Doing Well While Doing Good: Reassessing the Scope of Directors' Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries

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Table of Contents

I. Conversions into For-Profit Firms 414
  A. "The Largest Reform Ever": Hospital Conversions 415
  B. Students for Sale?: The Privatization of Education 418
  C. The Resistance 424
  D. The Philosophical Objection 426
II. Analyzing the Two Models of Corporate Thought 430
III. Corporate Law Principles 434
  A. Ordinary Business Decisions 434
    1. Status of the Law 434
    2. Application to Public Benefit Corporations 440
  B. Decisions in the Context of a Takeover 445
    1. Status of the Law: *Revlon* and its Progeny 445
      a. Defensive Actions 446
      b. Placing the Company Up for Sale 447
      c. Change-of-Control Transactions 450
      d. Corporate Reorganizations 451
    2. Application to Public Benefit Companies 454

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HeinOnline -- 59 Wash. & Lee L. Rev. 409 2002

a. Defensive Actions and Corporate Reorganizations . . . 454
b. Placing the Company Up for Sale and Change of Control Transactions . . . 455
C. Help on the Horizon: Constituency Statutes . . . 459
1. Content of Constituency Statues . . . 460
2. Conduct Permitted by Constituency Statutes . . . 462
IV. Empirical Evidence on Post-Conversion Conduct . . . 464
A. Evidence on the Post-Conversion Behavior of For-Profit Hospitals . . . 466
B. The Post-Conversion Behavior Relating to Schools . . . 469
Conclusion . . . 473

Over the past two decades, we have witnessed a rise in "privatization" – a conversion from the operation of certain businesses by nonprofit and government entities to the operation of these businesses by for-profit companies.[1] Privatization has occurred within a variety of different industries, including correctional facilities, insurance agencies, health care, and most recently, education.[2] The growing number of for-profit conversions[3] has sparked considerable debate regarding the propriety of altering the previously not-for-profit[4] structure that characterized these industries to one that assumes a for-profit form. Supporters tout the advantages of privatization, claiming that, among other things, conversions will provide much needed resources as well as greater efficiency to these industries. Critics raise a variety of objections ranging from the for-profit corporation's inability to provide effective services

1. Some have construed the term "privatization" broadly to include any increased governmental or nonprofit reliance on the private sector. *See, e.g.*, E.S. Savas, *Privatization & Prisons*, 40 VAND. L. REV. 889, 889 (1987) (defining privatization as "increased governmental reliance on the private sector . . . to satisfy the needs of society"); Lewis D. Solomon, *Reflections on the Future of Business Organizations*, 20 CARDOZO L. REV. 1213, 1215 (1999) [hereinafter Solomon, *Reflections*] (defining privatization as act "of increasing the role of the private sector, in an activity"). This Article defines the term more narrowly to refer to the transfer of ownership or assets from the public/government sector to the private sector. *See, e.g.*, Mary M. Shirley, *The What, Why, & How of Privatization: A World Bank Perspective*, 60 FORDHAM L. REV. 23, 24 (1992) (defining privatization as "the transfer of ownership of assets to the private sector").

2. *See infra* note 15 (discussing extension of privatization across various industries).

3. This Article uses the terms "privatization" and "conversion" or "for-profit conversion" interchangeably.

4. This Article uses the term "not-for-profit" to refer to all public entities including nonprofit and governmental entities.

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to claims that privatization may erode important civic values.[5] However, the rallying cry for many opponents of privatization is that "Wall Street and profit maximization" have no place in certain sectors of our society.[6] This cry stems from the philosophical belief that the for-profit corporation's principal goal is maximizing shareholder wealth and that this goal is wholly incompatible with the social and charitable core missions of many not-for-profit industries.[7] Nowhere is this cry more strident than in the context of privatization within industries that deliver important services to the public, such as health care or education.[8] Opponents contend that once a for-profit conversion occurs, the social or charitable commitments of certain industries inevitably are subverted to the corporate director's obligation to maximize shareholder value.[9]

Against this backdrop stands a debate within the corporate community that should influence the debate regarding privatization. Indeed, corporate scholars disagree about the theory that should provide standards for the actions of for-profit corporations and their directors. Some corporate scholars

5. *See infra* Part I.D (discussing philosophical objections to privatization).

6. *See, e.g.*, Philip P. Bisesi, *Conversion of Nonprofit Health Care Entities to For-Profit Status*, 26 CAP. U. L. REV. 805, 845 (1997) (quoting Rhode Island legislator George D. Caruolo who argued that "Wall Street and the maximization of profits would have no place in the world of health care"); Ad Hoc Comm. to Defend Health Care, *For Our Patients, Not for Profit: A Call To Action*, 278 JAMA 1733, 1733 (1997) (stating that "companies responsive to Wall Street and indifferent to Main Street" are taking over nonprofit hospitals).

7. *See, e.g.*, Bradford H. Gray & Walter McNerney, *For-Profit Enterprise in Healthcare: The Institute of Medical Study*, 314 NEW ENG. J. MED. 1523, 1524 (1986) (noting that "[s]ome objections to for-profit health care stem from the belief that it is fundamentally inconsistent with the values and purpose that should animate health care organizations").

8. *See id.* (noting objection that for-profit healthcare is "fundamentally inconsistent with the values and purpose that should animate health care organizations"); *see also* John Greenwald, *School for Profit: Private Companies Can Run Public Schools, But Can They Make Them Pay?*, TIME, Mar. 20, 2000, at 56 (noting that "the very notion [of for-profit public schools] seems heretical"); Peter Schrag, *Edison's Red Ink Schoolhouse – The Biggest Brand Name in For-Profit Education Is Floundering*, NATION, June 25, 2001, at 20 (noting, "what the critics most dislike – is simply the idea that somebody is trying to turn public education into a profit-making enterprise"); William C. Symonds, *Edison: Pass, Not Fail*, BUS. WK., July 9, 2001, at 70 [hereinafter Symonds, *Edison Pass*] (noting that parents, teachers, and activists who defeated one private school's attempt to operate schools in New York all believed that such schools were out to "profiteer from poor children"); Edward Wyatt, *Higher Scores Aren't Cure-All, School Run for Profit Learns*, N.Y. TIMES, Mar. 13, 2001, at A1 [hereinafter Wyatt, *Higher Scores*] (noting that "mostly [opponents of privatized education] promoted a single principle: profit-seeking companies should stay out of public education").

9. *See, e.g.*, Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reform*, 23 J. CORP. L. 631, 641 (1998) ("For profit directors and officers are principally concerned about long-term profit maximization. While nonprofit directors and officers keep economic matters in mind, they are principally concerned about the effective performance of the nonprofits' mission.").

favor the "social entity"[10] conception of the corporation – that the corporation and its directors should serve the interests of the various constituencies the corporation impacts. These scholars claim that certain critical Delaware court decisions, as well as the passage of so-called "constituency" statutes[11] that permit directors to take into account a variety of different interests in performing their management duties, have signaled a shift away from the traditional notion that directors have a duty to maximize shareholder profit.[12] Others dispute this claim. Instead, they argue that corporate jurisprudence continues to subscribe to the traditional "shareholder-primacy" conception of the corporation that maximizing the wealth of shareholders should be the primary, if not

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10. Scholars have referred to this concept in a variety of different ways including a "corporate enterprise" concept and the "stakeholder" model. All refer to the notion that a corporate model that considers a broader set of interests should displace the traditional shareholder-centered model of the corporation.

11. As Professor Eric W. Orts observed, the manner in which one refers to these statutes often reveals on which side of the debate a person falls with respect to the propriety of these statutes. *See* Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 16 (1992) (suggesting that choice of label for statute conveys favor or disfavor). Those who favor the statutes refer to them as "stakeholder" statutes, based on the notion that a variety of different groups have a stake in the corporation and that these statutes promote consideration of their interests. Some have objected to this label because it implies that these groups have some financial stake in the corporation, when only shareholders hold such an interest. *See, e.g.*, Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1425 n.6 (1993) (suggesting that "stakeholder" incorrectly implies that constituency has financial interest in firm). Others who oppose such legislation refer to them as "nonshareholder" statutes. Like Professor Orts, this Article will use the relatively neutral title of "constituency statutes" to describe those provisions that explicitly allow corporate directors and officers to consider interests other than those strictly related to the shareholders. *See* Orts, *supra*, at 18 (proposing "neutral label is conveniently short and comports with the avowed purpose of the statute to include . . . interests beyond those of the shareholder").

12. *See, e.g.*, William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 264-73 (1992) (analyzing "property" and "social entity" conceptions of corporate law). After reviewing the changes in Delaware law and the enactment of the corporate "stakeholder" statutes by various states, Allen, former chancellor of the Delaware Court of Chancery, concludes that "ultimately both our courts and, more importantly, our legislatures have, in effect, endorsed the entity view." *Id.* at 276. Chancellor Allen notes, "stealing is still proscribed and self-dealing transactions still have to be justified as fair to the corporation, but what arguably is eradicated is the command . . . that maximizing the financial interests of shareholders through lawful means over some time period is the core duty of a corporate director." *Id.* at 276-77; *see also* Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1411-12 (1993) (arguing that existence of constituency statutes reflects erosion of shareholder-primacy norm); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 911 (1990) (noting judicial change away from recognition of shareholder-primacy concept); David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 240 (1991) (proposing that "judicial and legislative restrictions on hostile takeovers suggest at least a partial willingness to subordinate shareholder to non-shareholder interests").

HeinOnline -- 59 Wash. & Lee L. Rev. 412 2002

exclusive, aim of the corporation.[13] The resolution of this corporate law debate may shed light on the validity of the arguments against privatization. Indeed, if the shareholder primacy model remains dominant, then opponents of privatization may have a well-founded concern that directors of a for-profit corporation cannot consider sufficiently the interests of other constituents because of their duty to increase the profits of their shareholders. However, if the social entity model has gained acceptance, then this concern may be groundless.

By evaluating the extent to which current corporate law allows directors of recently privatized firms to make decisions that benefit their public constituencies, even at the expense of shareholder profit, this Article approaches the corporate law debate through the prism of privatization.[14] In bringing these two issues together, this Article serves dual purposes. First, this Article fills an important gap in the privatization debate by analyzing the corporate law conceptions upon which the opponents of privatization base their philosophical objections. This analysis focuses on health care and education. Because critics raise the strongest philosophical objection to privatization of these industries, examining the validity of the objection in the context of these industries provides a useful test as to its validity more generally. Second, this Article provides some insight into the relative prominence of the two positions regarding the aims of corporate law.

Part I of this Article examines the trend towards privatization in the education and health care fields, the forces behind the trend, and the philosophical opposition to privatization in these areas. Part II elaborates on the social entity and shareholder primacy theories of the corporation. Part III addresses the evolution of the fiduciary duty of directors and the impact this evolution has had on the relative prominence of the two theories of the firm, as well as the possible effect of this evolution on the actions of directors in these post-conversion entities. Part III also evaluates constituency statutes and the degree to which the statutes allow directors greater flexibility to make decisions that serve the interests of non-shareholders. The bulk of this Article focuses on the extent to which corporate law allows or requires directors to consider particular interests in performing their duties. Part IV takes up the

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13. *See, e.g.*, Bainbridge, *supra* note 11, at 1424-25 (noting that mainstream of corporate law remains committed to shareholder maximization norm); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Constituency Statutes*, 70 TEX. L. REV. 579, 586-87 (1992) (noting that practice of equating shareholder interests with those of corporation has remained largely intact).

14. This Article seeks only to analyze the constraints placed on director conduct by directors' fiduciary duties. It does not seek to assess the extent to which other forces, such as the stock market or shareholder voting, may impact directors' conduct towards shareholders and non-shareholders.

HeinOnline -- 59 Wash. & Lee L. Rev. 413 2002

separate issue of the kind of decisions that directors of post-conversion entities actually will make by analyzing the empirical evidence related to the behavior of companies after their conversion.

This Article concludes that opponents of privatization base their philosophical objection to privatization on a theoretical conception of the for-profit corporation that is more myth than reality. In fact, a review of the current status of the for-profit director's duties reveals that the social entity model of the corporation governs most of a director's decision-making. This means that corporate law allows directors of post-conversion companies to take actions that advance the interests of their beneficiaries, even when those actions fail to generate the maximum level of shareholder profit. Hence, opponents of privatization are laboring under a misconception about the aims of the corporation, and to the extent that they base their objections to privatization on this misconception, their objections do not have much force. Moreover, there is empirical evidence to support the notion that, in practice, directors of post-conversion corporations have behaved in a manner consistent with the social entity model of the corporation. This evidence, buttressed by the current status of corporate law, undercuts the force of the philosophical objection to privatization. It also suggests that the social entity model may have taken center stage in our conception of the corporation.

I. Conversions into For-Profit Firms

Although there have been conversions in many other fields,[15] this Article focuses on those that occur in connection with hospitals and entities that deliver K-12 education.[16] While privatization generally has sparked contro-

15. In addition to health care and education, the practice of privatization has extended to insurance companies, public works and transportation, emergency medical services, the criminal justice system, the public welfare system, and correctional facilities. *See, e.g.*, Savas, *supra* note 1, at 890 (discussing privatization trends in various areas). *See generally* Michele Estrin Gilman, *Legal Accountability in an Era of Privatized Welfare*, 89 CAL. L. REV. 569 (2001) (discussing privatization of social welfare programs); David A. Sklansky, *The Private Police*, 46 UCLA L. REV. 1165 (1999) (discussing privatization of policing responsibilities). One of the biggest industries to experiment with privatization has been the prison industry. For a discussion of this phenomenon, see generally ADRIAN L. JAMES ET AL., PRIVATIZING PRISONS: RHETORIC AND REALITY (1997) (discussing privatization of prisons in Britain); PRIVATIZING CORRECTIONAL INSTITUTIONS (Gary W. Bowman et al. eds., 1993) (discussing financing, construction, and management of prisons); W.J. Michael Cody & Andy D. Bennett, *The Privatization of Correctional Institutions: The Tennessee Experience*, 40 VAND. L. REV. 829 (1987) (discussing history of prison privatization in Tennessee); Peter J. Duitsman, *The Private Prison Experiment: A Private Sector Solution to Prison Overcrowding*, 76 N.C. L. REV. 2209 (1998) (discussing privatization as solution to overcrowding); Savas, *supra* note 1 (discussing cost effectiveness of private prisons).

16. This Article refers to post-conversion corporations in these fields as "public benefit" corporations.

HeinOnline -- 59 Wash. & Lee L. Rev. 414 2002

versy, conversions related to hospitals and K-12 education generate the greatest level of controversy primarily because opponents believe that the uncompromised delivery of the services required in these industries poses the greatest challenge for the directors of the for-profit corporation.[17] Before discussing this controversy, this Article discusses the growth of privatization in these industries and the manner in which it occurs.

A. "The Largest Reform Ever": Hospital Conversions

In the 1990s, the health care industry experienced a dramatic change, with one commentator even calling it "one of the largest reforms ever to have occurred in any industry in the United States."[18] In 1995 alone, more than $1.6 billion in not-for-profit healthcare assets were sold to the private sector.[19] In addition to the changes in the ownership structure for health maintenance organizations (HMOs)[20] and health care insurers, such as Blue Cross and Blue Shield,[21] the number of hospitals converting from public or nonprofit status

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17. *See infra* Part I.D (discussing philosophical objections to privatization).

18. Lawrence E. Singer, *The Conversion Conundrum: The State and Federal Response to Hospitals' Changes in Charitable States*, 23 AM. J.L. & MED. 221, 225 (1997); *see also* Bisesi, *supra* note 6, at 805 ("A revolution has descended upon the health care industry."); James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701, 702 (1998) ("[T]he United States has witnessed the largest redeployment of charitable assets in the Anglo-American world since Henry VII closed the monasteries in 1536-1540."). Although hospital conversions have occurred throughout the nation, the heaviest concentration has been in California, Florida, Georgia, and Texas. Jack Needleman et al., *Hospital Conversion Trends*, HEALTH AFF., Mar.-Apr. 1997, at 187 [hereinafter Needleman, *Conversion Trends*].

19. Shelley A. Sackett, *Conversion of Not-For-Profit Health Care Providers: A Proposal For Federal Guidelines on Mandated Charitable Foundations*, 10 STAN. L. & POL'Y REV. 247, 250 (1999).

20. In 1995, approximately 70% of HMOs were for-profit, *see* Gary Claxton et. al., *Public Policy Issues in Nonprofit Conversions: An Overview*, HEALTH AFF., Mar.-Apr. 1997, at 9, 13-15, as compared to approximately 20% in 1981, Bisesi, *supra* note 6, at 823. For a discussion of conversions related to HMOs, see generally Theresa McMahon, *Fair Value? The Conversion of Nonprofit HMOs*, 30 U.S.F. L. REV. 355 (1996) (analyzing conversion process of one California HMO).

21. Five Blue Cross and Blue Shield plans have converted, or are trying to convert, to for-profit status while forty-seven operate for-profit subsidiaries. Bisesi, *supra* note 6, at 823. For a discussion of conversions related to Blue Cross and Blue Shield, see *id.* at 823-25 (discussing increase in mergers and conversions of such plans). *See also* JACK NEEDLEMAN, NONPROFIT TO FOR-PROFIT CONVERSIONS IN HEALTH CARE: A REVIEW 23-24 (Pioneer Inst. for Pub. Pol'y Res., White Paper No. 5, 1999) (citing "access to capital and entrepreneurship" as driving force behind conversions) [hereinafter NEEDLEMAN, CONVERSION REVIEW]; Sackett, *supra* note 19, at 253-55 (discussing reasons why plans convert); L.D. Schaeffer, *Health Plan Conversions: The View from Blue Cross of California*, HEALTH AFF., Winter 1996, at 183-87 (analyzing conversion of Blue Cross California).

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to for-profit status increased significantly during this period. As compared to previous years, the number of hospitals converting to for-profit status in 1994 almost quadrupled, going from approximately nine per year to thirty-four in 1994, and then to fifty-nine in 1995.[22] Because of these changes, for-profit hospitals currently account for 15% of the total number of hospitals.[23]

Privatization occurs in connection with hospitals in a variety of ways,[24] but the common denominator is that the not-for-profit enterprise loses its ownership and control over the hospital. The most typical conversion mechanism is an asset sale pursuant to which the for-profit corporation purchases the assets of the not-for-profit organization.[25] Upon distribution of the assets, the nonprofit entity dissolves, while the for-profit entity survives as owner and operator of the hospital.[26] In other cases, a nonprofit entity may merge into a for-profit corporation with the for-profit corporation as the surviving entity.[27] In other settings, not-for-profit hospitals do not necessarily change forms; rather, the hospitals participate in joint ventures with for-profit entities

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22. Claxton, *supra* note 20, at 12. Despite this overall increase in the number of hospital conversions, the total percentage of for-profit hospitals has been relatively constant over the past twenty years. *See* David A. Hyman, *Hospital Conversions: Fact, Fantasy, and Regulation Follies*, 23 J. CORP. L. 741, 749-54 (1998) (analyzing data showing stability of percentage of for-profit hospitals).

23. Hyman, *supra* note 22, at 749.

24. This includes an asset sale, a merger or consolidation, a "drop down" conversion, a "conversion in place," or a joint-venture transaction. *See* Fishman, *supra* note 18, at 714-15 (explaining different conversion mechanisms); Singer, *supra* note 18, at 232-34 (same).

25. *See* Fishman, *supra* note 18, at 714 (describing asset sale as "typical for the aquisition of a non-profit hospital by a for-profit acquirer"); Sackett, *supra* note 19, at 248 n.2 (describing asset sale to for-profit entity as "typical" conversion); Singer, *supra* note 18, at 232 (referring to asset sales as "Type A" conversions).

26. Tax laws require that a tax-exempt organization dedicate its assets to a charitable purpose upon dissolution. Treas. Reg. § 1.501(c)(3)-1(d)(3) (1996). To accomplish this, once the conversion occurs, the nonprofit transfers the sale proceeds and any remaining assets to another charitable organization, usually a foundation. To comply with the tax rules, use of these sale proceeds must be consistent with both the nonprofit's original mission and the historical uses of its assets.

The tax laws also provide that no portion of a nonprofit's net earnings shall inure to the benefit of a private shareholder or individual and that no insider, such as a director or officer, shall receive a substantial economic benefit as a result of the nonprofit's activities. *See* I.R.C. § 501(c)(3) (1996) (private investment rule); Treas. Reg. § 1.501(a)-1 (1997) (private inurement rule); Treas. Reg. § 1.501(c)(3)-1(d)(1) (1996) (private benefit rule). If the converted assets are not sold at fair market value and the owners of the post-conversion entity include managers of the former nonprofit, the IRS could deem the managers to have received a profit from the sale and hence to have violated the private inurement or private benefit doctrine. Because of this problem, the IRS instituted a new rule imposing an excise tax sanction on those who violate the tax laws through undervaluation of these conversions. *See generally* Fishman, *supra* note 18, at 727-29 (describing IRS response to violation of private investment and benefit doctrines).

27. *See* Singer, *supra* note 18, at 232-33 (discussing various methods of conversion).

HeinOnline -- 59 Wash. & Lee L. Rev. 416 2002

pursuant to which a new company is formed whose purpose it is to offer hospital services.[28] Such hospitals contribute assets to the newly formed company in exchange for cash and a small interest in the new venture, while the for-profit company contributes cash in exchange for a larger interest in the venture.[29]

Three of the largest for-profit corporations that own hospitals are HCA-The Healthcare Co., formerly Columbia/HCA Healthcare Corp. (HCA); Universal Health Services, Inc. (UHS); and Tenet Healthcare Corp. (Tenet).[30] HCA, formerly Columbia Hospital, was formed in 1987, and within ten years it owned 350 hospitals.[31] As of December 2000, HCA operated 196 hospitals in twenty-four states.[32] In 1995, UHS operated twenty-nine hospitals; it currently operates fifty-nine hospitals in twelve states.[33] Tenet, headquartered in California, grew from thirty-five hospitals in 1994, to 111 hospitals in seventeen states in the year 2000.[34] All of these entities manage hospitals, delivering health care services to millions of patients nationwide every year. Moreover, all of these entities have shareholders who expect a profit on their investment.

While several forces led to the explosion in privatization of hospitals,[35] one of the most significant catalysts was the hospitals' need for capital infusion.[36] Rising health care costs, coupled with the constraints on nonprofits'

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28. *See* Bisesi, *supra* note 6, at 830; Claxton, *supra* note 20, at 9; Singer, *supra* note 18, at 233-34.

29. Typically, the nonprofit entity receives an ownership interest equal to 20% of the new venture. *See* Bisesi, supra note 6, at 830.

30. *See* Sean Nicholson et al., *Measuring Community Benefits Provided by For Profit and Nonprofit Hospitals*, HEALTH AFF., Nov.-Dec., 2000, at 168, 172-73 (analyzing financial data of HCA, UHS, and Tenet).

31. Fishman, *supra* note 18, at 709.

32. HCA-THE HEALTHCARE CORP., 2000 ANNUAL REPORT, 2 [hereinafter HCA ANNUAL REPORT]. Prior to 1997, HCA grew through a series of mergers and acquisitions. *Id.* at 3. In July of 1997, prompted by federal investigations, HCA restructured its operations and significantly reduced the number of hospitals it owned and operated. *See id.*

33. UNIVERSAL HEALTH SERVICES, INC., PROSPECTUS, May 10, 2001, at 4 [hereinafter UHS PROSPECTUS].

34. *See* TENET HEALTHCARE CORP., 2000 ANNUAL REPORT 1.

35. Other reasons for the growth in privatization include a belief that the nonprofit hospital could not remain competitive and the benefits of economies of scale. *See* NEEDLEMAN, CONVERSION REVIEW, *supra* note 21, at 19-23 (citing financial distress, need for capital improvements, and fear of loss of market share); Bisesi, *supra* note 6, at 821 (noting that decline in inpatient admissions contributed to privatization movement by creating fewer resources for hospitals); Fishman, *supra* note 18, at 713 (citing ability to pursue lobby activity and consolidate); Claxton, *supra* note 20, at 13-15 (citing efficiency, market share and growth strategies, reduced regulatory constraints, and potential benefits for managers).

36. "Increasingly, nonprofit tax-exempt hospitals have come to believe that they are at a significant disadvantage vis-à-vis their for-profit brethren in their ability to attract the capital

HeinOnline -- 59 Wash. & Lee L. Rev. 417 2002

ability to raise funding, created pressure to convert to for-profit status. These increased costs stemmed from decreases in federal reimbursements related to Medicare, a reduction in inpatient admissions, and limits imposed by managed care ranging from reductions in bed days to decreases in referrals.[37] Unfortunately, nonprofit hospitals were unable to access the capital necessary to meet these rising costs. Traditionally, nonprofit hospitals raised money through donations and tax-exempt bonds.[38] Hospitals issued these bonds at a lower interest rate, resulting in a lower cost of capital for hospitals, while placing them at a competitive advantage in terms of financing.[39] However, changes in the health-care industry and bond ratings have reduced this competitive advantage. Moreover, federal tax laws impose use restrictions on the funds borrowed by nonprofits, further curtailing the growth of large nonprofit hospitals.[40] Unconstrained by such laws, the for-profit sector can raise money through public offerings and other arrangements unavailable to nonprofits. Therefore, when hospital costs began to rise, nonprofit hospitals increasingly found themselves searching for additional capital; forging an alliance with the for-profit sector appeared to be a welcome solution.

B. Students for Sale?: The Privatization of Education

It was only a matter of time before the privatization wave encompassed K-12 education, one of the last major industries controlled by the public sector. While nonprofit[41] schools continue to dominate the educational

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needed to compete in the market." Singer, *supra* note 18, at 221-22; *see also* Fishman, *supra* note 18, at 713 (noting access to capital as fundamental reason for conversion); Sackett, *supra* note 19, at 250 ("A principal factor motivating many not-for-profits to convert is an increased need for access to capital in order to compete with for-profit entities.").

37. Although, historically, the federal government fully reimbursed hospitals for costs related to the care of Medicare recipients, in 1991, Medicare instituted a fixed-payment reimbursement system resulting in lower levels of hospital reimbursements. Singer, *supra* note 18, at 225; *see also* Bisesi, *supra* note 6, at 820-21 (noting increased pressure placed on hospitals because of managed care organizations discounts, reduction in Medicare and Medicaid reimbursements, and decline in inpatient admissions).

38. *See* Fishman, *supra* note 18, at 713 (discussing use of tax exempt financing by hospitals); Singer, *supra* note 18, at 226-27 (discussing tax exempt financing as key source of capital for hospitals).

39. *See* Singer, *supra* note 18, at 226-27 (discussing competitive advantages of tax-exempt financing).

40. *See id.* at 227 (discussing limits of Tax Reform Act of 1986). The restrictions limit the amount of funds a hospital may raise through tax-exempt financing for non-hospital purposes, such as administrative costs. *See* 26 U.S.C. § 145 (1996) (limiting face value of non-hospital bonds to $150,000).

41. This Article uses the term "nonprofit" as applied to companies that manage schools to refer to public schools as well as private schools organized as nonprofits.

HeinOnline -- 59 Wash. & Lee L. Rev. 418 2002

arena,[42] for-profit education has made notable inroads.[43] Revenues from for-profit education companies account for about 10% of the total amount spent on education.[44] The number of public schools operated by for-profits has grown steadily. In fact, while today there are approximately 250 for-profit public schools serving more than 120,000 students, these schools did not exist a decade ago.[45] As of the fall of 2001, the largest for-profit provider of K-12 education has a total enrollment larger than the local school system in Boston or San Francisco.[46]

Privatization in the K-12 arena takes place in one of two ways. For-profit companies either directly operate public charter schools or contract with local school districts or charter school boards to manage particular schools in exchange for funding based on the number of students enrolled at the schools.[47] For-profit managers of education initially entered the K-12 market by contracting directly with school boards to operate local public schools within their district.[48] However, this route proved challenging.[49] The passage

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42. *See* F. Howard Nelson & Nancy Van Meter, *What Does Private Management Offer Public Education?*, 11 STAN. L. & POL'Y REV. 271, 271 (2000) (discussing competitive disadvantage of for-profit schools); Jay Mathews, *New School of Thought: Making Education Pay; For-Profit Initiative Has Backing*, WASH. POST, Apr. 19, 2000, at E1 (noting that for-profit companies run only 250 of all 80,000 public schools).

43. In addition to K-12 education, these companies also operate tutoring centers, corporate training seminars, colleges, and schools devoted to early child care. For example, Sylvan Learning Systems operates the largest network of tutoring centers, while the University of Phoenix is the largest for-profit college. *See, e.g.*, Lisa Gryboski, *PA Colleges Bemoan Entrance of For-Profits*, MORNING CALL, June 17, 1998, at A1 (referring to the University of Phoenix as "leader" of for-profit collegiate movement). In addition, Columbia University and several other educational and cultural institutions, including the University of Michigan and the University of Chicago, host a for-profit web site, http://www.fathom.com, that provides information regarding on-line courses, lectures, and other educational endeavors. *See* Sarah Carr & Vincent Kiernan, *For-Profit Web Venture Seeks to Replicate the University Experience Online*, CHRON. OF HIGHER EDUC., Apr. 14, 2000, at A59 (discussing on-line collaboration of Columbia University with other institutions).

44. William C. Symonds, *Industry Outlook 2000: Services*, BUS. WK., Jan. 10, 2000, at 138 [hereinafter Symonds, *Outlook*].

45. *See* Greenwald, *supra* note 8, at 56 (discussing rapid expansion of for-profit schools).

46. *See* Symonds, *Edison Pass*, *supra* note 8 (noting that with schools serving some 75,000 pupils, Edison will be larger than the Boston or San Francisco system); William C. Symonds et al., *How to Fix America's Schools*, BUS. WK., Mar. 19, 2001, at 66 [hereinafter Symonds, *Fixing America's Schools*].

47. In fact, the bulk, if not all, of the funds these private companies receive comes from public sources. *See, e.g.*, EDISON SCHOOLS, INC., PROSPECTUS, Mar. 20, 2001, at 18-19 [hereinafter EDISON PROSPECTUS] (noting that it receives all of its revenue from public sources and that it derives funding from special state and federal programs such as Title I of Elementary and Secondary Education Act, which earmarks funds for low income families).

48. *See* Nelson & Van Meter, *supra* note 42, at 271 (discussing history of for-profit schools' entry into market). Education Alternatives, Inc., now the Tesseract Group, Inc. (Tes-

HeinOnline -- 59 Wash. & Lee L. Rev. 419 2002

of charter school legislation provided a second alternative for private companies seeking access to the public schools. Such legislation, currently enacted in thirty-seven states, the District of Columbia,[50] and Puerto Rico[51] authorizes local school boards or other governmental bodies to grant charters for the creation and operation of public charter schools. The schools operate independently of the state public school system, although they continue to be subject to some state and federal regulation.[52] Under their charter school legislation, some states allow the granting of a charter directly to a private entity, and for-profit companies thus manage schools pursuant to a contract with the granting agent. Other states do not permit the granting of charters to

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seract), became the first private firm to manage a public school board when it contracted with the Dade County, Florida school board in June of 1990. *See* Lewis D. Solomon, *The Role of For-Profit Corporations in Revitalizing Public Education: A Legal and Policy Analysis*, 24 U. TOL. L. REV. 883, 900-03 (1993) (discussing "Tesseract" model in public sector). However, because of controversies related to inflated attendance records and misrepresented test scores, Dade County eventually chose not to renew its contract. Nelson & Van Meter, *supra* note 42, at 271-72. Others who experimented with for-profit education also encountered difficulties, resulting in the termination of the earlier contracts. *See id* (discussing contract terminations in Minneapolis, Minnesota and Wilkesboro, Pennsylvania).

49. *See* Nelson & Van Meter, *supra* note 42, at 271-72 (discussing early contract difficulties with local school boards).

50. These states include Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Louisiana, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Virginia, Wisconsin, and Wyoming. THE CTR. FOR EDUC. REFORM, CHARTER SCHOOL HIGHLIGHTS AND STATISTICS [hereinafter CHARTER SCHOOL HIGHLIGHTS], *available at* http://edreform.com/pubs/chglance.htm. Pursuant to this legislation, over 500,000 students are enrolled currently in over 2,000 charter schools. *Id.* Minnesota passed the first charter school in 1991 with California following suit in 1992. *See* Judith Johnson & Alex Medler, *The Conceptual and Practical Development of Charter Schools*, 11 STAN. L. & POL'Y REV. 291, 293 (2000) (discussing history of charter schools).

51. *See* Jonathan S. Rosenberg, *Education Law Institute 2001, Current and Emerging Issues in Special Education: Charter Schools*, 96 PLI/NY 813, 816 (2001) (including Puerto Rico).

52. All private entities that run public schools continue to be subject to some state and federal regulation. *See* Frank R. Kemerer & Catherine Maloney, *The Legal Framework for Educational Privatization and Accountability*, W. EDUC. L. REP., Mar. 29, 2001, at 589-605 (discussing constitutional and regulatory restrictions on private educational entities). Charter schools are also subject to oversight from the body granting their charter. *See id.* at 609-21 (discussing accountability mechanisms). After studying the states operating the most for-profit charter schools, one group of researchers concluded that the private entities that operate charter schools are "subject to considerable accountability." *Id.* at 609. Arizona, Massachusetts, and Michigan are the states with the most charter schools operated by for-profit companies. *Id.* The study found that at least in Michigan and Massachusetts, the schools were subject to the same requirements as public schools with regard to teacher certification, fiscal oversight, student assessment, and periodic reporting. *See id.* at 619 (discussing impact of legal framework on autonomy of private entities operating charter schools).

HeinOnline -- 59 Wash. & Lee L. Rev. 420 2002

private firms. In these states, private firms operate charter schools via subcontracts, pursuant to which they enter into an agreement for management of the charter school with a third party that holds the charter.[53]

Spearheading the movement into for-profit education is Edison Schools, Inc. (Edison), which at the time of this writing, is the largest for-profit operator of K-12 schools.[54] Since opening its first four schools in 1995,[55] Edison has grown steadily and became one of a select few of these companies with publicly traded stock[56] when it hosted its initial public offering in 1999.[57] As of the 2001-2002 school year, Edison manages 136 public schools in twenty-one states and the District of Columbia.[58] Edison serves

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53. *See id.* at 606 (discussing "contract model" of privatization); Solomon, *supra* note 48, at 891-92 (same).

54. *See e.g.*, Symonds, *Edison Pass, supra* note 8, at 70 ("Right now, [Edison] is the leader by every measure in the nascent business."). Edison is the brainchild of Christopher Whittle, who serves as its CEO. Whittle's first for-profit educational venture was Channel One, a program of news and commercials in the classroom, which he sold in 1994 for $300 million. Mathews, *supra* note 42. In addition, the current chairman of Edison, Benno Schmidt, Jr., left his position as president of Yale University to participate in the Edison Project. William Raspberry, *Can Whittle Save the Schools?*, WASH. POST, June 8, 1992, at A19.

55. EDISON PROSPECTUS, *supra* note 47, at 43.

56. *See* Nelson & Van Meter, *supra* note 42, at 272 (noting that few private education-management companies trade publicly). Only two other companies, Tesseract and Nobel Learning Communities, Inc. (Nobel), trade publicly. *Id.* at 273. However, Tesseract, previously Education Alternatives, Inc., filed for Chapter 11 in October 2000. *See* THE TESSERACT GROUP, INC., CURRENT REPORT, FORM 8K, Oct. 6, 2000 (reporting bankruptcy to SEC). Other for-profit entities involved with charter schools include SABIS Educational Systems, Advantage Schools, The Leona Group, Beacon School Management, Mosaic, and National Heritage Academy. Nelson & Van Meter, *supra* note 42, at 272.

57. Edison's initial public offering in November 1999 raised more than $100 million, although the listing price of $18 per share was below the expected $25 per share. *See, e.g.*, Symonds, *Outlook, supra* note 44, at 138 (analyzing increased investor interest in for-profit education); Mathews, *supra* note 42 (discussing Wall Street's backing of Edison); Edward Wyatt et al., *Education Pays Off Royally*, N.Y. TIMES, Nov. 17, 1999, at B15 (noting results of Edison's 1999 IPO). Edison has not shown a profit since its inception, but it reported its first quarter of positive cash flow at the end of 1999. Mathews, *supra* note 42. Since 1999, Edison has had two secondary offerings: in August 2000 and in March 2001. Edison raised approximately $71 million in its August 2000 offering and another $81 million in the March 2001 offering. EDISON SCHOOLS, INC., QUARTERLY REPORT, FORM 8K, Mar. 31, 2001, at 6-7.

58. This is an increase from 113 public school operated by Edison at the end of the 2000-01 school year. EDISON PROSPECTUS, supra note 47, at 43; *see also Edison Schools to Buy Rival School Manager for $36 Million in Stock*, WALL ST. J., June 5, 200,1 at B6 [hereinafter *Edison to Buy Rival*] (reporting on Edison's first acquisition); Symonds, *Edison Pass, supra* note 8, at 70 (discussing Edison's rapid growth). Given Edison's acquisition of LearnNow, Inc., another for-profit manager of schools, it likely will continue to expand in the future. *See Edison Completes LearnNow Deal*, WALL ST. J., July 6, 2001, at B5 (reporting likely completion of Edison's acquisition of LearnNow). By comparison, Tesseract operated fifteen schools, which included eleven charter schools and four private schools. Hal Mattern, *School Changing*

approximately 75,000 students.[59]

A belief that the private sector can do a better job of delivering quality education than their public counterpart has fueled the growth in privatized education. As one private management company's annual report states:

> Education is a politically "hot issue," both nationally and in many local areas. The broad public debate has shifted from whether our existing K-12 system has failed in terms of performance to which reform movements promise the best and quickest improvements.[60]

Because of their additional resources and nationwide support system, for-profit educators believe that their programs offer benefits that public school systems cannot.[61] Along with private vouchers, home-schooling, and charter schools, the private management of public schools represents one of the alternatives to what the American public has begun to believe is the failing governmental school system.

In addition to the relative dissatisfaction with public schools, the growing amount of venture capital money available to these companies fueled the growth of for-profit education. Indeed, a small but distinct group of venture capitalists enthusiastically has embraced for-profit educational endeavors.[62]

Hands; Tesseract Trying to Stop Bleeding, ARIZ. REP., May 24, 2000, at D1. Nobel operates 171 private schools in fifteen states, the bulk of which (close to 150) are pre-elementary schools. *Id.*; *see also* NOBEL LEARNING COMMUNITIES, INC., 2000 ANNUAL REPORT 1 [hereinafter NOBEL ANNUAL REPORT] (providing statistical overview of business); Greenwald, *supra* note 8, at 56 (noting that as of March, 2000, 145 of Nobel's schools were pre-elementary).

59. This is compared to the 57,000 students served in the 2000-2001 school year. Symonds, *Edison Pass*, *supra* note 8, at 4. Of those 57,000 students served, approximately 41,400 were in grades pre-K-5, 12,600 were in grades 6-8, and 2,800 were in grades 9-12. EDISON PROSPECTUS, *supra* note 47, at 43. By comparison, Nobel serves approximately 28,000 students. NOBEL ANNUAL REPORT, *supra* note 58, at 1.

60. NOBEL ANNUAL REPORT, *supra* note 58, at 10. As one commentator noted, "[E]ducation is the last big bastion of the economy largely controlled by the government. And given how poor a job the government has done, it's no wonder the private sector is rushing in." Symonds, *Outlook*, *supra* note 44, at 138; *see also* Alexis Moore, *As Debate Rages, For-Profit Charter Schools Move Forward*, STAR-LEDGER, Feb. 6, 2000, at 8 (claiming that "[i]nvestors seem to believe that these companies can turn at least part of the nation's multibillion-dollar education sector from nonprofit institutions into consolidated, money-making businesses").

61. For example, Edison schools offer longer days and school years combined with an emphasis on technology and foreign language skills. Edison believes that it can invest in the future and exploit advantages of scale in a manner that public schools cannot. *See* EDISON PROSPECTUS, *supra* note 47, at 43-44 (promoting Edison's competitive advantage over public schools).

62. *See, e.g.*, Greenwald, *supra* note 8, at 56 (noting that "venture capitalists from Wall Street to Silicon Valley are eagerly pumping funds into educational start-ups"). One market-research firm estimated that, from 1998 to 1999, the amount of private-venture capital money available to education startups quadrupled to $3.3 billion and predicted that in 2000 that number would increase to $4 billion. *See* Symonds, *Outlook*, *supra* note 44, at 138 (comment-

HeinOnline -- 59 Wash. & Lee L. Rev. 422 2002

For example, several major Wall Street firms, such as Smith Barney and Montgomery Securities, have created investment literature designed to encourage participation in the K-12 education market.[63] Also, one private equity fund, with a management team that includes the former governor of Massachusetts and two former U.S. Secretaries of Education, has emerged with an exclusive focus on for-profit education, raising over $150 million to support these endeavors.[64] Similarly, Edison received over $300 million from such sources.[65]

The creation of charter schools also accounts for the increase in for-profit education. As two researchers noted, "the charter school movement gave new life to the concept [of privately managed public schools]."[66] The number of charter schools with for-profit operators accounts for about 12% of all charter schools.[67] In some states, the number of privately managed charter schools is

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ing on research performed by Eduventures.com). Similarly, in 1997, Kohlberg Kravis & Co. paid $609 million for Kindercare, an entity that provides curriculum materials for pre-school and kindergarten children in learning centers. Kendra Wall, *Investors Go Back to School*, UPSIDE MAG., Oct. 1, 2000, at 253, 255. Fortsmann Little led a $35 million investment round in Caella University, a for-profit university that offers web-based courses and certifications. *Id.* at 255. Acceptance of this opportunity is not widespread among investors and many express reservations about the risk of the investment. *See* Nelson & Van Meter, *supra* note 42, at 273 (noting that "many of the education entrepreneurs in the K-12 market have not convinced the investment community that they will deliver a strong return on investment").

63. *See* Nelson & Van Meter, *supra* note 42, at 272-73 (describing investment literature of securities firms, which notes, among other things, that revenue stream is "predictable and guaranteed" and that student population shows "continued growth").

64. *See* Avital Louria Hahn, *An Educational Niche and a Former Governor Help Leeds Weld Master the Game: Private Equity Firm Has Much of the For-Profit Education Market to Itself*, INVESTMENT DEALERS DIG., Mar. 5, 2001 (reporting on Leeds Weld entry into for-profit schools investment sector). In early 2001, former Massachusetts governor William Weld became a board member and general partner of Leeds Weld & Co. (Leeds), formerly known as Leeds Equity Partners, and expressed a belief that for-profit education could solve many of the problems in the public school. *Id.* The advisory board for Leeds includes both Lamar Alexander and Richard Riley. *Id.*

65. *See* Mathews, *supra* note 42 (noting that Edison received over $350 million from major investors). Leeds invested some $45 million dollars in Edison. Wall, *supra* note 62. Edison also benefits from the support of philanthropic organizations. *See* Ann Grimes, *School Board Seeks to Revoke Edison Charter*, WALL ST. J., Feb. 20, 2001, at B1 (explaining that California philanthropic organization "pledged $25 million to California districts that work with Edison and donated $1.8 million to the Edison Charter Academy").

66. Nelson & Van Meter, *supra* note 42, at 272; *see also* Moore, *supra* note 60 (noting that "[f]or-profit education-management companies interested in opening alternative schools are doing so by way of charter-school movement"); Symonds, *Outlook*, *supra* note 44, at 138 (noting that for-profit schools – through the charter school movement – "are riding the biggest reform wave in American education").

67. *See* Frank Kemerer & Catherine Maloney, *The Legal Framework for Educational Privatization and Accountability*, 150 EDUC. L. REP. 589, 605 (2001). This is up 2% from 2000

quite significant.[68] In fact, researchers estimate that private, for-profit, management companies operate at least 70% of Michigan's charter schools.[69] Also, one Philadelphia school district, considered one of the worst in the country, hired three for-profit companies, including Edison, to operate all of the schools within its district.[70] As the number of charter schools grows, the number of schools with for-profit operators probably will grow as well.

C. The Resistance

The shift toward for-profit delivery of education and hospital services has encountered considerable opposition. In the health care context, state attorneys general and other community groups challenged for-profit conversions both before and after they occurred.[71] However, many of these efforts proved unsuccessful.[72] In the wake of these defeats, opponents focused on securing legislation to regulate the conversion process.[73] Currently, thirty-five states

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when 10% of the 1,700 charter schools were run by for-profit organizations. *See* Moore, *supra* note 60.

68. Kemerer and Maloney found that the permissive nature of some state charter laws accounted for the high number of privately operated charter schools. Kemerer & Maloney, *supra* note 67, at 609. In Arizona, for example, individuals as well as public and private entities may apply for charters, teachers do not need to be certified, and the state has no collective bargaining. Moreover, the Arizona laws exempt charter schools from the state rules governing other public schools. Amidst this clearly hospitable climate, for-profit education in Arizona via the charter school has flourished. *Id* at 160. Not only is Arizona the current host of the largest number of charter schools, *see* CHARTER SCHOOL HIGHLIGHTS, *supra* note 50 (charting number of charter schools by state), but many of these schools are operated by privately-managed companies. *See* THE TESSERACT GROUP, INC., QUARTERLY REPORT, Mar. 31, 2000, at 8 [hereinafter TESSERACT QUARTERLY REPORT] (noting significant revenue from Arizona).

69. *See, e.g.*, JERRY HORN & GARY MIRON, EVALUATION OF THE MICHIGAN PUBLIC ACADEMY INITIATIVE 98 (1999) (indicating jump in use of for-profit management companies by charter schools); Kemerer & Maloney, *supra* note 67, at 609 (observing that about 70% of Michigan academies are operated by educational management organizations); Nelson & Van Meter *supra* note 42, at 272 (noting high use of for-profit companies in Michigan).

70. *See* Brent Staples, *A Case of Radical Surgery on Failing Schools*, N.Y. TIMES, June 10, 2001, at A14 (noting that district in Chester has performed so poorly that school board had considered dissolving and dispersing its students to surrounding school districts).

71. *See, e.g.*, Singer, *supra* note 18, at 236-37 (describing several "high profile" challenges to hospital conversions).

72. In fact, some have argued that this conversion is inevitable. *See* Sackett, *supra* note 19, at 247 (arguing that conversions are natural consequences of inadequacies in health care and that "flat opposition to for-profit health care provision is a waste of resources and time").

73. Indeed, members of Congress have proposed legislation providing for significant federal oversight of the conversion of tax-exempt hospitals. Additionally, several states have introduced bills creating monitoring procedures for the conversion of hospitals into for-profit entities. Sackett, *supra* note 19, at 251-52; *see also* Bissei, *supra* note 6, at 833-37 (noting meeting of attorneys general that sparked action aimed at overseeing conversion process as well

HeinOnline -- 59 Wash. & Lee L. Rev. 424 2002

have considered or passed legislation aimed at regulating hospital conversions.[74] These statutes typically require notification to, or approval of the conversion by, the state attorney general. The attorney general reviews the process, focusing on a variety of factors including the payment of fair value for the hospital assets, the potential for the continuance of charitable care post-conversion, and the prevention of any conflicts of interests.[75]

A similar kind of opposition confronted the movement towards for-profit education.[76] In April 2001, New York parents and teachers successfully opposed Edison's attempt to take over five public schools.[77] The San Francisco school board strenuously opposed Edison's management of some of its schools,[78] although Edison ultimately was successful.[79] Moreover, opponents of privatization in education have a strong ally in the teachers' unions whose

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as state oversight that resulted from meeting); Singer, *supra* note 18, at 222 n.9 (listing various states' legislation related to conversion process); *id.* at 240 (explaining state laws aimed at monitoring conversion process).

74. *See, e.g.*, Kevin F. Donohue, *Crossroads in Hospital Conversions – A Survey of Nonprofit Hospital Conversion Legislation*, 8 ANNALS HEALTH L. 39, 63 (1999) (noting number of states that had considered or enacted legislation governing conversions).

75. *See id.* at 67-69 (explaining that conversion requires Attorney General's approval); *see also* Singer, *supra* note 18, at 241 (noting requirement that state attorneys general review conversion). Concerns in the hospital conversion context are similar to concerns in the takeover context that directors will attempt to profit from self-dealing. *See e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (noting "omnipresent specter that a board may be acting primarily in its own interests"). State legislators recognize that nonprofit conversions create significant risks of self-dealing by directors and much of the legislation has been aimed at thwarting this behavior. *Id.*

76. Indeed, charter schools in general have encountered considerable opposition, including constitutional challenges. *See, e.g.*, BRYAN C. HASSEL, THE CHARTER SCHOOL CHALLENGE 21-30 (1999) (noting controversy surrounding charter schools); Andrew Broy, *Charter Schools and Education Reform: How State Constitutional Challenges Will Alter Charter School Legislation*, 79 N.C. L. REV. 493, 533-49 (2001) (detailing legal challenges to charter schools); Wendy Parker, *The Color of Choice: Race and Charter Schools*, 75 TUL. L. REV. 563, 602-15 (2001) (discussing possible constitutional challenges to charter schools); Karla A. Turekian, *Traversing the Minefields of Education Reform: The Legality of Charter Schools*, 29 CONN. L. REV. 1365, 1383-93 (1997) (explaining legal issues facing charter schools); Note, *The Hazards of Making Public Schooling a Private Business*, 112 HARV. L. REV. 695 (1999) (detailing challenges faced by private companies running private education). Because many of the for-profit educators operate charter schools, any attack on these schools necessarily will undermine the privatization efforts in this arena.

77. *See Edison to Buy Rival*, *supra* note 58; Lynette Holloway, *Parents Explain Resounding Rejection of Privatization at 5 Schools*, N.Y. TIMES, Apr. 13, 2001, at B1 (explaining why parents voted against Edison proposal).

78. *See* Grimes, *supra* note 65 (detailing opposition to Edison in San Francisco).

79. In July 2001, the school district agreed to discontinue its efforts to revoke Edison's charter and allow Edison to apply for renewal of its charter. *See* Edward Wyatt, *California Battle Over Charter School Ends*, N.Y. TIMES, July 3, 2001, at A12.

HeinOnline -- 59 Wash. & Lee L. Rev. 425 2002

members often act in concert with parents and community leaders to resist efforts by the local school board or charter authority to privatize their schools. Highlighting this fact, Edison's prospectus notes that "we regularly encounter resistance from teachers' unions in local school board debates over whether to enter into a management agreement with us."[80] In a few instances, unions brought litigation against Edison to prevent Edison's entrance into their public school system.[81] While these efforts have not derailed the conversion process completely, they have been able to slow it down considerably.[82]

D. The Philosophical Objection

Opponents raise many objections to the privatization of these industries.[83] Generally, the crux of their concern is that the core mission of hospitals and K-12 educators is antithetical to the corporate goal of increasing the wealth of its shareholders.[84] At least two underlying premises are embedded in this objection.[85]

The first one encompasses a belief that the services provided by the public school system and hospitals are essential. Healthcare represents a critical, life-and-death service. Public hospitals historically provided health

80. EDISON PROSPECTUS, *supra* note 47, at 12. The fact that these labor unions have such a strong impact on the conversion process may confirm many observations that other constituent groups do not need directors to take into account their interests because they have organizations to protect them, while shareholders' sole protector is the directors.

81. *See id.* at 12 (noting that teachers' unions occasionally challenge management agreements in court). For example, the Baltimore teachers' union filed suit seeking to void Edison's contract to operate three elementary schools. Eric Siegel, *School Pact Draws Suit*, BALT. SUN, Apr. 21, 2000, at 1B.

82. For example, Edison's New York contract was rejected, while the controversy in San Francisco lasted for months. *See supra* notes 80-81 and accompanying text (explaining actions of unions in opposing privatization). Based on the experience in health care, one may predict that this opposition will subside and the focus will shift toward increased regulation of the conversions and the behavior of these for-profit enterprises post-conversion.

83. *See, e.g.*, Solomon, *supra* note 48, at 920-25 (citing arguments raised by critics including argument that privatization may block common educational experiences, erode civic equality, and promote commercial products as well as improper values); Julie Huston Vallarelli, Note, *State Constitutional Restraints on the Privatization of Education*, 72 B.U. L. REV. 381, 382-83 (1992) (discussing belief that privatized education benefits wealthy and hastens white flight).

84. *See* Hyman, *supra* note 22, at 744-45 (explaining that philosophical bias in favor of nonprofit hospitals reflects view that for-profits will not provide community benefits); Sackett, *supra* note 19, at 250 (noting that nonprofit boards have fiduciary duty to their charitable purpose, while for-profit boards owe duty to shareholders); Wyatt, *Higher Scores*, *supra* note 8 (noting that what appears to underlie objections of Edison opponents is philosophical opposition to school run by for-profit company); Grimes, *supra* note 65 (noting that school officials are most bothered by fact that public funds are spent on profit-making endeavors).

85. *See infra* notes 86-97 and accompanying text (discussing premises).

HeinOnline -- 59 Wash. & Lee L. Rev. 426 2002

care to those who lacked the ability to pay for it.[86] While today's public hospitals may have strayed from their more charitable roots,[87] many continue to adhere to the notion that public hospitals have a fundamental responsibility to provide health care and other benefits to those in need.[88] Similarly, K-12 education represents a critical service. Early education significantly impacts the lives of the students by providing them with the skills necessary to survive, prosper, and even participate in a democratic society.[89] Moreover, like their

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86. *See, e.g.*, NEEDLEMAN, CONVERSION REVIEW, *supra* note 21, at 12 (noting that historically, while well-off were treated at home or by family members, early hospitals treated only poor, transient, or those without family support); Fishman, *supra* note 18, at 703 (noting that "from the time of Elizabethan Statute of Uses" nonprofit hospitals have served as symbol of charitable healthcare provider); Sackett, *supra* note 19, at 248 (stating that "American hospitals have a long history of providing charitable care").

87. *See, e.g.*, Fishman, *supra* note 18, at 704 (noting that modern changes have made notion of voluntary hospital into myth); Hyman, *supra* note 22, at 758-60 (noting that empirical evidence "provides disheartening news to those who believe nonprofit hospitals are particularly virtuous"). Indeed, while federal law previously required that tax exempt hospitals provide free care directly to indigents, changes in the tax laws have relaxed the standard considerably so that hospitals are not required to provide free care or even a full-time emergency room. *See* I.R.S. Rev. Rul. 69-545, 1969-2 C.B. 117 (redefining charitable care requirement to "community benefit" standard). For a discussion of this change, see generally Nina J. Crimm, *Evolutionary Forces: Changes in For-Profit and Not-For-Profit Health Care Delivery Structures; A Regeneration of Tax Exemption Standards*, 37 B.C. L. REV. 1, 40-46 (1995) (noting change from narrow construction of term "charitable care," which limits exemption to hospitals that provide free or reduced-cost care to indigents, to broader construction, which includes all hospitals that provide benefits to community, even if such hospitals fail to provide free health care); Sackett, *supra* note 19, at 248-49 (explaining move from charitable care for indigents to community benefits, including "medical research, training, and teaching").

88. *See, e.g.*, Stuart Auerbach, *Managed Care Backlash*, WASH. POST, June 25, 1996, at Z12 ("The switch to medicine-for-profit clashes with the outdated but still-cherished national myth of community-based nonprofit hospitals .... This is an idealized picture of medicine in the United States, but its comforting image is firmly placed in the national psyche.").

89. Education is important for both political and social reasons. *See, e.g.*, J. TUSSMAN, GOVERNMENT AND THE MIND (1977) (noting that public schools should shape students into good citizens); Michael B. Katz, *The Present Moment in Educational Reform*, 41 HARV. EDUC. REV. 342, 355 (1971) (noting that public schools are asked to check immorality and create sense of community); Solomon, *supra* note 48, at 920 (arguing that critics of privatization view schools as places in which "children from all walks of life come together" as productive citizens); Nat Stern, *Challenging Ideological Exclusion of Curricular Material: Rights of Students and Parents*, 14 HARV. C.R.-C.L. L. REV. 485, 492-93 (1979) (noting socialization aspect of public schools); Cheryl L. Wade, *For-Profit Corporations That Perform Public Functions: Politics, Profit and Poverty*, 51 RUTGERS L. REV. 323, 336-39 (1999) (noting that education is important public service distinct from traditional services provided by corporations); Mark G. Yudof, *When Governments Speak: Toward a Theory of Government Expression and the First Amendment*, 57 TEX. L. REV. 863, 878 (1979) (noting that "public school teachers are charged with instilling values to a captive audience"). The Supreme Court also has recognized the unique nature of the public school. *See* Plyler v. Doe, 457 U.S. 202, 221 (1982) ("Public schools are the most vital civic institution for the preservation of a democratic system

HeinOnline -- 59 Wash. & Lee L. Rev. 427 2002

ideas about public hospitals, many Americans have a "traditional concept of a public school system in which the local public sector assumes complete responsibility for providing education to every (or nearly every) school-age child."[90] Thus, the presumption that both the hospital and the public school system are responsible for providing essential services is deeply embedded in the American psyche.

The second premise embedded in the objection to privatization is that the for-profit corporation runs counter to the special mission of these industries. This premise also appears to have firm roots in our society.[91] In fact, critics within both industries express a deep-seated philosophical objection to for-profit management. Professor David Hyman notes, "It is clear that there is a widespread 'philosophical bias' in favor of the nonprofit form for hospitals."[92] Opponents believe that the profit-maximizing aim of for-profit hospitals prevents post-conversion hospitals from serving the community and providing access to healthcare to all those in need.[93] The following captures this sentiment:

> Nonprofit and for-profit administrative boards differ in the character of their fiduciary duties.... [N]onprofits have a fiduciary duty to the organization's charitable purpose and benefit to the public.... Once converted, however, the board of a for-profit maintains a fiduciary duty to shareholders. This duty requires them to operate the hospital so as to generate returns on shareholder investment.[94]

This perceived difference between the duties of directors in a nonprofit and for-profit corporation appears to be at the heart of the objection to hospital conversions and also animates the opposition in the education arena. Thus, one commentator notes that while some have asserted other reasons for their opposition to privatized education, "what appears to underlie their objections is a philosophical opposition to a school run by a company whose purpose is

of government.") (internal citations omitted); Abington Sch. Dist. v. Schempp, 374 U.S. 203, 241-42 (1963) (Brennan, J. concurring) ("It is implicit in the history and character of American public education that the public schools serve a uniquely *public* function: the training of American citizens . . . ."); Brown v. Bd. of Educ., 347 U.S. 483, 493 (1954) ("Education is perhaps the most important function of state and local governments."); W. Va. State Bd. of Educ. v. Barnette, 319 U.S. 624, 637 (1943) (noting that public schools are "educating the young for citizenship").

90. Solomon, *supra* note 48, at 920.

91. *See supra* notes 87-88 and accompanying text (explaining bias toward non-profit hospitals).

92. Hyman, *supra* note 22, at 744.

93. *See, e.g.*, Gray & McNerney, *supra* note 7, at 1524 (noting conflict between making profit and treating indigent patients; Sackett, *supra* note 19, at 247 (noting that health care community views changes to for-profit hospital care with "considerable alarm").

94. Sackett, *supra* note 19, at 250.

HeinOnline -- 59 Wash. & Lee L. Rev. 428 2002

to earn a profit."[95] Parents, teachers, and legislators express a singular concern that the very nature of the for-profit corporation demands that the students' interests be subordinated to those of shareholders.[96] These groups argue that companies like Edison will cut corners in a variety of large and small ways that will harm school children. Capturing this belief, Professor Lewis Solomon, who questioned the merits of the objections to privatized education, explained the critics' concerns as follows:

> If a for-profit ownership venture experiences a bad year, will it close one or more schools before the end of a school year, thereby stranding students, or will the squeeze on profits lead to a compromise on quality? Would profitmaking entities exploit children to maximize profits by: using low quality text, supplies, meals; hiring cheaper, less competent teachers; inflating grades to foster the illusion of academic achievement or ignoring children with special needs?[97]

These questions illustrate the belief that the duties of for-profit directors and the missions of public benefit corporations are at polar opposites. Based on this view, conversions into for-profit firms will cause the welfare of students, like that of patients, to fall victim to profitability concerns. However, this assessment is based on a particular conception of the for-profit corporation. If the conception is not accurate, then the suggestion about the probable responses of directors within these corporations may be inaccurate

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95. Wyatt, *Higher Scores*, *supra* note 8.

96. Interviews of teachers and parents who oppose efforts to privatize public education reveal that nearly all have concerns about the priorities of corporations like Edison. *See, e.g.*, Grimes, *supra* note 65 (noting that president of San Francisco school board, who launched campaign to revoke Edison's charter at San Francisco elementary school, claimed philosophical opposition to for-profit management of public schools); Holloway, *supra* note 77 (noting New York parents fear that their children would be used as guinea pigs in business experiment); Moore, *supra* note 60 ("Parents and educators who have fought granting charters to such [for-profit] companies often express a philosophical objection to the idea of a for-profit's performing a traditionally nonprofit function."); Rene Sanchez, *Edison School Project Growing Slowly: Public Education Venture, Entering Third Year, Has Yet to Make Profit*, WASH. POST, Aug. 22, 1997, at A03 (noting that "[m]any school districts are still reluctant to work with . . . for-profit group[s] trying to manage public schools, because they doubt the companies will be able to profit without taking budget shortcuts that may not be beneficial to students"); Edward Wyatt & Abby Goodnough, *As Bid to Privatize Schools Ends, Supporters Second-Guess Effort*, N.Y. TIMES, Mar. 31, 2001, at B2 (noting community's concern that children would be reduced to dollar signs). This kind of sentiment has existed since the inception of schools like Edison. *See, e.g.*, Mathews, *supra* note 42 (commenting that since its inception, educators have been concerned that while Channel One "might make money . . . [it] would not help kids").

97. Solomon, *supra* note 48, at 924. Professor Solomon responds to these concerns and concludes that for-profit corporations may create competition within the public educational system that will force the development and implementation of more efficient and creative schools. *Id.* at 925-26.

HeinOnline -- 59 Wash. & Lee L. Rev. 429 2002

as well. Evaluating corporate law in the context of privatization will help determine the merits of the shareholder-dominated conception of corporate law and, in turn, the merits of such an objection to privatization.

II. Analyzing the Two Models of Corporate Thought

As Chancellor Allen, formerly of the Delaware Court of Chancery, wrote, "our society has been schizophrenic on the subject of corporation law for a long time."[98] Indeed, two seemingly inconsistent conceptions of the business corporation – one that views the corporation as a profit-maximizing machine and the other that recognizes the corporation's responsibility for addressing the concerns of all its constituents, including employees, customers, creditors, and similar groups – have dominated our thinking about directors' objectives.

The first, and more conventional, understanding of the corporation, referred to herein as the "shareholder primacy" model, is that the corporation exists in order to maximize the value of the shareholder's interests.[99] This conception of the corporation was justified first by the notion that shareholders are the property owners of the corporation and, therefore, are entitled to legal protection of their property – their invested capital.[100] In their classic book, Adolf Berle and Gardner Means described the arrangement between the corporate directors and shareholders as analogous to a trust relationship, in which the directors hold the shareholders' property in trust for the shareholders' benefit.[101] Because of this relationship, directors owed a duty of undivided loyalty to the shareholders to enhance the value of shareholders' property. More recently, scholars have offered a different rationale for the corporation's focus on the shareholder.[102] This justification, influenced by neoclassi-

98. Allen, *supra* note 12, at 264.

99. *See* Adolf A. Berle, Jr., *For Whom Corporate Managers are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367-69 (arguing that corporations exists exclusively to make profits for shareholders); Millon, *supra* note 12, at 228-29 (noting that "modern view of the corporation as an engine for shareholder wealth maximization" arose around turn of twentieth century).

100. *See* ADOLF A. BERLE, JR. & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 9 (1932) (referring to shareholders as "owners"and noting that corporate governance must focus on the problems caused by the separation of ownership and control); Millon, *supra* note 12, at 229-30 (explaining idea that shareholders hold corporations as property); Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32, 33 (stating that corporate executives are employees of shareholders).

101. *See* BERLE & MEANS, *supra* note 100, at 119-95 (presenting trust model of corporate law); *see also* William W. Bratton, *Berle & Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 762-765 (2001) (explaining Berle and Means trust model).

102. Several scholars have advanced and discussed the contractual view of the corporation. *See generally* Barry D. Baysinger & Henry N. Butler, *AntiTakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); Lucien Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L.

HeinOnline -- 59 Wash. & Lee L. Rev. 430 2002

cal economic analysis,[103] starts from the presumption that a corporation is essentially a web of contractual relations forming a "nexus of contracts."[104] Under this view, contracts govern the rights of both shareholders and non-shareholders. The directors' relationship with the shareholders is a contract pursuant to which the director serves as the shareholders' agent. However, because the interests of directors and shareholders are not always aligned, legal rules must ensure that directors do not shirk their responsibilities to shareholders in favor of their own interests.[105] Thus, implicit in the contract between directors and shareholders is an understanding that directors have a legal duty to promote the shareholders' interest over those of other groups.[106]

This preference for shareholders' interests is justified because non-shareholders have alternative mechanisms, unavailable to shareholders, by which they can influence the corporation. Indeed, contracts govern the rights of groups, such as employees and creditors, and these contracts can be altered to the extent that they fail to protect the groups' interests.[107] Even privately-managed schools are governed by contracts that place restrictions and affirmative obligations on the treatment of students.[108] Moreover, powerful interest groups often represent and promote the concerns of these other corporate constituents. Most notably, labor unions often have considerable influence over managerial decision-making. For example, not only did labor unions play a crucial role in the passage of constituency statutes,[109] but they also

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REV. 1395 (1989); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99 (1989); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982). For a critique of this theory, see William W. Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 432-64 (1989) (explaining deficiencies in contract theory).

103. *See* Bratton, *supra* note 101, at 415-16 (explaining neoclassical foundation of contractual theory of firm).

104. *See id.* at 432-64 (explaining contract theory).

105. *See* Millon, *supra* note 12, at 232 (noting that legal rules are used to enforce duties to shareholders). Proponents of the contractual view of the corporation refer to the problem that managers may shirk their duty to shareholders or engage in other forms of misbehavior as agency costs. *Id.* at 231-32; *see also* Bratton, *supra* note 101, at 418 (mentioning legal rules against self-dealing).

106. *See, e.g.*, Millon, *supra* note 12, at 232-33 (detailing "explanation for shareholders' legal right to insist on management's exclusive fidelity to their interests").

107. *See, e.g.*, Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991) (mentioning contractual duties between groups). In *Katz v. Oak Industries, Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986), Chancellor Allen explained that groups, such as creditors, must look to contracts for protection of their rights.

108. *See* Grimes, *supra* note 65 (noting details of Edison's contract with San Francisco).

109. *See, e.g.*, Bainbridge, *supra* note 11, at 1444 (noting that "from the shareholders' perspective, the unions helped kill the goose that laid the golden egg").

HeinOnline -- 59 Wash. & Lee L. Rev. 431 2002

currently play a pivotal role in determining whether for-profit education will gain acceptance.[110] Because shareholders have relatively little external influence over the corporation, it is appropriate that directors consider their interests above those of other constituent groups. Thus, the shareholder primacy model is not only descriptively accurate, but also is the normatively appropriate model of the corporation.

The second conception, referred to herein as the "social entity model," sees the modern corporation as a social institution that should consider the interests of all of the groups it impacts.[111] Proponents of this model argue that employees and creditors who invest either their services or their capital in the firm are as much a part of the firm as shareholders and have a stake in the future position of the corporation.[112] In their view, the corporation consists of a variety of different relationships. As managers of the entire corporate enterprise, directors have a duty to enhance the interests of every group within that enterprise.[113] Embedded in the social entity theory is a notion of corporate social responsibility.[114] Because the modern corporation has the power and resources to impact those outside interests significantly, managers have a responsibility to consider the interests of many groups in society when carrying out their duties.[115] Ultimately, shareholders are just one group among many to whom directors have a responsibility.

Critics of the social entity model complain that the model fails to provide a solution for what Professor Stephen Bainbridge calls the "two masters" and "managerial sins" problems.[116] The two masters problem refers to the notion

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110. *See supra* notes 80-82 and accompanying text (discussing unions' role).

111. Most scholars refer to this conception as the "stakeholder" theory of the corporation. *See, e.g.*, William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 208-15 (1992) (outlining stakeholder theory); Timothy L. Fort, *The Corporation as Mediating Institution: An Efficacious Synthesis of Stakeholder Theory and Corporate Constituency Statutes*, 73 NOTRE DAME L. REV. 173, 184-86 (1997) (detailing stakeholders theory); David Hess, *Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness*, 25 J. CORP. L. 41, 54 (1999) (explaining popularity of stakeholder theory); John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1465-69 (1994 (noting stakeholder theory).

112. *See, e.g.*, WILLIAM M. EVAN, ORGANIZATION THEORY: RESEARCH AND DESIGN 362-63 (1993) (discussing interests that groups have in corporations).

113. *See* Fort, *supra* note 111, at 184-85 (noting manager's duty to stakeholders).

114. *See id.* at 185 (explaining directors' duties to stakeholders, including local community and stating that stakeholders affected by corporate decisions "ought to participate in the decisions that substantially affect them"); Hess, *supra* note 111, at 52-53 (noting that stakeholder theory includes notion that corporations impact many groups and, thus, corporation's managers must have responsibilities for those groups).

115. *See* Hess, *supra* note 111, at 52-53 (explaining duties of corporation to public).

116. *See* Bainbridge, *supra* note 11, at 1435-42 (outlining issues surrounding two masters and managerial sins problems).

HeinOnline -- 59 Wash. & Lee L. Rev. 432 2002

that while the interests of shareholders and other groups often coincide, occasionally it is impossible for directors to pursue the concerns of all groups.[117] The shareholder primacy model resolves this problem by requiring corporate directors to favor the shareholder. However, because the social entity model does not have such a requirement, that model provides no satisfactory resolution to this problem.[118] The second problem, which inevitably flows from the first, refers to the idea that by insulating directors' decisions even when they have no appreciable benefit for shareholders, the social entity model allows managers to further their own personal interests without any accountability.[119] Under the shareholder primacy model, to the extent that a director's decision is not beneficial to shareholders, shareholders have the right to sue the director, and this right operates as a check against self-interested behavior. However, the social entity model does not require directors' actions to be beneficial to shareholders in order to be legitimate. Hence, it will be easier for directors to pretend their actions were designed to benefit one of several groups even when they were motivated by more self-centered concerns.[120]

117. Others have also complained of the two masters problem. *See, e.g.*, Mitchell, *supra* note 13, at 589 ("The spectre is raised of a board of directors blindly groping to balance the conflicting interests of a variety of constituent groups without any means of measuring the interests required to be considered or of assessing the relative priorities of such interests."); James J. Hanks, Jr., *Non-Stockholder Constituency Statues: An Idea Whose Time Should Never Have Come*, INSIGHTS, Dec. 1989, at 20, 24-25 (explaining difficulties directors face in dealing with multiple stakeholders).

118. Proponents of the social entity model argue that directors have been entrusted with the discretion to make difficult decisions in the past, and, thus, we should have confidence that they will be able to weigh competing interests and come to a satisfactory resolution. *See, e.g.*, Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1418 (1993) (referring to social entity theory as "stakeholder" or multi-fiduciary" theory of firm, and noting that objections to this theory fail to account for fact that we currently expect directors to weigh competing obligation when they make decisions). They also argue that we should have confidence that our judiciary will develop adequate principles to govern the behavior of directors in this area. *Id.* at 1419.

119. FRANK H. EASTERBROOK &DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (1991) (commenting that "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"). This problem reflects the accountability concern expressed by many opponents of constituency statutes. *See, e.g.*, Lynda J. Oswald: *Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause*, 24 J. CORP. L. 1, 2 (1998) (noting that constituency statutes "create a class of managers whose decisions are utterly discretionary"). Professor Bainbridge recognizes that the tremendous discretion afforded director's decisions by the business judgment rule often allows directors to make decisions that further their own interests. Bainbridge, *supra* note 11, at 1439-41. However, he maintains that under the social entity model there is no limit to such actions because, while currently directors' decisions must be related at least plausibly to the shareholders' interests, under the social entity model, directors can play various groups against one another to maximize their own concerns. *Id.* at 1438.

120. This Article does not seek to further the normative debate relating to these two con-

HeinOnline -- 59 Wash. & Lee L. Rev. 433 2002

III. *Corporate Law Principles*

Under current law, courts typically scrutinize directors' duties based upon the context in which their decisions are made,[121] distinguishing between those made in the ordinary course of business and those made in the context of a takeover or other fundamental change of control of the corporation. Courts review the former decisions under a deferential standard. The latter decisions receive more exacting judicial scrutiny. This section will explore decisions made in both contexts as well as the impact of constituency statutes on those decisions.[122]

A. *Ordinary Business Decisions*

1. *Status of the Law*

In the early part of the nineteenth century, the traditional view that the directors of a for-profit corporation owed a duty exclusively to the share-

ceptions of the corporation, but rather seeks a more descriptive response to the status of our conception of the corporation.

121. Courts also apply separate standards for decisions tainted by self-dealing and those unencumbered by any conflicts of interests. Self-dealing decisions implicate the duty of loyalty, and courts generally require them to be intrinsically fair to the corporation. Historically, the law either prohibited directors from being involved in a conflict of interest transaction or allowed these transactions to be voidable at the option of the corporation. *See, e.g.*, Potter v. Sanitary Co. of Am., 194 A. 87, 91 (Del. 1937) (advancing rule of per se voidability). Today, a conflict of interest transaction will be upheld as long as it is fair to the corporation or it has received approval by a majority of the disinterested shareholders or directors. *See, e.g.*, DEL. CODE ANN. Tit. 8, § 144(a)(3) (1999); Marciano v. Nakash, 535 A.2d 400, 405 (Del. 1987) (upholding conflict of interest transactions as long as they are intrinsically fair to corporation); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) (stating that conflict of interest transaction is only upheld if transaction is fair, which involves both fair price and full disclosure to shareholders). Virtually all states, including Delaware, have a statute providing for approval of a conflict of interest transaction. *See* Michael Bradley & Cindy Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 26 n.159 (1989) (discussing statutes). Decisions made outside of the self-dealing context implicate the duty of care and are generally subject to a lower standard of review. This Article focuses on conduct implicating the duty of care.

122. This discussion, particularly as it relates to business decisions made during a change of control, will focus primarily on Delaware law because that state continues to be considered at the vanguard of corporate law. More than half of the Fortune 500 companies are incorporated in Delaware. R. Cammon Turner, *Shareholders vs. The World*, BUS. L. TODAY, Feb. 1999, at 32, 34; *see also* S. Samuel Arsht, *A History of Delaware Corporation Law*, 1 DEL. J. CORP. L. 1, 1 (1976) (noting Delaware corporate law is "the most popular of such laws in the United States"). Also, the two largest for-profit education companies, Edison and Nobel, are Delaware companies. EDISON PROSPECTUS, *supra* note 47, at 1; NOBEL ANNUAL REPORT, *supra* note 58, at 1. Moreover, two of the largest providers of for-profit healthcare, HCA and UHS, are both Delaware corporations. UHS PROSPECTUS, *supra* note 33, at 1; HCA ANNUAL REPORT, *supra* note 32, at 1. Hence, Delaware law will govern decisions made by their directors.

HeinOnline -- 59 Wash. & Lee L. Rev. 434 2002

holders guided directors' decisions and judicial review of those decisions.[123] Under corporate law, directors manage the affairs of the corporation, and their management must be consistent with the best interests of the corporation.[124] Consistent with the shareholder primacy model, courts construed this duty to the corporation as one owed to the shareholders, requiring directors to act in the best interests of shareholders by maximizing their profit.[125]

The oft-cited 1919 Michigan Supreme Court decision, *Dodge v. Ford Motor Co.*,[126] captures this conventional expression of the directors' obligations.[127] In that case, the Dodge brothers, who owned approximately 10% of the stock of the Ford Motor Company (FMC), sued the directors of FMC based on the directors' decision to suspend the payment of special dividends. Henry Ford, chairman of the board and a majority stockholder of FMC, had refused to pay the dividends because he wanted to retain the company's profits to expand the business and make affordable cars for the public.[128] The Dodge brothers claimed that the directors of FMC, whose year-end profits for the 1916 fiscal year were approximately $60 million, had an obligation to distribute any accumulated profits to the shareholders.[129]

Ford disagreed, insisting that the corporation had a responsibility to benefit the general public and that his decision to withhold dividends was consistent with this responsibility.[130] In an interview with the *Detroit News*,

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123. *See* Millon, *supra* note 12, at 230 ("By 1932, corporate law had already endorsed the view that shareholder financial interests should guide managerial decision-making without regard to competing, nonshareholder claims.").

124. Modern statutes require that the corporation be managed by or under the direction of the board of directors. ERNEST L. FOLK ET AL., FOLK ON THE DELAWARE GENERAL CORPORATE LAW § 141 (2d ed. 1990); Rev. M.B.C.A. § 8.01 (1969). Such statutes further provide that directors, when carrying out this duty, act in the bests interests of the corporation. *See* Rev. M.B.C.A. § 8.30 (2000).

125. *See* Millon, *supra* note 12, at 228 (equating shareholder interests with profit maximization).

126. 170 N.W. 668 (Mich. 1919).

127. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (outlining shareholder privacy doctrine).

128. It is arguable that Ford refused to pay dividends because he believed the Dodge brothers planned to use the additional money to build a rival car company. Also, Ford, who owned 85% of the outstanding shares, may have refused to pay dividends to avoid paying taxes. Because by 1920 the maximum federal income tax rate was 73%, Ford would have owed a substantial amount of tax payments as a result of the issuance of any special dividends.

129. 170 N.W. at 679. FMC's accumulated profit at the end of the 1916 fiscal year was almost $174 million. *Id.* at 670. In 1915, the special dividend was $10 million. This dividend was substantially more than the regular dividend paid to shareholders. Indeed, in 1915, the Dodge brothers, who owned 10% of the company, received $1 million as a special dividend, while receiving only $120,000 as a regular dividend. *See id.* at 670, 683.

130. *Id.* at 684.

HeinOnline -- 59 Wash. & Lee L. Rev. 435 2002

Ford stated, "And let me say right here, that I do not believe that we should make such an awful profit on our cars . . . [I]t has been my policy to force the price of the car down as fast as production would permit, and give the benefits to users and laborers."[131] At trial, when questioned about this statement, Ford went even further, suggesting not only that the corporation's goal was to consider a wide range of groups, but also that the shareholder's interests should not be considered primary to others.[132] Ford was asked, "What is the Ford Motor Company organized for except for profits?" Ford responded, "Organized to do as much good as we can, everywhere, for everybody concerned . . . [a]nd incidentally to make money."[133] This exchange reveals Ford's belief that wealth maximization reflected an incidental goal of the corporate enterprise that should be subordinated to the concerns of the public.

The Michigan Supreme Court vehemently disagreed with this view of the corporation and not only ordered Ford to pay special dividends, but also issued one of the strongest endorsements of the shareholder-primacy model to date.[134] The court reasoned that Ford's attitude toward the corporation reflected confusion about the duties a director owed to his shareholders.[135] The court believed the issue was clear: "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."[136] This reasoning reflects "as pure an example as exists" of the shareholder-primacy conception of the corporation and confirms the fears of opponents of privatization.[137]

However, even during this time period, the *Dodge* court's view of the corporation's primary objective did not go unchallenged. The decision sparked considerable discussion about the proper goal of the corporate enterprise. This was epitomized in the classic debate between Harvard Law School Professor Adolf Berle and Columbia Law School Professor Merrick Dodd.[138] Berle, agreeing with *Dodge*, claimed that the principal function of the corpora-

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131. ALLEN NEVINS & FRANK E. HILL, FORD: EXPANSION AND CHALLENGE, 1915-33, at 97 (1957) (quoting interview).

132. *Dodge*, 170 N.W. at 684.

133. *See* NEVINS & HILL, *supra* note 131, at 99-100 (quoting interview).

134. *Dodge*, 170 N.W. at 685.

135. The Michigan Supreme Court stated, "There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his co-directors owe to protesting, minority stockholders." *Id.* at 684.

136. *Id.*

137. *See* Allen, *supra* note 12, at 268 (discussing *Dodge*).

138. *See, e.g.*, Joseph L. Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458, 1458 (1964) (discussing debate).

HeinOnline -- 59 Wash. & Lee L. Rev. 436 2002

tion and its directors was to maximize shareholder profit.[139] In contrast, Dodd urged the consideration of the interests of a variety of corporate constituents, such as employees and creditors, because such groups have a stake in the corporation's welfare.[140] Dodd believed that directors' decisions should encompass the interests of all those who interacted and were impacted by the corporation.[141] This debate, as well as the competing views of the *Dodge* court and Henry Ford, captured the schizophrenia noted by Chancellor Allen.[142]

While this debate may have begun as largely theoretical, in recent years, courts have indicated a preference for a more expansive view of the corporation by allowing directors to consider other interests, even at the expense of the shareholder.[143] Courts never formally rejected the shareholder primacy model, but fashioned a doctrine that seemed to accommodate both corporate paradigms. Under this doctrine, courts allowed directors to make decisions that at first blush appeared to be antithetical to the interests of shareholders, as long as directors could provide a plausible connection between the decision and the long-term interests of the shareholders. An example of this is the case of *Shlensky v. Wrigley*,[144] in which a minority stockholder sued the directors of Chicago National League Ball Club, Inc., which owned and operated the Chicago Cubs baseball team, for refusing to schedule night games and refusing to install lights in Wrigley Field.[145] The shareholders maintained that the teams' failure to play night games was causing the company to lose money.[146]

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139. *See* Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931) (stating that "all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessary and at all times exercisable only for the ratable benefit of all shareholders").

140. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1147-48 (1932). Berle later conceded that "the argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention." ADOLFE A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954). Berle agreed that directors of the modern corporation not only had a profit making role, but also were administrators of a community of interests. *Id.*

141. *See* Dodd, *supra* note 140, at 1148 (finding it undesirable to emphasize view that corporations exist for sole benefit of shareholders).

142. *See* Allen, *supra* note 12, at 268

143. *See* Rima Fawal Hartman, Note, *Situation – Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH. & LEE L. REV. 1761, 1761 (1993) ("Judicial opinions, legislative acts, and scholarly legal articles are replete with evidence of dissatisfaction with the traditional idea that a corporation is a mere profit-making entity whose interests are equivalent to the interests of those who hold its stock.").

144. 237 N.E.2d 776 (Ill. App. Ct. 1968).

145. *See* Shlensky v. Wrigley, 237 N.E.2d 776, 777 (Ill. App. Ct. 1968) (stating claim).

146. *Id.*

HeinOnline -- 59 Wash. & Lee L. Rev. 437 2002

The directors admitted that they were not interested in whether the baseball team would increase their profits by playing night games.[147] Rather, the directors' decision stemmed from their belief that night games would have a "deteriorating effect upon the surrounding neighborhood."[148] Pointing to the principles set out in *Dodge*, the shareholders argued that this decision was illegitimate because it rested on concerns unrelated to the shareholders' financial interests.[149]

Disagreeing, the Illinois Court of Appeals found that the directors' decision complied with their duty.[150] The court rationalized that directors did not have to pursue the course of action with the most immediate potential for financial gains.[151] Instead, directors could make decisions that would further the corporation's and the shareholder's long-term interests.[152] The deterioration of the surrounding neighborhood could impact a patron's decision to attend a baseball game and in the long-term could reduce the profitability of the corporation and hence the profit of the shareholder.[153] Thus, the directors could properly consider the impact their policies would have on the neighborhood.[154] Based on this reasoning, the directors could forgo short-term profits to prevent the neighborhood's deterioration, which would have an effect on the corporation's potential to generate long-term profits.[155] In *Wrigley*, we see the beginning of courts' reliance on the long-term interests of shareholders to justify board decisions that do not appear to have any short-term value to shareholders. This reliance seems contrary to *Dodge*. Certainly, the board in *Dodge* could have benefitted from this long-term/short-term dichotomy. Indeed, it is arguable that a FMC policy of "doing good" by making fewer expensive cars and employing a large work force in the long-term may increase both employee and customer satisfaction. Moreover, this policy could generate positive publicity for FMC. Under *Wrigley*, these long-term effects may have been enough to enable the FMC board to withhold the short-term benefit of special dividends. Moreover, these justifications may have been

147. *See id.* at 778 (discussing defendant's refusal to install lights based on opinion that baseball should be played during daylight hours).

148. *Id.* (quoting president and director Philip K. Wrigley).

149. *Id.* at 779.

150. *See id.* at 781 (affirming trial court's dismissal of complaint).

151. *Id.* at 780.

152. *See id.* (stating that court was not satisfied that directors' decision was against corporation's long term-interests).

153. *Id.*

154. *See id.* (pointing out that "it appears to us that the effect on the surrounding neighborhood might well be considered by a director").

155. The court maintained that the corporation's interests in the property value "might demand all efforts to keep the neighborhood from deteriorating." *Id.*

HeinOnline -- 59 Wash. & Lee L. Rev. 438 2002

sanctioned even if Ford had been motivated by non-shareholder concerns. Interestingly, while the court made efforts to tie the directors' decision to the (albeit long-term) interests of shareholders, there was no evidence that such a concern actually motivated the directors' decision. The Illinois court's willingness not only to overlook the real motivation for the directors' conduct, but to generate a shareholder-related justification for such conduct runs counter to the holding and spirit of *Dodge*. Other courts similarly gave directors wide latitude to address the concerns of other groups as long as they could muster some plausible relationship between the shareholders' interests and such concerns.[156] By invoking the specter of the corporations' long-term interests, corporate law could approve of decisions that benefitted other groups without admitting to a rejection of the concept that directors' ultimate responsibility was to enhance the shareholders' profit.

Courts' ability to toe such a line was reinforced by the tremendous deference given to directors' actions. Common and statutory law require that a director perform her duties in good faith with the care of an ordinary prudent person and in a manner that she reasonably believes to be in the corporation's best interests.[157] The duty is primarily procedural in nature, requiring that directors make decisions based on adequate information and due deliberation.[158] Courts' analyses of directors' duties is modified by the business judgment rule.[159] The business judgment rule presumes that directors act in good faith and dictates that as long as directors do not engage in fraud or self-dealing and make rational, informed decisions, courts will not second-guess their actions.[160] As applied to corporate managers, this rule means that courts

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156. *See, e.g.*, Theodora Holding Corp. v. Henderson, 257 A.2d 398, 405 (Del. Ch. 1969) (upholding corporate donation because of its long-term benefit to shareholders); Smith Mfg. Co. v. Barlow, 98 A.2d 581, 586 (N.J. 1953) (upholding corporate charitable donation because corporation has social responsibility to public); Holst v. N.Y. Stock Exchange, 299 N.Y.S. (App. Div. 1937) (affirming directors' decision to pay workman compensation claim of employee who suffered injury while playing on corporation's soccer team because team benefitted corporation).

157. As set forth in the Revised Model Business Act, the duty of care is articulated as follows. A director shall discharge his duties as a director, including his duties as a member of a committee: (1) in good faith; (2) with the care that an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation. Rev. M.B.C.A. § 8.30 (2000). Most states have enacted statutes to this effect. *See* Bradley & Schipani, *supra* note 121, at 18 n.107 (discussing Act).

158. Decisions that have held directors liable for a breach of their duty of care involved a director's inattention to corporate business, *e.g.*, Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (N.J. 1981), or a director's failure to consider carefully all of the ramifications of a potential transaction, *e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

159. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

160. *See e.g.*, *id.*; Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

will honor the majority of directors' decisions.[161] This deference is evidenced by the fact that, outside of the self-dealing context, there are very few cases in which courts have imposed liability on directors for a violation of their fiduciary duties.[162] Moreover, this discretion enables directors to make decisions that benefit non-shareholders free from the interference of the courts and shareholders. The elasticity of courts' reasoning in cases like *Wrigley*, coupled with the judicial deference for directors' decisions evidenced in their application of the business judgment rule, means that courts sanction the vast majority of directors' decisions, even if they subordinated the financial interests of shareholders to other groups. In fact, as Professor William Simon recently noted, there is no modern case in which a court has overturned a manager's decision because that decision placed public interests above shareholder interests.[163]

2. *Application to Public Benefit Corporations*

The *Dodge* conception of a corporation may not have been able to accommodate public benefit companies. Taken literally, the case stands for the proposition that directors cannot favor the interests of other constituents over shareholders. Thus, *Dodge* is consistent with the philosophical objection that there is a tension between the directors' duties in these firms and their commitment to a mission aimed at benefitting the public. *Dodge* seems particularly troublesome for the for-profit hospital. At least in *Dodge*, Ford aimed to reap some money from his policy of making inexpensive cars, while

161. *Aronson*, 473 A.2d at 812.

162. In 1968, after a national review of the relevant cases, Professor Joseph Bishop found that "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). Bishop only found four such cases and claimed that they carried no real conviction. *Id.* at 1100. Recent studies confirm Bishop's assessment. Indeed, nearly fifteen years later, Stuart Cohn performed a similar study and only found seven cases. Stuart Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 593-94 (1983); *see also* Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 981 (1994) (noting that his findings on Delaware law relating to duty of care "were as disappointing as that earlier encountered by Bishop"); Thomas C. Lee, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. PA. L. REV. 239, 240 (1987) (noting that duty of care has been doctrine "whose bark is worse than its bite"). While certainly some high-profile cases exist, there continues to be a judicial reluctance to impose liability on directors for the decisions they make. *See* Horsey, *supra*, at 981-83 (noting lack of Delaware cases discussing issue).

163. William H. Simon, *What Difference Does it Make When Corporate Managers Have Public Responsibilities?*, 50 WASH. & LEE L. REV. 1697, 1698 (1993).

HeinOnline -- 59 Wash. & Lee L. Rev. 440 2002

directors of such hospitals would be attempting to provide charitable care to patients who could not afford to pay for it. *Dodge* suggests that directors of a for-profit hospital should forgo charitable care altogether because it does not serve to enhance directly the wealth of shareholders. In this sense, corporate law appears to mandate the course of action that promises the greatest potential for profits without regard to other interests or interest groups.

The restrictions that *Dodge* placed on directors' decision-making abilities can be illustrated by considering one of the questions raised by Professor Solomon's analysis of critics' concerns – whether directors of a privately-managed K-12 school would decide to close a school prior to the end of the school year to conserve shareholder profits.[164] Assume that X Corp. is a privately-managed education firm that must decide whether or not to close a school that is losing money because the cost of maintaining the school is higher than the revenue generated from the school.[165] Assume further that closing the school during the middle of the year will save X Corp. significant resources in teachers' salaries and other expenditures relating to maintaining the school. By contrast, the school closing will have a decidedly negative impact on several different constituencies. Indeed, students will suffer because they will be forced into new schools with new instructors and a new regimen. It follows that surrounding schools will also suffer by having to absorb an influx of new students mid-year.[166] Then too, teachers and adminis-

164. One might imagine a similar scenario with respect to hospitals. Indeed, without conversions, several public hospitals may have been forced to close because of a lack of resources to sustain their operation. While closures may prevent pouring additional money into the hospitals, they have a negative impact on the patients, doctors and employees of the hospital as well as the surrounding hospitals that must absorb the patients. *See* Singer, *supra* note 18, at 228 (noting that, for some hospitals, closures may be inevitable, and these hospitals see for-profit entities as means of ensuring continued health care).

165. The notion that the costs of privatized schools could exceed revenue is not purely hypothetical. Indeed, schools have fixed per-pupil funding that may fall short of the myriad administrative and other costs associated with operation of the schools. *See* EDISON PROSPECTUS, *supra* note 47, at 14 (noting that their agreements with school officials are risky because they require Edison to operate school with funding that does not vary with actual costs). On the other hand, not all directors will have the freedom to shut down a school prior to the end of the school year because some of the management agreements that govern privately-operated schools require that these companies agree to operate schools for a fixed period of time and at a fixed cost. *Id.* Thus, to the extent actual costs exceed the amounts under this management agreement, the company may lose money, but will not have the option of closing the school until after the management agreement expires.

166. Compulsory school attendance laws, passed by every state and the District of Columbia, require all children between specific ages to attend a school or receive some form of education. Thus, if a school closes during the middle of the school year, alternative arrangements must be made for the school children. Consequently, one school closure has a significant impact on other schools in the area that will be required to expend additional resources on new school children. In the same vein, under the so-called federal anti-dumping legislation enacted

HeinOnline -- 59 Wash. & Lee L. Rev. 441 2002

trators will suffer by losing their jobs, and, given that the layoff will come during the middle of the school year, these teachers may not have any prospects of securing new jobs. This is to say nothing of course about the harms such actions will generate for the parents and spouses of those affiliated with the school.

By analogy to the principles set forth in *Dodge*, one might argue that corporate law commands directors to shut down the school so that resources can be saved and diverted to other projects. In fact, their decision to continue funding an unprofitable venture may be viewed as similar to Ford's policy in that this decision would benefit the public at the expense of the shareholders. For this reason, it would be advisable for the directors to close the school. Then too, *Dodge* suggests that the shareholders would prevail in a suit challenging the failure to close the school. In this way, as Professor Solomon's questions suggest, traditional corporate law principles may require directors of public benefit corporations to ignore the concerns of students and patients in order to maximize profit.

By contrast, modern case law allows directors to pay heed to the concerns of non-shareholders, suggesting that for-profit directors will be able to adapt to the unique responsibilities of managing public benefit corporations. Under the social entity paradigm, reflected in cases such as *Wrigley*, directors can continue operating the school even if the continuation is aimed at protection of interests beyond those of shareholders. Indeed, given that the *Wrigley* court enabled the directors to disregard the option of night games completely,[167] directors of X Corp. can refuse to close the school entirely as long as they believe that a closure would have a negative effect on the school children. Just as the directors appeared unconcerned about the profit potential of night games, *Wrigley* further suggests that the directors of X Corp. can make this decision without regard to the financial benefits that would inure to the shareholders as a result of such a closing. Indeed, as long as the directors (or the court) can formulate a rational reason why the decision to close the school would harm the long-term interests of the corporate enterprise, courts will honor it. For example, the negative publicity involved with a closing may impact the ability of X Corp. to negotiate arrangements with other school districts. Also, the directors may have a long-term strategy for increasing

in 1986, 42 U.S.C. § 1395dd, hospitals may not refuse emergency care to patients based on their inability to pay; this includes refusal by transfer to another hospital. Thus, when a hospital closes, other hospitals must provide at least emergency healthcare services to those who need it. Because of this policy, hospital closures have a broad impact on the patients as well as the surrounding communities that must absorb those patients.

167. *See* Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (affirming trial court's decision to dismiss case on grounds that the decision to forgo night games was not improper).

HeinOnline -- 59 Wash. & Lee L. Rev. 442 2002

revenues related to the school that necessitates waiting a few years before the strategy comes to fruition.[168] The wide discretion afforded to directors under the business judgment rule further protects directors of these public benefit companies.[169] Under that rule, if a court finds that the directors' decision to keep a school open is rational, then a court most likely will honor the decision. Thus, corporate law enables directors to respond safely to the dilemma posed by Solomon's question by opting against school closure. This fact highlights the decentralization of the shareholder primacy norm.

Elaborating on the school closure issue further reveals the dominance of the social entity model. Thus, assume that directors of X Corp. believe that there is only a slim possibility of generating profits, even in the long term. Also, assume that there are three available alternatives among which the directors of X Corp. must choose. The first is to close the school immediately prior to the completion of the school year. This option will be the most cost effective for the shareholders, but, as explained previously, would have the most devastating effect on the school children and the surrounding population. The second option is to wait until the end of the school year to close the school, thereby enabling the students to complete the school year and allowing school employees additional time to find alternative arrangements for employment the following school year. Although this option will require X Corp to spend additional resources maintaining the school, given that it is only half a school year, the additional expense may not be materially significant. This may be particularly true in light of the fact that the publicity associated with a mid-year school closure could impact negatively the company's stock price and ability to enter into other school contracts. The third alternative is to keep the school open indefinitely in an effort to make the school more cost effective. Obviously, this third alternative will involve spending significantly more resources than the first or second one. In addition, while X Corp. may receive some reputational benefit from the third option, it may not be enough to offset the tremendous loss of profits this third option would entail.

The shareholder primacy model may dictate that the directors choose the first alternative. By contrast, under *Wrigley*, the second option appears to be appropriate because there is clearly a rational long-term benefit to shareholders – the avoidance of negative publicity and its monetary side-effects. The third option appears more problematic. Indeed, while shareholders have an interest in avoiding negative publicity, this goal can be furthered by the second option. Consequently, the tremendous cost of indefinite continued

168. This could entail increasing the enrollment or reducing the administrative costs by creating a more centralized process. In fact, Edison believes that over time it will be able to exploit the advantages of scale in a manner that will reduce its administrative overhead significantly.

169. *See supra* note 156 (citing cases in which directors were given wide discretion).

operation of the school suggests that there is no real benefit to shareholders under the third plan.

However, the shareholder's victory is not completely certain. Indeed, directors of X Corp. continue to receive the benefit of the business judgment rule, pursuant to which courts have not been willing to reject directors' plans even when they appear excessive. In fact, even in *Dodge*, at the so-called zenith of courts' acceptance of the shareholder-primacy paradigm, the Michigan Supreme Court refused to halt Ford's plan to create additional manufacturing plants.[170] In addition to refusing to pay dividends, Ford also had planned to construct manufacturing plants that would absorb a considerable portion of the company's resources.[171] The shareholders objected to this expansion policy, asserting that their existing plants were suitable for their current manufacturing needs and that Ford's sole reason for creating new plants was to make cheaper cars and employ more labor.[172] Ford even acknowledged that his plan was to "employ still more men; to spread benefits . . . to the greatest possible number, to help them build up their lives and their homes."[173] The shareholders viewed this plan as "reckless in the extreme"[174] because it would entail spending a considerable amount of the company's resources without any real benefit to the shareholders.

Although the court acknowledged that the plan called for additional spending with apparently little possibility of return for shareholders, the court was not willing to halt the plan.[175] Indeed, the court expressed its reluctance to question decisions because "judges are not business experts."[176] This deference, even in the midst of the court's allegiance to the shareholder primacy model, suggests that courts may sanction X Corp.'s decision to pursue the third option. Keep in mind, the *Dodge* court had ample evidence of Ford's desire to enhance the welfare of the general public without regard to profit.[177] That court's willingness to overlook this evidence not only contradicts the popular belief that the *Dodge* court completely rejected the social entity model, but also reveals a tolerance for judicial deference of company programs. Indeed, Professor Simon points to the fact that the *Dodge* court did not enjoin Ford's expansion plan as evidence that the court (and all modern courts) sanction director policies, even when they place the interests

170. Dodge v. Ford, 170 N.W. 668, 684 (Mich. 1919).

171. *See id.* at 672-74 (discussing reasons for Ford's failure to pay dividends).

172. *Id.* at 683.

173. *Id.* at 671 (quoting statements made in Detroit press).

174. *Id.* at 673 (quoting bill filed by plaintiffs).

175. *Id.* at 684.

176. *Id.*

177. *See id.* at 683-84 (quoting Ford's statement that he wanted to spread benefits of industrial system).

HeinOnline -- 59 Wash. & Lee L. Rev. 444 2002

of the public above those of the shareholder.[178] In this way, courts have given directors ample room to pursue their business objectives despite the fact that they may have only an incidental benefit to shareholders, such as the X Corp.'s third option. This judicial deference reveals the elasticity of corporate law and undermines the notion that the duties of directors prevent them from pursuing anything other than wealth maximization for shareholders.

B. Decisions in the Context of a Takeover

1. Status of the Law: Revlon *and its Progeny*

In the 1980s, the amount of corporate takeover activity increased dramatically,[179] and courts had to determine if board action taken in the context of this activity was consistent with directors' fiduciary duty. The courts' treatment of shareholders' interests in the takeover context is critical to an understanding of the goals of corporate law because decisions made in this context reflect a clear choice between maximizing shareholder wealth and protecting other corporate constituents. First, during this period, the short-term/long-term dichotomy no longer proves useful because once the shareholders tender their shares in a takeover transaction, they no longer will be a part of the ongoing corporate enterprise. Thus, the shareholders will have no stake in the future of the enterprise and no long-term interests, financial or otherwise, in the concerns of other corporate constituents. Consequently, the board cannot rely on the long-term interests of shareholders to justify decisions to forgo the short-term value of takeovers. Second, takeovers impact shareholders and other groups differently. On the one hand, takeovers often enable shareholders to reap substantial financial benefits. As a result of one of the largest takeover transactions, shareholders received $109 per share for their stock while their shares were trading at $53 a share.[180] As this suggests, takeovers represent one of the best opportunities for directors to maximize the wealth of their shareholders. On the other hand, takeovers may trigger layoffs and other forms of dislocation for other members of the corporation.[181] Because

178. *See* Simon, *supra* note 163, at 1698 n.4 (noting that *Dodge* court only ordered payment of retained earnings and did not enjoin Ford's plan).

179. During the 1980s, 30% of Fortune 500 companies were targets of hostile takeovers. *See* John C. Coates, IV, *Measuring the Domain of Mediating Heirarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 851 (1999) (noting increase in takeover bids).

180. This reflects the much-publicized takeover contest for RJR-Nabisco, Inc. which culminated in a leveraged buyout of the company in 1988 for $24.8 billion. *See, e.g.*, BRYAN BURROUGH & JOHN HEYLAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 503-515 (1990) (discussing buyout).

181. *See, e.g.*, Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 ARIZ. L. REV. 989, 1022 (1993) (noting that corporate takeovers pose substantial threat to non-shareholder constituents).

HeinOnline -- 59 Wash. & Lee L. Rev. 445 2002

the financial gain made by shareholders may come at the expense of these other groups, their concerns during takeovers are in conflict with these other groups. Therefore, any willingness by courts to subordinate shareholders' interests in this context signals significant abandonment of the shareholder primacy paradigm.[182] While some Delaware case law in the takeover arena adheres to the shareholder primacy concept, other cases revealed the courts' preference for the social entity model.[183] A preference in this context signals a true shift in the courts' understanding of the corporation's proper goal.

Court analysis of takeover activity centers on four critical scenarios. First, when board members take actions designed to defend against a takeover attempt.[184] Second, when a board agrees to put its company up for sale.[185] Third, when a board effects a business reorganization.[186] Fourth, when a board enters into a change of control transaction.[187] Analyzing these decisions has forced courts to clarify the kinds of interests directors could consider when carrying out their fiduciary duties.

a. Defensive Actions

In *Unocal Corp. v. Mesa Petroleum Co.*,[188] the Delaware Supreme Court indicated that it would scrutinize more carefully board actions designed to thwart certain takeover attempts.[189] The Delaware court noted that management interests often were at odds with shareholder interests because, like employees, managers have a desire to maintain the status quo.[190] Given the

182. As one scholar notes, "[J]udicial and legislative willingness to place restrictions on the market for corporate control represents an important prelude to the frontal assault on shareholder primacy." Millon, *supra* note 12, at 240.

183. *See, e.g.*, Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (noting that, even within the takeover context, board is generally under no duty to maximize shareholder profit).

184. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 941, 954 (Del. 1985) (noting "enhanced duty" when board members address and defend against pending takeover bid).

185. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (noting that, in the takeover context, upon board's recognition that corporation is up for sale, board's duty changes from protecting corporate bastion to maximizing shareholder value).

186. *See Time*, 493 A.2d at 1151-55 (applying enhanced duties to corporation's strategic plan involving business reorganization).

187. *See* Paramount Communications, Inc., v. QVC Network, Inc., 637 A.2d 34, 43, 45 (Del. 1993) (noting that sale or change of control transaction implicates enhanced judicial scrutiny).

188. 493 A.2d 946 (Del. 1985).

189. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (noting directors' "enhanced duty which calls for judicial examination" in cases involving takeover attempts).

190. *See id.*

HeinOnline -- 59 Wash. & Lee L. Rev. 446 2002

misalignment between directors' and shareholders' interests, the Delaware court could not grant directors the deferential treatment previously afforded to their decisions.[191] Thus, the court announced that when board members attempted to thwart a hostile takeover attempt, thereby denying shareholders the ability to receive large returns, these members would have to justify their decision in a more exacting fashion.[192]

However, although the court displaced its customary deference to board decisions, it indicated that the social entity concept should continue to dictate directors' conduct.[193] The court stated that boards legitimately could consider a host of other constituencies when defending against takeover attempts.[194] The court specifically noted that one of the concerns that directors legitimately could consider was "the impact on constituencies other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[195] This decision marks one of the first times the Delaware court explicitly condoned the social entity model. Moreover, it reveals that as long as a board is not willing to sell its company, it can institute defenses measures aimed at protecting groups other than shareholders.

b. Placing the Company Up for Sale

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[196] the Delaware Supreme Court concluded that when the board agrees to put a company up for sale, the directors' duty changes to one aimed at protecting the shareholders' financial interests.[197] In *Revlon*, in response to a threatened tender offer by Pantry Pride, Inc. (Pantry Pride), the board of Revlon, Inc. (Revlon) adopted several measures designed to prohibit Pantry Pride's acquisition of Revlon, including a program whereby the company repurchased 10 million of its shares in exchange for notes.[198] The notes contained certain covenants that

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191. *See id.* at 958 (noting that protection conferred under business judgment rule is not absolute).

192. The Delaware Supreme Court announced a two-step inquiry related to directorial measures designed to defend against a takeover. *Id.* at 955. First, directors must show that they have reasonable grounds to believe that a takeover posed a danger to corporate policy. *Id.* Second, directors must prove that the defensive maneuver adopted was reasonable in proportion to such threat. *Id.* at 955-56.

193. *See id.* (maintaining that concern for welfare of stockholders does not end takeover analysis).

194. *See id.* at 955 (discussing directors' analysis of takeover bids).

195. *Id.*

196. 506 A.2d 173 (Del. 1986).

197. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986) (reasserting shareholder primacy doctrine in context of agreements to sell).

198. The company also instituted a shareholders' rights plan that effectively would prohibit acquisition of the company unless the board agreed to redeem the rights. *Id.* at 177. Under the

HeinOnline -- 59 Wash. & Lee L. Rev. 447 2002

effectively prevented takeover of the company.[199] When Pantry Pride finally announced a cash tender offer of $47.50 per share, conditioned upon elimination of the defensive measures, the board rejected it as inadequate.[200] Pantry Pride then increased its offer to $56.25 with the same conditions.[201] The Revlon board again rejected the offer.[202] Instead, the board entered into an agreement with Forstmann Little & Co. (Forstmann) pursuant to which Forstmann would purchase Revlon stock at $57.25 a share in a leveraged buyout.[203] As a result of the buyout, Forstmann would sell certain divisions of Revlon. The Revlon board also granted Forstmann a "lock-up" option to purchase certain divisions of Revlon at $100-$175 million below their value even if Fortsmann was not the ultimate purchaser of the Revlon shares.[204] In return, Fortsmann consented to pay full value for the outstanding notes, which had declined in value since their issuance.[205] When Pantry Pride again raised its offer, only to have Revlon rebuff them, it filed an action to enjoin the consummation of the Forstmann deal.[206]

The Delaware court first confirmed that *Unocal* governs board actions aimed solely at repelling a hostile takeover attempt.[207] Thus, the Revlon board's adoption of the repurchase plan to protect shareholders from Pantry Pride's inadequate offer was legitimate.[208] Moreover, if the board had believed that Pantry Pride's offer threatened non-shareholder interests, the board's fiduciary duty would have enabled it to take defensive actions designed to protect those interests.[209]

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plan, each Revlon shareholder would receive one Right for each share of common stock, which could be exchanged for a $65 principal Revlon note at 12% interest. *Id.* The Rights, which could be redeemed by the board for 10 cents each, would become effective whenever anyone acquired beneficial ownership of 20% or more of Revlon shares unless the purchaser acquired all of the company's stock for $65 a share. *Id.* This kind of plan is known as a "poison pill." *Id.* at 180.

199. The notes limited Revlon's ability to incur additional debt, sell assets, or pay dividends without board approval. *Revlon*, 506 A.2d at 177.

200. *Id.* at 181.

201. *Id.* at 184.

202. *Id.*

203. *Id.*

204. The Fortsmann agreement also included a $25 million cancellation fee and a "no-shop" provision which prevented Revlon from soliciting or discussing any competing transactions with other parties. *Id.* at 175-79.

205. *Id.* at 178.

206. *Id.* at 179.

207. *Id.* at 176

208. *Id.*

209. *See id.* at 181 (stating that board's response to Pantry Pride's offer was within board's duties and responsibilities).

HeinOnline -- 59 Wash. & Lee L. Rev. 448 2002

However, once the board made the decision to sell the company and break it up, its duty "changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."[210] In the courts' view, the board's action of engaging Fortsmann reflected the board's acceptance of the sale and break-up of the company.[211] Indeed, not only did Fortsmann plan to sell divisions of the company if it consummated a takeover, but the board agreed to sell Fortsmann certain divisions of Revlon even if a Fortsmann takeover was not consummated.[212] This acceptance of a corporate sale and break-up meant that the board's primary concern should have shifted toward obtaining the best financial value for its shareholders.[213] Because the Revlon board continued to institute defensive measures even after Pantry Pride raised its offer price to a more acceptable level, the board violated their fiduciary duty.[214]

In addition, the *Revlon* court found it unacceptable for the board to consider the interests of other corporate constituents when carrying out this duty.[215] The Revlon board maintained that it had not breached its duty because the decision to accept the Forstmann deal reflected a consideration of other corporate constituents, principally the noteholders.[216] The board argued that because Forstmann agreed to support the full value of the notes, his offer was more beneficial to the noteholders.[217] Because the Forstmann deal provided protection to other corporate constituents, the board believed that *Unocal* enabled it to legitimately accept that deal even if it provided less value to the shareholders.[218] The court disagreed, stating that once the board agreed to sell the company and effect its break up, decisions made in favor of other groups were inappropriate.[219] Instead, the board only could consider other group interests if they were "rationally related benefits accruing to the stockholders."[220] These interests, however, clearly could not take precedent over the board's duty to increase the shareholders wealth.[221] Because the board allowed considerations

210. *Id.* at 182.

211. *See id.* (stating that it was apparent to all parties that break-up of Revlon was inevitable).

212. *Id.*

213. *Id.*

214. *See id.* (noting impropriety of board's continued use of defensive measures).

215. *Id.* at 185.

216. *See id.* at 182 (noting that directors' argument that *Unocal* permitted consideration of other corporate constituencies' interests). .

217. *Id.*

218. *Id.*

219. *See id.* (stating that concern for non-shareholder interests was improper).

220. *Id.*

221. *Id.* at 184.

other than the maximization of shareholder profit to impact their judgment, the court concluded that the directors had breached their duty.[222]

c. Change-of-Control Transactions

Consistent with *Revlon*, the Delaware Supreme Court also held that directors had an obligation to maximize shareholder value in the context of a change-of-control transaction. In *Paramount Communications, Inc. v. QVC Network, Inc.*,[223] Viacom, Inc. (Viacom) sought to acquire Paramount Communications, Inc. (Paramount) through a tender offer of 51% of Paramount stock followed by a stock for stock merger.[224] The transaction would result in Viacom owning a majority of the stock of Paramount.[225] The Paramount/ Viacom agreement contained several defensive measures designed to forestall any competing takeover attempts.[226] When QVC Network, Inc. (QVC) launched a competing tender offer for Paramount stock at a higher price, but subject to the removal of the defensive measures, the board rejected it.[227]

The Delaware Supreme Court found that the board's rejection violated its fiduciary duty.[228] The Paramount board claimed that an alliance with Viacom would prove better for the corporation in the long-term and, therefore, took measures that favored such an alliance.[229] However, the court stated that the board's focus was inappropriate.[230] In the court's view, once a change of control occurs, the current stockholders no longer would have the leverage to demand premium value for their shares.[231] As such, directors have an "obligation to take the maximum advantage of the current opportunity to realize for the stockholders the best value reasonably available."[232] To protect its original agreement with Viacom, the Paramount board not only refused to remove defensive measures, but also made no significant quantitative assessment of

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222. *Id.*

223. 637 A.2d 34 (Del. 1993).

224. *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 40 (Del. 1993) (outlining Viacom's proposed acquisition of Paramount).

225. *See id.* (noting that Viacom's offer was for 51% of Paramount's stock).

226. The measures included a no-shop clause, a $100 million termination fee and a stock option agreement that was very beneficial to Viacom. *Id.* at 39.

227. *Id.* at 41.

228. *Id.* at 49.

229. *Id.*

230. *Id.*

231. *See id.* at 43 (reasoning that once control shifts, current shareholders cannot demand control premium). Thus, the Delaware court stringently asserted the dominance of the shareholder-primacy model, stating that the directors must focus on "one primary objective — to secure the transaction offering the best value reasonably available for the stockholders." *Id.* at 44.

232. *Id.* at 43.

HeinOnline -- 59 Wash. & Lee L. Rev. 450 2002

the consideration QVC offered.[233] Because of this, the court indicated that the board missed opportunities to secure a more favorable transaction for its shareholders, consequently breaching its fiduciary duty.[234] In this way, the Delaware Supreme Court indicated that directors could not maintain a long-term strategy at odds with shareholders' goal of increasing their short-term value during a change of control.[235]

The *Paramount* court also suggested that consideration of other groups' interests could not impact board decisions in this area.[236] While the court acknowledged that a board might be able to consider other interests in the context of a change of control, all of the interests enumerated by the court were financial in nature.[237] Noticeably, the court, in quoting an earlier decision concerning the interests that a board legitimately could consider, did not include the portion of the decision that specifically referenced the directors' ability to consider the interests of other constituents.[238] By dropping this language, the court apparently confirmed the dominance of the shareholder primacy model in the context of change-of-control transactions. This confirmation, by its terms, rejects the social entity paradigm.

d. Corporate Reorganizations

In contrast with *Paramount*, the Delaware Supreme Court held in an earlier case, *Paramount Communications, Inc. v. Time, Inc.*,[239] that in business reorganizations not involving a change of control or break-up of the company, directors need only comport with *Unocal* and, therefore, may consider inter-

233. *See id.* at 49 (holding that board's agreement to defensive measures and disparate treatment of bidders was unreasonable). The board claimed that the Paramount transaction would be more advantageous than an alliance with QVC, but failed to produce substantial evidence in support of this claim. *See id.* at 41 (detailing board's basis for believing that Paramount transaction was more advantageous).

234. *See id.* at 49-50 (detailing missed opportunities with QVC).

235. The court stated that the Paramount board's view of the value of the strategic alliance "became an empty rationalization as the opportunities for higher value for the stockholders continued to develop." *Id.* at 51.

236. *See id.* at 43-45 (discussing directors' obligations in sale or change of control transactions).

237. *See id.* at 44 (holding that board should consider "[an offer's] fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; . . . the risk of nonconsum[m]ation; . . . the bidder's identity, prior background and other business venture experiences; and the bidder's business plan for the corporation and their effects on stockholder interests") (alterations in original) (quoting Mills Acquisition Co. v. MacMillan, Inc, 559 A.2d 1261, 1282 n.29 (Del. 1989)).

238. The dropped language states: "the potential acquisition on other constituents, provided that it bears some reasonable relationship to general shareholder interests." *Mills Acquisition Co.*, 559 A.2d at 1282 n.29.

239. 571 A.2d 1140 (Del. 1989).

HeinOnline -- 59 Wash. & Lee L. Rev. 451 2002

ests beyond those of shareholders.[240] After several years of planning and as part of its strategic plan to expand operations, the board of Time, Inc. (Time) entered into a stock for stock merger agreement with Warner Communications, Inc. (Warner).[241] As a result of the agreement, a new entity, Time-Warner, would exist, with Warner shareholders owning approximately 62% of the new entity.[242] Throughout the merger negotiations with Warner, the directors of Time emphasized their desire to preserve the journalistic integrity of Time – the "Time Culture."[243] In fact, the board continually insisted that they would agree to a merger with Warner only if the directors of Time controlled the board of the resulting corporation, thereby insuring the preservation of the Time culture.[244] This issue was so important to the Time board that when Warner refused to guarantee Time's dominance on the surviving board, negotiations between the two entities ended.[245]

Eventually negotiations resumed, with Warner agreeing to retain Time's senior management after the merger.[246] After coming to suitable terms on the remainder of the deal, both companies scheduled shareholder meetings to vote on the proposed transaction.[247] Time adopted several defensive measures, including a no-shop clause, designed to thwart any takeover attempts.[248]

240. *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1142 (Del. 1989) (holding that "possibility of inadequate value" is not only cognizable corporate threat in tender offer situation).

241. *See id.* at 1143-47 (detailing negotiations and final agreement to merge). The merger was to be a stock exchange by which Warner would be merged into a wholly-owned subsidiary of Time, with Warner becoming the surviving corporation. The common stock of Warner would then be converted into Time common stock at an agreed-upon ratio. Afterward, the surviving company would be named Time-Warner, Inc. *Id.* at 1146; Lyman Johnson & David Millon, *The Case Beyond* Time, 45 BUS. LAW. 2105, 2105 n.2 (1990).

242. *Time*, 571 A.2d at 1146.

243. *See id.* at 1143 n.4 (noting Time management's concern that merger would divert Time's focus from news journalism to entertainment). Chancellor Allen referred to this culture as both "pride in the history of the firm – notably Time magazine and its role in American life – and in part a managerial philosophy and distinctive structure that is intended to protect journalistic integrity from pressures from the business side of the enterprise." Johnson & Millon, *supra* note 241, at 2105-06 (citations omitted).

244. *See Time*, 571 A.2d at 1144 (stating that Time's board felt merger was feasible only if Time controlled board of resulting corporation).

245. *See id.* at 1145 (noting that negotiations ended "when the parties reached an impasse" on this issue).

246. *See id.* at 1145-46 (detailing resumption of negotiations after Time and Warner agreed that Warner's co-CEO ultimately would step down).

247. Although Delaware law did not require a vote by the Time stockholders, Time was required to obtain a vote by the rules of the New York Stock Exchange. *Id.* at 1146.

248. *Id.* at 1146-47. In addition to the no-shop clause, which prevented Time from considering other consolidations, Time secured promises from banks that they would not finance a third-party attempt to acquire Time. *Id.*

HeinOnline -- 59 Wash. & Lee L. Rev. 452 2002

Despite these efforts, and shortly before the shareholder meetings, Paramount launched a competing tender offer.[249] Time rejected the offer, primarily based on the board's belief that an alliance with Warner would ensure the retention of the Time culture.[250] However, the Time board feared that the Paramount offer would cause its shareholders to reject the proposed Warner merger.[251] Thus, Time recast the merger as a tender offer that did not require shareholder approval. The shareholders of Time and Paramount sued to enjoin the consummation of the tender offer.[252] The Delaware Supreme Court upheld the Time board's actions.[253]

The court began by concluding that the board's actions did not constitute a change of control implicating *Revlon* because the board's actions did not make the dissolution or break-up of the company inevitable.[254] Rather, the transaction amounted to a corporate reorganization. As long as the board's conduct did not reflect "an abandonment of the corporation's continued existence, *Revlon* duties are not triggered, though *Unocal* duties attach."[255] Thus, the board had no duty to maximize shareholder wealth, but could consider the various interests proscribed under *Unocal*. The court explained that financial interests were not the only legally cognizable interests that board members could consider in connection with a tender offer.[256] Instead, board members could consider important corporate policies, such as retention of the Time culture.

Moreover, *Time* revealed that board members could subordinate shareholder concerns to protect other interests. In fact, the court allowed the Time board to decline a seemingly higher offer to protect corporate policy. More

249. *See id.* at 1147-49 (detailing Paramount's initial all-cash purchase price of $175 per share and its eventual increase to $200 per share). After the initial announcement of the offer, Time stock rose from $126 to $170 per share. *Id.* at 1147.

250. *See Time*, 571 A.2d at 1149 (stating that Time's directors believed that Paramount deal "pose[d] a threat to Time's survival and its culture"). The Time board also professed a belief that, in the long-term, the value of the Time-Warner transaction would be greater than the Paramount tender offer. *Id.* The court, however, focused on the extent to which the preservation of Time culture was a legitimate concern for Time in the context of a takeover. *See id.* at 1153 (holding that Time could evaluate Paramount's all-cash offer on bases in addition to adequacy of value).

251. *See id.* at 1149 (noting Chancellor Allen's finding that restructured transaction "resulted from Paramount's offer and its expected effect on a Time shareholder vote").

252. *Id.* at 1141-42.

253. *Id.* at 1155.

254. *See id.* at 1150 (rejecting *Revlon* claim because Time's board negotiation did not make dissolution or break-up "inevitable").

255. *Id.* at 1150-51.

256. *See id.* at 1153 (holding that *Unocal* does not stipulate "narrow and rigid construction").

HeinOnline -- 59 Wash. & Lee L. Rev. 453 2002

importantly, in allowing the Time board to recast their merger transaction as a tender offer, the court enabled the board to prevent its shareholders even from casting a vote related to the Time-Warner transaction. Thus, *Time* illustrates that when planning a reorganization, board members can favor the interests of non-shareholders or corporate policies, even when such actions deprive shareholders of short-term profits and other important rights, such as the voting right.

2. Application to Public Benefit Companies

Delaware case law in the takeover context presents a murky picture for all for-profit corporations, including those with public beneficiaries. However, not all companies will be subject to the market for corporate control, and public benefit companies may not be likely candidates for takeover activity. If this is true, the often-confusing case law in this area need not concern us. Of course, because takeover case law encompasses corporate decisions related to changes of control and business reorganizations, it is important to understand the applicability of these cases to public benefit companies.

a. Defensive Actions and Corporate Reorganizations

As long as a public benefit company seeks only to defend against a takeover attempt, Delaware courts prefer the social entity model indicated by *Unocal*. Therefore, boards of post-conversion companies may consider the interest of the other groups they serve, even when confronted with a takeover attempt. For example, board members of a hospital could defend against a hostile takeover based on the potential acquirer's practice of sharply reducing charity care after acquisition. Additionally, *Time* makes it clear that public benefit corporations may engage in corporate reorganizations that consider interests of their public beneficiaries. Certainly, if the board in *Time* could consider the impact of a transaction on its culture, directors of a public benefit corporation can consider the impact a reorganization transaction would have on students and patients. Moreover, in the context of reorganizations, board members can deny shareholders the chance to participate in takeovers altogether. In fact, the Delaware courts "have repeatedly stated that the refusal to entertain an offer may comport with a valid exercise of a board's business judgment."[257] By allowing directors to prevent shareholders from taking advantage of typically lucrative tender offers, cases such as *Paramount* more plainly indicate the court's willingness to de-center shareholders' financial interests for other values.[258]

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257. *Time*, 571 A.2d at 1152.

258. *See* Millon, *supra* note 12, at 225 (reasoning that cases like *Paramount* indicate willingness to subordinate shareholders' financial interests to "other values").

HeinOnline -- 59 Wash. & Lee L. Rev. 454 2002

b. Placing the Company Up for Sale and Change-of-Control Transactions

Under *Revlon*, once a company is deemed to be up for sale, directors' duties shift away from considering the interests of all corporate constituents. This poses a source of tension for directors of public benefit companies. Similarly, *Paramount* reveals that when a company engages in a change of control transaction, it must consider primarily the interests of shareholders. The *Revlon* duty of wealth maximization, reiterated by *Paramount*, epitomizes the tension emphasized by opponents of for-profit conversions. Thus, one author noted:

> It would be entirely in accordance with their duty of care and business judgment responsibilities, for example, for the directors of a nonprofit hospital to accept a low bid from one of several suitors because the chosen bidder would provide a far higher level of public benefit or service to the community. In most circumstances, a for-profit board would not have – and should not have – such freedom.[259]

This expression of the difference between the duties of directors appears consistent with *Revlon*. For example, while *Unocal* enables directors to consider other groups when they are not willing to sell the corporation, once the board members of a public benefit corporation make the decision to sell, corporate law may require the members to consummate the sale in a manner that compromises the company's charitable mission. *Revlon* implies that directors can consider other interests only if they are rationally related to those of the shareholders. However, as applied to the aforementioned example of the low bid, this formulation of a director's duty could not be used to support the acceptance of a low bid by directors of a public benefit company because directors would find it difficult to fashion a scenario whereby acceptance of that bid would be consistent with the interests of shareholders. More importantly, *Paramount* suggests that while the board may make inquiries into the financial soundness of the bid, they may not reject the bid in order to protect the kind of non-financial concerns that are endemic to public benefit corporations.[260] Therefore, to the extent that *Revlon* applies to these corporations,[261]

259. Goldschmid, *supra* note 9, at 641.

260. *See supra* notes 223-38 and accompanying text (discussing *Paramount* case).

261. Some suggest that *Revlon* should apply to the boards of *nonprofit* corporations when they enter into conversion transactions. *See generally* Colin T. Moran, *Why* Revlon *Applies to Nonprofit Corporations*, 53 BUS. LAW. 373, 387-88 (1998) (arguing that *Revlon* should apply to nonprofit corporations' conversions for doctrinal and public policy reasons). In making this declaration, Moran rejected an argument for modifying Revlon to enable directors of nonprofits to reject bids if they believe the bidder will not conduct itself in a manner consistent with the nonprofit's mission. *Id.* Moran believed that while applying *Revlon* to nonprofits might be problematic, it would be even more difficult for a court to determine whether or not the bidder's conduct was consistent with a nonprofit's mission. *Id.*

the doctrine creates a seemingly insurmountable tension between the duties of directors in public benefit companies and the pursuit of the more altruistic goals of the entities.

On further analysis, Delaware decisions may severely limit *Revlon*'s impact. First, the impact of *Paramount* on change-of-control transactions is less certain when read in conjunction with *Time*. Indeed, *Paramount* and *Time* have many similarities. Both cases involved plans in which a new entity or group would hold more than 50% of the shares of the targeted company. Also, in both cases, board members first entered into a transaction with one company that they claimed was more compatible with the corporation's long-term agenda. Then, too, the corporate boards defended against hostile take-overs on the basis of their previous agreements. Given these similarities, one would have expected *Paramount*, which was decided after *Time*, either to comply with the principles in *Time* or to reject them. Instead, the *Paramount* court sidestepped the issue. The court claimed that the two cases were distinguishable because while *Paramount* involved a change of control, *Time* did not. In the *Paramount* court's view, the initial merger agreement between Time and Warner did not result in a change in control because the stock of both corporations was publicly held and, hence, control would remain "in a large, fluid and changeable market."[262] In contrast, the transaction in Paramount amounted to a change of control because although a majority of Paramount stock was publicly held, the stock of both Viacom and QVC was privately held; hence, under the court's analysis, their combination with Paramount would reflect a change of control.[263] Indeed, the *Paramount* court noted that if Warner had been a privately-held company, its merger with Time would have constituted a change of control.[264] If this distinction is to be taken seriously, public benefit corporations can engage in mergers in which a change of control takes place, as long as they involve two public companies. This limits the *Revlon* duty to change of control interactions involving private companies.

Second, these cases continue to leave open the possibility that companies can engage in transactions falling short of a dissolution or break-up without triggering *Revlon*. Indeed, the distinction between change of control transactions articulated by the *Paramount* court seems tenuous at best. The *Time* court held that the Time-Warner transaction did not constitute a change of control because the transaction did not involve a dissolution or break-up of the

262. Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 47 (Del. 1993).

263. *See id.* at 37-38 (analyzing control of Paramount, Viacom, and QVC stock); *id.* at 42-43 (holding that sale of majority of shares to single, cohesive group results in "significant diminution" of current shareholders' rights and, thus, gives acquirer power "to alter [the] vision" of company).

264. *Id.* at 46.

HeinOnline -- 59 Wash. & Lee L. Rev. 456 2002

corporate enterprise.[265] Moreover, in distinguishing *Time* and *Revlon*, the *Time* court noted that this feature clearly triggers a shift in a director's duty.[266] However, while purporting to follow *Time*, the *Paramount* court rejected the argument that both a break-up and a change in majority stock ownership is required to trigger the *Revlon* duty.[267] Moreover, the *Time* court refused to rely on the characterization of a change-of-control transaction accepted by *Paramount*.[268] While these cases appear to conflict with one another,[269] the *Paramount* court professed a desire to limit that case to its facts. The court stated, "We express no opinion on any scenario except the actual facts before the Court, and our precise holding herein."[270] By limiting *Paramount* to its facts, the court leaves open the possibility that other transactions, specifically those not involving a corporate break-up, may not trigger the *Revlon* duty to subordinate non-shareholder concerns. Arguably, one critical distinction between *Paramount* and *Time* is that while the Time board professed a concern for non-shareholder interests during the course of the entire transaction, the Paramount board appeared primarily concerned with financial interests. Based on this distinction, board members of public benefit corporations who structure a sale of the corporate enterprise or other restructuring transactions with due regard for their charitable or other missions and remain committed to the mission throughout the course of the sale may not be deemed to have violated their duty. Any restructuring transactions involving public benefit corporations are likely to be closer to the facts and spirit of *Time* than *Paramount*, thereby enabling these boards to avoid triggering *Revlon* when engaging in a "change of control." Also, in the aforementioned example, directors of the public benefit company may be able to choose the lower bid as long as they express a desire to provide a high level of public service throughout the bidding process. Indeed, a board's desire to continue the provision of charitable care or particular education services seems more compelling than the desire to protect a company's journalistic integrity sanctioned by *Time*. Thus, courts may be more willing to endorse this conduct, even when it is closer to the *Revlon* trigger.

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265. Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989).

266. *See id.* (holding that *Revlon* duties are invoked where there is "clear break-up" or abandonment of long-term strategies coupled with pursuit of alternative involving break-up).

267. *Paramount*, 637 A.2d at 47-48.

268. *See Time*, 571 A.2d at 1150 (noting that while lower court held that there was no change of control because control would pass to fluid group of public shareholders, Delaware Supreme Court would adopt different rationale).

269. *See* Johnson & Millon, *supra* note 241, at 2112 (noting difficulty of harmonizing *Time* and *Paramount*).

270. *Paramount*, 637 A.2d at 43 n.13.

Moreover, given the narrowing dicta in *Time* and *Paramount*, it may be reasonable to believe that Delaware courts will allow greater latitude to public benefit companies. Indeed, these cases reveal the Delaware courts' insistence on "read[ing] *Revlon*'s flash point narrowly."[271] Even while seeming to adopt the shareholder primacy model, the *Paramount* court suggested that only rarely would it adhere to such a model.[272] Thus, the *Paramount* court began its analysis by stating that under normal circumstances, "neither the courts *nor the stockholders* should interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which such decisions are entitled."[273] This assertion reveals the eclipsing nature of the social entity model. Indeed, given that in ordinary business decisions the court has followed the social entity model explicitly sanctioned in *Unocal*, the court appears to concede its general prominence. Moreover, by referring to its prior framework as the norm, the *Paramount* court suggests that its insistence on shareholder primacy under *Revlon* represents a deviation from that norm.[274] The *Time* court also emphasized that the principles articulated in *Revlon* only applied to a limited set of circumstances.[275] Outside of these narrow instances, the *Time* court insisted that a board "is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[276] This language reveals the court's desire to restrict the *Revlon* duty of shareholder maximization, while allowing directors wide latitude to consider the concerns of all groups. This means that directors of public benefit corporations normally will not run afoul of their fiduciary responsibilities if they consider the concerns of students, patients, and other groups when making decisions. In this way, public benefit corporations fit quite snugly in the niche carved out by *Time*, indicating that *Revlon* may have no appreciable impact on these directors.

Taken as a whole, this discussion indicates that Delaware law has strayed from its shareholder-focused roots. Because of this, in almost all situations, directors of public benefit corporations have significant flexibility to make

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271. *See* Johnson & Millon, *supra* note 241, at 2110-11 (noting that even though Chancery court read *Revlon* narrowly, Delaware Supreme Court read it even more narrowly).

272. *See Paramount*, 637 A.2d at 41-42 (stating that although directors are representative of stockholders, normally directors' decisions command deference).

273. *Id.* at 42 (emphasis added).

274. *See id.* (citing *Revlon* as exemplary of "rare situations" mandating judicial review of reasonableness of directors' decisions).

275. *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989) (holding that only two general circumstances trigger *Revlon* duties). Indeed, the *Time* decision "blunt[ed the] force [of *Revlon*] by treating it as a special case." Johnson & Millon, *supra* note 237, at 2112. The authors note that while the court "pays its respect to the *Revlon* reasoning" it refuses to extend it and insisted on reading it narrowly. *Id.* at 2110.

276. *Time*, 571 A.2d at 1150.

HeinOnline -- 59 Wash. & Lee L. Rev. 458 2002

decisions that maximize the interests of other groups regardless of the context. Clearly *Wrigley*, *Unocal*, and even *Paramount* confirm the notion that the duty to maximize shareholder value without regard to other interests applies only in limited takeover settings. Because it is unclear if these companies will be subject to takeover attempts, these settings may not even arise. More specifically, even within the context of takeovers, the board can institute defensive measures and engage in significant restructuring without regard to *Revlon*. *Revlon* is implicated if directors agree to the break-up of the corporation, initiate a sale of the corporation, or engage in a change-of-control transaction. However, with respect to the latter two transactions, the Delaware courts' failure to define clearly when they actually arise, coupled with its seeming desire to limit *Revlon*, may provide public benefit companies ample opportunity to conduct takeover-like activity while paying heed to non-shareholder interests. Indeed, there is reason to believe that when directors of these companies remain committed to their social or charitable missions, the directors may be able to consider these missions when consummating some transactions. Hence, the claim that corporate law prevents these directors from making decisions aimed at protecting a particular mission or group, even during times of major transition, is tenuous at best.

C. Help on the Horizon: Constituency Statutes

The passage of constituency statutes also signals a movement toward an expansion of the interests that directors can consider. Constituency statutes represent a response to the perceived negative impact corporate takeovers have on employees, creditors, and other members of the community.[277] As expressed previously, corporate takeovers involving a break-up or major reorganization of the corporation often displace employees and jeopardize creditors' positions.[278] State leaders enacted constituency statutes to enable directors to consider the concerns of employees, creditors, and others who may be impacted negatively by corporate takeovers.[279] Though enacted in response to takeovers, constituency statutes have swung the pendulum in the direction of the social entity concept by permitting directors to evaluate the concerns of groups other than shareholders.[280] As a consequence, this legisla-

277. *See* Orts, *supra* note 11, at 24 (noting that constituency statutes were "born legislatively as part-and-parcel of the spate of state antitakeover statutes").

278. *See id.* (noting common belief that takeover market "caused, or at least significantly facilitated a geographical redistribution of wealth, as well as an attendant loss of jobs").

279. *See id.* (noting that state legislatures passed constituency statutes largely in response to constituents who perceived hostile takeovers negatively).

280. *See, e.g.*, Allen, *supra* note 12, at 276 (stating that social entity concept "animates" constituency statutes); Mitchell, *supra* note 13, at 610 (noting that non-shareholder constituency statutes are "the most obvious feature of the reordering of the corporate legal landscape").

tion enables directors of public benefit corporations to more effectively take into account the interests of their beneficiaries. Of course, not all states have adopted these statutes.[281] States that do not have this legislation may be more restrictive of public-benefit companies in their range of considerations. The most obvious and problematic exception is Delaware, which has yet to enact a statute.[282] Given that most large public companies – including most of the large education and hospital companies – are incorporated in Delaware,[283] the absence of a statute in Delaware significantly moderates the impact of these statutes on corporate law. However, these statutes reflect an important legislative shift toward an acceptance of the social entity model of the corporation and, as a consequence, one cannot ignore their impact.[284]

1. Content of Constituency Statutes

To date, thirty-two states have enacted some form of constituency statute.[285] These statutes vary in the kind of groups or interests directors may consider, although all have the unifying goal of broadening the concerns to which directors can respond.[286] Some statutes apply only to a specific group

281. *See infra* note 285 (detailing states that have passed constituency statutes).

282. Orts, *supra* note 11, at 74.

283. *See supra* note 122 (discussing abundance of companies that have incorporated in Delaware).

284. *See supra* note 280 (discussing how constituency statutes promote social entity concept).

285. As of June 2001, the following states each had adopted some form of constituency statute: Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Jersey, New Mexico, New York, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Vermont, Virginia, Wisconsin, and Wyoming. *See, e.g.*, ARIZ. REV. STAT. ANN. § 10-2702 (West 1996); CONN. GEN. STAT. ANN. § 33-756 (West 1997); FLA. STAT. ANN. § 607.0830 (West 2001); GA. CODE ANN. § 14-2-202 (Supp. 2001); HAW. REV. STAT. § 414-221 (Supp. 2001); IDAHO CODE § 30-1602 (Michie 1999); 805 ILL. COMP. STAT. ANN. 5/8.85 (West 1993); IND. CODE ANN. § 23-1-35-1 (Michie 1999); IOWA CODE ANN. § 491.101B (West 1999); KY. REV. STAT. ANN. § 271B.12-210 (Michie Supp. 2001); LA. REV. STAT. ANN. § 12:92 (West 1994); ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 2001); MD. CODE. ANN., CORPS. & ASS'NS. § 2-104(9) (Supp. 2001); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West Supp. 2001); MINN. STAT. ANN. § 302A.251 (West Supp. 2002); MISS. CODE ANN. § 79-4-8.30 (2001); MO. REV. STAT. § 351.347 (Supp. 2001); NEB. REV. STAT. § 21-2432 (1997); NEV. REV. STAT. § 78.138 (2001); N.J. STAT. ANN. § 14A:6-1 (West Supp. 2001); N.M. STAT. ANN. § 53-11-35 (Michie 2001); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 2002); N.D. CENT. CODE § 10-19.1-50 (2001); OHIO REV. CODE ANN. § 1701.59 (West Supp. 2001); OR. REV. STAT. § 60.357 (1999); 15 PA. CONS. STAT. ANN. § 1715 (West 1995); R.I. GEN. LAWS § 7-5.2-8 (1999); S.D. CODIFIED LAWS § 47-33-4 (Michie 2000); TENN. CODE ANN. § 48-103-204 (1995); VT. STAT. ANN. tit. 11A, § 8.30 (Supp. 2001); VA. CODE ANN. § 13.1-727.1 (Michie 1999); WIS. STAT. ANN. § 180.0827 (West 1992); WYO. STAT. ANN. § 17-16-830 (Michie 2001).

286. *See* Edward S. Adams & John H. Matheson, *A Statutory Model for Corporate Constituency Concerns*, 49 EMORY L.J. 1085, 1086-88 (2000) (stating that purpose and effect of

HeinOnline -- 59 Wash. & Lee L. Rev. 460 2002

of constituents such as employees, suppliers, customers, and the local community.[287] Others enable directors to consider a broader array of interests – from those related to customers and suppliers to those impacting "the economy of the state and nation."[288] Pennsylvania, the first to pass constituency legislation, adopted a broad statute, providing that, in discharging the duties of their respective positions, directors may consider,

> to the extent they deem appropriate:
> (1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located, [;]
> (2) The short-term and long-term interests of the corporation . . . [; and] . . .
> (4) All other pertinent factors.[289]

In essence, all constituency statutes have two significant impacts upon public benefit companies. First, the statutes explicitly sanction management decisions that consider non-shareholder interests. Second, these statutes overrule *Revlon*-like decisions in the states in which they apply.[290]

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constituency statutes is to expand criterion on which directors may rely); Orts, *supra* note 11, at 26-27 (stating that constituency statutes allow directors to consider "expanded group of interests").

287. *See, e.g.*, IDAHO CODE § 30-1602 (Michie 1999).

288. States with such a broad pronouncement include Florida, Hawaii, Kentucky, Massachusetts, Minnesota, Nevada, New Mexico, North Dakota, Ohio, Oregon, South Dakota, Vermont (which includes economy of the state, region, and nation), and Wyoming. FLA. STAT. ANN. § 607.0830 (West 2001); HAW. REV. STAT. § 414-221 (Supp. 2001); KY. REV. STAT. ANN. § 271B.12-210 (Michie Supp. 2001); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 1996); MINN. STAT. ANN. § 302A.251 (West Supp. 2002); NEV. REV. STAT. § 78.138 (2001); N.M. STAT. ANN. § 53-11-35 (Michie 2001); N.D. CENT. CODE § 10-19.1-50 (2001); OHIO REV. CODE ANN. § 1701.59 (West Supp. 2001); OR. REV. STAT. § 60.357 (1999); S.D. CODIFIED LAWS § 47-33-4 (Michie 2000); TENN. CODE ANN. § 48-103-204 (1995); VT. STAT. ANN. tit. 11A, § 8.30 (Supp. 2001); WYO. STAT. ANN. § 17-16-830 (Michie 2001).

289. 15 PA. CONST. STAT. ANN. § 1715 (West 1995).

290. Only the Connecticut statute requires directors to consider non-shareholder interests. *See* CONN. GEN STAT. ANN. § 33-756 (West 2000) (stating "the director shall consider" interests of variety of different groups including employees, creditors, customers, community, and society as well as "any factors directors reasonably believe to be in the bests interests of the corporation"). All of the other constituency statutes are permissive in nature. Some have asserted that the permissive nature of the statutes indicates a lack of "a true commitment by state legislatures to ensure corporate decision-making includes consideration of stakeholders." Adams & Matheson, *supra* note 286, at 1120. However, the fact that most of these statutes are permissive is not determinative for purposes of this Article. This Article seeks to determine the extent to which these statutes, and corporate law in general, enables directs greater flexibility to make decisions unrelated to shareholder interests, not whether or not directors will be required to make these decisions.

2. Conduct Permitted by Constituency Statutes

In the context of ordinary business decisions, constituency statutes may be viewed as a codification of the duty amplified in *Wrigley*.[291] Almost three-fourths of constituency statutes permit directors to consider the long-term interests of shareholders and the corporation when making their decisions.[292] In this respect, these statutes are consistent with judicial opinions like *Wrigley* that allow a director to consider community interests even when there is a less than immediate advantage for the shareholders. Based on these statutes, directors of public benefit corporations may be free to continue operation of a relatively under-performing school or continue providing charitable services within a hospital, as long as they can articulate a reason why continuation may increase the value of the shareholders' interests in the long term. Thus, some view these statutes as providing explicit legislative sanction for conduct already permitted by judicial opinions.[293]

However, some statutes appear to go further than court decisions such as *Wrigley* and allow directors to consider other groups' interests without tying them to the concerns of shareholders. Nearly all of the statutes include "community" or "community interests" as one of the factors a director may consider when making a decision with respect to the corporation.[294] Some states, like Pennsylvania, also have a catch-all provision enabling directors to consider "all other pertinent factors" when making decisions.[295] Then too, a

291. *Cf.* William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 387 (1990) (arguing that enlightened management "properly considers the interest of these constituencies when pursuing shareholder welfare"); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 35-36 (1991) (reasoning that constituency statutes will be beneficial if they simply prevent courts from intruding in internal corporate decisions that do not implicate director or manager self-interest).

292. Twenty-three of the thirty-two states with constituency statutes refer to the long-term interests of shareholders as a factor to be considered by directors.

293. *See, e.g.*, Adams & Matheson, *supra* note 286, at 1092 ("Constituency statutes do not represent a new invention attempting to penetrate corporate legal regimes, but instead constitute an innovative means to express the ideals embraced by corporate America throughout the twentieth century.").

294. Twenty-nine of the thirty-two state statutes refer to community interests. States not referring to community interests are Arizona, New Jersey, and Virginia.

295. In addition to Pennsylvania, several other states have statutes that enable directors to consider "any other relevant factor" in their decision-making process. These include Georgia, GA. CODE. ANN. § 14-2-202(b)(5) (1994) (permitting directors to consider all pertinent factors); Illinois, 805 ILL. COMP. STAT. 5/8.85 (West 1993) (same); Indiana, IND. CODE ANN. § 23-1-35-1(d) (Michie Repl. 1999) (same); Maine, ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 2001-2002) (same); Oregon, OR. REV. STAT. § 60.357 (1999) (same); Tennessee, TENN. CODE ANN. § 48-103-204 (1995) (same); Wisconsin, WIS. STAT. ANN. § 180.0827 (West 1992) (same); and Wyoming, WYO. STAT. ANN. § 17-16-830 (Michie 2001) (same).

HeinOnline -- 59 Wash. & Lee L. Rev. 462 2002

few states do not require directors to regard explicitly the interests of any one group as dominant or controlling.[296] Even statutes that do not contain this language do not require that a director consider non-shareholder interests in conjunction with shareholder concerns.[297] Therefore, these statutes may provide wider discretion than cases like *Wrigley,* which leave doubt as to how far directors can pursue other interests when they are not linked to the shareholders.

These statutes appear to sanction precisely the kind of action that opponents of privatization claim that case law would not permit for-profit companies to take, and they confirm the general flexibility that directors have. Certainly, the definition of community or community interests that is referred to in most of these statutes would encompass the interests of students and patients who are served by public benefit companies. This definition also may include consideration of interests broader than that of the immediate beneficiaries. For example, these statutes would allow the directors of a public benefit hospital to consider the fact that a hospital closure would strain the economic resources of other hospitals within their community. These statutes also appear to allow directors to consider these interests divorced from shareholder concerns. In this regard, directors of public benefit corporations would have the freedom to make decisions that subordinate those concerns.

In the takeover context, constituency statutes also serve to overrule *Revlon*-like decisions in the states in which the statutes apply. Not only were the statutes enacted in response to Delaware's stance on defensive measures during a takeover,[298] but almost one-third of the statutes apply only in the takeover context.[299] These statutes allow directors to consider non-share

296. *See* IND. CODE ANN. § 23-1-35-1(d) (Michie Repl. 1999) (noting that directors may consider various interests); IOWA CODE ANN. § 490.1108 (West 1999) (same); 15 PA. CONS. STAT. ANN. § 1715(a)(4) (West 1995) (same). The Pennsylvania statute, for example, provides that in considering the best interests of the corporation or the effects of any of its actions, directors shall not be required to regard any interests of any particular group as dominant or controlling. *Id.* § 1715(b).

297. As an example, the Iowa statute allows directors to consider customers and then, as a separate factor, allows directors to consider the long-term and short-term interests of the corporation. *See* IOWA CODE ANN. § 490.1108(1)(a), (c) (West 1999) (allowing directors to consider various factors in making decisions).

298. *See* Orts, *supra* note 11, at 24-25 (discussing sources of anti-takeover legislation).

299. This includes Iowa, IOWA CODE ANN. § 490.1108 (West 1999); Louisiana, LA. REV. STAT. ANN. § 12:92(g) (West 1994); Maryland, MD. CODE ANN. CORPS. & ASS'NS § 2-104(9) (Repl. 1999); Missouri, MO. ANN. STAT. § 351.347(1) (West 2001); New Jersey, N.J. STAT. ANN. § 14A:6-1 (West Supp. 2001); Oregon, OR. REV. STAT. § 60.357 (1988); South Dakota, S.D. CODIFIED LAWS § 47-33-4 (Michie 2000), and Tennessee, TENN. CODE ANN. § 48-103-204 (1995). South Dakota is the only statute that applies to a slightly broader context than a takeover. That statute applies to directors' conduct in situations in which a "change of control" is involved. This is arguably more extensive than just a takeover contest, possibly including a

holder interests during all phases of a takeover struggle, including the stage at which directors contemplate a break-up or reorganization of the corporation. *Revlon* may not permit this, because *Revlon* requires that once a break-up occurs, shareholders' interests must predominate in directors' decisions.[300] Thus, in Minnesota, the site of incorporation for one of the education companies, Tesseract,[301] a director may structure a takeover involving the break up of the company while taking into account more than the financial value the transaction has for the shareholder. Therefore, directors governed by constituency statutes will have wider latitude to make decisions consistent with their mission, regardless of the context.

IV. Empirical Evidence on Post-Conversion Conduct

Of course, while corporate fiduciary law may permit directors of public benefit companies to favor the interests of their beneficiaries to shareholders, it does not require directors to make those decisions. As a consequence, it is not clear which conception of the corporation dominates director decision-making *in practice*. This section analyzes the empirical data related to post conversion conduct to determine if in fact directors have behaved in a manner more consistent with the shareholder primacy model than the social entity model.

Unfortunately, the evidence on this issue is equivocal, and for the most part, anecdotal. Opponents of privatization claim that directors, when confronted with the decision whether to provide services for students and needy patients or to maximize profits, will attend to their bottom line at the expense of these groups. There is evidence to support this position.[302] However, those who claim that for-profit companies have been able to provide top-quality services, without compromising companies' commitment to its public beneficiaries, dispute this evidence. As with most situations, the truth probably lies somewhere in the middle.

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sale of a controlling block of shares. *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 46 (Del. 1993) (distinguishing between change of control when more than 50% of shares change ownership from situation in which one corporation takes over operating control of another).

300. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (reaffirming shareholder primacy doctrine in context of break-up). Even under *Time*, directors had not committed to an actual break-up of the company and presumably if they had, then *Revlon* duties would have attached requiring directors to abandon any strategy that did not relate to maximizing shareholder profit. *See, e.g., Paramount*, 637 A.2d at 47 (noting that one of two situations which implicate *Revlon* is when corporation effects business reorganization involving break-up of company).

301. TESSERACT QUARTERLY REPORT, *supra* note 68.

302. *See infra* notes 308-13 and accompanying text (discussing studies showing decreased charity care after for-profit conversion).

HeinOnline -- 59 Wash. & Lee L. Rev. 464 2002

It is no easy task to determine whether or not public benefit companies have remained committed to their charitable or social mission. Indeed, various studies use different measures of success that in turn can impact the outcome of the analysis greatly. This problem surfaces both in healthcare and in education. In the context of hospitals, experts have disagreed about what constitutes charitable services.[303] Some studies define charitable services narrowly to mean only charity care – the provision of care to patients who cannot pay and from whom the hospital has no expectation of repayment.[304] Other studies focus on uncompensated care, which includes both charity care and so called "bad debt" (the amount of billed charges left unpaid by privately insured or by others who were expected to pay).[305] Still other studies take a more expansive approach, including both uncompensated care as well as the amount of additional community benefits that a hospital provides, such as the provision of Medicaid and unprofitable services like emergency and trauma care, burn care, and substance abuse treatment.[306] This definitional problem hampers a straightforward analysis of whether for-profit hospitals continue to provide charitable services.

A similar problem appears in the education context. In recent years, it has become common to equate the success of a school with its students' ability to achieve high marks on standardized tests. This assessment is not the only, nor arguably even the most reliable, indicator of a school's success.[307]

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303. *See infra* note 305.

304. *See* NEEDLEMAN, CONVERSION REVIEW, *supra* note 21, at 25 (noting difference between charity care and uncompensated care).

305. Most of the studies have focused on uncompensated care. *See, e.g.*, Kenneth E. Thorpe et al., *Hospital Conversions, Margins, and the Provision of Uncompensated Care*, HEALTH AFF., Nov./Dec. 2000, at 189 n.7 (noting that bulk of empirical research completed on uncompensated care has focused on charity care and bad debt); Gary Young & Kamal R. Desai, *Nonprofit Hospital Conversions and Community Benefits: New Evidence From Three States*, HEALTH AFF., Sept./Oct. 1999, at 146 (investigating short- and long-term community impacts of non-profit hospital conversions). Apparently hospitals are inconsistent in differentiating between charity care and uncompensated care, and, thus, most studies define charitable services in terms of uncompensated care. *See* NEEDLEMAN, CONVERSION REVIEW, *supra* note 21, at 25 (noting that uncompensated care includes both charity care and bad debt).

306. *See* Nicholson et al., *supra* note 30, at 168-69 (developing new, more expansive method for defining community benefits to include uncompensated care, other unbilled public-good services, losses on medical research and Medicare and Medicaid shortfalls); Young & Desai, *supra* note 305, at 148 (utilizing four indicators of community benefits: uncompensated care, net prices, unprofitable services, and community representation on board).

307. Indeed, many have opposed the use of these assessments, arguing that they cannot capture accurately the educational experience. *See, e.g.*, Rachel Smolkin, *The Stakes Are High for Testers and Testees*, PITTSBURGH POST-GAZETTE, Aug. 27, 2000, at A1 (noting opponents who argue that decisions that impact students' futures should not rest on test scores alone and that tests encourage rote memorization rather than creative thinking and problem solving).

Analysis of this data must acknowledge the limits of many of the yardsticks we use to measure success both in hospitals and at schools.

A. Evidence on the Post-Conversion Behavior of For-Profit Hospitals

With regard to hospitals, proponents claim that the focus on profit-making will deter administrators of public benefit companies from providing charitable services. As an example of this behavior, a report issued in 1999 by the Consumers Union found that, between 1993 and 1998, the level of charity care decreased significantly in four out of five California hospitals after their switch to for-profit status.[308] In fact, while only one hospital's charity care increased by 71%, the remaining four showed decreases in charity care, with one hospital's level of charity care decreasing 94%.[309] Similarly, another nationwide study of hospital conversions between 1990 and 1997, conducted by researchers at Emory University's School of Public Health, concluded that uncompensated care levels declined when nonprofit hospitals converted to for-profit status.[310] That study found that, when a not-for-profit converted to for-profit status, uncompensated care fell from 5.3% to 4.7% of the total expenses of hospitals, amounting to an average of $400,000 less that was spent on uncompensated care.[311] This number decreased further for public hospital conversions, falling by 2.7% or approximately $800,000 less per year spent on uncompensated care.[312] The study concluded with the warning that "a continued rise in the number of for-profit hospitals could reduce the willingness or even the capacity of hospitals to finance care for

308. *See* JULIO MATEO, JR. & JAIME ROSSI, WHITE KNIGHTS OR TROJAN HORSES? A POLICY AND LEGAL FRAMEWORK FOR EVALUATING HOSPITAL CONSOLIDATIONS IN CALIFORNIA, at iv (1999), *available at* http://www.consumersunion.org/health/white_knight.htm (finding decline in charity care in absence of "tight charity-care, service, and patient volume commitments"). The study reviewed ten hospital conversions occurring during the time period, but only found sufficient data on five of them. The hospitals included in the study were: Sacred Heart, Hanford; Centinela Hospital, Inglewood; Good Samaritan, San Jose; United Western Medical Center, Santa Ana; United Western Medical Center, Anaheim; Pacific Hospital of Long Beach; Riverside Community Hospital, Riverside; Queen of Angels, Los Angeles; Watsonville Community Hospital, Watsonville; and Sharp Healthcare, Murrieta. *Id.* at ii.

309. *Id.* at iv. The report found that United Western Medical Center of Santa Ana sustained a 94% decline. Good Samaritan in San Jose had an 88% decrease in charity-care between its last year as a nonprofit and its first year as a for-profit, United Western Medical Center of Anaheim showed an 84% decline, and at Riverside Community Hospital, charity-care declined by 31%. Only Pacific Hospital of Long Beach revealed an increase in charity-care by 71%. *Id.* at v.

310. *See* Thorpe et al., *supra* note 305, at 192 (concurring with other national studies based on AHA data). The study identified 431 hospital conversions during that period, of which 127 converted from not-for-profit to for-profit status. *Id.* at 189.

311. *Id.* at 191.

312. *Id.*

HeinOnline -- 59 Wash. & Lee L. Rev. 466 2002

those who are unable to pay for it."[313] This dire warning suggests that directors of these hospitals have not and will not be able to consider adequately the interests of their more needy beneficiaries. This assessment seems to support the notion that the social entity model of the corporation has not guided directors' conduct.

Other studies undermine this notion and indicate that the level of charity care at for-profit hospitals remains relatively the same after conversion from nonprofit hospitals.[314] For example, a study of hospital conversions over a 12-year period in California found that the level of hospital charity care remained relatively the same throughout the period of the study.[315] Similarly, a 1999 report conducted by researchers at Boston University's School of Public Health, focusing on conversion activity in three states between 1981 and 1995, found little proof that conversions threatened the provision of uncompensated care and community benefits, including the provision of emergency and trauma care, neonatal care, burn care, and substance abuse treatment.[316] The study also found little difference in the prices that for-profits charged for services after they converted.[317] Additionally, a study of Massachusetts hospitals conducted by Jack Needleman, a professor of economics and health policy at Harvard's School of Public Health, echoes these findings, concluding that levels of uncompensated care do not decline after a conversion to for-profit status.[318] Each of these studies is consistent with earlier, more limited studies that suggested the absence of any decline in uncompensated services at hospitals after their switch to for-profit status.[319] Based on these studies,

313. *Id.*

314. *See* Hyman, *supra* note 22, at 758 (arguing that many for-profit hospitals provide substantial charity care).

315. *See* Gary J. Young et al., *Does the Sale of Nonprofit Hospitals Threaten Health Care for the Poor*, 16 HEALTH AFF., Jan/Feb 1997, at 137-41 (noting that acquisition of non-profit hospitals by investor-owned corporations does not lead uniformly to less uncompensated care).

316. *See* Young & Desai, *supra* note 305, at 147-48 (finding that conversions do not have appreciable impact on community benefits). The study reviewed forty-three conversions in California, Florida, and Texas. Of these conversions, twenty occurred in California, fifteen in Florida, and eight in Texas. These states experienced some of the highest levels of conversion activity during this period. *Id.* at 147.

317. *See id.* at 152 (concluding that conversions do not reduce community benefits relative to uncompensated care, prices, or services).

318. *See* NEEDLEMAN, CONVERSION REVIEW, *supra* note 21, at 26 (noting that uncompensated care may not be at risk in conversion to for-profit status). Needleman found that after conversion, neither HCA nor Tenet ended community services identified as important prior to their conversion. *See id.* at 29 (discussing effects of HCA and Tenet conversions to for-profit entities).

319. *See id.* at 26 (reviewing results of earlier studies in California and Florida); Young & Desai, *supra* note 305, at 152 (noting that findings of study are consistent with earlier, more limited research).

HeinOnline -- 59 Wash. & Lee L. Rev. 467 2002

some scholars argue that claims about post-conversion conduct are overstated.[320] At the very least, these findings provide evidence that directors serve their public constituents and make decisions in a manner consistent with the social entity model of the corporation.

In furtherance of this notion, some analysts note that public benefit hospitals provide important community services that make it difficult to assess whether not-for-profit or for-profit managers provide more community benefits. Indeed, some commentators point out that by paying taxes, unlike their nonprofit counterparts, for-profit hospitals provide benefits in the form of additional revenue for the local community.[321] The Boston University study also pointed out that conversions have helped to preserve some hospitals that might have closed due to poor financial performance.[322] Moreover, even the Emory study, which found reductions in uncompensated care nationwide, noted that converted hospitals not only pay taxes, but also often create charitable foundations from the sale of the nonprofits assets.[323] The study concluded that this behavior makes it "uncertain whether more or fewer funds flow to a community as a result of an ownership conversion."[324]

In the face of the conflicting evidence, it may be most accurate to conclude that "[t]he debate over the benefits of nonprofit health care entities versus for-profit entities is long standing and has not been resolved in any meaningful way."[325] Indeed, it does not appear that privatization has triggered the significant reduction in the levels of charity care provided by hospitals as opponents predicted. This may be attributable to the fact that nonprofit hospitals do not provide as high a level of charity care prior to their conversion as some presume.[326] Several studies reveal that over the years, the level

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320. *See, e.g.*, Hyman, *supra* note 22, at 756-62 (citing studies that showed evidence that non-profit and for-profit hospitals behave similarly).

321. *See id.* at 761 (noting that if one considers taxes paid by for-profit hospitals, nonprofit hospitals provide far less community benefits); Claxton et al., *supra* note 20, at 17 (noting that if one factors in taxes paid by for-profit firms, then community benefits they provide would exceed those provided by nonprofits); Young & Desai, *supra* note 305, at 154 (recognizing that non-profit conversions offer benefits in form of new company assuming local taxes).

322. Young & Desai, *supra* note 305, at 154.

323. *See* Thorpe et al., *supra* note 305, at 192 (noting uncertainty over whether more funds flow to community as result of ownership conversion).

324. *Id.*

325. Bisesi, *supra* note 6, at 845. Similarly, Needleman concludes that while the levels of charity care and uncompensated care see no real change, the findings are mixed with respect to community benefits, such as programs targeting the poor, and that they change from hospital to hospital. *See* NEEDLEMAN, CONVERSION REVIEW, *supra* note 21, at 39 (noting impact of conversion on poor and uninsured patients).

326. *See* Hyman, *supra* note 22, at 758 (noting that level of charity care provided by nonprofit hospitals "provides disheartening news to those who believe nonprofit hospitals are

HeinOnline -- 59 Wash. & Lee L. Rev. 468 2002

decisions that maximize the interests of other groups regardless of the context. Clearly *Wrigley*, *Unocal*, and even *Paramount* confirm the notion that the duty to maximize shareholder value without regard to other interests applies only in limited takeover settings. Because it is unclear if these companies will be subject to takeover attempts, these settings may not even arise. More specifically, even within the context of takeovers, the board can institute defensive measures and engage in significant restructuring without regard to *Revlon*. *Revlon* is implicated if directors agree to the break-up of the corporation, initiate a sale of the corporation, or engage in a change-of-control transaction. However, with respect to the latter two transactions, the Delaware courts' failure to define clearly when they actually arise, coupled with its seeming desire to limit *Revlon*, may provide public benefit companies ample opportunity to conduct takeover-like activity while paying heed to non-shareholder interests. Indeed, there is reason to believe that when directors of these companies remain committed to their social or charitable missions, the directors may be able to consider these missions when consummating some transactions. Hence, the claim that corporate law prevents these directors from making decisions aimed at protecting a particular mission or group, even during times of major transition, is tenuous at best.

C. *Help on the Horizon: Constituency Statutes*

The passage of constituency statutes also signals a movement toward an expansion of the interests that directors can consider. Constituency statutes represent a response to the perceived negative impact corporate takeovers have on employees, creditors, and other members of the community.[277] As expressed previously, corporate takeovers involving a break-up or major reorganization of the corporation often displace employees and jeopardize creditors' positions.[278] State leaders enacted constituency statutes to enable directors to consider the concerns of employees, creditors, and others who may be impacted negatively by corporate takeovers.[279] Though enacted in response to takeovers, constituency statutes have swung the pendulum in the direction of the social entity concept by permitting directors to evaluate the concerns of groups other than shareholders.[280] As a consequence, this legisla-

277. *See* Orts, *supra* note 11, at 24 (noting that constituency statutes were "born legislatively as part-and-parcel of the spate of state antitakeover statutes").

278. *See id.* (noting common belief that takeover market "caused, or at least significantly facilitated a geographical redistribution of wealth, as well as an attendant loss of jobs").

279. *See id.* (noting that state legislatures passed constituency statutes largely in response to constituents who perceived hostile takeovers negatively).

280. *See, e.g.*, Allen, *supra* note 12, at 276 (stating that social entity concept "animates" constituency statutes); Mitchell, *supra* note 13, at 610 (noting that non-shareholder constituency statutes are "the most obvious feature of the reordering of the corporate legal landscape").

HeinOnline -- 59 Wash. & Lee L. Rev. 469 2002

representing the majority of schools in operation for at least two years.[330] In the study, AFT pinpointed at least three areas in which Edison has introduced cost-cutting measures that apparently subordinated student interests in favor of making a profit.[331] First, the AFT report claims that when Edison hires staff for its schools, it tends to favor beginning teachers, who are at the bottom of the salary scale, over experienced teachers who receive higher salaries.[332] AFT argued that this practice is problematic. According to AFT, several

330. TRENDS, *supra* note 329, at 3. The states are California, Colorado, Florida, Kansas, Massachusetts, Michigan, Minnesota, and Texas.

331. *See* STUDENT ACHIEVEMENT, *supra* note 329, at 17-23 (discussing Edison cost-cutting measures). Some opponents of for-profit management of schools also complain that for-profit managers of schools will inflate test scores in order to appear successful. *See id.* at 4 (suggesting that Edison exaggerated test score gains). Indeed, this is one of the concerns raised by Professor Solomon in his critique of privatization. *See* Solomon, *supra* note 48, at 924 (discussing criticisms of privatization). Currently there has been no evidence of such conduct on the part of Edison. However, even if Edison does inflate scores and introduce some cost cutting measures to ensure higher test scores, this practice may not stem from its desire to make profits for its shareholders, but rather from other external pressures. Indeed, more and more states are requiring public schools to administer tests that have tremendous consequences, including whether teachers or administrators receive bonus pay or whether students advance to the next grade. *See* Smolkin, *supra* note 307 (discussing effects of high-stakes standardized testing). Like privately-managed schools, funding in public schools can be tied to test scores. Thus, in California, schools that post the biggest gains in standardized test scores are eligible for large monetary rewards, including $25,000 for teachers of high-achieving classes. Jessica Garrison, *Three O.C. Schools Stand to Miss Out on Testing Bonuses*, L.A. TIMES, Nov. 2, 2000, at B4. In other states, principals and teachers face the loss of their jobs if they fail to improve student test scores. *See* Stephen Dinan, *Schools Chief Tries to Spur Principals*, WASH. TIMES, May 6, 1999, at C3 (noting public announcement by administrators that principals and teachers would be replaced if they failed to improve test scores). These high-stakes exams create pressure on students and teachers that may lead to conduct antithetical to the best interests of students. For example, there have been many allegations of cheating in the wake of these exams. These allegations have arisen in Ohio, New York, Texas, and Maryland. *See, e.g.*, *Extra Credit*, WASH. POST, May 15, 2001, at A07 (discussing cheating and plagiarism by high-school students). In fact it appears that cheating is a nationwide problem. A recent study of 4,500 students at twenty-five high schools across the country reveals the high level of cheating. *See id.* (noting results of study by Rutgers University Professor Donald McCabe); *Rutgers Study Finds Extensive Cheating*, BALT. SUN, Apr. 29, 2001, at 15B (same). Thus, more than 150 schools in California were accused of exempting students from exams so that they could obtain better overall scores. Garrison, *supra*. These schools clearly sacrifice their educational goals to show improvement on these tests. Hence, the fact that Edison may do so as well only suggests that it has fallen victim to these same pressures, not that the for-profit corporation compels directors to behave in this manner.

332. *See* STUDENT ACHIEVEMENT, *supra* note 329, at 17-18 (noting that hiring preference for beginning teachers keeps personnel costs down). For example, the AFT report notes that in 1995-96, only 12% of the teachers in Edison's elementary school in Wichita had a master's degree as compared to 47% of teachers in the rest of the district. *Id.* at 18. Also, in Edison's Sherman elementary schools, 28% of the teachers were new compared to 7% in the remainder of the district. *Id.*

HeinOnline -- 59 Wash. & Lee L. Rev. 470 2002

experts agree that teacher experience makes a big difference in student achievement and that it is not beneficial for students to be taught by a majority of less experienced teachers.[333] However, AFT noted that the practice of employing a large number of teachers with less experience keeps personnel costs down.[334] Consequently, AFT argued that Edison's hiring policy "suggests that getting a skilled and experienced staff takes second place to keeping costs down."[335]

Second, AFT claimed that Edison appeared to have an unofficial policy of raising its class size, which is "a big money saver."[336] The AFT report notes that although few policy makers ever suggest increasing class size,[337] Edison schools tend to have larger than average class sizes.[338] Because Edison gets paid based on the number of students it enrolls in its schools,[339] increasing class size may suggest that Edison has put profit-making goals above the interests of its students.

Third, the AFT report indicates that Edison limits special education to children who can spend most of their time in regular classes.[340] According to AFT, there is considerable dispute about whether it is advantageous to educate all special education children, regardless of the nature of their disability, in regular classes.[341] However, the AFT report states, "[w]hat no one disputes is that mainstreaming special education students . . . is less expensive than providing them with small classes and highly trained special education teach-

333. *See id.* at 17 (describing study by National Commission on Teaching and America's Future that concluded that teacher expertise is "one of the most important factors" in determining student achievement, as well as studies by Ronald Ferguson in Texas and Alabama emphasizing importance of teacher experience).

334. *Id.* at 18. For example, the AFT report notes that at Edison's schools in Wichita, personnel costs were 20% lower than the average costs for school district personnel. *Id.* The AFT report points out that while teacher salaries at Edison are comparable to salaries elsewhere in the district for the same level of experience, hiring beginning teachers means that Edison does not have to pay the increased salary that more experience teachers receive. *See id.* at 17-18 (noting also that Edison's differentiated staffing means that younger, less experienced teachers do much better financially than in other schools).

335. *Id.*

336. *Id.* at 19.

337. *See id.* (noting that Edison's average class size is high by national and local standards).

338. According to the AFT report, the average elementary school classroom in the United States contains twenty-four students. *Id.* (noting that class size has changed little in thirty years). However, in the Edison schools in Colorado, class sizes were up to 30 students, and at one Edison school in Boston, the class size grew to 28. *Id.* at 20.

339. *See id.* at 15 (noting that Edison schools receive per-pupil funding).

340. *Id.* at 20.

341. *See id.* at 20-21 (pointing out that range of children classified as special education students is enormous and that some suffer from severe emotional disturbances).

HeinOnline -- 59 Wash. & Lee L. Rev. 471 2002

ers."[342] According to AFT, Edison's policies related to hiring, class size, and special education enables Edison to save significant money. As a consequence, these policies suggest that profit concerns rather than the best interests of Edison's student beneficiaries dictate Edison's management decisions.[343] This assessment appears to confirm the primacy of a shareholder-centered conception of the corporation as applied to Edison.

In response, Edison claimed that AFT misrepresented its education program. First, Edison pointed out that it employed teachers across levels of responsibility and that it depends on a range of teacher experience in its schools.[344] Edison also noted that it devotes substantial capital to professional development and that its longer teacher schedule and innovative programs often attract less experienced teachers who tend to have greater flexibility.[345] This practice negates the notion that Edison's management has placed profit concerns above the interests of students. Second, claiming that the AFT report is largely anecdotal,[346] Edison maintained that its class sizes vary from community to community, with many of them following the local norm and some of them falling under the average class size.[347] In Edison's view, this variation does not suggest a pattern of cost-cutting, but rather a pattern too general to draw substantive conclusions about Edison's policy in this area.[348]

Third, Edison disputed AFT's statement that its inclusion program saved money on special education.[349] In contrast to AFT's assertion, Edison claimed that experts do not agree that inclusion saves money. Instead, Edison maintained that "an effective inclusion program costs *more* money to implement because special education teachers must support teachers in addition to special

342. *Id.* at 21. AFT reported that Edison's president indicated that Edison would save money by educating special education students in regular classes. *See id.* (noting that Edison president said that Edison would deliver excellent results in regular classroom setting).

343. *See id.* at 17 (noting that company's announced goal is to make profit for investors).

344. *See* EDISON RESPONSE, *in* TRENDS, *supra* note 329, at 13 (noting that Edison values experienced teachers for necessary leadership roles).

345. *See id.* at 13 (noting that Edison schools attract young teachers because program demands changes and younger teachers are more receptive to changes).

346. *See id.* at 13 (claiming that AFT failed to assess class sizes within twelve schools on which report focused, but relied on newspaper accounts for its information).

347. *Id.* at 12. Edison points out that class sizes at some of its elementary schools in Texas average twenty to twenty-four, while Edison's two schools in Michigan average seventeen students per class. Edison notes that is class sizes "vary too much for such statistics to be meaningful." *Id.*

348. *See id.* at 12 (noting that because Edison's class sizes vary, it makes little sense to make comparisons to national average).

349. *See id.* at 12-13 (noting that experts agree that inclusion programs cost more to implement because special education teachers must support teachers as well as students).

HeinOnline -- 59 Wash. & Lee L. Rev. 472 2002

needs students."[350] Finally, Edison pointed out that its education program is far richer in curriculum than many public schools and that Edison generally puts more money into the classroom than public school administrators.[351] Edison's response suggests that its management has not subordinated student interests in favor of making money.

More importantly, these studies suggest that it is too early – and perhaps too difficult – to make a determination regarding the conduct of directors in privately-managed education companies. Indeed, AFT noted that it has limited evidence related to the cause of Edison's decisions and that "it would be unfair to draw conclusions based on [this] limited evidence."[352] Also, both AFT and Edison agreed on the need for further study. In fact, Edison has commissioned an independent auditor to analyze the performance of its schools.[353] Even with this additional study, it may be difficult to determine with any degree of certainty whether or not managers of such schools pursue policies aimed at saving money or at providing a quality education. This is especially true given the disagreement about the types of policies that will produce a quality education. Because of these limitations, it is difficult to draw any conclusions based on the available empirical evidence in this area. Certainly, the forgoing evidence does not reveal which conception of the corporation governs manager's conduct in the context of privately-managed schools.

Conclusion

The analysis in this Article suggests that philosophical objections to conversions of public benefit companies may be based on an inaccurate conception of corporate fiduciary law. In the context of ordinary business decisions, corporate law is very permissive and allows directors the freedom to pursue the interests of non-shareholders even if pursuing these interests does not maximize shareholder profits. This permissiveness stems in part from the courts' reluctance to interfere with the decisions of directors as indicated by the application of the business judgment rule. Furthermore, the relative failure of courts to take action against directors based on a breach of

350. *Id.* at 13.

351. *See id.* at 5 (noting that Edison offers twice as much fine arts as most public schools, superb character and ethics curriculum, Spanish language instruction for every child starting in kindergarten, longer school day and year, and technology program that equips every teacher and family with computer).

352. STUDENT ACHIVEMENT, *supra* note 329, at 17. The AFT report concludes that it is "too early to tell" if the problems highlighted by the report result from defects at particular schools or from a pattern of cutting corners. *Id.* at 23.

353. Edison commissioned the RAND corporation. *See* TRENDS, *supra* note 329, at 9 (noting Edison's intent to provide continuous analysis of performance of its schools).

HeinOnline -- 59 Wash. & Lee L. Rev. 473 2002

their fiduciary duty to shareholders confirms this. Even in the takeover context, in which shareholders and other group interests conflict, Delaware courts allow directors to focus on non-shareholder concerns in all but the most limited of circumstances. The director's ability to favor other groups even in this context signals the dominance of the social entity model. Outside of Delaware, constituency statutes go further, permitting directors to pay heed to the concerns of non-shareholders in all contexts, including those related to fundamental changes in the corporation. This suggests that the social entity conception of the corporation has taken precedence over the shareholder primacy model, or at the very least, that commentators overstate the dominance of the shareholder-centered model.

Because the objection to privatization fails to appreciate corporate fiduciary law concepts properly, this objection should not control the debate about the desirability of for-profit education or healthcare. If the corporate form does not constrain the choices directors must make in relation to their beneficiaries, then we must explore more fundamentally whether or not these entities can provide better, more efficient services to our students and patients. Certainly, other forces, such as capital markets or voting, may cause directors to pay heed to shareholder profit. Also, there may be other concerns with privatization in these fields such as the possible erosion of civic values or the possibility that it may undermine equal access to education.[354] In addition, it may not be possible for these companies to make a profit, particularly in the education market. However, although the evidence is mixed, it suggests that profit-making may not be at odds with improving public education or obtaining quality health care. If this is true, then perhaps we should focus on providing mechanisms that accommodate and regulate the entrance of for-profit companies into these fields, rather than attempting to reject their entrance wholesale. More importantly, given the mixed evidence on the results of such endeavors and the general agreement that the healthcare and education industries need change, we should abandon our myths about the for-profit enterprise and weigh the arguments for privatization more carefully and stringently before opposing what could be part of a realistic solution.

354. *See, e.g.*, Solomon, *supra* note 48, at 920-25 (explaining arguments against for-profit management of schools).

HeinOnline -- 59 Wash. & Lee L. Rev. 474 2002