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Corporate Ethics, Agency, and the Theory of the Firm

THE SARBANES-OXLEY ACT OF 2002[1] WAS ENACTED as a legislative response to a wave of corporate scandals. Unlike the Wall Street insider trading scandals of the late 1980s,[2] the crisis at the dawn of the new century concerned the behavior of managers in Corporate America.[3] Their conduct brought to the forefront the role of agency in the problem of corporate ethics. During the roundtable session dedicated to the problem, several commentators suggested that the theory of the firm and corporate law do not sufficiently account for the problem.[4] This Article is a continuation of that dialogue.

Let's start with a metaphor: one cannot fill water in a vessel that does not exist. This captures the essential problem in thinking about the firm and its ethical obligations. Under the prevailing "nexus of contracts" theory, the corporation as an independent entity does not exist. The logical end of this idea is dissociation of corporate law and economic theory from the problem of ethics in corporate action. Like the concept of the nonexistent firm, corporate ethics is reduced to the ethical problems and dilemmas of the autonomous person. That being the case, the issue is a matter of personal philosophy and responsibility, perhaps subject to legal regulation, but not within the ambit of corporate law.

This short Article suggests that the problem of corporate ethics cannot be reduced to an examination of the autonomous person. Although the greatest influence on action and choice is one's moral constitution, it does not follow that the agent's behavior is the same within or without the firm. Ethics is a function of corporate form. The theory of agency cannot dismiss the firm as a fiction or metaphorical shorthand because that which does not exist should not be able to cause or influence moral deliberation and action. Thus, the theory of the firm, which em-

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1. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).
2. *See generally* JAMES B. STEWART, DEN OF THIEVES (1991).
3. *See, e.g.*, Elisabeth Bumiller, *Corporate Conduct: The President; Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1.
4. Symposium, *The Sarbanes-Oxley Act of 2002, Five Years Later: Assessing its Impact, Charting its Future*, 3 J. BUS. & TECH. L. 207 (2008).

phasizes profit and wealth maximization, should incorporate a richer, more realistic account of the economics and ethics of agency.

I.

The problem of corporate ethics is profound. Little needs to be said on the point that modern corporations wield enormous power, and thus their actions raise ethical issues. Corporations are rivaled only by government, as formal institutions go, in terms of influence on human welfare.[5] Corporate action aggregates the combined efforts of many factors of production. With such concentrated power, the orbit of harm is broad.[6] If the firm's activity affects only its contractual constituents, the constituents would bargain for the allocation of these costs and reach an efficient outcome absent impediments to bargaining. But a corporation is not a closed universe of contracting parties. Corporations impart significant negative externalities on those who are outside the nexus of contracts.[7] It is not for want of imparting harms that corporations take action ending in that result; corporate agents are influenced by conflicting value systems. The most difficult ethical problem arises when profit conflicts with substantial interests of noncontractual constituents.

Since the problem of corporate ethics is as undeniable as its influence on social wealth and welfare, we can fairly ask: does the prevailing theory of the firm account for the problem? There are two broad conceptions of the firm: the property model and the entity model.[8] Among legal and economics scholarship, the entity model is the minority position.[9] The property conception, having the strongest support in the academy, is considered the prevailing theory of the firm, and the subject of

5. Liberal (or progressive) commentators have expressed alarm at the scale and growth of corporate power. *See generally* Joel Bakan, The Corporation: The Pathological Pursuit of Profit and Power (2004); Noreena Hertz, The Silent Takeover: Global Capitalism and the Death of Democracy (2003); Marjorie Kelly, The Divine Right of Capital: Dethroning the Corporate Aristocracy (2001); Lawrence E. Mitchell, Corporate Irresponsibility: America's Newest Export (2001).

6. Consider these well known, if not iconic, problems: the Ford Pinto, Royal Dutch/Shell in Nigeria, Union Carbide in Bhopal, Pfizer's clinical testing of Trovan in Nigeria, and Google in China, just to name a few. *See* Ike Okonta & Oronto Douglas, Where Vultures Feast: Shell, Human Rights, and Oil in the Niger Delta (2001); The Ford Pinto Case (Douglas Birsch & John H. Fielder eds., 1994); Sanjoy Hazarika, *Bhopal Payments by Union Carbide Set at $470 Million*, N.Y. Times, Feb. 15, 1989, at A1; Tamar Lewin, *Families Sue Pfizer on Test of Antibiotic*, N.Y. Times, Aug. 30, 2001, at C1; Clive Thompson, *Google's China Problem (and China's Google Problem)*, N.Y. Times, Apr. 23, 2006, § 6 (Magazine), at 64.

7. The limited liability shield ensures that a certain amount of aggregate cost under tort law goes uncompensated. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L.J. 1879 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 Colum. L. Rev. 1565, 1566, 1617–18 (1991); *see also* Robert J. Rhee, *Tort Arbitrage*, 60 Fla. L. Rev. 125, 181–82 (2008) (arguing that the theory of negligence is inefficient in deterring torts by corporations).

8. William T. Allen, *Our Schizophrenic Conception of the Corporation*, 14 Cardozo L. Rev. 261, 264–72 (1992).

9. The entity model views the corporation as a social institution, and thus it more comfortably accommodates the idea that firms should have ethical obligations and some responsibility towards the general social welfare. *Id.* at 265.

inquiry here.[10] While it is beyond the scope of this Article to delve into the nuances of the property model, a brief description highlights the problem.

The model finds its roots in Ronald Coase's theory of the firm. In his seminal article *The Nature of the Firm*, Coase asked the basic question: why do firms exist?[11] His answer was that firms minimize the transaction cost of the economic activity.[12] If an entrepreneur owns all factors of production, there would be no need for a firm. But, of course, this does not reflect the constraints of the real world. Entrepreneurs need the cooperation of the factors of production, which can be sought independently or through a firm structure. Without the firm, entrepreneurs would require a series of contracts, and the contracting cost would be extraordinarily high.[13] Coase's insight was that the production through a firm structure reduces this cost.[14] Rather than an independent entity, the firm is seen as a market in which autonomous people contract for their inputs in the pursuit of an enterprise. Thus, the most important function is the discovery of efficient price.[15]

Under the property model, the corporation is seen as an aggregate of private property rights of the firm's contractual constituents.[16] Rather than an entity of independent social and economic significance, the corporation is said to be a "nexus of contracts."[17] Economists have argued that the firm "is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals."[18] The nexus of contracts is a metaphor for joint

10. The property conception of the firm has strong support from academics, activist investors, and increasingly directors, while the entity theory of the firm has support from corporate managers and directors, and less support in the academy. *See, e.g.*, William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Mediation on Bridging the Conceptual Divide*, 69 U. Chi. L. Rev. 1067, 1075–76 (2002).

11. R.H. Coase, *The Nature of the Firm*, 4 Economica 386, 390 (1937).

12. *Id.* at 390–93.

13. *See id.* at 391.

14. *See id.* ("A factor of production (or the owner thereof) does not have to make a series of contracts with the factors with whom he is co-operating within the firm, as would be necessary, of course, if this co-operation were as a direct result of the working of the price mechanism. *For this series of contracts is substituted one.*" (emphasis added)).

15. *See id.* at 390 ("The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism. The most obvious cost of 'organising' production through the price mechanism is that of discovering what the relevant prices are.").

16. Allen, *supra* note 8, at 264–65.

17. Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 12 (1991).

18. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 311 (1976). According to the contract theory, corporate law can be seen "as a standard-form contract, supplying terms most venturers would have chosen but yielding to explicit terms in all but a few instances." Easterbrook & Fischel, *supra* note 17, at 15. The nexus of contracts theory has many supporters in the legal academy. *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, 1427 (1993) ("[T]he firm is treated not as a thing, but rather as a nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm.").

production through express and implied contractual arrangements that aggregate assets to generate cashflow and that define each constituent's respective property interest therein. In this arrangement, shareholders hold the claim on the residual assets and cashflow. Since shareholders are last in line, they have the greatest incentive to see that the corporation makes a profit. While no one technically "owns" the corporation (for a nexus of contracts is incapable of ownership), shareholders are seen as residual risk bearers and thus in effect have a financial interest in the firm akin to the owner of a business.[19] Accordingly, the relationship between a shareholder and manager can be analogized to that of a principal and agent, though technically they do not stand in such a legal relationship.[20]

The theory of agency supports the nexus of contracts argument and the profit maximization norm.[21] Corporate agents, it is argued, owe an obligation to maximize shareholder profit.[22] The corporation is a wealth producing structure. Society should conscript the firm's strength, its tendency to maximize wealth.[23] If society wishes to maximize social welfare and the corporation's activity is inconsistent with this goal, it can change the price structure instead by penalizing or taxing the activity to provide efficient deterrence.[24] But society should not change the structure of

19. Easterbrook & Fischel, *supra* note 17, at 36–39; *see also* Allen, *supra* note 8, at 265 n.7 (explaining that shareholders can be seen as owners of the firm).

20. Jensen & Meckling, *supra* note 18, at 308. There is an inherent problem with the application of the principal-agent dichotomy to the corporation. The managers, broadly defined as the board of directors and officers, are not agents of the shareholders *qua* owners of the firm. Shareholders do not have the ability to direct their "agents." Easterbrook and Fischel reworked this awkward concept of principal-agent in a way that makes the legal argument more palatable. *See* Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in* Corporate Law, 31 J. Corp. L. 719, 725 (2006). *See generally* Easterbrook & Fischel, *supra* note 17. But ultimately the "claim that shareholders are 'principals' and directors are 'agents' contradicts the realities of corporate law." Blair & Stout, *supra*, at 728; *see* William W. Bratton, *Confronting the Ethical Case Against the Ethical Case for Constituency Rights*, 50 Wash. & Lee L. Rev. 1449, 1450 (1993) ("The agency concept may be only a metaphor at bottom, but theory of the firm discussants treat it as if it were a component in a production model."). This Article uncritically accepts the principal-agent metaphor for the purpose of maintaining a consistency of terminology with the economic model of the firm.

21. *See* Easterbrook & Fischel, *supra* note 17, at 9–15.

22. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439, 439 (2001) ("There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.").

23. Easterbrook & Fischel, *supra* note 17, at 38.

24. "Far better to alter incentives by establishing rules that attach prices to acts (such as pollution and layoffs) while leaving managers free to maximize the wealth of the residual claimants subject to the social constraints." *Id.* at 38; *see* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. Pa. L. Rev. 2063, 2065 (2001) ("[A] stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own."); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1189, 1200 (2002) ("[S]hareholder primacy is a second-best solution that is good for *all* the stakeholders in the firm, because it limits what might otherwise be the runaway agency costs that might be incurred by all if directors were not held to a clear and easily observed metric of good corporate governance."); *see also* Allen, Jacobs & Strine, *supra* note 10, at 1074–75 (describing the reason for shareholder primacy). This idea is rooted in classical economics. Adam Smith made the famous observation: "By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to

the firm in a way that it is less apt to maximize wealth; the agent must be incentivized to advance the shareholder's interest for a manager cannot effectively serve two or more constituencies whose interests may conflict. A clear charge to the agent minimizes agency cost, which maximizes the value of the firm.[25] Any claim for injury by one outside the nexus of contracts must "lie outside of corporate law."[26] Thus, corporate law is enabling, and should not be seen as regulatory.[27]

The nexus of contracts model is a cogent, internally coherent explanation of the firm. The theory, however, is not without controversy. Like many great scientific discoveries (and false claims of discovery), the theory requires a suspension of one's ordinary perception of the world. The nonintuitive assertion here is that under this theory "the corporation tends to disappear, transformed from a substantial institution into just a relatively stable corner of the market in which autonomous property owners freely contract."[28] The corporation as a "person" is a "weak and unimportant fiction."[29] An independently significant entity does not reflect reality.[30] "Corporations, we are told, do not really exist; when we refer to one—General Motors or RJR Nabisco, for example—we are just using a rhetorical shortcut to refer to the vast network of contracts or implicit contracts that is the 'reality.'"[31] This view reduces all essential aspects of the corporate enterprise to the actions, choices, and contractual arrangements of the autonomous person. In an argument that oddly mirrors a well-known shibboleth of the gun lobby,[32] we are told that "firms do not do things; people do things."[33] A nexus of contracts is no more capable of having moral conscience or ethical obligation than a machine, a nexus of materials, is capable of having a soul.

The property conception of the firm is problematic in theorizing the relationship between the ethical obligation of the firm and its agents. The presupposition here is not reification of the firm. One should not anthropomorphize the firm to argue

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trade for the public good." Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 485 (Regnery Publ'g, Inc. 1998) (1896).

25. *See* Easterbrook & Fischel, *supra* note 17, at 38; Hansmann & Kraakman, *supra* note 22, at 442 ("[T]he most efficacious legal mechanisms for protecting the interests of nonshareholder constituencies—or at least all constituencies other than creditors—lie outside of corporate law.").

26. Hansmann & Kraakman, *supra* note 22, at 442.

27. *See* Easterbrook & Fischel, *supra* note 17, at 14.

28. Allen, *supra* note 8, at 265.

29. William T. Allen, *Contracts and Communities in Corporation Law*, 50 Wash. & Lee L. Rev. 1395, 1400 (1993). "[T]he personalization of the firm implied by asking questions such as 'what should be the objective function of the firm', or 'does the firm have a social responsibility' is seriously misleading. *The firm is not an individual*." Jensen & Meckling, *supra* note 18, at 311.

30. Easterbrook & Fischel, *supra* note 17, at 12.

31. Allen, *supra* note 29, at 1401.

32. Bruce E.H. Johnson & Ambika K. Doran, *Amendment XXVIII? Defending Corporate Speech Rights*, 58 S.C. L. Rev. 855, 861 (2007) (noting the similarity of attribution of corporate action to the gun lobby's slogan "guns don't kill people, people kill people").

33. Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 Pepp. L. Rev. 971, 971 n.1 (1992); *see also* G. Mitu Gulati, William A. Klein & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. Rev. 887, 891 (2000) ("[I]t is dangerous to ignore the reality that firms can transact only through individuals . . . .").

moral agency.[34] This is not only conceded, but embraced. The problem of corporate ethics should focus on the behavior of the agents, but such examination is not without context. The inquiry is whether the corporate form explains in part an agent's ethical deviance.

The problem of corporate ethics can be restated as an economic account of how agents act on behalf of the firm. A central argument in the theory of the firm is the existence of an agency relationship between shareholder and manager. Economists note that there is no perfect agent.[35] Without a firm, a person acts on only his preferences and in most cases we presume that his actions are motivated by a desire to maximize his utility.[36] Within a firm, however, an agent is subject to conflicts, perceived or real, between his preferences and those of his principal's.[37] This problem can be as mundane as the slacking employee, or as significant as the disloyal corporate officer. Given this truth, the idea explored here is a simple one: in confronting an ethical dilemma, an agent tends to behave differently when acting within and without the firm, and thus the problem of corporate ethics and its connection to the theory of the firm cannot be reduced to the choices of autonomous moral agents, but instead must include a consideration of the corporate form. If so, the problem of corporate ethics is inextricably tied to the corporate form itself, which leaves open the question whether the corporate law should have a role that is beyond strictly enabling.

II.

Corporate law scholarship on the theory of the firm follows the lead of economists and focuses much attention on the theory of agency. Many years ago, Adolf Berle and Gardiner Means observed that the corporation separates ownership from control.[38] A divergence of interest between principal and agent creates agency cost, defined as the sum of the contracting cost, monitoring cost by the principal, the bonding cost by the agent, and residual loss.[39] Immediately pertinent to the issue of corporate ethics is residual loss, the principal's reduction in profit (wealth) due to

34. *See* David Luban, Alan Strudler & David Wasserman, *Moral Responsibility in the Age of Bureaucracy*, 90 Mich. L. Rev. 2348, 2368 (1992) (arguing that organizations are not moral persons). *But see* Peter A. French, *The Corporation as a Moral Person*, 16 Am. Phil. Q. 207 (1979) (arguing that corporations should be treated as full members of the moral community and have equal rights and duties as all moral persons).

35. *See* Michael C. Jensen, A Theory of the Firm 5 (2000) ("[P]eople will not act in the interests of others (their principals or partners) to the exclusion of their own preferences.").

36. *See id.*

37. *See* Michael J. Meurer, *Law, Economics, and the Theory of the Firm*, 52 Buff. L. Rev. 727, 727–28 (2004).

38. Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 4 (1933).

39. Jensen & Meckling, *supra* note 18, at 308. Monitoring cost is the expenditure to monitor the agent, such as the cost of audit systems and outside advisers. Bonding cost is a payment to the agent to expend resources to protect against the risk of an agent's deviation from the principal's interest. These costs include contractual guarantees to have accounts audited and contractual limitations on an agent's power to manage. *Id.*

an agent's deviance from the principal's interest.[40] In the extreme case, it can lead to the ruin of firms, such as Enron.[41] Two characteristics of residual loss are worth noting. First, it is unidirectional in that loss, but not profit, is a cost. This seems intuitive enough for it would be odd to consider profit a form of cost to shareholders. Second, the cost is equivalent to a disutility because shareholders are typically uninformed and disengaged from management and they receive benefit (utility) from corporate profit. On the surface, these propositions seem quite sensible and they are, for the most part. The idea of agency cost and the shareholder primacy norm are complementary: agency cost is inimical to profit, which in turn advances the principal's interest. And, herein is a continuing source of controversy. "It is the further step taken by the law and economics theorists, their attempts to forge an equivalence between rationality and profit maximization, that does give rise to warm disagreement."[42]

The problem of corporate ethics can be examined from the perspective of agency cost. Start from the premise that ethical dilemmas, by definition, are never easy because action typically requires selection of conflicting values. Profit, as an attribute in the abstract, is always a good thing, but it exists always in relation to cost, internalized or externalized. In a competitive world, profit is limited and an ethical dilemma presents a choice of profit and some other value. Inconsistency with profit maximization need not entail asset diversion for self-interest, the typical case of theft or disloyalty by the agent.[43] Cases like Enron are easy from this standpoint. The most difficult ethical problems arise when the agent acts on behalf of the principal.

We can give tangible context to this discussion. Assume a classic cost-benefit, tort problem. The firm has a choice of either installing a safety feature with a manufacturing cost of a, or accepting the inevitable liability, including diminishment of goodwill, with a cost of b, where the manufacturing cost is greater than the liability cost ($a > b$). Given the actuarial data, the firm is on notice that more people will die without the safety precaution. The profit from both choices is expected to exceed the cost of capital, and thus the project is economically profitable.[44] The only question is the quantum of profit. Given the choice, the manager installs the safety feature based on her consideration that lives are worth more than incremental profit.

40. *Id*. The suggestion is not that the other components of agency cost are irrelevant. They are not, but a discussion is beyond the scope of this Article.

41. *See, e.g.*, John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid*,*"* 57 Bus. Law. 1403 (2002) (discussing Enron management's failure to properly oversee its firm).

42. Allen, *supra* note 29, at 1405.

43. *See* Easterbrook & Fischel, *supra* note 17, at 10 ("Sometimes this division of interests will lead the employee to divert the firm's assets to himself. Theft is the dramatic way to do this; diversion of 'corporate opportunities' may be another . . . .").

44. *See generally* G. Bennett Stewart, III, The Quest for Value: A Guide for Senior Managers (1991).

The manager's choice can be seen in two lights. One view is that the agent acted based on her personal ethical mores. The motive, however characterized (selfish or selfless), is irrelevant. The economist would say that the manager chose the action because she derived utility from pursing her vision of a social good; the key inquiry is the deviation from the principal's interest, which is presumed to be wealth. Foregone profit can be seen as residual loss since the agent's preference was given priority over the incremental profit opportunity. If the moral constraint was so great, she had the option to resign, but barring this dramatic action, she must give fidelity to the job description. The failure to maintain this fidelity resulted in residual loss.

An alternative view is that the agent acted based on her best guess of the prevailing ethical preference of shareholders. Rather than rely on a default standard of wealth maximization, the agent acted consistently with what shareholders would have done if they had been fully informed and given the choice of action. The characterization of profit sacrifice (residual loss) as an agency cost is inaccurate since fidelity is the determinative inquiry. Ethically, this is indistinguishable from the situation where a principal instructs the agent to deliver his property to a social cause or to mitigate the harm at the cost of profit. Economically, however, there is a complicating factor arising from the firm structure. The agent cannot ascertain the principal's actual preference.

As a theoretical matter, the "principal," just like the "firm" (it is said), does not exist, as it is an aggregation of many shareholders with heterogeneous preferences and ethical standards. Shareholders conflict in matters of profit, strategy and values.[45] Not only do shareholders differ in the selection of conflicting value, but they differ in the manner in which value is maximized.[46] As Easterbrook and Fischel warned, we must be careful in ascribing too much into shorthand metaphors for

45. *See* Jonathan Macey, *The Nature of Conflicts of Interest Within the Firm*, 31 J. Corp. L. 613 (2006). The problem of inter-shareholder conflict, as Macey noted, is seen in *High River L.P. v. Mylan Laboratories, Inc.*, 353 F. Supp. 2d 487 (M.D. Pa. 2005). There, Mylan made a bid for King Pharmaceutical at a price of $16 per share. Even after this bid, King shares traded substantially below the bid price at $12 per share. Complaint at 3, High River L.P. v. Mylan Labs., Inc., 353 F. Supp. 2d 487 (M.D. Pa. 2005). Several major shareholders of Mylan thought that the bid price was too high and attempted to block the deal. Subsequently, a hedge fund, Perry, bought a stake in King at $12 per share. *Id.* If the takeover was successful at $16 per share, it would profit $26 million. *Id.* To influence this result, it also bought 9.9% of shares in Mylan with the intent to vote these shares in favor of the deal. *Id.* To hedge the exposure to Mylan stock, Perry sold short the same amount of Mylan stock. *Id.* The effect of the simultaneous purchase and shorting of the Mylan stock was to give Perry votes in Mylan without being exposed to Mylan's financial risk. *Id.* The hedging and voting buying strategy created an obvious divergence of interest among Perry and other shareholders in Mylan who were exposed to its financial risk. *Id.* Aside from this dramatic example of inter-shareholder conflict, we can easily imagine the different agendas and values of shareholders who are institutions, hedge funds, social activists, financial activists, management insiders, entrepreneurs, families, and individuals.

46. Concepts like profit or value maximization cannot be transformed into a legal duty because they cannot tell us how to act or what action should be taken. "[V]alue maximizing says nothing about how to create a superior vision or strategy. And value maximizing says nothing to employees or managers about how to find or establish initiatives or ventures that create value. It only tells us how we will measure success in activity." Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 Bus. Ethics Q. 235, 245 (2002).

groups of autonomous individuals with different sets of priorities and preferences.[47] That shareholders invest to earn a return is apparent, but this obvious fact does not support the proposition that we can ascertain an order of preference consistent with a singular view of the principal-shareholder in a decisional context requiring such ordering.[48]

Let's discard the theoretical problem and assume that the collective shareholders can fairly be categorized into a single principal and that wealth, quite correctly, is the reason for the investment in the firm. There is still a practical problem. The conflict between profit and ethics can be restated as one of high transaction cost of the intermediation structure. It would be inordinately costly to pose complex questions of rank ordering preferences on shareholders in the course of recurring, difficult management decisions. In the above cost-benefit example, consider the procedures and effort required for principals to make an informed decision based on the shareholders' moral standard. Given the problem of ascertaining the actual preference, the conception of the firm can adopt two approaches. It can either incorporate a mechanism whereby an agent is allowed to make a best guess as to what the prevailing preference would be if the principals could hypothetically express their wishes, or it can assume a narrow view of that preference.

The profit maximization norm is really a theory of approximation, an assessment that shareholders are rational wealth maximizers. This assessment of the *person* must be distinguished from the *reason* for investment in the firm, which is obviously a financial return. The approximation can be seen as efficient because it eliminates the information cost that would be associated with discovering the actual preference of the principals in most cases. The shareholder primacy norm can be seen, much like corporate law itself, as a default standard that encompasses the correct contract term in most cases if the relevant parties could have bargained for

47. Easterbrook & Fischel, *supra* note 17, at 12. Easterbrook and Fischel's comparison of the corporation and the government is informative. They argued:

> It is meaningful to speak of the legislative branch of the U.S. Government, or Congress, or of the House, or of a committee of the Senate, or of members of Congress, depending on context, but it would be misleading to think of Congress—an entity with a name—only as an entity, or to believe that its status as an entity is the most significant thing about the institution. "Congress" is a collective noun for a group of independent political actors and their employees, and it acts as an entity only when certain forms have been followed (such as majority approval in each house). So too with corporations.

Id. Picking up where this argument left off, it would be convenient to characterize all Congressmen as having the singular motive of serving the public interest. But this proposition, even if true, does not yield a predictive model of collective behavior in the pursuit of the public interest. The same is true for the collective group of shareholders. We can note in shorthand that shareholders pursue profit, but this says little about how they would behave when a particular circumstance requires the rank ordering of preferences towards particular actions and their expected outcomes.

48. Leo Strine argued the point through a hypothetical in which the shareholder has decided to sell the company and must select between tradeoffs in offered price and job protection concessions for employees. Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There?*, 75 S. Cal. L. Rev. 1169, 1177–83 (2002).

the choice under condition of zero transaction cost. This argument, however, is far from self-evident in the circumstance of an ethical dilemma. No rational person invests in the market to lose money or to contribute to the social cause in any significant way, and so the profit maximization norm covers a vast swath of corporate action without controversy. But it is controversy that gives rise to hard ethical dilemmas. A view of the shareholder or owner as ordinarily socialized would produce a different norm of conduct. This is seen when the corporate form is disintermediated from personal deliberation.

Assume the above cost-benefit hypothetical in the context of an entrepreneur owned enterprise. The entrepreneur possesses an ordinary moral constitution. Confronted with the essential choice of dollars or lives, many owners would forego profit. No doubt that many would also select the opposite.[49] The point is not diminished that this choice would be much harder for a person of ordinary moral constitution if she would be singularly accountable based on a direct causality between action and injury. When there is a substantial value at stake, such as life, liberty or dignity, the act of accommodation is ordinary and comports with empirical observation of how people actually behave.[50] There may be nothing heroic or saintly about relinquishing profit. In the single owner context, a person would not want to be held morally accountable for personal injuries, destruction of environment, economic support of repressive regimes, deplorable work conditions, etc.[51] It is neither here nor there that this aversion to moral accountability can be explained in economic terms (i.e., the pursuit of one's utility). As an approximation, the profit maximization norm is not the most accurate default standard in circumstances presenting difficult moral dilemmas.

Moreover, the theory of agency cost, a foundational concept in the property theory of the firm, is not based on wealth maximization. Its authors, Michael Jensen and William Meckling, argued that an entrepreneur owner of a firm will maximize her *utility*, which may be pecuniary or non-pecuniary, such as "love" or

49. Some have argued that sole owners could be more prone to unethical behavior than shareholders, who hold diversified portfolios of investments. Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 Notre Dame L. Rev. 1431, 1445–46 (2006). This argument, however, is problematic. Shareholders do not control the corporation in its day-to-day affairs, and thus are operationally removed from the decision-making processes that typically involve an ethical choice. In thinking about the problem of corporate ethics, we should focus on the behavior of agents vis-à-vis shareholders. As discussed in this Article, shareholder preference should be relevant under a principal-agent framework. In this regard, if it is true that shareholders would behave more ethically than a sole owner, a contestable point, the agent should consider it when confronted with an ethical dilemma. This, then, creates a tension with the shareholder profit maximization norm. As discussed in Part III, the problem is that the corporate form creates a temporal, spatial and relational distance between action and consequence. *See infra* Section III (discussing the works of philosophers, psychologists, and legal scholars on this concept).

50. For example, while the law does not impose a general duty to rescue people in distress under tort law or criminal law, many people engage in such rescue to their peril. *See, e.g.*, Eckert v. Long Island R.R. Co., 43 N.Y. 502, 503–04 (1871) (involving a plaintiff that was killed while rescuing a boy from defendant's train tracks).

51. *See infra* Part III.

"respect."[52] The rational self-interested person is frequently misinterpreted to mean pathological selfishness with no leeway in preference for the well-being of others.[53] But the assumption of a rational person simply connotes the idea that people are not perfect agents.[54] The distinction between wealth and utility maximization in the theory of agency cost is significant. A utility maximizing single owner may, and probably would, make allowances for profit sacrifice in furtherance of human welfare directly connected to the entrepreneur's activity.[55] Sacrifice, rescue, accommodation and compromise are empirically observed facts. Given this reality, profit may constitute an agency cost in the circumstance where it would have been sacrificed had there been a hypothetical, costless dialogue between an agent and an informed principal.[56] If the assumption of a rational person is relaxed to that of a reasonable person having an ordinary moral constitution, the choice of profit would certainly be conditional.[57]

These tensions explain the vigorous debate concerning the ultimate purpose of a corporation.[58] Profit is said to be the corporate end. But, in the context of assessing a corporate ethical dilemma, this proposition simply begs the question. No serious person disputes that profit, as a proxy for value creation, is one of the most important attributes of operating a firm, but this is not to say that there is not a serious question on whether profit maximization is conditional.[59] Beneath the economic superstructure of corporate law percolates "contestable philosophical or political presuppositions."[60] Since profit is not costless and some cost is externalized in a

52. Jensen & Meckling, *supra* note 18, at 312.

53. Jensen, *supra* note 35, at 5.

54. *Id.*

55. *See, e.g.*, *id.* (theorizing that even Mother Teresa would choose to help raise money for the impoverished citizens of Calcutta rather than accept an invitation to help raise funds for an organization that she shared little interest in, such as the Boston Symphony Orchestra).

56. Indeed, Easterbrook and Fischel argued that, consistent with the Coase Theorem, "corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low." Easterbrook & Fischel, *supra* note 17, at 15.

57. The American Law Institute takes the position that "certain kinds of conduct must or may be pursued . . . even if the conduct either yields no economic return or entails a net economic loss[)]." Am. Law Inst., Principles of Corporate Governance: Analysis and Recommendations § 2.01 cmt. f (1994).

58. This debate is a hoary one. *Compare* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049, 1049 (1931) (stating that corporate agents exercise power "only for the ratable benefit of all the shareholders as their interest appears"), *with* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145, 1148 (1932) (stating that a corporation "has a social service as well as a profit-making function").

59. Even Milton Friedman argued that profit maximization is conditional as to deception and fraud. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times, Sept. 13, 1970, § 6 (Magazine); *see* Milton Friedman, Capitalism and Freedom 133 (40th Ann. ed., Univ. of Chicago Press 2002) (1962).

60. Allen, *supra* note 29, at 1395.

way that could not have been bargained for, explicitly or implicitly, wealth maximization must have a "political-moral component."[61]

Consider the following scenario: a corporation is faced with a choice of selling state-of-the-art technology to a repressive regime with the reasonable foresight that such technology will be used to engage in the violation of human rights, and such a sale is not a violation of the law.[62] Clearly, the corporate agent can forego this profit opportunity without legal consequence.[63] Such decision could easily be justified as being not in the longterm interest of shareholders or posing too great of reputational risk, or perhaps that such a transaction is inconsistent with the core values of the firm. The rationalization would imply at least a tradeoff between present profit and some future benefit, and so long as this nexus is present, however abstract or unformulated, courts conveniently avoid any serious analysis of the cost-benefit.[64] But assume the choice is one of profit sacrifice without any basis to rationalize a future pecuniary benefit. The question is really: should profit be foregone? A legal duty or economic norm to maximize shareholder profit enjoys the benefit of simplicity, but it also runs into the problem of an inability to avoid in principle morally repugnant actions. Certainly, one option is a "ruthlessly narrow focus,"[65] an argument that the corporation should "make as much money as possible while confirming to the basic rules of the society."[66] This simple view is not without precedent. In *Dodge v. Ford Motor Co.*,[67] the Michigan Supreme Court said, "[a] business corporation is organized and carried on primarily for the profit of the

61. *See id.* at 1405 ("Thus, either a descriptive account or a normative account of corporation law that I might advance would include a powerful element of wealth maximization, but it would inescapably include as well a political-moral component.").

62. *See, e.g.*, Edwin Black, IBM and the Holocaust (Three Rivers Press 2002) (2001) (charging that IBM knowingly provided crucial technology that was used by Nazi Germany to execute the Holocaust). *But see* Press Release, IBM, IBM Statement on Nazi-era Book and Lawsuit (Feb. 14, 2001), *available at* http://www-03.ibm.com/press/us/en/pressrelease/1388.wss (acknowledging that IBM's equipment was used by Nazi Germany, but that "IBM does not have much information about this period"); Press Release, IBM, Addendum to IBM Statement on Nazi-era Book and Lawsuit (Mar. 29, 2002), *available at* http://www-03.ibm.com/press/us/en/pressrelease /828 (noting that Edwin Black "does not demonstrate that I.B.M. bears some unique or decisive responsibility for the evil that was done"). IBM was not the only reputable company that dealt with or supported the Nazi regime. *See, e.g.*, Harold James, The Deutche Bank and the Nazi Economic War Against the Jews (2001); *see also* Joseph Borkin, The Crime and Punishment of I.G. Farben (1978).

63. The business judgment rule would insulate the agent from liability. *See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (finding that a court should not second guess a corporation's decisions, unless the decision involved fraud, illegality, or conflict of interest, even when those decisions resulted in a loss of profits); *see also* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. Rev. 733, 763–76 (2005) ("Despite contrary assertions by advocates of a profit-maximization duty, the law has never barred corporations from sacrificing corporate profits to further public interest goals that are not required by law.").

64. *See, e.g., Shlensky*, 237 N.E.2d at 780 (considering the "long run" economic interest of the corporation in assessing a decision that could be construed to sacrifice profit).

65. Allen, Jacobs & Strine, *supra* note 10, at 1083. R

66. Friedman, *Social Responsibility*, *supra* note 59; *see* Milton Friedman, Capitalism and Freedom 133-34 (40th ann. ed. 2002).

67. 170 N.W. 668 (Mich. 1919).

stockholders. The powers of the directors are to be employed for that end."[68] But few, if any, jurisdictions have announced such a seemingly unconditional rule of shareholder primacy.[69] The opinion is unique in this sense, explaining why this 1919 Michigan opinion is still prominent today. There is a novelty appeal to the unusual.[70] While the case is an obligatory citation for proponents of shareholder primacy, Delaware most notably consistently has refused to articulate a clear shareholder mandate.[71] Quite the contrary, Delaware law generally has considered the corporation from an entity perspective, which conflicts with the law and economic view that the firm is nothing more than a nexus of contracts.[72] In fact, there is only one Delaware opinion that discusses the "nexus of contracts" theory, and a fair reading shows that it marginalizes the analytic importance of the prevailing law and economic concept.[73]

It has been argued that the choice of corporate law "does not create substantial third-party effects."[74] This argument strengthens the credibility of the contract metaphor and the application of the Coase Theorem.[75] But the assertion that corporations, and thus the laws governing corporations, are essentially closed universes of contracting parties is hard to accept.[76] If indeed there are no or little third party effects, much of the rationale for limited liability would be undermined. The parties to the contract can "negotiate" this point through the pricing mechanism.[77] Yet,

68. *Id.* at 684.

69. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 301 (1999) (noting that *Dodge* is "highly unusual").

70. "A majority of states have adopted stakeholder statutes, which allow corporate directors to take the interests of non-shareholder stakeholders into account when making decisions for the corporation." Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. Rev. 283, 291 n.33 (1998).

71. *See*, *e.g.*, Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) ("[A] board of directors . . . is not under any *per se* duty to maximize shareholder value . . . ."); *see also* Allen, Jacobs & Strine, *supra* note 10, at 1067 (noting that Delaware law is "ambivalent" on the question of shareholder primacy).

72. *See* Allen, Jacobs & Strine, *supra* note 10, at 1079 (noting that "Delaware law inclines toward the entity model" to the extent that it gives boards substantial power to thwart takeovers); Strine, supra note 48, at 1176 R (stating that "the entity model prevails"); *see also Paramount Commc'ns, Inc.*, 571 A.2d at 1150; Adolf A. Berle, Jr., The 20th Century Capitalist Revolution 169 (1954) (noting that in corporate practice the "argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention"); Stout, *supra* note 24, at 1204 ("Delaware courts seem to have come down rather firmly on Dodd's side of the Berle-Dodd debate.").

73. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 195 n.75 (Del. Ch. 2006). The Westlaw search term used was: (nexus /2 contracts). Another Delaware case came up in this search, but only because it cites the title of a law review article. MM Cos., Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1126 n.5 (Del. 2003) (citing Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 Iowa L. Rev. 1 (2002)).

74. Easterbrook & Fischel, *supra* note 17, at 17.

75. *See id.* ("It is unimportant that [the terms of the contract] may not be 'negotiated'; the pricing and testing mechanisms are all that matter, as long as there are no effects on third parties. This should come as no shock to anyone familiar with the Coase Theorem.") (citing R.H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960)).

76. *See supra* note 6 and accompanying text.

77. One can argue that limited liability would still be an efficient default rule for contracting parties. Stephen M. Bainbridge, Corporate Law and Economics 132–38 (2002). If such a default rule were effi-

limited liability is the foundational concept of corporate law.[78] While the benefits of limited liability may include cost efficiency associated with contracting and monitoring as claimed by law and economic scholarship,[79] no one disputes that limited liability also externalizes some cost of profit generation.[80] Additionally, there are of course externalities for which the law provides no claim. In an era of globalization, this is an important point since not all countries have a strong system of rights or regulatory oversight. The law's reluctance to adopt a narrow view of shareholder primacy is rooted in the practical difficulty of separating ethical questions from economic choices. The hard question on shareholder primacy is not a choice of profit to shareholders or benefit to others,[81] but is instead shareholder profit or harm to others. Profit is not made in a vacuum; it always has an associated cost, some of which is always externalized.

III.

The theory of agency, the problem of ethical choice, and the profit maximization norm are inextricably linked. The question remains whether the corporate form

cient, however, one would question the need for legal intervention in the contracting process. In other words, sophisticated market participants (creditors and public companies) would adopt efficient terms. They would agree on limited liability as a boilerplate credit term with little expenditure of transaction cost and would factor in defaults through the cost of debt, as is the case now with limited liability. There are no obvious impediments to bargaining among sophisticated market participants, and thus the case for legal intervention under the application of the Coase Theorem is less obvious. Moreover, the capital market may be served by having a variety of firms, some that contract for limited liability and others that do not, and each market participant would identify the contractual arrangements that best suit his appetite for risk. Certainly, limited liability is routinely contracted away in many corporate transactions involving small or closed corporations despite the legal protection afforded to the corporate form. And, if risk aversion of retail shareholders and the need for diversification are the concern, shareholders could invest through large institutional investment vehicles as is largely the case now. Such investment would achieve superior diversification than any retail shareholder can achieve by herself, and it would greatly minimize the risk of personal liability since a creditor can claim against the assets of the institutional intermediary first (presumably the class of institutional shareholders would have the funds to pay off any liability). Thus, a rule of personal liability would result in greater diversification and mitigation of portfolio risk of the average retail shareholder. Lastly, even if personal liability poses a net increase in risk to retail shareholders, it may not be as risky as certain investment strategies they routinely undertake—for example, undiversified "all in" investments in speculative ventures or highly levered personal portfolio—and yet the law does not take a paternalistic approach or is even influenced by the fact that natural persons tend to be risk averse. As we have learned from the recent problems with the housing and credit markets, people take great financial risks in credit transactions, and they also manage catastrophic risks, such as earthquakes and hurricanes, which are more likely to inflict financial devastation than personal liability through investment in a public company. At the end of the day, it is an empirical matter whether the potential financial catastrophe of personal liability is qualitatively different or quantitatively higher than other routinely accepted types of financial catastrophe that can befall any natural person.

78. Easterbrook & Fischel, *supra* note 17, at 40 ("Limited liability is a distinguishing feature of corporate law—perhaps *the* distinguishing feature.").

79. *See id.* at 40–62 (providing economic analysis of limited liability).

80. *See supra* note 7 and accompanying text; *see also* Bainbridge, *supra* note 77, at 134 ("Limited liability thus generates negative externalities by creating incentives for shareholders to cause the company to invest in higher risk projects than would the firm's creditors."). R

81. *See, e.g.,* Kahn v. Sullivan, 594 A.2d 48 (Del. 1991) (considering the propriety of a substantial corporate charitable donation to a museum).

can promote unethical choice. Here, again, Coase's conception of the firm is relevant. Despite the emphasis on contractual relationships, Coase also viewed the firm as having a central control: "A firm, therefore, consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur."[82] While this command-and-control aspect of the firm has been criticized,[83] hierarchical management is the operating paradigm of public companies.[84] In a complex enterprise, such as a public company, there is no credible way to eliminate the need for a chief executive, divisional heads, group managers, and so forth, all of whom ultimately report to the board of directors.[85]

The hierarchical nature of a corporation presents a structural problem in ethics. Although the firm is cost efficient, as Coase showed, the structure is susceptible to distortions in moral deliberation. It tends to diffuse personal responsibility and to create conflicts with one's ethical standard in weighing competing values. In short, the firm structure changes the behavior of the actors within and thus produces results that are different than had they acted independently. To see this problem, we step back, away from economic theory, and see how philosophers, social scientists, and legal scholars have perceived the problem of moral choice within social structures.

The philosopher Hannah Arendt asked how ordinary people can behave immorally.[86] The subject of her philosophical examination was Adolf Eichmann, who was responsible for the transportation and logistics needed to execute the Holocaust.[87] Like many ordinary people, Eichmann was married, had a family, wanted to do well in his profession,[88] and professed to have lived by a well-defined moral system.[89] He was not a "monster" in the sense of some obvious psychological defect or abnormality,[90] but was a rather "normal" person.[91] How then could such a person participate in such enormity?

82. Coase, *supra* note 11, at 393.

83. *See, e.g.*, Érica Gorga & Michael Halberstam, *Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge-Based Theory of the Firm*, 101 Nw. U. L. Rev. 1123, 1130 (2007) ("Coase's explanation, however, relies on a very narrow understanding of firm organization—one that assumes the entrepreneur exercises fiat control. Coase uncritically adopts this view of firm hierarchy by generalizing from nineteenth century conceptions of the relation between employer and employee.").

84. "Given the shareholder-management divide, the autocratic-CEO paradigm appears to be the only arrangement that allows for the effective functioning of a corporation." Alan Greenspan, The Age of Turbulence 436 (2007).

85. *See* Del. Code Ann. tit. 8, § 141(a) (West 2008).

86. Hannah Arendt, Eichmann in Jerusalem (Penguin Books 1976) (1963).

87. *See id.* at 153.

88. Professional advancement and recognition were most important to Eichmann. *Id.* at 43–44, 62.

89. Eichmann claimed to have lived his life under Kantian moral principles, leading Arendt to observe that Eichmann had a capacity for self-deception and inconsistency that made him appear to be a "clown." *Id.* at 54, 135–37.

90. *Id.* at 54.

91. The assessment was based on psychological examinations. *Id.* at 25–26. To this assessment, Arendt added: "Behind the comedy of the soul experts lay the hard fact that his was obviously no case of moral let alone legal insanity." *Id.* at 26.

Arendt observed that the bureaucratic apparatus of the political machine allowed a process of moral proxy where Eichmann delegated his moral authority.[92] She observed that Eichmann not only obeyed the law, but felt compelled to act consistent with the social norms that laid the foundation of that law.[93] His sole motivation was to do well in his given job and to advance within the organization.[94] By himself, he was incapable of committing the crimes,[95] certainly not with his own hands or with sole power to set policy, but within the organization he was capable of participating in horrific action. His fatal defect was a "lack of imagination" and "sheer thoughtlessness,"[96] traits that are not extraordinary, but rather common. In Arendt's final analysis, the cause of Eichmann's actions was the "stupidity" of a man who, motivated to do his job well and to achieve the ends set by the socio-legal environment of the time and place, failed to think and see the consequences of his actions.[97] Thus, in a controversial conclusion, Arendt characterized the man and the crime as "the banality of evil."[98]

Like Arendt, the philosopher Alasdair MacIntyre argued that institutions of modern society create a "moral and cultural distance" between action and consequence.[99] Reflecting on the specific problem of corporate malfeasance, he observed that "large corporations are collectively quite willing to undertake courses of action

> The trouble with Eichmann was precisely that so many were like him, and that the many were neither perverted nor sadistic, that they were, and still are, terribly and terrifyingly normal. From the viewpoint of our legal institutions and of our moral standards of judgment, this normality was much more terrifying than all the atrocities put together, for it implied—as had been said at Nuremberg over and over again by the defendants and their counsels—that this new type of criminal, who is in actual fact *hostis generis humani* [enemy of mankind], commits his crimes under circumstances that make it well-nigh impossible for him to know or to feel that he is doing wrong.

Id. at 276.

92. *See id.* at 114 ("[T]he élite of the good old Civil Service were vying and fighting with each other for the honor of taking the lead in these 'bloody' matters. 'At that moment, I sensed a kind of Pontius Pilate feeling, for I felt free of all guilt.' *Who was he to judge?* Who was he 'to have [his] own thoughts in this matter'? Well, he was neither the first nor the last to be ruined by modesty."); *see also id.* at 116 ("As Eichmann told it, the most potent factor in the soothing of his own conscience was the simple fact that he could see no one, no one at all, who actually was against the Final Solution."); *id.* at 126 ("He did not need to 'close his ears to the voice of conscience,' as the judgment has it, not because he had none, but because his conscience spoke with a 'respectable voice,' with the voice of respectable society around him.").

93. *See id.* at 137 ("Much of the horribly painstaking thoroughness in the execution of the Final Solution—a thoroughness that usually strikes the observer as typically German, or else as characteristic of the perfect bureaucrat—can be traced to the odd notion, indeed very common in Germany, that to be law-abiding means not merely to obey the laws but to act as though one were the legislator of the laws that one obeys.").

94. *See id.* at 287 ("Except for an extraordinary diligence in looking out for his personal advancement, he had no motives at all.").

95. *See id.* ("And this diligence in itself was in no way criminal; he certainly would never have murdered his superior in order to inherit his post.").

96. *See id.* at 47–48 ("[A] more specific, and also more decisive, flaw in Eichmann's character was his almost total inability ever to look at anything from the other fellow's point of view.").

97. *See id*. at 287. In this sense, Arendt famously, and controversially, observed that on a strictly factual level there was a "banality of evil." *Id*.

98. *Id.*

99. The Ford Pinto Case, *supra* note 6, at 283.

that individuals in the corporation would be deeply shocked by if it was proposed that they as individuals should do what the corporation does."[100] Such intermediation interferes with ordinary moral deliberation. Human beings are not perfectly deliberative. Moral assessment becomes more opaque as responsibility is diffused and as the distance between action and consequence becomes greater. The combination of corporate power and moral weakness endangers the concept of individual responsibility.[101] Thus, the problem of corporate ethics is not reducible to the autonomous person.

The question of moral choice has not been limited to a philosophical inquiry. Like Arendt and MacIntyre, the psychologist Stanley Milgram inquired into the question of how ordinary people can obey immoral orders.[102] In a classic series of experiments, he asked volunteer participants ("teachers") to administer electric shocks to test subjects ("learners") in an experiment purportedly designed to study the effect of punishment on learning.[103] As the learners failed to perform properly, the teachers were instructed to increase the level of electricity.[104] The level of shock ranged up to dangerous and fatal levels.[105] The experiment was a ruse, and the real subjects were the "teachers" who were required by the constraints of the experiment to administer electric shocks.[106] The experiments showed that participants went far beyond the predicted behavior, and many subjects, despite reservation and discomfort, ultimately obeyed orders of the experimenter to give highly painful or dangerous levels of electric shock.[107]

Milgram's findings are consistent with Arendt's philosophical conclusion on the nature of evil.[108] Milgram identified two crucial factors in the subject's deliberative process: hierarchical structure and agency.[109] First, hierarchical structures, like those found in corporations, tend to suppress the psychological and moral controls of autonomous persons.[110] Second, agency brings about an "agentic state," wherein "the person entering an authority system no longer views himself as acting out of his own purposes but rather comes to see himself as an agent for executing the

100. *Id.*

101. *Id.*

102. *See* Stanley Milgram, Obedience to Authority: An Experimental View (1974). Like Arendt's work, his work was inspired in part by a desire to underst the Holocaust. *Id.* at 1–2.

103. *Id.* at 3.

104. *Id.*

105. *See id.*

106. *Id.* at 3–4.

107. *Id.* at 4–5.

108. *See id.* at 5 (summarizing that his and other studies find over and over again the "extreme willingness of adults to go to almost any lengths *on the command of an authority* . . . ." (emphasis added)).

109. *Id.* at 129–133.

110. *See id.* at 129 ("More generally, whenever elements that function autonomously are brought into a system of hierarchical coordination, changes are required in the internal structure of the elements. These changes constitute the system requirements, and they invariably entail some suppression of local control in the interest of system coherence.").

wishes of another person."[111] In short, an autonomous person behaves differently when he is in a subordinate agency role, and under these conditions he "no longer regards himself as responsible for his actions."[112]

Arendt, MacIntyre and Milgram's inquiries sought the causes of extraordinary events like the Holocaust and ordinary malfeasance like the flawed cost-benefit analysis used in the production of the Ford Pinto. Of course, the scale between the enormity of the Holocaust and everyday externalities imparted by corporations is incomparable. But the lesson is the same: "the bureaucratic pattern of organization that fragments the knowledge required for moral decisionmaking is common to large institutions throughout contemporary society."[113] The insights of Arendt, MacIntyre and Milgram are important to the problem of corporate ethics.[114]

Legal scholars also have recognized the problem of moral proxy. David Luban, Alan Strudler, and David Wasserman argued that bureaucratic organizations can inhibit proper moral deliberation.

> *Bureaucratic organizations parcel out morally significant knowledge among various individuals along the same lines as organizational tasks. The division of labor is equally a division of knowledge. Supervisors may not know of wrongful actions by subordinates implementing management decisions, while subordinates may believe they have been left no discretion and no alternatives. Put these conditions together and you have a recipe for organizational wrong-doing that will never trouble the conscience of anyone within the organization. Individuals within the organization do not know, or perhaps do not want to know, what their actions add up to.*[115]

While most moral theories emphasize the autonomy of the moral agent—just as the economic theory of the firm emphasizes autonomous choice of contracting parties—there is insufficient focus on the roles of diffuse responsibility, limited knowledge, and agency.[116] The authors concluded that "the corporate structure may

111. *Id.* at 133.

112. *Id.* at xii. This was precisely Arendt's conclusion on how Eichmann justified his actions. *See supra* note 91 and accompanying text.

113. Luban, Strudler & Wasserman, *supra* note 34, at 2359.

114. *See id.* 2358–62 (citing Arendt's observations on the Holocaust and Milgram's works on obedience to argue that corporate structures can promote immoral choices); *see also* Douglas Litowitz, *Are Corporations Evil?*, 58 U. Miami L. Rev. 811, 836–37 (2004) (arguing that Arendt's concept of the "banality of evil" is applicable to the corporate context).

115. Luban, Strudler & Wasserman, *supra* note 34, at 2355. "In every human group there is less reason to guide and to check impulse, less capacity for self-transcendence, less ability to comprehend the needs of others and therefore more unrestrained egoism than the individuals, who compose the group, reveal in their personal relationships." *Id.* at 2358 (quoting Reinhold Niebuhr, Moral Man and Immoral Society xi–xii (rev. ed. 1960)).

116. *Id.* at 2363; *see also* John M. Darley & Bibb Latané, *Bystander Intervention in Emergencies: Diffusion of Responsibility*, 8 J. Personality & Soc. Psychol. 377 (1968) (analyzing the failure to rescue by neighbors in the Kitty Genovese murder). This problem is not simply a moral problem, but also a legal problem. American

be a locus of events causally relevant to morally significant harm" and that "[o]rganizations are real and irreducible to their component individuals."[117]

Similarly, John Coffee argued that moral choices are not so clear in the trenches of corporate management.[118] It is the unusual case that top executives of a firm will instruct subordinates to engage in patently wrong deeds.[119] In this regard, the type of frauds that took place in Enron, Tyco and WorldCom are atypical. Unethical behavior typically arises from ambiguous situations, when information may be imperfect and responsibility may be diffused. In these circumstances, individuals may set aside their personal morals and act on behalf of the perceived good of the firm or group.[120] Often, there are conflicting value systems that create ambiguity where there would otherwise be none. From this perspective, it is understandable that the locus of corporate misdeeds is "predominately at the lower to middle management level."[121] Normal people, doing ordinary jobs, are susceptible to unethical conduct as a result of their agency and organizational dynamics.[122]

Filtered through corporate intermediation, an ethical dilemma is no longer simply subject to an autonomous person's moral compass, which presumably does not significantly vary between principals and agents in the absence of the corporate form. Not only does an ethical dilemma present a conflict between the interests of agent and principal (the primary focus of economists and legal scholars), but also between the interests of principal and noncontractual constituents. The profit maximization norm simplifies decisionmaking in ethical dilemmas. It provides the legitimizing principle to resolve the conflict, thus allowing agents to avoid personal accountability. It creates the social condition in which managers delegate their moral authority to a greater institutional purpose, a sort of moral proxy from managers to an abstractized, simplified version of the shareholder's interest. As Coffee observed, the corporate agent who engages in wrong "has not breached the stockholders' trust, but instead is faithfully pursuing their desires" when considered in the context of the profit maximization norm.[123] "The market in effect demands

tort law does not recognize a general duty to rescue. *See, e.g.*, Yania v. Bigan, 155 A.2d 343, 346 (Pa. 1959). Given the potential diffusion of responsibility in a rescue situation, a workable rule is difficult to formulate. *See* Saul Levmore, *Waiting for Rescue: An Essay on the Evolution and Incentive Structure of the Law of Affirmative Obligations*, 72 Va. L. Rev. 879, 933–34 (1986).

117. Luban, Strudler & Wasserman, *supra* note 34, at 2377.

118. *See* John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 Mich. L. Rev. 386, 395–97 (1981).

119. *See id.* at 397 (noting that "corporate crime is predominantly [committed] at the lower to middle management level").

120. *See id.* at 396–97.

121. *Id.* at 397.

122. *See, e.g.*, The Ford Pinto Case, *supra* note 6, at 112 (arguing that organizational culture "amounts to a collection of scripts," which not only alters perceptions of issues but also actions); *see also* John Z. De Lorean & J. Patrick Wright, *How Moral Men Make Immoral Decisions—A Look Inside GM*, *in* The Big Business Reader: Essays on Corporate America 36 (Mark Green & Robert Massie, Jr. eds., 1980) (arguing that the corporation organizational form clouds the complex decision-making in ethical dilemmas).

123. Coffee, *supra* note 118, at 418.

misconduct, and the manager responds to that demand out of a fear that otherwise the marketplace will discount the value of his firm's shares."[124] In this narrow, ruthless version of the shareholder primacy norm, the ethical dilemma ultimately boils down to a cost-benefit with wealth as the end.

The problem of agency and its cost is broader than what the prevailing view of the firm suggests. Agency cost typically arises when the interest of the agent and principal are not aligned.[125] But when the alignment of interests becomes closer in the context of an ethical dilemma, cost in the form of foregone profit also results. Ultimately, how profit sacrifice is considered depends on a normative view of whether the agent should advance the principal's wealth or utility. If the latter, there is room in the theory of agency cost to accommodate ethical deliberation without having profit sacrifice be characterized as residual loss.[126] An unconditional rule of profit maximization is unrealistic. A better rule is to apply a variable standard: a rule allowing the agent to take a best guess as to what the principal would do if the process of informed consent was costless.[127] In most cases, this rule and the profit maximization norm are one and the same. In difficult circumstances, however, the rule provides better approximation of the principal's interests because it mitigates the distorting effects of the corporate form on individual action.

IV.

When thinking about the theory of the firm and the problem of corporate ethics, we must distinguish the instrumental legal question from the broader policy construct. As an instrumental matter, whether agents are under a duty to maximize profit is of little practical relevance. Empirical observation suggests that corporations exist because they create wealth, but the shareholder primacy norm, in whatever form given by corporate agents, is unenforceable.[128] Agents have enormous discretion to conduct business as they see fit.[129] Agents must always maintain a strong profit motive to ensure economic viability, and the market forces of execu-

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124. *Id.* at 418–19. Indeed, law and economics scholars have argued that violation of the law is acceptable so long as wealth is maximized:

> But what is the source of management's duty? If managers act on behalf of shareholders, the duty must come from a need to prevent injury to these shareholders. If a given act involves a violation of law, penalties may follow. Managers' duty calls for them to minimize the sum of penalty costs and the cost of compliance with the rule.

Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1192 (1981).

125. *See supra* note 39 and accompanying text.

126. *See supra* note 55.

127. Indeed, as an analytic device, a hypothesized dialogue is consistent with contract principles. *See* Kenford Co. v. County of Erie, 537 N.E.2d 176, 179 (N.Y. 1989) ("[*T*]*he common sense rule to apply is to consider what the parties would have concluded had they considered the subject.*").

128. *See supra* notes 58–73 and accompanying text.

129. *See supra* note 63 and accompanying text.

tive labor and corporate control ensure a healthy degree of fidelity to that end.[130] One would be hard pressed to find a director or executive of a public company who did not try to make profit or "win" the competitive game of business. With that said, it is also fact that within the contours of these broad constraints the shareholder primacy norm is malleable to the agent's broad discretion. The business judgment rule provides broad cover to an agent's action, whether motivated by a desire to benefit the principal or some other reason.[131] In most cases, profit sacrifice is legally unassailable,[132] and a legal duty to maximize profit would be an unworkable rule and ultimately unenforceable.[133]

In the debate on corporate ethics, theory has a close connection to practice. The normative end of corporate law can legitimize or not conduct that sacrifices shareholder profit for some other social value. The continuing debate on Sarbanes-Oxley focuses on the cost-benefit of the regulatory scheme,[134] but beneath the dollars and cents of the matter is a deep philosophical debate not only on the immediate question of regulation of corporate governance, but also on the role of law in regulating individual behavior and ethics.[135] Beyond the specifics of regulation, the legal framework and theory provides the contextual circumstance of the ethical dilemma. As Stephen Bainbridge noted, the broad concepts of the firm have "more of a psychological than a legal impact" and affect management's "socialization" rather than its legal obligations.[136]

This point is illustrated by a personal classroom experience. In the fall of 2006, I taught Torts and Business Associations ("BA") in the same semester. An intuition crossed my mind: do my students in Torts and BA think about the costs of acci-

130. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 112 (1965). According to Margaret Blair and Lynn Stout's team production theory, no one monitors the board of directors. *See* Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash. U. L.Q. 403, 421 (2001) ("[I]t is essential that the hierarch remain free from the command and control of any of the team members."). Instead, "economic pressures" constrain the board. *Id.* at 438.

131. Indeed, it is apparent that the justifications for many corporate actions, which withstand legal scrutiny, are questionable. This may be a cynical view, but I do not think so. It is simply recognition that there is a distinction between the legal standard of pleading and evidence, and an unrestricted probabilistic assessment based on the known facts.

132. *See, e.g.*, Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 815 (N.Y. Sup. Ct. 1976), *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976). In *Kamin*, accounting profit and perhaps short-term stock price was enhanced, though the board's decision diminished the true economic value of the firm.

133. *See* Elhauge, *supra* note 63, at 770 ("In any event, even if the duty of care did nominally require profit-maximization, the business judgment rule makes plain that the duty of care cannot be enforced in a way that would bar managers from exercising discretion to sacrifice corporate profits in the public interest.").

134. *See* Greenspan, *supra* note 84, at 430–31 ("[F]ew in the business community would argue that the cost and effort of implementing Section 404. . . [has] created a net plus for either their company or the U.S. economy as a whole.").

135. Consider, for example, Section 906 of Sarbanes-Oxley, which requires that CEOs and CFOs certify the accuracy of financial statements. 18 U.S.C.A. § 1350(a) (West 2008). The aim of this provision is to impart a sense of greater personal responsibility with appropriate sanction. Such mandatory nature of an agent's duty of care towards financial statement accuracy is in tension with Delaware law, which allows a corporation to opt out of certain duties. *See* Del. Code Ann. tit. 8, § 102(b)(7) (West 2008).

136. Bainbridge, *supra* note 18, at 1440–41.

dents in the context of a business decision in the same way? A simple, informal survey was devised to test the intuition. The students were presented with a classic cost-benefit problem, modeled off the Ford Pinto case, and were asked to decide how they would resolve the problem.[137] The problem stated that the manufacturing cost of fixing a fuel liner was $113 million more than the total liability cost, but not fixing the liner would result in 450 additional cases of deaths and serious injuries. The students were presented with a binary choice of dollars or lives. Each class was split into two groups: one group was asked to assume the role of a sole owner of the business, and the others were told to assume they were the chief executive of a company with many shareholders.[138] Each student was asked to read the problem, and to anonymously submit their decision in writing.

The results were interesting. Students in Torts did not differentiate between their roles as principal and agent: 10% of sole owners chose to save manufacturing costs, while 11% of chief executives did the same. Students in BA, however, perceived the problem differently: 18% of sole owners decided to save manufacturing costs, while 24% of chief executives did the same.[139]

Since this was not a formal repeated experiment, I certainly draw no hard conclusions from these results. The survey was more in nature of an anonymous straw poll. The results, however, strengthen an initial intuition and the thoughts developed in this Article.[140] A couple of points are worth noting. First, third-year students were more willing to engage in traditional cost-benefit analysis. By this time, most of them would have been exposed to the concept, for example, of the Hand Formula.[141] Second, the cost-benefit analysis was based on the measure of wealth. My guess is that if the students engaged in a cost-benefit analysis from the perspective of welfare, several would probably have arrived at a different conclusion.[142] Third, third-year students seem to distinguish between the roles of principal and

137. The experiment was conducted before teaching *United States v. Carroll Towing Co.*, 159 F.2d 169 (2d Cir. 1947), and *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).

138. Each group was separated during the exercise so that students were unaware of the experiment variable.

139. The breakdowns for the Torts students were: single owners (4/40), and chief executive (4/35). The breakdowns for the BA students were: single owners (6/34), and chief executive (8/34). Only a few students in each group swung the results, but this is expected. As economists warn, the difference in behaviors frequently occurs at the margins. Because the opportunity to conduct the survey again has not presented itself, one should be careful not to overstate the results. The number of participating students was limited (143 students in total), who were divided into smaller groups (34–40 students). There is the possibility that they could just be random variations, and thus the numbers should be taken with a grain of salt. With that said, large swings in numbers were not expected, and changes were expected to be seen on the margins.

140. A post-exercise debriefing with students would have been helpful, but this would have breached anonymity.

141. *See Carrroll Towing Co.*, 159 F.2d at 173 ("[I]f the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether B less than PL.").

142. *See generally* Matthew D. Adler & Eric A. Posner, New Foundations of Cost-Benefit Analysis (2006) (arguing that cost-benefit analysis should have a moral foundation based on human welfare considerations).

agent, whereas first year students did not. Here, again, with legal training students would have learned to put aside personal points of view and mores and to assume the role of an agent. Lastly, third-year students were closer to being a lawyer than a layperson, and first year students were closer to being a layperson than a lawyer. I do not suggest a substantive judgment here on the ethics of the situation, only the observation that the decision of a person with conflicting values produced different outcomes. Even in this simple exercise, we can see how law students learn to adopt the agent's role and the obligations of that role are set forth by the prevailing legal standards and economic norms.

Agency matters when choices involve ethical dilemmas. Since agency relationships are fiduciary, the characterization of corporate managers as agents lends a veneer of moral authority to the profit maximization norm.[143] It is interesting that ethical concepts are routinely discussed in the ordinary course of business school curriculum and scholarship.[144] "In contrast, the legal academy tends to avoid direct mention of business ethics, even though the subject matter overlaps."[145] The concern is the possibility of regulatory overreaching in matters of behavior.[146] But it is also true that corporate law has an ethical foundation, and the debate on values and their order necessarily affect the behavior of agents. My own takeaway from the above classroom exercise is that regardless of how the law and legal education try to shy away from deontological inquiries, the questions of ethics in business conduct is inevitable and whatever answer is given, whether wealth is the supreme value or conditional to some other thing, it provides the foundation of corporate law.

v.

To conclude, the problem of corporate ethics is profound. Corporations continue to evolve and, quite likely, grow in power and influence with the advent of consolidation and globalization. The day-to-day decisions of a business manager routinely have a moral component: Should the firm engage in a merger or acquisition transaction that would require massive layoffs? Should it spend more to ensure a cleaner environment or better working conditions when positive law would not require it? Should it provide safer products when the cost-benefit analysis suggests that liability would be cheaper? Should it submit to a government's demand to limit privacy or access to information as a condition of market entry? Should it take action that mitigates the tragedy of the commons such as global warming? The choices and actions of agents depend on the presuppositions: whether wealth maximization is a better default standard, and whether profit sacrifice is consistent with shareholder

143. Bratton, *supra* note 20, at 1451.

144. *Id.* at 1453. For example, the Wharton School of the University of Pennsylvania has an academic department and curriculum dedicated to business and market ethics. *See* Wharton, Legal Studies and Business Ethics, http://lgst.wharton.upenn.edu/ (last visited Feb. 10, 2008).

145. Bratton, *supra* note 20, at 1453.

146. *Id.* at 1454.

preference. The economic theories of the firm and agency cannot be devoid of ethical considerations for they have significant impact on how managers, who wield concentrated economic power, conceive their roles. Lastly, they have significant influence on the formulation of the rules of law, such as the business judgment rule, limited liability, takeover defenses, and shareholder democracy.