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The Corporation's Place in Society

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MORALITY, COMPETITION, AND THE FIRM: THE MARKET FAILURES APPROACH TO BUSINESS ETHICS. BY *Joseph Heath*. New York: Oxford University Press. 2014. Pp. ix, 372. $65.

The social responsibility of business is to increase its profits.

—Milton Friedman[1]

Economic justice is concerned with the fairness with which benefits and burdens . . . are distributed . . . among organizational stakeholders.

—Newman S. Peery, Jr.[2]

The vast majority of economic activity is now organized through corporations. The public corporation is usurping the state's role as the most important institution of wealthy capitalist societies. Across the developed world, there is increasing convergence on the shareholder-owned corporation as the primary vehicle for creating wealth.[3] Yet nothing like this degree of convergence has occurred in answering the fundamental questions of corporate capitalism: What role do corporations serve? What is the goal of corporate law? What should corporate managers do? Discussion of these questions is as old as the institutions involved.

Contemporary reflection on these questions takes the form of two starkly different and estranged orthodoxies.[4] Both are now decades old, but neither shows any sign of either subsiding or emerging victorious. In corporate finance, economics, and most of corporate law, the orthodoxy is that a corporation should aim exclusively to maximize shareholder value within

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1. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 32.

2. NEWMAN S. PEERY, JR., BUSINESS, GOVERNMENT, AND SOCIETY 12 (1995) (emphasis omitted).

3. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439–41 (2001).

4. Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level*, 61 FLA. L. REV. 1, 10 (2009) ("What is striking is that two different disciplines [of corporate law and business ethics] have apparently settled on two completely different answers to the central question in their fields—for whom should a corporation be governed? Even more striking has been the general lack of interest from either side in bridging the gulf between business ethics and corporate law." (footnote omitted)).

the constraints established by law ("shareholder theory").[5] In business ethics, the leading view is that corporate managers should balance the interests of all the constituencies affected by a firm's actions, including employees, suppliers, consumers, owners, and the broader society ("stakeholder theory").[6]

Joseph Heath's new book, *Morality, Competition, and the Firm*,[7] revisits these questions. Heath criticizes the two standard views and develops an alternative, which he calls a "market failures" approach (p. 1). Heath endorses much of the shareholder view, but offers a powerful critique of its application. In essence, he suggests that it is managers' ethical responsibility to pursue shareholder wealth maximization if, and only if, doing so is conducive to aggregate social efficiency.[8] Often this will be the case, but under

5. Academically, the shareholder value view is reflected in the leading treatises of corporate finance, economics, and corporate law. *See, e.g.*, Richard A. Brealey et al., Fundamentals of Corporate Finance 12 (8th ed. 2015) ("[T]here is a natural financial objective on which almost all shareholders can agree: Maximize the current market value of shareholders' investment in the firm."); Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, J. Applied Corp. Fin., Fall 2001, at 8, 8 ("Most economists would answer simply that managers must have a criterion for evaluating performance and deciding between alternative courses of action, and that the criterion should be maximization of the long-term market value of the firm."); Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 Wash. & Lee L. Rev. 1565, 1588 (1993) ("A favorite claim by law-and-economics reformers is that the principles of corporate law reduce to a single goal: maximize profit and shareholder wealth."). Nor is this view merely an academic conceit. See *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919), for what is certainly the most famous judicial articulation of this view: "[I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others . . . ." *See also* Reinier Kraakman et al., The Anatomy of Corporate Law 28 (2d ed. 2009) ("[I]t is sometimes said that the appropriate role of corporate law is simply to assure that the corporation serves the best interests of its shareholders or, more specifically, to maximize financial returns to shareholders . . . ."); *Businesses' Tax Dodges Are Burden to All*, Morning Call (Mar. 1, 2000), http://articles.mcall.com/2000-03-01/news/3292412_1_tax-shelters-tax-loopholes-federal-income-taxes [http://perma.cc/R4S8-8ZMR] ("The business of a corporation is to maximize its earnings for its shareholders[.]" (quoting then-House Majority Leader Dick Armey)).

6. Lumen N. Mulligan, *What's Good for the Goose Is Not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 Mich. L. Rev. 1981, 2004 (2007) ("By most accounts, stakeholder theory is the preeminent contemporary normative theory of business ethics, especially among business practitioners."); Robert Phillips et al., *What Stakeholder Theory Is Not*, 13 Bus. Ethics Q. 479, 489 (2003). *See generally* R. Edward Freeman, Strategic Management: A Stakeholder Approach (1984) (discussing stakeholder theory as a practical tool for business management); Robert Phillips, Stakeholder Theory and Organizational Ethics (2003) (discussing stakeholder theory as a dominant theory of organizational ethics).

7. Joseph Heath is a Professor in the Department of Philosophy and the School of Public Policy and Governance at the University of Toronto.

8. There are two principal conceptions of efficiency in welfare economics, termed Pareto efficiency and Kaldor-Hicks efficiency. One state of the world is a Pareto improvement over another if no one is worse off in the new state and at least one person is better off. A Pareto optimum exists when there could be no change to the state of the world that would make one person better off without making anyone worse off. Because of its extremely demanding conditions, major social policies are unlikely to ever constitute strict Pareto improvements. Even a law against fraud, for example, makes con artists worse off. As a result, the

conditions of market failure—when the allocation of goods and services in a market is inefficient for some reason—it is possible to increase shareholder wealth without contributing to social efficiency. Heath's approach forbids corporate managers from pursuing shareholders' interests when doing so exploits a market failure. This simple ideal of corporate managers as custodians of social efficiency turns out to have dramatic implications for business ethics.

The scholarship addressing what corporate managers should aim to achieve is extensive.[9] What sets Heath's book apart is the remarkable breadth of legal, economic, and political analyses that he brings to bear and the brilliance with which he synthesizes them.[10] This book is one of the new century's most important contributions to addressing capitalism's fundamental questions.

This Review begins with the foundations of the market failures approach and a critique of the shareholder and stakeholder views. Heath's critical project is largely successful and surely one of the most important contributions of the book. I then turn to the viability of the market failures approach. While sympathetic to the insights driving it, I ultimately find the market failures view to be far more exacting than Heath imagines it to be. Heath's book aspires to offer both compelling and realistic ethics for corporate managers, and it is in his second aspiration that I think he fails. This is, in itself, rather striking. Heath explicitly takes his vision of corporate purpose and managerial ethics to consist solely of the pursuit of efficiency, which he calls a kind of "implicit morality of the market."[11] Yet even the naked goal of social efficiency imposes a set of moral requirements so demanding as to be plainly utopian.

I then turn to what I take to be a clear-eyed—some might say pessimistic—assessment of the prospects for any demanding business ethic within the specific institutional environment of today's corporate marketplace. Specifically, I argue that features of that marketplace effectively punish any form of ethical conduct that cuts into corporate profits. In the current configuration, business ethics with bite is thus in a very real sense unsustainable. I

Kaldor-Hicks criterion of efficiency was developed. A change in the world is Kaldor-Hicks efficient if those who are better off as a result of the change could compensate those who are worse off, so that no individual was worse off, and at least one person was still better off. Jules L. Coleman, *Economics and the Law: A Critical Review of the Foundations of the Economic Approach to Law*, 94 Ethics 649, 649–51 (1984); *see also* J.R. Hicks, *The Foundations of Welfare Economics*, 49 Econ. J. 696, 700–01, 706 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 Econ. J. 549 (1939).

9. *See supra* notes 4–6; *infra* Section I.A.

10. This Review cannot hope to cover the vast number of topics that Heath discusses in his provocative, nearly 400-page book, but students of applied ethics, sociology, political philosophy, corporate law, and economics will all find much of interest.

11. P. 173. Heath borrows this phrase from Christopher McMahon. *See* Christopher McMahon, Public Capitalism: The Political Authority of Corporate Executives 117 (2012).

suggest how we might imagine alternative environments in which corporations can aspire to more than profit.

I. What Are Corporations For?

There is nothing intrinsically valuable about the interests of shareholders. So how did a single-minded emphasis on pursuing their interests become the dominant view of corporate purpose across economics, corporate law, and finance? Few slogans have put down as deep roots in the academic, popular, and political imaginations as Milton Friedman's famous declaration that "*The Social Responsibility of Business Is to Increase Its Profits*."[12] Seeing the appeal of this view is thus important. Surprisingly, the easiest way to do so is through sketching the case for Heath's own approach.

The basic architecture of the market failures approach is to focus on the normative goal of a system of private, market-based competition among producers and consumers, and then to elaborate a set of ethical principles based on promoting that goal. The goal is a simple one—social efficiency. The simplest way to see this is that the law actually prohibits forms of cooperation that are promoted by everyday morality, effectively demanding that firms compete with one another. In particular, antitrust laws generally prohibit agreements among businesses in the same area to stop competing with each other.[13] Corporate managers who agree, for instance, to charge the same price—and thus to "defect" from market competition—can go to prison as a result.[14] This is despite the fact—or rather because of it—that price competition is a kind of prisoner's dilemma for the firms involved, in which the outcome is suboptimal for all of them, but conducive to economic efficiency at a social level.[15]

Thus, the highly competitive markets that are characteristic of developed economies do not simply appear by happenstance. They arise within a well-structured legal environment, which clearly defines and enforces contract and property rights[16]—and as mentioned, firms compete within a legal environment that expressly prohibits cartelization.[17] A well-functioning market is thus a kind of staged competition or institutionalized collective-action problem designed to achieve the benefits of specific forms of competition and avoid the pathologies associated with monopolies or price-fixing (pp. 5, 33).

The reason for seeking competitive markets is explained on the first day of Economics 101. A competitive market leads to an efficient allocation of

12. *See* Friedman, *supra* note 1, at 32.

13. Sherman Antitrust Act, 15 U.S.C. § 1 (2012) (making contracts, combinations, and conspiracies in restraint of trade potential felonies).

14. *Id.*

15. *See* p. 33.

16. Hernando de Soto, The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else 6–10 (2000).

17. Sherman Antitrust Act § 1.

resources.[18] Goods and services are directed toward those who express the greatest willingness to pay for them, and informative prices arise from the equalization of supply and demand.[19] Heath thus takes efficiency to be the ultimate justification for market-based capitalism and the appropriate goal of corporate managers (p. 10). Markets are "essentially special-purpose institutions designed to promote efficiency" (p. 10).

It would be more accurate to call the "market failures" approach to business ethics an "efficiency" account, as its guiding idea is that the ethic of business managers is to operate corporations to promote social efficiency. It bears emphasizing that this does not mean corporate managers are supposed to have social efficiency in mind whenever they make business decisions. In any adversarial context, participants can generate social benefits by competing against each other—benefits that they need not personally have in mind (p. 28). For example, lawyers contribute to the justice of the adversarial system by zealously pursuing their clients' cases, and athletes contribute to great athletic spectacles by pursuing their own victories.[20]

Indeed, managers' usual contribution to competitive markets is competing well, which means maximizing the value of the firm's net product. This is equivalent to maximizing the value of the residual claim, that is, the return to owners. Because most firms are owned by equity shareholders, maximization of the residual claim means maximizing profits (profit is the revenue of a firm leftover after all of a firm's contractual obligations have been satisfied).[21] Thus, the typical way in which managers promote social efficiency *is by pursuing shareholder wealth maximization*. Heath thus walks us through the basic insights that lead quite naturally to the shareholder wealth maximization view of corporate ethics. That view boils down to the thesis that markets in which profit-seeking firms compete against each other generate benefits for all of society, and that the way to best ensure that firms are maximally profit-seeking are for managers to maximize the profits of a firm's owners (pp. 28–33).

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18. This well-known idea is formalized in the First Fundamental Theorem of Welfare Economics, which states that under certain general assumptions, a competitive equilibrium leads to a Pareto-efficient allocation of resources, which is a condition in which no one can be made better off without someone else being made worse off. This general conception of a competitive equilibrium is a foundation for welfare economics in general. *See* Hal R. Varian, Intermediate Microeconomics: A Modern Approach 522 (5th ed. 1999).

19. *See, e.g.*, Paul Anthony Samuelson, Foundations of Economic Analysis 238–39 (photo. reprint 1971) (1947).

20. *See* p. 28.

21. *See* p. 31. The people best suited to ensuring that firms are competitive are their owners, for the simple reason that the owners of a business are its residual claimants—the group entitled to all of the profits of a firm, but only its profits. Other individuals involved with a firm, such as employees, bondholders, suppliers, and consumers, are fixed claimants—they have a specific contractual agreement with the firm, which grants them some fixed sum. Not so with owners, who are entitled only to any firm revenue that is leftover once everyone with a fixed contractual claim has been paid—that is, to profit. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416, 1446–47 (1989).

A. *The Market Failures Approach*

So how does the market failures approach differ from the shareholder view? The key idea of the market failures approach is that, while pursuing shareholder wealth maximization will promote social efficiency under many circumstances, there are a wide variety of situations in which this is not the case. Under those circumstances, corporate managers are obliged to *not* maximize shareholder value because doing so does not promote social efficiency.

There are two important and distinct claims here. The first is identifying the conditions under which pursuit of firm profitability does not promote economic efficiency. These conditions are referred to as *market failures*.[22] For market competition to generate Pareto efficiency, a number of restrictive conditions known as the Pareto conditions must be in place. When one or more of these conditions is not satisfied, a market will not reach a Pareto optimal condition—it will, put plainly, fail to be efficient.[23] Well-known market failures include information asymmetries, externalities, and public goods.[24] These market failures are unfortunately common.[25] The simplest example of a market failure may be pollution, which is a negative externality. A negative externality is a situation in which one party imposes the costs of a decision he makes on another party without fully compensating that party. So, while it is comparatively easy to protect individuals' property rights against trespass over their land, it is very difficult to enforce an individual's right to clean air over her house. As a result, industrial firms can produce harmful toxins that permeate the atmosphere and go unpunished, allowing them to effectively externalize the costs of their firms' business on the local citizens.[26]

When it is difficult to enforce property rights, say over air, a negative externality may occur. In that case, the market could fail because the polluting business does not need to price the cost of its pollution into its activity.

22. *See* Paul A. Samuelson & William D. Nordhaus, Economics 677 (19th ed. 2010) (defining market failure as "[a]n imperfection in a price system that prevents an efficient allocation of resources"); Joshua D. Wright, *The Antitrust/Consumer Protection Paradox: Two Policies at War with Each Other*, 121 Yale L.J. 2216, 2222 (2012) ("A market failure occurs when functioning markets fail to realize full gains from trade through efficient production."); *see also* Bernard Salanié, Microeconomics of Market Failures 1 (MIT Press 2000) (1998) (defining market failures as "circumstances where market equilibrium is not optimal").

23. *See* Christopher R. Leslie, *Achieving Efficiency Through Collusion: A Market Failure Defense to Horizontal Price-Fixing*, 81 Calif. L. Rev. 243, 267–69 (1993).

24. Harvey S. Rosen, Public Finance 47–48 (7th ed. 2005); Maxwell A. Miller & Mark A. Glick, *The Resurgence of Federalism: The Case for Tax-Exempt Bonds*, 1 Tex. Rev. L. & Pol. 25, 29 (1997).

25. *See generally* Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 Harv. L. Rev. 1593, 1602 (2014) ("Familiar types of market failure include externalities, asymmetric information, and market power."); Benjamin K. Sovacool, *Placing a Glove on the Invisible Hand: How Intellectual Property Rights May Impede Innovation in Energy Research and Development (R&D)*, 18 Alb. L.J. Sci. & Tech. 381, 383 (2008).

26. *See* Miller & Glick, *supra* note 24, at 29–30.

Under such circumstances, pursuing shareholder profit by polluting maximizes the firm's value, but rather than promoting social efficiency, it enriches shareholders at the expense of society.

Heath's prescription is simple: in such cases, managers must not engineer or exploit the market failure. The "set of permissible profit-maximizing strategies is limited to those strategies that would be permissible under conditions of perfect competition" (p. 34). Corporate managers should not pollute (beyond what is socially desirable), seek monopolies, seek to deceive their customers about the quality of their products, erect barriers to entry, or otherwise bring about or exploit a market failure (pp. 36–37).

Instead, it is the duty of corporate managers to avoid adopting any business strategy that increases firm profitability by exploiting some market failure (p. 37). Corporate managers may not pursue shareholders' interests when they come at society's expense (pp. 38–39). The approach's major claim is as follows:

> [T]he market is essentially a staged competition, designed to promote Pareto efficiency, and in cases where the explicit rules governing the competition are insufficient to secure the class of favored outcomes, economic actors should respect the spirit of these rules and refrain from pursuing strategies that run contrary to the point of the competition. (p. 5)

The market failures approach diverges from the shareholder view by insisting that when the justificatory link between shareholder wealth maximization and social efficiency breaks down, managers not only cease to have an obligation to maximize shareholder value, but they are obligated to avoid pursuing it when doing so exploits some market failure (pp. 31, 36–37). As Heath puts it, "[a] competitive market only serves to promote efficiency under certain conditions, and there are various ways of acting that subvert it. Such actions are not just unethical, but egregiously so, because they fail to satisfy even the artificially low standard that is set for the evaluation of marketplace behavior" (p. 10).

I consider concerns about implementation in Part II, but putting those aside, it is difficult to disagree with Heath's revision of the standard corporate finance view. After all, few in economics, corporate finance, or corporate law think there is something intrinsically valuable about serving shareholders' interests; rather, serving those interests makes sense in a broader picture in which doing so serves society's interests. The link between those two, however, is contingent. It requires an absence of market failure, and when markets fail, so may the link between shareholder value and social efficiency.

Two naïve illusions may nonetheless fuel the position that the pursuit of shareholder value within the constraints of law exhausts managers' moral obligations. One is that markets never fail in important ways. Given the experience of the last few decades with important market failures—including negative externalities like pollution, underproduction of public goods, information asymmetries, and market power—this position seems remarkably Pollyannaish. One need only recall the fairy-tale conditions under which the Coase theorem or First Fundamental Welfare theorem hold.[27]

The second illusion is that when markets fail, the government should resolve those failures, and if it does not do so, it is not managers' obligation to do the right thing. This view cannot survive scrutiny either. First, even in principle, legal interventions are extremely costly and intrusive and face considerable difficulties in detecting and punishing all incidences of wrongdoing (p. 34). Even more importantly, the process of passing legislation is subject to a widely documented set of pathologies that make it difficult even for responsive democratic governments to pass desirable laws.[28]

Lest Heath's account sound like that of a philosophical radical, it is worth examining precisely how close his view is to the mainstream of corporate law. A leading treatise on the subject, *The Anatomy of Corporate Law*,[29] provides a brief account of the normative foundations of the authors' theory of corporate law. Authors Henry Hansmann, Reinier Kraakman, and others ask, "[w]hat is the goal of corporate law?" and answer that "[a]s a normative matter, the overall objective of corporate law—as of any branch of law—is presumably to serve the interests of society as a whole[,]" and in particular, "the aggregate welfare of all who are affected by a firm's activities, including the firm's shareholders, employees, suppliers, and customers, as well as third parties such as local communities and beneficiaries of the natural environment."[30]

They then turn to the narrower proposition that the goal of corporations should be to serve the interests of shareholders or maximize the firm's value for them. It is a claim Hansmann and Kraakman have endorsed elsewhere,[31] but Hansmann and Kraakman's service in *The Anatomy of Corporate Law* is to disambiguate two distinct interpretations of that claim. One interpretation is to take the assertion at face value as saying that the sole

27. *See* pp. 3, 34.

28. *See, e.g.*, Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups 22–57 (1971).

29. Kraakman et al., *supra* note 5. Heath is clearly familiar with the seminal treatises on corporate law. *See, e.g.*, p. 123.

30. Kraakman et al., *supra* note 5, at 28. Kraakman and his coauthors equate "the aggregate welfare" with "overall social efficiency" and Kaldor-Hicks efficiency, and I use these terms interchangeably here as well. *Id.* More precisely, they equate social welfare with "Kaldor-Hicks efficiency within acceptable patterns of distribution"—an important caveat. *Id.* at 28 n.79; *see also* William T. Allen et al., Commentaries and Cases on the Law of Business Organization 7 (3d ed. 2009) (urging the use of Kaldor-Hicks efficiency as the criterion for evaluating corporate law and corporate governance arrangements).

31. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Reflections on the End of History for Corporate Law*, *in* The Convergence of Corporate Governance: Promise and Prospects 32, 32–33 (Abdul A. Rasheed & Toru Yoshikawa eds., 2012) ("The strongest and clearest claim we make is . . . that what we term the 'standard shareholder oriented model' (SSM) . . . is the most attractive social ideal for the organization of large-scale enterprise."); Hansmann & Kraakman, *supra* note 3, at 439 ("There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.").

interest of corporate law is maximizing value for shareholders. They dismiss this interpretation, noting that "[t]here would be little to recommend" a system in which creditors or employees lost $2 for every $1 shareholders gained.[32] Instead, they endorse a second interpretation, which is that "focusing principally on the maximization of shareholder returns is, in general, the best means by which corporate law can serve the broader goal of advancing overall social welfare."[33]

In essence, the market failures approach claims that corporate managers should seek to maximize shareholder value when and only when it promotes aggregate efficiency, serving the interests of society as a whole.[34] Generally, pursuing shareholder wealth does promote social efficiency, but under certain identifiable circumstances, this is clearly not the case. In those situations, Heath insists, the very foundations of a view like Hansmann and Kraakman's require that corporate managers not pursue shareholders' profits.

B. *Stakeholder Theory*

The most important alternative to the corporate finance view is stakeholder theory, which Heath subjects to exacting criticism. Stakeholder theory claims that corporations should treat their many constituents—shareholders, employees, creditors, consumers, neighborhoods—equally, carefully balancing their interests when they conflict.[35] Heath's objections to stakeholder theory generally fall into two broad camps. The first set of criticisms aims to deflate motivations for the theory by showing that ordinary adversarial marketplace behavior is neither principally about self-interest nor immoral, contrary to certain commonsense intuitions that motivate some stakeholder theorists. The second set of criticisms aims to show that a firm that genuinely catered equally to the interests of all of its patrons or constituents, as desired by stakeholder theory, would be significantly inefficient. This matters because stakeholder theory does not present itself as an alternative to capitalism, like socialism. Instead, it presents itself as a conception of *business ethics* to be taught to *corporate managers*. As a result, it would be a very curious feature of such a view if it was foundationally incompatible with a competitive corporate marketplace.

32. Kraakman et al., *supra* note 5, at 28.

33. *Id.*

34. Heath refers to his own view as "Paretian," p. 5, but given the near-impossibility of genuine Pareto improvements when a policy dramatically alters a business's strategy, it seems more accurate to conceptualize his account as aiming at Kaldor-Hicks efficiency. It is worth noting that while Heath's view is a novel entrant to the current debate in business ethics, his general position that the structures of a market economy are justified where (and only where) they serve the interests of society as a whole is at least as ancient as Aquinas.

35. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 253 (1999); Kevin Gibson, *The Moral Basis of Stakeholder Theory*, 26 J. Bus. Ethics 245, 245–46 (2000); *see also* Julia Sferlazzo, *Learning Legal Ethics from MBAs: How a Comparison of Legal and Business Ethics Could Promote Ethical Professional Behavior*, 25 Geo. J. Legal Ethics 769, 773 (2012).

A preliminary confusion, while not especially sophisticated, is sufficiently widespread to merit attention. In substance, this position posits that shareholder wealth maximization merely glorifies the self-interest of shareholders and that the exclusive pursuit of self-interest is a bad thing. Equating self-interest with shareholder wealth maximization is confused, however, at least if treated as a criticism of shareholder value as a goal of corporate law or corporate managers. After all, shareholder wealth maximization is typically not the self-interested goal of corporate managers. The natural goal of corporate managers is to *enrich themselves*, rather than shareholders. Indeed, this problem of corporate managers' interests not being aligned with that of a firm's owners is widely considered the chief problem for corporate law to ameliorate.[36]

Heath persuasively demonstrates that stakeholder theory dramatically exacerbates the principal-agent problem between shareholders and corporate managers. He points out that the developed world actually has ample experience in the operation of stakeholder-oriented firms (pp. 55–58). After all, in the mid-twentieth century, it was common for the governments of wealthy nations to operate major corporations that were expected not only to turn a profit, but also to serve other social responsibilities (pp. 55–57). Heath surveys the ample social-scientific evidence on the difficulties these state-owned enterprises faced in accomplishing their goals. The bottom line is that these firms failed not only to be profitable, but also to produce many of the social benefits they were supposed to achieve. They became instead havens for unprofitability and for opposition—within the government-owned enterprise—to state regulation of market failures (pp. 57–58).

A different line of criticism of stakeholder theory builds on Henry Hansmann's enormously influential work on corporate ownership.[37] One of Hansmann's most interesting contributions is showing that while most firms are owned by shareholders—contributors of equity capital—every one of the firm's constituents sometimes owns a firm.[38] So, in a dairy cooperative, suppliers jointly own the business; in a mutual insurance company, the customers own it; in a law firm, the partners collectively own it, and so on.[39] Hansmann's analysis of when a given constituent will own a firm—and of why shareholders are such prevalent owners—centers on the political costs of ownership.[40] In general, the most efficient owners of the firm tend to be the stakeholders who share homogenous interests in the firm's performance.[41] The more heterogeneous the desires of the owners, the more conflict

36. *See, e.g.*, Kraakman et al., *supra* note 5, at 35–53.

37. *See* chapter 5.

38. Henry Hansmann, The Ownership of Enterprise 12–16 (1996); *see also* Henry Hansmann, *Ownership of the Firm*, 4 J.L. Econ. & Org. 267 (1988).

39. Hansmann, The Ownership of Enterprise, *supra* note 38, at 13–16.

40. Hansmann, *Ownership of the Firm*, *supra* note 38, at 277–78.

41. *Id.* at 278.

there is among owners, and the harder it becomes to assess whether management is performing well.[42] From this perspective, stakeholder theory poses an enormous problem for efficiently run businesses because it requires managers to attempt to equally balance the interests of all constituents, effectively importing into every firm the defects of extremely heterogeneous owner interests. The problem is that *no firm is owned by all of its patrons* and almost no businesses are even owned by multiple groups of patrons.[43] The total absence of such firms is powerful evidence that there are deep inefficiencies introduced by management that must cater to heterogeneous stakeholders.

II. The Prospects for Business Ethics: A Critical Assessment

"[T]he point of philosophy is not just to understand the world, but to change it."[44] Heath laudably thinks the point of business ethics is to improve the quality of corporate management. He notes that while "[m]any business ethicists . . . deny that they have any ambition to make people behave more ethically[,]" he "actually consider[s] that objective to be central to [his] task" (p. 12). Indeed, Heath is emphatic in his belief that:

> [T]he central role of business ethics is to . . . correct the self-understanding of participants in the market economy, who are being bombarded—both by the business press and a certain segment of the academy, who appear not to have recovered from the epiphany they experienced in their first-year economics class—by a seductive but ultimately false suggestion that the institutions of the market free them from all forms of moral constraint. (p. 19)

Thus, while Heath's theory may have implications for a variety of domains, its central ambition is to offer realistic prescriptions for the business ethics that managers should be taught.

Unfortunately, the market failures approach faces some debilitating and potentially fatal problems. In fact, these problems generalize across the entire class of theories in business ethics that ask more of corporate managers than the shareholder approach does. This diagnosis is rather grim, but it is necessary to understand the obstacles that business ethics faces to make progress.

A. *The Problem of Competition*

The most immediate problem is the competitive structure of the economy itself—a "staged competition" (p. 5) in which we deliberately pit businesses against each other in an adversarial contest designed to produce

42. *Id.* at 279.

43. *But see* p. 130.

44. P. 12. This is, of course, an echo of Marx's famous declaration that "The philosophers have only *interpreted* the world in various ways; the point is to *change* it." Karl Marx, *Theses on Feuerbach*, *in* The German Ideology 571 (1998).

certain efficiency benefits. In this competitive environment, any firm willing to substantially reduce its profits to act more ethically will see its market share progressively diminish until it goes out of business. Deliberately raising prices to act ethically is unsustainable unless every other competitor also does so (p. 85). This is because the character of market competition selects out unprofitable firms and makes no exceptions for unprofitability driven by ethical conduct. Thus, in highly competitive industries, firms opting to eschew profitable, legal, but unethical business strategies are unlikely to survive. The very structured competition that makes the market effective in establishing useful incentives and generating informative prices will punish conduct designed to unilaterally serve the ends of the broader society.

Heath's book hints at a response to this objection,[45] which is that business ethics should strive to facilitate multilateral action by corporate managers to stop exploiting some market failure or avoid engineering or exploiting new market failures. This is not as far-fetched as it may seem. There are other areas of the economy that are highly competitive but in which ethical behavior is widely observed—ethical behavior that eats into profits. We do not generally think that doctors prescribe the most expensive drugs and treatments possible simply because they can. The medical profession, we think, instills in its members norms that have at least some ethical bite.[46] Heath suggests that through iterative interactions, managers in the same industry may build up sufficient trust with one another so as to enter agreements to each avoid taking advantage of some market failure (p. 38).

Agreements among corporate managers to jointly engage in unprofitable ethical conduct, however, will suffer from the same powerful temptation to "defect," which makes agreements to fix prices so unstable, even in the absence of antitrust enforcement.[47] Because a member of a cartel can always make more money by unilaterally defecting and lowering prices, cartels are inherently unstable.[48] Agreements sacrificing profit would also be unstable because such industries would attract new and less scrupulous entrants.[49] These problems do not suggest that agreements among managers to act unprofitably but ethically are impossible—only that they are difficult.

45. *See* p. 38.

46. *See* p. 71 (noting the medical profession's "stringent" code of conduct enforced by mechanisms such as medical licensing boards). There are legitimate questions as to whether the ethical professionalization of corporate managers is a plausible goal. Management certainly lacks the historical pedigree and accrued norms of other professions, such as law, medicine, or engineering, but there are some hints that MBA students are beginning to take the idea of ethical norms seriously. *See, e.g.*, Robert Rhee et al., *Ethical Issues in Business and the Lawyer's Role*, 12 Transactions: Tenn. J. Bus. L., no. 3, 2011, at 37, 37 (discussing Harvard and Columbia business schools' requirement that MBA students make pledges to act ethically and responsibly).

47. *See* Christopher R. Leslie, *Trust, Distrust, and Antitrust*, 82 Tex. L. Rev. 515, 524–25 (2004).

48. *See id.* at 526.

49. *See id.* at 565.

To recap, the first distinct problem facing business ethics is the competitive structure of the corporate marketplace. Firms run by ethical managers willing to sacrifice profit for society's interests will likely be eliminated by competitors in the long run. Let us assume, however, that because of managers' professionalization, business ethics avoids this obstacle.

B. *The Problem of External Control*

A second distinct problem will still arise to bar business ethics with bite from surviving. This is the fact that corporate managers ultimately answer to a corporation's shareholders.[50] Even if business ethicists succeeded in instilling in corporate managers a sense of their high ethical vocation, ethical managers would soon be weeded out by less ethical owners, unless the latter were also converted. If profits began to decline at a firm or even across an entire industry, shareholders would quickly assemble at the next board of directors meeting and select a new board. This board would promptly fire the ethical officers and replace them with less scrupulous successors. Unlike the partners of a law firm, who must answer solely to each other, the managers of a public corporation must answer to the unprofessionalized shareholders of the firm. There is, of course, some room for slack, even in competitive product markets with competition for corporate control as well. Managers are able to extract some private benefits—and create some public benefits—without repercussions, but the competitiveness of both markets will impose important limits.

It seems to be a curious myopia of business ethics—in which, unfortunately, Heath is also guilty—that it has largely sought to reimagine the ethics of managers without revisiting the ethics of owners or consumers as well. We are left groping for a reason why business ethics has left our broader understanding of capitalism and its central regulatory institutions untouched. Perhaps it is that in everyday life we do not expect there to be a class of controlling persons who oversee and systematically punish the altruistic for their sacrificial conduct. But this is exactly the situation that will face socially minded managers in a world in which nothing has changed the perspective or control of shareholders over firms' management. Unlike, perhaps, personal ethics, you simply cannot formulate viable business ethics for corporate managers without paying careful attention to the corporate environment.

Even a publicly traded firm *both owned and managed* by individuals who subscribed to a market failures philosophy would be dynamically unstable. The share price of that company's stock would be depressed relative to what its value would have been if the company acted less ethically. The price of a public company's shares reflects the discounted value of the future cash flows associated with that company.[51] If that company had made an ethically

50. *See, e.g.*, Edward B. Rock, *The General Counsel of a Nonprofit Enterprise: Some Questions*, 46 Hous. L. Rev. 17, 19 (2009).

51. Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. Pa. L. Rev. 1, 47 (2007) ("In

driven decision to be less profitable, then the share price would reflect that long-term drop in profitability. This depression of the share price, however, creates an automatic profit opportunity for a prospective purchaser willing to take control of the firm and reverse course. As a result, for the very reason of their ethical conduct, ethical firms would be perennial takeover targets.[52] We should expect business ethics that target solely corporate managers to suffer greatly at the hands of an ownership class if the owners remained indifferent to those ethical values.

If this seems extreme, consider the effects of adopting a market failures approach on some of the largest corporations. Assume that the scientific majority is correct that adverse global climate change is driven by current human levels of carbon use. If so, the carbon used in fossil fuels is enormously underpriced because of a market failure that prevents the price of carbon products from reflecting environmental harms caused by carbon use.[53] Part of the profit of major oil companies, such as ExxonMobil, is driven by the fact that they sell products that are hugely underpriced—as opposed to how they would be priced in a complete market—since they benefit from market failure. Imagine, if you can, that the senior management of ExxonMobil decided to begin pricing their products at a level that reflected the actual cost of those products to society. That is, they decided to stop exploiting the market failure. According to current estimates, they would have to voluntarily pay $85 per CO-2 ton.[54] Adopting this policy would not only cause Exxon's share price to drop, it would cause it to plummet. Even if the owners did not sue management,[55] either their own shareholders or new owners would soon fire them. The new owners would

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both finance theory and the appraisal remedy, the value of a shareholder's stock is the pro rata value of the discounted future free cash flows . . . .").

52. The shareholder approach does not face this obstacle. Agency costs are overwhelmingly more likely to make a corporation unprofitable than profitable, so corporations that are better at controlling agency costs should be more likely to survive in the long run. *Id.* at 36.

53. *Cf.* Timothy J. Brennan, *Prizes Versus Patents: A Comment on Jonathan Adler's* Eyes on a Climate Prize: Rewarding Energy Innovation to Achieve Climate Stabilization, 42 Envtl. L. Rep. 10719, 10719 n.7 (2012) ("The primary virtue is that if carbon used in fossil fuels is underpriced because environmental harms, particularly from climate change, are not incorporated in the price, then a carbon tax comes closer to getting prices right in the economy rather than force a gap between prices and marginal cost.").

54. Nicholas Stern, Executive Summary of Stern Review: The Economics of Climate Change xvi (2007), http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/Executive_Summary.pdf [http://perma.cc/8XT2-837S].

55. It is unclear whether a firm's owners could have a viable suit against their managers for breach of fiduciary duty if management were to avoid a profitable business strategy for ethical reasons. The substantial discretion provided to corporate managers by the business judgment rule may protect them from such a suit, and the case law of many states suggests that their highest courts do not share the view of many corporate scholars that the duty of corporate managers is solely to maximize shareholder value within the constraints of law. *See generally* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. Rev. 733, 738 (2005) ("Corporate managers . . . have always had some legal discretion (implicit or explicit) to sacrifice corporate profits in the public interest. . . . None of the fifty states has a statute that imposes a duty to profit-maximize or that makes profit-maximization the sole

acquire shares at low prices, intending to quickly increase shareholder value (at society's expense) by reversing corporate policy. This example is not chosen at random. The Stern Report, probably the best known government report on the subject, notes that "[c]limate change presents a unique challenge for economics: it is the greatest and widest-ranging market failure ever seen."[56]

This is a point worth emphasizing. Any approach to business ethics that bites into the profits of a firm but ignores the market for corporate control is going to suffer enormous problems in achieving any acceptance. Realizing a market failures or "efficiency" approach to business ethics thus faces considerable obstacles, which is something to reflect on. Market efficiency on its own implies a set of moral demands that are so startling in their scope as to seem almost utopian.

So, what is to be done? I propose a brief suggestion, not as an actual candidate for reform (it is too radical for my taste), but rather as an illustration of the kind of dramatic change to the corporate control environment that might ease some of the tensions facing business ethics. There has been an increasing trend over the last fifteen years for U.S. financial legislation to include substantive corporate governance requirements.[57] There has also been a recent rethinking of what exactly the status of being a "public" corporation should entail.[58] At the intersection of these two developments is a candidate for the kind of structural reform that is likely necessary for a vision of business ethics like Heath's to become feasible. The idea is to have a "market failures" independent director on the board of each public company. This director would ensure that the firm did not exploit any market failure, or more modestly, ensure that a firm did not try to engineer any new

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purpose of the corporation. . . . [T]he influential Principles of Corporate Governance by the American Law Institute (ALI) explicitly state that common law fiduciary duties do not prohibit managers from sacrificing profits to further the public interest . . . ."). *But see* Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. Davis L. Rev. 581, 605 (2002) ("Since the early-twentieth century case of *Dodge v Ford*, corporations have been deemed to have an 'unyielding' duty to look after the interests of the shareholders, which has been translated into a duty to maximize profits." (footnotes omitted)).

56. Stern, *supra* note 54, at i.

57. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. This trend has not been without its able and trenchant critics. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521, 1528 (2005); Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, Reg., Spring 2003, at 26, 31.

58. *See, e.g.*, Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 Geo. L.J. 337, 338 (2013); Hillary A. Sale, *The New "Public" Corporation*, 74 Law & Contemp. Probs. 137, 141 (2011); Hillary A. Sale, *Public Governance*, 81 Geo. Wash. L. Rev. 1012, 1013–14 (2013).

market failure. So, for instance, such a director might oversee a firm's lobbying activities to check whether the firm was inappropriately seeking to dissuade government officials from trying to regulate some market failure.[59] These market failures directors might also be part of organizations within industries devoted to reaching consensus on how that industry might stop exploiting a given market failure.

Conclusion

The obstacles of competition and owner control, while significant, should not cause us to despair. For inspiration, just look to the ingenuity that scholars have devoted to the central quest of corporate law—aligning the interests of managers with shareholders to overcome the agency problem created by the separation of ownership and control. Boards of directors, independent directors, the market for corporate control, shareholder empowerment, incentive contracts—the list of devices heralded at one time or another as the silver bullet for agency costs goes on and on.[60] Heath's book is a clarion call for scholars of corporate law and corporate finance to start taking seriously how the corporate environment could be altered to make it easier for corporations—as well as the government—to take steps to eliminate market failure. Imagining a more robust ethics for corporations requires carefully and comprehensively rethinking the institutional and social environment in which they function. Perhaps the greatest contribution of Joseph Heath's wonderful book is to have clarified this task ahead.

59. *Cf.* Leo E. Strine, Jr. & Nicholas Walter, *Conservative Collision Course?: The Tension Between Conservative Corporate Law Theory and* Citizens United, 100 Cornell L. Rev. 335, 385 (2015) (noting that the ultimate shareholders of for-profit corporations are humans with concerns about the negative externalities that a profit-seeking motive alone may cause). Another possible response—which I owe to Heath—is the use of "other constituency" statutes, which explicitly permit managers to consider nonshareholder interests. *See* A.A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 Del. J. Corp. L. 33, 41 (1991).

60. *See, e.g.*, Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 Colum. L. Rev. 231, 232 (2008).