Caveat Investor: An Alternative to the Fiduciary Theory of the Corporation

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Here is a common way of thinking about the corporation. Shareholders own the assets of a business enterprise, but they do not have the time or expertise to manage them, so they hire full-time managers to do it for them. In hiring managers, shareholders empower these individuals to control the corporation's assets for the purposes of maximizing their returns. By accepting managerial positions, managers take on a positive obligation to make decisions that will promote the basic objective of shareholders. So as managers make decisions about what products to make, how to make them, how to market them, and so on, they have both the authority and an obligation to make as much money for their shareholders as they can, within the constraints of the law and morality. If at some point they make a decision that aims to promote some other goal besides making money for shareholders—say, saving the rainforest—they both overstep the bounds of their legitimate authority over the corporation's assets and violate their fundamental duty to

shareholders. They are essentially "hijacking" the corporation for their own personal use.[1]

Let's call the common way of thinking I just described the *fiduciary conception* of the corporation. The conception is "fiduciary" in the sense that it is based on the idea that when shareholders invest in a corporation, they *entrust* the management of their assets to its corporate officers. As a moral theory of the corporation, the fiduciary conception is supposed to offer us a set of ideas that will help us to think through questions about the obligations of managers, while at the same time providing us with an illuminating justification for these conclusions. I will argue, however, that the fiduciary conception fails to do this. In particular, it fails to come to terms with an important aspect of the corporation, namely its *independent* character. The fiduciary conception paints a highly personal picture of the connection between managers and shareholders, and this seems to conflict with many common sense intuitions about the nature of a corporation.

My plan for this paper is as follows. I will begin by articulating the fiduciary conception in a way that brings out its moral underpinnings, and then I will criticize the view for failing adequately to account for the independent nature of the corporation. Once I have set out the fiduciary view and criticized it, I will begin to develop an alternative conception, one that appeals to a different set of ideas to make sense of the corporation and the obligations of managers within it. My view will accommodate the independent character of the corporation better than the fiduciary conception does, and I believe that it will show that the obligation of managers to pursue the interests of shareholders is not nearly as strict as it is sometimes taken to be. My overarching goal is to

deflate the character of the managerial obligation to pursue the interests of shareholders, making room for a more complex view of what the obligations of managers might be.

1. The fiduciary conception of the corporation

I want to begin by articulating the moral idea that underlies the fiduciary conception of the corporation. The best way to do this is by means of an example.

Imagine that your parents are coming to visit you this weekend and you want to pick them up at the airport. Unfortunately, you have a scheduling conflict and you can't pick them up yourself, so you ask your friend to do it for you. Suppose that he accepts. We might say, at this point, that you *entrust* your friend with the task of picking up your parents with your car. By entrusting him with this task, you have done two things. First, you have given him a certain limited authority to make decisions about your car. When you give him the keys, your friend gains *de facto* control over your car, but since you have not transferred *ownership* to him, whatever authority he has over the car derives ultimately from your authority over it. Insofar as you give him the car for the purpose of picking up your parents, it is natural to think that his authority over the car extends only as far as is necessary for him to carry out this task. Second, by accepting, your friend now has a positive obligation to use his *de facto* control over your car actively to pursue your ends. So if the weekend comes around and your friend makes no effort to get your parents, there is no obvious sense in which he has overstepped the bounds of his legitimate authority over the car—he has not used it in ways that are impermissible. Nonethe-

less, by failing to make any effort to get them, he *has* violated his positive obligation to pick them up, an obligation that stems from the fact that he agreed to do this for you.

To illustrate the significance of the underlying idea, suppose that your friend is on his way to the airport to pick your parents up and the car starts running low on gas. Though you did not specifically tell him that he could stop off at a gas station to fill up, there would be nothing wrong with him pulling over and doing so. Stopping for gas is essential if he is going to pick your parents up, so it both falls within the purview of his delegated authority over your car and is consistent with his positive obligation to further your ends. But now suppose that your friend decides to drive down to Daytona Beach for Spring Break. Driving to Daytona Beach has nothing to do with picking your parents up, so your friend is overstepping the bounds of his legitimate authority over your car—he is "hijacking" it for his own purposes. Moreover, since going to Daytona Beach will interfere with his getting to the airport on time, he is also violating his positive obligation to pick your parents up.

The fiduciary conception uses the idea of "entrusting people" as the basis for a moral theory of the corporation. It starts with the idea that we each have a certain moral power to entrust people with our property for the purposes of pursuing our ends—the case of entrusting your friend to pick your parents up at the airport is one example. The fiduciary conception suggests that shareholders exercise this same power when they empower managers to make money for them using their assets. Shareholders are in a position analogous to you in the example and managers are in a position analogous to your friend. Shareholders own the underlying assets of the corporation in much the same way that you own your car. They entrust managers to pursue a certain end using these assets,

namely increasing returns. When managers accept, they gain *de facto* control over the assets of the corporation, but their authority is limited because they do not *own* these assets. Their authority derives ultimately from the authority of shareholders, and it seems reasonable to think that the authority granted by shareholders extends only as far as is necessary to pursue the goal of increasing returns. By the same token, managers have a positive obligation to use their *de facto* control over the assets of the corporation in ways that promote the interests of shareholders because they agree to do so when they accept their positions. So imagine that a manager decides to use a more expensive production process because it uses less material from Brazil and this will help to save the rainforest. By using the assets of the corporation to pursue some other goal besides increasing returns, the manager is essentially "driving to Daytona Beach." On the one hand, he is using the assets of the corporation to pursue objectives other than increasing returns for shareholders, which amounts to hijacking these assets for his own purposes. And on the other hand, he is sacrificing shareholder returns, which amounts to a violation of his positive obligation to promote this end.

It is important to be clear about the nature of the fiduciary conception and the difference between this view and other competing views. For one thing, we should not confuse the fiduciary conception with a generally utilitarian approach to the corporation. According to a familiar utilitarian argument, managers should maximize returns for shareholders because this would lead to a higher level of aggregate welfare in society. An economy consisting of corporations that maximize returns for shareholders tends to be more efficient than one in which corporations pursue other objectives, so one might argue that the aggregate level of welfare in society would be higher if managers were re-

quired to pursue these ends.[2] From the utilitarian standpoint, the fact that aggregate welfare would be higher if managers maximize returns for shareholders means that managers have a duty to pursue this objective. I take it that the utilitarian argument for maximizing returns for shareholders is different from the fiduciary conception. On the fiduciary view, the reason that managers are obligated to maximize returns for shareholders is because shareholders entrust them with this task. According to the utilitarian argument, by contrast, the reason that mangers should pursue this goal has little to do with shareholders, but stems rather from the fact that society as a whole would be better-off if managers acted this way. The fiduciary view is, at bottom, a deontological conception of the corporation, not a consequentialist one.

We should also distinguish the fiduciary view from a conception of the corporation based simply on the idea of a contract. According to the fiduciary view, managers have an obligation to pursue the interests of shareholders, even if there is no contract that explicitly sets out that they have an obligation to do so. In cases where managers are employed "at will," without an explicit legal contract, the fiduciary view would say that they still owe it to their shareholders to maximize the returns on their investment. This marks one important difference from the contract view. Another important difference is that the fiduciary view aims to tell us something about the shape and structure of the law. The law places certain demands on corporate managers that have nothing in particular to do with the contractual arrangements between the various parties. For example, managers have to make the financial records of the corporation available for investors to examine, and this requirements holds even if it is not explicitly mentioned in any contract between investors, managers and the corporation. The idea of respect for contracts on its own tells

us little about how we should structure the various laws that regulate the corporation independently of the contractual arrangements between the parties. By contrast, the fiduciary view does tell us something about how these laws should be structured: it says that the laws of business should be structured around the idea that shareholders own the business enterprise and that managers have an obligation to further the interests of shareholders within the bounds of other aspects of the law and basic morality.

With a basic understanding of the fiduciary conception of the corporation, I want to turn now to several criticisms of the view. The problems that I want to focus on have to do with the character of the relationship that the fiduciary view suggests exists between shareholders and the corporation.

(a) Limited Liability

Perhaps the most important feature of the modern business corporation from the moral point of view is limited liability. If I take a loan out from a bank and I cannot pay it back, the bank can make a claim on all of my personal assets as payment for the loan. By contrast, when I invest in a corporation, my risks are limited to the amount that I actually invest in it. So when a corporation takes out a loan from a bank or issues bonds, shareholders are not personally liable if the corporation fails to repay these debts. Creditors can make claims on the corporation's assets, but they cannot make claims on the personal assets of shareholders.[3] No legal relationship exists between the corporation's creditors and its shareholders, and the most that shareholders can lose is the amount of money that they originally invested in the enterprise.

Unfortunately, the fiduciary conception of the corporation seems to be at odds with the idea of limited liability. The central idea behind limited liability is the idea that the corporation is an independent entity, one that can enter into contracts and incur debts that have nothing to do with the individuals who occupy its various offices or those who invest in it. The fiduciary view suggests that there is no intermediary that stands between shareholders and the assets of the corporation. Shareholders own the corporation's assets and merely entrust managers with them as a way of furthering their goal of making money. It is the fact that these assets belong *to them*, not some other entity, that forms the basis of their claim that managers should be pursuing *their* interests when making business decisions. But if the assets of the corporation belong to them personally, then there is no *prima-facie* reason to think that there is a separation between the assets of the corporation on the one hand and the personal assets of investors on the other. So it is hard to make sense of the idea of limited liability on the fiduciary view.

An example may help in seeing the force of the point. Suppose that you buy an ice cream parlor and pay the suppliers, employees and others from your own personal funds. One day you find that you lack the time and expertise to run the place, so you hire a manager to run it for you. When you entrust him with the business, you give him the authority necessary to run its day-to-day operations and he incurs a positive obligation to exercise your property rights in ways that will further your interests. Your personal ownership over the parlor, the machinery, the bank accounts and everything else is essential on the fiduciary view because this is what forms the basis of the claim that the manager of the enterprise should be pursuing your interests. But now if you own all of the assets of the enterprise in this way, then it seems that there is no intermediate entity that stands

between you and the corporation's operations. Even if your manager makes all the right choices, it may turn out that business slows down and revenues are not sufficient to cover costs. If the manager was simply acting as your agent, exercising delegated control over your building, your machinery and your bank accounts, then it seems that there is nothing that stands between your personal assets and the creditors that are looking to get paid. When the store manager pays the ice-cream supplier and the electric company, he does not do so with *his* money or with the *company's* money, he does it with *your* money, acting on your behalf. So it seems natural that when the bills have to get paid, creditors will look to you to cover the costs incurred by your manager's actions.

It seems, then, that there is a conflict between the fiduciary conception of the corporation and the idea of limited liability. If shareholders own the assets of the corporation in a way that could provide a basis for the claim that managers must pursue their interests, then it seems that there is no intermediate entity that owns these assets and that creditors should be able to look to shareholders for payment when revenues do not cover costs. In fact, the claims of limited liability seem transparently self-serving on the fiduciary view: it is awfully convenient for shareholders to claim that the corporation belongs to them personally when it comes time to decide how profits should be distributed, but then to repudiate the corporation when it comes time to pay suppliers, customers, and employee pension plans.

(b) Resolving the conflict of duties

A second problem with the fiduciary view is that, taken on its own, it actually tells us very little about what the managers of most publicly held corporations should do. To see

why, let's imagine that shareholders own the corporation in the way that the fiduciary view suggests. It follows that managers have an obligation to pursue the interests of shareholders. When there is only one shareholder or there is complete agreement among shareholders, the fiduciary view seems to give managers relatively clear guidance about what to do. But publicly held corporations have hundreds, sometimes thousands of shareholders, each with his or her own distinctive set of goals. In these cases, the fiduciary theory gives the manager very little guidance about what to do. After all, the view says that managers have an obligation to pursue the ends of each shareholder, so when there is a conflict among the ends of shareholders, there is simply no fact of the matter about what a manager should do. We have a pure conflict of duties.

Here's an example to illustrate. In the late 1980s there was a serious dispute among shareholders at AT&T about their affirmative action program.[4] Shareholders agreed that they wanted the corporation to make money for them, but they disagreed vehemently about how it should go about doing so. Some believed that AT&T should accelerate the process of overcoming a history of discriminatory hiring practices at the corporation by using preferential hiring policies to bring more women and minorities into the workforce. Others argued that AT&T should not engage in any form of preferential hiring, not simply because it would hurt the bottom line if the best qualified candidates were not hired, but because it would be immoral to make hiring and promotion decisions on the basis of gender and race. Given this disagreement about how the corporation should go about making a profit, the fiduciary conception says that it is simply indeterminate what managers at AT&T should do. On the one hand, they have an obligation to pursue the ends set for them by those who want to introduce a preferential hiring policy,

and on the other, they have an obligation to pursue the ends set for them by those who oppose the preferential hiring policy. What we have here is a pure conflict of duties. In fact, it seems that *anytime* there is a disagreement among shareholders, the fiduciary conception leaves managers without any clear guidance about what they should do.

Defenders of the fiduciary view might argue here that all their view needs is a collective decision-making rule to determine what managers should do in cases where there is a conflict among shareholders. For example, maybe the fiduciary view should say that in cases of conflict, mangers have an obligation to do what the majority of shareholders in the corporation want them to do. Unfortunately, merely stipulating a decision-rule will not address the underlying moral issue. Consider that on the fiduciary view, managers have an obligation *to each shareholder*: each shareholder entrusts his assets to managers, so managers have an obligation to pursue the interests of each shareholder. In order for a collective decision-making rule to have any moral significance, for managers, each shareholder would have to be *bound* to abide by the collective decision rule. If I entrust my assets to X as a way of furthering some goal G, the mere fact that a lot of other people would like to pursue some other goal H does not release X from his obligation to further G. By the same token, if a minority of shareholders opposes affirmative action, managers at AT&T still have an obligation to further their ends, even if it turns out that most other shareholders reject this position. There is still a mere conflict of duties. In order for the vote to have any moral significance, it must be the case that shareholders who voted against the plan have some kind of obligation to direct managers to pursue it anyway. Unless some such obligation exists, the collective decision-rule simply has no significance from the point of view of the manager's obligation. So without some definite

moral argument in favor of a collective decision-rule, the fiduciary conception has *nothing* to say about what managers in most publicly held corporations should do.[5]

(c) Overly demanding

A third problem with the fiduciary view is that it seems overly demanding given a reasonable degree of liquidity in capital markets.[6] Suppose that management adopts a production process that lessens returns for shareholders but will help in the long run to save the rainforest. Suppose that a group of shareholders disagrees with this decision and would prefer that managers simply maximize the returns on their investment. What might these shareholders do? Perhaps the most natural thing for them to do is simply to take their money elsewhere. If they do not like the policies that management is pursuing, they are free to sell their shares and move their money to some other corporation. There is mobility in the capital market just as there is mobility in the labor market, and when workers don't like their jobs, we sometimes say that they are free to work somewhere else, so the natural thing to say if shareholders don't like what managers are doing is that they are free to take their money elsewhere.

The fact that there is liquidity in capital markets suggests that the fiduciary conception of the corporation is overly demanding. In the case where you entrust your friend to pick your parents up with your car, part of the reason why we feel that your friend is under an obligation is that once the car is in his hands, there is very little that you can do to protect your property. But the same is certainly not true in the case of the corporation. Though the assets of the corporation themselves are not under the control of investors, the *particular investment* that each shareholder has in the corporation *is* under his control.

In most cases, a shareholder can protect himself against the effects of decisions that he does not endorse by simply selling his shares and taking his money elsewhere. Given that shareholders can protect themselves in these ways, it seems very heavy handed to think that there managers have an obligation to shareholders that is anything like the obligation that your friend has to you when you entrust him with your car.[7]

2. A fair and efficient division of responsibilities in capital markets

At this point, I have described the fiduciary theory of the corporation and suggested some reasons why we should be skeptical about it. I want to turn now to an alternative view that I think is more attractive and fits better with the independent nature of the modern corporation. There are two parts to the view. One is of an account of the nature of the corporation and the basic rationale for its existence, while the other is an account of what managers owe to shareholders. I will concentrate mostly on the second part of the view, but I want to start by saying something about the first part.

The nature of the corporation and its rationale

Corporations come in many shapes and sizes. Though we are mainly interested in private, for-profit enterprises, it is important to think about these corporations in the context of the wider range of enterprises that constitute corporations in the ordinary sense. Corporations fall into two broad categories: public and private. Public corporations are established by the government and their main purpose is to provide some service to the

public. Public corporations are often non-profit enterprises, but they need not be. The Tennessee Valley Authority, for example, is a public corporation that was established by the government to manage public lands in and around the Tennessee River in the interests of national defense, industrial development, and public safety. But Amtrak is a public corporation established by the government to provide passenger rail services to the public in the interests of making a profit. Private corporations, on the other hand, are established by private citizens and their purposes vary widely. Many private corporations are not-for-profit enterprises, such as hospitals, universities, and churches, which are simply established to provide some service to the public or to pursue some other goal. But many private corporations are for-profit enterprises—e.g. Coca Cola Boeing, etc—and they are established to provide good and services to the public for the purposes of making money.

There are several important similarities between different sorts of corporations, whether they are public or private, for profit or not for profit. First, all corporations are characterized by limited liability. Each of these enterprises operates as an independent entity that is distinct from the various individuals who occupy offices within the organization and from the individuals who invest in it. Creditors can only make claims on the assets of the corporation itself because their agreements are ultimately with the corporation, not with the individuals who manage it or invest in it. Second, all of these corporations have articles of incorporation that state what the fundamental purpose of the corporation is supposed to be. Amtrak's articles of incorporation, for example, state that the purpose of the corporation is to "to revitalize rail transportation service in the expectation that the rendering of such service along certain corridors can be made a profitable commercial undertaking […]."[8] Coca Cola's articles incorporation say that its purpose is

to "to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware."[9] Third, all of these corporations have articles of incorporation that resemble the constitution of a nation-state in that they establish a set of procedures for setting policies and making decisions. Amtrak, for example, has a nine-member board of directors that includes the Secretary of Transportation, the President of Amtrak, 5 members appointed by the President of the United States (subject to congressional approval) and two members appointed by those who hold preferred stock in the enterprise. Coca Cola similarly has a board of directors whose members are elected by shareholders.

The power to create a corporation is one of the most important powers available to us under our economic system. We should think of this power as one among a variety of instruments, such as property rights and contracts, which allow us to pursue our ends in association with others. In order to understand the purpose of a corporation, it is important not to focus simply on existing corporations and ask what their members are trying to do; we must focus on the power to form a corporation and ask what role this power plays in our system. Why should our economic practices include the power to incorporate a business enterprise? Why should we want a system of corporate capitalism that allows us to form corporations, rather than a system of personal capitalism in which business is conducted simply through property rights and personal contracts?

I take it that an important part of the rationale for corporate capitalism is that introducing corporations into the mix of basic instruments helps to encourage social innovation. Giving people the power to incorporate a business enterprise makes it easier for them to exploit economies of scale and scope.[10] Under personal capitalism, there may be

some people who are rich enough to set up large-scale factories that can produce goods in quantities that are sufficient to take advantage of savings that come from consuming raw materials in bulk. And there may be some who are rich enough to set up large-scale business operations that can produce a range of different products that all employ certain common components. But under corporate capitalism, you not only have these rich people, you also have a lot of other, less rich people who can pool their resources together to exploit these possibilities. Of course, pooling resources is possible under personal capitalism; it's just that corporate capitalism facilitates the process of amassing capital to exploit economies of scale and scope.

Adding corporations to the mix of basic instruments also helps to encourage the pursuit of socially useful ideas by lowering risks for investors. If the power to incorporate a business enterprise were not available to people, then whenever someone had a good idea for a business, they would have to risk their own financial future in order to pursue it. But the power to incorporate a business enterprise allows individuals to manage their exposure to business risk by contributing only a certain part of their personal wealth to the business venture. So, for example, suppose that I have a great idea for a new way to distribute music on the internet. The power to incorporate a business enterprise allows me to pursue this idea without risking my house, personal savings and credit history. I can set up a corporation and contribute only some part of my personal wealth to the pursuit of this idea. By the same token, the corporation allows other potential investors to limit their exposure in much the same way, by contributing some limited portion of their wealth to the project. In this way, the power to incorporate helps to

encourage social innovation by allowing people to establish an independent legal entity and use it to manage their exposure to financial risks.

When theorists talk about the purpose of the corporation, they often come to the conclusion that the purpose of the corporation is to make money for shareholders. When separated from the fiduciary conception of the corporation, it is hard to see what the rationale for this claim could be. People establish corporations for all sorts of reasons: sometimes they are interested in a money making venture, sometimes they are interested in providing a public service, and sometimes they are interested in some combination of the two. There is no more reason to think that every corporation is established to further the same end than there is to think that every contract is entered into to further the same goal. Of course, when you move from particular corporations to the power to form a corporation in general, it seems that there is something that unites most corporations together. We have reason to prefer an arrangement that allows us to form corporations over one that does not because these instruments allow us to pursue our ends while controlling our exposure to risks. But the fact that the power to form a corporation is valuable in this way should not lead us to think that corporations have some underlying goal that they all pursue.

The point of these observations is that if you want to know what the purpose of some corporation is, you cannot simply contemplate “the nature of the corporation.” Corporations have no intrinsic goals by their very nature any more than contracts do. To see what the goal of a corporation is, you have to look at each particular corporation and examine its stated objectives. Since the corporation’s articles of incorporation serve as its constitution, it seems natural to look to these articles for a statement of the guiding idea

behind the organization. Once we distance ourselves from the idea that corporations must, by their very nature, generate profits for shareholders, we can think more clearly about what the basis might be for thinking that corporations should sometimes pursue this goal. What sorts of obligations do these enterprises and their managers owe to those who invest in them? This is the question that I will address in the next section.

3. Capital markets and legitimate expectations

Corporations are independent legal entities, distinct from both the individuals who occupy offices in the corporate hierarchy and the individuals who happen to own shares at any given time. Each corporation has articles of incorporation that set out its basic goals and set out the procedures through which the organization will be governed. As investors enter the capital market, they face an array of different corporations in which they can invest. They are free to investigate their alternatives and make a decision about where to put their money. Assuming a certain degree of liquidity in the capital market, investors can expect to be able to buy and sell shares in response both to changes in economic circumstances and in response to managerial decisions. Given these basic facts, how should we think about the duties that managers owe to shareholders?

I think that we can look to another market to provide us with a good model. Let's compare the situation of investors in the capital market with the situation of consumers in the market for goods and services. When consumers come to the marketplace, they have all sorts of expectations about manufacturers and the goods that manufacturers produce. Some of these expectations are *legitimate* in the sense that consumers have a right to rely

on these expectations in making decisions and manufacturers have a corresponding duty to live up to these expectations. By contrast, other expectations are not legitimate in the sense that consumers have no right to rely on these expectations in making decisions and manufacturers have no corresponding duty to live up to them. For example, one expectation that consumers may have in the marketplace is that managers will not make false statements about their products. This expectation is legitimate because consumers have a right to rely on it in making decisions about what to buy and manufacturers have a corresponding duty to live up to it. Another expectation that consumers might have is that the products they buy are durable and made to last. This expectation is not legitimate because consumers have no moral right to rely on it and because manufacturers have no moral duty to live up to it.

In order to distinguish legitimate expectations from illegitimate ones, we have to think of the rights and duties of market actors as defining a kind of division of labor. Whenever consumers have the right to rely on a certain expectation, this represents a benefit for consumers and a burden for manufacturers. For example, when consumers have the right to rely on the expectation that manufacturers are telling the truth about their products, this represents a benefit for consumers (they do not have to spend their time verifying what manufacturers say) and a burden for manufacturers (they have to spend time making sure that what they say is true and accurate). Conversely, when consumers have no right to rely on the expectation that manufacturers are producing durable, long-lasting products, this represents a benefit for manufacturers (they are free to produce cheap junk) and a burden for consumers (they have to make more of an effort to find durable and long-lasting goods).

Morality requires that the division of responsibilities in the marketplace should be both fair and efficient. We can think of fairness in the following way. Each group in the marketplace has certain basic interests, such as the consumer's interest in being able to find the goods that he wants. The division of responsibilities in the marketplace will serve some interests and conflict with others. The division of responsibilities is fair when each group finds that their interests are accommodated in a reasonable way given the interests of the other groups. The division of responsibilities is efficient when no group's interests are sacrificed for reasons that have nothing to do with the interests of another group. Expectations in the marketplace are legitimate when they correspond to a fair and efficient division of labor, and expectations are illegitimate when they correspond to an unfair and inefficient division of labor.

I want to concentrate mostly on the idea of fairness, so let's consider an illustration from the law. Consumers may expect that the products they find in the marketplace are safe for their normal uses—e.g. when you go to Radioshack, you expect that whatever radio you buy, it will not electrocute you when you turn it on. For many years, the law in the United States did not recognize this as a legitimate expectation. Under the *caveat emptor* regime, it was the buyer's responsibility to examine the products that he finds in the marketplace to determine whether they are safe. Manufacturers had no legal responsibility to ensure that the products they brought to the market were safe for their intended uses. The *caveat emptor* regime may well have represented a fair and efficient division of labor in a simpler time, when the market consisted mostly of goods such as apples and shovels that most people could assess for themselves. But in a more complex marketplace, with technologically sophisticated products that consumers often buy without an

opportunity for inspection, the *caveat emptor* regime does not represent a fair and efficient division of responsibilities. Consumers have an interest in not being exposed to certain sorts of risks, but the *caveat emptor* doctrine allows manufacturers to impose all sorts of risks on them—after all, most consumers are not in a position to determine whether the brakes on their new care will actually stop the vehicle in an emergency. This seems unfair given that we can protect consumers from these risks at a reasonable cost to manufacturers. Fairness seems to tell in favor of a regime that places greater burdens on manufacturers to bring safe products to the marketplace, thereby protecting consumers from exposure to certain sorts of risks.

Questions about the duties of managers and investors in the capital market can and should be understood on the model of questions about the duties of manufacturers and consumers in the market for goods and services. Investors come to the capital market to buy shares in corporations. They have various expectations about how corporations will act. Some of these expectations are legitimate in the sense that investors have a right to rely on these expectations in making investment decisions and corporations have a corresponding duty to live up to these expectations. But some of these expectations are not legitimate in the sense that investors have no right to rely on these expectations in making investment decisions and corporations have no corresponding duty to live up to them. In order to determine which expectations are legitimate and which ones are not, we have to focus on the corresponding division of labor. Expectations are legitimate when they correspond to a fair and efficient division of labor in the capital market, while expectations are not legitimate when they correspond to an unfair or inefficient division of labor.

4. Which expectations are legitimate?

I cannot offer a complete account of which expectations in the capital market are legitimate and which ones are not, but I want to examine a few expectations in order to suggest the broad outlines of what managers owe to shareholders under the kind of view that I am advocating.

(a) One expectation that investors should be able to rely on is that corporate financial statements will accurately depict the financial position of the corporation. Investors have an interest in being able to make informed decisions about what sorts of risks they want to take, and they also have an interest in minimizing the time they spend investigating their alternatives. Suppose now that investors were not able to rely on the statements that corporations make. If they could not rely on corporations to provide them with accurate information, they would have to spend a substantial amount of time verifying the claims that corporations make. Moreover, they are rarely in a position to investigate the financial situation of a corporation for themselves and they rarely have the expertise to formulate a general picture of the corporation's position given the raw data. The division of responsibilities in this case seems unfair because it places unreasonable burdens on investors given that corporations could make information available to investors at relatively little cost to themselves and because they have access to the expertise necessary to paint an accurate picture of their financial position. So it seems that fairness tells in favor of a division of labor in which corporations have a duty to provide accurate information about their financial position to investors and investors have a right to rely on these statements in making financial decisions.

(b) Another important expectation is that managers will come forward in cases where they have a conflict of interest. Again, investors have an interest in being able to make informed decisions about what sorts of risks they want to take, and they also have an interest in minimizing the time they spend investigating their alternatives. Suppose now that there were no duty for managers to come forward and inform investors when there is a conflict between their successfully carrying out their duties in the corporation and some other financial interest. Under this division of responsibilities, the burden would fall on shareholders to find out for themselves whether corporate managers have divided loyalties. This arrangement seems unfair because investors are rarely in a position to find out about the conflicting business interests of a manager. It would take an enormous amount of time for investors to monitor each of their various holdings to see whether the officers in each corporation had divided loyalties. A managerial obligation to disclose conflicts of interest would help to ensure that investors are in a position to make an informed decision about what sorts of risks they want to take on. Moreover, managers have ready access to the relevant information, so they would be able to provide this information to investors at relatively little cost to themselves. So it seems that fairness would tell in favor of a general obligation for managers to come forward in cases where they have a serious conflict of interest.

(c) Consider now an expectation that lies at the heart of the debate about corporate social responsibility. Imagine a division of labor in which corporations have no obligation to maximize returns for shareholders, but have an obligation instead to make their management policies known to investors. Under this regime, a corporation would be permitted to adopt, say, a policy of paying employees a living wage, even if this policy

would lower returns for shareholders, so long as the corporation made clear to investors through a prospectus or some other means that this was the company's policy. Would this represent an unfair division of responsibilities?

Here it seems to me that the answer is no. The central interests involved are the shareholder's interests in being able to make informed decisions about the risks he wants to take, his interest in being able to further his ends through his investments, and his interest in minimizing the time that he has to spend investigating the alternatives. Under the arrangement that I described, shareholders would have reliable information made available to them about what sorts of policies a corporation was going to pursue. Given a certain degree of liquidity in the capital market, they would not only have an opportunity to make an informed decision, but they would also have ample opportunity to sell their investment and move their money to some other corporation if they did not endorse the new policies.

Some shareholders might complain that it is unfair of managers to adopt the living wage policy because this would lower the value of their investment. But the mere fact that it lowers the value of their investment is not enough to show that there is any unfairness here. Investors were fully aware of the risk that managers might adopt some such policy when they decided to invest in the corporation. And insofar as they assessed the risks and freely undertook the risk that managers might introduce such a policy, they can hardly complain of unfairness when they have to bear the cost of their initial decision.

Of course, the arrangement I described would place greater burdens on investors in terms of investigating their options, as there would be greater diversity among the corporations in the marketplace. Investors could not simply rely on the expectation that

every corporation was aiming to maximize returns on their investment. But it is worth noting that this burden of investigation comes with an important benefit. Under the sort of arrangement that Milton Friedman favors, there is very little diversity in the market and all corporations simply maximize returns for shareholders. Under the arrangement that I am describing investors have the option of investing in corporations that make money in ways that they would actually endorse. Instead of being limited to investing in corporations that make money in ways that might sacrifice other things that are important to them—say, the rainforest—investors now have the opportunity to invest in corporations that make money in ways that are consistent with their broader objectives. This is a significant benefit that seems to make the increased burdens of investigation reasonable from the shareholder's point of view.

(d) I want to conclude by noting that although the approach that I am advocating diverges from the fiduciary conception in many ways, there is one point on which I think that two views would agree. It seems to me that an approach based on the idea of a fair and efficient division of responsibilities in the capital market would strongly favor a *prima-facie* requirement that corporations aim to generate increasing returns for shareholders. Although it is permissible for corporations to pursue other goals besides generating increasing returns, so long at it makes these policies clear to investors, it seems that in the absence of any such declaration, the default position should be a strategy of increasing returns. Shareholders should have a right to expect that, in the absence of declarations to the contrary, corporations are aiming to make money for them. The idea here is that most investors want their investments to yield high returns, much the same way that most consumers want products that are safe for their intended uses. Manufacturers have

a *prima-facie* obligation to bring products to the marketplace that are safe for their intended uses, and this allows consumers to concentrate their attention on finding products that further then ends in other ways. The equivalent claim in the capital market would be that corporations have a *prima-facie* obligation to generate increasing returns for shareholders. This obligation would free investors from certain burdens of investigation, though allowing for corporations to pursue other sorts of ends when they make this clear and explicit.

5. Conclusion

I have argued that the fiduciary theory suffers from an important weakness: it does not come to terms with the independent character of the modern corporation. The fiduciary view seems to rely on the idea that investors have a direct ownership claim on the assets of a corporation, which then entitles them to determine what goals the corporation should pursue. This conflicts with the idea that investors enjoy the protection of limited liability because the corporation is an independent legal entity that stands between investors and the various activities of the business enterprise.

In contrast to the fiduciary theory, I have offered an alternative that acknowledges the full independence of the corporation. Corporations are fee-standing enterprises that individuals and governments establish to pursue various ends. The reason that corporations have obligations towards investors has little to do with the fact that investors own the corporation in the way that the fiduciary view suggests. Rather corporations have duties to investors because corporations participate in capital markets, looking for investors.

Morality requires that there should be a fair and efficient division of labor in the marketplace. I argued that certain sorts of corporate obligations could be understood simply as requirements of fairness. So in much the same way that manufacturers have a responsibility produce safe products for consumers, corporations have a prima-facie responsibility to increase returns for shareholders. Importantly, however, this responsibility is defeasible, and if corporations give fair warning to investors, there is no reason why they could not, as independent enterprises, seek to pursue other goals besides maximizing returns for shareholders.

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[1] I take the common view of the corporation that I am describing to be the view that Milton Friedman advocates in his famous essay on the social responsibility of the corporation. See Milton Friedman, "The Social Responsibility of Business is to Increase its Profits" *New York Times Magazine* (September 13, 1970).

[2] There is a large literature that addresses the relative efficiency of an economy in which firms seek to maximize returns for shareholders. See, for example, Michael Jenson, *A Theory of the Firm* (Cambridge, MA: Harvard University Press, 2000) and Henry Hansmann, *The Ownership of Enterprise* (Cambridge, MA: Harvard University Press, 1996). It is essential to distinguish this utilitarian argument from other arguments for profit maximization, such as the fiduciary argument. For a discussion of these issues, see Waheed Hussain "Corporations, Profit Maximization, and the Personal Sphere" *Economics and Philosophy* (forthcoming).

[3] Except in special cases involving fraud, deception, or failures of incorporation.

[4] See Tom Beachamp, "AT&T's Policies on Affirmative Action" *Case Studies in Business, Society and Ethics, 5th ed.* (Upper Saddle River: Pearson Prentice Hall, 2004).

[5] Proponents of the fiduciary view often hide this problem by implicitly assuming a certain decision rule. Milton Friedman, for example, suggests that managers should pursue the one goal that most shareholders would endorse, namely maximizing returns on their investment. But in order for managers to be bound to pursue this end, it is not enough for shareholders to generally want to pursue it; there must be some sense in which they are bound to direct managers to pursue it. So suppose that I am a committed environmentalist and that I would only pursue profits in ways that minimize costs on the environment. When managers maximize returns on my investment without regard for the environment,

there is an obvious sense in which they are not pursuing my ends. And even if it is true that *other* investors do not share my concern for the environment, their opinions are irrelevant as far as my assets are concerned. With regard to my assets, there is an important sense in which managers have hijacked what belongs to me in order to pursue their own ends. What the proponent of the fiduciary view has to show is that I am somehow obligated to revise my ends and direct managers to pursue profit in ways that might sacrifice the environment. Unless the proponent of the fiduciary view can say something about why I must revise my ends in this way, it is hard to see why managers are not simply overstepping the bounds of their authority over my assets and violating their positive obligation to pursue my ends.

[6] John Boatright makes an argument along these lines in "Fiduciary Duties and the Shareholder-Management Relation: Or What's So Special about Shareholders?" *Business Ethics Quarterly* 4 (1994).

[7] In "The Social Responsibility of Business is to Increase its Profits," Milton Friedman draws a parallel between corporate spending on social causes and taxation. He suggests that when an executive spends profits on social causes, he is essentially imposing a tax on shareholders and deciding how this tax will be spent. (See Friedman, pg. ***.) However, the two cases seem hardly parallel. Taxes imposed by the government are coercive because there is no real way for individuals to avoid paying them—you could emigrate from the country, perhaps, but for most people that is simply not an option. By contrast, managerial expenditures are not coercively imposed on shareholders because if they don't like the way that managers are running a business enterprise, they are free to sell their stake and invest in another corporation.

[8] 1970 US Code Congress & Administrative News 4735, 4737, 4741.

[9] http://ir.cokecce.com/governance/incorporation.cfm

[10] Alfred Chandler famously argues that the rise of the modern business corporation was tied to the rise of the telegraph and the railroad. These technologies made it possible for people to exploit economies of scale and scope for profit, though it would require a much larger, more complicated and more demanding form of business organization to do so. See Chandler, *The Visible Hand* (Cambridge, MA: Harvard University Press, 1977).