Chapter 14

Room to Argue, page 426: The Profit Motive

As this box notes, there is substantial debate over the true purpose of corporations and whether they should be operated purely for profit motives. **Reading One** below (by Elhuage) supports the notion of corporate social responsibilities. **Reading Two** (by Fisch) opposes corporate philanthropy. **Reading Three** (by Henderson and Malani) summarizes both points of view.

Reading One

SACRIFICING CORPORATE PROFITS IN THE PUBLIC INTEREST
Einer Elhauge
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New York University Law Review

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IV. Why an Operational Discretion to Sacrifice Corporate Profits in the Public Interest Is Desirable and Even Efficient

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A. Why Even a Legal Regime That Maximizes Shareholder Profits Necessarily Confers Managerial Discretion to Sacrifice Profits in the Public Interest

Even if one narrowly (and mistakenly) defined efficiency to equal shareholder profit-maximization, managerial discretion to sacrifice profits is still necessary because the economic efficiencies that come from delegating the management of a business to someone other than shareholders or judges cannot be achieved without creating such discretion. As economists have shown, the optimal level of agency costs requires some tradeoff between monitoring costs and the costs of permitting agent discretion even if one assumes shareholder profitability is the only goal. In the economic lingo, giving such discretion to managers lowers total agency costs because any residual loss of shareholder profits is offset by the savings in monitoring costs, which we might equally call the benefits of delegation.

As a result, the economically efficient level of agency costs will always leave some agency slack: that is, some agent discretion to act in ways other than the financial interests of the shareholders. And the agents who can exercise such agency slack to sacrifice corporate profits by benefiting themselves (say, by renting corporate luxury boxes in stadiums) can also do so by benefiting the public interest (say, by donating funds to local charities). In either case, shareholders focused on the bottom line will care about only the total amount of agency slack and profit-sacrificing behavior and not about precisely how those profits were sacrificed. And in either case, a strained claim that the activity somehow increases corporate profits (by building goodwill with clients or the community) will allow the conduct to survive legal scrutiny under the business judgment rule, which sets what both the law and proponents of a duty to profit-maximize regard as the optimal degree of legal monitoring. As we have already seen in Part III, this business judgment rule level of monitoring effectively eliminates

any enforceable duty to profit-maximize and leaves managers with de facto discretion to sacrifice a reasonable degree of corporate profits to further public interest objectives.

Understanding this point neatly deflates the argument by proponents of a duty to profit-maximize that the goal of profit-maximization is objective and easier to monitor than a goal of advancing the public interest, which (because it goes beyond legal compliance) is either vague or controversial. To begin with, the ability of judges to monitor public interest goals is irrelevant because the claim at issue is not that corporate managers should have some ill-defined legal duty to pursue the public interest; the claim is that they have discretion to do so, in part because the business judgment rule inevitably gives it to them. In contrast, a real enforceable duty to profit-maximize would require judicial monitoring and thus runs against the problem that the very reason for the business judgment rule is precisely that profit-maximization is too hard for judges to monitor.

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Worse, this commonly understood problem actually understates the difficulty. Even greater difficulties are raised by possible disjunctions between ex post and ex ante profit-maximization. Proponents of a profit-maximization duty normally seem to assume that, if decision X will maximize the combination of short-and long-term profits at the time that decision is made, then the manager must make decision X. But suppose, as many scholars have argued, that a manager with discretion not to make decision X can sometimes enter into an implicit contract that she won't do X in exchange for others (say, workers or the community) conferring some benefit on the corporation that cannot be taken back (say, harder work or a favorable zoning review), and that such implicit contracts are often more profitable and efficient than legally binding commitments would be. For example, suppose it is profit-maximizing for a corporation to enter into an implicit contract with its employees that they will work to develop their skills in a way that makes them more valuable to the corporation (but not to other firms) in exchange for the corporation refraining from cutting their salaries to levels that do not reflect their firm-specific investments of human capital. In that sort of case, the later decision to refrain from doing X (cutting salaries) would look profit-sacrificing from an ex post perspective that considers only post-decision profits, but would be ex ante profit-maximizing when one considers that the ability to make that later decision was necessary to create a profitable implicit contract. Allowing managers to exercise their discretion to sacrifice ex post profits in such a case thus enables them to enter into implicit contracts that are ex ante profit-maximizing. Lacking legal enforcement, such implicit contracts must owe their enforcement to social or moral sanctions against reneging on such loose understandings, which can only be effective if not overridden by a legal duty.

As Professors Blair and Stout have noted, this point is not limited to implicit contracts that require some special understanding between the corporation and others, but can justify the general existence of managerial profit-sacrificing discretion on the ground that it is likely to reward and thus encourage firm-specific investments by other stakeholders that are ex ante profit-maximizing. With the analysis in this article, we can further develop this point to say that the mere existence of profit-sacrificing discretion can be ex ante profit-maximizing because of a very general expectation that such discretion will make managers responsive to social and moral sanctions. Suppose that others (not just stakeholders) will comply with social or moral norms that are beneficial to the corporation only on the expectation that the corporation will comply with social and moral norms that are beneficial to others. For example, suppose a town will comply with social and moral norms not to exact all they can

out of a corporation on a zoning issue only because they expect the corporation to comply with social and moral norms to avoid some profit-maximizing environmental harms. The town has no special understanding with the corporation; their expectations simply affect whether they calculate that the corporation will confer a net benefit on the town. In that sort of case, the mere fact that managers have the discretion to engage in ex post profit-sacrificing compliance with social and moral norms (here by avoiding certain environmental harms) is ex ante profit-maximizing. A regime that denied corporate managers the discretion to engage in ex post profit-sacrifices would decrease shareholder profits in such cases, for it is the prospect of such managerial behavior that encourages others to treat the corporation in beneficial ways that increase [781] profits before the profit-sacrificing decision has to be made. This point requires no special understanding of the sort that one might call an implicit contract; just a very general sort of social understanding that actors are likely to comply with social and moral norms, which leads to a social reciprocity that is profit-maximizing for each actor. A duty to profit-maximize ex post would ironically decrease shareholder profits by constraining this discretion and thus disable the corporation from engaging in such profit-maximizing social reciprocity.

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In short, even if shareholder profit-maximization were our only goal, fulfilling it would inevitably create considerable management discretion to sacrifice profits in the public interest. True, this theory explains only the latent discretion to sacrifice profits in the public interest that inevitably results from the business judgment rule itself. It does not provide the sort of affirmative justification that would explain why the law goes beyond that, allowing even patent exercises of discretion that do not pretend to maximize profits either ex post or ex ante. For that, we need a more affirmative justification for the desirability of sacrificing corporate profits in the public interest, to which I turn in the next section.

But the inevitable existence of this latent discretion even if one favors profit-maximization remains enormously important because, in the lion's share of cases, it produces the same result as a limited patent profit-sacrificing discretion. This means that both the existence and degree of profit-sacrificing discretion is largely inevitable. It also means that the fact that the law has taken the next step of embracing, when necessary, a limited patent discretion to sacrifice profits in the public interest produces little, if any, reduction in profits. The limited nature of this marginal reduction in profits makes it easier to justify with any affirmative gains from the managerial discretion to pursue the public interest even when that undoubtedly sacrifices profits. …

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<u>Reading Two</u>

QUESTIONING PHILANTHROPY FROM A CORPORATE GOVERNANCE PERSPECTIVE

Jill E. Fisch
New York Law School Law Review
41 N.Y.L. Sch. L. Rev. 1091 (1997)

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II. The Rationale For Philanthropy from a Corporate Perspective

Corporate law's primary difficulty in formulating a methodology for evaluating corporate philanthropy is in understanding why corporations donate to charity. …

Fund-raisers and their counterparts in corporate giving departments offer a traditional response: charitable giving benefits the corporation. As Hildy Simmons explained, corporations donate because of enlightened self-interest. There is no reason to be concerned about corporate philanthropy because corporations do well by doing good. This argument has held sway with the few courts that have considered the propriety of corporate philanthropy. …

It is possible to identify many examples of donations that benefit the corporate donor. Corporate sponsors of the Olympics, for example, used charitable giving as an alternative to other forms of advertising and marketing and enhanced their reputations at the same time. To the extent that charitable donations provide a direct corporate benefit, however, they are not really philanthropic. Rather, donations that benefit the corporation should perhaps be recognized as an alternative form of business expense. …

This analysis fails to explain the distinctive legal treatment of corporate philanthropy. If corporate donations are simply an alternative form of business expense, they require no independent authority under either corporate or tax law. Given that corporate business expenses are deductible from gross income, there is little need to resort to the charitable contribution analysis of 170 for the corporation to claim a tax deduction. …

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… Corporate expenditures today are judged under the business judgment rule, a standard that accords substantial deference to management's judgment. The fact that a perceived benefit is intangible, noneconomic, or uncertain will not invalidate a corporate expenditure.

Traditional corporate law standards create another problem, however, when used to evaluate contributions as business expenditures. The judicial deference accorded to such expenditures under the business judgment rule may not be appropriate in the context of philanthropic expenditures. The business judgment rule is premised upon a presumption of management disinterestedness. It is inapplicable in situations in which there is a possible conflict of interest or self-dealing. As Jayne Barnard explains, although defenders of corporate philanthropy claim it benefits the business, corporate giving is frequently motivated by the personal preferences of corporate executives who use their power to choose the recipients of large corporate grants in order to support preferred causes or reap the social perquisites afforded to large donors. Corporate donations may also assuage management's moral guilt, providing well-paid corporate executives with the opportunity to be philanthropists at shareholder expense.

The possibility that corporate giving is motivated by management self-interest rather than profit maximization is further supported by studies that fail to find a conclusive link between

charitable giving and profitability. Of course, there are many possible explanations for these results. It is difficult to obtain firm-specific data, and further obstacles are presented by the problem of classifying the data and determining what to include as corporate philanthropy. Does cause-related marketing count? How should studies quantify gifts in kind or gifts of services? Should the public relations or advertising component of a donation be separated out? It is also difficult to assess the direction in which causation runs. Hildy Simmons describes the corporate decision about how much money to donate as a function of expected profits, that is, corporations target their giving level at a specified percentage of profits. If giving is a function of expected profits, there will obviously be an identifiable relationship between giving and profits, but the existence of that relationship does not support any conclusion about causality.

Philanthropy is problematic for corporate law if economic studies cannot establish that philanthropic decisions are profit maximizing. The problem arises, in part, because the law recognizes that the markets in which a corporation operates constrain management discretion within permissible limits. The discipline of the market provides a substitute for extensive regulatory oversight. Market checks also reduce the agency costs of corporate decision-making without the need for extensive shareholder involvement; the market operates as a monitor. The market operates as a poor monitor for management decisions that are not tied to profit maximization, however, and traditional deference to management creates the possibility of self-dealing. If the extensive enterprise of corporate philanthropy is spurred by the fact that management rather than the company benefits, then corporate law should respond by regulating corporate giving.

Defenders of corporate philanthropy in terms of corporate social responsibility offer an alternative explanation. They suggest that corporate giving is not motivated by either management self-dealing or the quest for profit. Instead, corporate philanthropy has been described in terms of moral obligation. …

The source of a corporation's moral obligations is unclear, however. Even if natural persons have obligations to "give something back to society," stemming from the nature of the human condition, the social contract, or religious principles - a question beyond the scope of this essay - the existence of individual obligations does not resolve the question for the corporation. Corporations are not individuals, nor do they, by virtue of the corporate form, inherit all the rights and responsibilities of natural persons. It is unnecessary to assume that the aggregation of investment funds and use of the corporate form for the purpose of pursuing a business objective necessarily carry social responsibilities apart from the obligations of the individual participants.

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Even in states which have legislatively endorsed the stakeholder model of corporate governance, the characterization of philanthropy as a corporate obligation is inconsistent with existing practice. If philanthropy is based on a corporation's moral or social obligation - perhaps justified by the grant to corporations of special powers and legal rights, such as limited liability - why is it optional? Corporations vary tremendously in their giving patterns, from IBM, which donated $ 118.3 million to charity in 1992 alone, to Sunbeam, whose CEO Albert Dunlap has publicly stated his opposition to corporate giving and who, in his previous position, eliminated the charitable foundation at Scott Paper. Why do regulators make no effort to monitor the degree to which corporations adhere to their obligation to society and to

enforce noncompliance with societal norms? The laxity of the current regime allows complete free-riding by some corporations on the philanthropic efforts of others, free-riding that may well put socially responsible corporations at a competitive disadvantage in the marketplace if charity does not produce a benefit to the corporation.

There are also problems with entrusting corporate moral obligations to the discretion of corporate management. In addition to the agency costs created by this delegation, it is not clear that shareholders would willingly grant management discretion to choose how much to give and which philanthropic causes to serve. The exercise of this discretion, removed from the oversight of disclosure to or approval by shareholders, need have no connection to shareholder values or widely-held social priorities.

Evidence on charitable giving provides some reason to doubt that corporate donations reflect the charitable objectives of individual shareholders. Studies show that most individual giving goes to religious organizations. Similarly, when Berkshire Hathaway, the one publicly-traded company to allow shareholders to designate charitable recipients, instituted "The Berkshire Program," it found that a large number of gifts were made to charities with a religious affiliation. The contribution policies of most publicly-held corporations, however, explicitly prohibit donations that are to be used for religious purposes.

Moreover, to the extent that corporate social responsibility is defended by attacking the private property model of the corporation and defining the corporation as something of a public resource, voluntary charitable giving seems a poor substitute for the traditional method of collecting and distributing funding for the public interest - the tax system. If society views charities as serving general social needs, the process of funding these needs through tax revenues and allocating the revenues through the legislative process allows majoritarian decision-making about the appropriate spending priorities. Corporate contributions substitute the decisions of management for those of the voting public and its elected representatives.

The defense of charitable giving in terms of the public interest, raises a troubling dimension to corporate philanthropy: the political nature of some charitable spending. Many prominently philanthropic corporations are those involved in heavily regulated industries. Philip Morris and Exxon exemplify the efforts of companies subject to extensive regulation to display their public-spiritedness through charitable giving. Donations of this type, which attempt to buy not merely public but also legislative goodwill, may be analogized to lobbying. Indeed, corporations may direct their giving to the causes favored by those politicians viewed as likely to impose greater regulatory restrictions, in an effort to deter intrusive regulation. This rationale might explain why Exxon is a prominent donor to environmental causes. Unlike direct political expenditures, charitable giving rarely incurs the negative public opinion response associated with lobbying. Moreover, in an era in which political contributions are subject to increasing scrutiny, we should not overlook the potential of charitable spending to influence the political process.

To the extent that corporate philanthropy has a political dimension, it may also create internal corporate conflict. Controversy about AT&T's donations to Planned Parenthood and Domino Pizza's support for the Right to Life movement demonstrates the potential political problems associated with corporate philanthropy. Neither tax regulations nor corporate governance guidelines designate appropriate beneficiaries of corporate largess, relying instead upon the tax exempt status of charitable recipients as a proxy for their suitability. However, charitable donations that allow corporations to take political positions inconsistent with those of their

shareholders pose similar First Amendment questions to those that have been raised in the debate over regulation of corporate political speech.

The political dimension of corporate giving is particularly relevant to Faith Kahn's proposal that the SEC mandate more extensive disclosure of charitable giving by corporations. Although many corporations voluntarily disclose their charitable donations in separate philanthropy literature such as charitable giving pamphlets, as Faith observes, there is virtually no disclosure about charitable donations in investor-related information such as annual reports. If corporations donate because giving creates goodwill and favorable publicity beneficial to the corporation or out of a sense of moral obligation or altruism, we would expect to see extensive publicity associated with corporate philanthropy even in the absence of SEC-mandated disclosure. Greater publicity for corporate giving would appear to further the objectives behind the donations. Moreover, even if corporations did not direct disclosure of their philanthropy to the investment markets, if a corporation's philanthropic practices were relevant to its profitability, we would expect to see securities analysts research and distribute the information as material to investors.

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III. Conclusion

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First, is corporate giving good for business? Even under a narrow characterization of business objectives as profit maximization, existing studies have been unable to determine the relationship, if any, between corporate philanthropy and profitability. Further research in this area, to the extent it can overcome the technical difficulties noted above, is sorely needed. Empirical evidence may allow us to weigh the claim that philanthropy is good for business against the alternative characterization of corporate giving as management self-dealing.

Second, is giving good for shareholders? Although the status of the shareholder primacy model in corporate law is unclear, shareholder interests remain a principal reason for the adoption of regulatory standards. Even if corporate philanthropy has no discernable effect on the bottom line, corporate giving may further shareholders' interests under a social responsibility, altruism, or common objective model of the corporation. Here too, further research avenues exist. Would shareholders voluntarily vote to authorize corporate philanthropy? What efforts have shareholders made to prevent corporate giving? Do shareholders view corporate giving as a substitute for their own giving and, if so, does corporate giving provide a satisfactory substitute?

This analysis extends beyond the question of whether corporations should donate and suggests issues about the manner in which corporations set their donation policy. Although Berkshire Hathaway has innovated a procedure for shareholders to designate the recipients of corporate philanthropy, there is no evidence that this portends a general trend for corporations to provide shareholders with greater control over giving policies or the choice of charitable beneficiaries. Particularly, if corporate philanthropy is justified as derivative of shareholders' moral obligations, it is unclear that the existing managerial structure of the firm offers an appropriate vehicle for shareholders to delegate the satisfaction of these obligations. Indeed, the broad discretion traditionally afforded to management may pose a risk to

shareholders' interests analogous to that presented by management's control over corporate political activity.

Third, is corporate giving good for society? The justifications for corporate philanthropy based on principles of social responsibility rest upon the view that, whether or not corporate giving causes a corporation to do well, giving money to charity constitutes doing good. This perspective is reflected in the existing treatment of corporate philanthropy under both tax and corporate law. The substantive conclusion that corporate giving is good for society is premised on two distinct components: 1) charitable giving is generally good, and 2) some charitable giving should take place at the corporate, as opposed to the individual, level.

Analysis of the first point is beyond the scope of this essay. Accepting the premise that charitable giving is good however, does not automatically lead to the conclusion that charitable giving by corporations is desirable. It is possible to hypothesize that corporate contributions raise overall societal giving levels, that corporations are able to donate more efficiently, or corporate decision-makers are better able to determine societal needs than individuals. Addressing these hypotheses suggests a need for corporate law to recognize the quasi-public role created for management in allocating funds generated by private property and enhanced through the tax subsidy, to social programs.

It is difficult to see why corporate executives are particularly qualified to prioritize social expenditures. The attributes that qualify an individual to manage a corporation are not obviously linked to the ability to identify social needs and structure spending decisions to address those needs. Nor is it likely that corporate shareholders, in choosing boards of directors, believe they are selecting for these qualities. Most importantly, the selection of corporate decision-makers is a private decision made exclusively by the corporation's shareholders. Corporate managers, unlike political officials, are not accountable to the general public. Delegating discretion over the funding of social programs to the private sector creates a risk that the results will differ from the priorities set through the democratic process.

Reading Three

This reading summarizes the two arguments above and provides interesting solutions to how to balance corporations' for-profit nature and demand for social responsibilities.

Corporate Philanthropy and the Market for Altruism
M. Todd Henderson, Anup Malani
Columbia Law Review
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I. The Existing Debate

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A. Why Do Corporations Engage in Philanthropy?

Prominent scholars such as Michael Porter argue that philanthropy helps a firm's bottom line and can be a source of competitive advantage. Numerous studies claim to support the link between giving and profit. The mechanisms by which this link operates include generating good feelings among customers, suppliers, or employees; attracting high quality employees; or decreasing the risk of government or activist action. Whether the source of the goodwill and increased profits is the advertising benefits of doing good or something else is beside the point. All that matters is that the firm is actually doing some public good and that the act of doing this helps not only strangers to the firm but also its shareholders. Even Milton Friedman, who famously claimed that the "only … responsibility of business [is] to use its resources and engage in activities designed to increase its profits," acknowledged that corporate philanthropy may be justified when it is necessary to maximize long-run profits.

Other scholars argue that philanthropy is simply managerial graft, no different from a CEO using a fancy corporate jet for personal purposes. Managers are spending other people's money, and, because monitoring by shareholders is imperfect, managers will do so in ways that maximize their own utility rather than that of the shareholders. Numerous studies claim to support this view. The agency costs account is supported by the facts that the law does not require firms to disclose to shareholders corporate charitable gifts and that many firms do not do so. Proponents of this view call into question the causal connection between donations and profits relied on by the opposing camp. They argue that profits, or the expectation of profits, may allow corporations to be more generous - thus explaining the observed correlation between corporate success and philanthropy.

The empirical research is not conclusive, but suggests that corporate philanthropy reflects a blend of motives. Even studies finding evidence consistent with profit-maximizing motives also find that companies with lower agency costs - greater monitoring by creditors, more independent boards, less free cash available to managers - gave less to charity than other firms. We think these studies fairly capture reality: Both positive theories are more or less true and will be present at various levels in most cases. Just as a CEO's decision about the use of a corporate jet may be motivated by both personal and shareholder concerns, it would be surprising if decisions about doing good for others were not mostly based on mixed motives.

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B. Should Corporations Engage in Philanthropy?

It should not be surprising that scholars who believe that corporate philanthropy helps the bottom line support it and scholars who believe corporate philanthropy is an example of managerial graft oppose it. The common goal in both camps is the promotion of shareholder interests.

There is, however, a third (and for our purposes largely irrelevant) camp in the debate. Comprising mainly progressive academics, this camp champions the cause of "corporate social responsibility" (CSR). Their argument is founded on either a moral claim (firms have an abstract moral duty to do good) or a historical one (firms are licensed by the state, and therefore must serve it). Whatever the case, they assert that managers have an obligation to focus on more than profits, the more being some unspecified amalgamation of the interests of employees, communities, governments, and other "stakeholders." Although undoubtedly

opposed to managerial graft, the proponents of corporate social responsibility may simply view it as a cost that is exceeded by the benefits of corporate philanthropy. They do not care about the impact on corporate profits.

The opposing view, summarized by Milton Friedman, claims that the CSR movement conflates business and politics in ways that obscure rather [582] than illuminate the relevant issues. Friedman criticizes CSR on the ground that business knows nothing of politics or social policy…

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V. The Merits of Corporate Philanthropy

Having proposed a new framework for understanding corporate philanthropy and its relationship to the nonprofit sector and government programs, it is time to return to the basic questions that motivate this Essay: Should corporations engage in philanthropy and, if so, how should the government regulate this activity?

A. Should Corporations Engage in Philanthropy?

Business schools teach their students - the future leaders of for-profit corporations - that companies should only enter a market if they have an edge over their competitors. Otherwise they will sacrifice their bottom line and perhaps fail. Given that there is a market for altruism like there is for other products, the same lesson applies to the production of altruism.

To wit: Corporations should only engage in philanthropy if they have a cost or quality advantage over other competitors in that market. This includes other corporations and nonprofits and the government. Of course, it is a little complicated to determine how competitive the government is. After all, contributions to government production are mandatory, so people (and corporations) do not have much choice over whether to purchase government altruism. So the more nuanced version of our claim is that a corporation should engage in a particular philanthropic activity only if demand for that activity is not already satisfied by the government and if the corporation is better able to perform that activity than other corporations and nonprofits.

Although the debate over the merits of corporate philanthropy does not tackle social work by nonprofits or the government, our framework has normative implications for these actors as well. A nonprofit should only engage in a specific philanthropic activity if it is not crowded out by the government and it has a comparative advantage over other nonprofits and for-profit corporations. The government should only engage in a specific altruistic activity if that activity is subject to free riding and is therefore likely to be undersupplied by corporations and nonprofits. Of course, this is a necessary but not sufficient condition for government action. If the government's cost of addressing the undersupply is greater than consumer surplus from that additional supply, then the government should remain on the sidelines.

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Room to Argue, page 440: Too Far or Not Far Enough?

Corporate constituency statutes generally permit, but do not mandate, consideration of non-shareholder interests by corporate decision makers. **Readings Four and Five** address the benefits and shortcomings of such statutes.

Reading Four

This reading argues that constituency statutes do not mean loss of the focus on shareholders.

WHOM SHOULD THE CORPORATION SERVE? THE BERLE-DODD DEBATE REVISITED SIXTY YEARS LATER

A.A. Sommer, Jr.
Delaware Journal of Corporate Law
16 Del. J. Corp. L. 33 (1991)

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IV. "THE BEST INTERESTS OF THE CORPORATION"

All, or virtually all, of the other constituency statutes provide, as does the original Pennsylvania formulation (and the more recent one as well), that directors "may, in considering the best interests of the CORPORATION, consider the effects of any action upon employees. . . ." A critical question in interpreting these statutes is the significance to be accorded the emphasized language. The answer to that question depends upon the content one gives the word "corporation." If the word "corporation" is understood as a synonym for the shareholders as a body, then the other constituency statutes are consistent with what appears to be the prevailing state of the law in American and English jurisdictions: non-shareholder interests and constituencies may be taken into account if in so doing the long-term interests of the shareholders as a body are served, or at least not disadvantaged. On the other hand, if "corporation" is used to mean a separate judicial entity that has interests, long- or short-term, to be protected by directors in addition to or part from those of shareholders, then one is left with the chore of defining those interests, and of doing it in a way that is different from simply restating the long-term interests of shareholders.

If the proper understanding of "corporation" in this context is the latter, then presumably the directors have a very broad latitude in acting to protect the interests of the corporation. Such latitude could certainly be construed to include protection of the interests of all groups that relate to the welfare of the corporation, including not only shareholders as providers of capital, but also creditors, employees, communities, suppliers, customers, and so on. Clearly all of these contribute to the welfare of the corporation if the corporation is seen as something other than the equivalent of the interests of its shareholders. Thus, it may well be argued that if this is the meaning of "corporation" in the context of the other constituency statutes, then the other constituency statutes are a redundancy. In other words, if the obligation of the directors to serve the best interests of the corporation necessarily permits consideration of other interests and constituencies, the language authorizing the taking into account of non-shareholders' interests is unnecessary.

English scholars identify the interests of shareholders as a group with the corporation. Professor L. C. B. Gower, perhaps the most distinguished scholar of English companies law, states in his treatise that the directors' obligations run into to the corporation. However, he recognizes that the distinction between "corporation" (or "company" to use the more common British term) and its shareholders (or, again using the English term, "members") is elusive:

But what exactly is meant by saying that they [directors] must act in the interests of the company? Despite the separate personality of the company it is clear that directors are not expected to act on the basis of what is for the economic advantage of the corporate entity, disregarding the interests of the members.

Similarly, Professors Boyle and Birds have said,

> It is . . . thought that from the point of view of strict law, while the 'interests of the company' may now include the interests of the company's employees [as a result of section 309 of the Companies Act], and in certain situations the interests of its creditors [when a company is insolvent or on the verge of insolvency], it otherwise means the interests of the company as a commercial entity, to be judged in most cases by reference to the interests of present and future shareholders alone. Thus the only circumstances in which the directors may legitimately promote the interests of any other groups or entities are those where to do so ultimately advocates the interests of the shareholders.

Professor Robert Pennington has summed up the state of English law most concisely:

> Directors' powers are given to them to be used for the benefit of the company, that is, for the benefit of the shareholders as a whole, and not for the benefit of the directors themselves, nor for the benefit exclusively of a section of the shareholders or employees of the company, nor for the benefit of the company's parent or holding company or the company's subsidiaries, or of outsiders.

In the United States the equivalence of "corporation" and "shareholders" (or at least the long-term interests of shareholders) is most clearly seen in the manner in which courts and writers have used these terms, and that usage tends to show that they use them as equivalents. In Unocal, the Delaware Supreme Court, in the course of two pages, described the directors' "fundamental duty and obligation" as running first to "the corporate enterprise, which includes stockholders," later to "the corporation and its shareholders," and finally, to just "the corporation's stockholders."

In a similar vein, Fletcher in Fletcher Cyclopedia of the Law of Private Corporations, in describing the fiduciary duties of directors, speaks in the same section of directors' duties as running to the corporation and as running to shareholders, and includes numerous citations supporting each position.

This blurring of the distinction between the corporation and its shareholders is most clearly seen in the so-called Unocal doctrine which the Delaware Supreme Court has developed as a tool for dealing with the defensive measures taken by target boards. Under this doctrine, before the traditional business judgment rule is applied, the court must first determine

whether the target board reasonably perceived there was a threat to the "policy and effectiveness" of the corporation, and then whether the board's response was reasonable and proportionate to the threat. In Unocal the threat to the corporation's policies and effectiveness supposedly stemmed from the coercive and inadequate nature of the offer. In the Paramount case, the Delaware Supreme Court reiterated the nature of the Unocal threat: "Unocal involved a two-tier, highly coercive tender offer. In such a case, the threat is obvious: shareholders may be compelled to tender to avoid being treated adversely in the second stage of the transaction."

It is difficult to see how the threat of a coercive offer or an inadequate offer would constitute a threat to the "policies or effectiveness" of a corporation, while a noncoercive or adequate offer would not: in either case, the continued existence of the corporation would be jeopardized with the consequent termination of all policy and effectiveness.

Thus, even in Unocal, a seminal case in Delaware corporate jurisprudence, the supreme court blurred the distinction between the interests of the corporation and those of the shareholders. Chancellor Allen well expressed the dilemma reflected in this blurring in a footnote in TW Services, Inc. v. SWT Acquisition Corp.:

> The knowledgeable reader will recognize that this particular phrase [the board's duty to the corporation and its shareholders] masks the most fundamental issue: to what interest does the board look in resolving conflicts between interests in the corporation that may be characterized as "shareholder long[-]term interests" or "corporate entity interests" or "multi-constituency interests" on the one hand, and interests that may be characterized as "shareholder short-term interests" or "current share value interests" on the other?

The identity of shareholder and corporate interests is suggested in section 2.01 of the ALI corporate governance draft which indicates that the objective of the corporation is "the conduct of business activities with a view to enhancing corporate profit and shareholder gain." While we may muse upon the difference between "corporate profit" and "shareholder gain," any "corporate profit," as we would currently understand it, would be a gain to the shareholders, if only in the sense that the net worth of the corporation would increase.

If one accepts that when one speaks of the "best interests of the corporation" he or she in fact speaks of the best interests of its shareholders, the question then is how one identifies the best interests of the shareholders. Shareholders and their interests come in shapes and sizes as varied as their numbers. Some shareholders invest for long-term gain, others for short-term gain; some invest for dividend income, others for capital appreciation. Some shareholders are huge institutional investors controlling billions of dollars, others are individuals with as little as a hundred or fewer shares. Increasingly institutions are using portfolio indexation as an investment technique: they develop a portfolio which is a mirror of an index, such as the Standard & Poor's 500, and make changes in it only to reflect changes in the makeup of the index; such investors clearly view specific companies differently from the way individuals do. The diversity of interests is seen most dramatically when rumors surface about the possible takeover of a company. Immediately arbitrageurs acquire large amounts of the stock of the rumored target; their perspective is a matter of days, at most weeks, and inevitably what the longer term shareholders previously perceived as their best interests may go through a swift transformation.

Accepting the equivalence of "corporate best interests" with "shareholder best interests" appears to simply substitute one quagmire for another.

Reading Five

This reading argues that constituency statutes did not bring the expected positive influences.

CORPORATE SOCIAL RESPONSIBILITY THROUGH CONSTITUENCY STATUTES: LEGEND OR LIE?
Gary von Stange
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IV. AN EVALUATION OF CONSTITUENCY STATUTES AND THEIR SCOPE

A. General Overview

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[Constituency] statutes, as they currently exist, do not force a corporation to conduct itself in a socially responsible manner. Nor will these statutes significantly transfer wealth from shareholder to nonshareholder. As such, these statutes do not signal the death of the corporation.

B. A Viable Threat to Shareholder Welfare

Constituency statutes do pose a viable threat to shareholder welfare and therefore could negatively impact financial markets and the economy. These statutes unfortunately promote unaccountability in incumbent management by widening the separation between ownership and control. Management, by claiming it was merely considering other constituencies, can hide behind these statutes to justify business decisions that benefit management and not shareholders. Indeed, in light of the pervasive conflicts of interest that endure between shareholders and management, it is clear that if any group within the corporation is in need of additional legal protection it is the shareholders.

Most importantly, burdening the corporation with substantial and ill-defined social responsibilities undermines the market to the detriment of investors and society generally, including the intended beneficiary constituencies. The largest long-run costs of a corporate law that emphasizes other constituencies would be imposed not just on shareholders, but on the general public through a less efficient allocation of resources and a less innovative and productive economy, as compared with the allocation of resources that now results from firms' profit seeking under the current legal regime.

C. Institutional Investors

Because institutional investors now own more than fifty percent of stock in the nation, their "leverage to bring delinquent managements and directors to task" is significant. Indeed, institutional investors are now actively promoting their interests in corporate decisionmaking. Some commentators believe that the rise of institutional owners may help bridge the relationship between shareholders and directors, yet claim it is a development not fully materialized. On the other hand, powerful institutions such as the California Public Employees Retirement System and the Teachers Insurance and Annuity Association College Retirement Equities Fund are plainly increasing pressure of corporations to consider their financial interests. For example, TIAA-CREF recently mailed 1500 copies of their policy statement on corporate governance to corporations throughout the country. This policy statement both states TIAA-CREF's perspective on what it considers good corporate governance and identifies the voting guidelines TIAA-CREF will adhere to on certain proxy issues.

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D. Debt and Equity Financing Considerations

Corporations need to raise and maintain capital to compete in today's global marketplace. Constituency statutes, if they indeed transfer wealth from shareholders to nonshareholder constituencies, increase the cost of raising this capital. The effects of this additional cost could more than offset any nonshareholder gain secured by the statutes in both equity and debt markets.

For example, if a lender feels that a corporation will not maximize profit then the risk involved by extending the loan will increase. Concomitantly with this increased risk is an added premium to the interest rate charged for the loan. The cost of capital becomes more expensive when nonshareholders are afforded rights.

The difficulty in raising equity capital could be even more profound. Investors will need to factor into their decisions that their return will be less because profits will be diverted at any time to nonshareholders. New investors will therefore require a larger amount of stock in return for their capital infusion. Conflicts will develop between existing shareholders and the board over offering too much stock for the capital contribution as compared to the amount received by the existing shareholder at the time of his contribution.

Even if one believed that corporations should not only assist nonshareholder constituencies but that profits should eventually be diverted to the constituencies that are best served by corporate social responsibility, the inevitable consequence will be fewer profits to be diverted. The eventual result of a system where corporations significantly weigh and promote the interests of nonshareholder constituencies over shareholders will be a less efficient distribution of resources, a less innovative and fertile economy and an overall diminution of available capital for those groups that corporate constituency statutes were intended to benefit.

Additionally, even if constituency statutes reveal themselves over time to be legitimate tools to assist society welfare in general, then why are corporations discriminated against? Why are these statutes limited to corporations? Why not extend them to partnerships, trusts or sole proprietorships?

E. Interpreting Constituency Statutes

Although constituency statutes should survive legal scrutiny, the determination of their scope is still open to interpretation. Some commentators offer theories that these statutes must be interpreted in the broadest sense so that nonshareholder constituencies' interests will dominate or, in the very least, be considered on an equal basis with shareholders. These commentators argue for this theory despite the plainly permissive nature of almost all the statutes. They evidently insist on expanding the statutory language based purely on social theories of wealth transference. Clearly, they are wrong.

Under a broad interpretation of these statutes, a board would be free to deny a substantial premium to shareholders in a takeover context, enforce takeover defenses, and justify their decisions based upon their concerns for other constituencies. Management would be virtually unaccountable to shareholders for their conduct, thereby denying a board's fiduciary duties. Additionally, because the statutes are permissive in nature, they create no fiduciary duties to these other constituencies. Consequently, it is specifically a broad statutory interpretation that poses the greatest danger.

If a broad interpretation of these statutes was intended, then a new fiduciary duty running to nonshareholder constituencies would have been included. However, none of these statutes expressly mandates a new fiduciary duty, nor do they grant other constituencies standing to enforce new rights. In fact, some statutes, notably New York's, explicitly deny nonshareholder standing. With regard to those statutes silent on the matter of standing, it is an implausible assertion that legislatures intended to afford such groups standing despite no competent evidence in either the statutory language or the accompanying legislative history. Without affording nonshareholders standing, other-constituency statutes will be unenforceable by the parties who have an interest in their enforcement. The power in these statutes, therefore, is not primarily exercised for the benefit of nonshareholder constituencies; instead, incumbent management is the beneficiary. These statutes help management grow another step removed from shareholders and regrettably even less accountable for their actions.

Indeed, some commentators argue that corporate managers helped in the passage of constituency statutes to protect their own interests rather than to aid nonshareholder constituencies. They wanted protection from takeovers and they wanted job stability. Any statute that permits management to weigh the impact of their business decisions on other constituencies at the expense of shareholder interests enlarges management discretion because of the indeterminacy and instability of interest group preferences. It is precisely management though who would argue vehemently against changing the permissive nature of these statutes into mandatory provisions. Interestingly, many of the same directors who vigorously lobbied state legislators in favor of nonshareholder constituency statutes are equally vigorous in their opposition of plant closing laws and other worker protection statutes.

Therefore, a broad interpretation of the statutes accomplishes nothing except to vest more unbridled power in the hands of management. Accordingly, constituency statutes must be interpreted narrowly so that management remains accountable to shareholders for their decisions.

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