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CORPORATE LAW AND THE ROLE OF CORPORATIONS IN SOCIETY: MONISM, PLURALISM, MARKETS AND POLITICS

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In light of the Supreme Court's decision in Peoples Department Stores v. Wise, the author examines the debate in corporate law as to whether corporate managers should be concerned exclusively with the pursuit of wealth for the stockholders, or whether they should be thought of as having a broader mandate. Although the normative debate has been inconclusive within the corporate law academy, the author argues that it may usefully be recharacterized as a debate about the respective roles of two modalities of social decision-making: markets and politics. The advantage of this redescription is that it brings to the fore considerations that are overlooked or misconceived in the debate as it is conventionally structured.

À la lumière de la décision rendue par la Cour suprême dans l'arrêt Peoples Department Stores c. Wise, l'auteur se penche sur la question de savoir si, en droit des sociétés, le mandat des dirigeants d'entreprise devrait se limiter à la recherche de profits pour les actionnaires ou si ce mandat devrait s'étendre à d'autres objectifs. Bien que le débat normatif n'ait pas abouti à un consensus sur cette question parmi les universitaires en droit des sociétés, l'auteur soutient qu'il serait utile de repenser le problème en termes des rôles respectifs de deux modalités de prise de décisions sociales, qu'on peut nommer les marchés et les politiques. L'avantage d'une telle réorientation du débat est qu'elle met en évidence certaines considérations qui sont souvent occultées ou mal interprétées dans le débat tel qu'il est actuellement structuré.

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1. Introduction

Are the managers of a corporation best viewed as custodians of shareholders' money and thus accountable only to the shareholders, or are they the leaders of an institution that has social responsibilities of its own?[1] What does corporate law require of corporations and their managers? Does it require them always to act solely with a view to maximizing stockholder profits, or may management sometimes be justified in pursuing a less profitable course out of a concern for the interests of employees, the environment, or even society as a whole?

These are the questions with which, from a corporate law perspective, the longstanding debate about the role of corporations in society is concerned. In this debate, two basic positions may be identified, which we may call "monism" and "pluralism."[2] According to the monist view, managers' powers are to be used exclusively for the purpose of generating wealth for the shareholders, and "social responsibility" may enter into consideration only as a means to this end. Exemplary of this view is Lord Bowen's famous admonition in *Hutton v. West Cork Railway* that "[t]he law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company."[3]

Pluralism considers that shareholders are but one constituency among many, and conceives of the manager's role as advancing some conception of the common interest of all of the constituencies. Where the interests of constituencies conflict, pluralists believe that managers ought to balance them against one another in some fair manner rather than automatically favouring the shareholders' interests.[4] The French concept of "*intérêt*

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[1] This article is concerned with widely-held corporations, those whose shares trade on a stock exchange and have many shareholders. In this essay, the term "corporation" without a modifier should be understood as referring to a widely-held corporation.

[2] The French economist Michel Albert has used similar terms to describe these positions: "monisme actionnarial" and "pluralisme partenarial." See M. Albert, "Quels modèles d'entreprise pour un développement durable ?" (Lecture to the *Académie des sciences morales et politiques*, Dec. 2002). Robert Clark has also employed the term "monism" as a label for the empirical claim, in relation to a particular apparently "publicly-spirited" decision or to such decisions in general, that they are in reality "conducive to profit maximization in the long run." See R. Clark, *Corporate Law* (Boston: Little Brown, 1986) at §16.2.2.

[3] (1883), 23 Ch. D. 654 at 673 [*Hutton*].

[4] Within pluralism, one may distinguish between mandatory and permissive pluralistic duties. The former would obligate managers to take into account the interests of non-shareholders, perhaps granting the latter a cause of action. See, for example, L. Mitchell, "A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes"

social" may be thought of as exemplifying the pluralist view.[5]

There is, in addition, an intermediate position, which may be called qualified monism. Adherents of qualified monism believe that the mandate of managers is to generate wealth for the shareholders, but that under some circumstances, this goal may yield to other considerations. Many different versions of qualified monism are imaginable, differing from one another as to the circumstances that will justify departures from orthodox monism. One well-known example is the Delaware-law notion that "[a]t least…in the vicinity of insolvency, a board of directors is not merely the agent of the [shareholders], but owes its duty to the corporate enterprise."[6] An example along different lines is the American Law Institute's *Principles of Corporate Governance*, which endorse monism but nonetheless contemplate that directors and officers may act "on the basis of ethical considerations even when doing so would not enhance corporate profit or shareholder gain."[7]

Each of these three positions found favour with one of the courts that heard the *Peoples Department Stores v. Wise* litigation. Greenberg J. of the Quebec Superior Court endorsed qualified monism, citing with approval an article by Jacob Ziegel[8] as well as several Commonwealth judicial decisions that have in essence held that "creditors are entitled to consideration…if the company is insolvent, or near-insolvent, or of doubtful insolvency, or if a contemplated…course of action would jeopardise its solvency."[9]

Writing for a unanimous panel of the Quebec Court of Appeal, Pelletier J.A. endorsed a more orthodox monism. The "traditional perspective," he wrote, "see[s] the interests of the corporation as coinciding with the interests of all of the shareholders in the pursuit of the objectives of the creation of the corporation."[10]

(1992) 70 Tex. L. Rev. 579. The latter would authorize managers to take into account the interests of non-shareholders, without obliging them to do so. See, for example, E. Elhauge, "Sacrificing Corporate Profits in the Public Interest" (2005) 80 N.Y.U. L. Rev. 733.

[5] See Association française des entreprises privées and Conseil national du patronat français, *Le conseil d'administration des sociétés cotées (Rapport Viénot I)* (1995) at 8.

[6] *Crédit Lyonnais Bank Nederland N.V. v. Pathé Communications Corp.* (1991), No. 12150, 1991 LEXIS 215 (Del. Ch. Dec.30, 1991) at 108.

[7] American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (St. Paul: The Institute, 1992) at § 2.01(b).

[8] J. Ziegel, "Creditors as Corporate Stakeholders: The Quiet Revolution - An Anglo-Canadian Perspective," (1993) 43 U. Toronto L.J. 511.

[9] *Peoples Department Stores v. Wise* (1998), 23 C.B.R. (4th) 200 at paras. 190-203 (Que. S.C.).

[10] *Peoples Department Stores v. Wise* (2003), 244 D.L.R. (4th) 509 at para. 82 (Que.

For its part, the Supreme Court of Canada chose pluralism:

> [I]t is clear that the phrase the 'best interests of the corporation' should be read not simply as the 'best interests of the shareholders.'…[I]n determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.[11]

Unlike Greenberg J., who acknowledged that he was innovating in following a course charted by other Commonwealth courts,[12] the Quebec Court of Appeal and the Supreme Court of Canada both claimed that their diametrically opposed interpretations of the "best interests of the corporation" were settled law. In reality, the law was far from settled. While the only Canadian case on point, *Teck Corp. Ltd. v. Millar*,[13] seemingly endorsed pluralism,[14] the supporters of monism argue that the *Teck* court's rejection of the "classical theory" was obiter.[15] On the other hand, the authorities relied on by monists, *Hutton*[16] and *Parke v. Daily News Ltd*.,[17] are English trial court decisions that, although clearly adopting the monist position, have yet to be applied in Canada in a case involving the duties of corporate directors.[18]

C.A.) (in the original version: "[la] perspective traditionnelle…tend à faire coïncider l'intérêt de la société avec celui de l'ensemble des actionnaires dans la poursuite des objets pour lesquels la société a été formée").

[11] *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461 at 481-82.

[12] *Supra* note 9 at para. 200 (stating that Canadian law should "evolve" in the direction indicated by the Commonwealth decisions cited).

[13] (1972), 33 D.L.R. (3d) 288 (B.C.S.C.) [*Teck*].

[14] For example, Berger J. wrote: "A classical theory that once was unchallengeable must yield to the facts of modern life…. [If the directors] observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company."

[15] See, for example, W. Gray, "*Peoples v. Wise* and *Dylex*: Identifying Stakeholder Interests Upon or Near Corporate Insolvency – Stasis or Pragmatism?" (2004) 39 Can. Bus. L.J. 242 at 243, note 3; J. MacIntosh, "The End of Corporate Existence: Should Boards Act as Mediating Hierarchs?: A Comment on Yalden," in A. Anand and W. Flanagan eds., *The Corporation in the 21st Century: Ninth Annual Queen's Business Law Symposium* (Kingston: Queen's University Press, 2003).

[16] *Supra* note 3.

[17] [1962] 1 Ch. 927 (Ch.D.).

[18] In addition to these cases, additional "circumstantial evidence" might be cited on either side of the debate. For example, supporters of monism have pointed to the fact that courts have occasionally equated the interests of the corporation with those of "all of the shareholders." See, for example, *Palmer v. Carling O'Keefe* (1989), 67 O.R. (2d) 161 (H.C.). However, these cases have involved conflicts among shareholders as opposed to

With the Supreme Court's endorsement of pluralism, the law may now be settled.[19] On the other hand, the normative debate between monists and pluralists remains inconclusive, although the monist position predominates among corporate law scholars in North America.[20] In this essay, I analyze this debate and argue that what is ultimately at stake is the respective roles of two different modalities of social decision-making: markets and politics. I then offer a sympathetic interpretation of the Supreme Court's endorsement of pluralism in *Peoples v. Wise*, before closing with two cautionary notes.

2. Monism versus Pluralism

The normative debate between monism and pluralism has taken place on two levels, the conceptual and the pragmatic. At one level, the debate may be seen as a confrontation of two conceptual arguments: the notion that the shareholders are the corporation's owners versus the notion that incorporation is a concession, or privilege, granted by the state. At another level, monists and pluralists exchange arguments about the social welfare consequences of limiting the manager's mandate to the maximization of the shareholders' wealth, or of broadening it to encompass additional considerations.

A. Property or Concession: Neither Here nor There

I begin with the two conceptual arguments. Although they continue to have popular resonance, both arguments have been discredited, or at least neutralized, in the academic debate.

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conflicts between shareholders' interests and the interests of non-shareholder constituencies. The proposition that the directors may not give preference to the sectional interest of one group of shareholders at the expense of the others does not entail the proposition that only the interests of the shareholders are relevant. For their part, pluralists may point to the amendment of s. 137(5)(b) of the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 [*CBCA*] to eliminate a provision that permitted management to dispense with circulating a shareholder proposal if it had been submitted "primarily for the purpose of promoting general economic, political, racial, social or similar causes." See note 91 *infra*.

[19] On the other hand MacIntosh, *supra* note 15, (himself a monist) has suggested in conversation that the Supreme Court's endorsement of pluralism, like that of Berger J. in *Teck*, is obiter. I also refer below to the experience in Delaware, where a final appellate court decision that at first glance appeared to endorse pluralism, did not in fact end the debate. See text accompanying notes 103 and 104, *infra*.

[20] See, for example, H. Hansmann and R. Kraakman, "The End of History for Corporate Law" (2001) 89 Geo. L.J. 439 at 439.

The first of these arguments holds that corporations ought to be managed in the shareholders' interests because a corporation's shareholders are its owners. Milton Friedman, who is perhaps the best known exponent of this view, declared that "the corporate executive, the manager, is the agent of the individuals who own the corporation [i.e., the stockholders]…and his primary responsibility is to them."[21] This view of the relationship between corporations and stockholders has its origins in the conception of the corporation that prevailed in the Anglo-American world in the nineteenth century. Often referred to as the "aggregate" theory, this conception analogized the corporation to a partnership, and the stockholders to the owners of the business.[22]

Hutton ("no cakes and ale") dates from this period.[23] So does *Santa Clara County v. Southern Pacific Railway Co.*,[24] in which the Supreme Court of the United States held that corporations are entitled to the protection of the Fourteenth Amendment, apparently because impairments of corporate property were in substance infringements of shareholders' property rights.[25]

As Morton Horwitz observed, the aggregate theory fell out of fashion in the opening years of the twentieth century.[26] Corporations grew exponentially in size as legal barriers to corporate consolidation were eliminated.[27] Shareholders increased in number and anonymity, coming to resemble passive suppliers of capital more than business owners. Taking the place of the aggregate conception was the "entity" theory, according to which the corporation was not the property of the stockholders, but rather an institution within society.[28] This view conceptualized corporate managers not as employees exercising powers delegated to them by the shareholder-owners of the corporation, but as the leaders of great institutions with social responsibilities potentially going far beyond the pursuit of profits for the stockholders. Merrick Dodd's articulation of this

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[21] M. Friedman, "The Social Responsibility of Business is to Increase its Profits", *New York Times Magazine* (Sept. 13, 1970).

[22] See W. Allen, "Our Schizophrenic Conception of the Corporation" (1992), 14 Cardozo L. Rev. 261, at 266-70 (Allen refers to this conception as the "property" conception); M. Horwitz, "*Santa Clara* Revisited: The Development of Corporate Theory" (1985) 88 W. Va. L. Rev. 173 at 182.

[23] *Supra* note 3.

[24] 118 U.S. 394 (1886).

[25] Horwitz, *supra* note 22 at 177.

[26] *Ibid*. at 223.

[27] An important episode was New Jersey's amendment of its general corporations statute to permit corporations to own shares in other corporations, a reform that marked the beginning of inter-state competition for incorporations: see Horwitz, *ibid.* at 195.

[28] Allen, *supra* note 22 at 265.

argument in 1932 remains a staple of the literature.[29]

However, when I suggest that the ownership argument for monism has been discredited, my point is not simply that the aggregate conception on which it rests has been superseded. There is a more fundamental problem with the ownership argument: it is circular.[30] Ownership and property are legal constructs. As a generation of lawyers in North America has been taught, property is a "bundle of rights." After ascertaining the shareholder's bundle of rights, including determining whether it includes a right to the manager's undivided allegiance, we may for convenience attach a familiar shorthand label to those rights, such as "ownership." However, to invoke ownership as a ground for the existence of a component right is to assert a conclusion without justifying it.

A second discredited, or at least neutralized, argument is invoked mainly by the supporters of pluralism. The concession theory maintains that since corporations are creatures of the state, the state is justified, in the public interest, in imposing special conditions on the conduct of business by corporations. In particular, pluralists argue that society is entitled to expect that corporations will carry on business with due regard for the public interest. Allan Hutchinson, for example, has recently argued that:

> Corporations are public creations which are brought into existence and sustained by legislative enactment…. If particular individuals wish to avail themselves of the many private benefits of incorporation…it seems entirely fair and appropriate that they assume a reciprocal series of public responsibilities.[31]

Like the aggregate theory, the concession theory likely had greater descriptive resonance in an earlier age. Specifically, the notion of incorporation as a privilege seems an apt description of the situation when incorporation required a special act of Parliament or a discretionary grant of letters patent by the sovereign and was often accompanied by monopoly privileges.

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[29] E.M. Dodd, Jr., "For Whom Are Corporate Managers Trustees?" (1932) 45 Harv. L. Rev. 1145 esp. at 1148, 1161.

[30] L. Stout, L. Mitchell and W. Allen, among others, have also pointed out the circularity of the ownership argument. See L. Stout, "Bad and Not-So-Bad Arguments for Shareholder Primacy" (2002) 75 S. Cal. L. Rev. 1189; L. Mitchell, *Corporate Irresponsibility: America's Newest Export* (New Haven: Yale University Press, 2001) at 124; Allen, *supra* note 22 at 269; E. Weinrib, "The Fiduciary Obligation" (1975) 25 U. Toronto L.J. 1 at 10-11.

[31] A. Hutchinson, *The Companies We Keep: Corporate Governance for a Democratic Society* (Toronto: Irwin Law, 2005) at 9.

Arguably, the general availability of incorporation by registration takes much of the wind out of the sails of the concession theory.[32] Indeed, the theory's polar opposite — the "nexus of contracts," or contractarian conception of the corporation — is now the dominant understanding of the corporation within the corporate law academy.[33] This conception views the corporation as a collection of voluntary relationships — "contracts," in law and economics jargon — among the shareholders, employees and other participants in the business. In enacting general incorporation statutes, the state does little more than provide a facility for the exercise of freedom of contract by these participants. Even statutorily limited liability, except perhaps for torts, can be understood as part of the participants' bargain. In this conception, such liability is merely a default rule which the participants may waive, if they so desire.[34]

The weakness of the concession theory does not reside solely in the challenge posed by its rival, contractarianism. One may concede that corporations are creatures of the law — this is no less true of the institutions of property and contract themselves — and that it is legitimate for the state to organize or regulate them in a way that maximizes social welfare. The question then becomes whether social welfare is more likely to be maximized if corporate managers focus on the shareholders' interests than if they pursue a broader set of goals.[35] Thus, even if one accepts its premise, the concession theory does not resolve the debate between monism and pluralism.

B. Pragmatic Arguments

Perhaps in recognition of the indeterminacy of the conceptual arguments, and with the rise of the economic analysis of corporate law, scholars have turned to pragmatic arguments in the debate between monism and pluralism. The question addressed by such arguments is not "What is a corporation?" or "Who are the corporation's owners?" but, instead, "What are the consequences for social welfare of opting for monism rather than pluralism, or vice versa?"

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[32] See Horwitz, *supra* note 22 at 184.

[33] M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305; F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991).

[34] See P. Halpern, M. Trebilcock and S. Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 U. Toronto L.J. 117; H. Hansmann and R. Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) 100 Yale L.J. 1879.

[35] See, for example, Hansmann and Kraakman, *supra* note 20 at 441.

(a) Social Costs versus Agency Costs

The basic social trade-off concerns, on the one hand, the costs imposed upon non-shareholders by corporations' pursuit of shareholder wealth, and, on the other hand, the agency costs (borne in the first instance by shareholders) resulting from the increased managerial discretion that a broader mandate would entail**.**

With respect to the social costs imposed by monism, it is a truism that the maximization of one value (for example, shareholder wealth) will sometimes occasion the impairment of some global value of which it is but one component (for example, social welfare).

The defenders of monism rightly point out that mechanisms exist whereby social welfare and shareholder wealth may be aligned to a considerable extent.[36] For instance, enlightened self-interest ensures that profit-focused managers pay heed to the interests of non-shareholders to the extent that doing so is a cost-effective way of purchasing customer patronage, employee loyalty, and so on.[37] As even Lord Bowen readily acknowledged, "Most businesses require liberal dealings."[38] In any case, where managers have insufficient incentives to take particular social interests into account, regulatory law may step in and impose a standard of conduct backed by fines or other sanctions. Nevertheless, although these mechanisms ensure that the gap between profit-maximizing and socially optimal conduct is smaller than might otherwise be assumed, it is difficult to deny that a gap exists.

On the other hand, pluralism imposes costs of its own in the form of increased agency costs.[39] The argument is a familiar one: the performance of managers under a broad mandate is more difficult to evaluate than their performance under a narrow mandate. The corporation's financial statements and its stock price, for example, provide rough signals of whether the managers have succeeded in increasing shareholder wealth. By contrast, how can anyone know whether the managers have increased social welfare, or even the joint wealth of the corporation's participants? The consequence of these difficulties is an increase in agency costs:

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[36] See, for example, Easterbrook and Fischel, *supra* note 33, at 38; D. Fischel, "The Corporate Governance Movement" (1982) 35 Vand. L. Rev. 1259 at 1269; S. Bainbridge, "In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green" (1993) 50 Wash. & Lee L. Rev. 1423 at 1439.

[37] A. Meese, "The Team Production Theory of Corporate Law: A Critical Assessment" (2002) 43 Wm. & Mary L. Rev. 1629 at 1639.

[38] *Hutton*, *supra* note 3 at 672.

[39] Stout, *supra* note 30 at 1200.

expanded opportunities for the managers to pursue their own interests at the expense of the interests of shareholders and non-shareholders alike, and increased monitoring expenditures by shareholders and non-shareholders.[40] This is true, monists add, regardless of whether pluralism is formulated in permissive terms (as in the Supreme Court's decision in *Peoples*) or in mandatory terms, for a duty to all is a duty to no one.[41]

But the agency costs entailed by pluralistic legal duties may also be less than is sometimes understood. In particular, one may question whether defining managers' duties under corporate law in non-pluralistic terms is of much use in controlling agency costs, in light of two factors. First, it is almost always possible to construct a rationalization in terms of the "long-term" interests of shareholders for an act that is immediately beneficial to non-shareholders. Second, it is virtually impossible in practice for a shareholder litigant to challenge successfully any such rationalization, because of the reluctance of courts to second-guess managers' business judgment.[42] *Dodge v. Ford Motor Co.*, nominally a leading authority for monism, in fact illustrates the powerlessness of a monist legal standard.[43] Despite rapping Henry Ford's knuckles for overtly disavowing a profit motive, the court declined to interfere with his radical plan to raise wages and reduce prices, because "judges are not business experts" and the court could not be certain that the plan would not ultimately lead to greater profits for the Ford Motor Co.[44] Indeed, many scholars otherwise sympathetic to monism agree that in controlling agency costs, it is the market for corporate control rather than directors' duties that does the heavy lifting.[45]

Although both the agency costs associated with pluralism and the social costs entailed by monism are smaller than is often assumed, an

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[40] M. Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) 149 U. Pa. L. Rev. 2063 at 2065; S. Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance" (2003) 97 Nw. U. L. Rev. 547 at 581.

[41] Easterbrook and Fischel, *supra* note 33 at 38 ("[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither.").

[42] *Brant Investments v. Keep Rite Inc.* (1991), 3 O.R. (3d) 289 (C.A.) (articulating the business judgment rule). In Delaware, see *Aronson v. Lewis*, 473 A.2d 805 at 812 (Del. 1984).

[43] 204 Mich. 459 (Mich. 1919).

[44] *Ibid.* at 507-08.

[45] The position is most notably associated with Henry Manne. See H. Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. Pol. Econ. 110. Manne's argument has been influential: one study found his article to be the most-cited law review article of all time. See W. Carney, "The Legacy of 'The Market for Corporate Control' and the Origins of the Theory of the Firm" (1999) 50 Case W. Res. L. Rev. 215 at 225.

unanswered, and perhaps unanswerable, question remains as to which of the two types of cost is greater in magnitude. Arguments commonly advanced on one side or the other of the debate typically emphasize one type of cost and ignore the other, leaving the debate inconclusive. In the next two sections, I examine two such arguments: the "residual claimants" argument for monism and the "team production" argument for pluralism.[46]

(b) The "Residual Claimants" Argument

The "residual claimants" argument is an attempt to break the stalemate by showing that monism is not only in the interests of shareholders; it is also in the interests of non-shareholders.

Shareholders are said to be the "residual claimants" in the sense that, upon liquidation of the corporation, all claims on the corporation's assets by parties other than the shareholders — that is, by lenders, employees, customers, the state, and so on — must be fully paid before the shareholders may receive any payment on account of their shares. Once the claims of the other parties have been paid in full, the remaining assets are distributed to the shareholders.

When the shareholders' status as residual claimants is invoked as part of a normative argument in support of monism, what is meant is that the maximization of the value of this "residual claim" also maximizes the value of the enterprise as a whole, since the other claims, not being residual, are "fixed."[47] There are two possible interpretations of this argument. First, the argument appears to assume that actions taken to maximize the value of the shareholders' "residual claim" can have no negative impact on non-shareholder claimants. However, the assumption underlying this version of the argument is patently unrealistic. In every case where the choice between monism and pluralism will make a difference to a particular decision, the choice that maximizes the wealth necessarily harms non-shareholders. Where the benefit to shareholders is outweighed by the harm to non-shareholder claimants, the decision that maximizes shareholder wealth is (by definition) socially detrimental, and it is possibly even destructive of enterprise value.

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[46] A more detailed discussion of these arguments may be found in I. Lee, "Efficiency and Ethics in the Debate about Shareholder Primacy," Del. J. Corp. L. (forthcoming 2006) ["Efficiency and Ethics"] (criticizing the team production theory) and I. Lee, "Corporate Law, Profit Maximization, and the 'Responsible' Shareholder" (2005) 10 Stan. J.L. Bus. & Fin. 31 at 50-52 ["Responsible Shareholder"].

[47] See, for example, MacIntosh, *supra* note 15 at 63 (arguing that since shareholders are the residual claimants, "when directors seek to maximize the value of the shares, they will tend in the majority of situations to maximize the aggregate (or 'global') value of the corporation").

The second possible interpretation of the residual claimants argument acknowledges that corporate decisions may harm non-shareholder claimants, but invites us to treat such harm as irrelevant because it is part of the non-shareholders' "fixed" bargain.[48] This interpretation raises the question as to why we should assume that the non-shareholders have agreed to assume the risk of such harm, in other words, why we should assume that their bargain is "fixed" in this particular respect.

An argument from agency costs allegedly supplies the reason. Because of agency costs, the enterprise is worth more as a whole if a single constituency with homogeneous interests is designated to be the exclusive beneficiary of the managers' allegiance (that is, to be the only residual claimants), than if the managers' allegiance is dispersed among numerous constituencies. The other constituencies receive "fixed" terms adequate to compensate them for their participation in the enterprise — if they were not adequate, then they would not choose to participate. Indeed, since the value of a monist enterprise is greater, non-shareholder constituencies may receive richer albeit fixed terms for their participation in a monist enterprise than they would in a pluralist enterprise.

Thus, the more sophisticated version of the residual claimants argument invites us to conclude that, because of the agency costs advantages of monism, non-shareholders have accepted and been compensated for their "fixed" status.

Although the agency costs argument is attractive, we should not accept without qualification the proposition that non-shareholder constituents have implicitly agreed to assume all unforeseen risks. In particular, we have reasons to doubt that non-shareholders can be understood to have assumed the risk of high-potential-harm, low-probability occurrences. Risk-averse individuals would require such a high level of fixed compensation for such risks that it may well be uneconomical to provide it. At least for such risks, we have as much reason to assume, in the absence of explicit agreement to the contrary, an agreement to try to avoid causing the harm, even if managerial discretion is thereby increased.

Moreover, even assuming monism's attractiveness to the parties to the corporate "nexus of contracts" — shareholders, employees, creditors and customers — there remains the question whether its advantages are outweighed by the costs it may impose on non-parties, such as the victims of tortious harm or environmental damage. The stalemate, therefore, remains intact.

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[48] The argument is an application of the "nexus of contracts" conception of the corporation.

(c) The "Team Production" Theory

An important recent pluralist contribution to the debate has suggested that, in addition to the harm to non-shareholder interests traditionally understood to represent the social costs of monism, monism may impose another type of cost. Margaret Blair and Lynn Stout's "team production" theory conceptualizes the corporation as a team and all those who commit resources to the corporation — shareholders, workers, suppliers, and so on — as team members.[49] According to Blair and Stout, a characteristic of production in teams is that the team members need to be induced to make "firm-specific investments," by which these authors mean essentially any commitment of resources that the team member cannot be completely certain will be recoverable or compensated.[50] To give a concrete example, it is helpful if workers put in more than the minimum amount of effort that prevents their dismissal, but they will be reluctant to do so if they are not certain that once made, these investments will be rewarded. That shareholders need to be induced to invest capital, even though there is no guarantee that they will get their money back, is a further example. Of course, the team members often draw up detailed contracts to protect themselves, but extra effort is often better generated through implicit understandings.[51]

The guardian of these implicit understandings is the board of directors, which Blair and Stout refer to as a "mediating hierarchy."[52] The board's function is to be a trustworthy and disinterested party; it is not itself a member of the team, has no claim of its own on the team's output, and must not be dominated by any member of the team.[53] The board is responsible for coordinating the team's activities and dividing

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[49] M. Blair and L. Stout, "A Team Production Theory of Corporate Law" (1999) 85 Va. L. Rev. 247 ["Team Production"]; M. Blair and L. Stout, "Director Accountability and the Mediating Role of the Corporate Board" (2001) 79 Wash. U.L.Q. 403 ["Director Accountability"].

[50] Blair and Stout, "Team Production," *ibid.* at 272 *et seq.* The language of "firm-specific investment" conjures images of investment by employees in the acquisition of specialized skills or by suppliers in the acquisition of special technology, but the concept in fact includes any "irrevocable commitment of resources" — including generic resources such as money and fungible labour. Blair and Stout, "Team Production," *ibid.* at 272. For elaboration on this observation see Lee, "Efficiency and Ethics," *supra* note 46, at 20-22.

[51] See, along similar lines, A. Schleifer and L. Summers, "Breach of Trust in Hostile Takeovers," in A. Auerbach, ed., *Corporate Takeovers: Causes and Consequences* (Chicago: University of Chicago Press, 1988) and B. Chapman, "Trust, Economic Rationality, and the Corporate Fiduciary Obligation" (1993) 43 U. Toronto L.J. 547.

[52] Blair and Stout, "Team Production," *supra* note 49 at 250-51; Blair and Stout, "Director Accountability," *supra* note 49 at 404.

[53] Blair and Stout, "Director Accountability," *ibid.* at 421.

up the fruits of its labour among the team members.

In light of the agency costs problem, I would question the wisdom of Blair and Stout's bottom-line suggestion that the board should be free of the control of any member of the team.[54] Nevertheless, Blair and Stout's analysis usefully identifies an additional cost of monism. If managers are required to attend exclusively to the maximization of the shareholders' wealth, then they must in particular renege on implicit understandings with non-shareholders whenever this would be the most profitable course of action, that is, whenever they can get away with it. Since implicit understandings are precisely those that rest upon trust rather than sanctions, they are inherently vulnerable to being reneged upon. Consequently, monism imposes costs by weakening the commitment value of implicit understandings and thereby depriving firms of one means of inducing irrevocable investments of effort and other resources by participants in the venture. The question remains, of course, whether the costs of monism, including the cost identified by Blair and Stout, outweigh or are outweighed by the agency costs of pluralism.

3. Markets versus Politics

The debate within law and economics between monism and pluralism is stalemated because of the difficulty (or impossibility) of measuring the agency costs of pluralism or the social costs of monism. In this part of the essay, I want to suggest a different approach to the debate. I do not claim anything so ambitious as that this approach resolves the debate. My suggestion is, more modestly, that we may better understand the strengths and weaknesses of the two positions if we think of the debate in terms of two different modalities of social decision-making that we may call "markets" and "politics."[55]

A. Markets and Politics Explained

By the term "markets," I mean the mechanism whereby social decisions

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[54] For detailed criticisms of the team production theory, see D. Millon, "New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law" (2000) 86 Va. L. Rev. 1001; Meese, *supra* note 37; J. Coates IV, "Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?" (1999) 24 J. Corp. L. 837; MacIntosh, *supra* note 15; Lee, "Efficiency and Ethics," *supra* note 46.

[55] For other explorations of the dichotomy between markets and politics, see A. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Cambridge, Mass.: Harvard University Press, 1970); D. Farber, *Eco-Pragmatism: Making Sensible Environmental Decisions in an Uncertain World* (Chicago: University of Chicago Press, 1999); I. Lee, "Is There a Cure for Corporate 'Psychopathy'?" (2005) 42 Am. Bus. L.J. 65 ["Corporate Psychopathy"].

are made indirectly (as if guided by an invisible hand) by the aggregation of innumerable voluntary transactions among individuals. We rely on the market mechanism for a great many social decisions. To take a simple example, consider why it is that in an airplane there are two, if not three or four, classes of passengers. The reason, of course, is that some people are willing to pay more for the privilege of sitting at the front and enjoying greater comfort, while others are willing to ride at the back and forgo certain amenities if they can pay less, and the airline has determined that it makes sense to provide both choices. A social decision, namely the separation of airplane passengers into classes and the entitlements of the members of each class, is the result of aggregated private decisions.

By "politics" I mean a process involving collective deliberation, that is to say a process whereby decisions are taken on a collective basis following consideration of reasons.[56] It is not difficult to find examples of this mechanism at work. For instance, consider why it is that law students at the University of Toronto cannot take summer courses for credit. The explanation is that, following an exchange of arguments concerning, among other things, fairness, the relevant body (Faculty Council) made a decision, on behalf of the law school, not to permit it.

The virtues of the market mechanism are well known. The market's reliance on voluntary transactions is respectful of individual autonomy. Moreover, social trade-offs arrived at through the aggregation of the priorities revealed by individuals in actual transactions may more faithfully reflect their preferences than would, for example, a decision based on a bureaucrat's judgment of the value of the interests at stake from a perspective external to the affected individuals.

But the market does not only have virtues; it also has inherent limitations. I am not referring here to so-called market imperfections, such as problems relating to collective action, transaction costs or asymmetric information.[57] These may of course be significant, but in addition the market mechanism has limitations that are inherent, in the sense that they

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[56] In its emphasis on discourse and reasons, my definition of politics evokes the notion of "deliberative democracy" familiar to political theorists. See, for example, A. Gutmann and D. Thompson, *Democracy and Disagreement* (Cambridge, Mass.: Belknap Press of Harvard University Press, 1996); J. Fishkin, *Democracy and Deliberation: New Directions for Democratic Reform* (New Haven: Yale University Press, 1991); J. Rawls, "The Idea of Public Reason Revisited" (1997) 64 U. Chi. L. Rev. 765. Whereas deliberative democrats offer their theory of public reasoning as an alternative to the conceptualization of democracy as majoritarian vote aggregation, my account highlights collective, reasoned decision-making as a counterpart to the invisible hand of the market.

[57] See M. Trebilcock, *The Limits of Freedom of Contract* (Cambridge: Harvard University Press, 1993).

are characteristics even of a perfectly functioning market. One important limitation is that market outcomes deviate systematically from the social optimum when individual endowments are unequal. As a clearinghouse for individual needs and preferences, the market weighs those needs and preferences by what the individual is willing and able to give up in order to protect or advance them. As a result, it weighs the interests of different individuals according to their respective economic resources. So it is, for instance, that greater resources are allocated to the development of medicines that fight baldness than to drugs against tuberculosis.[58]

In addition, markets lack the deliberative element that is characteristic of politics. There are two ways in which deliberation may sometimes be advantageous. In the first place, individuals do not always choose that which maximizes their welfare. This statement is controversial among economists; for them the notion that individuals maximize their "utility" is axiomatic. But it is important to remember that the economists' definition of the utility of individuals in terms of their choices is a methodological device, not a description of ontological reality. We may account for the gap between choice and welfare in terms of cognitive limitations (individuals may misperceive what will make them happy, for example) or, following Amartya Sen, we may account for this difference in terms of the defeat of higher-order preferences by weakness of the will.[59] Either way, deliberation may be a useful means of eliciting welfare information that is not reflected in individual market choices.[60]

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[58] J. Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (Toronto: Penguin Canada, 2004) at 49.

[59] A. Sen, "Rational Fools: A Critique of the Behavioral Foundations of Economic Theory" (1977) 6 Phil. & Pub. Aff. 317 at 326-27.

[60] For two reasons, we might be tempted to suppose that the "higher-order preferences" of individuals are worthy of special consideration — perhaps even greater consideration than the preferences revealed in individuals' choices. First, ethical commitments fall within this category. Second, we might think that higher-order preferences are wiser than the more immediate urges that prevail in their actual choices. We should, however, resist this temptation. As Sen observed (*ibid*. at 344), there is nothing in the concept of a higher-order preference that requires it to be especially "noble". Racial or class solidarity, for example, can be the object of a higher-order preference. We also run the risk of not distinguishing appropriately between what individuals want, and what they should want, if we too readily substitute for an individual's revealed preferences the "higher-order" preferences that as analysts we think it would be wiser for them to act upon. So I make no claim that higher-order preferences are more worthy of consideration than revealed preferences — only the narrower claim that they are worthy of *some* consideration. This claim does not rest on their alleged moral superiority or greater wisdom, but on the simple fact that they are an aspect of an individual's welfare. A social decision-making mechanism that relies exclusively on revealed preferences will overlook this information about what contributes to individuals' welfare. It will exhibit a bias against a particular type of contributing preference — ethical and other commitments.

In the second place, whereas the market conceptualizes social choices as competitions of interests, politics conceptualizes them as competitions of reasons, to be resolved through argument. The legitimacy of market outcomes thus depends on, among other things, the moral neutrality of the competing interests. When the competing interests are not morally neutral — for example, where particular preferences are unjust, particular interests are especially worthy of protection, or, more generally, a particular outcome recommends or disqualifies itself on grounds of justice — a satisfactory outcome will generally require a process involving discursive justification and persuasive argument, rather than the market mechanism. This is because the market is a forum for the reconciliation of interests, taken as given, and its outcomes are "just" only in the limited though important sense that they represent an equilibrium arrived at as a result of voluntary transactions.

In this exposition of the conceptual differences between markets and politics, and of the advantages of politics in dealing with certain types of questions, I would be remiss if I did not acknowledge the limitations of politics. It is possible, of course, that the outcome of a deliberative process may be unjust;[61] arguments may prevail not because of their greater merit but because of the greater influence of their proponents.[62] In addition, reasons proffered in an argument may conceal vested interest.[63] Nevertheless, so long as our skepticism does not cause us to abandon the concept of justice altogether, an awareness of the vulnerabilities of politics is not fatal to the claim that reasoning rather than transacting according to preferences — a competition of reasons rather than a competition of interests — is in principle a more adequate way of making social decisions where justice is at stake.

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[61] Consider, for example, that the Jim Crow laws were a product of the political system, and some of its rules were intended to pre-empt any more egalitarian outcome that the market mechanism might have led to in the absence of the laws. See R. Epstein, "Of Same Sex Relationships and Affirmative Action: The Covert Libertarianism of the United States Supreme Court" (2004) 12 Sup. Ct. Econ. Rev. 75 at 101; Richard A. Epstein, *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Cambridge, Mass.: Harvard University Press, 1992).

[62] See L. Sanders, "Against Deliberation" (1997) 25 *Political Theory* 347.

[63] The pathologies of politics are the subject of an entire branch of economics — public choice theory — the premise of which is that in the public sphere no less than the private sphere, individuals pursue their self-interest. Classic works include J. Buchanan and G. Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962), and M. Olson, *The Logic of Collective Action* (Cambridge, Mass.: Harvard University Press, 1971).

B. Markets versus Politics in Corporate Law

Let me now return to the debate about monism and pluralism. This debate, I want to suggest, is ultimately about whether the political mechanism has a place in corporate governance. Monists, after all, emphasize that their difference with the pluralists does not reside in any monist belief that shareholder wealth is the highest good, or even that corporations should act irresponsibly.[64] Monists argue that social welfare is maximized when corporations focus on the maximization of shareholder wealth because, aside from the agency costs advantages of monism, two external forces may be relied upon to align the pursuit of shareholder wealth with the maximization of social welfare: market forces and external legal sanctions.

In this argument of the monists, the market mechanism plays a central role. The market's role has two components. First, to the extent that groups such as customers or employees have preferences for socially responsible corporate conduct, a profit-focused manager will be attentive to these preferences. As Larry Ribstein recently argued, "Some consumers demand not only better designed and manufactured products and lower prices, but also that the product be made in a socially responsible way."[65] There are, in other words, markets for social responsibility. To the extent that consumer markets support a price differential in favour of a product manufactured in a particular socially responsible manner, the magnitude of that differential is an aggregate measure of the value consumers attach to a particular type of social responsibility, of how much money they are willing to sacrifice in order to be associated with the "socially responsible" product.

Second, market forces will lead managers to treat employees, customers and others dealing with the corporation with fairness, even generosity, in order to secure their loyalty, facilitate recruitment, or otherwise maximize corporate profits.[66] These sources of incentive to act responsibly are examples of the market mechanism at work. The choices of consumers, employees, and others in the various markets in which the corporation operates reveal their relative preferences for social responsibility, money, and other sources of value. For example, through their choices in the labour market, employees reveal their relative

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[64] For example, see Bainbridge's ironic, albeit defensive, description and rejection of the "notion that corporate managers and lawyers unwind from a hard day of nefarious skullduggery by torturing puppies." *Supra* note 40 at 585 (note 182).

[65] L. Ribstein, "Accountability and Responsibility in Corporate Governance," U. Illinois Law & Economics Research Paper No. LE05-015, <http://ssrn.com/abstract=746844>, at 23.

[66] See text accompanying note 37, *supra.*

preferences for money, on the one hand, and the sentiment of being treated fairly and generously by a corporation, on the other hand.

Theoretically, if managers focus on profits, the corporation's conduct will be determined by the equilibria in the markets in which the corporation operates. A profit-maximizing corporation will try to invest precisely that quantity of resources in, say, dolphin-safe tuna fishing practices that consumer markets will bear in the form of a higher price for dolphin-safe tuna. It will treat its employees with fairness and generosity, trying to stop just shy of the point at which the cost of additional gestures would exceed their value to the employees. The corporation's decisions on matters of "social responsibility" would not depend on the idiosyncratic sympathies of managers; they would reflect instead the very preferences of individuals who deal with the corporation and are therefore affected by its behaviour.

All but the most ardent free-marketers acknowledge that market forces may not be sufficient to ensure that social welfare is maximized.[67] Markets suffer from imperfections. Wealth redistribution from the rich to the poor might increase social welfare and, as I argued earlier, the market mechanism may unsatisfactorily deal with issues that concern justice. Where market forces are inadequate, monists suggest that external regulation may be used to correct managers' incentives, by attaching prices in the form of fines or taxes to anti-social conduct and rewarding, through subsidies, beneficial conduct. In addition, taxation and transfer payments may be used to achieve redistributive goals. Monists may concede that in the articulation of standards of conduct and in the fixing of rewards, penalties, taxes, and transfers, there is a role for the political mechanism. Studies will be conducted, arguments will be entertained, and the resulting policy will, ideally at least, be justified on the basis of reasons. However, in the monist view, this deliberation should be located exclusively within the public sphere — in ministries, administrative agencies and legislatures. Let managers focus on their core competence — maximizing private wealth.[68]

It is an appealing, and mostly compelling, argument, but two caveats nevertheless appear to be called for. First, questions of justice sometimes arise in the conduct of business, and it is inappropriate to assume that all such questions are either appropriately determined by the aggregation of preferences in markets or else fall within the exclusive competence of

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[67] Even Easterbrook and Fischel acknowledge the insufficiency of markets. See Easterbrook and Fischel, *supra* note 33 at 39.

[68] See for example Easterbrook and Fischel *ibid.* at 38; Hansmann and Kraakman, *supra* note 20 at 442.

governmental experts in public policy. In brief, that which is not legally prohibited and not punished by the market is not necessarily just. Let us consider a concrete example: should a manufacturer of data processing equipment discontinue a profitable business of supplying equipment to a totalitarian dictatorship upon learning that the equipment is being used in support of a slave labour program? I want to suggest that this not-so-farfetched dilemma[69] raises a question of justice, and that it would be inappropriate if the decision were based exclusively on whether the profitability of the line of business exceeds the sum of its liability and public-relations risks.

The second caveat follows from the admittedly trite observation that corporations control vast resources, that many decisions of social importance are made by corporations, and that both of these phenomena have become more pronounced over the course of the last century. These observations cut both ways in the debate between monists and pluralists. On the one hand, large corporations are capable of causing great social harm if managers focus solely on profits. On the other hand, the magnitude of corporate power led Adolf Berle to fear pluralism, which he warned would result in the "economic power now mobilized and massed under the corporate form…[being] simply handed over, weakly, to the present administrators with a pious wish that something nice will come out of it all."[70] The point I want to make, however, is that to the extent that monism confines the political mechanism exclusively to the governmental sector, the vast expansion of the corporate sector dramatically increases the degree to which we rely on the market mechanism, rather than the political mechanism, for decisions of social importance.

I do not need to take a position here on whether our increased reliance on the market mechanism is a positive or negative development overall. One would be hard pressed, of course, to declare it to be a negative development: few would question today the wealth-creation advantages of the market economy. But there may have been a price to pay. Consider the apparent decline in the level and quality of civic and political engagement.[71] Might the disengagement of citizens be in part the result of

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[69] See E. Black, *IBM and the Holocaust: The Strategic Alliance between Nazi Germany and America's Most Powerful Corporation* (New York: Crown Publishers, 2001).

[70] A. Berle, "For Whom Corporate Managers *Are* Trustees: A Note" (1932) 45 Harv. L. Rev. 1365 at 1368.

[71] Admittedly, the existence of a decline in civic and political engagements and, if one exists, its normative implications, are controversial among political scientists. See, for example, D. Stolle and M. Hooghe, "Review Article: Inaccurate, Exceptional, One-Sided or Irrelevant? The Debate about the Alleged Decline of Social Capital and Civic Engagement in Western Societies" (2005) 35 Brit. J. Pol. Sci. 149. But see J.B. White, "Free Speech and Valuable Speech: Silence, Dante, and the 'Marketplace of Ideas'" (2004)

their realization that the state is weak in the face of important social problems and that the public sphere and the political mechanism have become less important than corporations and markets?[72] Are there questions of justice, currently left to market forces to resolve, that would be more adequately dealt with through a deliberative process? In the event that a rebalancing is required in favour of the political mechanism, a monist conception of the corporation would oblige us to expand the governmental sphere by, for example, enacting regulations or even nationalizing one or more activity sectors.[73] One of the merits of a pluralist conception is that it offers an alternative to bigger government. Pluralist reformers propose that we instead expand our recourse to the political mechanism within corporate governance.[74]

The argument of this section has not been that we should rely exclusively on the political mechanism, or even that its role in corporate governance should be greater than it is. I argue here only against the separation thesis implicit in the case for monism — my quarrel is with the notion that there should be *no* role for the political mechanism in corporate decision-making.

C. A Hybrid Institution in Reality

In addition to the normative objection I have expressed above, I observe that, as a descriptive matter, the monist separation thesis is erroneous. The public corporation is in fact a hybrid institution in which decisions are guided predominantly, it is true, by market mechanisms, but in which the political mechanism is also present.[75] I have already begun to describe the role of the market mechanism in corporate decision-making and, in particular, the way in which the aggregated choices of individuals in voluntary transactions in product and labour markets affect the decisions

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51 U.C.L.A. L. Rev. 799 at 809-810.

[72] See E. Gidengil *et al*., "Turned Off or Tuned Out? Youth Participation in Politics" (2003) 5 Electoral Insight 9 at 14. Significantly, a study by André Blais of the reasons for low voter turnout among young Canadians concluded that non-participation is primarily attributable to a lack of interest and information, as distinguished from political cynicism. See A. Blais et al., "Generational Change and the Decline of Political Participation: The Case of Voter Turnout in Canada" (Paper prepared for the workshop *Citizenship on Trial: Interdisciplinary Perspectives on Political Socialization of Adolescents*, McGill University, June 2002) [unpublished]. See also A. Blais *et al*., "Where Does Turnout Decline Come From?" (2004) 43 Eur. J. Pol. Res. 221 at 227-29.

[73] This is the thrust of Bakan's recommendations in *The Corporation*, *supra* note 58.

[74] For a discussion of two pluralist reform proposals see Lee, "Corporate Psychopathy", *supra* note 55. Examples include Mitchell, *supra* note 30 and Hutchinson, *supra* note 31.

[75] In this part I elaborate upon the argument sketched out in Lee, "Efficiency and

taken by managers on behalf of the corporation, at least if managers focus on profits. But I have not yet mentioned the two most important of the markets from the standpoint of corporate governance: the market for the corporation's equity and the market for corporate control.[76]

One's interpretation of the equities market depends on one's assumptions about investors. If we assume investors to be solely interested in financial returns and risk, the prices prevailing in the market represent the aggregated opinions of actual and potential investors as to the corporation's financial prospects — a sort of consensus estimate of the present value of its future income stream. According to a more holistic view, prices prevailing in the equities market reflect investors' preferences not only for financial returns and risk, but also their preferences in relation to any potentially non-financial benefits or costs attached to particular investments.[77] Thus, for example, some investors might on ethical grounds shun Unocal Corporation on account of its operations in Myanmar, and invest their money instead in Whole Foods Market, perhaps accepting inferior risk or return characteristics as the price of a clear conscience. Some other investors may well ignore ethical considerations, and those investors who do not ignore them may attach different values to them, or even have different judgments as to the relative ethical quality of Unocal and Whole Foods. All of these individuals' preferences as revealed in their investment decisions are aggregated into the market price of the corporation's stock.

The special importance of the equities market for corporate governance resides in the fact that the stock price is the triggering mechanism in the market for corporate control. The latter mechanism describes, of course, the notion that regardless of any legal duty to attend to the shareholders' interests, managers have a strong incentive to do so to the extent that there are few legal or structural obstacles to hostile tender offers.[78] Deviation from the shareholders' interests will result in a stock price that is lower than it could be, which in turn will make the corporation a potential hostile takeover target, thereby jeopardizing the incumbent management's positions.

Ethics," *supra* note 46 at 68-69.

[76] Corporate law makes the stock market possible: the free transferability of shares, a corporate law provision, is indispensable to the existence of a stock market; limited liability is nearly so. Regarding the connection between limited liability and the stock market, see Halpern, Trebilcock and Turnbull, *supra* note 34.

[77] Proponents of this interpretation would presumably include Elhauge and Ribstein, both of whom suppose that some investors may derive utility from corporate social responsibility. See Elhauge, *supra* note 4 at 783-84; Ribstein, *supra* note 65 at 18.

[78] Manne, *supra* note 45; H. Manne, "A Free Market Model of a Large Corporation System" (2003) 52 Emory L.J. 1381 at 1389.

Indeed, the market for corporate control is the nexus of all of the other markets relevant to corporate decision-making, in the sense that all market forces that we describe as operating upon the corporation in fact operate upon managers (who make decisions on behalf of the corporation) through the market for corporate control. It is because of the market for corporate control that managers care about the stock price.[79] To the extent that the stock price values the corporation's net income stream, managers who care about the stock price will act as profit maximizers in the firm's product and labour markets.

If the importance of the market mechanism in corporate governance is well known,[80] often overlooked is the fact that the political mechanism is also represented within the governance structure of the public corporation. The mechanism is most strikingly reflected in the organization of the two principal decision-making organs within the corporation: the board of directors and the shareholders acting as a general body.

Both the board and the shareholders are collective bodies, responsible for the taking of collective decisions. A director acting alone has no authority, nor does one shareholder apart from the others.[81] Even the "majority of the board" and the "majority shareholders" wield no authority as such.[82] Rather, decisions taken following a particular process and culminating in a vote or a consensus are constituted as decisions of the board, or of the shareholders as a group. The paradigmatic means of action for both is, by way of a "meeting,"[83] dispensed with only where the

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[79] The existence of equity-based compensation is another important reason why managers focus on the stock price, but it is not an independent explanation since one needs to identify the source of managers' incentives to adopt and maintain equity-based compensation schemes.

[80] Regarding the influence of the "market for corporate control" concept in corporate law scholarship, see Carney, *supra* note 45. Commentators debate, of course, the practical effectiveness of the market for corporate control. There are legal and structural obstacles to takeovers and the mechanism's usefulness for controlling agency costs may be limited in the context of decisions involving substantial redistributions of wealth from shareholders to managers. See, for example, J. Coffee Jr., "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 Colum. L. Rev. 1145; L. Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law" (1992) 105 Harv. L. Rev. 1435 at 1462.

[81] A director can, of course, exercise delegated authority (*CBCA*, *supra* note 18 s. 115; *Delaware General Corporation Law*, 8 Del. C. 1953 [*Del. GCL*], §141(c)(2)). However, the delegation itself is pursuant to a decision of the board as a whole.

[82] Regarding the shareholders, see *Teck*, *supra* note 13, holding that the majority shareholders cannot give binding instructions to the board.

[83] *CBCA*, ss. 114 (directors' meetings), 132-144 (shareholders' meetings); *Del. GCL*, §141 (provisions concerning, among other things, directors' meetings), and 211

members of the body are unanimous about the action to be taken.[84]

In relation to meetings of both boards and stockholders, corporate law contains rules, the purpose of which is to ensure the integrity of the meeting. For example, boards and shareholders may meet by phone, but only if the technology "permits all participants to communicate adequately with each other during the meeting."[85] Shareholders must receive notice of the business to be transacted in sufficient detail to permit them to "form a reasoned judgment thereon."[86] Furthermore, shareholders may require the corporation to circulate, at corporate expense, the text of a proposed resolution and a brief statement in support of the resolution.[87]

Crucially, courts and legislators in North America have either rejected monism in defining directors' duties or have left matters uncertain. While a battle rages between monist and pluralist legal scholars as to which position is reflected in Delaware law, the reality is that the position is persistently ambiguous. As former Delaware Chancellor William Allen has observed, courts have long endeavored to "paper over" the conflict between monism and pluralism.[88] Because of the business judgment rule and the ease with which immediate sacrifice can be rationalized in terms of the shareholders' long-term interest, courts since *Dodge v. Ford* have not found it necessary and have accordingly avoided bringing the debate between monism and pluralism to a definitive end.[89] In the absence of a

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(shareholders' meetings).

[84] Concerning directors' meetings, see *CBCA*, s. 117; *Del. GCL*, §141(f). Concerning shareholders' meetings, see *CBCA*, s. 142. However, *Del. GCL*, §228(a) permits the shareholders to act by written consent signed by an absolute majority.

[85] *CBCA*, ss. 114(9), 132(4). *Del. GCL*, §141(i) is substantially identical to *CBCA*, s. 114(9), concerning directors' meetings. For shareholders' meetings, the requirement under *Del. GCL*, §211(a)(2) is that "the corporation…implement reasonable measures to provide such stockholders and proxyholders [attending via remote means] a reasonable opportunity to participate in the meeting and to vote on matters submitted to the stockholders, including an opportunity to read or hear the proceedings of the meeting substantially concurrently with such proceedings."

[86] *CBCA*, s. 137(6). In the United States, this is the purpose of Section 14(a) of the *Securities Exchange Act of 1934*, c.404, 48 Stat. 881 and the rules promulgated thereunder. See H. Manne, "Shareholder Social Proposals Viewed by an Opponent" (1971) 24 Stan. L. Rev. 483, at 484.

[87] *CBCA*, s. 137(1). In the U.S., see Rule 14a-8 under the *Securities Exchange Act of 1934*.

[88] Allen, *supra* note 22 at 272.

[89] Contrary to the claims of some monists, the debate was not clearly resolved in favour of monism by *In re Paramount Communications Inc. Shareholders' Litigation*, 637 A.2d 34 (Del.Supr. 1993) [*QVC*]. The Delaware Supreme Court ruled (at 48) that, once the board has decided to abandon its long-term strategy or to sell control of the company, the board's consideration of non-shareholder interests must cease and it must "seek the best

corporate-law duty obligating the board to treat the maximization of shareholders' wealth as the sole ultimate end, there is scope within the corporation's deliberative processes for the articulation of reasons appropriate to the resolution of questions of justice when they arise.[90]

Let us not get carried away. The corporation is not a republic, and shareholders' meetings are not Town Hall meetings.[91] That is not, however, the burden of my argument. I have sought to defend here only the more modest claim that in the decision-making processes of its two most important organs, the structure of the corporation accommodates the use of argument and exchanges of reasons, and not only the aggregation of interests revealed by market actors.

4. Conclusion

The Supreme Court's decision in *Peoples Department Stores v. Wise* has attracted criticism, especially in relation to the Court's reasoning.[92] I want to conclude my discussion of monism, pluralism, markets and politics by offering a sympathetic interpretation of the Court's decision.

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value reasonably available to the stockholders". *QVC* does not win the debate for monism, for two reasons. First, in the takeover context the bidder is offering to the shareholders to buy their shares. The fact that managerial interference in dealings between the shareholders and a third party concerning the shareholders' sovereign right to sell their shares must be governed by the shareholders' interests does not imply that the same is true where there is no risk of the managers treading on the shareholders' exit rights. Second, *QVC* does not alter the proposition that the board's threshold decision whether to abandon its long-term strategy or enter a process of selling the corporation may be made with due regard for non-shareholder interests.

[90] The language and interpretation of the shareholder proposal mechanism also accommodates ethical deliberation. See, e.g., *Medical Committee for Human Rights v. Securities Exchange Commission*, 432 F.2d 659 (D.C. Cir. 1970) at 681, upholding the right of shareholders to put to one another, via the shareholder proposal mechanism, the "question of whether they wish to have their assets used in a manner which they believe to be more socially responsible but possibly less profitable than that which is dictated by present company policy." In Canada, s. 137(5)(b) of the *CBCA*, which previously stood in the way of "socially" motivated shareholder proposals, was amended in 2001 to remove the limitation. See further A. Dhir, "Realigning the Corporate Building Blocks: Shareholder Proposals as a Vehicle for Achieving Corporate Social and Human Rights Accountability," (2006) 43 Am. Bus. L.J. 365 at 368.

[91] I certainly make no claim that boards and shareholders' meetings are in practice *ideal* deliberative bodies. For example, chief executive officers in practice exert considerable influence over the deliberations of boards and their outcome is often a foregone conclusion. It should not surprise us, however, to observe in the meetings of boards and shareholders pathologies similar to those experienced by other deliberative bodies, such as parliaments.

[92] See e.g. J. Ziegel, "The *Peoples* Judgment and the Supreme Court's Role in Private

The Supreme Court does not flesh out the concept of the "best interests of the corporation," except to tell us that it is not synonymous with the best interests of the shareholders;[93] that the interests of shareholders and non-shareholders alike may be taken into account, although none is paramount;[94] and that the board should strive to "creat[e] a 'better' corporation."[95] In other words, other than ruling out monism, the Court essentially leaves the definition of the "best interests of the corporation" to the board of directors.

In doing so, the Court admits a greater role for the political mechanism within the governance of *CBCA* corporations than would exist under either of the other two interpretations on offer — the Superior Court's monism-except-near-insolvency or the Court of Appeal's more orthodox monism. Either of the latter interpretations would have reduced the role of the political mechanism by confining the board's deliberations to a reduced set of values, such as the maximization of shareholders' wealth. Because the deliberative space made possible by pluralistic directors' duties is necessary for the appropriate resolution by boards of directors of ethical questions arising in the course of business,[96] I am supportive of the Court's decision not to impose the monistic definition, even though I agree with those who find the reasoning of the court suspect.[97] I close, however, with two qualifications to my approval of the Court's choice.

First, the monists' concern about agency costs may be a more serious issue in corporations with a controlling shareholder, because of the unavailability of the market for corporate control. I have previously mentioned the widely-held view that this market is immensely more significant than directors' legal duties as a source of protection for the interests of small shareholders.[98] However, where there is a controlling shareholder, the market for corporate control is not available, and the directors' legal duties take on greater importance. In light of the greater

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Law Cases" (2005) 41 Can. Bus. L.J. 236. In addition, the judgment has been criticized for weakening the legal constraints on directors. See W. Grover, "The Tangled Web of the *Wise* Case" (2005) 41 Can. Bus. L.J. 200; R. Flannigan, "Reshaping the Duties of Directors" (2004) 83 Can. Bar Rev. 365.

[93] *Supra* note 11 at para. 42.

[94] *Ibid.* at paras. 42, 47.

[95] *Ibid.* at para. 47.

[96] Alternatively, the qualified monist position adopted by the American Law Institute, *supra* note 7, is that authorizing directors to deviate from the maximization of profits "on the basis of ethical considerations" would also provide the necessary flexibility.

[97] See I. Lee, "*Peoples v. Wise* and the 'Best Interests of the Corporation'" (2005) 41 Can. Bus. L. J. 212.

[98] See, e.g., Manne, s*upra* note 45.

prevalence of controlled corporations in Canada compared to the United States,[99] the case for monism is stronger in this country.[100]

Second, although I am pleased that the Court did not endorse monism, I would have preferred to see it adopt the Delaware approach of keeping the standard ambiguous, particularly since the resolution of the issue was unnecessary to the disposition of the appeal. In explaining why the Delaware courts have never definitively made a choice for monism or pluralism, the then-chief justice of Delaware's specialist corporate law court emphasized, in a comment that is equally applicable to the Canadian context, that the choice is not simply a "technical question of law capable of resolution through analytical rule manipulation."[101] Nor, Allen added, is the normative question a "technical question of finance or economics":

> Rather in defining what we suppose a public corporation to be, we implicitly express our view of the nature and purpose of our social life. Since we do disagree on that, our law of corporate entities is bound itself to be contentious and controversial.[102]

If Delaware's experience is a guide, *Peoples Department Stores v. Wise* may not be the end of the story. In 1985, the Supreme Court of Delaware handed down its decision in *Unocal Corp. v. Mesa Petroleum Co.*, in which seemingly endorsing a pluralistic conception of directors' duties, it ruled that a board may take into account non-shareholders' interests and that the stockholders' interests are "not a controlling factor."[103] However, in subsequent cases, the Delaware Supreme Court

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[99] See R. Daniels and J. MacIntosh, "Toward a Distinctive Canadian Corporate Law Regime" (1991) 29 Osgoode Hall L. J. 863 at 884; E. Iacobucci, "A *Wise* Decision? An Analysis of the Relationship between Corporate Ownership Structure and Directors' and Officers' Duties" (2002) 36 Can. Bus. L.J. 337.

[100] Daniels and MacIntosh (*ibid.* at 887) appear at first glance to take a different position. They argue that the greater prevalence of controlled corporations *reduces* the conflict between the interests of managers and shareholders and that greater emphasis is warranted instead on conflicts of interest between majority and minority shareholders. This difference evaporates, however, if one recognizes that monistic directors' duties are a mechanism for dealing with inter-shareholder conflicts of interest in a controlled corporation. In a corporation with a sole shareholder (such as Peoples Department Stores itself), the situation is perhaps ambiguous. On the one hand, since sole shareholders are much more effective monitors of managerial performance than are dispersed shareholders, the whole problem of agency costs is greatly attenuated in such a corporation, as is, therefore, the need for monistic directors' duties. On the other hand, Friedman's "ownership" argument for monism (*supra* note 21 and accompanying text) might retain some of its appeal where a corporation has a sole shareholder, since such a shareholder may resemble a business owner rather than a passive investor.

[101] Allen, *supra* note 22 at 281.

[102] Allen, *supra* note 22 at 281.

[103] 493 A.2d 946 at 955 (Del. 1985).

retreated from this position, beginning in *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, where the court held that consideration of non-shareholders' interests is legitimate only if there is "some rationally related benefit" for the stockholders.[104] Thus, despite the Supreme Court's pronouncement in *Peoples*, there may still be life left in the legal debate between monism and pluralism, as there is still life left in the normative debate.

[104] 506 A.2d 173 at 176 (Del. 1986).