MUSINGS

A Copernican Revolution in Corporate Governance

A QUICK QUIZ: What is the purpose of the corporation, as defined by law?

A. To maximize returns for stockholders.

B. To serve the interests of stockholders but also of other stakeholders, such as employees, customers, creditors, suppliers, and communities.

Most people, I suspect, would say that answer B might win points in a philosophical argument, but in a court of law the only correct answer is A.

Wrong.

In a majority of states today (and corporate law is decided at the state level), the answer is B. In the last decade, twenty-nine states have passed new laws called constituency statutes, which explicitly permit corporate directors to consider the interests of a broad community of stakeholders, when deciding what is best for the corporation. It's a kind of Copernican revolution, really, because it means that stockholders are no longer the exact center of the corporate solar system.

These are laws, you might say, that have their head in the clouds and their feet in the boardroom. Conceptually, the groundwork for them was laid by thirty years of academic work in stakeholder theory, and by progressive management practices at companies like Control Data, Merck, and Dayton Hudson—pioneers in managing for stakeholder interests. But politically, what got the laws enacted was resentment against hostile takeovers—a resentment that drew together unlikely coalitions of corporations and unions, Republicans and Democrats.

In drafting constituency statutes, legislators were reacting to the excesses of the 1980s, trying to protect local corporations from takeovers—and thus protect local jobs. In particular, lawmakers wanted to shield corporate boards from shareholder lawsuits, charging that boards failed to maximize every dollar in a takeover decision.

New "constituency statutes" declare that stockholders are not the exact center of the corporate solar system.

Those lawsuits had become especially threatening in the mid-eighties—particularly in Delaware, the leading state for corporate jurisprudence. Court cases there, in one instance, created a new "duty to auction" to the highest bidder when a corporation was up for sale (Revlon v. MacAndrews & Forbes Holdings), and in another instance held directors personally liable—to the tune of $23.5 million—for accepting too low a price when selling a company (Smith v. Van Gorkom). Though directors in the second case never did have to pay (the insurance company and the buyers picked up the tab), the case sent waves of terror through corporate boardrooms nationwide.

In this atmosphere, when judge-made common law was moving toward harsh enforcement of shareholder rights, state legislators began moving in the opposite direction—passing constituency statutes. The laws in essence tell boards they do not have a duty to auction to the highest bidder. And they allow boards to say, in effect: Look, there are other considerations in an acquisition than simply taking the highest bid—considerations like the long-term health of the corporation, employee well-being, and commitment to the local community. Such considerations are legal, even if the upshot is that investors don't get top dollar.

How will these laws be used in court? Only a few cases have shown up so far—but one Pennsylvania case is telling. The 1987 case involved a decision by directors at Commonwealth National Financial Corporation to merge with Mellon Bank rather than Meridian Bancorp, in part because employees would have greater opportunity with Mellon. Citing the state's constituency statute, the court ruled that this consideration was consistent with fiduciary duty. It's a significant change indeed, and is precisely what state legislators intended: that fiduciary duty can extend not only to stockholders but to other stakeholders as well.

THE FIRST OF THESE remarkable little laws was passed by Pennsylvania in 1983. By the end of 1992 twenty-eight states had followed suit, including New Jersey, Massachusetts, Minnesota, Illinois, and Oregon. Conspicuously absent is Delaware, where over half the Fortune 500 is headquartered (though the state has backtracked some from its chilling Revlon and Smith cases). Most constituency statutes "permit" consideration of stakeholder interests, while Connecticut actually mandates such consideration. A few states—among them New York, Iowa, and Missouri—limit constituency statutes to acquisition or merger issues, though most draw the statutes more broadly, to refer to any board decision.

What does it all mean? No one's quite sure yet. The American Bar Association seems to be hoping constituency statutes will mean nothing, and has suggested that boards consider stakeholder interests only if they don't conflict with stockholder interests. Another critic fears the statutes might mean far too much, suggesting—absurdly—that they would allow boards to give away every dime of stockholder equity as some kind of "special bonus" to employees.

No, constituency statutes have not overturned the rights of private property, but they have clarified that those rights don't always trump other rights. Corporations now have a duty to care for—or at the very least not to harm—the interests of a broader community.

In a practical sense, this doesn't mean stakeholder groups can sue when their needs are disregarded. More lawsuits clearly wasn't the intent of these laws. But what the laws will do is give more room to enlightened managers and directors who are already managing for a community of stakeholders—and hopefully embolden more directors to do likewise. Indeed, the laws demonstrate that a new consensus is emerging around the stakeholder model of management.

Because we've lived for so long with the idea that business is only about making profits for shareholders, we've come to see it as some kind of natural law—as unbreakable as the law of gravity. But it's not. It is, quite simply, a state law. And it's a law that's evolving, as the democratic consensus of the community evolves. That evolution is well underway today—a kind of velvet revolution: bloodless, quiet, but no less remarkable.

—MARJORIE KELLY

With this issue, former Managing Editor Craig Cox assumes the mantle of Editor, and Marjorie Kelly moves into the role of Publisher and Editor-in-Chief. At the same time, the Musings column is assuming a new life as an editorial page, where we offer our analyses and opinions on current issues of the day. These changes are part of the magazine's ongoing efforts to create a significant national forum for progressive business views.