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Remarks by

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Thank you for the chance to speak to your Committee today.

I am Dr. Margaret Mendenhall Blair. I am an economist, and a Professor of Law at Vanderbilt University Law School where I specialize in corporate law, corporate finance, and corporate governance.

I want to speak to you today on a question about the fiduciary obligations that corporate directors have, by law, in this country. In particular, I want to address a claim often made in the financial press, and by members of what a Delaware Court judge has recently called the "corporate governance industry."[1] This is the claim that corporate directors have a legal duty to "maximize share value."[2]

What I hope you will take from my testimony today is that this claim is, at best, a misleading overstatement. At worst, this claim is simply false, but is often asserted as a weapon to try to persuade corporate managers and directors that they should take actions that benefit particular shareholders of a given corporation, regardless of whether those actions may impose high costs on creditors, employees, the communities where corporations have their operations, or other stakeholders, or sometimes even on the long run ability of the corporation itself to compete effectively for market share, or to develop the next technology.

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[1] Leo E. Strine, Jr., Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance, 33 JOURNAL OF CORPORATION LAW, 1, 1 (2007) at 5, (describing the "Corporate Governance Industry" as "the strange admixture of public pension fund administrators, proxy advisory and corporate governance ratings organizations, corporate law scholars, and business journalists, who profit in monetary and psychic ways from corporate governance tumult." Strine is Vice-Chancellor of the Delaware Chancery Court. He further adds that "to say these folks profit from tumult is not a normative argument; it is a positive claim." Id.

[2] In a recent article in FOREIGN AFFAIRS, for example, Robert Reich asserted that we cannot rely on corporations themselves to change the rules of the game that are driving them to lay off employees, cut wages, and move production overseas. "Corporate executives are not authorized by anyone – least of all by their investors – to balance profits against the public good," he claimed. Robert B. Reich, How Capitalism is Killing Democracy, FOREIGN POLICY, September/October, 2007. Typical of the share-value maximization rhetoric in the financial press is this quote from a financial analyst discussing Yahoo's recent decision to turn down an acquisition offer from Microsoft: "'While Yahoo!'s board has a fiduciary duty to maximize shareholder returns, running the risk of derailing a deal is dangerous to Yahoo! shareholders,' said Jefferies analyst Youssef Squali." Zachery Kouwe and Peter Lauria, Board Bucks Yang, NEW YORK POST, Feb. 15, 2008, *available at* http://www.nypost.com/seven/02152008/business/board_bucks_yang_97797.htm. Similar claims are repeatedly made in conversations about Yahoo's recent rejection of Microsoft's bid on blogs that follow those companies. *See, e.g.*, Isn't Yahoo! Management Supposed To Work For Its Shareholders? posting by Timothy Lee to TechDirt Blog http://www.techdirt.com/articles/20080304/192104440.shtml (Mar 5th 2008 10:24am). ("If I were a Yahoo! shareholder, I'd be pretty unhappy that things are being framed that way. Yahoo! management has a fiduciary responsibility to me, the shareholder, to maximize the value of my investment.")

Let me begin with an indisputable legal fact: There is no statutory requirement in the U.S. that corporations must maximize profits, or that directors are responsible for maximizing share value. The Model Business Corporation Act, §3.01 says simply, "Every corporation . . . has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation." Delaware Corporate Law just says that a corporation "may be . . . organized under this chapter to conduct or promote any lawful business or purposes."[3] State statutes assign all powers to act for a corporation to its board of directors, but do not in any way prescribe how directors are to carry out this task.[4]

Case law, which, in the U.S. is mostly made in the courts of the state of Delaware, also does not require share value maximization, except in one very narrow circumstance: When, in the course of buyout negotiations, it becomes inevitable that a corporation will be sold, the Delaware Supreme Court has said that directors' duties then change "from defenders of the corporate bastion to auctioneers charged with getting the best price for stockholders at a sale of the company."[5] Note that, implicitly at least, this formulation of the law accepts the proposition that directors may in all other circumstances act to preserve the long-run viability of the corporation itself, even if other actions might be more immediately rewarding to shareholders.

[3] DGCL §101(b).
[4] "All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction . . . of its board of directors." MBCA §8.01(b). "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors. . . ." DGCL §141(a).
[5] *Revlon v. MacAndrews & Forbes Holdings, Inc.*, Del 506 A.2d 173 (1986).

To be sure, courts often note that directors have a duty to act in the best interest of "the corporation and its shareholders."[6] In theory, and sometimes in practice, these interests coincide with one another.[7] But not always.[8] For this reason, courts have always interpreted the mandate to act in the "best interest of the corporation and its shareholders" very broadly, to give directors wide discretion .[9] Moreover, in applying this mandate, courts implicitly or explicitly recognize that the corporation is a separate entity from its shareholders, and that directors' duties normally run to the corporation first. (My colleague Prof. Bruce Scott will say more about the importance of the corporation being a separate legal entity, and I have written about the historical importance of this feature of corporate law.[10] I would be happy to elaborate on this point if this Committee wants to hear about this.)

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[6] "In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders." *Smith v. Van Gorkom*, 488 A2d 858 (Del. 1085). Directors "are charged with an unyielding fiduciary duty to the corporation and its shareholders." *Guth v. Loft, Inc.*, 2 A.2d 225 (Del. Ch. 1938), aff'd, 5 A.2d 503 (Del. 1939).

[7] Law and economics scholars have claimed that, since shareholders are understood to be the "residual claimants" in corporations, maximizing value for shareholders should be equivalent to maximizing total wealth created by the corporation. See Margaret M. Blair, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY, Brookings, 1995, at 227, for a discussion of this line of economic argument.

[8] Finance theory makes it clear that shareholders can be made better off at the expense of other corporate participants by shifting risk onto them. Because shareholders may not be held liable for corporate debts (a protection granted to shareholders under the corporate law doctrine known as "limited liaiblity"), share value can be increased if the corporation engages in highly risky ventures, where shareholders have a chance for substantial gain if the venture works out, but most of the cost of failure falls on creditors.

[9] In a classic case establishing the relevant legal doctrine, shareholders of the Chicago National League Ball Club Inc., which owned the Chicago Cubs, sued directors on grounds of negligence and mismanagement because they would not install stadium lights in Wrigley Field so that the Cubs could play night games. See *Shlensky v. Wrigley*, Illinois Appellate Court, 1968, 237 N.E.2d 776. The court dismissed the complaint for failure to state a claim. See Margaret M. Blair and Lynn A Stout, A Team Production Theory of Corporate Law, 85 *Virginia Law Review* 247 (1999), noting that a series of court decisions in the mid- to late-20th century have "allowed directors to sacrifice shareholders' profits to stakeholders' interests when necessary for the best interest of the 'corporation.' " Courts, for example, have sanctioned directors' decisions to expend corporate resources for charitable purposes, to avoid risky undertakings that would increase profits at the expense of creditors, and to fend off corporate takeover bids that threatened to harm employees or the community. *Id*., at notes 140-148 and surrounding text.

[10] Separate entity status for the corporation serves a crucially important economic function: it allows the corporation to hold assets in the name of the corporation over an indefinite time period, so that, unlike what would happen under default rules of partnership, the assets of a corporation will not be broken up and

Courts recognize that directors and managers must have very broad discretion to balance competing interests in a business enterprise because business decisions are often very complex. Courts further recognize that they should not be making business judgments for directors, or interfering with actions directors take "in good faith."[11] This legal doctrine is called the "business judgment rule."[12]

What this means is that directors are very rarely found in breach of their duties unless they engage in blatantly self-dealing behavior.

I by no means intend to suggest here that, in today's world, corporate directors and managers are not under significant pressure to find ways to increase share value,

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distributed when a shareholder dies or becomes insolvent or wants to redeploy her wealth. The shareholder is instead free to sell her shares, but she cannot force dissolution of the corporation itself. The ability to keep assets invested in an enterprise for an indefinite time was critical to the development of the railroads, and other businesses that required long-lived specialized capital investment. For an extensive discussion of how these rules developed under corporate law in the 19th Century U.S., see Margaret M. Blair, Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century, 51 UCLA LAW REVIEW, 2 (2003), 387.

[11] A classic statement of this position is the court's opinion in *Shlensky*, supra note 7 ("We are not satisfied that the motives assigned to Philip K. Wrigley, and through him to the other directors, are contrary to the best interests of the corporation and the stockholders. For example, it appears to us that the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. . . . By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one.
That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality of conflict of interest. . . we feel that unless the conduct of the defendants at least borders on one of the elements, the courts should not interfere." See also *In re Caremark International, Inc. Derivative Litigation* 698 A.2d 959 (Del. 1996) ("Whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests." (emhpasis in original))

[12] See e.g. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), at 812 ("The business judgment rule is an acknowledgement of the managerial prerogatives of Delaware directors under Section 141(a). It is a presumption that in making a business decision the directors of a corporation acted in an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts.")

sometimes even at the expense of the long run performance of the company.[13] But let me be clear that this pressure comes from the media, from shareholder advocates and financial institutions in whose direct interest it is for the company to get its share price to go up, and from the <u>self-imposed pressure</u> created by compensation packages that provide enormous potential rewards for directors and managers if stock prices go up. And by the way, those compensation packages also impose very little downside cost on managers or directors if stock prices decline, which means that managers also often have huge incentives to cause their companies to take very big risks in their efforts to achieve higher share prices.

These pressures might be alleviated with certain policy actions that this body and/or other regulatory bodies could, in theory, take. In Britain, for example, the British Companies Act 2006 explicitly codified what lawmakers believed to be the rule under their case law, which provides that directors have duties to multiple stakeholders.[14] A

[13] Numerous shareholder proposals filed with the SEC, seeking to urge or compel directors to take certain actions, including selling off divisions, paying special dividends, or accepting a takeover offer from another company, justify their proposal on the grounds that the action would "maximize share value." *See, e.g.*, Schedule 14A filed with the Securities and Exchange Commission by Wisconsin Central Shareholders Committee to Maximize Value, SEC File 0-19150, Oct. 23, 2000, announcing a proxy fight against directors of Wisconsin Central Transportation Corp. ("Edward A. Burkhardt, former Chairman, President and Chief Exeuctive Officer of Wisconsin Central Transportation Corporation (NASDAQ:WCLS), today announced the formation of a committee to improve company performance and to maximize share value."). Available at http://www.secinfo.com/dsvRs.55Wm.htm.

[14] (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

change in the tax rules, for another example, might reduce the current tax preference that makes compensation packages based on "stock options" so attractive relative to other approaches to executive compensation.[15]

In sum, decisions by managers and directors of U.S. corporations to choose investment strategies that may be profitable in the short-run, but that sell our country short by moving value-creating activities offshore, are decisions that those managers and directors must take personal responsibility for. These decisions are absolutely not mandated by law.

(I have some thoughts about how and why the notion that corporate managers must maximize share value came to be so widely accepted in the last three decades. But that is a longer story that I will not undertake to tell here unless the Committee wants to hear it. Instead I attach to this testimony a copy of Margaret M. Blair, Shareholder Value, Corporate Governance and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom" . CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY, Peter K. Cornelius and Bruce Kogut, eds., Oxford University Press, January 2003 Available at SSRN: http://ssrn.com/abstract=334240)

Companies Act 2006, c. 46, § 172, *available at* http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_13#pt10-ch2

[15] For a general discussion of how stock options receive favorable tax treatment, see Shevlin, Terry J. and Hanlon, Michelle, Accounting for the Tax Benefits of Employee Stock Options and Implications for Research (April 2001). University of Washington Working Paper. Available at SSRN: http://ssrn.com/abstract=271310 or DOI: 10.2139/ssrn.271310