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Readings for Students – What the Law Allows:

“The Fiduciary Responsibility: A Legal Perspective”

HBS # 9-304-064

By Lynn Sharp Paine.

This short note (6 pages) provides a basic legal definition of the fiduciary and the fiduciary’s special responsibilities of candor, care and loyalty, and their application in corporate contexts.

“When companies put shareholder second: OWNERSHIP: Michael Skapinker on whether a board’s duty is to maximize returns for stock owners or to secure the business’s long-term prosperity”

By Michael Skapinker, *Financial Times London Edition*, February 28, 2005.

This article provides a quick overview of legal precedents regarding the latitude of boards to consider factors beside share value maximization, with examples.

“M&A Legal Context: Basic Framework for Corporate Governance”

HBS # 9-803-200

By Carliss Y Baldwin and Constance E Bagley and James W. Quinn.

This note provides specific background regarding legal precedent with regard to mergers. For more detail, see “M&A Legal Context: Standards Related to the Sale or Purchase of a Company” (HBS # 90904-004), Carliss Y. Baldwin, Constance E. Bagley, James W. Quinn, 2004.

“The Devil Made Me Do It: Replacing Corporate Directors’ Veil of Secrecy with the Mantle of Stewardship”

By Constance E. Bagley and Karen L. Page, *San Diego Law Review*, Fall 1999, pp. 897-945.

This article includes a discussion of the theory of the firm and of externalities, drawing on Coase, Friedman, Berle and Means. Part III (pp. 921—932), in particular, provides a quick overview of legal arguments regarding corporate law and the role and limits of shareholder profit maximization. This brief section might be assigned on its own, if preferred.

“The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There any “There” There?”

By Leo Strine, *Southern California Law Review*, July 2002.

A readable discussion of two competing theories of the purpose of the corporation – the property model and the entity model – with an analysis of the role that U.S. corporate law plays with regard to each perspective in the particular instance of takeover situations.

“Reforming Corporate Governance: What History Can Teach Us”

By Margaret M. Blair, *Berkeley Business Law Journal*, Spring 2004, Vol. 1, No. 1, pp. 1-44.

This article provides a historical analysis of why the current corporate form developed. Section IV provides a brief (10 pages) overview of corporate governance reform proposals around the question of takeovers and takeover defense measures.

“Bad and Not-So-Bad Arguments for Shareholder Primacy”

By Lynn A. Stout, *UCLA School of Law Research Paper # 25, Law and Economics Research Paper No. 02-04*, pp.1189-1209.

This paper opens with summary of the 1932 Berle and Dodd debate regarding the purpose of the corporation, and then proceeds to address 3 arguments for shareholder primacy: shareholders as ‘owners;’ shareholders as “residual claimants;” the agency cost argument, which she counters with the team production argument. Each argument is explained in the context of relevant legal guidelines.

“Shareholder Value, Corporate Governance, and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom”

By Margaret M. Blair, Chapter 3 in *Corporate Governance and Capital Flows in a Global Economy*, edited by Peter Cornelius and Bruce Kogut, Oxford University Press, 2003, pp. 53 – 82.

This chapter reviews some of the “conventional wisdom” regarding corporate governance in light of recent corporate history and suggest some alternative perspectives and their relation to legal guidance.

“Managerial Duties and Business Law”

HBS # 9-395-244

By Research Associate Jerry Useem, under the supervision of Professor Joseph Badaracco.

This eleven page note consists of excerpts from *Principles of Corporate Governance: Analysis and Recommendation* (American Law Institute, 1992), providing pithy statements of legal duty with some brief commentary and interpretation. Topics covered include: Fiduciary Duty, Duty of Care and Business Judgment Rule, Duty of Fair Dealing, Tender Offers and Failure to Supervise. Although this Featured Collection on “What the Law Allows” focuses on the shareholder/stakeholder question, many of these topics are relevant and place this question into a broader context.

“Deception in Business: A Legal Perspective”

HBS # 9-306-019

By Professor Lynn Sharp Paine and Research Associate Christopher M. Bruner, J.D.

This four page note provides some basic definitions and legal guidelines on common-law fraud; fraud” under federal law; “misrepresentation”; deceptive non-disclosure; puffery; and “lawfulness” and “truthfulness”. Again as with the note on “Managerial Duties and Business Law,” although this note is not specifically focused on the question of the shareholder/stakeholder question, many of the topics are relevant and place this issue in a broader legal context.

Case – Takeover Situation:

“Veridian: Putting a Value on Values”
[HBS, forthcoming in Spring 2006]

While some CEOs would have welcomed the opportunity to sell their companies for a substantial premium over its current stock price, David Langstaff had not built Veridian – a medium-sized defense contractor -- to be a high flier in the stock market. Langstaff believed that he was building a "national asset" - a company dedicated to giving the nation's top technologists the opportunity to devise the best solutions to the nation's most pressing problems. While he had always stressed the importance of giving investors a fair return on their capital, Langstaff's focus had been on motivating Veridian's employees and helping its customers achieve superior results. Members of the board informally asked Langstaff what price would force their fiduciary responsibility to sell the company. Langstaff also wondered what other *options* Veridian had? [excerpted and adapted from case]

Teaching Purposes:

Provide opportunity for students to examine and clarify exactly what the law requires with regard to takeover situations, one of the classic contexts where shareholder primacy is invoked.

Some additional teaching purposes stated by case authors include:

- 1 Highlight the conflict in the role of the CEO in a purpose driven organization -- the tension between fiduciary duty and that of being an institutional leader seeking to perpetuate and sustain the firm. For example, this tension is evident in the conflict between short and long-term time frames and the differing requirements of the investment market and the market for corporate control. While these tensions are present in most companies, Veridian's commitment to building long-term value make the issues come out in sharp relief.
- 2 Provide a valuation exercise for a company committed to serving an expanded set of stakeholders. What role should employee and customer concerns play in making the decision to sell (if any at all)? What (if any) consideration should these constituencies play in setting a price? What is at stake for Veridian's shareholders, employees and customers in the decision? Are there other options or earlier steps that Veridian could have taken that would have given the Board greater latitude now?

“Share Price as a Poor Criterion for Good Corporate Law”
by Lynn Stout, UCLA School of Law, Law-Econ Research Paper No. 05-7

Academics, reformers, and business leaders all yearn for a single, objective, easy-to-read measure of corporate performance that can be used to judge the quality of public corporation law and practice. This collective desire is so powerful that it has led many commentators to grab onto the first marginally plausible candidate: share price. Contemporary economic and corporate theory (as well as recent business history) nevertheless warn us against unthinking acceptance of share price as a measure of corporate performance...

“A Team Production Theory of Corporate Law”
by Lynn Stout and Margaret Blair, Virginia Law Review, Vol. 85, No. 2, pp. 248-328, March 1999

Contemporary corporate scholarship generally assumes that the central economic problem addressed by corporation law is getting managers and directors to act as loyal agents for shareholders. We take issue with this approach and argue that the unique legal rules governing publicly-held corporations are instead designed primarily to address a

different problem - the "team production" problem - that arises when a number of individuals must invest firm-specific resources to produce a non-separable output...

“When the Existing Economic Order Deserves a Champion: The enduring Relevance of Martin Lipton's Vision of the Corporate Law”

by Leo Strine Jr. and Bill Allen, *The Business Lawyer*. 60(4): 1383-1398 (August 2005)

Deepest understanding comes when we see in the particular events before us the working out of the most general forces. In this essay, the authors seek to view Martin Lipton's important contribution to the development of corporation law of his era in terms of the largest economic and ideological forces at play over the last twenty-five years.

“First the Merger, Then the Mess,”

by Steven Pearlstein, *The Washington Post*, October 28, 2005.

It wasn't many years ago that Wall Street sharpies were out peddling the idea that professional service firms could smooth out their earnings by maintaining a healthy mix of government and non-government business, which tend to move in different cycles. Corporate executives embraced the concept and embarked on an acquisition spree, generating untold fees for Wall Street... But Wall Street fads are as perishable as a green banana...

Case Example – Takeover Situation:

“Shareholders should not always come first”

by Lynn Stout, *Financial Times*, March 27, 2005, FT.COM.

This Op Ed uses the MCI/Verizon/Qwest sale and suitor controversy to discuss the purpose of the corporation and the legal latitude that boards enjoy with regard to decision-making around the interests of various stakeholders. It also points up the possible diversity of shareholder interests.

To create an informal case study, this short Op Ed Could usefully be paired with:

“Verizon Wins Bidding for MCI: Qwest Drops Out As Industry Consolidates, Higher Rates Are A Worry; A Governance Test Case”

by Jesse Drucker and Almar Latour, *The Wall Street Journal*, May 3, 2005.

And

“MARKETPLACE: As Maytag Chooses a Suitor, It’s Not All About The Money”

by Andrew Ross Sorkin, *The New York Times*, July 28, 2005.

**Reading with embedded Case Examples –
Non-takeover situations:**

“Corporate Philanthropy Symposium: Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, The Prisoner’s Dilemma, Sheep’s Clothing, Social Conduct, and Disclosure”

By Melvin Aron Eisenberg, *Stetson Law Review*, 1998, vol. XXVIII, pp. 1-27.

Although the title is misleading, this paper discusses the general question of so-called “non-maximizing corporate conduct,” with philanthropy as merely one example of such behavior. The author identifies a number of different types of such non-maximizing behavior; shows that in some cases they actually are maximizing behaviors; and then discusses the guidance of the law for those remaining behaviors that do not appear to fit this criteria and the role of disclosure.

Hypothetical (and some actual) case examples are used throughout the paper, and although it was written for a law review journal, the piece is quite accessible for a non-lawyer audience. The case examples and taxonomy of so-called “non-maximizing” behaviors can be used as the basis of a discussion of the legal constraints and the degrees of freedom enjoyed by managers and boards of directors regarding corporate conduct in non-takeover situations.

Case Example with Supplementary Reading for Students – Pension Investors and the Fiduciary Responsibility:

“Institutional Investors Find Common Ground with Social Investors”

by Timothy Smith, December 2004.

Forthcoming in the four book series, *The Accountable Corporation*, edited by Marc Epstein and Kirk Hanson, Praeger Publishing, 2005.

“Investing in Socially Responsible Companies is a Must for Public Pension Funds – Because There is no Better Alternative”

By S. Prakash Sethi, *Journal of Business Ethics*, 56, 2005, pp. 99-129.

The two articles above raise the examples of state pension fund managers who interpret their legal and ethical fiduciary duty to include social and environmental considerations as well as economic ones.

“UNEP Finance Initiative: Innovative Financing for Sustainability.”

By Freshfields, Bruckhaus, Deringer

The objective of this report is to answer the following question put forth by the AMWG:

‘Is the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?’

The above articles could be paired with the following HBS case study which provides historical background on CALPERS’s institutional shareholder activism, as an illustration of some of the issues discussed in Smith’s article:

“California PERS (B)

HBS # 9-201-091

By James E. Sailer, Katharina Pick, Jay O. Light, Jay W. Lorsch, 2001.

“The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There any “There” There?”

By Leo Strine Jr., *Southern California Law Review*, July 2002.

Strine provides a discussion of two competing theories of the purpose of the corporation – the property model and the entity model – with an analysis of the role that U.S. corporate law plays with regard to each perspective in the particular instance of takeover situations. The author presents the well-known “James Trains” takeover/sale hypothetical which includes an interesting case example and discussion of the complexity facing pension investors with regard to shareholder value maximization.

Case Example with Faculty Background Reading – Corporate Philanthropy:

“Tsunami: the backlash. A troubling paradox about corporate philanthropy has surfaced. Is such largess even legal?”

By Malcolm Maiden, *The Age* (Melbourne, Australia), February 11, 2005.

This article presents the example of Australian law which pushes shareholder profit maximization further than U.S. law, and places it in the context of the philanthropic decisions.

This could make an interesting discussion of corporate philanthropy as an occasion to discuss the law and the latitude it affords to management and boards with regard to shareholder primacy, provided the distinctions between U.S. law and Australian law are presented: for example, Australia’s stricter labor laws providing employees greater protection and the prevalence of Australian companies that are controlled by a single large shareholder (or group of shareholders), suggesting that they are not subject to the same pressures faced by public companies in the U.S.

Useful background reading for faculty includes:

“A Contractarian Defense of Corporate Philanthropy”

By Margaret M. Blair, *Stetson Law Review*, Summer 1998, vol. XXVIII, pp. 27-50.

In particular, Part III of this article (pages 42-49) provides a discussion of the law regarding corporate philanthropy. The article embeds this discussion within a larger discussion of why the corporate form has evolved as it has and a presentation of the “team production” model of governance.

And

“Corporate Philanthropy Symposium: Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, The Prisoner’s Dilemma, Sheep’s Clothing, Social Conduct, and Disclosure”

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This paper discusses the general question of so-called “non-maximizing corporate conduct,” with philanthropy as merely one example of such behavior. The author identifies a number of different types of such non-maximizing behavior; shows that in some cases they actually are maximizing behaviors; and then discusses the guidance of the law for those remaining behaviors that do not appear to fit this criteria and the role of disclosure.