directors have the discretion to consider the impact of the takeover on other stakeholders (*Unocal*⁸). In addition, more than 30 states have passed so-called "constituency" statutes, which give express statutory authority to officers and directors to consider the interests of other constituents in deciding how to respond to an unwanted takeover offer.

Thus existing corporate law does exactly what Steve says would be "worse" policy than what he claims existing corporate law to be. Existing law gives directors reviewable discretion to make tradeoffs. As Professor Stout and I argue, this grant of discretion to directors can be understood as a solution to an economic contracting problem facing the participants in the corporate enterprise. But it can also be understood as an institutional arrangement by which a human community organizes itself for the special purpose of creating new wealth by making and distributing new products and delivering new services to other members of the larger human community.

If corporate directors and officers were always the venal, calculating, self-centered people that Professor Bainbridge seems to think most people are, one would think that this solution would not work very well, and one should be truly puzzled as to why so many business people voluntarily decide to organize themselves into corporations and thereby give up so much power to directors. Professor Stout and I believe, by contrast, that directors are, like most people, capable of behaving in ways and making choices that attempt to serve the interests of the community whose interests they have been charged with serving. Clearly, they do not always do so. But most people are outraged by what happened at Enron, for example, precisely because most people expect corporate officers and directors to be reasonably honest and forthright and to make

⁶ 508 A.2d 873 (Del. Ch. 1986).

⁷ 571 A.2d 1140 (Del. 1989).

⁸ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

reasonable efforts to protect and serve the interests of the corporation as a whole – including employees, and customers, and creditors, and trading partners, as well as shareholders.

The problem is that a large proportion of the academic and legal community have been trying to tell managers and directors for the last two decades that they are not supposed to do this, but rather they are supposed to ignore all other goals and just maximize share value. With Enron, it seems to me, we got what Steve's vision of human beings and of corporations would regularly deliver.