Item #02
SEMINAR IN LAW AND ECONOMICS
Professors Louis Kaplow & Steven Shavell

Tuesday, February 10, 2004
Pound 201, 4:30 p.m.

SACRIFICING CORPORATE PROFITS IN THE PUIBLIC INTEREST

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SACRIFICING CORPORATE PROFITS IN THE PUBLIC INTEREST

By Professor Einer Elhauge*

Let's start concrete before we get theoretical. Suppose clear-cutting is profitable and legal, but is nonetheless regarded as environmentally irresponsible. Can management of a timber corporation decline to clear-cut its timberland even though it sacrifices profits? One might be tempted to evade the question by claiming that being environmentally responsible is profitable in the long run, either because it preserves the forest for future harvesting or because it maintains a public goodwill that aids future sales. But suppose, in an incautious moment, management admits the present value of those future profits from not clear-cutting cannot hope to match the large current profits that clear-cutting would produce. Or, more realistically, suppose a takeover bid by a firm known to clear-cut establishes precisely that proposition by offering far more than the stock price that reflects the current stream of profits. Can management reject the profitable takeover bid on the grounds that it will lead to clear-cutting? And does our answer to either question change if it is not management, but the majority shareholder, who is declining to engage in profitable clear-cutting or accept a profitable bid from a clear-cutter?

In answering such questions, I aim to challenge the canonical law and economics account regarding the social responsibility of firms. That canonical account goes something like the following. Unless modified by statute, traditional fiduciary duties require corporate officials to further the interests of shareholders, and thus require them to maximize corporate profits subject to the obligation to comply with independent legal constraints.[1] Further, this is desirable as a matter

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[1] *See, e.g.,* ROBERT CLARK, CORPORATE LAW 17-19, 688, 690 (1986); Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991).

of both law and economics. If certain conduct imposes an excessive externality on others, then an independent law should regulate and impose liability whether or not the actor is a corporation, and if the conduct does not impose such an impermissible externality, then the most socially desirable thing for corporations to do is maximize profits.[2] The canonical account adds that a single goal like profit-maximization is easier to monitor,[3] and that there is no reason to impose a special "tax" on dissenting shareholders to further public interest goals that is not imposed on others.[4]

Then, the canonical account continues, something unfortunate happened. The 1980s takeover wave led to a political backlash that caused 29 states to adopt corporate constituency statutes that allowed or required managers to take the interests of other constituencies into account, sometimes generally, sometimes just in corporate control transactions.[5] But these statutes were not really designed to further the public interest; rather they were just a subterfuge for allowing management to block takeovers that were contrary to management interests.[6] Thus, these statutes should be narrowly interpreted. One way, proposed by the ABA and others, is to interpret these statutes to mean that, while management can consider the interests of other constituencies, they can do so only to the extent that doing so advances corporate profits.[7] Further, the canonical account stresses, the other 21 states remain governed by the traditional rule. And since these 21 states include Delaware, the 800 pound gorilla of corporate law where most of the big corporations are incorporated, they are more important in describing the current state of the law.

My contention is that each step in this canonical account is wrong. Corporate officials and

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[2] *See* CLARK, *supra* note , at 20-21, 30-32, 677-81, 692, 702; Macey, *supra* note , at 40-43.

[3] *See* CLARK, *supra* note , at 20, 679, 692, 702; American Bar Association Committee on Corporate Laws, *Other Constituency Statutes: Potential for Confusion*, 45 BUS. L. REV. 2253, 2269 (1990) [hereinafter "ABA"]

[4] *See, e.g.,* CLARK, *supra* note , at 603, 679; Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, The New York Times, Sept. 13, 1970 (Magazine at 33).

[5] *See* CHOPER, COFFEE & GILSON, CASES AND MATERIALS ON CORPORATIONS 42 (5th ed. 2000) [hereinafter "CHOPER, COFFEE & GILSON 5th Edition"].

[6] *See, e.g.,* Bainbridge, *Interpreting Nonshareholder Constituency Statutes,* 19 PEPP. L. REV. 971, 1025 (1992); Macey, *supra* note, at 26, 33, 44.

[7] *See* ABA, *supra* note , at .

controlling shareholders have never had an enforceable legal duty to maximize corporate profits. Rather they have always had some legal discretion to sacrifice corporate profits in the public interest. Indeed, this discretion could not be eliminated without destroying the business judgment rule that is the bedrock of corporate law. Perhaps more surprising, proper economic analysis does not prove this discretion is undesirable nor even inefficient. Even when designed optimally, legal sanctions will inevitably fail to cover some undesirable conduct because that underinclusion cannot be eliminated without increasing the overinclusion of desirable conduct. Thus, inducing optimal social conduct has always required supplementing imperfect legal sanctions with social sanctions and internalized moral norms. To impose a legal duty requiring corporations to maximize profits would worsen corporate conduct by overriding these important social and moral sanctions. It would mandate by law the "soulless corporation" that was the historical fear in the 1800s about states chartering the creation of corporations at all.[8]

Closer analysis also shows there is little to the arguments about having a simple goal to monitor and avoiding a special tax on shareholders. The argument that the duty to profit-maximize is easier to monitor does not work because the very reason for the business judgment rule is precisely that courts cannot reliably figure out what maximizes profits – that is, that a legal duty to maximize profits is too *hard* to monitor. And declining to make this a legal claim does nothing to prevent shareholders from choosing to adopt profit-maximization as the goal they choose to monitor in exercising their voting or investment rights. The argument that this imposes a tax on shareholders also doesn't work because it assumes a baseline of profit-maximization so that deviation from that baseline equals a "tax." If one instead assumes the baseline of discretion to sacrifice profits that reflects the actual state of affairs, then any tendency to sacrifice profits will be reflected in the stock price at which shares were bought, and the question becomes why the minority of shareholders

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[8] *See* LAWRENCE FRIEDMAN, A HISTORY OF AMERICAN LAW 171-72 (1st ed. 1973).

should be able to tax the majority for pursuing nonprofit objectives by forcing the majority to pay the minority for any lost profits. Resorting to such claims of an illegitimate "tax" on either side merely obscure the key issue, which is what baseline we want shareholders to have.

The best arguments against giving managers discretion to sacrifice corporate profits in the public interest are that managers (a) have incentives to be excessively generous in responding to social or moral pressures because the profits they are sacrificing reflect other people's money, and (b) might further conceptions of the public interest that differ from those of shareholders. But since managers are elected by majority of shareholders, they are likely to represent their interests to at least large extent. And although managers will have residual agency slack because shareholders cannot monitor them well, shareholders should be indifferent if they exercise that slack in a socially responsible way rather than some personally beneficial way. In any event, shareholders in public corporations have incentives to engage in socially suboptimal behavior because they are largely shielded from social and moral sanctions, so that managers who use their agency slack to respond to such social and moral sanctions will move corporate behavior in the right direction. This will be desirable unless this movement in the right direction not only overshoots the optimum, but does so by a larger margin than the shortfall that would be produced by social and moral insulation. But the risk of such excessive overshooting will likely be constrained by product markets, capital markets, labor markets, takeover threats, shareholder voting, and managerial profit-sharing or stock options. And in extreme cases where those nonlegal constraints are ineffective, the law can provide limits on managerial discretion to avoid excessive overshooting.

Nor does the fact that the takeover wave triggered the enactment of corporate constituency statutes prove that those statutes merely provide political cover for furthering the managerial interest in blocking takeovers. Rather, takeovers created two important special problems for a regime that allowed managers and controlling shareholders to sacrifice corporate profits in the public interest. First, takeover bids effectively monetized whether in fact the management of the corporation was

sacrificing corporate profits or not. Management could no longer credibly claim its profit-sacrificing behavior was somehow profit-maximizing in the long run because the fact that a bidder was willing to pay more than the current stock price proved that altering that behavior must offer profits with higher economic present value. This left managers without any persuasive argument that they needed to block the takeover to advance the financial interest of shareholders. Accordingly, if the law did not allow managers to block such a takeover to further other interests, then the threat of takeovers would have effectively imposed a duty to profit-maximize where there had been none before.

Second, hostile takeovers created a collective action problem for those shareholders who wanted to sacrifice corporate profits in the public interest. Acting individually, shareholders may tender even if they prefer (because of their public interest views) that a takeover not occur because they will be even worse off if the takeover occurs and they have not tendered. The basic reason is that each shareholder will individually reason that her decision about whether to tender her small aliquot of shares has little effect on whether a socially undesirable change in corporate behavior occurs, but does completely determines whether they get the takeover premium in a timely fashion. Accordingly, without takeover defenses, corporations will not be able to continue sacrificing profits even if that conduct is genuinely preferred by a majority of shareholders because such corporations will be taken over by bidders whose sole motivation is profit-maximization.

All this provides a perfectly valid justification for why a takeover wave would trigger the creation of corporate constituency statutes. Moreover, although the all-important Delaware never enacted a corporate constituency statute, the likely reason is that no statute was necessary because by common law its courts quickly held that managers had effective discretion to consider nonshareholder constituencies in deciding whether to block takeovers. None of this is to deny that some of the managers lobbying for the constituency statutes and caselaw may have had more venal motives in mind. But it does provide an explanation for why social interest groups joined their

efforts, and provides a neutral explanation that means these legal changes cannot simply be dismissed as mere management entrenchment.

In the discussion that follows, it will be vital to keep in mind some critical distinctions that often get lost on both sides of the social responsibility literature. The most important is the distinction between discretion and duty. The proposition established here is that managers have some discretion to sacrifice corporate profits in the public interest, not that there is any legally enforceable duty to do so. Arguments that such a duty to other constituencies would create various problems or conflicted loyalties thus attack a straw man as applies to a claim that such discretion properly exists. Relatedly, one must distinguish the abstract question of whether "the corporation" can sacrifice profits from the concrete issue of precisely whom can decide whether it does. The issues are related because to say that there is a legal duty (to maximize profits or further some public interest objective) is to say that any single shareholder can dictate that the corporation act in the manner than conforms with that duty, even if managers and every other shareholder disagrees.

Some other important distinctions concern the scope of discretion. My principle focus will be on the exercise of discretion in making operational decisions about the corporation that affect a general public interest, such as deciding whether to operate the corporation in a way that creates environmental harms. As we will see, the case for that sort of discretion is stronger than the case for a discretion to donate corporate funds because donations could be made separately by shareholders, whereas a corporation can not be operated in different ways for each shareholder. Nonetheless, the social and moral processes that influence the running of corporate operations will also influence donations in a way that makes it likely that preserving discretion in managers who are not insulated by those processes will likely improve donative behavior. Further, it would be inefficient to have a power to make profit-sacrificing operational decisions but not profit-sacrificing donations – or vice versa – because if only one of those powers is allowed it will often lead to inefficient substitution effects. Managers will use the permitted power even when it advances public

interest purposes at higher cost than the prohibited one. Thus, given the existence of a power to engage in profit-sacrificing conduct, allowing profit-sacrificing donations will be efficient. Likewise, given the clear statutory existence of a power to make profit-sacrificing donations, it would be inefficient to preclude profit-sacrificing conduct.

Finally, to say there is and should be some managerial discretion to sacrifice corporate profits is not to say that discretion is boundless. But normally the meaningful boundaries are not set by law. The discretion is instead powerfully limited by managerial profit-sharing or stock options, product market competition, the labor market for corporate officials, the need to raise capital, the threat of takeovers, and the prospect of being ousted by shareholder vote. Those forces are typically more than adequate to constrain management from becoming excessively generous with shareholder assets while operating the corporation. However, there are exceptional cases, especially when managers have a last period problem (and thus they do not care about the future viability of the firm or their future employment) and their action cannot easily be reversed (such as when they give away corporate assets). Consistent with this, the law does impose much sharper restrictions on managerial discretion when the firm is up for sale, a situation which often creates last period problems that leave managers less constrained by nonlegal factors.

More generally, the law does limit managers to sacrificing no more than a "reasonable" degree of profits.[9] Thus, while management can operate our timber company in a way that is less profitable than it would be if it used clearcutting, it could not eliminate corporate profits altogether by donating all the corporation's timberland as conservation land or by selling the corporation for far less than its current market value to a preservation society that plans to do the same. Unfortunately, the term "reasonable" is alone a conclusory label that offers no real guidance. But one can imbue the term with more content by comparing corporate conduct to the benchmark of

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[9] *See, e.g.*, I AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §2.01(b)(2)-(3) (1994) [hereinafter "ALI Principles"].

what would be within the range of plausible behavior for a sole proprietor who would be trading off his own profits for the avoidance of the relevant social or moral sanctions. One interesting indication of this is that tax cases have held that the law preventing corporations from deducting more than a "reasonable" amount of charitable contributions is exceeded if the share of corporate income donated exceeds 10% – which parallels the historical figure for the tithe expected of individuals in a community.

I. Does and Should Corporate Law Allow Sacrificing Profits In the Public Interest?

Most modern corporation scholars, particularly law and economics scholars, assert that under current law and proper policy analysis the sole purpose of business corporations is and should be legal profit-maximization.[10] Dean Robert Clark's assessment of the law is typical: he states flatly that the view "that the basic purposes of a corporation include not only the objective of making profits but also that of furthering the public interest, as conceived by its decision makers . . . is not embodied in current statutes and caselaw."[11]

This position is wrong as a descriptive matter. None of the fifty states has a corporate statute providing that the sole purpose of corporations is maximizing profits for shareholders, and corporate law in numerous ways permits corporations to sacrifice profits in the public interest. This position is also, I will argue, wrong as a normative matter. Businesses have always felt some social responsibility to help or refrain from harming those with whom the corporation has relations, including the larger community, even when such courses of action might not maximize profits or

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[10] See CLARK, *supra* note , at 676-703, 17-19, 20-21, 30-32, 33, 102-105, 136-40, 374-83, 539-40, 602-04 (1986) (presenting argument and collecting sources).

[11] CLARK, *supra* note , at 688, 690. *See also id.* at 17-19.

be required by law. There is no reason to structure corporate law in a way that prevents corporate businesses from acting on the same social and moral impulses that help influence noncorporate business. But that would be precisely the effect of a rule of law that made management liable, in a derivative action any minority shareholder could bring, to the corporation for operating the corporation in public-spirited ways that do not maximize profits.

A. The Duty to Engage in Profit-Sacrificing Legal Compliance

In arguing that corporate law does and should impose a duty to profit-maximize, proponents concede an important exception: management has a duty to comply with the law even though that may not be profit-maximizing.[12] This area of consensus is worth examining, for persuasively explaining this legal conclusion reveals underlying policy concerns that prove to be equally applicable outside the exception.

Suppose, for example, clear-cutting *were* illegal, but that it was still profit-maximizing given the expected legal penalties. Would management of our timber corporation now have a corporate duty (enforceable by shareholders) to violate the law because it was profit-maximizing? No, not only does management have no corporate duty to engage in illegal profit-maximizing, but management that does so would affirmatively violate a corporate law duty not to act unlawfully.[13] This substantive rule is reinforced by strong procedural rules. Shareholders are entitled to reimbursement by the corporation for their litigation expenses if they bring a derivative action that succeeds in getting the corporation to comply with the law, even though the corporation does not benefit financially from compliance.[14] A majority of shareholders cannot bar a minority shareholder

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[12]CLARK, *supra* note , at 686; Milton Friedman, *supra* note , at 33.

[13] See, e.g., ALI Principles, *supra* note, at §2.01(b)(1); Miller v. AT&T., 507 F.2d 759 (3rd Cir. 1974) (holding that illegal acts, even when undertaken to benefit the corporation, violate corporate management's fiduciary duty to the corporation); Eisenberg, *Corporate Legitimacy, Conduct, and Governance--Two Models of the Corporation*, 17 CREIGHTON L. REV. 1, 7 n.8 (1983) (collecting cases) [hereinafter "Eisenberg, *Corporate Legitimacy*"].

[14] *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

from bringing such a suit by ratifying illegal acts.[15] A shareholder is entitled to inspect corporate books and records if there is a "credible basis to find probable corporate wrongdoing."[16] And SEC rules require disclosure of evidence of illegal acts that bear on the integrity of management "even when financially insignificant."[17]

The standard legal explanation for this doctrine stresses that violating the law is per se wrongful and that corporations must comply with the same legal obligations as individuals.

> "[A] legal rule normally represents a community decision that the conduct is wrongful as such. Violations cannot then be morally or socially justified on the ground that in a particular case the violator's financial gains would outweigh either its financial losses or general social losses . . . . The corporation's obligation to obey law is based on the social norm of obedience to the law, and is therefore no different than the obligation of an individual."[18]

The conventional explanation by law and economics scholars focuses on the law's role in correcting market imperfections and policing externalities. Under this theory, corporate profit-maximization is desirable (it increases the national wealth in a way that can be regulated or redistributed to be pareto optimal) only so long as corporations function within a legal framework that makes markets competitive and prevents corporations from imposing uncompensated costs or injuries (negative externalities) on others.[19] Various noncorporate laws, the argument goes, embody public policy determinations of the extent to which the interests of nonshareholder groups merit protection from business activity: environmental laws protect the general public from pollution; labor and occupational safety laws protect employees; antitrust and product safety laws protect consumers; bankruptcy and secured transactions law protect creditors; and general contract, tort, and property law protect all these groups.[20] If corporations violate these law to improve profits, they contravene

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[15] *See* Rogers v. American Can, 305 F.2d 297 (3rd Cir. 1962).
[16] *See Security First Corp. v. U.S. Die Casting and Development,* 687 A.2d 563 (Del. 1997).
[17] *See* CHOPER, COFFEE & GILSON 5th Edition, *supra* note , at 375-76.
[18] Eisenberg, *Corporate Legitimacy, supra* note , at 9.
[19] *See* CLARK, *supra* note , at 20-21, 677-81.
[20] CLARK, *supra* note , at 30-32, 20-21.

the public policy determination by lawmakers, who have presumably taken all affected interests into account, that such violations are socially undesirable because they unduly harm nonshareholder interests.[21]

However, one cannot so easily avoid the conceptual tension between profit-maximization and the fiduciary duty to sacrifice profits to comply with the law. No one argues that corporations should be exempt from generally applicable legal penalties. What neither the legal nor economic explanation adequately explains is why profit-maximization in violation of the law should also be a violation of management's duties *to the corporation* that results in sanctions distinct from those imposed by the noncorporate law. Our corporation that violates the clearcutting law must pay the same fine as any noncorporate business. But why in addition can shareholders bring a derivative action against management for doing something that actually benefitted shareholders?

That the corporation's obligations to obey the law are no different from that of an individual (or non-corporate business) explains nothing: in fact it seems to suggest that the corporation's sanctions should be the same as the individual's. Imagine, for example, that our manager making the decision whether to violate a law against clearcutting was a sole proprietor. She would then directly face the same expected profit versus expected legal sanction decision that the corporate decisionmaker would face if legal violations did not violate his fiduciary duties, and we would, assuming she also only took profits and legal sanctions into account, expect her to make the same decision as the corporate decisionmaker would if purely maximizing corporate profits.

As for the economic argument that legal compliance optimizes corporate behavior, it fails to answer the question why, if these distinct sanctions on corporate management are appropriate,

[21]CLARK, *supra* note , at 677; Eisenberg, *Corporate Legitimacy, supra* note , at 9. Violations may be deemed undesirable because they harm nonshareholder interests more than they benefit shareholders, but more subtle economic or utilitarian judgments about how best to curb externalities are also possible. Violations may instead be deemed undesirable because shareholder interests could be advanced through other means at less harm to nonshareholder interests or because, under pareto optimal measures of social desirability, corporations should only be allowed to further shareholder interests when they can do so without harming nonshareholder interests.

they are not appropriate for non-corporate businesses as well. Surely the argument that any extra sanctions on unlawful conduct advance the purposes of that law is no longer credible. The modern literature on statutory interpretation recognizes that, because legislatures tradeoff conflicting interests and both underenforcement and overenforcement concerns when setting statutory sanctions, one cannot simply assume that adding further penalties advances the statutory purpose.[22] And the law and economics literature recognizes that, given a world of imperfect information and adjudication, the best possible sanctions will have to strike the optimal balance between underdeterring undesirable conduct and overdeterring desirable conduct.[23] Thus, sanctions can generally be increased for undesirable conduct only at the cost of increasing them for desirable conduct. If legal sanctions are suboptimal, then they should be increased for both corporate and noncorporate conduct. If instead legal sanctions are already at the optimal level that reflects the social tradeoff between overdeterrence and underdeterrence, then raising sanctions for corporate conduct would on balance worsen behavior.

A more fruitful approach is to focus on the fact that liability for violating fiduciary duties does not impose "extra" sanctions on the participants in the corporate enterprise: rather it simply reallocates those sanctions from the shareholders as a group to those who exercised control over the corporate decision to violate the law. This is true even for derivative actions that seek damages beyond the monetary disvalue of the legal sanction imposed, in order to compensate for other economic consequences of the violation (such as loss of goodwill with consumers), because those other economic sanctions would presumably also be felt by a non-corporate business.

Thus, the issue is not how high the sanctions on the corporation should be; the issue is how to best to allocate them among the corporate participants. A rule of corporate law that did not make

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[22] *See* Einer Elhauge, *Preference-Estimating Statutory Default Rules*, 102 COLUMBIA LAW REVIEW 2027, 2055 (2002); Frank Easterbrook, *Statutes'Domains*, 50 U. Chi. L. Rev. 533, 541 (1983).

[23] *See* Stephen Bundy & Einer Elhauge, *Knowledge About Legal Sanctions*, 92 MICH. L. REV. 261, 267-79 (1993).

legal violations a breach of fiduciary duties would simply let all these legal and economic sanctions fall on the shareholders just as they would on a sole proprietor. A regime that, like ours, does make legal violations a breach instead concentrates the sanctions on those controlling the corporation.[24] At the other extreme, a regime that made it an actual breach of corporate fiduciary duty to forego an opportunity to maximize profits through illegal activities would effectively result in managers having the same incentive structure as if the benefits, but not the costs, of illegal activity were concentrated on those controlling the corporation. Which system of allocating sanctions is best?

A rule of law that made failure to illegally profit-maximize a breach of fiduciary duty would misallocate sanctions in two senses. First, its allocation of legal and economic sanctions would skew the decisionmaking incentives of management. If managers act in a legal way that fails to maximize profits, they would not only forego whatever share of those profits they receive through stock holdings, options or other compensation, but also make themselves liable for the foregone profits of any other shareholders.[25] If managers chose to act illegally, they would suffer only whatever share of the corporation's legal and economic sanctions they are exposed to by their stock holdings, options, or compensation packages. Such a rule would thus make any management with less than

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[24] One complication is that the ALI provides that a court may allow managers to offset damages with any corporate gain from the particular illegal transaction being challenged if its recognition in this manner is not contrary to public policy. *See* ALI Principles §7.18(c). But given the public policy exception and the fact that courts have discretion to disregard this provision even outside this exception, this provision is rarely effective. Further, even when this provision is applied, managers cannot offset damages for that transaction with gains from other similar illegal transaction that were not caught; nor can they avoid damages by showing that the specific transaction was profitable *ex ante* given the low probability of detection and enforcement.

[25] Obviously, there are various practical problems with bringing such a suit. Bringing a lawsuit alleging failure to violate the law would likely increase the chances of the legal violation being detected to almost 100%. This would make it unlikely that any profit from the illegal conduct could be made after the lawsuit unless profits exceeded the legal penalties even without a discount for detection and enforcement. To be workable, the claim would have to be either that managers could have done something illegal in the past that now has been made legal, or that ex ante the legal violation would have been profitable given actual odds of detection and enforcement. The latter implies that the amount of recovery would presumably be for the expected net profit (profit minus expected sanctions) foregone. But the conclusion that controlling shareholders faced with such a claim would violate the law more frequently than sole proprietors does not depend on any particular measurement of damages: it is enough if the liability is positive in amount. See *infra* next note. In any event, the aim here is not to canvas fully the flaws of such a claim, but merely to illustrate some policy problems such a claim would raise that are relevant in assessing current doctrine.

a 100% claim on corporate profits more likely to violate the law than a sole proprietor.[26] The lower the percentage of corporate stock owned by managers, the worse this incentive skewing would be.

Second, one must take into account that a sole proprietor choosing to act illegally would face not just legal and economic sanctions, but social and moral sanctions that have force beyond any economic effect: the embarrassment of bad publicity, the reproach of family and friends, the pain of enduring insults and protests, the disdain of acquaintances and strangers, and the moral guilt and loss of inner worth that may come from not being law-abiding.[27] The addition of these social and moral sanctions will sometimes deter legal violations when legal and economic sanctions alone would not. Modern economic theory indicates that such social and moral sanctions are generally a desirable supplement to legal sanctions because they can be applied with lower information, error, and adjudication costs.[28]

A rule of law that allowed minority shareholders to sue for profit-sacrificing failures to violate the law would, however, mean that whichever shareholder feels the least social and moral sanctions could effectively dictate corporate decisionmaking for all shareholders. Indeed, one might expect particularly tough-hearted shareholders to specialize in buying shares in any corporations that fail to exploit profit-maximizing opportunities to violate the law, and then bringing derivative actions to force them to do so. Corporations would be governed by the lowest common moral denominator among all shareholders.

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[26] Suppose the profits from a legal violation are π_v, the legal liability is L, the share of profits to which management is entitled is S, the probability the violation will be detected and punished is P_v, and the probability a failure to profit-maximize through illegal conduct would be detected and punished is P_π. Assume also everyone is rational actor who only takes into account their economic interests (which excludes the social and moral sanctions I address later). Then the sole proprietor would violate the law whenever $\pi_v > P_v L$. In contrast, corporate management would (under a duty to profit-maximize even when it required illegal conduct) violate the law whenever: $S\pi_v + P_\pi(1\text{-}S)\pi_v > S\ P_v L$. In other words, the corporate manager faces a proportionate share of the same inequality as the sole proprietor with a bonus of avoiding liability to the other shareholders if he takes the profit-maximizing but illegal course of conduct.

[27] I will be using the term "social sanctions" to include only these sorts of nonmonetary penalties. I use the term "economic sanctions" to describe the economic impact that comes when others will not deal with a firm because of its unsavory reputation.

[28] *See* [cites].

Worse, in public corporations, shareholders suffer little or no social sanctions from illegal corporate action because they are not involved in corporate management and thus are largely shielded from social sanctions. Shareholders ordinarily will also be blissfully unaware about the details of operational decisions, and thus largely immune from the moral sanctions that require knowing what just what the corporation is doing. The corporate structure, in other words, will protect public shareholders from the ordinary social and moral sanctions that a sole proprietor would feel. They will thus be more likely to favor legal violations than would sole proprietors who suffered all those social and moral sanctions on top of legal and economic sanctions. And since these social and moral sanctions are a necessary supplement to achieve fully optimal behavior, weakening them would worsen behavior.

That explains why corporate law imposes no duty to profit-maximize illegally. But why not just have no relevant fiduciary duty, and thus let the legal and economic sanctions fall on the corporation and thus shareholders generally, rather than impose a fiduciary duty not to violate the law which concentrates those sanctions on management? If one considers only legal and economic sanctions, it would seem that having no corporate duty would optimize incentives because it would visit on management a proportionate share of the gains and sanctions from corporate conduct, and thus give corporate managers the same incentives as a sole proprietor. But when it comes to social and moral sanctions, we would then have a problem. For management decisions will largely be influenced by their need to please shareholders who are largely shielded from the social and moral sanctions attending illegal activity, and thus are likely to put pressure on management to maximize profits illegally even when a sole proprietor who personally suffered the social and moral sanctions would not. This is the structural feature that explains the historical and common law fear of the "soulless" corporation.[29] True, to the extent the shareholder ability to monitor management is

[29] *See infra* at __.

imperfect, as it surely is, managers will have agency slack and thus their behavior will likely be influenced by the own social and moral sanctions they personally suffer. In this zone, managers are likely to be *more* law-abiding that the average sole proprietor even without any corporate duty because managers will garner only a small portion of the economic benefits of illegal activity but suffer the full social and moral sanctions. But outside of this zone of agency slack, accountability to shareholders shielded from social and moral sanctions will lead management to act illegally more often than an investor-manager would. In such cases, having the legal and economics sanctions from the corporation's legal violations concentrated on management counters the incentive to excessive illegality otherwise created by accountability to shareholders shielded from social and moral sanctions.

Given this allocation of sanctions under existing law, it would not be surprising to see that corporations actually behave in a more law-abiding manner than sole proprietors, since corporate management suffers concentrated legal and economic sanctions as well personal social and moral sanctions. And that is apparently what we do see.[30] But the analysis above suggests we would see the reverse if the law imposed a corporate duty to profit-maximize even that violated a noncorporate law. We might well also see the reverse if instead our corporate law did not impose a fiduciary duty at all, and thus did not concentrate the corporation's legal and economic sanctions from illegal conduct on corporate management.

The main concern the current rule raises is that it might produce excessive overdeterrence by making management liable to the corporation for any injury it suffers from being caught in illegal acts. Managers might well be reluctant to have the corporation engage in conduct that is desirable but nonetheless close enough to the line of legality that they fear it being declared illegal by some erroneous judge or jury. This problem has been solved by making managerial liability to the

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[30] *See* [Arlen and/or other cite from Kraakman]

corporation for illegal acts mandatory only if the illegality is knowing, in which case overdeterrence should not be much of a concern. Otherwise, such managerial liability is just a default rule from which the corporation can opt out if it produces excessive overdeterrence.[31]

B. The Discretion to Refrain from Legal Profit-Maximizing Activity

Now, suppose there is no environmental regulation prohibiting clearcutting, but it is nonetheless regarded as environmentally irresponsible. Can our corporate management decline to engage in clearcutting even if it is in fact profit-maximizing? The legal answer is yes, and perhaps more surprisingly allowing management to exercise that discretion is economically efficient.

1. How Law Confers Such Discretion. – Despite contrary assertions, in fact the law has never barred corporations from taking public-spirited courses of action that do not maximize corporate profits even when not required by law. As even proponents of a profit-maximizing duty concede, no corporate statutes ever stated that the sole purpose of corporations is maximizing profits for shareholders.[32] Dean Clark asserts that lawyers, judges, and economists normally assume it anyway.[33] But this seems in tension with his concession that in fact corporate managers often assume that they are supposed to temper profit-maximization with a concern for other affected interests.[34] Groups that represent corporate management, like Business Roundtable, "have denied that profit-maximization should be the basic criterion by which managements should be judged."[35] Mainstream respected investors like Warren Buffet "says explicitly that he is willing to sacrifice the

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[31] Thirty-one states, including Delaware, have adopted statutes allowing corporate charters to eliminate manager liability to the corporation for illegal acts that are not "knowing." *See* CHOPER, COFFEE & GILSON 5th Edition, *supra* note , at 111 & n.46. Within two years of enactment, over 90% of Delaware corporations had adopted such a charter provision. *Id.* Further, even without such a statute, the ALI provides that corporate common law would allow a provision capping damages for unknowing illegality at the manager's annual compensation. ALI Principles, *supra* note , §7.19.

[32] See CLARK, *supra* note , at 17, 678.

[33] See *id.* at 17, 678.

[34] See *id.* at 690-91

[35] *See* CHOPER, COFFEE & GILSON, CASES AND MATERIALS ON CORPORATIONS 35 (3rd ed. 1989).

financial interests of shareholders in favor of 'social' considerations."[36] And many economists have argued that empirically corporate managers do not actually profit-maximize but only profit-"satisfice": that is, they achieve the level of profits necessary to avoid interference with their discretion but otherwise run the firm to advance other aims.[37]

In any event, we need not rely solely on statutory silence, nor on common perceptions of what it means. Every state's corporation statutes give management explicit authority to donate corporate funds for charitable purposes.[38] This is particularly significant since, as we shall see, the arguments for giving management discretion to make charitable donations is actually weaker than the arguments for giving them profit-sacrificing discretion in how they operate the corporation. Further, 29 states also have corporate constituency statutes that explicitly authorize managers to consider nonshareholder interests, specifically including the interests not only of employees but also of customers and the community at large.[39]

Even without any statute, such discretion seems recognized by the corporate common law that governs absent statutory displacement. This includes the supposedly conservative Delaware, which does not have such a corporate constituency statute, but does by caselaw authorize managers evaluating a takeover bid to consider "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), [and] . . . . [w]hile not a controlling factor . . . the basic stockholder interests at stake . . ."[40] Federal courts have similarly

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[36] *See* Henry Hu, *Buffett, Corporate Objectives, and the Nature of Sheep,* 19 CARDOZO L. REV. 379, 391-92 (1997).

[37] *See* CHOPER, COFFEE & GILSON 5th Edition, *supra* note , at 30 (collecting sources).

[38] See *id.* at 40.

[39] *Id.* at 42-43.

[40] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). *See also* Ivanhoe Partners v. Newmont Mining, 535 A.2d 1334, 1341-42 (Del. 1987) ("the board may under appropriate circumstances consider . . . questions of illegality, the impact on constituencies other than shareholders, . . . and the basic stockholder interests at stake"); Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1990) ("directors may consider, when evaluating the threat posed by a takeover bid, . . . 'the impact on 'constituencies' other than shareholders.'") There is a limited exception when the corporation has put itself up for sale, which I discuss later in this article. *See infra* Part III.B.

construed the state corporate laws of numerous other states.[41] More generally, the influential Principles of Corporate Governance by the American Law Institute (ALI) state that, without any statute, the basic background rule is that, “Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes."[42] The provision allowing consideration of business ethics clearly goes beyond authorizing traditional charitable contributions to authorize decisions to sacrifice corporate profits in the course of business operations.[43] Perhaps less obviously, the second provision is intended to do the same. It authorizes such decisions as declining to make sales that might adversely affect national foreign policy, investing in poverty-stricken areas, employing minorities and handicapped persons, or refraining from pursuing legal profit-maximizing activity that will harm the environment.[44] More generally, it permits corporations "to engage in humane behavior even where the behavior is not required by generally recognized ethical principles" and would not maximize profits.[45]

Proponents of a profit-maximization duty often try to narrow these contrary provisions and caselaw by reading them to authorize making donations, being ethical, and considering nonshareholder interests only to the extent that doing so maximizes profits in the long run.[46] But this narrow reading is strained. Neither the ALI nor statutory provisions are by their terms limited

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[41] *See* I DENNIS J. BLOCK, ET AL., THE BUSINESS JUDGMENT RULE 810-11 (5th ed. 1998).

[42] ALI Principles, *supra* note , §2.01(b)(2)-(3).

[43] See ALI comments; Eisenberg, *Corporate Legitimacy, supra* note , at 10-12.

[44] See ALI comments; Eisenberg, *Corporate Legitimacy, supra* note , at 12-14. Indeed, the stronger the nexus to corporate operations, the more likely the decision to sacrifice profits would be sustained under 2.01(b)(3). See Eisenberg, *Corporate Legitimacy, supra* note , at 13-14; ALI illustrations 16 & 22.

[45] Eisenberg, *Corporate Legitimacy, supra* note , at 12.

[46] CLARK, *supra* note , at 682-683; American Bar Association Committee on Corporate Laws, *Other Constituency Statutes: Potential for Confusion*, 45 BUS. L. REV. 2253 (1990); *see also* BLOCK ET AL., *supra* note , at 810-811, 813-14 (reporting some efforts to do so).

to cases where there is a convenient coincidence between maximizing profits and acting in the public interest. To the contrary, the ALI comments, and separate writings from the Reporter to the ALI, Professor Melvin Eisenberg, specifically note that the provisions authorizing ethical behavior and devotion of corporate resources to public welfare purposes govern even when such behavior conflicts with long (and short) run profit-maximization.[47] True, the ALI provisions are not themselves binding. But they do cite copious caselaw supporting them that go beyond the proposition that such public-spirited corporate conduct is permissible when it happens to maximize corporate profits in the long run.[48]

Further, the Delaware caselaw noted above specifically states that shareholder interests are "not a controlling factor," which seems inconsistent with the notion that the board may consider nonshareholder interests only to the extent they further shareholder interests.[49] And the corporate constituency statutes generally have separate provisions, one stating that managers can consider the long and short term interests shareholders, and another provision stating that managers can consider the effects of corporate conduct on other constituencies.[50] The latter provision would be superfluous if it merely allows managers to consider those effects when they had an effect on the long or short term interests of shareholders. Thus, the standard canon of statutory construction that, where possible, a statute should be interpreted to render all provisions meaningful indicates that the latter provision must have been intended to allow consideration of the impact on those other constituencies even when it did not maximize long or short term shareholder interests. Some statutes even explicitly reject the proposition that management must regard the interests of any particular group

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[47] Eisenberg, *Corporate Legitimacy, supra* note , at 6-7, 11-12 [given id. at 6 n.6, check to see whether Comments to ALI provides better sources. Illustrations 11 & 22] [check also 71 Cal L Rev 994].

[48] ALI Principles, *supra* note , §2.01 Reporter's Note 1. *See also* Eisenberg, *Corporate Legitimacy, supra* note , at 12-13 nn.21-22 (collecting supporting cases).

[49] *Unocal*, 493 A.2d at 955.

[50] *See, e.g.,* N.Y. Bus. Corp. Law §717(b); Connecticut Stock Corporation Law §33-756(d).

like shareholders "as a dominant or controlling interest or factor."[51] It is also hard to believe legislatures would have bothered to enact corporate constituency statutes to simply affirm the existence of such conventional exercises of business judgment. Likewise, this "no change" interpretation of these statutes by profit-maximization proponents seems inconsistent with the fact that these proponents also vociferously oppose these statutes[52] – if the statutes just identify factors relevant to figuring out what maximizes profits, what's the beef? The real motive for such a narrow reading appears to be the common view that these corporate constituency statutes and caselaw were a mere subterfuge for protecting managers from takeovers, which is an issue I take up in Part II.

In any event, the state corporate statutes authorizing charitable donations predated the takeover wave, and cannot be so easily dismissed. Twenty-four states (including Delaware) authorize "donations for the public welfare or for charitable, scientific, or educational purposes," [53] which is similar enough to the last ALI provision to suggest a similar power to sacrifice profits. Further, 19 other corporate statutes (as well as the Revised Model Business Corporation Act) make this even clearer by having *separate* provisions, one authorizing donations "furthering the business and affairs of the corporation," and another one authorizing (like in the first 24 states) "donations for the public welfare or for charitable, scientific, or educational purposes".[54] The first provision would render the latter provision superfluous if it applied only to donations that furthered the business of the corporation. Thus, again, the canon that a statute should be interpreted to render all provisions meaningful governs, and here implies that the latter sort of provision must authorize donations (for charitable and public welfare purposes) that do *not* further the business and affairs of the corporation. The remaining seven states (which include our biggest states, California and New York) are the most explicit of all, authorizing charitable donations "irrespective of corporate

[51] *See, e.g.,* Pa. Bus. Corp. Law §1715(b); Pa. Corp. Law §515(b); Ind. Code Ann. § 23-1-35-1(f) .
[52] *See* ABA, *supra* note ,at 2253, 2268.
[53] See *See* CHOPER, COFFEE & GILSON 5th Edition, *supra* note , at 40.
[54] See *id.*; RMBCA §3.02(13)&(15).

benefit."[55] Further, event, although corporate managers may often claim their donations increase long run profits, as an empirical matter this seems dubious,[56] thus in fact profit-sacrificing donations are being allowed.

Federal law also seems to recognize a discretion to sacrifice corporate profits to further public interest objectives because Rule 14a-8 allows shareholder proposals on social responsibility issues significantly related to the corporation's businesses even when not motivated by profit-maximizing concerns. As the SEC made clear in adopting this amendment, and as subsequent cases have held, this includes proposals whose significance in relation to corporate business is ethical rather than financial.[57]

Even when a statute or common law does not explicitly authorize management to sacrifice corporate profits to further nonshareholder interests, the business judgment rule makes clear that there is no legally enforceable duty that bars managers from exercising discretion to sacrifice corporate profits in the public interest. Statutory formulations of the duty of care usually state that a manager should discharge his duties "in a manner he reasonably believes to be in the best interests of the corporation."[58] Although read to imply a duty to profit-maximize by proponents,[59] these statutes never define the "best interests of the corporation" as meaning solely the interests of shareholders, nor do they ever define the interests of shareholders to mean solely their *economic* interests. Both are glosses added by proponents. Indeed, as noted above, corporate constituency

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[55] *See* CHOPER, COFFEE & GILSON 5th Edition, *supra* note , at 40.

[56] *See* Victory Brudney & Allen Ferrell, *Corporate Charitable Giving*, 69 U. CHIC. L. REV. 1191, 1192 n.4, 1195 (2002).

[57] SEC Exch. Act Rel. No. 34-12,999 (1976); Lovenheim v. Iroquois Brands Ltd., 618 F. Supp. 554 (D.D.C. 1985). Another possible exception, the ordinary business operations exception, should apply only if the state gives the board exclusive power to decide when to sacrifice profits in the public interest. See CLARK, *supra* note , at 381-82. The rule would not apply in that case because federal proxy rules aim to facilitate the shareholder powers that already exist under state law, not to create new ones.

[58] MBCA §8.30(a); [American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §4.01(a), at 14 (Tent. Draft No. 4, 1985) (stating that this standard "is believed to be consistent with present duty of care standards in most states.")]

[59] See CLARK, *supra* note , at 679 & n.2.

statutes in most states explicitly reject that definition by providing that, in evaluating the "best interests of the corporation," a director may consider the effects of corporate action on shareholders, employees, suppliers, customers or the larger community.

More important, even if the duty of care were interpreted to imply an aspirational duty to profit-maximize, the business judgment rule would still mean that this duty was not legally enforceable in a way that would bar managers(and controlling shareholders) from exercising discretion to sacrifice corporate profits in the public interest. Under the business judgment rule, the courts will not second-guess the business judgment of managers as to what course of conduct is in the best interests of the corporation as long as those managers do not have a conflict of interest. Further, the conflict-of-interest statutes that define the exception to the business judgment rule have been written in a way that makes them inapplicable to any claim of a conflict between the director's public interest views and shareholder interests. These statutes are explicitly limited to transactions where management has *financial* interests[60] or, at most, family interests of the sort that are understood in liberal society to be sufficiently personal as not to implicate the public interest.[61] This is crucial because otherwise a conflict of interest could always be claimed by alleging that corporate managers were deriving psychic pleasure from devoting corporate resources to furthering their particular vision of the public interest.[62]

The result is that, under the business judgment rule, courts are extraordinarily willing to sustain decisions that apparently sacrifice profits (at least in the short-run) on the ground that they may conceivably maximize profits (at least in the long-run). Because just about any decision to

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[60] See, e.g., Delaware General Corporation Law §144(a) (1969); New York Business Corporation Law §713(a) (1971); California General Corporation Law §310(a) (1976); 43 Bus. Lawyer 691, 694.

[61] See., e.g., Connecticut Stock Corporation Act §33-323(a) (1973). Courts generally treat family interests as raising conflict of interest problems even where statutes are limited to transactions in which the director has a financial interest. See Johnson v. Radio Station WOW, 144 Neb 406 (1944); Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966). But there are some exceptions. See Rocket Mining v. Gill, 25 Utah 2d 434 (1971).

[62] 43 Bus. Law. 691, 694 (1988).

sacrifice profits has a conceivable link to long-term profits,[63] a large degree of effective authority to sacrifice profits in the public interest is created.

Illustrative is *Shlensky v. Wrigley,*[64] where a derivative action claimed that Mr. Wrigley, a director, the President and 80% shareholder of the corporation owning the Chicago Cubs, had violated his fiduciary duties by refusing to install lights in Wrigley Field. The complaint alleged that Mr. Wrigley "has admitted that he is not interested in whether the Cubs would benefit financially" from installing lights, but rather was motivated by "his personal opinions 'that baseball is a "daytime" sport and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood.'"[65] The complaint further alleged a plethora of facts supporting a conclusion that installing lights would in fact increase corporate profits: (1) every other baseball team had installed lights for the purpose of increasing attendance and revenue; (2) Cub road attendance (where night baseball was played) was better than Cub home attendance; (3) Cub weekday attendance was worse than that of the Chicago White Sox, who played at night in the same city, even though their weekend attendance (when both teams played day ball), was the same; and (4) the cost of installing lights (which could be financed) would be more than offset by the extra revenue that would result from increasing attendance by playing night baseball.[66]

The court affirmed dismissal of the complaint, stating that it was "not satisfied that the motives assigned to [Mr. Wrigley] are contrary to the best interests of the corporation and the stockholders" because in the long run a decline in the quality of the neighborhood might reduce attendance or property value.[67] The court did not allow inquiry into Mr. Wrigley's actual motivation. Rather, the implicit holding was that actual motivation was irrelevant, because the court affirmed

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[63] Cf. Eisenberg, *Corporate Legitimacy, supra* note , at 12-13.
[64] 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968).
[65] *Id.* at . The other directors allegedly acquiesced in these wishes of their majority shareholder. *Id.*
[66] *Id.* at .
[67] *Id.* at

dismissal of the complaint without giving the plaintiff an opportunity to prove the allegations that Mr. Wrigley was motivated in part by his philosophical opposition to night baseball and that his concern for the neighborhood was unrelated to any concern about corporate profits.

Nor did the court hinge its holding on any conclusions about whether continuing day baseball would maximize profits, or was at all likely to do so. Indeed, in a remarkably hostile treatment, the court found the complaint defective because it failed to allege that the teams that installed lights actually made more profit or that the extra revenue from night baseball would offset the costs of operating and maintaining ballpark lighting as well as the costs of installing it.[68] Given the normal practice of reading complaints liberally and providing ample opportunity to amend, one would think that the missing allegations would be deemed implied or that the court would afford the plaintiffs an opportunity to amend their complaint to add the missing allegations. But the court was apparently unwilling to allow any inquiry into the causal link between corporate profits and a decision about business operations.

There are certainly sound policy reasons for the court's position. Motivational inquiries are problematic for all the familiar reasons,[69] and are likely -- absent some explicit admission by management -- to turn on the court's business judgment about which method of operation would maximize profits. And if we thought courts were better at managing businesses than their management was, then why have management at all rather than allow judges to govern all corporate decisions? Moreover, even where motives are clear, proving damages would necessitate a causation inquiry that would require the court to make a business judgment as to whether a different method of operations would have actually led to more profit. Even if putting lights in Wrigley field would have created profits that exceeded all costs, including costs of operation and maintenance, how could a court ever decide whether investing those funds in another relief pitcher wouldn't produce even

[68] *Id.* at

[69] See, e.g., CLARK, *supra* note , at 137-38.

more profit?

Avoiding such motivation and causation inquiries would thus seem advisable for all the reasons underlying the business judgment rule. The result, however, is that the standard for reviewing allegations that corporate management (or controlling shareholders) have sacrificed profits in the public interest is, at worst, no tougher than rational-basis scrutiny under the equal protection clause. If management offers any argument that the public-spirited activity is conceivably related to long-run profitability, or if a court can think of such an argument, the activity will be sustained without any inquiry into management's actual purposes.[70] Moreover, in application the review seems, if anything, more deferential than ordinary business judgment review. The reason courts rarely reach the issue whether corporations can sacrifice profits in the public interest is that they are so busy sustaining such decisions based on some tenuous connection to profitability.

Indeed, the only case that has apparently ever interfered with the corporate power to sacrifice profits in the public interest is *Dodge v. Ford Motor.*[71] In that case the Dodge brothers, minority shareholders in Ford Motor Company, brought a derivative action against Henry Ford, the controlling shareholder, seeking to force payment of certain suspended "special dividends" and enjoin further business expansion. Mr. Ford justified the refusal to pay the special dividends as necessary to fund a corporate policy of reducing car prices 18% while doubling production capacity.[72] He did not argue that this corporate policy would maximize corporate profits: indeed, he apparently conceded that all the cars Ford could produce would have been sold without reducing car prices. Rather his main argument was that "the fact that [a corporation] is organized for profit does not prevent the existence of implied powers to carry on with humanitarian motives such charitable works as are incidental to the main business of the corporation."[73] As the court put it, Mr.

[70] CLARK, *supra* note , at 682-83.
[71] 170 N.W. 668 (Mich. 1919).
[72] *Id.* at
[73] *Id.* at

Ford's main position seemed to be that the shareholders had made enough profit and some of the gains should be shared with consumers.[74]

The *Dodge* court rejected this argument, and enjoined the nonpayment of dividends, in a famous passage generally understood as the most ringing legal endorsement of the proposition that corporations must maximize profits.

> In discussing [the] proposition [that humanitarian expenditures incidental to corporate business are proper], counsel have referred to decisions . . . [that] turn finally upon the point, the question, whether it appears that the directors were not acting for the best interests of the corporation. . . . The difference between an incidental humanitarian expenditure of corporate funds for the benefit of employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious. There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting minority shareholders. A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to a reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[75]

Despite the heavy reliance placed on this case by those advocating pure profit-maximization,[76] upon closer examination the passage is not nearly so clear. The only proposition definitely rejected by the case is that corporate profits can be sacrificed for the benefit of the general public (here consumers). The court does not state that a corporation must be carried on exclusively for profit, but only "primarily" so, and specifically permits a corporation to make humanitarian expenditures "for the benefit of the employees." True, if one reads the first sentence's reference to "the best interests of the corporation" as meaning only the financial interests of the shareholders, then one might conclude that the court simply recognized that expending corporate funds on employees can maximize profits in the long run. But, as we have seen, the meaning of "the best interests of the

[74] *Id.* at

[75] *Id.* at

[76] See. e.g., CLARK, *supra* note , at 679.

corporation" is not nearly so clear, and can include other stakeholders in the corporation. The court may be conceding, or at least leaving open, the possibility that a corporation can operate its business in a manner humane to employees even though profits could be increased (in the long and short run) through less humanitarian operations.

More important, despite the above language, the *Dodge* court did not enjoin the business expansion, even though the plaintiff alleged that the motive for that expansion was a desire to spread out corporate profits by creating more jobs and even though the expansion would in part be funded by some reduction in dividends. Whether the court was manifesting the belief that benefitting employees at some expense to shareholders was an acceptable motive is unclear, because the court ran against another problem. The plaintiff's argument would require the court to involve itself in questions of motive and causation that are difficult to resolve and require business judgment to assess. Like the *Wrigley* court, the *Dodge* court refused to inquire into the actual motivation of management because it was "not satisfied that the alleged motives of the directors, in so far as they are reflected in the conduct of the business, menace the interests of the shareholders" and refused to inquire into the causal link between the expansion and profitability because "judges are not business experts."[77]

The ruling on the refusal to pay dividends in order to lower car prices avoided these problems only because Henry Ford conceded that the motivation for this was to sacrifice profits and because damages could be measured by the foregone dividends without inquiring into the profitability of other methods of operation. Ford's plan would have been immune from any modification at all had he merely alleged either that lowering prices would increase cars sales enough to increase short-term profits or that creating goodwill with consumers would increase profits in the long run. The inroads on the de facto authority of corporations to sacrifice profits in

[77] 170 N.W. at

the public interest is minor indeed. At worst it seems, in any states that still follow the *Dodge* holding, those controlling or managing the corporation cannot affirmatively assert a desire to sacrifice shareholder profit under circumstances where damages are easily measurable. If the motive or causation issues are any less clear, business judgment deference will protect their decision.

Moreover, the aberrational *Dodge* holding may have resulted from other factors that suggested Henry Ford either had a conflict of interest or was violating independent laws on competition. At the time of the conduct being challenged, Mr. Ford was running for the U.S. Senate, thus raising the concern that what was styled as sacrificing corporate profits to further the public interest might instead really be sacrificing profits to further his own interest in election. This would raise a conflict-of-interest problem outside the zone of any discretion to sacrifice profits, much like the corporate manager who donates corporate funds to a charity he runs or to an opera house that gives him the best seat in the house.[78] An even more venal self-interested purpose may have been that Mr. Ford was suspending dividends in order to force the Dodge brothers to sell their stock to him at favorable prices (which eventually happened), thus violating his fiduciary duty not to use his corporate control to benefit himself financially at the expense of other shareholders.[79] There may also have been some implicit concern that Mr. Ford was violating his fiduciary duty to act legally under the antitrust and unfair competition law of the times. The Dodge brothers had decided to start their own business, and Ford may have implemented this plan to deprive them of the necessary capital to do so and to engage in what may have been considered preemptive predatory pricing.[80]

So even *Dodge*, the high-water mark for the supposed duty to profit-maximize, is fairly weak support for such a general duty. Even it did not constrain the operational decision that really

[78] *See* Eisenberg, *Corporate Conduct that Does Not Maximize Shareholder Gain*, 28 STETSON L. REV. 1, 22-25 (1998) [hereinafter "Eisenberg, *Corporate Conduct*"]; Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem,* 41 N.Y. L. SCH. L. REV. 1148 (1996-97).

[79] *See* CLARK, *supra* note , at 604.

[80] *Id.*

sacrificed corporate profits, and the ruling on the distribution of dividends may have reflected concerns about latent conflicts of interest or independently illegal conduct. And it is dubious whether *Dodge* remains good law. It is an old case, decided in 1919, and although often quoted by commentators, any claim of a general duty to profit-maximizes has not had much influence on subsequent cases or statutes, which as noted above have permitted some discretion to sacrifice corporate profits in the public interest.

None of this implies a legal enforceable corporate *duty* to engage in profit-sacrificing conduct when not required by other law to do so. The above cases and statutes all use language of discretion. The statute that might seem an exception is the Connecticut corporate constituency statute, which does contain mandatory language that management "shall consider" various nonshareholder interests.[81] But because this and other corporate constituency statutes set forth a duty only to the corporation, they can be enforced against management only via a derivative action by shareholders. Thus, even for Connecticut corporations, nonshareholder interests have no way of forcing managers to even consider their interests if managers prefer not to, though an interesting case could arise if they bought some shares in order to do so. In any event, even if management has an enforceable duty to consider nonshareholder interests, nothing in the law gives it any duty to give those interests any particular weight, so the discretion remains undisturbed.

2. Why Some Discretion to Sacrifice Corporate Profits in the Public Interest Is Desirable and Even Economically Efficient. -- Even if the law gives management the discretion to sacrifice corporate profits in the public interest, is that desirable? The answer turns out to be 'yes,' and more surprisingly 'yes' even if we assume that economic efficiency is our ultimate metric of desirability.

In one sense, the answer is easy because the economic efficiencies that come from delegating management to someone other than shareholders or judges cannot be achieved without creating such

[81] Connecticut Stock Corporation Law §33-756(d).

discretion. As economists have shown, achieving the optimal level of agency costs requires some tradeoff between monitoring costs and the costs of permitting agent discretion.[82] 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 benefitting themselves (say by renting corporate luxury boxes in stadiums) can also do so by benefitting the public interest (say by donating funds to local charities). In either case, a strained claim that the activity somehow increases corporate profits (by building goodwill with clients or the community) will mean that it will survive legal scrutiny under the business judgment rule, which must be taken as setting what the law regards as the optimal degree of agency slack. And in either case, shareholders focused on the bottom line will care only about the total amount of agency slack and profit-sacrificing behavior, and not precisely how those profits were sacrificed.

But in another sense the above argument is too easy because it 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 to allow even patent exercises of discretion. Nor would it explain why the law responded to the threat that takeovers would eliminate that discretion by making the discretion more explicit. For that, we need a stronger affirmative justification.

In addressing this affirmative issue, it is important not to obscure issues by continuing to talk about whether "the corporation" can pursue public interest objectives at some loss of profit. No one seriously doubts that shareholders could not, by unanimous vote, choose to run corporate operations in a manner that sacrificed profits. Nor do any of the policy objections discussed below give any reason to prevent such action. If shareholders can individually fund or pursue public welfare

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[82] *See* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

objectives, there seems to be no reason not to allow them to do so collectively. The real issue is whether those who control or run the corporation can sacrifice profits over the objections of some shareholders.

More specifically, the issue is whether those who control or run the corporation can sacrifice profits without paying damages to compensate dissenting shareholders. Even if one thought there should be a duty to maximize profits, enforcing it by injunctive relief would be both undesirable and overly intrusive. A court granting injunctive relief would become embroiled in an ongoing power struggle over how best to operate the corporation to maximize profits, a task that would require ongoing judicial monitoring of corporate operations to secure compliance. Moreover, even if it is unfair or unadvisable to allow those controlling the corporation to force minority shareholders to forego profits to further the causes of the controlling parties, it also seems unfair and unadvisable to allow the minority to force via injunction the controlling parties (particularly if they are majority shareholders) to operate the corporation in a way they feel is wrong or immoral. An award of damages should fully satisfy the profit objectives of the minority, and as long as the controlling party is willing to compensate the minority for any injury it suffers, there seems no reason it should not be free to use its control to further the public interest objectives it chooses. Certainly, if made economically indifferent, the minority cannot claim a greater right to choose the corporation's public interest objectives than the majority.

Much of the argument usually centers around whether or not shareholders are wrongfully "injured" by a corporate decision to forego maximum profits. This turns out not to be a fruitful avenue of inquiry. For example, those favoring a regime that allows corporations to have goals other than profit-maximization often argue that shareholders are not injured because they can always sell their shares. If, however, the shareholder bought her shares when the expectation was pure profit-seeking, then the economic loss that results when a corporation embarks on a course of sacrificing profits cannot be avoided by selling one's shares because the expected decline in future

earnings will be capitalized into the value of the shares. Those favoring a duty to profit-maximize, in contrast, argue that shareholders are hurt by a failure to profit-maximize because it lowers the value of their shares. But if the shareholder bought into the corporation with full knowledge about its willingness to temper profit-maximization, and understood that such tempering cannot legally be challenged, then the shareholder will have bought in at a lower stock price and can claim no injury.

Other arguments accordingly focus on shareholders' expectations. One side stresses that minority shareholders take their shares on the understanding that corporations are run by management and controlled by majority shareholders. The other side counters by asserting that they also invest with the expectation that the corporation will be run for profit. Empirical evidence on shareholder expectations is, however, usually lacking. No doubt shareholders do not regard stock investments as tantamount to charitable contributions, but it seems equally unlikely that shareholders invest expecting unabashed profit-seeking untempered by any sense of social responsibility. Expectations of pure profit-maximization seem particularly unlikely in light of the laws expressing authorizing charitable contributions and countenancing other forms of public-spirited activities noted above.

The deeper problem, as this last point reveals, is that the expectations argument is ultimately circular. Shareholder expectations are likely to reflect the governing legal regime. If that regime mandates pure profit-maximization, shareholders will expect pure-profit maximization. If that regime allows corporations to temper profit-maximization, shareholders will expect tempering. Whatever shareholder expectations happen to be at the moment is not important:[83] the ultimate policy question is what expectations we want shareholders to have.

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[83] It may raise important transitional problems, though typically the degree of reliance parties place on any status quo will be more efficient if the relying parties bear the risk that the status quo will be change. *See* Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986).

A related policy objection to allowing corporate profit-sacrificing stresses the illegitimacy of allowing those running the corporation to "tax" minority shareholders to further public interest objectives the minority has not chosen. As Dean Clark nicely put the argument, "it is morally good to be generous, but please be generous with your own money, not that of other persons."[84] Note that this argument applies even though the issue is whether the majority can sacrifice profits over the objections of the minority. Although such a majority would also be taxing itself, it would be forcing the minority to fund a percentage of public interest objectives the majority has chosen. But the argument has a basic flaw. Terming a corporate decision to sacrifice profits a "tax" or a use of money belonging to "other persons" implicitly assumes a baseline of pure profit-maximization to which shareholders are entitled, so that any deviation equals a tax. If we instead assume that corporations can pursue some unprofitable social activities, then the question becomes why the minority can tax controlling parties for the exercise of their right to pursue non-profit objectives. And if the money never belonged to the shareholders in the first place, then they cannot be said to have been taxed out of it.

Moreover, if operating the corporate in a public spirited way that sacrifices profits is desirable, coercive financing of shareholders may also be appropriate even if we call it a "tax." The reasons is that, without coercive financing, shareholders who in the heart of hearts would rather sacrifice profits to advance the non-public goal will have an incentive to dissent, hoping the majority will still further the public spirited activity but without their contribution. They will, in other words, free ride without coercive financing. Their position is precisely analogous to the citizen who would vote for building a damn with tax money coercively taken from everyone, but would not voluntarily make an individual contribute if someone went door to door seeking contributions to build the damn.

We are then left with the more weighty affirmative argument for a regime that requires

[84] CLARK, *supra* note , at 603, 679; Milton Friedman, *supra* note , at 33.

corporations to maximize profits through any means that do not violate the law. The goal of profit-maximization, the argument goes, is objective and easier to monitor than a goal of advancing the public interest, which (when undefined by law) is either vague or controversial.[85] Shareholders will be encouraged to invest both by the high rate of return and by the improved corporate accountability, and corporations will, by pursuing profit-maximization, increase the national wealth.[86] At the same time, we need not jeopardize public policy objectives because those can be fully embodied in law. Business operations can be regulated (by laws applicable to corporate and non-corporate businesses) to fully protect or compensate nonshareholder groups who might be injured by those operations, increased corporate profits can be taxed to fund public goods or further goals of equitable wealth distribution, or some combination of strategies can be employed to ensure that the end result is pareto optimal.[87] And other shareholders can either legally protect themselves by contract with the corporation, or have their legal protection provided by judicial gap-filling of such contracts.[88] Allowing corporations to pursue non-profit goals would thus worsen the economic performance of corporations by destroying the clarity of the corporate goal without improving the ability of society to further public interest objectives.[89]

Neither prong of the argument, however, withstands analysis. Profit-maximization is not, in fact, easier to monitor in any relevant sense. Indeed, as the discussion above suggests, judges are

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[85] CLARK, *supra* note , at 20, 679, 692, 702; ABA, *supra* note , at 2269.

[86] CLARK, *supra* note , at 20-21, 679-80, 692, 702; Eisenberg, *Corporate Legitimacy, supra* note , at 5.

[87] CLARK, *supra* note , at 20-21, 680; Macey, *supra* note , at 42-43; supra at . This view is often coupled with the view that government should be limited to coercive resolution of collective action problems, such as determining whether and how to redistribute wealth, produce public goods, establish a legal framework for market activity, and correct any market failures. CLARK, *supra* note , at 696-98. There is, however, no necessary connection. As long as one has faith that the governmental forum is (for whatever reason) the correct one for determining what public interest functions should be furthered, one may want corporations to sacrifice profits in the public interest only when required by the laws coming out of those governmental forums.

[88] Macey, *supra* note , at 40-41.

[89] A related argument is that non-profit corporations exist to pursue public interest goals. This is true, but provides no reason not to have mixed-purpose organizations. Nor does it justify preventing business corporations from running their operations in a manner that best advances the public interest.

largely incapable of determining whether corporations are maximizing profits.[90] It seems dubious that even the most energetic judicial efforts to force corporations to maximize profits at the expense of non-profit goals would be at all effective. Absent some showing that those running the corporation are profiting financially at the expense of the shareholders, shareholders are effectively remitted to mechanisms of corporate accountability other than derivative actions.

Moreover, the ability of judges to monitor public interest goals would be relevant only if the issue were whether corporations should have some ill-defined duty to pursue the public interest that could be enforced via a derivative action. That is not the issue here. The issue here is whether those running the corporation can, if they wish, pursue non-profit goals over the protests of minority shareholders.

Of course, it may be that profit-maximization is an easier goal for *shareholders* to monitor. But allowing corporations to pursue non-profit goals does not mean that shareholders cannot, if they wish, use profit-maximization as their criterion in deciding how to vote or invest. It simply means that minority shareholders cannot expect courts to enforce profit-maximization as a goal versus other goals unrelated to the financial interests of those controlling the corporation.

A related argument is that the goal of corporations should be profit-maximization because various methods of market accountability will lead to the demise of any corporations that do not profit-maximize.[91] To the extent this is true, it seems to be sound advice for corporate management to take into account, but it only reduces any need for judicial policing of public interest activity. Nor is it true that a failure to maximize profits will lead to certain corporate death via the product market, capital market, or market for corporate control. Product markets are often imperfect, and many corporations can survive without pricing their goods competitively. Where product markets are

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[90] See supra at ; [need to also collect cites on weakness of duty of care standards generally, possible starts: 77 Yale L.J. 1078, 1099; 52 Geo. Wash. L. Rev. 789, 796; 62 Tex. L Rev 591; 45 Ohio St. L.J. 615; 35 Stan L Rev at 935-37].

[91] See, e.g., CLARK, *supra* note , at 687-88, 692.

competitive, moreover, corporations can still fund public interest activities without increasing prices and being hurt in the product market by the simple expedient of reducing their rate of return.[92] To be sure, this will lower the value of their stock, presumably until the rate of return per share matches other rates of return in the capital market. This will make it harder for the corporation to raise capital, but hardly impossible: it can still fund reinvestment out of earnings (although they are lower), it can still borrow from lenders (although less so since lower earnings can finance smaller loans), and it can still issue equity (albeit at lower prices).[93] Any decline in stock price would, however, make it profitable (absent any transaction costs or other obstacles) for a purely profit-maximizing takeover bidder to take control of the corporation and cease its pursuit of non-profit goals. A perfect market for corporate control would, thus, make it impossible for corporations to continue pursuing non-profit goals. But the market for corporate control is anything but perfect. Takeover bidders face enormous obstacles and transaction costs, not only in sheer logistics but in state regulation and corporate defensive tactics. Indeed, as we will see later in this Article, many of these obstacles are created precisely to preserve the ability and power of corporations to continue sacrificing profits in the public interest.

The second prong of the argument for requiring corporations to maximize profits is that other laws can fully protect the interests of nonshareholder groups. If a corporation complies with these laws, and the laws are appropriately designed, then corporate pursuit of profit-maximization will, the argument goes, advance shareholder interests without harming nonshareholder interests. The usual critique of this argument is that defects with the lawmaking process, such as capture by special interest groups, make the claim that laws reflect the public interest dubious on many issues.[94] This

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[92] Eisenberg, *Corporate Legitimacy, supra* note , at 15 (noting that corporations can survive for protracted periods with minimal returns).

[93] Eisenberg, *Corporate Legitimacy, supra* note , at 15.

[94] Weiss, 28 U.C.L.A. L. Rev. 343, 378-93; S. Breyer, Regulation and Its Reform (1982); CLARK, *supra* note , at 680, 688, 691. *See generally* Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31, 35-44 (1991).

seems undeniably troubling, although perhaps not alone sufficient to justify allowing corporations to pursue non-profit goals since the decisions of corporate management on such issues are unlikely to be any more representative of the public interest,[95] particularly given that it is generally the corporations that are alleged to have captured the government.

But the argument that the law fully embodies the public interest ignores various other realities. To begin with, often the types or magnitudes of harm that corporations inflict on nonshareholder groups change before the government has time to act, especially given the usual lag time for governmental action. This cannot be corrected by simply making governments act faster because there is always a balance between speed and the necessity of spending the time to secure the knowledge, deliberation, or social consensus that gives us some assurance the governmental action is in the public interest. Even ignoring delays in timing, a separate problem is that it takes great efforts and often significant resources to secure governmental action, thus frequently making it more efficient (from the perspective both of the affected interests and of society) to lobby corporations directly with social and moral pressure. The effort to legally define and enforce public interest objectives, in other words, will often rationally be avoided by society and the participants because the net benefits of obtaining legal definition and enforcement (over relying on social and moral sanctions) will not be worth the costs.

Furthermore, even in an ideal world with perfectly unbiased decisionmaking processes and costless decisionmaking, sanctioning systems and laws cannot, due to the inevitable lack of perfect information and imprecision in defining undesirable activity, be made sufficiently precise to deter or condemn all undesirable activity.[96] This goes beyond the argument that illegal activity often goes underpunished,[97] for the distinction between defining rules of conduct and enforcing them is not that

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[95] CLARK, *supra* note , at 681.

[96] See Bundy & Elhauge, *supra* note , at 267-79; Dan-Cohen, *Decision Rules and Conduct Rules*, 97 HARV. L. REV. 625; Kraakman, *Gatekeepers*, 2 J. LAW ECON & ORG. 53, 56-57 (1986).

[97] CLARK, *supra* note , at 684-87.

sharp: both are inevitably imprecise due to imperfect information and enforcement. For example, rules of conduct are often defined in terms of objective or readily identifiable factors in order to render legally irrelevant information within the control of one party even though that information would be pertinent to the desirability of the conduct.[98] More generally, the legal system frequently chooses rules over open-ended legal standards that correspond more closely to the desirability of the conduct because the latter is both more expensive to administer and more likely to be applied erroneously because of imperfect information or errors in weighing information.[99] But because they don't use standards that incorporate all the factors that bear on conduct desirability, such rules are necessarily over- and underinclusive on their face.[100] Indeed, even the most open-ended of legal standards (like the antitrust rule of reason) have this feature to some extent because they do not include *all* factors that might bear on the desirability of the conduct, but rather limit the inquiry to some defined set of factors. One could try to make legal rules very broad to eliminate any underinclusion of undesirable conduct, but that would create excessive costs in overincluding desirable conduct.[101] Thus, even the most efficient and socially optimal legal rules will generally underinclude some significant degree of undesirable conduct.[102]

Accordingly, even when the laws are optimal, corporate conformity with the law does not suffice to render corporate conduct socially desirable. Nor can we be sure that corporate profit-making within legal limits will be efficient from the societal perspective: it may, due to the inevitable imperfections of law, impose harms that exceed the benefits of the extra profits.

In short, legal regulation is an important but insufficient means of policing behavior, be it the behavior of individuals, non-corporate businesses, or corporations. A variety of social processes

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[98] See Bundy & Elhauge, *supra* note , at 267-79.
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*

and moral norms also play important supplemental role in maximizing the likelihood of desirable behavior. Accordingly, Dean Clark's proposal -- that we redouble our efforts to define public policy objectives and determine when it is wise to contract out implementation of those objectives to profit or non-profit corporations[103] -- is fine as far as it goes, but incomplete. It fails to face up to the fact that no matter how energetic our efforts, any lawmaking process will have defects, any legal definition will be imprecise, and the costs of legal definition and enforcement will often exceed the benefits. Because of these inherent limits with legal regulation of behavior, there will always be a need to further guide behavior through social or moral channels.

The real question is whether corporate law should be structured in a manner to minimize the influences of these social and moral processes or not, and it is ultimately on the strength of these social and moral processes that the argument in favor of allowing corporations to sacrifice profits in the public interest must rest. It should thus not be surprising if, as Dean Clark asserts, lawyers and economists assume that the corporations need only profit-maximize within the law to assure that their behavior is socially desirable,[104] for that position reflects an exaggerated view of the importance of both fields: lawyers who overestimate the influence of the law and economists who overestimate the importance of self-interested behavior. Nor should it be at all surprising that those actually subject to the social and moral processes that play such an important role in real life -- that is, corporate managers -- persist in having a far different view of their role.[105]

Where the investors in a business play an important role in managing the business -- as in the case of a sole proprietor or general partnership -- they become subject to a host of social or moral processes that guide their behavior in non-profit maximizing ways. In part, these social processes

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[103] See CLARK, *supra* note , at 696-703

[104] CLARK, *supra* note , at 17.

[105] CLARK, *supra* note , at 690-91 (insisting that these views must reflect either an ignorance of legal authorities or a bid for greater discretionary power); Milton Friedman, *supra* note , at 33; *supra* at __ (noting views of Business Roundtable and Warren Buffett).

involve the usual set of social sanctions that attend antisocial behavior even when it is legal. In part, however, these social or moral processes involve a greater awareness that comes from confrontation with problems and the results of one's actions. The manager who sees their workers suffer under a poor working environment will, if at all motivated by a concern for others, be more likely to improve those working conditions. Finally, these social processes in part involve a creation of private values to which economic theory (which takes people's values as givens that they maximize) cannot speak. Persons can be socially molded to derive personal gratification from doing good. For example, social processes can make materialists into philanthropists: creating values that make the philanthropists feel good when they donate money to worthy causes. This results in a world-state better than any possible without the creation of those values. Unlike with taxation, the philanthropist's incentives to create wealth are not diminished because they feel as much pleasure (with their new values) from donating the money as they would have felt from buying a Porsche. And yet the same sort of redistribution is accomplished that would have otherwise required taxation. Thus, it is not surprising that businesses have always felt some social responsibility to contribute to the community -- sometimes informed by an enlightened view of their long term economic interest, but often based on nonfinancial grounds.

On this social and moral dimension, corporations have historically been viewed with great suspicion. The "old maxim of the common law" was that "corporations have no souls."[106] Their "soulless" nature was in the nineteenth century a source of great opposition to the chartering of corporations at all:

> The word "soulless" constantly recurs in debates over corporations. Everyone knew that corporations were really run by human beings. Yet the metaphor was not entirely pointless. Corporations did not die, and had no ultimate limit to their size. There were no natural bounds to their life or to their greed. Corporations, it was feared, could concentrate the worst urges of whole groups of men; the economic power of a corporation would not be tempered by the mentality of any one person,

[106] LAWRENCE FRIEDMAN, *supra* note , at 448.

or by considerations of family or morality.[107]

But why should corporations, which after all are owned and run by humans, be feared more than ordinary businesses? The answer that they are large and never die hardly seems satisfactory, both because that can be true of noncorporate business enterprises and because one would think that humane considerations would nonetheless tug at the human managers running even a huge and immortal organization. A better answer lies the corporate structure, which in publicly held corporations makes it difficult for shareholders to be informed about corporate operations that may impact the public interest, and which generally shields shareholders from many of the social processes that induce businessmen to behave in socially desirable ways under circumstances where the law and profit motives are insufficient to do so.[108] So uninformed or insulated, shareholders may be more relentless in pressing corporate management for unabashed profit-seeking untempered by social consequences because they don't have the knowledge to feel moral guilt or the social exposure to feel social sanctions. A corporation run by managers perfectly accountable to shareholders would be soulless because the corporate structure insulates shareholders from the social and moral processes that give us soul.

The best response to this fear about corporate soullessness is precisely the fact that managers have a discretion that can only be imperfectly monitored by shareholders, and the exercise of that discretion is subject to social and moral sanctions, pressures, and processes that run counter to their accountability to shareholders. People will protest outside managers' offices, letters will flow into their mailboxes, and the applause from corporate donations will ring in their ears. Moreover, managers will to some extent be more likely than noncorporate manager-owners to give into social pressures and moral guilt in ways that sacrifice profits because they will mainly not be sacrificing

[107] LAWRENCE FRIEDMAN, *supra* note , at 171-72.

[108] Shareholders will be particularly shielded under caselaw that does not permit inspection of shareholder records or lists to further public interest purposes out of a fear that shareholders will be "harangued." CLARK, *supra* note , at 103.

their own money. Managerial responsiveness to pressure may (if managers are allowed to act on it) thus compensate for shareholder insulation.

Thus, a legal regime that created an enforceable duty to profit-maximize would be harmful in precisely the two ways that made it unacceptable when the profit-maximizing conduct was illegal.[109] First, because the duty could be enforced by any single shareholder, it would dictate corporate governance by the lowest common moral denominator: that is, by whichever shareholder cares least about social and moral sanctions. Even if the average shareholder would feel the same social and moral sanctions as the average sole proprietor, such a duty would leave corporate behavior dictated by the subaverage shareholder who feels lower social and moral sanctions, and thus make corporate behavior worse than the average behavior of a sole proprietor. Indeed, allowing any minority shareholder to force the majority of shareholders to act with the sole purpose of maximizing profits within the law would mean that the shareholder who felt the least sense of social responsibility would be in command. It would, in effect, allow any minority shareholder to sue all the other shareholders into ignoring their sense of social responsibility -- thus enforcing the very soullessness for which corporations have historically been feared.

Second, in publicly held corporations, shareholders will suffer much lower social or moral sanctions from engaging in socially undesirable conduct than a sole proprietor because the shareholders are shielded both from social pressures and from moral knowledge. Given the inevitable underinclusion of even optimal legal regulation, those social and moral sanctions are necessary to optimize behavior even outside the bounds of illegality. Thus, a corporation whose behavior was governed solely by an enforceable duty to further the profit interests of publicly diffused shareholders would likely engage in more socially undesirable behavior than a sole proprietor because the social and moral sanctions on those shareholders is so much lower. This is

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[109] *See supra* I.A.

consistent with the fact that, although shareholder proposals on social responsibility are often made, they usually lose overwhelmingly with shareholders, and actually are normally more successful in persuading management than shareholders.

This is a powerful reason why management should be able to engage in public-spirited profit-sacrificing behavior even without first obtaining approval by a majority of shareholders. The law may justifiably conclude that investors should not be able, by adopting the corporate form, to render their businesses immune from the sort of social and moral pressures that influence non-corporate businesses. Since managers are the only participants in the publicly held corporation that are effectively confronted with social and moral sanctions, they should have the power to respond to them. Given their insulation, majority shareholder sentiment will predictably underweigh the social interests implicated. Moreover, even if it were abstractly desirable to require management to obtain a shareholder vote on whether to sacrifice profits, that would not be feasible for the slew of decisions that must be made in the course of ordinary corporate operations about how relentlessly to pursue profits.

There remains the important problem that managers will have incentives to be excessively generous in spending other people's money because they bear the full brunt of social or moral sanctions and not the full costs of the sacrifice of corporate profits. Perhaps worse, managers might further conceptions of the public interest that differ from those of shareholders. One classic illustration of this was the case that was the genesis of the federal proxy rule allowing shareholder proposals on social responsibility issues that were not motivated by profit-maximizing concerns: *Medical Committee for Human Rights v. SEC*.[110] In that case, proponents motivated primarily by humanitarian concerns against the use of napalm tried to pass a shareholder proposal against a corporation selling napalm, and managers responded in part by saying that they wanted to make

[110] 432 F.2d 658 (D.C. Cir. 1970), *vacated for mootness*, 404 U.S. 403 (1972).

napalm even if it was unprofitable because it furthered their patriotic duty to help the United States win the Vietnam war. The same activity that furthered the manager's conception of the public interest harmed the public interest conception of at least some shareholders.

Although these are serious concerns, the risk of such abuses is lessened by the fact that the shareholders elected the managers and can remove them from office. In voting, shareholders can consider the extent to which managers either pursue the wrong social objectives or pursue the right ones excessively. This shareholder voting constraint is certainly imperfect given rational apathy, but it should preclude extreme cases of managerial deviation from shareholder interests. In any event, it seems likely that shareholders will generally be indifferent about how managers exercise the agency slack that results from that imperfection. As long as the total amount of agency slack is unaffected, shareholders do not suffer if that slack is exercised in a socially responsible way rather than some personally beneficial way.

Moreover, here exercises of discretionary slack are likely to move corporate behavior in the right direction given that public shareholders' relative insulation from social and moral sanctions would otherwise give them incentives to engage in socially suboptimal behavior. The problem remains that, even though exposure to social and moral sanctions may move managers in the right direction, their incentives for excessive generosity may push them so far in that direction that they overshoot the optimal tradeoff of profitability and social responsibility. This can be undesirable if they overshoot by a margin that is so great that it leaves their behavior further away from the optimum tradeoff than it would be with pure profit-maximization. But this is an argument against unlimited discretion, not an argument that managers should not have some degree of discretion. Ordinarily, the risk of such excessive managerial generosity is sufficiently constrained by product market competition (a firm that takes on excessively high costs cannot survive), labor market discipline (a manager who sacrifices too much in profits will find it harder to get another or better job) and capital markets (the stock and stock options held by managers will be less valuable if they

sacrifice profits too much).[111] In special cases where those forces fail to provide an effective constraint, the law can (and we shall see does) impose some limits on the discretion to sacrifice profits in the public interest.

One cannot of course expect too much of this. It may be that management rarely chooses to sacrifice profits given product market competition, future job prospects, stock options and other rewards for corporate profit-making. And it may be that shareholders rarely would allow directors to pursue non-profit goals, or to do so to only a limited degree.[112] Indeed, it is unclear whether on balance we should expect corporations to engage in less or more socially responsible behavior than noncorporate businesses. On the one hand, the pressure of shareholders shielded from social or moral pressures (exerted through means other than derivative action, such as by voting or investment decisions) should tend to cause corporate managers to sacrifice profits less often. On the other hand, the fact that corporate managers are not sacrificing profits coming out of their pockets should, to the extent their accountability to shareholders is imperfect, tend to cause them to be a little freer in sacrificing profits.

But although only a fool designs a system on the assumption that people will be public-spirited, only a cynical fool precludes the possibility. For the real question posed by those who think a failure to profit-maximize should be a violation of a manager's fiduciary duties to the corporation is whether we should restructure corporate duties to guarantee that the corporation's sense of social responsibility ended at law's edge. To that, the answer seems to be that there is no reason to believe that the law (and the markets within which corporations operate) are able to induce desirable behavior so completely that it would be beneficial to create a corporate law duty that would insulate

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[111] *See* Easterbrook, *Managers' Discretion and Investor Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 543 (1984).

[112] This may be changing as investors increasing represent government pension funds, unions, and university endowments, which have their own noneconomic agendas. Further, the has been an increasing market for mutual funds that specialize in making investments that take environmental or other social concerns into account.

corporations from the social and moral processes that help regulate non-corporate business activity.

II. DEFENDING AGAINST CORPORATE TAKEOVERS IN THE PUBLIC INTEREST

Much of the law recounted above was less explicit in authorizing the sacrifice of profits to further nonshareholder interests before the advent of a vigorous takeover market in the 1980s began to lead to takeover bids for any corporation that failed to maximize profits. In fact, the pre-takeover law provides an example of incompletely theorized agreement in law. Some judges and lawmakers likely believed that managers should have some discretion to sacrifice profits in the public interest. Others perhaps believed that in theory managers should maximize profits, but that some profit-sacrificing discretion was an inevitable byproduct of the business judgment rule and the efficient delegation of managerial authority. As long as takeovers did not make it clear just when managers were sacrificing profits and shareholder interests, this theoretical disagreement did not have to be resolved. Courts could just issue opinions authorizing exercises of managerial discretion on the grounds that they could be rationally related to long-term shareholder interests. This mushy standard was more than sufficient to permit any desirable exercise of a discretion to sacrifice profits in the public interest.

This sort of incompletely theorized agreement is not at all uncommon. As John Rawls argued, often different normative theories can result in the same principle, and thus allow a liberal democracy to adopt that principle without resolving the underlying theoretical disagreement.[113] This is true in law as much as anywhere, and Cass Sunstein has showed that judges and other lawmakers with different underlying theories frequently reach incompletely theorized agreements on certain

[113] JOHN RAWLS, POLITICAL LIBERALISM 133-72 (1993)

legal conclusions.[114] Why bother expressing an underlying theoretical disagreement that will make a unanimous opinion a divided one without altering the conclusion?

But such incompletely theorized agreements fracture when special or changed circumstances make the otherwise converging theories diverge in result. And here the change in circumstances that exposed the underlying theoretical disagreement was the development of a vigorous and well-financed takeover market. This development posed two significant threats to any managerial discretion to sacrifice profits in the public interest.

First, noncoercive takeover bids monetized the mushy. While without takeovers managers could temper profit-maximization with social concerns and claim their strategy somehow was rationally related to long-term shareholder interests, takeovers monetized whether in fact the strategy sacrificed corporate profits or not. This meant, for example, that environmentally aware management could no longer hide behind the excuse that clear cutting was costly in the long run because the fact that the bidder was willing to pay more than the current stock price proved that the economic present value of those costs must be lower than the benefits of clear cutting. Or at least it did so if one accepted the conventional economic view that the current stock price accurately reflected the discounted value of the stream of future profits, and that shareholders were best placed to decide for themselves whether accepting a noncoercive takeover bid advanced shareholder interests. And during the 1980s takeover wave it seemed likely courts would accept that view rather than the ultimate view of the Delaware Supreme Court, which stopped the hostile takeover wave with the remarkable conclusion that managers could justify blocking takeovers on the paternalistic ground that managers could judge the value of expected future profits more accurately than the stock market in setting the current stock price, even if shareholders voting on tender offers thought

[114] Cass R. Sunstein, *Incompletely Theorized Agreements*, 108 HARV. L. REV. 1733 (1995).

otherwise.[115] And even someone who anticipated this view could not have been certain that the courts would find it credible even when takeover bids were 50% over the stock market price.[116]

Thus, during the 1980s, management had no persuasive argument that blocking a takeover that was at a premium over current market prices would somehow advance shareholder interests. But if the law did not permit managers to employ defensive tactics to block such a takeover, then the mere threat of takeovers could effectively impose a duty to profit-maximize that would constrain the previously accepted degree of managerial discretion to sacrifice profits in the public interest. Indeed, if the law continued to articulate that discretion in terms of its rational relationship to profit-maximization, then the fact that the bid exceeded prior market price could be deemed to *prove* that the prior managerial conduct must not have been profit-maximizing, and thus must have violated any duty to profit-maximize that the managers had.

Second, even shareholders who did wish to sacrifice profits in the public interest faced a collective action problem when presented with a tender offer. Acting individually, such shareholders may tender even if they prefer (because of their public interest views) that the takeover not occur, and indeed they will tender whenever they will be even worse off if the takeover occurs and they have not tendered. Basically, the shareholders will tender because they will individually reason that their decision about whether to tender has little effect on whether socially undesirable change in corporate operations occurs but completely determines whether they get the benefits of accepting the tender offer.

Suppose that shareholders value the economic worth of their shares at the profit-maximizing rate of return lower than they value the combination of the economic worth of their shares at a lower

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[115] *See* Paramount Communications v. Time, 571 A.2d 1140, at ___ n.17 (Del. 1990) (allowing managers to block takeovers to avoid "substantive coercion," which the court defined as "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve managemen[t].")

[116] In *Paramount*, the bid was $200, which was 59% higher than the pre-bid stock market price of $126. *Id.* at __. Such takeover premiums of 50% were common in that era. *See* [cites].

rate of return and the noneconomic satisfaction they derive from the corporation's public interest activity. When faced with a tender offer by a bidder who intends to make the firm purely profit-maximizing, the value these shareholders put on any public interest benefits from the public-spirited way the target conducts business should make them worse off if the tender offer succeeds. These shareholders will perceive the post-takeover value of their shares (the economic value of their shares in a purely profit-maximizing corporation) as less than the pre-takeover value (the combination of economic and noneconomic value of those shares in a corporation with mixed profit and non-profit goals). Despite this, these shareholders are likely to tender their shares even though the bidder offers a price the shareholders value less than they value their pre-takeover target shares as long as (in any tender offer conditional on gaining control) the tender offer price exceeds the shareholder's evaluation of the post-takeover target shares. The reason is that their decision to tender is unlikely, unless they are a very large shareholder, to affect whether the tender offer succeeds, but they will be significantly harmed if the tender offer goes through and they have not tendered. They will tender if the expected value of tendering in the likely case when their tender does not affect the outcome exceeds the expected value from the unlikely case when their non-tender makes the difference in blocking the takeover.

Assuming the tender offer is conditional on gaining control, shareholders should reason as follows. Either their tender will determine whether the takeover occurs or it will not. If it will, then the expected difference in value between nontendering and tendering is the pretakeover value minus the tender price. If their tender will not alter the outcome, and the takeover occurs, the value of tendering versus nontendering is the tender price minus the post-takeover value. If their tender will not alter the outcome, and the takeover does not occur, then tendering versus nontendering had no effect because the tender offer is conditional on the takeover succeeding. The expected value of nontendering is thus: (probability tender affects outcome) x (pretakeover value - tender price). The expected value of tendering is: (probability tender does not affect outcome) x (tender price - post-

takeover value). Accordingly, each shareholder will tender if they believe: (probability takeover will occur whether or not they tender) x (tender price - post-takeover value) > (probability their nontender will block takeover) x (pretakeover value - tender offer price).

Because for any small shareholder, the likelihood of their nontender blocking the takeover is trivially small, a decision to tender is likely if there is any significant difference between the tender offer price and the post-takeover value of the stock. Why might the tender offer price exceed the value of post-takeover shares? One reason is that the tender offer price includes a control premium (reflecting the financial gains from possessing control) that will not be available to the shareholder in a minority position. That effect could be eliminated if, as often happens, the tender offer also commits to a second step merger at the tender offer price. But another adverse effect would remain: because the second step merger comes later, its discounted present value to the shareholder is lower than the value of accepting the same price in a tender offer, which gives the shareholder the money immediately. True, this adverse effect is small, amounting to the normal rate of return on that money for the few weeks or months of delay. But it only takes a small effect to overcome the trivially small benefits of not tendering given the vanishingly low odds that any individual shareholder's nontender will block a takeover. Moreover, because every other shareholder will have this same incentive to tender, a shareholder will expect the other shareholders to tender, thus increasing the perceived probability the takeover will occur and further increasing the incentives to tender.

If the tender offeror makes a tender offer for any and all shares, the incentive to tender is even greater. A shareholder who does not expect a majority of shareholders to tender will tender because they will gain money without sacrificing their public interest goals. A shareholder who does expect a majority to tender has no reason not to tender. The only reason a shareholder might not tender is if she thought: (probability their nontender would block a takeover) x (pre-takeover value - tender offer price) > (probability takeover will occur whether or not they tender) x (tender

offer price - post-takeover value) + (probability no takeover will occur whether or not they tender) x (tender offer price - pretakeover economic value). The logic is the same as above, except that even if the takeover does not go through, the individual decision to tender does have an effect because the tender offer is not conditional on the takeover going through. Where the takeover fails, the shareholder who accepts the tender offer enjoys the tender price and the public interest benefit of no takeover and loses the pretakeover value of the stock, which simply equals the pretakeover economic value plus the public interest benefits. The net result is to get the tender price minus the pretakeover economic value. That is, the shareholder gets the cash difference between the pretakeover market price and the tender offer without sacrificing any public interest goals.

Accordingly, without takeover defenses, corporations could not continue sacrificing profits to further social objectives, even if genuinely preferred by a majority of shareholders, because such corporations will be susceptible to takeovers by bidders whose sole motivation is profit-maximization. Unless individual shareholders have a significant chance of blocking the takeover with their own nontender, those bidders need only launch a conditional bid for more than the value of a minority position in the corporation if it profit-maximizes, or launch a bid for any and all shares at a price greater than the pretakeover market price and no worse than the posttakeover minority position.[117]

To illustrate, let's go back to our timber corporation. Suppose that, under the current policy of abjuring clear-cutting, a minority position in the stock now trades at its economic value of $100 per share, but would trade at $110 per share if the corporation took advantage of profitable opportunities to clear cut. The majority shareholders realize this, but have elected less environmentally ruthless management because they are willing to sacrifice $20/share to avoid clear-

[117] Actually, to be precise the bid can be at less than the posttakeover price if the (probability takeover will occur whether or not they tender) x (post-takeover value - tender offer price) < (probability no takeover will occur whether or not they tender) x (tender offer price - pretakeover economic value). But as the probability that the takeover will occur approaches one this becomes less significant.

cutting. The takeover bidder, who intends to clear cut, launches a conditional tender offer for 60% of shares at $115. The shareholders will perceive the post-takeover value of nontendered shares as $110, which is less than the pre-takeover value of $120 ($100 economic plus $20 noneconomic) but also less than the tender offer price of $115. Each individual shareholder will thus tender if (115-110) x (probability takeover will occur whether or not they tender) > (120-115) x (probability their nontender will block takeover). Assuming that the former is greater than the latter given the trivial likelihood that one shareholder's tender decision will affect the outcome, each shareholder will thus individually tender, even though the takeover leaves them all worse off collectively. Their incentive to tender will only be increased if they fear other shareholders may not share their public interest views or if they realize that everyone else has the same incentive to tender. This will even further increase the probability the tender offer will go through. Thus, without takeover defenses, any group willing to bid over $110 can force the corporation to clear cut even though the majority of shareholders put a value on avoiding clear cutting that exceeds the profits from it.

Indeed, if the bidder launches a bid for any and all shares, then even a tender price below $110 can suffice. Suppose, for example, the bidder bids $109 for any and all shares. Then each shareholder will tender unless the (probability their nontender would block a takeover) x (120 - 109) > (probability takeover will occur whether or not they tender) x (109 - 110) + (probability no takeover will occur whether or not they tender) x (109 - 100). If the probability their nontender would block a takeover is insignificantly small, they will then tender unless they believe that the probability a takeover will occur is nine times the probability the takeover will fail. And any tender offer of $110 or more will suffice to induce tender as long as the probability the tender offer will fail is greater than the probability the individual shareholder could block the tender offer with her own nontender.

One might wonder why, if shareholders receive utility from the fact that the corporation is furthering the public interest, they would not have bid up the pre-takeover stock price to reflect that

utility. Why, in other words, have I assumed that the stock market price reflects only the economic value of the stock and not the utility shareholders might be deriving from its public-spirited conduct? The answer is that an individual shareholder's decision to buy stock gives them a proportional right to the corporation's *financial* proceeds, but does not (given her small share) give her any meaningful voting control over corporate operational decisions and thus does not give her any real control over whether the public interest goal is satisfied. Accordingly, shareholders will pay an amount that reflects the financial value of the stock, but won't pay more for a voting control that has no value in small individual holdings. Consistent with this, in dual class capitalizations, where one class of stock has more votes per share than another class but both have the same financial rights, it turns out that the different classes of shares sell for the same amount unless one person gets enough shares to enjoy voting control over the corporation.[118]

The above collective action problem would seem to justify, at a minimum, requiring a tender offeror to obtain approval by a majority vote of the shareholders, with shareholders allowed to separate their vote on the collective issue of whether the takeover goes through from their individual decision to tender. And in fact, many states did respond to the takeover wave by enacting control share acquisition statutes that did precisely that.[119] To be sure, Professor Bebchuk has ably argued that such statutes are justified to protect shareholders even if we assume they have purely financial interests in stock.[120] But this justification is problematic in two respects if limited to the economic value shareholders put in stock. First, if the stock market is efficient, it is not clear why shareholders would view the pre-takeover economic worth as greater than not only the market price but a tender offer at a substantial premium above the market price. Second, it is not clear why shareholders would view the economic value of a minority position in an independent target (the pretakeover

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[118] *See* [cites].

[119] See [CHOPER, COFFEE & GILSON 3rd Edition, *supra* note , at 1094-95 & nn.21-22 (collecting control share acquisition statutes).]

[120] See, e.g., Bebchuk, 98 Harv. L. Rev. 1963 (1985). .

value) as greater than the economic value of a minority position post-takeover.

In contrast, if one relaxes the assumption that shareholders are single-mindedly concerned with economic value, then it becomes quite plausible that they would view both the tender offer price and the post-takeover value of the corporation (purely economic in the hands of the successful bidder) as worth less than the pre-takeover value of the corporation (both economic and social). This theory also seems to explain more persuasively why the problem is not solved by merely facilitating auctions. In any event, whether or not Bebchuk's answers to these issues make his theory persuasive even if shareholders only gain economic value from corporate decisions, the above provides an important supplementary rational for these control share acquisition statutes. If one wished to fully pursue this strategy of preserving discretion to sacrifice profits in the public by giving authority to shareholders acting collectively, then other steps would be advisable, like: (1) requiring corporations to disclose facts relevant to assessing social issues (e.g., the facts relevant to any environmental problems corporate operations may cause);[121] and (2) changing the state law on inspection, which currently does not give shareholders the right to inspect corporate records to aid efforts to persuade the company to sacrifice profits in public interest.[122]

However, even if a majority of shareholders has approved the tender offer, the problem remains that shareholders as a group are too insulated from social and moral processes to make optimal tradeoffs between profit-maximization and other goals. Control share acquisition statutes could thus only be a partial answer to problem that hostile takeovers posed for any state that wanted to preserve the discretion of managers to sacrifice profits in the public interest. To fully protect that

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[121] This could be done by SEC regulation or by amending a particular corporation's charter. Indeed, it is interesting that the only shareholder proposals on social issues that tend to come close to getting a majority are those that seek to require such disclosures.

[122] *See* State ex rel. Pillsbury v. Honeywell, Inc., 219 Minn. 322 (1971); National Consumer's Union v. National Tea Co., 302 N.E.2d 118 (Ill. App. 1973). Dean Clark justifies this rule as necessary to protect shareholders from being "harangue[d]." CLARK, *supra* note , at 103. But under my theory, this is not a persuasive argument such protection exacerbates the harmful insulation of shareholders from the type of social and moral pressures experienced by non-corporate owners.

discretion, lawmakers would have to go further and explicitly authorize managers to consider the interests of nonshareholder interests in deciding whether to employ defensive tactics. They would, in short, have to abandon the old incompletely theorized agreement on a test that allowed such discretion only to the extent it could be rationally related to shareholder interests.

Which is precisely what happened. It was only after the takeover wave made it necessary that we got the corporate constituency statutes and Delaware caselaw that both explicitly allowed managers to consider the interests of other constituencies, and made clear that shareholder interests were not controlling.[123] Notice that this turns on its head the conventional view that the fact the takeover wave provoked this change in law proves the change was just a pretext to entrench management.[124] While that may have also been a motivation (incompletely theorized agreement is everywhere in law), the fact is that there is also a more neutral justification. Unless such an authority were made explicit, takeovers would have ended a discretion to advance public interest goals that is desirable for entirely separate reasons. Indeed, such a theory would seem necessary to explain why nonmanagerial groups joined in lobbying for these corporate constituency statutes. The notion that they were just duped into supporting something that only advanced the interests of managers does not seem plausible. Instead, they must have understood that protecting such managerial discretion from the threat posed by hostile takeovers would advance the social interests these nonmanagerial groups aim to foster.

III. LIMITS ON THE DISCRETION TO SACRIFICE PROFITS IN PURSUIT OF SOCIAL OBJECTIVES

The very factors that mean we cannot expect too much from a corporation discretion engage

[123] *See supra* Part I.A.1. The Delaware courts articulated an exception when the corporation was up for sale, but that reflects a last period problem considered below in Part III.

[124] *See supra* note _ (collecting sources).

in profit-sacrificing public-spirited activity also mean we do not have that much to fear. Even without a legally enforceable profit-maximization duty, corporate behavior is unlikely to be excessively generous with shareholder assets given the incentives and constraints imposed by managerial profit-sharing or stock options, shareholder voting, and the product, labor, capital, and takeover markets. The average corporate charitable donation, for example, amounts to only 1.25-1.3% of corporate income,[125] which is somewhat less than the individual rate of 1.9-2.2%.[126] There thus seems little evidence that the existing discretion to sacrifice profits has systematically made corporations excessively generous with shareholder assets given these nonlegal constraints.

Still, one might justifiably wonder what, if any, are the *legal* limits to this discretion. One issue is whether limits should exist on the *methods* by which corporations can sacrifice profits. Even if corporations should be able to advance the public interest by altering operational decisions, why should they be able to do so by just giving away corporate funds rather than allowing shareholders to make those donative decisions? Another issue is what, if any, legal limits exist on the *extent* to which a corporation can sacrifice corporate profits in the public interest. Presumably corporate management could not donate all corporate assets, but what short of that are the definable limits on the posited discretion? A final issue concerns whether the corporate charter can itself limit this discretion to sacrifice corporate profits in the public interest. Is the existence of this discretion *mandatory* or is it just a *default* rule from which a corporation could opt-out in its charter?

A. Operations v. Donations.

The argument above focused on the discretion of corporate management to make operational choices that failed to maximize profits, arguing that it is important that such operational choices be

[125] *See* CHOPER, COFFEE & GILSON 5th Edition, *supra* note , at 40; Eisenberg, *Corporate Conduct, supra* note , at 19 n.34.

[126] *See* http://nccs.urban.org/chargiving/stgive01_text.pdf.

influenced by social or moral sanctions. But why should corporations be able to simply give away corporate funds to charities or other good causes? Unlike with operational choices, we cannot say that the corporation must make a decision one way or the other, and that any operational decision it makes necessarily applies to all those who hold shares in the operation. For donations, the corporation could simply instead send the money it would otherwise donate to the shareholders in dividends, or simply retain it and thus allow it to increase the stock price, either of which would give shareholders extra wealth that shareholders could use to donate to the extent they want and to whichever charities advance their own (likely diverse) conceptions of the public interest. If this argument is persuasive, it raises a puzzle, for the power to make donations is legally the *clearest* of the corporation powers to sacrifice profits in the public interest.[127]

The conventional answer to this is that shareholders have a free rider problem.[128] Although each may want the Sierra Club to be better funded to advance environmental causes, if others make the necessary donations to provide that funding, each will get the benefits of the Sierra Club's environmental activities regardless of whether he individually contributed. So, if they act individually, each shareholder will donate less than they collectively believe is optimal. But this analysis is problematic as a matter of both theory and fact. Theoretically, the problem is that this free rider issue is in no way distinctive to individuals who happen to make investments in shares. It applies to every individual in society generally, and thus seems more aptly addressed by general governmental taxes. Empirically, the problem is that individuals in fact contribute at a *higher* rate than corporations. Thus, it does not appear to be the case that free riding problems among individuals lead to a greater tendency to under-donate.

Another explanation is that, compared to individual donors, corporations are better placed

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[127] *See supra* at I.B.1.
[128] *See* CHOPER, COFFEE & GILSON 5th Edition, *supra* note , at 41.

to monitor the use of donations by recipient charities.[129] Maybe, but that merely means there is a useful role to be played by a centralized donation monitoring institution – it does not show why we should regard for-profit corporations as best suited to perform that function. Instead of effectively funneling donations through for-profit corporations, individual shareholders could donate to foundations that specialize in monitoring the use of funds by recipients. Foundations that specialize in such charity monitoring are likely to be better at it that for-profit corporations, which seems confirmed by the fact that corporations themselves often give their donations to just such foundations. Further, foundations can specialize in a particular conception of the public interest their monitoring seeks to advance. Allowing shareholders to select among foundations is thus likely to better advance their diverse conceptions of the public interest than binding them to the donations made by corporations they have mainly chosen for investment purposes. There seems no good reason to bundle the investment and charity-monitoring function in this way.

Finally, some argue that corporate donations are justified by tax advantages because the corporate tax rate would apply to any corporate income that is paid out in dividends, thus leaving shareholders with less money to donate.[130] But this claim seems flawed. First, the type of managerial discretion to make donations at issue also applies to business associations like limited partnerships, which are not subject to the double taxation of dividends that creates the problem with having the corporation pay out dividends. Second, the tax advantage really does not flow not from the corporation making the donation rather than the shareholders, it flows from avoiding the dividend distribution. Corporations could avoid the tax problem with dividend distributions by simply retaining the money, which would make the stock price appreciate. Then shareholders could donate the same amount as the corporation would have donated, a donation that will mainly consist of the appreciated value of the stock, on which shareholders will receive a deduction that is not

[129] *See id.*
[130] *See id.*

offset by any income from dividends. Indeed, if (as in the U.S. and Europe) the corporate tax rate is lower than the individual tax rate,[131] this strategy actually strong tax advantages over having the corporation itself make the donations.

For example, in the U.S., the top corporate tax rate is 35% and the top individual tax rate is 40%. Suppose the corporation has $100, and the question is what is the most tax effective way to donate it to charity. One way is to donate the $100 to charity directly, which gives the charity $100 without the taxpayer having taxable income or paying anything out of pocket. Suppose instead the corporation retains the money. The stock price should go up by $65, which reflects this $100 minus the $35 that must go to the taxing government. The taxpayer can contribute that $65 in appreciated stock to the charity and add $35 from his own funds to get $100 to the charity. And since he gets a 40% deduction on the $100 donation, this lowers his taxes by $40, which is *more* than the $35 the taxpayer added, meaning this method confers a $5 benefit on the shareholder compared to having the corporation make the donation. Thus, the taxpayer can get the $100 to the charity *more* cheaply through corporate retention of income and taxpayer donation of appreciated stock than by corporation donation. This should always be true as long as the personal income tax rate exceeds the corporate tax rate.

The traditional arguments for the corporate power to donate thus all seem unsatisfactory. Why, then, does it exist? One answer is that the social and moral processes mentioned above are also important in molding the desire to donate. The manager who is confronted by the environmental harm she has caused may be more likely to feel social sanctions or moral guilt about it that might motivate donations. The manager who has operated in a local community and seen first hand the sundry ways in which the corporation has impacted or benefitted from that community may

[131] *See* Fuest et al, *Why is the corporate tax rate lower than the personal tax rate?*, Economic Policy Research Unit (EPRU), University of Copenhagen, Working Paper Series 00-17, at 18, available at http://www.econ.ku.dk/epru/files/wp/00-17.pdf.

be more likely to want to make donations to benefit that local community. The manager who has experienced the enormous value of innovation in his industry may be more likely to make donations to fund research universities. Thus, while shareholders may as individuals donate even more than corporations do, they are unlikely to have the particular donative impulses that come from operating the corporation. If we assume the social and moral processes that create those donative impulses are desirable, then since shareholders are shielded from them, the discretion to make such donations should be left with the managers who have that human contact. We are also likely to get additional donations from such a regime since shareholders and managers are subject to different social and moral processes that will induce different sorts of donations.

Another answer is that donations may often be a cheaper way of meeting social and moral obligations than altering corporate operations. Thus, if we allow social and moral sanctions to affect managerial discretion over operations, it would be inefficient to deprive them of discretion over the sometimes cheaper alternative of making donations. For example, suppose social and moral sanctions would (if donations were not a possibility) cause a firm to avoid clear-cutting a 100 acre forest even though that sacrifices $1 million in profits. Now suppose the firm could, by making a $500,000 donation, help a nonprofit preserve a different 150 acre forest that is environmentally more important. In that case, social and moral processes may lead the firm to make the donation instead of stopping from clear-cutting, with a gain to both the corporate bottom line and our environment. The same is also true of noncorporate firms: for example, big law firms often find it too expensive to meet felt pro bono obligations by having their own lawyers do the pro bono work. It is cheaper to instead have their lawyers work at $500/hr and then donate some of those earning to public interest firms whose lawyers are both far cheaper and have more specialized skill in in the relevant sort of legal work. The result can save the law firms money and produce more and better pro bono lawyering. In short, donations are often a more efficient substitute for altering business operations.

Nor are shareholders likely to lose much in profits from allowing managers to make

donations that shareholders would not make. The reason is that, given a fixed amount of agency slack, any corporate funds diverted to manager's pet charities will simply substitute for other ways of compensating the manager. Why should shareholders care if the manager decides to donate $1 million to the Sierra Club rather than take an additional $1 million in salary or perks? Indeed, viewed as a substitute for management (rather than shareholder) donations, corporate donations do have an big tax advantage because managers can generally get a tax deduction for donations only up to 50% of their income. Managers who enjoy, as part of their effective compensation package, the power to direct corporate donations that total more than their salary thus would suffer an increase in taxes if instead all their compensation were paid in salary and managers tried to make the same level of donations out of their own funds.

While all this justifies allowing corporate donations, the justifications seem weaker than those for permitting corporate operations to sacrifice profits in the public interest, or at least certainly no stronger. Why, then, is it that corporate statutes are *clearest* about authorizing profit-sacrificing donations? The answer is probably that the managerial power to run the corporation has always given managers enough discretion to have their operational decisions molded by social and moral forces. In contrast, many courts had historically held that making corporate donations was ultra vires: that is, beyond the power of corporations.[132] States thus had to enact statutes to make the corporate power to make donations explicit. That was not necessary for ordinary operational discretion until, as we shall see, takeover bids made it necessary.

But we can conclude something from the fact that corporations *are* clearly authorized to make donations in the public interest even though that is less justifiable than allowing them to sacrifice profits in making operational decisions. We can conclude that, if the former is authorized, the latter must be too. Indeed, it would make no sense not to, for authorizing profit-sacrificing

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[132] See R. Franklin Balotti and James J. Franks, *Giving at the Office: A Reappraisal of Charitable Contributions by Corporations*, 54 BUS. LAW. 965, 968-69 (1999).

donations but not operational decisions in the public interest would create the inefficiency noted above in reverse. Managers who wanted to advance public interest causes could simply substitute donations for operational decisions, and the limitation on the latter would tend to cause them to do the former even when the latter is more efficient. Thus, the existence of a clear statutory power to make profit-sacrificing donations alone suffices to establish the efficiency of a corporate power to make profit-sacrificing operational decisions.

B. Legal Limits on the Degree of Profit-Sacrificing

Normally no legal limit on public-spirited profit-sacrificing is necessary because it is sufficiently policed by the economic incentives and market forces outlined above. But in some special cases, those legal limits do matter. One possibility is that some managers may have an idiosyncratic view about the extent and nature of the firm's social and moral obligation, and feel so strongly about that obligation that their feelings overwhelm the ordinary disincentives imposes by economic incentives and market forces . Imagine, for example, a corporation that finds itself run by person who experiences a religious conversion that makes him decide to donate all corporate assets to his religion. If his moral convictions are sufficiently powerful, this might override the threat that this would lose him his job and all prospects of obtaining a similar job in the future.

More typically, legal limits become important when a last period problem undermines the ordinary effectiveness of the nonlegal constraints on excessive profit sacrificing. Suppose, for example, a manager is retiring. Then none of the market constraints will be meaningful to him because he won't be there to experience them. And if he does something irreversible, like giving away corporate assets, shareholder voting offers no remedy. The last period problem posed by retirement is normally not large because it would be rare to have all the managers retire at once, and usually enough managers are involved that no one retiring manager can engage in excessive profit-sacrificing without the approval of others. Even the chief executive officer will, given his pending

retirement, have relatively little ability to get the rest of the board of directors to go along. This is one reason to have multiple directors. Still, it does pose a problem requiring some legal limits. This is especially true when the firm is run by a controlling shareholder who has effectively decided to make an end-of-career donation of his share of corporate assets to some favorite charitable cause with a matching donation expropriated from the other shareholders of their shares. Such a shareholder could oust any directors who tried to get in his way, and thus some legal limit would be necessary to protect the minority shareholders.

But the last period problem that typically creates the greatest need for legal limits results when the corporation is up for sale to a firm because that can give all existing managers a last period problem. Since the firm is being sold, the existing management's decisions about how much to temper profit-maximization in the sale will no longer be meaningfully constrained by product or capital markets, nor by the threat of takeover bids or being ousted by shareholder vote. The remaining incentives provided by the labor market or managerial profit-sharing or stock options may be insufficient to constrain excessive profit-sacrificing, or be undermined by buyer (or donee) provision of a new job or special payments to outgoing management.

The law addresses these problems in various ways. Historically the most common has been to take advantage of the legal ambiguity over whether public-spirited activities or donations were allowed only to the extent they maximized long-run profits. Although the business judgment rule meant that in reality effective discretion to sacrifice profits existed even under this approach, the fact that some courts like *Dodge* articulated such a test meant that to be safe management had to be able to offer some plausible claim that their conduct would increase long-term profits. This does not actually eliminate profit-sacrificing, but it does naturally create a limit on the *degree* of profit-sacrificing. In the extreme hypotheticals above, where management just gives away all corporate assets, then it clearly would not have any such plausible claim. And in less extreme examples, the more management gives away, the less plausible any long-term profitability claim may be. For

example, if management gives away half its assets, or stops clear-cutting even though it cuts profits in half, it will be hard to plausibly claim that the increased goodwill would be so large that it would offset this effect. Thus, the real constraint imposed by the test requiring a rational relationship to profitability was not that it eliminated profit-sacrificing but that it set a limit on the degree of profit-sacrificing. But this approach was not always effective at preserving some degree of discretion, and (as discussed above) became much less so once takeover bids became prevalent. Thus, corporate law has had to become increasingly explicit that it did mean to authorize some discretion to sacrifice profits, rendering this approach less effective.

As it has become explicit about authorizing profit-sacrificing activity, the law has had to use other limits. The ALI does so by saying that managers can sacrifice no more than a "reasonable" degree of profits.[133] This would also constrain management from stopping clear-cutting if it eliminated all profits, and presumably if it reduced profits by 50%. But what if stopping clear-cutting reduced profits by 15% – would that be reasonable? Alas, conclusory words like "reasonable" fail to resolve such issues. They are more placeholders for standards that are either implicitly applied or that one hopes will be provided latter. This problem is only exacerbated by the fact that reasonableness is determined by considering "all the circumstances in the case."[134] This comes perilously close to a we-know-it-when-we-see-it test.

Somewhat more helpfully, the ALI suggests the two principal factors to determine reasonableness are: (1) the customary level of profit-sacrificing behavior or donations by similar corporations and (2) the nexus between the public-spirited activity and the corporation's business.[135] Unfortunately, the former factor doesn't provide much help. There will always be corporations that are above-average and below-average in their profit-sacrificing levels. If all corporations that

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[133] *See* ALI Principles, *supra* note , §2.01(b)(2)-(3).
[134] *See* Eisenberg, *Corporate Conduct, supra* note , at 19.
[135] *Id.*; Eisenberg, *Corporate Legitimacy, supra* note , at 13.

exceed the average level are behaving illegally, then half the firms will always be in violation. Presumably, the ALI does not mean to condemn every corporation that donates more than 1.3% of corporate income. And if the law stops them from doing so, then the average will keep declining until it reaches zero. The real issue is the *degree* to which corporate profit-sacrificing can exceed this average level, and looking at the average level cannot really answer that question.

The nexus factor does not help at all with operational decisions that sacrifice profits, for such decisions by definition *always* have a close nexus to the corporation's business. The nexus factor does help more with corporate donations. But the aid is hampered by the fact that the ALI does allow corporate donations with no nexus at all to corporate operations, and instead just weighs the lack of nexus in some unclear way along with the overall size of the donation to determine reasonableness.[136] It is particularly difficult to know what weight to attach to a lack of nexus because the ALI never explains *why* nexus to the corporation's business should matter. We know from the ALI illustrations that it would conclude a donation with no nexus to business operations is reasonable if it constitutes less than 0.01% of corporate income, but not if it constitutes 20%, but we don't why.[137] The only explanation offered is that the latter could not increase long-term profitability, but this seems inconsistent with its conclusion for the first illustration – where the profit-sacrifice was smaller but still there – and conceptually inconsistent with the fact that it has rejected any requirement that the activity actually maximize long-term corporate profits.

I believe the underlying problem is that one cannot articulate a theory that helps determine what degree and nexus of corporate profit-sacrificing is reasonable without first establishing a convincing affirmative theory about precisely why corporate management should be able to sacrifice profits at all. With the affirmative theory articulated above, we can begin to make to make some headway on the issue. The affirmative reason to allow corporate management to temper profit-

[136] *See* ALI Principles, *supra* note , §2.01 Illustrations 15-16.
[137] *Id.*

maximization is to subject corporate decisions to the same social and moral processes that apply to sole proprietors when they run businesses. Given that rationale, the appropriate benchmark for determining reasonableness would be look to the range of plausible behavior for a sole proprietor in the same business position. If the degree of profit-sacrificing exceeds what any typical sole proprietor would do in response to social or moral considerations when they are sacrificing their own profits, then it is unreasonable.

This hardly provides a bright-line test but at least provides some guidance about what to look at to determine the extent of profit-sacrifice that is reasonable. There has been little direct litigation about this for operational decisions, perhaps because the degree of profit being sacrificed in such cases is generally so obscure. But for corporate donations, there have been tax cases that have gotten at the issue indirectly while interpreting the tax code that prevents corporations from deducting more than a "reasonable" amount of charitable contributions. These courts have held that this limit is exceeded if the share of corporate income donated exceeds 10%.[138] This figure might seem purely arbitrary, but it does have venerable antecedents since 10% was the tithe that individuals were historically expected to contribute to their religious and social communities.

We might sensibly apply such a 10% limit to operational sacrifices of profits as well. In fact, unless the same percentage limit were applied to both donative and operational profit-sacrificing, the law would produce inefficient substitution effects between the two. Consistent with this, the ALI concludes that it would be unreasonable for a manager to change all a corporation's restaurants to a vegetarian menu, but reasonable for a manager to forego 10% of sales by not making a computer sale to a foreign country that would adversely affect national foreign policy.[139] Perhaps these conclusions reflect the ALI's view that national foreign policy interests are simply more important than saving animals from being eaten. But it seems highly problematic for courts to decide such

[138] *See* CHOPER, COFFEE & GILSON 5th Edition, *supra* note , at 40.
[139] ALI Principles, *supra* note , §2.01 Illustrations 13 & 22.

issues based on the happenstance of which social goals are thought most important by the judge or jury that happens to get drawn. And if the importance of the social goal is not the distinguishing factor, then the only relevant difference seems to be that the latter fit within a 10% limit but the former did not.

It may well be that explicitly recognizing such a discretion to sacrifice up to 10% of corporate profits would reduce not just uncertainty but the actual extent of discretion that exists under the alternative of a pseudo profit-maximization standard that allows anything with some conceivable relation to long-term profitability. Because a real profit-maximization standard would undesirably eliminate all discretion to temper the pursuit of profits, courts applying a nominal profit-maximization standard tend to accept with credulity any strained claim of a connection to profits, thus leaving management with no clear limits. If courts instead explicitly admit the profit-sacrificing discretion exists and limit it to 10% of profits, courts would probably engage in more independent fact finding and thus be more likely to prevent management from exceeding the 10% limit in reality.

The theory above can also explain both why we should have a nexus requirement for profit-sacrificing donations and what sort of nexus to look for. Recall that the affirmative reason for allowing corporations to make donations is both that the operational experiences of management subject them to social and moral processes that create donative impulses and that a lack of donative power would lead to inefficient substitution of donations with operational profit-sacrificing. The relevant business nexus accordingly should be whether there is something about conducting corporate operations that increases charitable impulses toward the sort of charity involved. Without that sort of business nexus, there is no good reason for the corporation to be making the donation rather than shareholders. Such a nexus should be an absolute requirement for a profit-sacrificing donation rather than (as the ALI suggests) a mere factor to be balanced against the extent of sacrifice, for that sort of nexus is a necessary condition for the affirmative justification for corporate

donations to hold at all. Thus, if the management of our timber corporation decides to donate corporate money to a pro-life group, then I would say that even a small profit-sacrificing donation cannot be justified because there is nothing about the experience of running a timber operation that explains any special propensity toward making such a donation. The charitable impulse instead results from the manager's personal experiences, and thus should come out of her personal funds rather than corporate funds.

The final strategy the law employs is to alter the legal limits depending on whether management has a last period problem that makes it less susceptible to nonlegal constraints. For example, in Delaware, as noted above, managers assessing a takeover bid can consider nonshareholder interests and need not treat shareholder interests as "a controlling factor."[140] If managers are seeking to block a takeover bid and continue operating the corporation, they do not face the last period problem noted above because any profit-sacrificing will continue to be constrained by product, labor, and capital markets, as well as by shareholder voting and their own profit-sharing incentives.

But sometimes takeover bids occur in a context whether the corporation has been put up for auction. There managers do face the last period problem noted above because they will not continue to operate the corporation. And under Delaware law, the legal standard changes. Where a firm is up for auction, the important Delaware Supreme Court opinion in *Revlon* instead concluded:

> A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.[141]

Later, in *Mills Acquisition,* the Delaware Supreme Court stated that managers of a firm put up for

[140] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). *See also* Ivanhoe Partners v. Newmont Mining, 535 A.2d 1334, 1341-42 (Del. 1987); Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1990).

[141] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

auction who are assessing the various takeover bids may consider ""the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests."[142] To be sure, the *Revlon* language suggests the Delaware Supreme Court thought that normally nonshareholder interests could only be considered when rationally related to shareholder interests, and was pointing out that such a rational relationship could not longer exist when shareholders were being cashed out. But this apparently just reflects the incomplete waning of the prior incompletely theorized agreement, for (as shown above) Delaware caselaw in fact does not make shareholder interests controlling and thus allows consideration of nonshareholder interests other than just when that happens to maximize shareholder value. When the corporation is being sold, however, management does have last period problems that should make us concerned that they will excessively sacrifice shareholder interests. It thus makes sense to add a special requirement in auction cases that any management decision bear a rational relationship to shareholder interests. Similar language does not appear in the Delaware Supreme Court cases about considering nonshareholder interests to block takeovers when the firm is not up for auction.[143]

Subsequent Delaware cases have made clear that, even when a firm is put up for auction, the firm need not simply be sold to the highest bidder. Rather, as *Mills Acquisition* states, all management need only show a rational relationship to shareholder interests. Where some of the bids involve a mix of cash and securities, this allows some consideration of nonshareholders interests on the theory that treating them well may in the long run increase the value of the securities shareholders receive. Thus, a board can conclude that a bid that looks worse for shareholders at current security prices nonetheless bears a rational relationship to shareholder interests when one considers nonshareholder interests. This was made plain in the *RJR Nabisco* litigation. There an

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[142] Mills Acquisition v. Macmillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1989).

[143] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); Ivanhoe Partners v. Newmont Mining, 535 A.2d 1334, 1341-42 (Del. 1987); Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1990).

auction was conducted. The winning bid offered a mix of cash and securities with a face value of $109 that the corporation's investment banker valued at $108-108.50.[144] A disappointed rival bidder had offered a similar mix with $3 more in cash for a face value of $112 that the corporation's banker valued at $108.50-109.[145] The Delaware chancery court, in an opinion by Chancellor Allen, sustained the board's decision to accept the first bid, reasoning that the *Revlon* duties applicable in an auction did not bar management from considering nonshareholder interests when the bids are "substantially equivalent."[146] The Delaware Supreme Court dismissed an appeal from this judgment, agreeing that "No legal rights have been established here. The legal issues presented are being addressed by this Court in *Mills Acquisition* . . ."[147]

This conclusion is interesting in two ways. It shows that, even in the auction context, management enjoys substantial discretion because of its power to value bids that include securities. Here that amounted to a discretion of at least 3%. Second, the fact is that – even as valued by the corporation itself – the two bids were *not* equal: the accepted bid had a value of $108-108.50 and the rejected bid a value of $108.50-109.00. The corporation's own analysis thus indicated there was *no* chance the winning bid was worth more than the rejected bid – the best the corporation could say is that the difference in value was between $0 and 1.00. Accordingly, the rejected bid necessarily must have had higher *expected* value to shareholders. The decision effectively holds then that, even in the auction context, management can go beyond considering nonshareholder interests to the extent they can claim a rational relationship to shareholder value. Management can apparently conclude

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[144] *See In re RJR Nabisco, Inc. Shareholders Litig.,* 1989 WL 7036, at *1, 14 Del.J.Corp.L. 1132, 1137 [1988-89 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 94,194 (Del. Ch. 1989) (Allen, C.).

[145] 1989 WL 7036, at *2, 9-10, 18; 14 Del.J.Corp.L. at 1138, 1147-48, 1150, 1163. The winning bid was for $81 in cash, $18 in pay-in-kind preferred stock, and $10 in converting debentures; the rejected bid was for $84 cash, $24 in pay-in-kind preferred stock, and $4 in convertible preferred . *Id.*

[146] 1989 WL 7036, at *4; 14 Del.J.Corp.L. at 1141 (where "the bids in hand were substantially equivalent in value" the board could accept the bid that "had non-financial aspects that permitted a reasonable person to prefer it") . *Accord* BLOCK, *supra* note , at 812 (citing *RJR* for the proposition that "Boards conducting an auction . . . may consider the interests of non-shareholder constituencies such as employees in choosing between two 'substantially equivalent' offers for control.").

[147] 1989 WL 16907 (unpublished opinion reported in table at 556 A.2d 1070).

that consideration of nonshareholder interests overrides small differences in shareholder value, amounting to less than 1% of expected shareholder value, on the grounds that only "substantial" equivalence is required.

In short, it appears that even under the *Revlon* rules applicable to auctions, management still enjoys some degree of discretion to sacrifice shareholder profits to further the interests of other constituencies. It need only, if it wants to do so, make sure that the winning bid is structured to include some securities whose value can be claimed to have some rational relationship to shareholder value. And it may not even need to do that if the difference in price is less than 1%.

However, this degree of discretion still reflects a sharp constriction from the discretion managers normally enjoy to sacrifice corporation profits in the public interest, and the courts seem far more ready to vigorously enforce legal limits in such an auction context. This fits well with the theory of this article, for it is precisely in such auction contexts that management has last period problems that neutralize nonlegal limits on the discretion to engage in profit-sacrificing activities, and thus require tighter legal limits that do not eliminate, but do constrain, that discretion.

C. Mandatory v. Default Rule

Could a corporation in its initial charter opt out of the corporate law rule that gives management and controlling shareholders the current limited discretion to sacrifice corporate profits in the public interest? If it wants to opt out of the *limits* on that discretion, the clear answer appears to be 'yes.' Indeed, a corporation can opt out by saying it will devote 100% of profits to the public interest, which is precisely what it does when it forms a nonprofit corporation that cannot distribute profits to investors at all. Nor does there appear to be any reason not to permit a corporation to do so in its charter for any figure between 10-100%. As long as shareholders know the provision is in the charter, the price they pay for their shares will reflect an appropriate discount for that provision. And the organizers of the corporation must socially or morally benefit enough from including the

provision to exceed its resulting reduction in the price they will get for corporate shares, otherwise the organizers would not include it. The answer would, however, be different if a majority of shareholders tried to amend the corporate charter in midstream, for then that would expropriate the investment of other shareholders, who invested based on the default rule that allows only a limited degree of profit sacrificing.

In fact, we do see corporate provisions that might be considered to constitute such an opt-out. Many news corporations, for example, have charter provisions that require managers to consider or maintain the editorial independence of its staff.[148] Under the above logic, such provisions should be deemed enforceable even if they sacrifice more than 10% of profits. More generally, a 1995 study showed that 7.4% of corporations had provisions allowing directors to consider non-financial aspects of mergers,[149] which is higher than it might look considering that such provisions are not necessary for the vast bulk of corporations that are incorporated in either Delaware or any of the 29 states that have enacted statutes authorizing such consideration. Such opt-outs indicate a desire to opt-out of the possible risk a court will impose a profit-maximization duty, and suggest that even shareholders desire such an opt-out with surprising frequency.

Could a corporate charter instead opt out of any discretion, by imposing a enforceable duty to profit maximize? Presumably not, because such a provision would be neutralizing social and moral sanctions that exist to protect the interests of third parties who are not party to the corporate contract and thus would not have consented to the corporate charter provision. That is, to the extent the law allows "soulless" corporations to be chartered only because the humans that run them are given a discretion that can be influenced by the same social and moral processes than apply to noncorporate businesses, then it is legally mandatory that those charters allow the free exercise of that discretion. Nor is it clear how a charter provision could make any such duty truly enforceable

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[148] *See* BLOCK, *supra* note , at 822 n.1205.
[149] *Id.i at 823.*

without abrogating the business judgment rule more generally. And in the unlikely event that a corporation found it beneficial to make such an abrogation, it is unclear courts would accept it, for that would amount to transferring the burden of management to our publicly subsidized judiciary.

The conclusion that this discretion is mandatory seems supported by the corporate constituency statutes, especially Connecticut's since it has the language requiring that managers "shall" consider nonshareholder interests.[150] But I am not aware of any caselaw that allows or prohibits a provision requiring pure profit-maximization, apparently because no corporation has ever attempted one. This itself is interesting because, given that in fact current law does give managers some discretion to sacrifice profits, one would have thought corporations would have attempted to opt out of it (or clarify it) if the current state of law posed any serious burden on shareholders. To be sure, in my view the law would deem the preservation of some profit-sacrificing discretion as mandatory, but this issue must be regarded as unsettled given the lack of caselaw. Thus, one would have expected adversely affected corporations to at least attempt to opt out in their charter by adopting a pure duty to profit-maximize. The fact that they have not done so suggests that they would not derive any positive benefit in share prices from doing so, probably because making any such duty effective would require inefficiently jettisoning the business judgment rule, whose protections confer much more benefits to corporations than the costs of profit-sacrificing discretion.

[150] Connecticut Stock Corporation Law §33-756(d).