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SACRIFICING CORPORATE PROFITS IN THE PUBLIC INTEREST

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The canonical law and economics view holds that corporate managers do and should have a duty to profit-maximize because such conduct is socially efficient given that general legal sanctions do or can redress any harm that corporate or noncorporate businesses inflict on others. Professor Elhauge argues that this canonical view is mistaken both descriptively and normatively. In fact, the law gives corporate managers considerable implicit and explicit discretion to sacrifice profits in the public interest. They would have such discretion even if the law pursued the normative goal of corporate profit-maximization because minimizing total agency costs requires giving managers a business judgment rule deference that necessarily confers such profit sacrificing discretion. Nor is corporate profit-maximization a socially efficient goal because even optimal legal sanctions are necessarily imperfect and require supplementation by social and moral sanctions to fully optimize conduct. Accordingly, pure profit-maximization would worsen corporate conduct by overriding these social and moral sanctions. In addition to being socially inefficient, pure profit-maximization would harm shareholder welfare whenever shareholders value the incremental profits less than avoiding social and moral sanctions. For companies with a controlling shareholder, that shareholder is exposed to social and moral sanctions and has incentives to act on them, and thus

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controlling shareholders are well-placed to decide when to sacrifice corporate profits in the public interest. In contrast, the structure of large publicly-held corporations insulates dispersed shareholders from social and moral sanctions and creates collective action obstacles to acting on any social or moral impulses they do feel. Thus, in public corporations, optimizing corporate conduct requires giving managers some operational discretion to sacrifice profits in the public interest even without shareholder approval because, unlike shareholders, managers are sufficiently exposed to social and moral sanctions. Managerial incentives toward excessive generosity are constrained by various market forces, which generally mean that any managerial decision to sacrifice profits in the public interest substitutes for more self-interested profit sacrificing exercises of agency slack. Managerial discretion to sacrifice profits is further constrained by legal limits on the amount of profit sacrificing, which become much tighter when market constraints are inoperable because of last-period problems. Managers should have donative discretion because courts cannot distinguish profit-enhancing donations from profit sacrificing ones, because shareholders are insulated from the social and moral processes that desirably generate the special donative impulses that arise from running business operations, and because otherwise managers would often inefficiently substitute more costly operational profit sacrificing decisions to avoid social and moral sanctions. This explains the legal requirement that corporate donations have a nexus to corporate operations. Antitakeover laws can partly be explained as necessary to preserve sufficient managerial discretion to consider social and moral norms.

INTRODUCTION

Let's start concrete before we get theoretical. Suppose clear-cutting is profitable and legal, but is nonetheless regarded as environmentally irresponsible under prevailing social norms. Can management of a timber corporation decline to clear-cut its timberland even though that 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 that 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 socially undesirable clear-cutting?

My answers to these questions will challenge the canonical law and economics account on corporate social responsibility, which goes something like this. Unless modified by statute, traditional fiduciary duties require corporate managers 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 of both law and economics. A single goal like profit-maximization is easier to monitor.[2] Nor is there any reason to impose a special "tax" on dissenting shareholders to further public interest goals that is not imposed on others.[3] If certain conduct imposes excessive harm on others or merits taxation, then an independent law should regulate and impose liability or taxes whether or not the actor is a corporation, and if the conduct does not impose any impermissible harm or merit taxation, then the most socially desirable

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[1] *See, e.g.*, STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 419–29 (2002); ROBERT CHARLES CLARK, CORPORATE LAW 17–19, 677–81 (1986); MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 97 (1995); American Bar Association Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2257–61 (1990) [hereinafter ABA]; Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1492 (1992); Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 527 (2002); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1191–92 (1981); Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 267 n.65 (1989); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440–41 (2001); Jonathan R. 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); Jonathan R. Macey & Geoffrey P. Miller, *Corporate Stakeholders: A Contractual Perspective*, 43 U. TORONTO L.J. 401, 402–03 (1993). Nonprofit corporations are a different story even under the canonical account, but my analysis here is limited to the typical business corporations that can distribute profits to investors.

[2] *See, e.g.*, BAINBRIDGE, *supra* note 1, at 421–22; CLARK, *supra* note 1, at 20, 679, 692, 702; JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 69–70 (2d ed. 2003); ABA, *supra* note 1, at 2269–70; Easterbrook & Fischel, *supra* note 1, at 1191–92.

[3] *See, e.g.*, BAINBRIDGE, *supra* note 1, at 421, 428–29; CLARK, *supra* note 1, at 603; Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32.

thing for corporations to do is maximize profits.[4] Other stakeholders could either legally protect themselves by contract with the corporation or have their legal protection provided by judicial gap-filling of such contracts.[5] Part of what makes this account canonical is that it helps define the boundaries of the corporate law field. It leaves corporate law scholars free to ignore issues about any effects the corporation may have on the external world as topics best addressed by other legal fields, and to focus on more tractable models about which corporate rules would maximize shareholder value.

Then, the canonical account continues, something unfortunate happened. The 1980s takeover wave led to a political backlash that caused thirty states to adopt corporate constituency statutes allowing or requiring managers to take the interests of other constituencies into account, sometimes generally, sometimes just in corporate control transactions.[6] But these statutes were either misguided or just a subterfuge for allowing management to block takeovers that were contrary to managerial interests.[7] 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

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[4] *See* CLARK, *supra* note 1, at 20–21, 30–32, 677–81, 692, 702; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 37–39 (1991); Hansmann & Kraakman, *supra* note 1, at 441–42.

[5] *See* BAINBRIDGE, *supra* note 1, at 421, 425–28; Hansmann & Kraakman, *supra* note 1, at 441; Macey, *supra* note 1, at 40–41; Macey & Miller, *supra* note 1, at 417–21. An important dissenting strand argues that explicit contracts cannot solve team production problems among stakeholders, thus making it efficient to allow the board of directors to allocate firm surplus among those stakeholders, which includes not just shareholders, but employees, creditors, and others who make firm-specific investments that increase corporate production. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249–53, 265–87, 319–20 (1999). Although this excellent work rejects the notion that shareholders have primacy over other stakeholders, its ultimate justification is that such board decisions will maximize corporate profits by encouraging others to make firm-specific investments that increase those profits. *Id.* at 304–05. It thus justifies decisions that may sacrifice shareholder profits in the short run or *ex post*, but only on the grounds that those decisions increase profits in the long run or ex ante. *See infra* Part IV.A. It would not justify board decisions to sacrifice corporate profits to protect the environment or persons who are not part of the team that helps produce corporate output, nor to protect team members more than necessary to encourage profit-maximizing firm-specific investments.

[6] *See* COX & HAZEN, *supra* note 2, at 69; Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85, 85 (1999).

[7] *See, e.g.*, COX & HAZEN, *supra* note 2, at 69; ABA, *supra* note 1, at 2253; Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1025 (1992); Bebchuk, *supra* note 1, at 1492–93; Macey, *supra* note 1, at 26, 33, 44; Macey & Miller, *supra* note 1, at 402, 405, 412–13.

doing so increases corporate profits.[8] Further, the canonical account stresses, the other twenty states remain governed by the traditional rule. And because these twenty states include Delaware, the eight-hundred-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 turns out to be wrong. Corporate managers have never had an enforceable legal duty to maximize corporate profits. Rather, they have always had some legal discretion (implicit or explicit) to sacrifice corporate profits in the public interest. Indeed, as I show below, the implicit version of this discretion could not be eliminated without destroying the business judgment rule that is the bedrock of corporate law. But statutes and case law have also been willing to make this discretion explicit, especially when necessary to preserve it. None of the fifty states has a statute that imposes a duty to profit-maximize or that makes profit-maximization the sole purpose of the corporation. Every state has a statute authorizing unprofitable corporate donations. And those states that have enacted statutes on the topic have authorized managers to weigh the interests of other constituencies against shareholder profits in operational or corporate control transactions. Likewise, the influential Principles of Corporate Governance by the American Law Institute (ALI) explicitly state that common law fiduciary duties do not prohibit managers from sacrificing profits to further the public interest, and the case law has been willing to hold the same explicitly wherever it could not ratify such discretion implicitly by using deferential business judgment rule review.

Perhaps more surprisingly, proper economic analysis does not prove this discretion is undesirable or even inefficient. Because the analysis is rather long and complex, let me summarize up front the main points that will be supported in greater detail in the body of the article.

To begin with, even a legal regime that seeks only to maximize shareholder profits would provide the sort of business judgment rule deference that inevitably allows latent profit-sacrificing discretion to exist. The alternative to eliminating this discretion by creating a legally enforceable duty to profit-maximize would put the litigation process, rather than managers subject to market processes, in charge of operational decisions. This would surely lower shareholder profits

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[8] *See* CLARK, *supra* note 1, at 682–83; ABA, *supra* note 1, at 2269; *see also* 1 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE 808–23 (5th ed. 1998) (reporting some efforts to construe state statutes narrowly).

and increase total agency costs given the length, cost, and high error rate of the litigation process. Even if courts could figure out whether the conduct failed to maximize profits in the short run, it would be too difficult to tell whether it might increase profits in the long run because of increased goodwill or similar effects. Still greater difficulties are raised by the disjunction between ex ante and *ex post* profit-maximization created by claims that efficient implicit contracts or social understandings sometimes involve others conferring sunk benefits on a corporation expecting that managers will have discretion to reciprocate later with an operational decision that sacrifices profits *ex post* (ignoring the sunk benefits) but that maximizes profits ex ante (because necessary to induce the sunk benefits). In short, the argument that the law should adopt a duty to profit-maximize because it is easier to monitor has matters exactly backwards. 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 the profit-sacrificing discretion created by business judgment deference suffices to cover the lion's share of profit-sacrificing discretion that exists.

There are also affirmative justifications for profit-sacrificing discretion that explain why the law is willing to go beyond latent discretion and authorize patent discretion when necessary. If managers are acting as loyal agents for most shareholders, then even patent exercises of the power to sacrifice profits in the public interest will enhance shareholder welfare by furthering what most shareholders view as the public interest. Because any operational decision must apply to all shareholders, such a profit-sacrificing decision cannot avoid also governing the interests of dissenting shareholders. But the objection that profit-sacrificing discretion imposes a "tax" on dissenting shareholders fails because it implicitly assumes a baseline of profit-maximization, where deviation from that baseline equals a "tax," when the very issue being debated is what that baseline should be. Given the existence of a legal rule that confers profit-sacrificing discretion on managers acting for most shareholders, dissenting shareholders receive the returns that they should expect. Further, controlling shareholders have incentives to enter into Coasean bargains to alter profit-sacrificing decisions whenever they cease to maximize total shareholder welfare, and, as I will show, the transaction costs of such bargaining will be minimized by making such discretion the initial entitlement.

Even when corporate managers are not acting as loyal agents, but are instead exercising their agency slack to deviate from shareholder views, their exercises of profit-sacrificing discretion will generally still make corporate conduct more socially desirable. The reason is that proponents of a duty to profit-maximize are wrong in assuming that any desirable regulation of conduct can be accomplished through law. Even optimal legal sanctions will inevitably fail to cover some undesirable conduct because that underinclusion cannot be eliminated without increasing the overinclusion of desirable conduct. Thus, optimal regulation of behavior has always required supplementing necessarily imperfect legal sanctions with social sanctions and internalized moral norms. Compared to noncorporate businesses, the corporate structure creates two problems for this supplemental means of regulating conduct: (1) Shareholders are insulated from the exposure and knowledge that creates social and moral sanctions, and (2) shareholders have collective action problems that make it difficult for them to act on any social or moral impulses they do feel. Managerial conduct that perfectly represented shareholders would thus tend to produce socially suboptimal conduct. Enforcing a legal duty requiring corporate managers to maximize profits would worsen these problems by: (1) requiring corporate behavior to equal the suboptimal conduct we would get without any social and moral sanctions and (2) shifting governance power (via the derivative action) to whichever shareholder cares least about social and moral considerations. It would mandate by law the "soulless corporation" that was the historical fear in the 1800s aroused by states chartering the creation of corporations at all.[9] In contrast, allowing managers to use their agency slack to respond to social and moral sanctions will move corporate behavior in the right direction, assuming our society's social and moral norms correctly identify which direction is right.

One might worry that corporate managers exercising agency slack will have incentives to be excessively generous in responding to social or moral sanctions because, unlike sole proprietors, they would be sacrificing other people's money. But this is unlikely to be a problem for several reasons. To begin with, unless the total amount of agency slack were increased, any managerial decision to use their operational discretion to sacrifice corporate profits in the public interest should substitute for profit-sacrificing behavior that would have been more personally beneficial to managers. This would eliminate any managerial incentive to be excessively generous, leave shareholders financially indifferent, and further the public interest views reflected in social and moral sanctions. And there is little reason to think that public interest exercises of operational discretion increase total agency slack because such exercises of discretion reflect either latent profit-

[9] *See* Lawrence M. Friedman, A History of American Law 194 (2d ed. 1985).

sacrificing (which does not alter agency slack) or patent profit-sacrificing (which actually reduces agency slack by better informing shareholders).

Further, even when managers have incentives to be excessively generous, they also have offsetting incentives for excessive stinginess created by accountability to shareholders who are underresponsive to social and moral sanctions. The net result of these counteracting incentives may well not exceed the behavioral optimum. And even when it does, the net effect will be socially desirable unless the resulting corporate conduct not only overshoots the optimum, but does so by a larger margin than the shortfall that would be produced by a duty to profit-maximize. This possibility of excessive overshooting provides an argument against *unlimited* discretion, but not an argument against allowing managers *some* degree of discretion. In fact, the risk of such excessive overshooting is constrained by product markets, capital markets, labor markets, takeover threats, shareholder voting, and managerial profit-sharing or stock options. These forces are typically more than adequate to constrain managers from being excessively generous. And in extreme cases where those nonlegal constraints are ineffective, the law can and does provide limits on managerial discretion to avoid excessive overshooting. Finally, to the extent excessive generosity remains a problem, the alternative of creating an enforceable fiduciary duty to profit-maximize would harm shareholders even more by ending business judgment deference (which would lower shareholder profits) and by interfering with patent profit-sacrificing in the majority of cases where managers do loyally represent majority shareholder sentiment (which would lower shareholder welfare).

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 problems for a regime that already allowed managers to sacrifice corporate profits in the public interest. First, takeover bids effectively monetized whether in fact managers were sacrificing corporate profits or not. Managers could no longer credibly claim that their 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 could have effectively imposed a duty to profit-maximize where there had been none before.

Second, hostile takeovers created a new collective action problem for those shareholders who wanted to sacrifice corporate profits to further public interest objectives. 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. 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 that her decision does completely determine whether she gets the takeover premium in a timely fashion. Accordingly, without takeover defenses, corporations wouldn't 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 the takeover wave triggered the creation of corporate constituency statutes. Although all-important Delaware never enacted a corporate constituency statute, no statute was necessary in that state because its courts had by common law 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 case law may have had more venal motives in mind, nor to deny that the law giving managers discretion to block takeovers (unlike the law recognizing operational discretion) may have been to keep total agency slack higher than it could have been. But it does provide both an explanation for why social interest groups joined managers in such lobbying and a neutral justification indicating that these legal changes cannot simply be dismissed as nothing more than management entrenchment.

While profit-sacrificing corporate donations are even more clearly authorized by statutes, they are somewhat more difficult to justify than operational profit-sacrificing because a corporation could instead increase shareholder wealth and leave shareholders free to donate their share of that wealth in different ways, whereas a corporation cannot conduct operations in a different way for each shareholder. This also means that shareholders making donations would not face the same collective action problems they face in pursuing public interest views on corporate operations or takeovers: Shareholders can just make separate donations of their share of increased corporate wealth without need of collective coordination. But, as with operational discretion, if managerial donative discretion is a problem, it is likely small and better than the alternative for reasons similar to those noted above. Prohibiting all corporate donations would harm shareholders by barring those donations that enhance profits by creating goodwill, and trying to prohibit only those donations that sacrifice profits would require courts to make business decisions that lie beyond their competence. More important, shareholders are insulated from the social and moral processes that desirably generate the special donative impulses that arise from running business operations. Managers who are not insulated from the social and moral effects of corporate operations are thus likely to make more socially desirable donations.

Donations also raise a new point about substitution effects. Inefficient substitution would result if the law allowed managers to engage in profit-sacrificing conduct but not donations, for then managers would respond to social and moral pressures by making profit-sacrificing operational decisions even when a donation could have advanced the same public interest objective more effectively or at lower cost. Accordingly, given that a power to engage in profit-sacrificing conduct is both inevitable and affirmatively justifiable, substitution effects make it efficient to allow profit-sacrificing donations even if the latter would not be justifiable standing alone. This substitution concern works in reverse as well. Given that statutes clearly authorize profit-sacrificing donations, any judicial effort to prohibit profit-sacrificing conduct through common law fiduciary duties would produce inefficient substitution toward donations even when they advance the public interest less effectively or at higher cost.

To avoid possible misunderstanding, let me make clear what I am not saying. I am not saying that managers have a legally enforceable *duty* to sacrifice corporate profits in the public interest; I am saying that they have *discretion* to do so. As applied to a claim that such discretion properly exists, arguments that a duty to other constituencies would create various problems or conflicted loyalties[10] thus attack a straw man. If we thought our legal sanctions were accurate enough to justify creating a legal duty to engage in certain conduct, then I can see no reason not to do so in a general law that was also applicable to noncorporate actors, rather than with a special duty applicable only to corporate managers. But it is precisely the fact that there are residual areas beyond the reach of even optimally framed legal duties that justifies the supplemental strategy of allowing corporate managers (like

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10 *See, e.g.*, BAINBRIDGE, *supra* note 1, at 421–22, 430; ABA, *supra* note 1, at 2269–70; Easterbrook & Fischel, *supra* note 1, at 1191–92.

noncorporate businesses) to exercise a discretion guided by social and moral sanctions rather than by solely legal duties. On the other hand, it is widely conceded that managers *do* have a special duty to their corporation to comply with the law even when the expected legal sanctions for doing so are lower than the expected profits. I will show that this rule makes sense only if shareholder insulation from social and moral sanctions is a serious problem.

I am not saying there is an "objective" public interest, let alone that courts can and must identify it to determine whether managers are properly exercising their discretion. By sacrificing profits "in the public interest," I simply mean to describe cases where managers are sacrificing corporate profits in a way that confers a general benefit on others, as opposed to conferring the sorts of financial benefits on themselves, their families, or friends that courts police under the duty of loyalty. Of course, people disagree about which efforts to confer general benefits on others are truly desirable. Some think clear-cutting is horrific; others think it is perfectly fine or justifiable if it increases employment. Whether a discretion to benefit others will be exercised in a way that is truly desirable depends largely on whether the social and moral sanctions that influence the exercise of that discretion move behavior closer to socially desirable outcomes or further from them. My analysis assumes only that our social and moral sanctions have enough general accuracy that they overall move us closer to the outcomes that society deems desirable rather than being affirmatively counterproductive.

By focusing on profit-sacrificing conduct, I do want to cut off the usual reaction of "fighting the hypothetical" with claims that the socially responsible conduct at issue really increases profits in some indirect way. I understand there are broader definitions of corporate social responsibility, one of which includes any corporate conduct that goes beyond legal compliance even if it is profit-maximizing. Such broader definitions may arguably be of greater practical interest to activists interested in getting corporations to engage in certain conduct. After all, it is much easier to persuade corporations to stop clear-cutting if one can show that doing so is not only good but profitable. But such profitable activities raise no real issue of legal or normative interest. Of course, corporate managers can and should do good when it maximizes profits: What could be the argument to the contrary? The serious question is whether they can and should do good when it decreases profits. I wonder also whether socially responsible conduct that maximizes profits is really even of much practical interest. Agitating for corporations to engage in responsible conduct that increases their profits is a lot like saying there are twenty-dollar bills lying on the sidewalk that they have missed. Maybe sometimes they have missed them, but they already have ample incentives to recognize and act on such profit-maximizing opportunities. Arguments that socially responsible conduct would increase profits are thus probably less about identifying profit-maximizing opportunities that corporations have missed than about helping create a patina of conceivable profitability that makes it easier for managers to engage in conduct that really sacrifices expected corporate profits.[11] In any event, it is implausible to think that *all* socially beneficial corporate conduct conveniently happens to be profit-maximizing, and what requires analysis is the portion that does not.

I am not denying that managers' *primary* obligation is and should be to make profits, nor am I saying that their discretion to sacrifice profits should be increased, let alone made boundless. I am rather saying that this obligation to make profits is not and should not be *exclusive*, but that instead managers do and should have some limited discretion to temper it in order to comply with social and moral norms. I emphasize this because the literature generally uses the term "shareholder primacy" to describe the duty to profit-maximize.[12] For my purposes, this terminology conflates two distinct issues. Managers should have discretion to sacrifice profits so that they can respond to social and moral sanctions by tempering profit-maximization in the same way that individuals who run their own businesses would. But I have no doubt that such business proprietors primarily seek profits and see no reason why corporate managers should not do the same. The managerial discretion to sacrifice profits thus does not mean that shareholders have no primacy over other stakeholders.

Managers' existing profit-sacrificing discretion is in fact desirable precisely because it is bounded. Normally, the meaningful boundaries are set not by law but by the market constraints outlined above. How-

[11] The other argument offered for defining corporate social responsibility as conduct that exceeds legal compliance is that it is more clear and measurable. But so many behavioral choices could be said to exceed bare legal compliance that calling all of these choices corporate social responsibility reduces the concept to meaninglessness. For example, if a firm decides not to come close to violating the patent of another firm, it exceeds legal compliance, but is that really corporate social responsibility? To make the concept meaningful, such a definition must implicitly be limited to conduct that exceeds legal compliance *in some socially desirable way*. But such a limit just begs the question of what legal conduct is socially desirable and deprives the definition of its supposed advantage in clarity.

[12] *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 85–86 (2004); Blair & Stout, *supra* note 5, at 287; Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2063–65 (2001); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 (1998); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189 (2002).

ever, 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. Where no such last-period problems exist, the general backstop limit has historically been to simply apply deferential business judgment rule review. This preserves a de facto discretion to sacrifice corporate profits because managers can almost always make a plausible argument that they somehow might increase profits in the long run. But it does limit the degree of profit-sacrificing because if managers attempted to sacrifice huge amounts of profits, it would be difficult to make even a strained argument that their conduct might increase profits in the long run. In short, the true function of conventional business judgment review has not been to impose a real duty to profit-maximize but to set some outer limit on the *degree* of profit-sacrificing discretion.

This approach, however, is not always sufficient to provide the necessary discretion, and has become less effective as developments like takeovers have required corporate law to provide explicit authority to sacrifice profits in the public interest. As a result, modern law has further limited managers to sacrificing no more than a "reasonable" degree of profits.[13] Unfortunately, this legal standard is rather conclusory absent some theory about why managers should have discretion. The theory articulated in this article helps provide content by indicating that the appropriate benchmark should be the degree of profit-sacrificing that would plausibly be engaged in by individuals sacrificing their own business profits to avoid social or moral sanctions. One way to make the latter benchmark more concrete would be to conclude that, because ten percent was the tithe that morally devout individuals were historically expected to contribute to their religious and social communities, managers exceed their discretion if they cause their corporation to alter its conduct in a way that clearly reduces corporate profits by over ten percent. This outside limit appears to be consistent with the legal authority we have on this issue. The theory in this article also explains both why the law additionally requires that profit-sacrificing donations have a nexus to corporate operations and what sort of nexus to look for: the sort of nexus

[13] *See infra* Part VII.A.1.

that exposes managers to the moral and social processes that are the basis for conferring donative discretion on them.

Finally, in claiming that such managerial discretion is efficient, I am not claiming that it will necessarily increase shareholder wealth or welfare. It does seem likely that such discretion will normally increase shareholder welfare because the alternative of enforcing a legal duty to maximize profits would be inefficient, because discretion that is *ex post* profit-sacrificing can be ex ante profit-maximizing, and because discretion will increase shareholder welfare to the extent managers act as loyal agents for the public interest views of most shareholders. Consistent with this, corporations have not tried to opt out of the current doctrine by adopting an enforceable duty to profit-maximize in their corporate charters. To the contrary, ninety percent of them have adopted corporate charter provisions eliminating manager liability even under the current weakly enforced duty of care.

But even if a corporation elected to restrict operational discretion with a charter provision imposing a profit-maximization duty and could show it would increase shareholder wealth, such a charter provision should be unenforceable. It would impose excess administrative burdens on courts, and discourage ex ante efficient social understandings or implicit contracts that would otherwise increase shareholder wealth by allowing shareholders to renege on them *ex post* through such a charter provision. It would also create collective action problems for those shareholders who do suffer dissatisfaction from corporate noncompliance with social and moral norms, and inflict greater harm on nonconsenting third parties by neutralizing the social or moral sanctions that are necessary to optimize corporate conduct. In contrast, the doctrine authorizing corporate donations is and should be treated as a mere default rule from which corporations can opt out because a charter forbidding such donations would not raise these same problems.

I
The Social Regulation of Noncorporate Conduct

It helps to begin with some baseline understanding about how societies regulate noncorporate conduct. Much, but not all, of that regulation is legal. The law prohibits certain conduct, and imposes sanctions on the prohibited conduct, but these legal sanctions are imperfect for well-known reasons. Part of the reason is that our lawmaking processes are inevitably imperfect because of both interest group influence and the lack of any perfect means of aggregating preferences about what the law should be.[14] But a more fundamental reason is that imperfect legal sanctions are in fact optimal.

Even in an ideal world with perfectly unbiased decisionmaking processes, legal sanctions can never be made sufficiently precise to deter or condemn all undesirable activity because we lack perfect information and cannot perfectly define or adjudicate undesirable activity.[15] Trying to eliminate those imperfections in information and adjudication would be not only unfeasible and costly but also undesirable in principle because of the harms that perfect surveillance would impose.[16] Even if we could eliminate imperfect information by constantly videotaping everyone at zero financial cost, we probably would not find it worth the harm to privacy and the resulting deterrence of innovation and desirable spontaneous interaction. Nor would it eliminate uncertainties about how best to interpret the videotapes. Given such inevitably imperfect information and adjudication, the law can never perfectly distinguish between desirable and undesirable conduct, and thus the best possible sanctions can do no better than strike the optimal balance between underdeterring undesirable conduct and overdeterring desirable conduct.[17]

This goes beyond the argument that illegal activity often goes underpunished,[18] for one implication of modern analysis of optimal legal sanctions is that the distinction between defining rules of conduct and enforcing them is not that 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 information within the control of one party legally irrelevant even though that information would be pertinent to the desirability of the conduct.[19] 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 are both more expensive to administer and more likely to be applied erroneously given imperfect information and

[14] *See generally* Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31, 35–44, 101–09 (1991) (summarizing literature on interest group influence and inevitable imperfections with any system of aggregating preferences).

[15] *See* Stephen McG. Bundy & Einer Elhauge, *Knowledge About Legal Sanctions*, 92 MICH. L. REV. 261, 267–79 (1993); Reinier H. Kraakman, *Gatekeepers*, 2 J.L. ECON. & ORG. 53, 56–57 (1986).

[16] *See* Bundy & Elhauge, *supra* note 15, at 268–69.

[17] *Id.* at 267–79.

[18] CLARK, *supra* note 1, at 684–87.

[19] *See* Bundy & Elhauge, *supra* note 15, at 267–79.

errors in weighing information.[20] But because rules do not use criteria that incorporate all the factors that bear on the desirability of conduct, rules are necessarily over- and underinclusive on their face.[21] Indeed, even the most open-ended 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.[22] Thus, even the most efficient and socially optimal legal rules will generally underinclude some significant degree of undesirable conduct.[23] This is true no matter what strategy the law adopts on rules versus standards, standards of proof, and size of penalties, because all raise the problem that expected sanctions can be increased for undesirable conduct only at the cost of increasing them for desirable conduct.[24]

This system of necessarily imperfect legal sanctions is supplemented by a system of economic sanctions.[25] Even when legal remedies would not suffice to deter us from engaging in certain undesirable conduct, we might hesitate from doing so because our reputation would suffer, causing others to stop doing business with us. These economic sanctions could make it profitable to forgo that undesirable conduct. For example, if we run a sole proprietorship that is considering whether to clear-cut, and we know that doing so will cause many consumers to refuse to buy from us, that would be an economic sanction.

Unfortunately, economic sanctions are also likely to be imperfect for various reasons. Those harmed by our actions may not have a relationship with us that allows them to impose economic sanctions. Even if they are, they may not be informed enough to do so, or may not be able to inflict a large enough economic sanction to deter the misconduct. When many parties are harmed, they may also have collective action problems that mean none of them have incentives to engage in individually costly decisions to impose economic sanctions.

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20 *Id.*

21 *Id.*

22 *Id.*

23 *Id.*

24 *Id.*

25 *See* David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 392–93 (1990); Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1336–37 (2001) (collecting sources).

For example, consumers who care about the environment face information problems in determining what our business has done, whether that conduct was desirable given all the facts, and what downstream products incorporate inputs from our business. The consumer buying furniture would, for example, have a hard time knowing whether that furniture uses our lumber, let alone whether what we did really constituted clear-cutting, or whether that conduct was undesirable given the tradeoffs with local employment. Consumers could try to rely on crude proxies, like labels provided by sellers or groups like the Sierra Club, but consumers cannot be sure about the extent to which those labels are accurate or fully reflect each consumer's views, nor will such crude proxies provide the nuanced judgments that some corporate conduct might require.[26]

Further, consumers have motivational problems because generally they are not identical to the set of people who suffer the harm from the undesirable conduct. If our actions harm the environment in Oregon, consumers located in other states may conclude it does not harm them much, leaving them insufficiently motivated to sanction it. Consistent with this, empirical evidence indicates that economic sanctions for crimes (like environmental crimes) that harm unrelated third parties are far lower than for crimes that harm suppliers, employees, or customers as buyers.[27]

Finally, even perfectly informed and motivated consumers would face collective action problems. Each consumer would know that her individual purchase decision will determine whether she gets the best-priced good, but that the loss of one sale will have little effect on a businesswide decision about whether to engage in antisocial conduct. For example, suppose our furniture sells at a \$1 discount given the lower costs of clear-cutting, but imposes a social harm that consumers understand and care about enough to value at -\$10 per piece of furniture. Each individual consumer has incentives to buy our furniture to get the \$1 discount regardless of what she assumes the other consumers will do. If she assumes the other consumers are not going to stop buying because of the clear-cutting, then she knows declining to buy our furniture won't stop the \$10 harm from occurring but will cost her \$1. If she assumes the other consumers are going to stop buying because of the clear-cutting, then she knows that the \$10 harm will be

[26] *See* Beth Daley, *Eco-Products in Demand, But Labels Can Be Murky*, BOSTON GLOBE, Feb. 9, 2005, at A1.

[27] *See* Cindy R. Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence*, 42 J.L. & ECON. 489, 490–91, 504, 522–23 (1999); Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757, 797 (1993).

stopped regardless of what she does, so she might as well take the $1 discount. Such collective action problems will generally make economic sanctions ineffective when they require numerous consumers to take action against their economic interest. Again, the empirical evidence is consistent with this theory, showing that substantial economic sanctions are typically imposed in cases where the customers are government agencies that lack such collective action problems, rather than private parties who do.[28]

None of this is disproven by the fact that some consumers do sometimes engage in socially responsible consumption. Rather, the above theory and evidence suggests two things about such consumer action. First, because socially responsible consumer action is clearly unprofitable for individual consumers given their motivational and collective action problems, it can be explained only by taking seriously the sort of social and moral sanctions that I discuss below. Such social or moral sanctions may motivate consumers to boycott clear-cut lumber by, say, rewarding them with esteem by peers or good internal feelings only when they boycott clear-cut lumber. Second, consumers are likely to be insulated from full social and moral sanctions compared to those who run business operations (for reasons parallel to those discussed below for shareholders), and collective action problems will reduce consumer incentives to boycott even to the extent consumers are altruistically motivated. These factors will reduce the rate of socially responsible consumption below its socially optimal level and make it insufficient to create economic sanctions that would deter all of the undesirable business conduct left undeterred by legal sanctions. Indeed, the empirical evidence summarized above suggests that consumers provide little effective economic sanction at all.

In short, like legal sanctions, economic sanctions are inevitably imperfect. Thus, we cannot assume that enlightened self-interest will suffice to optimize behavior. Instead, optimizing conduct requires supplementing legal and economic sanctions with a regime of social and moral sanctions that encourages each of us to consider the effects of our conduct on others even when doing so does not increase our

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[28] *See* Alexander, *supra* note 27, at 491–92, 494–95, 505, 523. *See also* Paul R. Portney, *Corporate Social Responsibility: An Economic and Public Policy Perspective*, *in* ENVIRONMENTAL PROTECTION AND THE SOCIAL RESPONSIBILITY OF FIRMS 107, 113–18 (Bruce Hay et al. eds., 2005) (concluding from literature review that, despite various examples of green consumerism, there is no serious statistical evidence that shows it affects corporate profit margins, and summarizing one example where consumer surveys indicated they were willing to pay for cleaner fuels but actually chose other fuel that was less than five cents cheaper).

profits.[29] Social sanctions might include active negatives like the embarrassment of bad publicity, the reproach of family and friends, the pain of enduring insults and protests, or being disdained or shunned by acquaintances and strangers. It might also include simply losing the pleasure that comes with knowing others think well of us. People can be strongly motivated by the desire to gain social prestige, respect, and esteem, which others can withhold passively at no or little cost to themselves.[30] All these social sanctions can injure and deter us even if they do not cost us any money.[31] Moral sanctions include the guilt or self-loathing we experience for violating moral norms, the loss of pleasurable feelings of virtue, inner peace, or satisfaction, and the effect of any moral norms that might make certain choices just unthinkable regardless of how much they might benefit us.[32]

The social efficiency of a social or moral norm does not mean that compliance with it is individually profitable and that social and moral sanctions are thus unnecessary. Often, social and moral sanctions are efficient precisely because they can induce each of us to engage in conduct that is collectively beneficial yet individually unprofitable.[33] Other times, social or moral sanctions are efficient because they

[29] For some excellent works that review the voluminous literature, see STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 598–646 (2004); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 339–54 (1997); Eric A. Posner, *Efficient Norms*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 19–23 (Peter Newman ed., 1998); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 904–47 (1996).

[30] *See* McAdams, *supra* note 29, at 342, 355–75.

[31] My terminology thus differs from others who use the terms "social norms" or "social sanctions" to also cover what I would call "economic sanctions" because they affect whether the conduct is profitable. *See, e.g.*, ERIC A. POSNER, LAW AND SOCIAL NORMS 5, 7–8 (2000); Robert D. Cooter, *Three Effects of Social Norms on Law: Expression, Deterrence, and Internalization*, 79 OR. L. REV. 1, 5 (2000).

[32] *See* SHAVELL, *supra* note 29, at 600–01. A much debated issue is whether moral norms operate as internal costs that influence individual cost-benefit choices or as a sort of moral reasoning that precludes cost-benefit tradeoffs entirely. *Compare id.* at 604 (modeling moral norms as cost), *and* Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 585–89 (1998) (same), *with* Kaushik Basu, *Social Norms and the Law*, *in* 3 NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 476, 477 (Peter Newman ed., 1998) (modeling moral norms as limiting feasible choice set); *and* Martha C. Nussbaum, *Flawed Foundations: The Philosophical Critique of (a Particular Type of) Economics*, 64 U. CHI. L. REV. 1197, 1211 (1997) (criticizing modeling moral norms as cost). For my purposes, the difference does not matter because either would have the same implications for my analysis. Because one can just think of the latter view as a special case where moral sanctions are infinite, I will for convenience use the term "moral sanction" to encompass both views.

[33] *See* ROBERT C. ELLICKSON, ORDER WITHOUT LAW 123–26, 167–83 (1991); Robert D. Cooter, *Decentralized Law for a Complex Economy: The New Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1657–77 (1996); McAdams, *supra* note 29, at 343–44 & 344 n.25.

enforce informal understandings or norms of trust that are more efficient than explicit contracting but require ex ante commitments to behave in ways that will be unprofitable *ex post*.[34] The norm of tipping for good waiter service is an example.[35] So is the norm of complying with legally unenforceable promises even when it has become inconvenient to do so.[36] In businesses, the typical example involves others (like workers or suppliers) making firm-specific investments that increase the business's efficiency because they trust that the business will comply with social or moral norms against opportunistically exploiting those investments later by failing to reward them.[37] Such a norm is efficient ex ante, but compliance with it after sunk benefits are received can be *ex post* unprofitable and thus require non-monetary social or moral sanctions for enforcement.

Such social and moral sanctions are important, perhaps even more important than legal and economic sanctions. Consider your own behavior. To what extent is your day-to-day behavior really altered by legal and economic sanctions, rather than by social and moral norms? For most of us, I expect the answer is mainly by the latter. We comply with social promises, hold doors open for strangers, and refrain from lying and abusing each other's trust, even when doing otherwise is legal and personally beneficial, and this is desirable because others reciprocate by following the same norms in ways that benefit us even more. Nor would the bulk of us steal or commit murder even if those weren't crimes. Indeed, the degree of legal compliance in society cannot be explained without social or moral sanctions given that legal and economic sanctions are frequently insufficient. For example, social and moral sanctions likely explain why there is widespread compliance with U.S. tax laws even though the odds that tax evasion will be detected and prosecuted are extremely small, and why airport no-smoking rules and city pooper-scooper laws have strong behavioral effects even where they receive no legal enforcement at all.[38] Social and moral sanctions may even be more important than law to market efficiency. For example, the experience with simply adopting capitalist laws to create markets in former communist nations has had somewhat disappointing effects, which one

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[34] *See* Robert H. Frank, *If* Homo Economicus *Could Choose His Own Utility Function, Would He Want One With a Conscience?*, 77 AM. ECON. REV. 593, 593–603 (1987) (providing formal model).

[35] *See* Saul Levmore, *Norms as Supplements*, 86 VA. L. REV. 1989, 1990–93 (2000).

[36] *See* SHAVELL, *supra* note 29, at 603.

[37] *See infra* Part IV.A.

[38] *See* Cooter, *supra* note 31, at 3–4, 10–11; Richard Craswell, *Do Trade Customs Exist?*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 125–35 (Jody S. Kraus & Steven D. Walt eds., 2000).

might attribute at least in part to the lack of well-established social and moral business norms in those nations.[39] The literature is replete with many other instances where behavior cannot be explained without the supplemental influence of social or moral norms.[40]

Social and moral sanctions have a regulatory advantage when those imposing them are better informed about the situation and particular actors can act in a more contextual way with lower procedural costs.[41] This is certainly true for moral sanctions. Each of us knows what we did and can adjudicate that fact against ourselves with relative ease. Social sanctions can also be imposed at relatively low procedural cost, but those imposing them may also be misinformed or inaccurate. Still, they often are imposed by those who are closer to the situation than legal adjudicators, and thus more likely to know the true facts. Moreover, social sanctions will be strongest when imposed by those whose views we care about, which usually will mean persons close and friendly enough to hear our side of the story and be relatively sympathetic to it.

Appropriate social and moral sanctions enable the legal system to reach a more optimal tradeoff by narrowing laws or lowering penalties to reduce legal overdeterrence even when that creates greater legal underdeterrence because the legal system can rely on social and moral sanctions to reduce the latter problem. The legal system will adopt relatively low legal penalties because the legal violations that would otherwise result will be reduced by social and moral norms that encourage law-abiding behavior. The legal system will also be relatively underinclusive because the undesirable conduct that lies outside legal prohibition will still be deterred by social and moral sanctions. These relatively low penalties and underinclusive laws will be socially desirable given the existence of social and moral sanctions, but they will also increase the importance of preventing particular actors from insulating themselves from social and moral sanctions.

Another advantage to social and moral norms is that often the right solution to a social problem is not the adoption of a law that mandates or forbids certain conduct for all persons. It is instead to have some, but not all, actors close to the scene provide some local service or benefits that they can provide more easily than government actors. This results from the same problem of legal underinclusion because an (unrealistically) perfect legal system could fashion a legal rule or standard that would identify the best local actors in every situ-

[39] *See* Richard H. Pildes, *The Destruction of Social Capital Through Law*, 144 U. PA. L. REV. 2055, 2062–63 (1996) (summarizing literature).

[40] *See* McAdams, *supra* note 29, at 340–47 (surveying literature).

[41] *See* SHAVELL, *supra* note 29, at 621–24; Cooter, *supra* note 31, at 21–22.

ation. But the solution here is not to have a social or moral norm that also mandates or forbids conduct for an identified set of persons. It is instead to have social or moral norms that induce charitable or volunteer impulses among enough of a broader set of local actors to produce the desired local service or benefit.

Whether moral and social sanctions improve behavior will, of course, depend on whether the underlying moral and social norms accurately identify undesirable behavior. For example, in a racist society, social and moral norms might be designed to drive people to engage in undesirable racist behavior. But this problem is equally true of legal and economic sanctions. Whether they improve behavior depends on how accurately they identify undesirable conduct, and, in a dysfunctional society, legal and economic sanctions may well encourage undesirable conduct. But, generally speaking, moral and social sanctions (like legal and economic sanctions) will roughly reflect the views of the society that inculcated or created them. Of course, you and I may have views about which conduct is desirable that differ from others in our society, and probably do for at least some conduct. But if we agree with prevailing societal norms on enough conduct, then over the full range of conduct, social and moral sanctions would tend to move behavior in a direction we would find desirable. And even where this is not true, it is enough that social and moral sanctions would on balance advance the outcomes that our society views as desirable, which is the normative perspective relevant for determining the level of managerial discretion that society will want to allow.

Another problem is that, like legal sanctions, social and moral sanctions might themselves be overinclusive and underinclusive.[42] But their regulatory advantages are likely to mean they would still improve the conduct that would result from a regime that used only legal and economic sanctions. Further, society can reduce the over and underinclusion of norms with laws designed to expand the application of good norms and discourage the overapplication of bad ones.[43] Such legal regulation will of course itself be imperfect. But it seems reasonable to assume that, on balance, the social and moral norms that are widely held and are allowed to flourish by society do so because they improve behavior in the eyes of others and society.

Conceivably, the judgment might go the other way. A society might determine that its own moral and social sanctions were overall

[42] *See* SHAVELL, *supra* note 29, at 607–08, 620–21; Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1705–11, 1724 (1996).

[43] *See, e.g.*, SHAVELL, *supra* note 29, at 618; McAdams, *supra* note 29, at 345–49, 391–432; Posner, *supra* note 42, at 1725–43; Sunstein, *supra* note 29, at 907, 910, 947–65.

counterproductive. If so, it would then make sense to impose, if feasible, a legal duty to profit-maximize on everyone (not just corporations) to override those sanctions. But as far as I know, no society has ever done so. Even if we assume away the enormous enforcement problems, it would certainly be a startling proposition, contrary to reams of moral philosophy, to conclude that our behavior is likely to improve if each of us refused to consider the effects of our conduct on others unless it ultimately redounded to our own financial gain. The absence of any general duty for citizens to profit-maximize thus seems to reflect a revealed preference of society for allowing social and moral sanctions to operate.

Given this baseline system of social and moral regulation, the burden would seem to be on those advocating a duty of profit-maximization for corporations to demonstrate that there is something special about corporations that makes it desirable to prevent them from acting on the same social and moral impulses that help influence the conduct of noncorporate actors and businesses. That is the issue I address next, concluding that current law correctly recognizes there is no special reason to impose such a special duty to profit-maximize on corporate managers. To the contrary, two important special features of corporations—shareholders' relative insulation from social and moral sanctions and collective action problems with acting on any social and moral impulses they have—make it particularly important to preserve managerial discretion to respond to social and moral considerations.

II
The Fiduciary Duty to Engage in Profit-Sacrificing Legal Compliance

Hard core advocates of the duty to profit-maximize, like Judge Easterbrook and Professor Fischel, argue that the law should allow and even require managers to violate the law when that is profit-maximizing, at least when the legal violation is not malum in se.[44] But most advocates of a duty to profit-maximize concede it should have an

[44] *See* Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 Mich. L. Rev. 1155, 1177 n.57 (1982) ("[T]he idea of optimal sanctions is based on the supposition that managers not only may but also should violate the rules when it is profitable to do so."); *id.* at 1168 n.36 (arguing same but putting aside malum in se cases); Daniel R. Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259, 1271 (1982); *see also* David L. Engel, *An Approach to Corporate Social Responsibility*, 32 Stan. L. Rev. 1, 4–5, 37–58 (1979) (concluding managers should perhaps engage in disclosure but should not otherwise engage in voluntary profit-sacrificing legal compliance).

exception for illegal conduct.[45] To illustrate, suppose clear-cutting *were* illegal but still profit-maximizing given the expected legal penalties. Would managers now have a fiduciary duty to violate the clear-cutting law because doing so was profit-maximizing? No. Under well-established law, not only do managers have no fiduciary duty to engage in illegal profit-maximizing, but managers that do so would affirmatively violate a fiduciary duty not to act unlawfully.[46]

The fiduciary duty to avoid profit-maximizing illegality is difficult to explain if only legal and economic sanctions matter. After all, if those were the only relevant sanctions, then sole proprietors would always engage in any illegal acts whose business profits exceeded legal and economic sanctions. Thus, even a fiduciary duty requiring managers to engage in profit-maximizing illegality would (if accurately enforced) only cause corporate managers to engage in the same activities as sole proprietors. Yet no court or legislature has ever adopted this position.

More importantly, an obvious alternative would be to have no applicable fiduciary duty, which would leave the corporation facing the same legal and economic sanctions as any noncorporate businesses, and thus should cause corporate managers acting on behalf of shareholders to make the same tradeoffs between those sanctions and expected business profits that sole proprietors would make. If those 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

45 *See, e.g.*, CLARK, *supra* note 1, at 684–86; Friedman, *supra* note 3, at 33.

46 *See, e.g.*, 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(b)(1) & cmt. g, § 4.01 (1994) [hereinafter PRINCIPLES]; *id.* at 149–51 & 158 n.11 (collecting cases holding that such illegal acts violate duty of care under comment d to "§ 4.01(a), first paragraph" and associated Reporter's Note); Miller v. AT&T Co., 507 F.2d 759, 762–63 (3d Cir. 1974) (holding that illegal acts, even when undertaken to benefit corporation, violate corporate management's fiduciary duty to corporation); Greenfield, *supra* note 25, at 1281–82, 1316–18 (noting that this limitation is implicit in fact that statutes allow corporations to be organized only for "lawful" purposes). 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. *See* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 389–92 (1970). A majority of shareholders cannot, by ratifying illegal acts, bar a minority shareholder from bringing such a suit. *See* Rogers v. Am. Can Co., 305 F.2d 297, 317 (3d Cir. 1962). A shareholder is entitled to inspect corporate books and records if there is a "credible basis to find probable corporate wrongdoing." *See* Sec. First Corp. v. U.S. Die Casting & Dev., 687 A.2d 563, 567 (Del. 1997). Finally, SEC rules require disclosure of evidence of illegal acts that bear on the integrity of management "even when financially insignificant." JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 387 (6th ed. 2004).

overdeterrence and underdeterrence, then imposing a fiduciary duty that effectively raises sanctions for such conduct would on balance worsen behavior.[47] Why, then, does corporate law impose special penalties on corporate managers with a fiduciary duty that makes managers liable to their corporation for engaging in illegal activities that were actually profitable for that corporation?

To explain this fiduciary duty, one must instead consider the effect of corporate structure on social and moral sanctions. As noted above, the degree of legal compliance we actually get in society requires effective social and moral sanctions that supplement our imperfect legal and economic sanctions. These social and moral sanctions are fully operative on sole proprietors. But the structure of the modern public corporation creates three important impediments to the enforcement of social and moral sanctions.

First, public corporations have many shareholders, some of whom will feel social and moral sanctions less than others. Accordingly, creating a fiduciary duty that allows any shareholder to bring a derivative action against profit-sacrificing refusals to violate the law would mean that whichever shareholder feels the least social and moral sanctions could effectively dictate corporate decisionmaking for all shareholders. More law-abiding shareholders would suffer social and moral sanctions against their will. 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.

Second, the corporate structure largely insulates all shareholders from the ordinary social and moral sanctions that a sole proprietor would feel. Shareholders are less likely to come into contact with those who might want to impose social sanctions for the business's illegal activities and will be harder to identify as being connected to the corporation at all. Moral sanctions are not susceptible to those problems, but raise different concerns because moral sanctions require knowing just what the corporation is doing, and shareholders will ordinarily be blissfully unaware about the details of operational decisions and applicable legal regulations. Even if these obstacles

[47] Likewise, the modern literature on statutory interpretation recognizes that adding further penalties on statutory violations will not necessarily advance the statutory purpose because legislatures trade off conflicting interests, as well as underenforcement and overenforcement concerns, when setting statutory sanctions. *See* Einer Elhauge, *Preference-Estimating Statutory Default Rules*, 102 COLUM. L. REV. 2027, 2055 (2002); Frank H. Easterbrook, *Statutes' Domains*, 50 U. CHI. L. REV. 533, 541 (1983).

could be overcome, shareholders are less likely to be deemed or to feel responsible because each is only one of many shareholders. This diffused responsibility should further insulate shareholders from social or moral sanctions.

Third, shareholders in public corporations have collective action problems that prevent them from becoming informed or acting based on social and moral sanctions even if they do care sufficiently about them. Even a caring shareholder has little incentive to spend time absorbing and analyzing information about whether the corporation is violating the law because she is one of many shareholders and thus would have little impact on any decision even if she were fully informed when she voted or made investment decisions. Further, even if both caring and fully informed, shareholders have little incentive to take social and moral issues into account when deciding whether to invest in a more profitable corporation because their individual refusal to invest will have little or no impact on how the corporation behaves but will definitely deprive them of the additional profits they could have made by investing. This collective action problem means that the investment decisions of even caring and informed shareholders will tend to drive down the stock price of corporations that sacrifice profits to comply with social and moral norms that those investors themselves hold.

These last two points mean that shareholder voting and investment decisions will largely ignore social and moral sanctions and put pressure on managers to do the same absent some contrary fiduciary duty. This shareholder pressure will thus favor profitable legal violations more than would sole proprietors who suffered all those social and moral sanctions on top of legal and economic sanctions.[48] This will tend to encourage corporate managers to maximize profits illegally even when a sole proprietor who personally suffered the social and moral sanctions would not. True, to the extent managers have agency slack from their shareholders, their behavior will likely be influenced by the social and moral sanctions they personally suffer. In this zone, managers are likely to be *more* law-abiding than the average sole proprietor even without any fiduciary 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 this zone of agency slack, accountability to shareholders insu-

[48] Shareholders do suffer economic sanctions in the form of lower stock prices after corporate crimes are alleged. *See* Alexander, *supra* note 27, at 497–500; Karpoff & Lott, *supra* note 27, at 796. But this decline in stock price reflects the future loss of business because of diminished reputation, which would impose an equivalent injury on the value of a business held by a sole proprietor even though it would not show up in any stock price.

lated from social and moral sanctions will lead management to engage in profitable illegal acts more often than a sole proprietor would.

Consistent with this, empirical research shows that managers have smaller ownership stakes in the median corporation that has been criminally convicted (4.17%) than in those that have not (8.38%).[49] This makes sense because where managers have a substantial ownership stake, they are both more likely to experience social and moral sanctions (because responsibility is less diffused) and better able to resist pressure from shareholders who are insulated from social and moral sanctions. But where managers do not have large ownership stakes, they are more likely to respond to the pressure of socially and morally insulated shareholders.[50] Likewise, this research

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[49] *See* Cindy R. Alexander & Mark A. Cohen, *Why Do Corporations Become Criminals? Ownership, Hidden Actions, and Crime as an Agency Cost*, 5 J. CORP. FIN. 1, 18 (1999).

[50] This effect is greatest over the zero to ten percent shareholding range, *id.* at 19, where managers are most likely to cross the line from impotent to influential in a large public corporation with dispersed shareholders. *See id.* at 8 n.9 (noting that equity stakes first begin to entrench managers at five percent). The authors of this study instead interpret their data to mean that managers with smaller ownership stakes have higher agency costs that cause them to allow more unprofitable corporate crimes. *Id.* at 1–2, 4. But this interpretation depends on their model, which assumes that managers can avoid unprofitable crimes by underlings only by incurring personal monitoring costs, thus creating an agency cost by causing managers' incentives to diverge from shareholder profits. *See id.* at 6. In fact, monitoring typically would (and certainly could) be done either by hiring employees to do it, or by reallocating manager efforts that would otherwise have gone to other corporate pursuits, either of which means shareholders would (or could) pay the monitoring cost. Managers thus seem to have no incentive to allow or engage in corporate crimes that are unprofitable net of the monitoring costs that shareholders do (or could) pay. If managers want corporate advancement, one would think that they would prefer avoiding unprofitable corporate crimes by getting shareholders to pay for the requisite monitoring, and if managers want personal gain and are willing to commit crimes, one would think they would commit crimes on their own behalf rather than for a corporation. The authors also acknowledge that their hypothesis is inconsistent with the evidence that criminal corporations are more likely to have boards dominated by outside directors, which should decrease the ability of managers to deviate from shareholder wishes. *Id.* at 7–8, 18.

Further, while this study often describes the sorts of corporations more frequently committing crimes, what it actually measures is not the commission of crimes but convictions. *See id.* at 11. The crimes with the highest expected profit (net of legal sanctions) are likely to be the ones least likely to be detected and result in conviction. Corporations can be criminally convicted for acts of their underlings only if those acts were intended to benefit the corporation. *See* Vikramaditya S. Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215, 1219–20 (2003). While this requirement is not a strong one, it requires some possibility of profiting the corporation and thus decreases the likelihood that criminal convictions really reflect ex ante unprofitable activities. It is also unclear that shareholders would want greater monitoring of unprofitable corporate crimes by underlings because (1) the odds of corporate criminal liability for such unprofitable crimes is lower given the intent-to-benefit-the-corporation standard, and (2) monitoring can increase the corporation's criminal exposure by involving top level managers, *see id.* at 1218, 1241–42, and increasing the likelihood that any corporate crimes by underlings will indicates that 52% of criminally convicted corporations have boards dominated by outsiders but only 37% of noncriminal corporations do.[51] This makes sense because an outside-dominated board will be less exposed to social and moral sanctions than a board dominated by insiders who have ongoing responsibility for operational decisions. Being more insulated, outsider-dominated boards are more likely to pressure managers to profit-maximize even when doing so violates the law.

Creating a fiduciary duty not to violate the law responds to these concerns by reallocating legal and economic sanctions from the corporation (and thus shareholders as a group) to the managers who exercise control over the corporate decision to violate the law.[52] By thus concentrating the legal and economic sanctions from the corporation's legal violations onto managers, this fiduciary duty counters the incentive to engage in excessive illegality otherwise created by accountability to shareholders who lack incentives to fully consider social and moral sanctions.

Given the existing fiduciary duty to comply with the law even when compliance requires sacrificing profits, public corporations today may well behave in a more law-abiding manner than sole proprietors, for their managers suffer concentrated legal and economic sanctions on top of personal social and moral sanctions. But we would probably see the reverse if the law failed to impose a fiduciary duty that offset shareholder pressure to ignore social and moral sanctions by concentrating legal and economic sanctions on managers. And we

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be revealed. *See* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 836, 842–58, 862–65 (1994).

[51] *See* Alexander & Cohen, *supra* note 49, at 18. Other studies have shown that boards dominated by outside directors are more likely to insist on profit-maximization in various ways. *Id.* at 30.

[52] Derivative actions for violation of this fiduciary duty can seek damages not only for the costs the corporation incurred in paying legal sanctions but also for economic consequences, like the loss of goodwill with consumers for violating the law. 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* 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.18(c) (1994) [hereinafter PRINCIPLES 2]. But given the public policy exception and the fact that courts have discretion to disregard this provision even outside this exception, it seems unlikely this provision would ever be effective. Further, even when this provision is applied, managers cannot offset damages for that transaction with gains from other similar illegal transactions 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. Thus, despite this nominal offset, this duty still tends to concentrate legal and economic sanctions on managers.

would definitely see the reverse if the law instead imposed a fiduciary duty requiring managers to engage in profit-maximizing illegalities.

The main concern the current rule raises is that it might produce excessive overdeterrence by making managers 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 may be declared illegal by our inevitably imperfect adjudication process. This problem has been addressed by making managerial liability to the corporation for illegal acts mandatory only if the illegality is knowing, in which case overdeterrence should not be much of a concern. When it is not knowing, such managerial liability serves as a default rule from which the corporation can opt out if it produces excessive overdeterrence, which ninety percent of corporations have done.[53]

To further reduce overdeterrence, even the default rule lifts any managerial liability when illegal corporate conduct aims to test the validity or interpretation of the law or when the relevant law (such as contract law) is designed to "price" breaches rather than prevent them.[54] It further eliminates liability when the law is manifestly overinclusive because it is an obsolete law whose violations are condoned by modern enforcement agencies or because noncompliance is necessary to avoid inflicting large harm on third parties.[55] The explicit goal of this pattern of duty and exceptions is to replicate the social and moral norms about legal compliance that apply to noncorporate actors.[56] Where those norms do dictate compliance, then managerial liability is imposed to countervail what might otherwise be the result of accountability to shareholders who are shielded from social and moral sanctions. But when the norms allow noncompliance, there is no need for such a countervailing managerial liability.

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[53] Delaware and approximately forty other states have adopted statutes allowing corporations to adopt charter provisions that eliminate manager liability to the corporation for illegal acts that are not "knowing," and well over ninety percent of Delaware corporations have chosen to do so. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1974); WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 255 (2003). Even without such a statute, the ALI provides that corporate common law would allow a provision capping damages at the manager's annual compensation for unknowing illegality. PRINCIPLES 2, *supra* note 52, § 7.19. Corporations can also effectively opt out of the default rule without adopting a corporate charter provision by simply buying directors' and officers' insurance, which is permitted when corporate wrongdoing is not "knowing." *See* Constance Frisby Fain, *Corporate Director and Officer Liability*, 18 U. ARK. LITTLE ROCK L.J. 417, 438 (1996).

[54] PRINCIPLES, *supra* note 46, §§ 2.01(b)(1) cmt. g, 4.01 cmt. d to 4.01(a).

[55] *Id.*

[56] PRINCIPLES, *supra* note 46, § 2.01(b)(1) cmt. g.

III
The Corporate Discretion to Refrain from Legal Profit-Maximizing Activity

Now, suppose there is no environmental regulation prohibiting clear-cutting, but it is nonetheless regarded as environmentally irresponsible. Can our corporate management decline to engage in clear-cutting even if it is in fact profit-maximizing? The legal answer is yes. Despite contrary assertions by advocates of a profit-maximization duty, the law has never barred corporations from sacrificing corporate profits to further public interest goals that are not required by law.

As even proponents of a profit-maximizing duty concede, no corporate statute has ever stated that the sole purpose of corporations is maximizing profits for shareholders.[57] To the contrary, every state has enacted a corporate statute giving managers explicit authority to donate corporate funds for charitable purposes.[58] Because the argument for giving managers such donative discretion is, as we shall see, actually weaker than the argument for giving them operational discretion, this suggests that state legislatures would also favor the latter. We do not have to guess about that because thirty states have adopted corporate constituency statutes that explicitly authorize managers to consider nonshareholder interests, specifically including the interests not only of employees but also of customers, suppliers, creditors, and the community or society at large.[59] Although these constituency statutes were prompted by the 1980s takeover wave, most are not limited to takeovers but rather apply to any management decision.[60]

Even without any statute, such discretion has been recognized by the corporate common law that governs absent statutory displacement. The ALI states that, without any statute, the basic background rule regarding for-profit corporations is that:

> Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business: (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law; (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.[61]

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57 *See* Clark, *supra* note 1, at 17, 678.

58 *See* Choper et al., *supra* note 46, at 39; *infra* Part VI.

59 Principles, *supra* note 46, §§ 2.01 Reporter's Note 8, 6.02 cmt. a (collecting statutes); Springer, *supra* note 6, at 85, 126–28.

60 *See* Principles, *supra* note 46, § 2.01 Reporter's Note 8; ABA, *supra* note 1, at 2266.

61 Principles, *supra* note 46, § 2.01(b)(2)–(3) & cmt. d.

The ethics provision plainly gives managers operational discretion to sacrifice profits in order to avoid conduct that might "unethically" harm employees, buyers, suppliers, or communities.[62] Depending on how elastic one's conception of ethics is, that could cover the bulk of socially responsible conduct. Any profit-sacrificing public-spirited activity not covered by the ethics provision would seem covered by the next one, which the ALI comments make clear authorizes not just donations but operational decisions such as declining to make profitable sales that would adversely affect national foreign policy, keeping an unprofitable plant open to allow employees to transition to new work, providing a pension for former employees, or other decisions that take into account the social costs of corporate activities.[63] Likewise, the ALI rule on hostile takeovers explicitly states that, "in addition to" considering shareholder interests and economic prospects, the board can consider "interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders."[64] This necessarily authorizes blocking takeovers that would sacrifice some amount of long-term shareholder profits.

True, even though they generally endeavor to restate existing law, the ALI provisions are not themselves legally binding. But the ALI provisions do cite case law supporting them that goes beyond the proposition that such public-spirited corporate conduct is permissible when it happens to maximize corporate profits in the long run.[65] Even the supposedly conservative Delaware, which does not have such a corporate constituency statute, does by case law authorize managers to reject a takeover bid based on "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[66] This Delaware case law also

[62] *Id.* § 2.01 cmt. h.

[63] *See id.* § 2.01 cmt. i, illus. 13, 20, 21. Indeed, the stronger the nexus to corporate operations, the more likely the decision to sacrifice profits would be sustained under 2.01(b)(3). *Id.*

[64] *Id.* § 6.02(b)(2). *See also id.* cmt. c(2) ("Such groups and interests would include, for example, environmental and other community concerns, and may include groups such as employees, suppliers, and customers.").

[65] *Id.* § 2.01 Reporter's Note 2. *See also* Herald Co. v. Seawell, 472 F.2d 1081, 1091 (10th Cir. 1972).

[66] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). *See also* Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1990) ("[D]irectors may consider, when evaluating the threat posed by a takeover bid, . . . 'the impact on 'constituencies' other than shareholders . . . .'") (citations omitted); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341–42 (Del. 1987) (observing that "the board may under appropriate circumstances consider . . . questions of illegality, the impact on

explicitly states that "stockholder interests" are "not a controlling factor."[67] Delaware case law also holds that managers may rebuff tender offers based on "any special factors bearing on stockholder *and* public interests."[68] Federal courts have similarly construed the state corporate laws of numerous other states.[69] And even Delaware case law before the 1980s takeover wave explicitly held that managers could make donations that sacrificed a "reasonable" amount of shareholder profits to further public interest objectives.[70] True, when cor-

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constituencies other than shareholders, . . . and the basic stockholder interests at stake"). *See infra* Part VII.A.2.

67 *Unocal*, 493 A.2d at 955–56.

68 Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1285 n.35 (Del. 1989) (emphasis added). The court also there stated that managers may base their rejection of a takeover bid on the "effect on the various constituencies, particularly the stockholders," which implicitly indicates the analysis is not limited to the effect on shareholders. *Id.*

69 See GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1019–20 (S.D.N.Y. 1985), which states:

> The exercise of independent, honest business judgment of an enlightened and disinterested Board is the traditional and appropriate way to deal fairly and evenhandedly with both the protection of investors, on the one hand, and the legitimate concerns and interests of employees and management of a corporation who service the interests of investors, on the other.

See also Block et al., *supra* note 8, at 809–12 (collecting cases).

70 *Theodora Holding Corp. v. Henderson*, 257 A.2d 398 (Del. Ch. 1969), held that the Delaware statute "must . . . be construed to authorize any reasonable corporate gift of a charitable or educational nature." *Id.* at 405. It then sustained a donation without any claim that it would increase that corporation's profits, but rather based on the arguments that the amount was small enough to be reasonable and that corporate donations made corporations collectively better off by making capitalism more socially acceptable. *Id.* But any individual corporation's donation to such a collective goal would remain unprofitable since no individual donation could alter the general social acceptability of capitalism and corporations would benefit from such general acceptability whether or not they contributed to it. Such conduct that is individually unprofitable and collectively profitable requires social or moral sanctions to induce compliance, and the court's description of the donative effects thus merely indicated that it furthered a desirable social or moral norm. *See supra* Part I. *Theodora* further favorably cited a prior case for the proposition that "the trend towards the transfer of wealth from private industrial entrepreneurs to corporate institutions, the increase of taxes on individual income, coupled with steadily increasing philanthropic needs, necessitate corporate giving for educational needs even were there no statute permitting such gifts" and that "a corporate charitable or educational gift to be valid must merely be within reasonable limits both as to amount and purpose." *Id.* at 404. That favorably cited prior case had reviewed the common law precedent, concluded that some of it correctly sustained corporate donations under common law by holding that such donations were valid "without referring to any limitation based on economic benefits to the corporation," and held that this ground was valid and sufficient to sustain the donation in that case. A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 585 (N.J. 1953). Further, *Theodora* was later relied on by *Kahn v. Sullivan*, 594 A.2d 48, 61 (Del. 1991), where the Delaware Supreme Court sustained a $50 million corporate donation to construct a museum without citing any evidence that it would increase long run corporate profits but rather based solely on the conclusion that the donation amount was reasonable "given the net worth of Occidental, its annual net income before taxes, and the tax benefits to Occidental." *Id.*

porate control is being sold, then that does trigger a duty to profit-maximize for special reasons I discuss later in this Article.[71] But the cases so holding emphasize that this profit-maximization duty applies only to such sales of corporate control and thus make clear it does not apply otherwise.[72]

Proponents of a profit-maximization duty often try to narrow these contrary provisions and case law 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.[73] But this narrow reading is strained. Nothing in the language of the ALI or statutory provisions limits them to cases where there is a convenient coincidence between maximizing profits and the public interest.

To eliminate any doubt, the ALI comments explicitly state that these provisions apply "even if the conduct either yields no economic return or entails a net economic loss."[74] The ALI comments also explicitly stress that, while the conduct covered by these provisions is often profit-maximizing in the long run, these provisions authorize such conduct even when that isn't true.[75] Likewise, the Delaware case law noted above specifically states that shareholder interests are "not a controlling factor," a view that conflicts with the notion that the board may consider nonshareholder interests only to the extent they further shareholder interests.[76] So, too, does the Delaware case law stating that managers may weigh "stockholder *and* public interests," and that the duty to profit-maximize does not apply unless corporate control is being sold.

Likewise, the corporate constituency statutes generally have separate provisions, one stating that managers may consider the long- and short-term interests of shareholders and another provision stating that managers can consider the effects of corporate conduct on other con-

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71 *See infra* Part VII.A.2.

72 *Id.*

73 CLARK, *supra* note 1, at 682–83; ABA, *supra* note 1, at 2269; *see also* BLOCK ET AL., *supra* note 8, at 810–23.

74 PRINCIPLES, *supra* note 46, § 2.01 cmt. f. *See also id.* § 4.01 cmt. d to § 4.01(a) ("There are, of course, instances when § 2.01 would permit the corporation to voluntarily forgo economic benefit—or accept economic detriment—in furtherance of stipulated public policies . . . ethical considerations . . . or public welfare, humanitarian, educational, or philanthropic purposes.").

75 *Id.* § 2.01, cmts. h & i. Indeed, the Comments authorize some degree of such conduct by a board when it could not maximize long run profits because the company is liquidating and thus has no long run. *See id.* illus. 13.

76 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

stituencies.[77] The latter provision would be superfluous if it merely allowed 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 like shareholders "as a dominant or controlling factor."[78] One such statute has an official comment saying that the statute "makes clear that a director is not required to view presently quantifiable profit-maximization as the sole or necessarily controlling determinant of the corporation's 'best interests.'"[79] Another state's statute expressly authorizes managers to decide that "a community interest factor . . . outweigh[s] the financial or other benefits" to shareholders.[80]

It is also hard to believe legislatures would have bothered to enact corporate constituency statutes simply to affirm the ability of managers to consider factors that might increase shareholder profits. Likewise, this narrow interpretation of these statutes by profit-maximization proponents seems inconsistent with the fact that these proponents also vociferously oppose these statutes.[81] 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 case law were either misguided or a mere subterfuge for protecting managers from takeovers, which is an issue I take up below.

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,"[82] which is similar enough to the last ALI provision to suggest a similar power to sacrifice profits. Further, nineteen other corporate statutes (as well as the Revised Model Business Corporation

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[77] *See, e.g.*, N.Y. Bus. Corp. Law § 717(b) (McKinney 2003); Conn. Gen. Stat. Ann. § 33-756(d) (West 1997).

[78] *See, e.g.*, Pa. Cons. Stat. Ann. §§ 515(b), 1715(b) (West 1995); Ind. Code Ann. § 23-1-35-1(f) & Official Comment to (d) (Michie 1999).

[79] Ind. Code Ann. § 23-1-35-1(f) & Official Comment to (d) (Michie 1999).

[80] *See* Iowa Code Ann. § 491.101B (West 1999).

[81] *See* ABA, *supra* note 1, at 2253, 2268.

[82] *See* Choper et al., *supra* note 46, at 39 & n.83 (citations and quotations omitted).

Act) make this even clearer by having *separate* provisions, one authorizing donations "further[ing] the business and affairs of the corporation," and another one authorizing (as in the first twenty-four states) donations for "charitable, scientific or educational purposes."[83] The first provision would render the latter provision superfluous if the latter authorized only 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 most populous states, California and New York) are the most explicit of all, authorizing charitable donations "irrespective of corporate benefit."[84] Further, although corporate managers generally claim their donations increase long run profits, as an empirical matter this frequently seems dubious,[85] and 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.[86]

None of this means that managers have a legally enforceable *duty* to engage in profit-sacrificing conduct when not required by other law to do so. The above legal authorities all use language of discretion.[87]

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[83] *See id.* (citations and quotations omitted); REVISED MODEL BUS. CORP. ACT § 3.02(13), (15) (2002).

[84] *See* CHOPER ET AL., *supra* note 46, at 39.

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

[86] 17 C.F.R. § 240.14a-8 (1998); Lovenheim v. Iroquois Brands, Ltd., 618 F. Supp. 554 (D.D.C. 1985). A 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 1, 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.

[87] *See, e.g.*, PRINCIPLES, *supra* note 46, § 2.01(b)(2)–(3) (using "may" language); *id.* cmt. h & illus. 11–14, 17–18, 20–22 (stressing that managers have legal discretion to choose whether or not to engage in various ethical or public-spirited conduct that sacrifices corporate profits); ABA, *supra* note 1, at 2262 (noting that other than Connecticut, no corporate constituency statutes mandate considering other constituencies). The discretionary language in all the corporate constituency statutes other than Connecticut's would seem to eliminate any claim of a legal duty, but to eliminate any doubt, some state statutes even

Connecticut's corporate constituency statute might seem the exception, for it does contain mandatory language that managers "shall consider" various nonshareholder interests.[88] But because this statute at most sets forth a duty to the corporation, it can be enforced against managers only via a derivative action by shareholders. Thus, 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 a Connecticut corporation in order to do so. In any event, even if managers of Connecticut corporations did have a truly enforceable duty to consider nonshareholder interests, nothing in the law requires them to give those interests any particular weight, so their discretion remains undisturbed.

Proponents of a profit-maximization duty generally rely on the duty of care, which in most states provides that a manager should discharge his or her duties "in a manner that he or she reasonably believes to be in the best interests of the corporation."[89] But duty of care laws never define the "best interests of the corporation" as meaning solely the interests of shareholders, nor do they ever define the interests of the corporation or shareholders to mean solely their *financial* interests. Both are glosses added by proponents. Indeed, as noted above, corporate constituency 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. The comments to the ALI Principles explicitly state that acts that

> voluntarily forgo economic benefit—or accept economic detriment—in furtherance of stipulated public policies . . . . ethical considerations . . . or . . . public welfare, humanitarian, educational, or philanthropic purposes . . . . even though they may be inconsistent with profit enhancement, should be considered in the best interests of the corporation and wholly consistent with [duty of care] obligations . . . .[90]

And, as noted above, courts have explicitly sustained profit-sacrificing corporate decisions despite the duty of care.

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explicitly state that these constituency statutes create no enforceable duty to consider nonshareholder interests. *See* GA. CODE ANN. § 14-2-202(b)(5) (2003); NEV. REV. STAT. § 78.138 (2003); N.Y. BUS. CORP. LAW § 717(b) (McKinney 2003); 15 PA. CONS. STAT. ANN. §§ 515, 1715 (West 1995).

[88] CONN. GEN. STAT. ANN. § 33-756(d) (West 1997).

[89] *See* CLARK, *supra* note 1, at 679 & n.2 (quoting MBCA § 8.30(a)); PRINCIPLES, *supra* note 46, § 4.01(a) & Reporter's Note 1.

[90] PRINCIPLES, *supra* note 46, § 4.01, cmt. d to § 4.01(a).

In any event, even if the duty of care did nominally require profit-maximization, the business judgment rule makes plain that the duty of care cannot be enforced in a way that would bar managers from exercising discretion to sacrifice corporate profits in the public interest. Under the business judgment rule, the courts won't second-guess managers' business judgment about what conduct is in the best interests of the corporation unless those managers have a conflict of interest. Statutes and cases define conflicts of interest to include only "the financial interests of the director and his immediate family and associates,"[91] thus making clear this exception does not apply if the alleged conflict is between the corporation's financial interests and some public interest cause, even if the manager derives a special psychic pleasure from furthering it.[92] Moreover, in applying the business judgment rule, courts refrain from reviewing not only whether the conduct actually increased profits, but also whether it was seriously likely to do so, or even whether managers were actually motivated by profit-maximization when they exercised their judgment. The result is that, under the business judgment rule, courts are

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[91] ABA Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Director's Conflicting Interest Transactions*, 43 BUS. LAW. 691, 694 (1988); *See also* CONN. GEN. STAT. ANN. § 33-781 (West 1997); DEL. CODE ANN. tit. 8, § 144(a) (1974); N.Y. BUS. CORP. LAW § 713(a) (McKinney 2003); Cal. Corp. Code § 310(a) (West 1990); REVISED MODEL BUS. CORP. ACT § 8.60; Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds* by Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Johnson v. Radio Station WOW, 14 N.W.2d 666 (Neb. 1944). A subsequent Delaware case might seem to point the other way because it stated that a duty of loyalty problem was raised by "any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally" or if the director was "influenced by personal or extraneous considerations." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361–62 (Del. 1993). But the case did involve a director with a financial interest, *id.* at 358 n.24, and thus any holding dropping that statutory requirement was dicta. The court may have simply assumed that the relevant "interests" and "considerations" were financial since it was instead focused on the issue of whether one director's conflict could vitiate the business judgment deference due the other directors. In any event, the Delaware Supreme Court has never held that a sufficiently "personal" interest is created by a manager's pleasure in seeing her public interest views furthered. One Delaware Chancery Court opinion did state that a conflicting interest might also be created by a manager's "hatred, lust, envy, revenge, or, as is here alleged, shame or pride." In re RJR Nabisco, Inc. S'holders Litig., Civ. A. No. 1038, 1989 WL 7036, at *15 (Del. Ch. 1989). But this was dicta in an unpublished lower court opinion, and the court did not explain how it squared that conclusion with the Delaware statute requiring a "financial interest." DEL. CODE ANN. tit. 8, § 144(a) (1974).

[92] The ABA Committee on Corporate Laws supports this viewpoint, *see* ABA, *supra* note 91, at 694:

> Thus, the law may preclude a director from voting on a transaction in which he has an economic interest even if, given his resources, the amount at stake will have no real impact upon his decisionmaking; yet the law does not prohibit the same director from voting on a transaction which significantly benefits a religious institution to whose creed he is deeply devoted and that guides his life.

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).[93] Because just about any decision to sacrifice profits has a conceivable link to long-term profits, this suffices to give managers substantial de facto discretion to sacrifice profits in the public interest.

Illustrative is *Shlensky v. Wrigley*,[94] which considered a claim that the directors of the corporation owning the Chicago Cubs (including the eighty percent shareholder, Mr. Wrigley) had violated their 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.'"[95] The complaint further alleged a plethora of facts supporting a conclusion that installing lights would in fact have increased corporate profits: (1) Every other baseball team had installed lights for the purpose of increasing attendance and revenue; (2) Cubs road attendance (where night baseball was played) was better than Cubs home attendance; (3) Cubs 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.[96]

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.[97] But the court did not allow inquiry into whether such long run profitability was Mr. Wrigley's

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93 Indeed, business judgment deference is so powerful that only a handful of cases has *ever* found a director liable under the duty of care absent evidence of fraud or self-dealing. *See* Smith, *supra* note 12, at 286 n.36. Courts have even held that the business judgment rule protects managerial decisions that were mathematically certain to sacrifice profits when the decision was made, such as a management decision to structure a transaction in a way that created plain tax disadvantages. *See* Bainbridge, *supra* note 12, at 98.

94 237 N.E.2d 776 (Ill. 1968).

95 *Id.* at 778. The complaint also alleged the other directors acquiesced even though they knew Mr. Wrigley was motivated by his personal views rather than the business interests of the corporation. *Id.*

96 *Id.* at 777–78.

97 *Id.* at 780.

actual motivation. Rather, it held irrelevant any motives other than fraud, illegality, or conflict of interest, thus rendering moot the allegations that Mr. Wrigley was not motivated by corporate profits but by public interest concerns.[98] Nor did the court hinge its holding on any conclusions about whether continuing day baseball would actually maximize profits, or was at all likely to do so, saying that such matters were "beyond [its] jurisdiction and ability."[99]

Thus, even if profit-maximization were the nominal standard, business judgment review would still sustain any public-spirited activity without any inquiry into actual profitability or managers' actual purposes as long as it has some conceivable relationship, however tenuous, to long run profitability.[100] And such a relationship can almost always be conceived. Indeed, it is hard to see what socially responsible conduct could not plausibly be justified under the commonly accepted rationalizations that it helps forestall possible adverse reactions from consumers, employees, the neighborhood, other businesses, or government regulators—especially given that the law does not require managers to "particulariz[e]" any profits they claim this reaps.[101] Because such business judgment review suffices to sustain the lion's share of decisions to sacrifice corporate profits in the public interest, courts rarely need to state explicitly that managers have such discretion.

The contrary case on which profit-maximization proponents tend to focus is the 1919 case, *Dodge v. Ford Motor Company*,[102] but that old precedent does not really support the proponents' claim. In that case, the Dodge brothers, ten percent shareholders in Ford Motor Company, sued because Henry Ford and his fellow directors had stopped paying special dividends to shareholders in order to fund an expansion of operations that would allow the firm to increase employment and cut prices.[103] The decision did include some strong pro-shareholder profits language and required Ford Motor to distribute more of its profits in dividends. But the opinion never stated that

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98 *Id.*

99 *Id.* As an alternative ground, 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 not only of installing the lights, but of operating and maintaining them too. *Id.* at 780–81. But given that courts must read complaints liberally and allow ample opportunity to amend complaints to overcome technical defects, such reasoning could not really support the court's conclusion had it been at all willing to allow inquiry into actual profitability.

100 *See* Clark, *supra* note 1, at 682–83.

101 Principles, *supra* note 46, § 2.01 cmt. f, illus. 1–5.

102 170 N.W. 668 (Mich. 1919); *see, e.g.*, Clark, *supra* note 1, at 679.

103 *Dodge*, 170 N.W. at 670–71, 683–85.

directors' exclusive duty is to maximize shareholder profits. Rather, it states that profits should be the primary but not exclusive goal of managers, and sustained the manager's expansion decision despite the court's factual conclusion that management based that operational decision largely on humanitarian motives.

The *Dodge* court stated:

> We do not draw in question, nor do counsel for the plaintiffs do so, the validity of the general proposition stated by counsel [that]. . . . '[a]lthough a manufacturing corporation cannot engage in humanitarian works as its principal business, the fact that it 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.[104]

The court also stated that "an incidental humanitarian expenditure of corporate funds for the benefit of the employees" was permissible.[105] Thus, if "incidental" to business operations, an expenditure could be for the benefit of charities or employees, rather than for the ultimate benefit of shareholders.[106]

The court accordingly made clear that corporate conduct did not have to have the ultimate aim of increasing long run shareholder profits. Instead, what the court emphasized was that the discretion to do otherwise was *bounded* by a requirement that other purposes remain incidental to a primary purpose of profiting shareholders. It stated that corporations are organized "primarily" for shareholder profits and thus cannot "conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others . . . ."[107] This language limits the degree of profit-sacrificing discretion rather than imposing a duty to exclusively profit-maximize.

Further, in terms of actual discretion, what matters is less such general language than what the courts actually sustain. And the *Dodge* court in fact sustained the directors' operational decisions, refusing to enjoin the expansion and expressly noting directors had discretion over pricing.[108] The court did so even though it concluded that this business plan would clearly reduce short run profits and it had "no doubt that certain sentiments, philanthropic and altru-

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[104] *Id.* at 684 (internal citations omitted and emphasis added).

[105] *Id.*

[106] *Id.* It so stated even though its citations were to cases where the claim was that benefiting employees would increase long run corporate profits, plus another case where a corporation conferred free water on a city in a way that probably decreased *ex post* profits but increased them ex ante. *See infra* Part IV.

[107] *Dodge*, 170 N.W. at 684.

[108] *Id.*

istic, . . . had large influence in determining the policy to be pursued by the Ford Motor Company."[109] The court reasoned that 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" because "the ultimate results of the larger business cannot be certainly estimated" and "judges are not business experts."[110] Thus, the court was not willing to strike down any operational conduct based on the managers' actual subjective motives. Nor was the court willing to assess the actual profitability of the conduct. Instead, the court sustained the conduct on the grounds that it could conceivably be profitable in the long run. This suffices to confer considerable de facto discretion even if one did wrongly interpret the opinion to impose a nominal duty of pure profit-maximization.

The *Dodge* court did strike down the refusal to declare any special dividends, but that was because the court found that the corporation was withholding more than it needed to fund the business expansion.[111] Thus, the refusal to declare special dividends was stricken not because it had a public interest motive but because it went beyond any business *or* public interest motive. What then could have been the purpose of withholding unneeded funds? Most likely it was that suspending dividends would depress stock prices, and thus force the Dodge brothers to sell their stock to majority shareholder Henry Ford at favorable prices (which eventually happened).[112] If so, this would have violated Henry Ford's fiduciary duty not to use his corporate control to benefit himself financially at the expense of other shareholders. That is, the otherwise aberrational court decision to interfere with the exercise of managerial discretion about dividend levels seems best explained on the view that the case really involved a conflict of interest raising duty of loyalty concerns.[113] In any event, the decision on dividends involved no actual sacrifice of profits, but rather a choice about whether to hold or distribute those profits.

109 *Id.*

110 *Id.*

111 *Id.* at 684–85.

112 *See* CLARK, *supra* note 1, at 604; Smith, *supra* note 12, at 315, 318–20.

113 Other explanations sometimes offered for this aberration are that the conduct violated antitrust law, *see* CLARK, *supra* note 1, at 604, or that Henry Ford was sacrificing corporate profits to further his own interest in winning a Senate election. But the former seems squarely rejected by the court's correct conclusion that obtaining a monopoly by cutting costs and prices did not violate antitrust law. *Dodge*, 170 N.W. at 675. And the latter appears inconsistent with the fact that the challenged conduct actually began in 1915–16, *see id.* at 670–71, given that Henry Ford did not run for the Senate until 1918. *See* SPENCER ERVIN, HENRY FORD VS. TRUMAN H. NEWBERRY: THE FAMOUS SENATE ELECTION CONTEST, at vii, 16–17 (1935).

Thus, the court order did not actually interfere with any management decision to sacrifice profits in the public interest.

So even *Dodge*, the high-water mark for the supposed duty to profit-maximize, indicates that no such enforceable duty exists. Nor does there appear to be any other case that has ever actually restrained a management decision to sacrifice corporate profits in the public interest. Rather, the cases uniformly sustain profit-sacrificing conduct either by (1) using lax business judgment review to accept strained claims of conceivable long run profitability or (2) concluding that reasonable amounts of profit-sacrificing are legal.[114] The cases all thus agree on the *result* of managerial discretion to sacrifice corporate profits in the public interest, though this could rightly be said to be an incompletely theorized agreement given that the cases differ in their articulated theory.

This sort of incompletely theorized agreement is not at all uncommon. As John Rawls argued, often different normative theories can support the same principle, which allows a liberal democracy to adopt that principle without resolving the underlying theoretical disagreement.[115] This is true in law as much as anywhere, and Cass Sunstein has shown that judges and other lawmakers with different underlying theories frequently reach incompletely theorized agreements on certain legal conclusions.[116] As long as profit-sacrificing corporate conduct can be sustained under the business judgment rule, courts need not choose between (1) the theory that managers affirmatively should have some discretion to sacrifice profits in the public interest, and (2) the theory that, even if managers should maximize profits, some discretion to sacrifice profits is an inevitable byproduct of the business judgment rule. However, the fact is that whenever

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[114] ALI states:

> Modern cases have . . . permitted the utilization of corporate resources for public welfare, humanitarian, educational, or philanthropic purposes without requiring a showing that a direct [corporate] benefit is likely. This result has been achieved through two kinds of approach. Under the first approach, the courts have in effect conclusively presumed that the utilization was for a profit-maximizing purpose, even where the evidence looked the other way. Under the second approach, utilization of corporate resources for such purposes has been recognized as a legitimate end in itself. . . .

Accord Principles, *supra* note 46, § 2.01 Reporter's Note 2; A.P. Smith Mfg. Co. v. Barlow, 92 A.2d 581, 584–90 (N.J. 1953) (reviewing case law and concluding that courts correctly sustain corporate donations under common law either (1) with "liberal findings" that they indirectly increased corporate profits or (2) by holding that such donations are valid "without referring to any limitation based on economic benefits to the corporation," and finding both grounds were valid and applicable in that case).

[115] John Rawls, Political Liberalism 133–72 (1993).

[116] *See generally* Cass R. Sunstein, *Incompletely Theorized Agreements*, 108 Harv. L. Rev. 1733 (1995).

actually required to make that choice, the law has consistently been willing to recognize an explicit power to sacrifice corporate profits in the public interest. Indeed, that is exactly what the law did in the 1980s when hostile takeover bids required such a choice by offering stock premiums that made manager claims of long run profitability implausible, and state courts and legislatures responded by making managers' discretion to sacrifice profits more explicit. But we are getting ahead of ourselves, for we must first address whether the legal result conferring profit-sacrificing discretion on managers is desirable and efficient. It is to that issue that I turn next.

IV
Why an Operational Discretion to Sacrifice Corporate Profits in the Public Interest Is Desirable and Even 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. This is true even if we wrongly equate efficiency with shareholder profit-maximization. And it is even more clearly true once we recognize that shareholders have interests other than economic ones, and that the corporate structure has implications for the ability of social or moral sanctions to police corporate conduct that might inefficiently harm those outside the corporation.

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

Even if one narrowly (and mistakenly) defined efficiency to equal shareholder profit-maximization, managerial discretion to sacrifice profits is still necessary because the economic efficiencies that come from delegating the management of a business to someone other than shareholders or judges cannot be achieved without creating such discretion. As economists have shown, the optimal level of agency costs requires some tradeoff between monitoring costs and the costs of permitting agent discretion even if one assumes shareholder profitability is the only goal.[117] In the economic lingo, giving such discretion to managers lowers total agency costs because any residual loss of share-

[117] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

holder profits is offset by the savings in monitoring costs,[118] which we might equally call the benefits of delegation.

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

Understanding this point neatly deflates the argument by proponents of a duty to profit-maximize that the goal of profit-maximization is objective and easier to monitor than a goal of advancing the public interest, which (because it goes beyond legal compliance) is either vague or controversial.[119] To begin with, the ability of judges to monitor public interest goals is irrelevant because the claim at issue is not that corporate managers should have some ill-defined legal duty to pursue the public interest; the claim is that they have discretion to do so, in part because the business judgment rule inevitably gives it to them. In contrast, a real enforceable duty to profit-maximize would require judicial monitoring and thus runs against the problem that the very reason for the business judgment rule is precisely that profit-maximization is too *hard* for judges to monitor.

It seems dubious that even the most energetic judicial efforts to force corporate managers to maximize profits at the expense of non-profit goals would be at all effective. After all, if we thought judges were better than managers at figuring out what maximizes corporate profits, then why have corporate managers at all rather than have judges make all corporate decisions? Presumably shareholders

118 *Id.* at 308.

119 *See, e.g.*, CLARK, *supra* note 1, at 20, 679, 692; ABA, *supra* note 1, at 2269–70.

instead delegate managerial authority to professional managers because they are better at managing businesses than judges are. Indeed, judges themselves have repeatedly expressed their lack of expertise in gauging the profitability of managerial decisions.[120] Any more vigorous judicial enforcement would thus likely increase the error rate, with mistaken judicial decisions (or the risk of them) deterring business decisions that would actually have increased shareholder profits.

One might imagine judges instead focusing more on managers' actual motives, rather than abjuring such an inquiry as the current doctrine does. But such motivational inquiries are problematic for all the familiar reasons,[121] including the imponderable difficulties of sorting out mixed motives. More importantly, because subjective motives are unobservable, courts will—absent the rare and unlikely-to-recur case of an explicit admission by management—have to ascertain motivation based on which purposes seemed objectively probable given the observable circumstances. Such an inquiry into objective motives will inevitably turn on the court's business judgment about which method of operation would actually maximize profits, which again gets us into the problem that courts are worse at making such decisions than corporate managers.

Moreover, even where motives are clear, proving damages (or an actual injury justifying injunctive relief) 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 would have produced even more profit? Avoiding such motivation and causation inquiries would thus seem advisable for all the reasons underlying judicial deference to business judgment.

These difficulties with judicial enforcement of a duty to profit-maximize are only worsened in situations where alleged profit sacrifices advance public interest objectives. As the discussion of the *Wrigley* and *Dodge* cases indicates, courts have a hard time figuring out whether corporate conduct really sacrificed profits in the short run at all. And even if courts could figure that out, courts have no real way of assessing the conventional claim that those short run losses of profit are offset by the long run profits that result because the conduct

[120] *See supra* notes 99 & 110 and accompanying text (quoting *Wrigley* and *Dodge*).
[121] *See, e.g.*, CLARK, *supra* note 1, at 137–38.

produces goodwill or other similar effects that in turn increase sales, employee efforts, local property values, or favorable treatment by other businesses, the community, or the government. Such claims are often dubious, but given their nature and counterfactual quality they are less likely to rest on hard data than on intuitive judgments that managers are better placed to make than judges. Further, they require judgments about the correct discount rate to apply to future profits, about which courts not only lack expertise but any governing legal principle.[122]

Worse, this commonly understood problem actually understates the difficulty. Even greater difficulties are raised by possible disjunctions between *ex post* and ex ante profit-maximization. Proponents of a profit-maximization duty normally seem to assume that, if decision X will maximize the combination of short- and long-term profits at the time that decision is made, then the manager must make decision X. But suppose, as many scholars have argued, that a manager with discretion not to make decision X can sometimes enter into an implicit contract that she won't do X in exchange for others (say, workers or the community) conferring some benefit on the corporation that cannot be taken back (say, harder work or a favorable zoning review), and that such implicit contracts are often more profitable and efficient than legally binding commitments would be.[123] For example, suppose it is profit-maximizing for a corporation to enter into an implicit contract with its employees that they will work to develop their skills in a way that makes them more valuable to the corporation (but not to other firms) in exchange for the corporation refraining from cutting their salaries to levels that do not reflect their firm-specific investments of human capital. In that sort of case, the later decision to refrain from doing X (cutting salaries) would look profit-sacrificing

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[122] *See* Paramount Communications v. Time, 571 A.2d 1140, 1154 (Del. 1990) (holding that managers must determine right time frame); Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 301–02 (1990).

[123] Early work in this vein argued that takeovers might cause implicit contract breaches that were profitable *ex post* but decreased corporate profits ex ante by discouraging other stakeholders from making firm-specific investments. *See* John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-ups*, 1988 Wis. L. Rev. 435, 446–48 (1988); John C. Coffee, Jr., *Shareholders Versus Managers*, 85 MICH. L. REV. 1, 9, 23–24, 73–86 (1986) [hereinafter Coffee, *Shareholders v. Managers*]; John C. Coffee, Jr., *Regulating the Market for Corporate Control*, 84 COLUM. L. REV. 1145, 1234–44 (1984); Charles R. Knoeber, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 AM. ECON. REV. 155, 161 (1986); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS 33 (Alan J. Auerbach ed., 1988). Professors Blair and Stout have since generalized this point beyond takeovers to argue that it justifies a general manager discretion to favor other stakeholders to reward and encourage their firm-specific investments. *See* Blair & Stout, *supra* note 5, at 304–05.

from an *ex post* perspective that considers only post-decision profits, but would be ex ante profit-maximizing when one considers that the ability to make that later decision was necessary to create a profitable implicit contract. Allowing managers to exercise their discretion to sacrifice *ex post* profits in such a case thus enables them to enter into implicit contracts that are ex ante profit-maximizing. Lacking legal enforcement, such implicit contracts must owe their enforcement to social or moral sanctions against reneging on such loose understandings, which can only be effective if not overridden by a legal duty.

As Professors Blair and Stout have noted, this point is not limited to implicit contracts that require some special understanding between the corporation and others, but can justify the general existence of managerial profit-sacrificing discretion on the ground that it is likely to reward and thus encourage firm-specific investments by other stakeholders that are ex ante profit-maximizing.[124] With the analysis in this article, we can further develop this point to say that the mere existence of profit-sacrificing discretion can be ex ante profit-maximizing because of a very general expectation that such discretion will make managers responsive to social and moral sanctions.[125] Suppose that others (not just stakeholders) will comply with social or moral norms that are beneficial to the corporation only on the expectation that the corporation will comply with social and moral norms that are beneficial to others. For example, suppose a town will comply with social and moral norms not to exact all they can out of a corporation on a zoning issue only because they expect the corporation to comply with social and moral norms to avoid some profit-maximizing environmental harms. The town has no special understanding with the corporation; their expectations simply affect whether they calculate that the corporation will confer a net benefit on the town. In that sort of case, the mere fact that managers have the discretion to engage in *ex post* profit-sacrificing compliance with social and moral norms (here by avoiding certain environmental harms) is ex ante profit-maximizing. A regime that denied corporate managers the discretion to engage in *ex post* profit-sacrifices would *decrease* shareholder profits in such cases, for it is the prospect of such managerial behavior that encourages others to treat the corporation in beneficial ways that increase

124 *See* Blair & Stout, *supra* note 5, at 275, 285.

125 *See supra* Part I. The point is similar to Robert Frank's model showing that merely having a trustworthy character will induce others to enter into efficient transactions with us, thus making it efficient to commit to having such a character even when it is disadvantageous to us. *See* Frank, *supra* note 34, at 593–603. Here, the commitment is to have managers who are free to act based on their character even when that becomes unprofitable.

profits before the profit-sacrificing decision has to be made. This point requires no special understanding of the sort that one might call an implicit contract; just a very general sort of social understanding that actors are likely to comply with social and moral norms, which leads to a social reciprocity that is profit-maximizing for each actor.[126] A duty to profit-maximize *ex post* would ironically decrease shareholder profits by constraining this discretion and thus disable the corporation from engaging in such profit-maximizing social reciprocity.

Such a claim of ex ante profit-maximization was implicitly recognized by the supposedly conservative *Dodge* opinion, which stated that it did not doubt the soundness of a prior United States Supreme Court case that had sustained a decision by corporate managers to give away the corporation's water to a city for municipal uses, where the city had previously given the corporation the rights to lay its pipes and carry water to residents, and most stockholders resided in that city.[127] One might try to shoehorn this case into a story about long-term profits by speculating that, if the corporation had not given the city water, the city might have tried to take away the corporation's pipe rights or otherwise exacted regulatory vengeance. However, any such subsequent city effort would have faced considerable problems under the takings clause because the corporation would have possessed vested property rights. In any event, the Court did not rely on any such theory. Nor did it cite any evidence of an implicit contract or special understanding at the time the corporation got the pipe rights. Instead, the Supreme Court sustained the corporate conduct as a proper means of reciprocating for the past (and literally sunk) benefits the city had conferred by allowing the underground pipes. One could restate this conclusion in the modern economic lingo by concluding that the city's decision to award these profitable piping rights to the corporation might never have been made without the prospect that corporate managers would have the discretion to comply with social or moral norms of gratitude (here, by engaging in future profit sacrifices to reward the city for that favorable treatment when the city needed it), so that sustaining the discretion to give away water was ex

126 Because this theory requires profit-maximizing social reciprocity, it does not suffice to explain all corporate compliance with social and moral norms, or even compliance with all norms that are collectively profit-maximizing but individually unprofitable. *See supra* Part I. For such norms, deviations can be profitable even when others expect deviations if collective action problems deprive any other individual actor of incentives to reciprocate in ways that decrease the individual corporation's profits. Enforcement through nonfinancial social or moral sanctions will thus be necessary.

127 Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (citing Hawes v. Oakland, 104 U.S. 450 (1881)).

ante profit-maximizing even though it diminished the stream of *ex post* profits that followed the water giveaway.

Thus, any duty to profit-maximize would theoretically and legally have to admit the defense that, even if the managerial decision sacrificed profits, the prospect that management would have the discretion to make such profit-sacrificing decisions encouraged others to treat the corporation well in ways that increased prior profits and thus made that discretion ex ante profit-maximizing. The problem, of course, is that although such a defense is conceptually valid there appears to be no way for courts to reliably ascertain when it is true in specific cases. Even when there is a special understanding that rises to the level of an implicit contract, a defining feature of such contracts is that they are not written down, making it difficult to verify their existence or terms. Even more difficult to verify would be the looser social understanding that others have greater incentives to treat the corporation well if they expect social and moral sanctions will induce better behavior by the corporation in the future. Thus, even if courts could overcome the insuperable problems involved in figuring out whether a managerial decision actually sacrificed *post*-decision profits, courts would have no way of really enforcing a legal duty to profit-maximize in the face of theoretical claims that managerial discretion to make decisions that sacrificed *post*-decision profits actually maximized shareholder profits ex ante.

Of course, it may be that profit-maximization is an easier goal for *shareholders* to monitor than public interest objectives. But declining to make profit-maximization an enforceable 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. It simply means that dissenting shareholders cannot expect courts to enforce profit-maximization over other goals unrelated to the personal financial interests of managers. Although shareholder monitoring is inevitably imperfect, shareholders are likely to be better than judges at making the sort of nuanced judgments about profitability required by the sorts of issues discussed above. More likely, shareholders will not get into any details but just monitor the overall profitability of the firm to make sure managers do not come below profit expectations. That is something shareholders can do in an ongoing fashion more effectively than the litigation process, which is notoriously slow and after the fact.

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

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

B. Why Some Managerial Discretion to Sacrifice Profits in the Public Interest Is Affirmatively Desirable and Efficient

Shareholder profit-maximization leaves out much that is relevant to overall social efficiency. To at least some extent, shareholders value nonfinancial aspects of corporate activities, such as whether those activities further the shareholders' social and moral views. Thus, maximizing shareholder welfare is not the same thing as maximizing shareholder profits. Further, limiting the inquiry to shareholder welfare leaves out any harm a corporation might inflict on interests outside the corporation, including the interests of other corporations. Considering these other factors reveals that managerial discretion to sacrifice corporate profits in the public interest is not just inevitable but affirmatively desirable and efficient.

1. Why Shareholder Welfare Maximization Affirmatively Justifies Sacrificing Corporate Profits in the Public Interest Whenever Managers Are Acting as Loyal Agents for Most Shareholders

Consider first the reality that some shareholders derive nonfinancial benefit from having corporate activities further their social and moral views, or that they would suffer social or moral sanctions from corporate violations of social or moral norms. This is certainly true for controlling shareholders like Henry Ford or Mr. Wrigley who are heavily involved in the management of their firms. It is also true for large, but not controlling, investors like Warren Buffett, who "says explicitly that he is willing to sacrifice the financial interests of shareholders in favor of 'social' considerations."[128] It is even true for many shareholders with smaller investments in public corporations. An increasing number of investors now put their money in funds committed to avoid investments in corporations that create environmental harms, make tobacco, alcohol, or weapons, or engage in some other activity that conflicts with various conceptions of the public interest. Between 1995 and 1997, the amount of investments managed using some form of social screen increased from $639 billion to $1.185 trillion, the latter figure representing nine percent of all investments.[129] By 1999, the figure was $1.5 trillion.[130] Likewise, investors increasingly are government pension funds, unions, and university endowments, which in part often have nonfinancial agendas.[131] For such shareholders, their welfare reflects a combination of their financial returns and their social or moral satisfaction with corporate activities.

An enforceable duty to profit-maximize would thus decrease shareholder welfare whenever the harm that shareholders suffer from decreased social or moral satisfaction with corporate activities exceeds the gain they derive from increased profits. Suppose, for example, that installing lights in Wrigley Field would increase the Cubs's profits by $1 million but cause Mr. Wrigley to suffer a disutility that he values at $2 million. If Mr. Wrigley were a sole proprietor, he could take this into account and refuse to install lights even though it would maximize his profits. But if using the corporate form to run the Cubs required him to profit-maximize, then the Cubs would have to install lights. As eighty percent shareholder, Mr. Wrigley would gain profits of $800,000 but suffer a net welfare loss of $1.2 million. If the twenty percent shareholders do not share his love for daytime baseball, they would gain $200,000. The net result is that enforcing a duty to profit-maximize would inefficiently result in a loss of shareholder welfare worth $1 million.

128 *See* Henry T.C. Hu, *Buffett, Corporate Objectives, and the Nature of Sheep*, 19 CARDOZO L. REV. 379, 391–92 (1997).

129 Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1287–88 (1999).

130 Michael S. Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment*, 57 BUS. LAW. 681, 681 (2002).

131 *See* Douglas M. Branson, *Corporate Social Responsibility Redux*, 76 TUL. L. REV. 1207, 1219 (2002).

The issue would be the same for our clear-cutting corporation if enough shareholders suffer a disutility from social or moral sanctions on clear-cutting that exceeds any profit gain. In that case, a duty to profit-maximize would require the corporation to engage in conduct that inflicts social and moral sanctions on shareholders even when those shareholders would prefer otherwise.

To the extent managers are acting as loyal agents for the majority of shareholders, managerial decisions to sacrifice profits in the public interest will by definition increase the welfare of most shareholders. Most is not all, however, which raises the commonly made objection that those running a corporation should not be able to "tax" dissenting shareholders to further public interest objectives that the dissenting shareholders have not chosen and may not share. 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."[132] Although majority shareholders who choose to sacrifice corporate profits would also be taxing themselves, the objection remains that they would be forcing the minority to fund a percentage of the public interest objectives the majority has chosen. In the Wrigley example, the objection would be that it is fine for Mr. Wrigley to increase his utility by spending $1 million of his own money, but not by getting twenty percent of that $1 million from nonconsenting shareholders.

However, this "tax" argument founders on closer analysis. To begin with, managers have no choice but to make an operational choice that will disappoint some shareholders. The corporation cannot be operated in different ways for different shareholders. Either lights will be installed, harming the eighty percent shareholder, or they won't be installed, harming the other twenty percent. Either clear-cutting will begin, harming the shareholders who morally oppose it, or it won't, harming the shareholders who care only about their financial returns. One may think it unfair to allow the majority shareholders to force dissenting shareholders to forgo profits to further the causes of the majority shareholders. But wouldn't it be even more unfair to give any dissenting shareholder the power to force the majority shareholders to operate the corporation in a way they feel is wrong or immoral, especially when that exposes them to social and moral sanctions or otherwise decreases overall shareholder welfare?

One implication of this analysis is that, even if one thought there should be an enforceable duty to maximize profits, enforcing it with injunctive relief would be undesirable. Injunctive relief to enforce

[132] CLARK, *supra* note 1, at 603, 679; *see also* Friedman, *supra* note 3, at 33.

such a duty would also embroil courts 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. General legal principles also indicate injunctive relief is improper when an adequate remedy in damages exists, which would certainly seem to be the case here because (by hypothesis) the dissenting shareholders are saying they only care about the money. An award of damages should fully satisfy the profit objectives of the dissenting shareholders, and as long as the controlling parties are willing to compensate the dissenting shareholders for any injury they suffer, there seems no reason the controlling parties should not be free to use their control to further the public interest objectives they choose. Certainly, if made financially indifferent, minority shareholders cannot claim a greater right to choose the corporation's public interest objectives than such majority shareholders as Henry Ford or Mr. Wrigley. So, we should at least rule out injunctive relief.[133]

One might, however, argue that the proper solution would be to allow controlling shareholders to make operational decisions that sacrifice profits to further some public interest objective (by denying any claim for injunctive relief) but still oblige them to reimburse the corporation for any sacrificed profits (by recognizing an action for damages). This would both avoid any "tax" on dissenting shareholders and make sure that the controlling parties really enjoy a welfare gain that exceeds the lost profits. Mr. Wrigley could keep lights out of Wrigley Field, but he would have to pay $1 million to the corporation owning the Cubs to compensate it for the lost profits. The dissenting

[133] The *Wrigley* court itself so held. Shlensky v. Wrigley, 237 N.E.2d 776, 778 (Ill. App. Ct. 1968) (citing Wheeler v. Pullman Iron & Steel Co., 32 N.E. 420 (Ill. 1892)) ("[C]ourts of equity will not undertake to control the policy or business methods of a corporation, although it may be seen that a wiser policy might be adopted and the business more successful if other methods were pursued."). I emphasize this conclusion in part because it runs counter to ALI comments that conclude injunctive relief should be not only available but favored over a damage remedy. *See* PRINCIPLES, *supra* note 46, § 2.01 cmt. j. The ALI reasoning seems based on the premise that the corporation would have to be the defendant because § 2.01 imposes duties on "the corporation." But it obscures matters to talk about whether "the corporation" can pursue public interest objectives at some loss of profit. No one seriously contends 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 raised by advocates of a profit-maximization duty give any reason to prevent such action. If shareholders can individually fund or pursue public welfare 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. To the extent they can't, the proper action would be a derivative action brought by a dissenting shareholder on behalf of the corporation against the managers or controlling shareholders for the profits they sacrificed.

shareholders would be in the same financial position as if lights had been installed and thus could not claim to have been taxed. While Mr. Wrigley's welfare gain would no longer be the $1.2 million he would enjoy without an enforceable duty, it would still be $1 million compared to his situation if lights had been installed.

But even limited to a claim for damages, this "tax" argument remains flawed because it implicitly assumes as a baseline the very issue being debated. Terming a 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 corporate managers can pursue some unprofitable social activities, then the question becomes why dissenting shareholders should be able to "tax" controlling parties for the exercise of their right to pursue such social objectives. And if the money never "belonged" to the dissenting shareholders in the first place, then they cannot be said to have been "taxed" out of it. For example, if Mr. Wrigley had the right not to install lights, why should the dissenting shareholders be able to "tax" him $200,000 for exercising it? Because the "tax" argument depends on the existence of a baseline, it would be circular to employ it as an argument about what that baseline should be.

One possible way to set the baseline would be by shareholder expectations. If shareholders buy into corporations knowing that they are run by managers and controlling shareholders who can temper profit-maximization, then shareholders will have bought in at lower stock prices that reflect that fact and can claim no tax or injury when the tempering occurs. On the other hand, if shareholders buy their shares expecting pure profit-maximization, then they will have bought at prices that reflect that expectation and thus will suffer a loss if profits are sacrificed. Nor can they avoid the economic loss that results when a corporation embarks on a course of sacrificing profits by just selling their shares because the now-expected decline in future earnings will be capitalized into the market price at which they can sell their shares. Unfortunately, solid empirical evidence on shareholder expectations that explores the relevant nuances appears lacking. But it seems clear that while shareholders expect profits and do not regard stock investments as tantamount to charitable contributions, they also do not expect unabashed profit-seeking untempered by any sense of social responsibility. Expectations of pure profit-maximization seem particularly unlikely in light of the laws noted in Part III that expressly authorize charitable contributions and countenance other forms of public-spirited activities.

As this last point reveals, the deeper problem is that the expectations argument is, like the tax argument, 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 that important.[134] The ultimate policy question is what expectations we want shareholders to have.

A better argument for a profit-maximization duty enforceable by money damages is that requiring controlling shareholders to pay the corporation for any lost profits would force them to internalize the "externality" their decision imposed on other shareholders and thus make sure that the profit-sacrificing conduct really did increase total shareholder welfare. Suppose, for example, that Mr. Wrigley's utility benefit from daytime Cubs baseball was only $900,000. Then without any duty he would not install any lights because this utility benefit would exceed the $800,000 in profits he would lose given his eighty percent share of the corporation's $1 million sacrifice. But his net welfare gain of $100,000 would here be less than the $200,000 the other shareholders would lose. In contrast, with a duty enforceable by money damages, he would refrain from installing lights only if his utility benefit from daytime baseball were really greater than the $1 million in lost corporate profits, which is the same as when his net welfare gain from not installing lights exceeds the $200,000 in harm to dissenting shareholders who only care about profits.

However, this "externality" argument for setting the baseline at profit-maximization runs into three other problems. *First*, this argument does not work if there are other shareholders who share the public interest view of the controlling shareholder and thus experience uncompensated *positive* externalities from his profit-sacrificing conduct. Suppose, for example, we added to the hypothetical in the last paragraph the fact that the twenty percent of shares not owned by Mr. Wrigley are held equally by 200 shareholders, 150 of whom actually share Mr. Wrigley's view about daytime baseball and would each experience a utility loss worth $2000 if lights were installed that exceeds the $1000 in additional profits they would earn. The other fifty shareholders care only about profits and threaten to sue Mr. Wrigley. Then Mr. Wrigley would install lights because his $100,000

134 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 might change. *See* Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986).

welfare gain from daytime Cubs baseball is less than the $200,000 in liability he would have to pay. Yet, installing lights would decrease shareholder welfare by a total of $1.2 million to earn an additional $1 million, which is inefficient.

One might imagine trying to avoid this problem by making damages payable not to the corporation for all lost profits but only to dissenting shareholders for their proportionate share of lost profits. But then each individual shareholder who actually agrees with Mr. Wrigley would have an incentive to dissent because she would reason that her individual decision to dissent would gain her $1000 in damages but have little impact on whether lights were installed. If she thought all the other 149 shareholders who share her position wouldn't dissent, then she would figure that lights wouldn't be installed no matter what she did, so she might as well dissent and get $1000 on top of her $2000 utility benefit. If she thought all the other 149 shareholders would dissent, then she would figure that Mr. Wrigley would decide to install the lights no matter what she did, so she might as well reduce her $2000 utility loss by dissenting and taking the $1000. In short, no matter what she thought the other like-minded shareholders would do, collective action problems would give each shareholder incentives to dissent even though the result of all of them dissenting would end up being harmful to their welfare. The same result would follow if one tried to make damages payable to the corporation not only by the controlling shareholder but also by all the other shareholders who indicated they agreed with the profit-sacrificing decision. Collective action problems would then cause each shareholder to indicate disagreement even when they actually agreed because individual decisions would have little impact on what corporate conduct occurred but would definitely avoid personal liability.

Second, as the Coase Theorem taught us, one can always flip any externality argument around, so that the characterization of something as an "externality" also has baseline problems.[135] Suppose, for example, we assumed that all the shareholders who held the twenty percent of stock not owned by Mr. Wrigley were pure profit-maximizers. If the law allowed Mr. Wrigley not to install lights, and he really would only get a net $100,000 benefit from doing so, then the other shareholders should be willing to pay him something between $100,000–200,000 to agree to install lights in Wrigley Field. Forcing the other shareholders to do so would make sure that they internalized the "externality" that profit-maximizing light installation would impose on Mr. Wrigley's welfare.

[135] R.H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1, 2–8 (1960).

One need not rely on having the other shareholders organize themselves to make a payment to Mr. Wrigley, which would present collective action problems. If the $200,000 profit harm to other shareholders exceeds Mr. Wrigley's net utility benefit, then Mr. Wrigley would have incentives to do a freeze-out merger that merges the existing firm into a new corporation owned solely by him, eliminating the minority shareholders at a merger price equal to the value of the corporation without the lights, and then have that new corporation commit to install lights.[136] If he wanted to remain an eighty percent shareholder, he could do so by then selling twenty percent of the shares in the new corporation for a stock price that should be $200,000 higher than the price for twenty percent of the old Cubs corporation. Or he could simply sell one hundred percent of the shares in the new corporation to new profit-maximizing managers that should be willing to pay $1 million more than the old stock price, which by hypothesis would exceed his utility benefit from control. A controlling shareholder like Mr. Wrigley would have an incentive to pursue one of those tactics whenever the monetary loss from his profit-sacrificing activity exceeded the utility benefit he derived from it.

In short, as the Coase Theorem further teaches, the efficient result will occur regardless of the initial legal entitlement as long as transaction costs are zero, so that the real issue is which initial entitlement minimizes transaction costs. Here, transaction cost considerations would seem strongly to favor giving the initial entitlement to the controlling shareholder. As the Wrigley examples above showed, if the controlling shareholder has the discretion to sacrifice profits, then opting out of that discretion whenever it decreases total shareholder welfare is a mere matter of paperwork within his control, which imposes little transaction costs. In contrast, the transaction costs of enforcing a duty to profit-maximize are extremely high because litigation is: (1) highly expensive and contentious; (2) risky for dissenting shareholders to fund given that they might lose; (3) unlikely to be effective because courts have such great difficulty figuring out what maximizes profits that they will either often erroneously condemn profit-increasing activities or give a business judgment deference that makes enforcement impracticable; and (4) even when the fact of profit-sacrificing is accurately determined, likely to err in calculating the amount of any profits sacrificed.[137]

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136 The commitment could be made by a charter provision, by contracting for light installation, or by making sunk investments in light installation.

137 This is true whether the duty is enforced via a claim for damages or injunctive relief.

Further, where other dispersed shareholders share the public interest views of the controlling shareholder, collective action problems are likely to impose an insuperable transaction cost to getting them to contribute to help the controlling shareholder pay damages for profit-sacrificing activity even when that activity actually enhances the welfare of those shareholders. Nor, unlike in the reverse case, could such collective action problems be overcome by merging the firm into a new corporation with a charter provision opting out of the initial entitlement, hereby allowing the profit-sacrificing activity. The reason is that, if the initial entitlement is profit-maximization, then all the old shareholders would have to be bought out at a high price that reflected profit-maximizing conduct. But even the old shareholders, who agreed with the controlling shareholder, would not be willing to pay a price for the new corporation that included the utility benefit they derived from profit-sacrificing conduct. Rather, they would assume they would get that utility benefit whether or not they invested in the new corporation. For example, in a first step merger the 150 shareholders who hypothetically agreed with Mr. Wrigley would get a price reflecting the $1000 profits that light installation would produce but would not pay an additional $2000 for new shares in a corporation with a provision prohibiting light installation because they would figure that the corporation wouldn't install lights no matter what they did.

Thus, the solution most likely to minimize transaction costs and maximize shareholder utility would be to give the controlling shareholder the right to make operational decisions that sacrificed corporate profits to further his conception of the public interest. As long as shareholders who cared only about profits bought their shares understanding this was the rule, they would not suffer any loss, for the price they paid for their shares would reflect this rule. But the controlling shareholder and others who shared his public interest views would gain, as would overall shareholder welfare.

Third, the argument that a profit-maximization duty enforceable by money damages makes the controlling parties internalize the externality their profit-sacrificing decisions impose on dissenting shareholders does not work when there is no controlling shareholder, but rather corporate managers who are acting on behalf of the public interest views of dispersed public shareholders. The liability for sacrificed profits would then be imposed on the managers, not the like-minded shareholders, and thus give managers incentives to have the corporation engage in profit-maximizing activity even when the conflict with the public interest views of shareholders caused a net loss of shareholder welfare.

Again, one could imagine trying to change this by having shareholders vote on whether to engage in such profit-sacrificing behavior and making shareholders liable for a share of the lost profits if they voted for such behavior or eligible to receive damages only if they dissented from it. But such a rule would create the same collective action problems in a public corporation with dispersed shareholders. Each shareholder would dissent even when she agreed with management because dissenting would get her a monetary gain without having any significant impact on whether collectively an operational decision is made that decreases shareholder welfare given her public interest views.

These collective action problems indicate that, even if we did call the profit-sacrificing conduct a "tax" on shareholders, such a tax might be justified on the ground that coercive financing can be necessary to overcome collective action problems among shareholders. Without such coercive financing, shareholders who, in their heart of hearts, prefer to sacrifice profits to advance the public interest, would have an incentive to dissent, hoping the majority would still further the public-spirited activity, but without their contribution. They will, in other words, free ride without coercive financing. Their position is analogous to the citizen who would vote for building a dam with tax money coercively taken from everyone but would not voluntarily make an individual contribution if someone went door to door seeking contributions to build the dam.

One might object that most shareholders must instead prefer profit-maximization because the lion's share of investors do *not* invest in socially conscious funds. But the same collective action problems that were just noted also mean that individuals would have little incentive to invest in funds that sacrificed additional profits to further their public interest views. After all, their individual decision to invest in such a fund would definitely reap them a monetary loss but have little impact on whether such funds were generally successful in changing corporate conduct. Thus, even if investors do have public interest views, they will have little incentive to act on them when making investment decisions among funds or corporations. Indeed, it is remarkable that many people do invest in socially responsible funds considering that their individual decision to do so has no significant impact on furthering even their most altruistic of motives.

While collective action problems mean that shareholder investment decisions should reflect very little of the utility that shareholders derive from socially responsible corporate activities, this does not at all mean that shareholders do not in fact derive significant utility from corporate conduct that sacrifices profits to further the public interest.

Political polls and the behavior of shareholders as voters in the political process suggest they are strongly influenced by public interest views. Further, one survey found that 97% of corporate shareholders agreed (75% strongly) that managers should consider other constituency interests and about 88% agreed that managers considering moving to a new plant that would be profitable to shareholders "should weigh the effect the move would have on its employees, customers, suppliers and people in the community it presently is in before deciding to move."[138] This should not be too surprising, for the social and moral norms that are likely to guide managerial discretion are generally broad-based enough that they will probably be shared by most shareholders. This is especially likely because, in their personal capacities, corporate shareholders are likely to be among the noncorporate parties who might be adversely affected by corporate activities—they as a group will encompass the employees, bondholders, community members, or citizens harmed by, say, environmental pollution. Thus, though for specific corporations shareholders may not be in the harmed group, they are likely to benefit from any social or moral norms that generally prevent corporations from unduly harming others.[139]

Of course, if managers are *not* acting as loyal agents for most shareholders, then their exercises of profit-sacrificing discretion may be harmful to shareholder welfare. Managers may instead further conceptions of the public interest that their shareholders find disagreeable, or weigh any public interest considerations more heavily than the utility that shareholders would derive from them. But if that is the objection, it would indicate that managers should be free to engage in profit-sacrificing conduct that a majority of shareholders has approved. Likewise, even absent such an affirmative vote, the fact is that managers are elected by a majority of shareholders. Thus, absent evidence to the contrary, one might presume that managerial tradeoffs between profits and public interest considerations likely reflect the views of most shareholders.

For example, suppose the Cubs stock were held completely by dispersed shareholders and corporate managers refused to install

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[138] Larry D. Soderquist & Robert P. Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management*, 1978 DUKE L.J. 819, 841 tbl.3 (1978).

[139] *See* JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC 1–30 (2000) (arguing that a fully diversified "universal shareholder" has holdings of different corporations, bonds as well as stock, and human capital as well as financial capital, and thus would not want one corporation to harm other corporations, bondholders or employees).

lights even though their decision sacrificed profits. If a majority of the dispersed shares were held by shareholders who derived no utility from maintaining daytime baseball, then one would think that they would elect new managers who would install lights. If a majority of shareholders do derive utility from daytime baseball that exceeds the lost profits, then they should elect managers who would not install lights. In making such a voting decision, the dispersed majority shareholders would not face the same collective action problems that plague them in the situations noted above because they would not be making the sort of decision that separates their individual gain from the collective decision. If they vote for managers who will install lights, they get the combination of increased profits and lost utility for those who like daytime baseball, and if they vote for managers who will not install lights, they get the inverse combination. Their individual voting decisions may have little impact on the ultimate corporate activity, but they will also have equivalently little impact on whether they get the resulting profits. Thus, their voting decisions do not suffer from the sort of disjunctions noted above.

Generally, total shareholder welfare will be maximized by making the decision that increases welfare for most shareholders. Still, in some cases, the concern remains that most shareholders might derive a welfare gain from profit-sacrificing corporate activities that exceeds their share of lost profits but does not exceed total lost profits when one includes dissenting shareholders who do not share their public interest views. For example, if 80% of the shares are held by dispersed shareholders who derive a utility benefit of $900,000 from daytime games, but the total lost profits are $1,000,000, then a natural concern is that managers acting on behalf of the 80% would fail to install lights because that increases the welfare of those shareholders even though that decision decreases total shareholder welfare. Still, over time one would think that the dissenting shareholders would sell their shares to shareholders who do share the public interest views of the majority shareholders and thus derive extra utility from it. The dissenting shareholders would receive a price that reflected the profit-sacrificing conduct, but if that was the expected rule, then that is also the price at which they would have purchased. The corporation would be left with a final set of shareholders who shared the majority shareholder view about daytime baseball, and would either derive enough utility from that to exceed their lost profits (in which case shareholder welfare is enhanced by continuing daytime baseball) or wouldn't (in which case they would elect managers who would install lights).[140]

True, shareholders can only exercise such oversight if they are accurately informed about the profit-sacrificing conduct of managers. But this is yet another argument for allowing patent exercises of profit-sacrificing discretion. If managers can sacrifice profits only surreptitiously, by making bogus claims that the conduct really enhances profits, then shareholders will have difficulty becoming informed about what is actually happening. Shareholders would have to be sufficiently informed about corporate activities to second-guess managerial assertions about what maximizes profits, ascertain how much in profits is being sacrificed, and what public interest justifications might be furthered. In contrast, if managers explicitly sacrifice corporate profits in the public interest, then shareholders will be alerted both to what is happening and about the need to focus on the issue, be informed about the profit-sacrifice and public interest justification at issue, and thus be better positioned to judge whether they agree with managers about the public interest justification and whether it merits the lost profits.

Patent profit-sacrificing by managers thus produces more informed decisionmaking by shareholders and is more likely to advance shareholder welfare. Latent profit-sacrificing increases information costs for shareholders and is thus less likely to advance shareholder welfare and more likely to increase agency slack. This is one important reason for moving beyond the latent profit-sacrificing discretion conferred by the business judgment rule to the patent discretion the law also recognizes.

In short, this Section shows that shareholder welfare would be maximized by a rule that allowed controlling shareholders to sacrifice profits in the public interest and allowed managers with dispersed shareholders to do so when they have majority shareholder support. The latter is clear when the shareholders have in fact voted for the specific operational decision in question. It is also likely to be true when managers who have been elected by shareholders are making profit-sacrificing decisions that have not explicitly been rejected by most shareholders. Where managers are acting as loyal agents representing the views of most shareholders, allowing managers to sacrifice

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140 Another possibility is that the 20% of shareholders who are purely profit-maximizers would pay the other 80% of shareholders $100,000 and $200,000 to install lights. However, unlike in the case of a controlling shareholder, it is difficult to see how they could enter into an enforceable transaction that allocated that payment just to the 80% of shareholders who agreed with managers without raising collective action problems about the incentives of shareholders to accurately identify into which group they fall.

profits in the public interest will maximize shareholder welfare. Those dissenting shareholders who care only about profits will receive just the economic return that they should have expected given the legal rule allowing such discretion. The other shareholders who get net utility from having profit-sacrificing corporate activities further public interest activities will enjoy greater welfare and have incentives to vote to alter the corporate decision whenever that ceases to be true.

2. *Why Social Efficiency Affirmatively Justifies Giving Managers Discretion to Sacrifice Corporate Profits in the Public Interest Even When They Are Exercising Agency Slack*

Sometimes, managerial decisions to sacrifice profits in publicly held corporations will not maximize shareholder welfare. That seems almost certainly true when managers sacrifice profits over the explicit objection of most shareholders. More generally, it is true when managers are exercising the agency slack left to them because shareholder monitoring is imperfect. Even though most managerial decisions should conform to shareholder welfare, considerable agency slack will be left when shareholders are dispersed because collective action problems undermine shareholder incentives to become informed before voting or even to exert the effort to read and assess any information disclosed to them. Each shareholder will know that if she expends the cost of making a better-informed vote, her vote will have little impact on the outcome, so she might as well remain uninformed and save the information costs.

Within this zone of agency slack, managers might engage in more or less profit-sacrificing than shareholders would want, or further public interest views that conflict with those of shareholders. Does this justify creating an enforceable duty to profit-maximize? No. As I show next, such managerial deviations from shareholder views are affirmatively likely to improve corporate conduct because shareholder insulation and collective action problems will make shareholders underresponsive to social and moral sanctions. And imposing an enforceable duty to profit-maximize would make corporate behavior even worse, thus harming third parties. Moreover, any attempt to really enforce a profit-maximization duty would likely harm even shareholders by interfering with both business judgment deference and those exercises of profit-sacrificing discretion that benefit most shareholders.

a. Why the Corporate Structure Means That Managers Improve Corporate Conduct When They Exercise

Their Agency Slack to Respond to Social and Moral Sanctions

As discussed in Part I, optimizing conduct has always required supplementing legal and economic sanctions with social and moral processes. In noncorporate businesses like a sole proprietorship or general partnership, the owners play an important role in managing the business and thus become subject to a host of social or moral processes that guide their behavior in non-profit-maximizing ways. In part, these processes work by subjecting business owners to the usual set of social and moral sanctions that attend antisocial behavior even when it is legal. In part, however, these social or moral processes work by creating a greater awareness that comes from confrontation with problems and the results of one's actions. The manager who sees her 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 and moral processes in part involve a creation of private values to which economic theory cannot speak because it takes people's values as given. Persons can be socially molded to derive personal gratification from doing good. For example, social processes can make materialists into philanthropists by creating the values that make the philanthropists feel good when they donate money to worthy causes. This can result in a state of the world better than any possible without the creation of those values. Unlike with taxation, the philanthropists' incentives to create wealth are not diminished if 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 noncorporate businesses have always felt some social responsibility to contribute to the community—sometimes informed by an enlightened view of their long-term financial interest but often based on nonfinancial grounds.

On these social and moral dimensions, corporations have historically been viewed with great suspicion. The "old maxim of the common law" was that "corporations have no souls."[141] This was more than a minor concern. The "soulless" nature of the corporation was one reason for the great opposition to chartering corporations at all in the nineteenth century:

> The word "soulless" constantly recurs in the debates on corporations. Everyone knew that corporations were really run by human beings. Yet the metaphor was not entirely pointless. Corporations

[141] FRIEDMAN, *supra* note 9, at 448.

> did not die, and had no ultimate size. There were no natural limits 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 man, or by considerations of family or morality.[142]

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 need 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.

Although not well expressed at the time, a better answer lies in the corporate structure, which raises two important obstacles for a regime that relies in part on social and moral processes to guide behavior. *First*, the corporate structure largely insulates the business owner-shareholders from social and moral sanctions and processes, especially in the large publicly held corporation that raises the concern we are now addressing about managers exploiting agency slack. It shields owner-shareholders from social sanctions by taking them out of the role of running corporate operations and making them largely anonymous to those who might want to impose social sanctions for any harms caused by those corporate operations.[143] Separating ownership from management of corporate operations also means the owner-shareholders do not participate in the sort of social and moral processes that give ordinary business owners affirmative desires to behave in socially desirable ways when the law and profit motives are insufficient to do so. Shareholders are also insulated from moral sanctions because of their relative lack of information about how corporate operations may impact the public interest. They lack the detailed and vivid information about corporate operations and their effects that would come from actually managing corporate operations. Such

[142] *Id.* at 171–72. A similar notion was noted in a modern case sustaining the authority of corporations to make reasonable amounts of donations even if they do not indirectly increase profits. *See* A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 586 (N.J. 1953) ("[J]ust as the conditions prevailing when corporations were originally created required that they serve public as well as private interests, modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate. Within this broad concept there is no difficulty in sustaining, as incidental to their proper objects and in aid of the public welfare, the power of corporations to contribute corporate funds within reasonable limits in support of academic institutions.").

[143] Shareholders will be particularly shielded under case law that does not permit the inspection of shareholder records or lists to further public interest purposes out of a fear that shareholders will be "harangued." *See* Clark, *supra* note 1, at 103.

limited awareness will vitiate the force of moral sanctions that, although self-imposed, do require information about the conduct and its effects to be effective. A shareholder does not feel much moral guilt about her corporation's clear-cutting if she isn't sure whether it is really doing it, how bad its environmental effects are, or whether they are offset by favorable employment effects.

So uninformed and shielded, shareholders in publicly held corporations will suffer much lower social or moral sanctions from undesirable corporate conduct than a sole proprietor engaged in the same business conduct. Given the inevitable underinclusion of even optimal legal regulation, these social and moral sanctions are necessary to optimize behavior even outside the bounds of illegality. Thus, a corporation whose managers always acted to maximize shareholder welfare would likely engage in more socially undesirable behavior than a sole proprietor because the social and moral sanctions on those shareholders are so much lower. Instead, we should expect corporate shareholders to be more relentless than other business owners in pressing managers for unabashed profit-maximizing untempered by social consequences because shareholders 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 our "soul."

Second, dispersed public shareholders have collective action problems that make it difficult for them to act on any social or moral impulses they do feel. This is certainly true when making investment decisions. Each shareholder deciding whether to buy or sell stock in a particular public corporation will know that her investment decision will definitely determine whether she gets a share of the associated profits but will have little impact on whether the corporation engages in the conduct that offends her social and moral sensibilities. These collective action problems mean that shareholder investment decisions will not tend to drive down the stock market price of corporations that violate social and moral norms even to the extent shareholders do care about those norms despite their insulation. To the contrary, the investment decisions of even caring and informed shareholders will tend to drive down the stock price of corporations that sacrifice profits to comply with social and moral norms that investors themselves hold.

Likewise, because each individual shareholder has little impact on who wins any shareholder vote, each will also have little incentive to expend energy on collecting or even reading information about operational decisions before they vote. Even if a shareholder cares deeply about the environment and receives information about a corporation's clear-cutting, she won't have incentives to spend time reading it, let alone checking it against other sources of information to determine if it is accurate in its claims. For she knows that, even if she were to spend all that time to make her vote a more informed one, her single vote is highly unlikely to alter the outcome.

The historical response to such fears about corporate soullessness rested largely on assurances that society could trust in the souls of the humans who managed them. To the extent this response was persuasive, I think what it meant was that managers would be subject to social and moral sanctions, pressures, and processes that would tend to counteract their accountability to shareholders. People will protest outside managers' offices, letters will flow into their mailboxes, and the applause from good corporate conduct will ring in their ears. Managers will know what the corporation is doing and see its effects sufficiently to experience moral guilt for causing any ill effects that violate moral norms. Managerial responsiveness to social and moral sanctions should thus compensate for shareholder pressure to ignore those social and moral sanctions. This is consistent with the fact that, although shareholder proposals on social responsibility are often made, they usually lose overwhelmingly with shareholders, and normally are more successful in persuading management than shareholders.

This historical response could make sense only if managers have some legal discretion to use their agency slack to sacrifice corporate profits in the public interest even when shareholders indicate otherwise in their votes or investment decisions. By eliminating that discretion, a legal duty to profit-maximize would take away the human element that helped justify allowing the use of the corporate form at all.

Indeed, creating an enforceable duty to profit-maximize would in two ways worsen the problems created by the corporate structure. First, a corporation whose behavior was governed solely by an enforceable duty to profit-maximize would be forced to engage in the sort of suboptimal conduct we would get with *zero* social and moral sanctions. This would worsen corporate conduct even more than mere accountability to shareholders who are insulated from those social and moral sanctions.

Second, because the duty could be enforced by any single shareholder in a derivative action, 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. Given the actual insulation of average shareholders, such a duty would make corporate behavior even worse than the average wishes of shareholders who already are underresponsive to social and moral sanctions. This would thus result in even greater underresponsiveness to social and moral sanctions than accountability to shareholders alone could produce. Such a duty to profit-maximize would 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.

Proponents of a duty to profit-maximize have ignored these issues because they assumed away any role for social and moral sanctions when they presupposed that any legitimate public interest objectives could be embodied in legal regulation. They argued that business operations could 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, that the corporate profits that would be increased by a duty to profit-maximize could be taxed to fund public goods or further goals of equitable wealth distribution, or that some combination of strategies could be employed to ensure that the end result would be Pareto optimal.[144] Duty proponents further argued that, even when general regulation was insufficient, other stakeholders could also protect themselves with legal contracts with the corporation, relying on judges to fill gaps in those contracts to fine tune that protection when unforeseen events arise.[145] Because their assumptions meant that the public interest was or could be fully taken into account by the law, duty proponents could then argue that legal profit-maximizing corporate conduct not only would increase national wealth and encourage shareholder invest-

[144] Clark, *supra* note 1, at 20–21, 680; Macey, *supra* note 1, at 42–43; *supra* notes 1–5 and accompanying text. This view is often coupled with the view that government should be limited to coercive resolution of collective action problems among the citizenry, 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 1, 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 fora.

[145] Macey, *supra* note 1, at 40–41.

ment, but also would be socially desirable.[146] Others who do not quite advocate profit-maximization but favor relatively narrow profit-sacrificing discretion have likewise relied on a similar premise that legislative action and inaction reflects long run political consensus about what is desirable.[147]

But as detailed in Part I, this belief in the perfection or even perfectability of law is misplaced. Instead, even the most efficient and socially optimal legal rules will fail to cover much undesirable conduct. Thus, 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 a societal perspective: It may, due to the inevitable imperfections of law, impose harms that exceed the benefits of the extra profits.

In addition, 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.[148] This cannot be corrected by simply making governments act faster because there is always a balance between speed and spending the time necessary 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 (compared to relying on social and moral sanctions) will not be worth the costs.

All these problems are further complicated by the fact that many corporations do business in numerous nations with varying legal standards. For example, before 1924, slavery was legal in the Sudan and not yet prohibited by international law.[149] Even if engaging in slavery in the Sudan in 1920 would have maximized profits, presumably no

146 Clark, *supra* note 1, at 20–21, 679–80, 692, 702. A related argument is that non-profit corporations exist to pursue public interest goals. This is true, but provides no argument against mixed-purpose organizations. Nor does it justify preventing business corporations from running their operations in a manner that best advances the public interest.

147 *See* Engel, *supra* note 44, at 2, 34–37.

148 *See* Christopher D. Stone, Where the Law Ends 94–96 (1975).

149 *See* Report of the International Eminent Persons Group, *Slavery, Abduction and Forced Servitude in Sudan* 19–24 (May 22, 2002), *available at* http://www.state.gov/documents/organization/11951.pdf (last visited Mar. 9, 2005).

court would have held that a U.S. corporation was then obligated to engage in Sudanese slavery when so doing was clearly contrary to social and moral norms held dear here. However, such a conclusion would mean that the duty did not really require all legal profit-maximizing activities but picked among them based on the strength of the social or moral norm against it. Alternatively, the courts could require a U.S. corporation to comply with U.S. law even when operating abroad. But if applied to all U.S. laws, such a requirement would subject U.S. corporations to disadvantageous regulations in foreign nations that those nations do not even want, such as tough environmental regulations that make sense in the U.S. but do not in an undeveloped nation. Slavery in the Sudan is admittedly an extreme case, but the general point remains valid: Variations in legal regulation among different nations will inevitably leave legal gaps requiring supplementation by social and moral sanctions that operate internationally.

In short, legal regulation is an important but insufficient means of policing behavior, be it the behavior of individuals, non-corporate businesses, or corporations. Accordingly, Dean Clark's proposal—that if current law fails to capture public interest goals that corporations can further, then we should just 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[150]—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, social and moral sanctions will also play an important supplemental role in maximizing the likelihood of desirable behavior.

It should not be surprising if, as Dean Clark asserts, lawyers and economists commonly assume that the corporations need only profit-maximize within the law to assure that their behavior is socially desirable,[151] 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 financially 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. Groups that represent corpo-

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150 *See* Clark, *supra* note 1, at 696–703.

151 *Id.* at 17.

rate management, like Business Roundtable, "have denied that profit maximization should be the basic criterion by which managements should be judged."[152] Surveys indicate that most managers believe that they must weigh shareholder interests against those of other stakeholders.[153] To be sure, there is other evidence that managers believe their "primary" goal should be shareholder profits,[154] but that is perfectly consistent with allowing managers to be influenced by the same social and moral sanctions that influence sole proprietors, who surely are primarily interested in their own profits but not to the exclusion of all social and moral considerations. Indeed, even Dean Clark concedes that, in fact, corporate managers often assume that they are supposed to temper profit-maximization with a concern for other affected interests.[155] Further, whatever managers say they do, empirically managers do not actually profit-maximize according to many economists, 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.[156]

Thus, social and moral factors do actually influence corporate management, making the real question whether corporate law should be structured to minimize the influences of these social and moral processes. My answer is "no." An enforceable duty to profit-maximize would override social or moral sanctions and make corporations behave in the same way as amoral individuals who ignore the social consequences of their conduct. This would worsen corporate conduct, assuming that our society's social and moral norms do, as a group, improve behavior.

In contrast, managerial discretion to respond to social and moral sanctions will move corporate behavior in the right direction, again assuming our society's social and moral norms correctly identify which direction is right. This remains true even when managers are taking advantage of agency slack to sacrifice profits more than dispersed public shareholders would want. The reason is that the corporate structure weakens the social and moral sanctions applicable to such shareholders and thus gives them incentives to encourage socially suboptimal corporate conduct.

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152 *See* JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 35 (3d ed. 1989).

153 *See* Smith, *supra* note 12, at 290–91 (1998); *See also* Blair & Stout, *supra* note 5, at 286 n.82.

154 *See* BAINBRIDGE, *supra* note 1, at 417–18.

155 *See* CLARK, *supra* note 1, at 690–91; *see also* Milton Friedman, *supra* note 3, at 33.

156 *See* CHOPER ET AL., *supra* note 46, at 29–30 (discussing underlying premises of "behavioral" model of firms).

One might object that many of the social and moral norms currently promoted are misguided or, well, dopey and probably harmful to the public interest. But I am not saying that corporate managers have any duty to respond to every social or moral claim put forth by some group. I am saying that they should have some discretion to do so. One must distinguish between all the social and moral pressures that are exerted, many of which may be bad, and those to which management yields, which are more likely to be meritorious. Nor am I saying that corporate exposure to social and moral sanctions will always increase the satisfaction of your preferences or mine. Rather, I am simply assuming for this point that the overall effect of such exposure would increase the satisfaction of societal preferences, which should be reflected in the full set of social and moral sanctions even though many individual norms may be questionable.[157]

b. Why Excessive Managerial Generosity Is Not a Problem

Assuming that social and moral sanctions are on balance desirable, managerial discretion to respond to them should move corporate behavior in the right direction. However, one might reasonably fear that corporate managers would have incentives to be excessively generous when exercising their agency slack because they bear the full brunt of social or moral sanctions but not the full costs of the sacrifice of corporate profits given that, unlike sole proprietors, they would mainly be sacrificing other people's money. Such incentives for excessive generosity might even push managers so far in that direction that they would overshoot the optimal tradeoff of profitability and social responsibility. But this is unlikely to be a problem for several reasons.

First, absent an increase in the total amount of agency slack, any managerial decision to use their operational discretion to sacrifice corporate profits in the public interest should substitute for profit-sacrificing behavior that would have been more personally beneficial to managers. This seems plausible from the managerial perspective because one would have expected them to fully exploit any agency slack they already have. If they could get away with delivering lower corporate profits, one would expect them to do so by diverting profits to executive compensation, perks, leisure, stock options or other personally beneficial uses until their failure to deliver higher profits is constrained by other forces. Thus, regardless of any discretion to sacrifice corporate profits in the public interest, one would expect man-

[157] *See supra* Part I; *see also infra* Part VII.B (addressing and rejecting notion that courts should review whether particular social or moral norms that influenced managers enjoy widespread support).

agers to have already gone as far as they could in failing to deliver higher corporate profits. And once they are at that point, then managers cannot simply use such discretion to sacrifice additional corporate profits for public interest causes, but rather have to find some way to offset those lost profits by diverting less to personally beneficial uses. The point is analogous to the familiar point that a monopolist only has a single monopoly profit and cannot just infinitely increase profits by raising prices. Such substitution also seems plausible from the shareholder perspective because, although shareholders cannot monitor specific operational decisions or determine whether managers are maximizing profits, shareholders can and do monitor the overall level of corporate profitability. Shareholders often won't know whether profits were sacrificed to further personal or public interests or out of sheer laziness or mismanagement, but they do notice declines in profits.

Thus, if agency slack is constant, managers who decide to make operational decisions that sacrifice profits to further some public interest objective will have to make up those profits by either managing the corporation better in other ways (perhaps cutting into their leisure time) or by forgoing other ways of sacrificing corporate profits (such as lucrative stock options, fancy offices, corporate jets, or generous executive compensation) that benefit managers personally. This means that, unless the amount of agency slack changes, managers who respond to social and moral sanctions by making profit-sacrificing corporate decisions will be sacrificing "their" profits in the sense of profits that would otherwise have benefited managers or allowed them greater leisure. This would leave managers facing much the same tradeoff as a sole proprietor and eliminate any incentive to be excessively generous. Indeed, serious enforcement of a pure profit-maximization standard seems likely to skew managerial incentives perversely, making managers more inclined than sole proprietors to advance their personal profits rather than the public interest. The reason is that under a profit-maximization standard, things like large stock options or generous executive compensation that help attract, retain, and motivate good managers would be much easier to justify than socially responsible corporate conduct, for which the connection to profits is more indirect.

Further, if agency slack is constant, any decisions managers made to sacrifice profits in the public interest would leave shareholders financially indifferent while still advancing the public interest views reflected in the social and moral norms to which managers are responding. The choice would simply be between paying for that fixed agency slack in the form of overcompensating managers or in the form of corporate compliance with social and moral norms. It is hard to see how the latter choice could possibly be undesirable.

Thus, the potential problem of excessive generosity cannot arise at all unless there are good reasons to think that managers' operational discretion to sacrifice profits in the public interest would increase total agency slack. And there is little reason to think it would. After all, shareholders cannot avoid giving managers operational discretion and thus cannot avoid the burden of monitoring it—such operational discretion is a necessary feature of creating an investment vehicle that delegates management to others. The lion's share of cases where this discretion is used to sacrifice corporate profits will reflect latent profit-sacrificing sustainable under the business judgment rule. And most of the remainder could be made latent if the law prohibited patent profit-sacrificing in the public interest. Such exercises of latent profit-sacrificing authority simply reflect the degree of agency slack managers enjoy under the business judgment rule; they do not increase it.

The remaining exercises of discretion would involve patent profit-sacrificing, where managers do not pretend the conduct increases corporate profits in some indirect manner. But a rule that allows such patent profit-sacrificing discretion generally does not increase total agency slack, as long as the legal and nonlegal limits on the amount of profit-sacrificing are the same for patent sacrificing as for latent sacrificing.[158] To the contrary, as I noted above, such patent profit-sacrificing tends to reduce agency slack by more accurately informing shareholders about what is really going on.

Managerial discretion to sacrifice profits in the public interest thus seems unlikely to increase total agency slack, and if agency slack is unchanged then any incentive for excessive generosity is eliminated. Public interest causes benefit from such discretion, but shareholders do not suffer if any fixed agency slack is exercised in a socially responsible way rather than some personally beneficial way.

Second, even when managers have incentives to be excessively generous, it is far from clear that those incentives would make managers so overresponsive to social and moral sanctions that they would overshoot the optimal tradeoff of profitability and social responsibility. The reason is that managerial accountability to shareholders who are underresponsive to social and moral sanctions will create countervailing incentives for excessive stinginess. The net effect may well leave corporate conduct below the optimum (that is, not sacri-

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158 *See infra* Part VII (detailing limits).

ficing enough profits to further the public interest) despite managerial discretion to sacrifice profits.

For the same reasons, it is unclear whether on balance we should expect corporations with managerial discretion to engage in less or more socially responsible behavior than noncorporate businesses. On the one hand, shareholders largely insulated from social or moral pressures should exert pressure through their voting or investment decisions that tend to cause corporate managers to sacrifice profits less often. On the other hand, corporate managers may have some incentives to be more generous to the extent shareholder accountability is imperfect and the managers are sacrificing profits that do not come out of their own pockets. If corporate businesses are larger and more well known in our modern economy, they might also be more likely objects of serious social sanctions. But whether corporate behavior under current law is more or less socially responsible than noncorporate business behavior is not the question. The question is whether it would improve corporate behavior to change current law by eliminating corporate managers' ability to respond to the social and moral sanctions that help optimize noncorporate behavior.

Third, suppose that managerial discretion to sacrifice profits does create manager incentives to be excessively generous, and that causes corporate behavior to overshoot the behavioral optimum. That will be undesirable only if managers overshoot that optimum by a margin that is so great that it leaves their behavior further away from the optimum tradeoff than it would be with a profit-maximization duty. But this possibility provides only 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 not by the law but 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 and may even prompt a takeover bid).[159] The risk of truly excessive overshooting will also likely be constrained by shareholder voting. While the shareholder voting constraint is certainly imperfect given shareholders' rational apathy, it should restrain extreme cases of managerial deviation from shareholder interests. Finally, to the extent management compensation turns on corporate

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

profits, as it often does, managers will have less incentive to sacrifice corporate profits.

Indeed, proponents of a duty to profit-maximize argue that such market forces will destroy any corporations that do not profit-maximize.[160] But they fail to see that, to the extent they are right about this, it only reduces any need for judicial policing of managerial public interest activity. In fact, although the product market, capital market, and the market for corporate control should constrain excessive managerial generosity, it overstates matters to think that they would produce certain corporate death for any manager who fails to maximize profits. To begin with, managerial profit-sacrificing discretion reflects an agency cost that will be shared by all corporations, like the cost of executive compensation, and thus will not be driven out by market competition.[161] Further, product markets are typically characterized not by perfect competition but by product differentiation and monopolistic or oligopolistic competition, which give corporations some discretion to price above cost.[162] Moreover, even where product market competition prevents corporations from raising prices to fund public interest activities, they can still fund those activities by reducing their rate of return to shareholders.[163] To be sure, this will lower the value of their stock, until the rate of return per share matches other rates of return in the capital market. But this hardly disables the corporation from raising capital. It can just issue more equity at these lower stock prices,[164] fund reinvestment out of earnings, or borrow from lenders to a greater extent.[165] All these strategies will reduce the return to existing shareholders, as well as the long run ability of the corporation to raise as much capital, but they will hardly drive the corporation out of business. These strategies may also not even be noticeable because

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[160] *See, e.g.*, CLARK, *supra* note 1, at 687–88, 692; RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 436 (6th ed. 2003).

[161] *See* Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253, 299–300 (2003); Jensen & Meckling, *supra* note 117, at 305, 330 ("[T]he existence of competition in product and factor markets will not eliminate the agency costs due to managerial control problems . . . . If my competitors all incur agency costs equal to or greater than mine I will not be eliminated from the market by their competition.").

[162] *See* Jean Tirole, The Theory of Industrial Organization 277–303 (1988); Bebchuk, *supra* note 1, at 1467; Elhauge, *supra* note 161, at 258, 260.

[163] *See* Coffee, *Shareholders v. Managers*, *supra* note 123, at 20–22, 28 n.76 (collecting sources showing that managers prefer to use internally generated funds and do so for ninety percent of capital expenditures); Melvin Aron Eisenberg, *Corporate Legitimacy, Conduct, and Governance—Two Models of the Corporation*, 17 CREIGHTON L. REV. 1, 15 (1983) (noting that corporations can survive for protracted periods with minimal returns).

[164] *See* Bebchuk, *supra* note 1, at 1466.

[165] *See* Eisenberg, *supra* note 163, at 15.

other corporate managers will likely be exercising the same profit-sacrificing discretion.

The resulting decline in stock price would 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 profit-sacrificing goals. A perfect market for corporate control would thus make it impossible for corporations to continue pursuing profit-sacrificing 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 also in state regulation and corporate defensive tactics.[166] Indeed, as we will see in Part V, many of these obstacles were in part created to preserve the ability of corporations to continue sacrificing profits in the public interest.

These various methods of market accountability thus will not entirely stamp out profit-sacrificing, but should normally suffice to prevent excessive amounts of profit-sacrificing. The empirical evidence on corporate donations, which if anything create a greater risk of excessive generosity than operational decisions, bears this out. The average corporation donates only 1.0–1.3% of income,[167] which is lower than the average individual rate of 1.9–2.2%,[168] and most of those corporate donations actually increase profit.[169] Thus, market forces on average seem clearly able to keep corporate managers from being excessively generous. To be sure, there are special cases where such market forces fail to provide an effective constraint on excessive managerial generosity. But to deal with those cases, the law can impose special limits on profit-sacrificing when these market forces are ineffective, as well as a general outside limit on the degree of profit-sacrificing. As we shall see in Part VII, this is what the law in fact does.

Finally, to the extent that excessive managerial generosity did harm shareholders more than it helped third parties, the cure is worse than the disease. Creating an enforceable duty to profit-maximize would harm shareholders more than such excessive generosity by

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166 *See id.* at 15–16 (noting transactions costs incurred to comply with takeover bids' statutory requirements).

167 *See* PRINCIPLES, *supra* note 46, § 2.01 Reporter's Note 2; CHOPER ET AL., *supra* note 46, at 39.

168 NAT'L CTR. FOR CHARITABLE STATISTICS, URBAN INST., PROFILES OF INDIVIDUAL CHARITABLE CONTRIBUTIONS BY STATE, 2002, at 1, http://nccsdataweb.urban.org/kbfiles/421/stgive_02.pdf (last visited Apr. 21, 2005).

169 *See* Peter Navarro, *Why Do Corporations Give to Charity?*, 61 J. BUS. 65, 90 (1988) ("The empirical analysis supports the hypothes[is] that contributions are . . . positively related to increases in dividends.").

ending business judgment deference. Assuming that this business judgment deference was set to minimize total agency costs, ending it would increase agency costs and thus lower shareholder profits.[170] And unless we abandoned the business judgment rule, there would be no meaningful reduction in managerial discretion or in incentives to be excessively generous. Further, any profit-maximizing duty would apply not only when managers are exercising agency slack, but also when they aren't. It would thus prevent managers who *are* loyally representing majority shareholder sentiment from profit-sacrificing when that increases total shareholder welfare.[171] This is a particular problem if one wanted to take the minimal step of prohibiting just patent profit-sacrificing, for managers are most likely to be open about the profit-sacrificing they are performing when they are loyally representing shareholder views.

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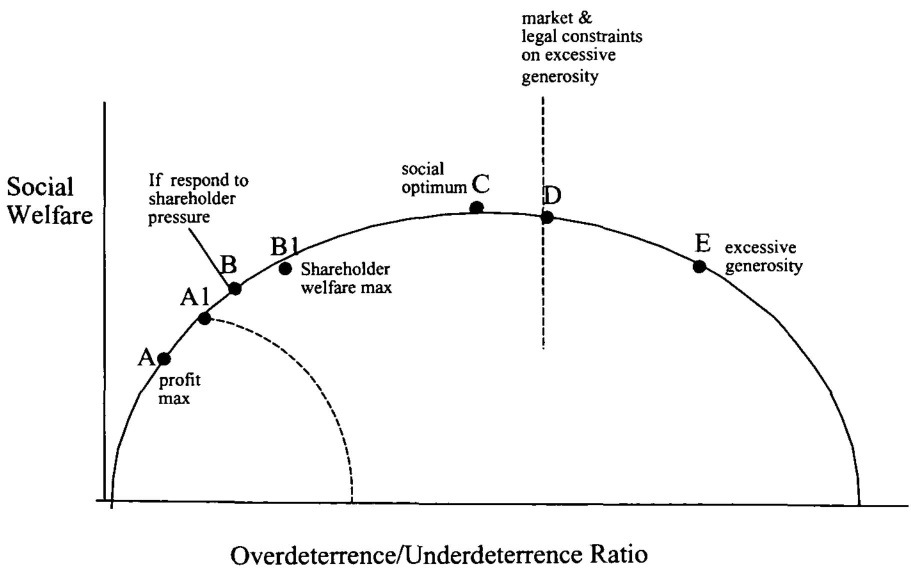
It may help to illustrate the foregoing analysis using a graph. Suppose the following graph reflects the social welfare of various possible tradeoffs between overdeterring desirable conduct and underdeterring undesirable conduct:



Point A1 reflects the optimum tradeoff that could be obtained using only legal and economic sanctions. At that point, further increases in legal sanctions are likely, given the error rate and magni-

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[170] *See supra* Part IV.A.
[171] *See supra* Part IV.B.1.

tude of sanctions, to increase overdeterrence by more than they decrease underdeterrence and thus lower social welfare. Point C reflects the optimal tradeoff that can be obtained if those sanctions are supplemented with social and moral sanctions against actors who fully control and profit from business operations and thus weigh those sanctions against the profits created by the conduct. Point A reflects the tradeoff obtained with actual legal and economic sanctions. Point A is lower than Point A1 because, as Part I explained, the existence of social and moral sanctions makes it optimal to lower legal sanctions from the levels that would be optimal without social and moral sanctions.

Assuming all sanctions have been set optimally, Point A reflects the behavior we would obtain if the firm engaged in whatever conduct maximized profits and thus ignored social and moral sanctions. Point B reflects the somewhat better behavior we would obtain if the corporation did not profit-maximize but instead responded to shareholder pressures as reflected in their investment and voting decisions. It is lower than Point C because shareholders are underresponsive to social and moral sanctions given their insulation and collective action problems. But it is higher than Point A because shareholders are at least somewhat responsive to social and moral sanctions. Point B1 reflects the behavior that would maximize shareholder welfare. It is higher than Point B because it reflects the full social and moral impulses of shareholders rather than being diluted by the collective action problems that shareholders face in acting on their social and moral impulses when making investment and voting decisions. But it is lower than Point C because even shareholders have suboptimal social and moral impulses given their insulation from social and moral sanctions.

Point C reflects the conduct a corporation would engage in if its managers were acting within their zone of agency slack *and* the total amount of agency slack were fixed so that any sacrificing of corporate profits came at their own expense. Under those assumptions, the behavior of managers would resemble the behavior of sole proprietors who weighed social and moral sanctions against the profits of conduct. Thus, to the extent these assumptions are accurate, profit-maximization would reduce social welfare by moving conduct from social optimum C to below the shareholder optimum B all the way down to Point A, thus harming both social and shareholder welfare.

But suppose agency slack was increased by recognizing the managerial discretion to sacrifice profits. That would raise a concern because, within the zone of increased agency slack, managers would be weighing social and moral sanctions that they experience against a loss of profits mainly borne by others, and thus would be excessively overdeterred. One might thus reasonably be concerned that, although social and moral sanctions would move managerial behavior in the right direction away from Point A or Point B, it would cause them to overshoot the social optimum, moving beyond Point C to Point E. However, the net effects are conflicting because within any zone of agency loyalty, responsiveness to shareholders would pull managers toward Point B, and within the zone of agency slack that existed before any increase in slack, managerial self-interest would pull managers toward Point C. The net effect might well be to put corporate conduct below the social optimum or not far from it. And even if managers overshot all the way to Point E, that overshooting would not be excessive if Point E resulted in higher social welfare than Point A, the result with pure profit-maximization.

In fact, the risk of excessive overshooting is effectively cabined by market and legal constraints on the degree of profit-sacrificing that can be indulged in by a manager, which prevents managers from going beyond Point D. Finally, even if we thought both that managers generally reached Point D and that the social welfare provided at Point D were lower than we would get with profit-maximization at Point A, the problem remains that moving us to Point A is not an available legal option. The reason is that any attempt to impose an enforceable duty to profit-maximize would perversely decrease shareholder profits by undermining the rule of judicial deference to managerial business judgment. Thus, it maximizes shareholder profits to adopt a business judgment rule that as a de facto matter gives managers the same sort of bounded discretion to sacrifice corporate profits represented by the range between Point A and Point D.

In short, no matter what our normative goal, we do not really have a realistic legal option other than giving managers discretion to go up to Point D. And we might as well stop worrying about the divergence between such discretion and pure profit-maximization not only because we cannot do much about it but also because exercises of discretion to move from A to any point between A and D are affirmatively socially desirable (and beneficial even to shareholders up to Point B1). The law just needs to be careful to bound the amount of profit-sacrificing discretion at Point D when special circumstances undermine the ordinary ability of market constraints to do so.

Those proponents of a profit-maximization duty who acknowledge any such duty is legally unenforceable tend to retreat to the claim that it is nonetheless valuable because it provides a social norm that restrains managers from being lazy or lining their own pockets.[172] But to the extent this is true, it simply reinforces my points that no legally enforceable duty exists and that social and moral norms play an important role in regulating corporate conduct. And even if the supposed profit-maximization duty is really a social norm, that doesn't mean it is the *sole* social norm. It would just be one norm among the larger complex of social and moral norms that regulate conduct. And the analysis in Part I would still indicate that pure profit-maximization would lead to worse conduct than decisionmaking that considered both profits and the social and moral consequences of that conduct.

In any event, *pure* profit-maximization does not empirically appear to be a prevalent social norm. As noted above, investors and corporate managers deny it, economists have argued that managers instead profit-"satisfice," supposedly supporting statements say only that the *primary* objective should be shareholder profits. Even Dean Clark concedes that managers often assume concerns about other affected interests should temper profit-maximization.[173] Nor does a norm of pure profit-maximization seem attractive to inculcate. If managerial laziness and self-dealing are the real problems, more targeted social or moral norms against those practices would tackle the problem in a way that is far less overinclusive. A norm of pure profit-maximization instead overinclusively demands that managers also maximize corporate profits even when such activity harms third parties in a way that violates the social and moral norms we traditionally use to optimize behavior.

c. Why Approval By a Majority of Dispersed Shareholders Should Not Be Required, But Approval By a Controlling Shareholder Should Be

The analysis above goes beyond showing that the law should not impose an enforceable duty to maximize profits. It also militates against the possible alternative legal strategy of making majority shareholder approval a requirement for public-spirited profit-sacrificing behavior in public corporations. The law may justifiably conclude that investors should not be able, by adopting the corporate form, to render their businesses largely immune from the sort of social and moral pressures that influence non-corporate businesses. Because managers are the only participants in the publicly held corporation who are effectively confronted with social and moral sanctions, they should retain the power to respond to them. Given their insulation

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172 *See, e.g.*, BAINBRIDGE, *supra* note 1, at 422–23.

173 *See supra* note 155 and accompanying text.

and collective action problems, 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. Thus, while Part IV.B.1 was correct that majority shareholder approval certainly *suffices* to make managerial profit-sacrificing efficient and desirable, it should not be regarded as a *necessary* condition in the case of a public corporation with dispersed shareholders.

The analysis here similarly indicates that encouraging greater disclosure to dispersed shareholders is not an adequate substitute for managerial discretion. Many interesting articles have been written indicating that the law should require managers to disclose whether corporate activities create the sort of harms that raise public interest concerns commonly held by shareholders.[174] Unless the disclosures were one-sided, it would presumably require managers to also disclose how much profits such activities reap, as well as disclosing any managerial decisions to avoid profitable activities that would have created such harms and how much in profits they sacrificed by doing so. Corporations could also adopt charter provisions requiring such social disclosure. If our only goal were shareholder welfare maximization, such a disclosure strategy could well be beneficial. Indeed, it is interesting that the only shareholder proposals on social issues that tend to come close to getting majority shareholder approval are those that seek to require such disclosures. But any disclosure to dispersed shareholders cannot alter the facts that shareholder insulation and collective action problems will leave shareholders with little incentive to study any disclosed information and quite underresponsive to social and moral sanctions even if they do. Thus, no matter how good the disclosure, shareholders in a public corporation would be likely to favor a suboptimal degree of socially responsible corporate conduct.

On the other hand, where a corporation has a controlling shareholder, then that controlling shareholder will be sufficiently identifiable and informed to be exposed to social and moral sanctions and will not have collective action problems in acting on them because her decisions can decisively affect what the corporation does. Such a controlling shareholder should accordingly be viewed as the "manager" for purposes of this Article in the sense that she controls corporate

174 *See, e.g.*, Douglas M. Branson, *Progress in the Art of Social Accounting and Other Arguments for Disclosure on Corporate Social Responsibility*, 29 VAND. L. REV. 539, 580 (1976); Williams, *supra* note 129, at 1205–07.

operations and is the actor that possesses profit-sacrificing discretion. Lower level managers should not enjoy discretion to sacrifice the corporation's profits absent some indication of approval by the controlling shareholder of the corporate policy. A sufficient indication of approval will generally exist simply because the controlling shareholder has selected managers who share her corporate philosophy, and requiring an affirmative shareholder vote would be too formal and impracticable given the range of managerial decisions that must be made. But managers should not be able to pursue public interest objectives secretly or over the known objections of a controlling shareholder.

One might wonder whether the modern prevalence of institutional investors should alter the above conclusions, or at least make the analysis of public corporations more like that of corporations with controlling shareholders. After all, compared to dispersed individual shareholders, such institutional investors are more likely to be informed about corporate activities, have fewer collective action problems because they have larger stockholdings, and are less likely to be insulated from social and moral sanctions because they can be identified as a locus of social and moral sanctions. Nonetheless, an enforceable duty to profit-maximize would still be ill-advised because it would force managers to ignore the social and moral sanctions that optimize corporate conduct no matter what the institutional investors thought.

Nor does the existence of institutional investors counsel for the alternative of requiring majority shareholder approval. Although more informed and less insulated than individual shareholders, institutional investors remain far *less* informed and *more* insulated than corporate managers because they are not directly involved in corporate operations. Moreover, institutional investors have their own collective action problems because each tends to have a very small percentage of the shares of any particular corporation and indeed each faces legal restrictions against obtaining more than five to ten percent of the stock in any corporation.[175] Thus, each institutional investor realizes that its investment decisions are unlikely to affect corporate conduct and has little incentive to take into account any social or moral impulses it may have. And the collective action problems with exercising their voting rights are large enough that, even when their financial returns are affected, institutional investors spend little effort

[175] *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 530–31, 542–53, 562–64, 567–68 (1990); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10, 17–23, 26 (1991).

monitoring corporation-specific policies and rarely make shareholder proposals or solicit proxies.[176]

More importantly, even if institutional investors did not have their own insulation and collective action problems, the fact remains that they have to please the individuals who invest in them to obtain their funds. And compared to individual shareholders, those individuals who invest with institutional investors are likely to be even more insulated from social and moral sanctions because they are twice removed from knowledge and responsibility. They may not even know what corporations their investment fund managers invest in, let alone precisely what all those corporations are doing, and they won't appear on the shareholder lists of any rapacious corporations. For example, individuals who would not dream of investing in tobacco corporations may think nothing of investing in index funds that do.

Even to the extent that the individuals who put their money with institutional investors do have social or moral impulses despite their double insulation, their collective action problems give them little incentive to act on them in choosing which institutional investor to invest with. Individuals do not have incentives to choose an institutional investor who conforms to the individual's own social or moral norms when that choice offers lower returns, for such an individual decision would have little impact on whether the institutional investor succeeds in advancing that social or moral norm but would definitely earn the individual lower returns. Consistent with this collective action problem, even the socially conscious investors who invest in investment funds that commit to social screening have to be induced by assurances that those funds will not actually sacrifice any profits, which necessarily reduces the ability of these funds to have any real impact.[177]

Indeed, the fact that even social-screening funds are forced to commit to profit-maximization underscores just how severe the underlying investor insulation and collective action problems are. Given that these social funds themselves profit-maximize, their investment decisions cannot accept a lower rate of return from more socially responsible corporations, and thus they cannot hope to temper profit-maximizing corporate conduct that harms the social and moral objectives of those funds. Even if they were willing to sacrifice profits, social funds which on any particular issue represent a relatively small share of the total capital market would be unlikely to meaningfully

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[176] *See* Black, *supra* note 175, at 559–60.

[177] *See* Knoll, *supra* note 130, at 682–84, 692, 710–13, 726; *see also* Portney, *supra* note 28, at 115–18 (collecting empirical evidence that in fact firms that use social screens do not incur lower rates of return on their stock investments).

alter the rate of return for profit-maximizing corporations that engage in conduct these funds consider socially and morally irresponsible. If the social funds tried to switch enough investment away from those profit-maximizing corporations to alter their rate of return, then the majority of investors who do profit-maximize would just bid up the stock price for those profit-maximizing corporations until the rates of return were equalized.

Rather than providing a vehicle for really influencing corporate conduct, these social-screening funds are best understood as a vehicle for investors to symbolically distance themselves from corporations who engage in socially undesirable conduct, in a way that does not alter that conduct or cost the investors any money. The existence of such socially responsible funds thus provides interesting evidence that individual investors do have social and moral interests but is not persuasive evidence that these funds or their investors can or do meaningfully influence whether corporate conduct furthers those moral and social interests. Nor can the existence of some socially responsible investment funds alter the reality that the social and moral interests of investors are likely to be socially suboptimal given their social and moral insulation from the realities of corporate conduct.

V
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 corporations that failed to maximize profits. As noted above, the law before the takeover era to some extent indicated an incompletely theorized agreement in law. Some judges and lawmakers likely believed it was affirmatively desirable that managers 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, 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 rationally be related to long-term profits. This mushy standard was more than sufficient to permit any desirable exercise of a discretion to sacrifice profits in the public interest.

But such incompletely theorized agreements fracture, and require resolution of the underlying theoretical disagreement, 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. Without takeovers, managers could temper profit-maximization with social concerns and claim their strategy somehow was rationally related to long-term profits. Takeover bids 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 financial present value of those costs must be lower than the benefits of clear-cutting. 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. During the 1980s takeover wave it seemed likely courts would accept that view rather than the ultimate view of the Delaware Supreme Court, which eventually helped stop the hostile takeover wave in 1990 with the remarkable conclusion that managers could justify blocking takeovers on the paternalistic ground that managers could assess the value of expected future profits more accurately than the stock market in setting the current stock price, even if shareholders accepting the tender offer thought otherwise.[178] Even someone who anticipated that the courts might take this view could not have been certain that the courts would, as they did, find it credible when takeover bids were fifty percent over the stock market price.[179]

Thus, during the 1980s, management had no persuasive argument that blocking a takeover bid that offered a premium over current market prices would somehow advance shareholder interests. If the law did not permit managers to employ defensive tactics to block such

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[178] *See* Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1990).

[179] In *Paramount*, the rejected takeover bid was $200, which was fifty-nine percent higher than the pre-bid stock market price of $126. *Id.* at 1147–49. Such takeover premiums of fifty percent were typical in the 1980s. *See* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 601 (1989).

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, those 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 have incentives to tender even if they prefer (because of their public interest views) that the takeover not occur because they fear being 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 financial benefits of accepting the tender offer.

Suppose that shareholders value the financial worth of their shares at the profit-maximizing rate of return lower than they value the combination of the financial worth of their shares at a lower rate of return and the nonfinancial satisfaction they derive from the corporation's public interest activity. They are now 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 makes them worse off if the tender offer succeeds. That is, the post-takeover value of their shares (the financial value of their shares in a purely profit-maximizing corporation) will be less than the pre-takeover value (the combination of financial and nonfinancial value of those shares in a corporation that tempered profit-maximization). Despite this, collective action problems will cause these shareholders to accept tender offers even when the price is lower than this pre-takeover value.

For tender offers conditioned on gaining control, the bidder can succeed with a price lower than this pre-takeover value as long as that price also exceeds the post-takeover value. Each shareholder will know that her individual decision to tender is unlikely to affect whether the tender offer succeeds, but that she will be harmed if the tender offer goes through and she has not tendered. Each will accordingly tender because the expected value of tendering in the likely case when their tender does not affect the outcome will exceed the expected value from the unlikely case when their nontender makes the difference in blocking the takeover.

Each shareholder should reason as follows. Either her individual 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 pre-takeover value minus the tender price. If her individual 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 her individual tender will not alter the outcome, and the takeover does not occur, then tendering versus nontendering has no effect because the tender offer is conditional on the takeover succeeding. The expected value of nontendering is thus: *(probability tender affects outcome) x (pre-takeover 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 she believes: *(probability takeover will occur whether or not he tenders) x (tender price - post-takeover value) > (probability her nontender will block takeover) x (pre-takeover value - tender offer price)*.

Because for any small shareholder, the likelihood of her individual nontender blocking the takeover is trivially small, she should tender if the tender offer price exceeds the post-takeover value of her stock to any nontrivial extent. 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 a small shareholder.[180] 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.[181] True, this adverse effect is small, amounting to the normal rate of return on that money for the few months of delay. But it takes only 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

180 *See* Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1708–13 (1985).

181 *Id.* at 1710.

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 offer is 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 at any price over the stock market price because she will gain money without sacrificing her public interest goals. A shareholder who does expect a majority to tender has no reason not to tender because she will gain money and the public interest harm will happen no matter what she does. The only reason a shareholder might not tender is if she thought: *(probability her nontender would block a takeover) x (pre-takeover value - tender offer price) > (probability takeover will occur whether or not she tenders) x (tender offer price - post-takeover value) + (probability no takeover will occur whether or not she tenders) x (tender offer price - pre-takeover financial 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 loses no nonfinancial benefit but gets the difference between the tender price and the pre-takeover financial value of the stock, the latter of which should equal its pre-takeover stock market price.

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 would 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 noncontrolling stock if the corporation profit-maximizes, or launch a bid for any and all shares at a price greater than the pre-takeover stock market price and no worse than the post-takeover value of noncontrolling stock. Indeed, shareholders who believe they have no significant chance of altering the outcome with their tender decision will also accept a bid for any and all shares at less than the post-takeover value if: *(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 - pre-takeover financial value)*. Shareholders might hold this view if they are unsure other shareholders have reached the same conclusion that they have, or believe that the effort to take over corporate control might fail for some reason other than a failure of most shareholders to accept the tender.

To illustrate, let's go back to our timber corporation. Suppose that, under the current policy of abjuring clear-cutting, the stock now trades at its financial 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 of shareholders realize this, but have elected less environmentally ruthless management because they are willing to sacrifice $20 per share to avoid clear-cutting. The takeover bidder, who intends to clear-cut, launches a conditional tender offer for sixty percent of the 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 financial plus $20 nonfinancial) 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)*. The former will be greater than the latter given the trivial likelihood that one shareholder's tender decision will affect the outcome. Thus, each shareholder will 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.

Likewise, if the bidder launches a bid for any and all shares, any tender offer of $110 or more will suffice to induce tender if the odds of a small shareholder affecting the outcome are insignificant. Suppose, for example, the tender offer is for $111. Then each shareholder will tender unless: *(probability their nontender would block a takeover) x ($120 - $111) > (probability takeover will occur whether or not they tender) x ($111 - $110) + (probability no takeover will occur whether or not they tender) x ($111 - $100)*. Given that the probability their nontender will block the takeover is effectively zero, they will always tender. If the tender offer is for precisely $110, each shareholder will tender as long as the probability that the tender offer will fail is greater than the probability that the individual shareholder could block the tender offer with her own nontender, which again should generally be true given that the latter is insignificant.

Indeed, 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: *(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, then they will tender unless they believe that the probability a takeover will occur is more than nine times the probability the takeover will fail. This might well be the case if the shareholder either is not over ninety percent confident of other shareholder views or believes there is a ten percent chance the takeover might fail even if most shareholders tender.

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 financial 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 her 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, dispersed shareholders will pay an amount that reflects the financial value of the stock, but they won't pay significantly more for any influence that stock's vote has on whether the corporation advances the public interest because that influence is effectively nil for small individual holdings of stock.

Consistent with this prediction, where a corporation has two classes of stock, one with many more votes per share than the other (almost always ten-to-one or greater), the median share with greater voting rights sells for only three percent more.[182] This suggests that the single vote per share of common stock is typically worth at most 0.3% of the stock market price. Further, this small premium simply reflects (and thus varies with) the odds that someone will pay more for their shares to assemble a controlling block that can actually alter corporate policy.[183] That means that the premium is even less than 0.3% at a pre-takeover stage when no takeover bid is in the offing.

[182] *See* Luigi Zingales, *What Determines the Value of Corporate Votes*, 110 Q. J. ECON. 1047, 1058–60 (1995).

[183] *Id.* at 1048–53, 1071.

Even that figure exaggerates the value of the vote's influence over nonfinancial aspects of corporate policy because it also includes any value the vote has in influencing the corporation to improve its financial performance. Clearly, people with small stock holdings quite rationally do not pay anything significant for the insignificant influence their stock has on whether the corporation advances the public interest.

This 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 either enacting control share acquisition statutes that require majority shareholder approval when a bidder acquired control or upholding charter provisions that required such a shareholder vote.[184] To be sure, in an influential article Professor Bebchuk argued that requiring a vote by tendering shareholders on whether they want the takeover bid to succeed is justified to protect shareholders even given his assumption that shareholders have only financial interests in stock.[185] He reasoned that otherwise shareholders might tender when the tender price is less than the pre-takeover value of the shares but greater than their post-takeover value because they fear the tender offer will succeed and thus leave them worse off than if they had tendered.[186]

However, Professor Bebchuk's justification is problematic in two respects, given his assumption that shareholders only put financial value on their stock. First, if the stock market is efficient, it is not clear why shareholders would view the pre-takeover financial value 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 financial value of noncontrolling shares in an independent target (the pre-takeover value) as greater than the financial value of noncontrolling shares post-takeover, which would be necessary for the bidder to be able to make a tender offer that is below the former but above the latter.

Professor Bebchuk's answer to the first problem is that shareholders may receive good news after the bid is made, increasing pre-takeover value in a way that would not be reflected by the pre-bid

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184 *See* CHOPER ET AL, *supra* note 46, at 1163 & nn.78–79 (collecting such statutes); Coffee, *Shareholders v. Managers*, *supra* note 123, at 101–03.

185 *See* Bebchuk, *supra* note 180, at 1698-99, 1747–64.

186 *Id.* at 1696, 1717–33.

stock price.[187] But typically the only significant good news is the fact of the tender offer itself, and market prices normally decline to pre-bid levels if no takeover bid succeeds within two years or less.[188] Professor Bebchuk does not directly answer the second question but rather explains why the tender offer price might exceed the post-takeover value.[189] But most of the reasons he describes would also depress the pre-takeover value of noncontrolling shares. Further, if his first condition of good post-bid news were met, then such good news should also increase the expected post-takeover value of the noncontrolling shares as well. Thus, neither theory can explain what really needs explaining: Why would shareholders expect a significant enough decline between the financial value of noncontrolling shares pre-takeover to post-takeover to allow bidders to make a tender offer between those values that would be coercive? Such shareholder expectations would be precisely contrary to the empirical evidence, which indicates that the post-takeover market price of noncontrolling shares tends to be significantly higher than their pre-takeover market price.[190]

In contrast, if we relax the assumption that shareholders are single-mindedly concerned with financial value, then it becomes quite plausible that they would view both the tender offer price and the post-takeover value of the corporation (purely financial in the hands of the successful bidder) as less valuable than the pre-takeover value of the corporation (both financial and social). This theory also seems to explain more persuasively why any coercion problem is not solved

[187] *See id.* at 1702–03. A different problem would be raised by two-tier tender offers that offer a tender price higher than the stock market price for fifty-one percent of shares but have a second step that cashes out nontendering shareholders at a price below the stock market price. Those could offer a blended price that was below the current stock market price but that still induces stockholders to tender to avoid being caught in the second step. But the solution to this, already provided by traditional appraisal rights, would be to prohibit a second-tier transaction at less than the pre-bid market price. *Id.* at 1709–10. Or the law could just prohibit partial bids or require that any second step be at the same price as the tender offer. Instead, the statutes and Professor Bebchuk's theory require shareholder voting on the tender offer even when the bid is not a two-tier tender offer at all. *Id.* at 1736–40. Moreover, such two-tier tender offers were always rare, and even when they existed normally the second-tier price was substantially above pre-takeover market prices and the blended price was fifty percent greater. *See* C. Steven Bradford, *Stampeding Shareholders and Other Myths: Target Shareholders and Hostile Tender Offers*, 15 J. CORP. L. 417, 424–27 & nn.48–50 (1990).

[188] *See* Bradford, *supra* note 187, at 433–34.

[189] *See* Bebchuk, *supra* note 180, at 1708–13.

[190] *See* Bradford, *supra* note 187, at 425 & n.50 (observing post-takeover market prices thirty-six percent higher than pre-takeover) (citing Michael Bradley, *Interim Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 360–65 (1980)).

by merely facilitating auctions between competing bidders.[191] In any event, whether or not Bebchuk's responses make his theory persuasive even if shareholders only gain financial value from corporate decisions, the above provides an important supplementary rationale for these control-share acquisition-statutes. If we wished to pursue fully this strategy of preserving discretion to sacrifice profits in the public interest by giving authority to shareholders acting collectively, then other steps would be advisable. Corporations could be required to disclose to shareholders any facts relevant to assessing social issues, such as the facts relevant to any environmental problems corporate operations may cause.[192] Or we could at least change 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 the public interest.[193]

However, even if a majority of shareholders has by vote approved a tender offer after full disclosure, the problems remain that (1) shareholders have little incentive to expend effort to absorb that information and (2) even if they do absorb it, shareholders as a group are too insulated from social and moral sanctions to make socially optimal tradeoffs between profit-maximization and other goals.[194] Shareholders insulated from the social and moral sanctions that enforce implicit contracts or more general social understandings that are ex ante profit-maximizing would also have incentives to renege on them by accepting a takeover bid whenever that is profitable *ex post*, so that the prospect of such reneging would actually reduce shareholder profits.[195] Understanding this shareholder insulation is necessary to

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[191] *See* Bradford, *supra* note 187, at 454–56 (reviewing empirical literature indicating that competitive bids defeat coercive bids).

[192] *See supra* Part IV.B.2.c.

[193] *See* Nat'l Consumers Union v. Nat'l Tea Co., 302 N.E.2d 118 (Ill. App. Ct. 1973); State *ex rel.* Pillsbury v. Honeywell, Inc., 191 N.W.2d 406 (Minn. 1971). Dean Clark justifies this rule as necessary to protect shareholders from being "harangue[d]." CLARK, *supra* note 1, at 103. Under my theory, this is not a persuasive argument because such protection exacerbates the harmful insulation of shareholders from the type of social and moral pressures experienced by non-corporate owners.

[194] *See supra* Part IV.B.2.

[195] *See supra* Part IV.A & n.123; *see also* Stout, *supra* note 12, at 1197–98, 1206; Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 847–56 (2002) (arguing that antitakeover defenses often increase ex ante shareholder profits and collecting evidence that in IPOs, when one would think corporate promoters want to maximize stock prices, promoters generally choose charters and states with anti-takeover provisions rather than opposite); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 709–10 (2003) (describing evidence that firms with such anti-takeover defenses in charters performed better after IPOs than other firms).

answer Professor Daniels' otherwise unanswerable critique that other stakeholders have no complaint when a takeover causes the corporation to breach an implicit contract because they get the remedy they implicitly contracted for, which is the imposition of nonlegal sanctions.[196] The answer is that because shareholders are insulated from nonlegal sanctions, the remedy such implicit contracts actually provide for is the imposition of nonlegal sanctions against uninsulated managers. Thus, the reason hostile tender offers can undermine implicit contracts (with or without approval by a majority shareholder vote) is that they switch the locus of decisionmaking from uninsulated managers to shareholders who are insulated from the social and moral sanctions that were supposed to enforce the implicit contracts.

Control share acquisition statutes could thus be only a partial answer to the sorts of problems that hostile takeovers posed for any state that wanted to preserve managerial profit-sacrificing discretion. To fully protect that discretion, lawmakers would have to go further and explicitly authorize managers to consider the interests of non-shareholder interests in deciding whether to employ effective defensive tactics that *didn't* require shareholder approval. They would, in short, have to abandon the old, incompletely-theorized agreement on a test that allowed such discretion, but that sometimes articulated it as allowable only because of its rational relationship to future shareholder profits.

This is precisely what happened. It was only after the takeover wave made it necessary that we saw the corporate constituency statutes, Delaware case law, and ALI provisions that explicitly allowed managers to consider the interests of other constituencies and made clear that shareholder interests were not controlling.[197] 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.[198] 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 management authority were made explicit, takeovers threatened to end a discretion to advance public interest goals that is desirable for entirely separate reasons. Consistent with this, the legislative history of these statutes indicates that they were intended to benefit not just managers, but others who would be harmed if managers lacked discretion

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196 *See* Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, 43 U. TORONTO L.J. 315, 337–38 (1993).

197 *See supra* Part III. The Delaware courts articulated an exception when corporate control was sold, but that reflects a last-period problem considered below in Part VII.

198 *See supra* Introduction and Part III.

to reject takeover bids.[199] This legislative purpose could make sense only if managers were not obligated to maximize profits. 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 advanced the interests of solely 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 represent or aim to foster.

By going beyond the requirement of a shareholder vote on tender offers to instead give managers effective legal discretion to block them, the law may have prevented a decline in agency slack that otherwise would have been created by the development of an active market for corporate control. The point is debatable because managers can also use such discretion to make better decisions on behalf of shareholders than shareholders themselves can make because managers are better informed and do not have the same incentives to renege on implicit contracts or social understandings that are ex ante profit-maximizing. That would tend to reduce agency costs to the extent managers do act on behalf of shareholders. But the doctrine also empowers managers to interfere with a market development that could have reduced managerial agency slack without requiring difficult judicial enforcement of a duty to profit-maximize. The net effect may well be that the doctrine giving managers discretion to block tender offers creates a net increase in managers' agency slack to deviate from shareholder interests. It seems unlikely, after all, that the entire fifty percent average premium paid by takeover bidders in the 1980s reflected financial gains from reneging on implicit contracts and violating other social and moral norms.[200] Some of this fifty percent presumably reflected a decrease in agency slack.

If it imposes a net increase in agency slack, then the doctrine giving managers discretion to block tender offers, unlike the doctrine recognizing managers' legal discretion to make profit-sacrificing operational decisions, requires a tradeoff between shareholder interests and third party interests.[201] But it would still be justifiable if the cost

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199 *See* Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846, 848–52 (1989).

200 Some empirical evidence indicates that takeover premiums were larger than any wealth transfer from employees or creditors, thus suggesting that breaches of implicit contracts with at least those two groups did not explain the size of the premium. *See* Daniels, *supra* note 196, at 319–21, 323–25.

201 *See supra* Part IV.B.2.

to shareholders from increased agency slack were offset by the benefits of improving the social and moral regulation of corporate conduct that come from preventing a decline in managerial profit-sacrificing discretion. Indeed, because shareholders are largely insulated from the social and moral sanctions that optimize corporate conduct, increasing the agency slack of managers to deviate from their views may be precisely the point. At some point, however, legal rules that increase agency slack are likely to create more harm than good. It may well be that the antitakeover rules have gone too far and made this tradeoff negative. The need to make such tradeoffs raises the issue of what the law does and should regard as the optimal degree of managerial discretion to sacrifice profits in the public interest. I'll get to that topic in Part VII. Before we get to issues regarding the degree of profit-sacrificing discretion, though, there is one more type of discretion whose very existence we need to explain: Why does the law give managers discretion to make profit-sacrificing corporate donations?

VI
The Corporate Discretion to Make Profit-Sacrificing Donations

The legal response to takeovers was not the first time that the law responded to a threat to managers' profit-sacrificing discretion by making that discretion more explicit in statutes and cases. In the early 1900s, a similar threat was posed by the fact that many courts were holding that making corporate donations was ultra vires: that is, beyond the powers conferred by the typical charter that authorized the corporation to conduct business.[202] Similar to the reaction to takeovers, the law responded with a statute in every state that made managers' authority to make corporate donations explicit, without limiting this new authority to those donations that indirectly increased corporate profits.[203]

This reaction requires separate justification. Even if corporate managers should be able to advance the public interest by altering operational decisions, why should they be able to do so by donating corporate funds rather than allowing shareholders to make such donative decisions? Unlike operational choices, we cannot say that the corporation must make a decision one way or the other in a way that necessarily applies to all shareholders. For donations, the corporation

202 *See* R. Franklin Balotti & James J. Hanks, Jr., *Giving at the Office: A Reappraisal of Charitable Contributions by Corporations*, 54 Bus. Law. 965, 968–69 (1999).
203 *See supra* Part III.

instead could send the money it would otherwise donate to the shareholders in dividends, or simply retain the money, which would increase the stock price. Either distribution or retention would give shareholders extra wealth that they could use to donate to the extent they want and to whichever charities advance their diverse conceptions of the public interest. One thus cannot conclude here, unlike with operational decisions, that the corporation simply has to choose a single position that must necessarily also apply to dissenting shareholders who hold other views of the public interest.[204]

Further, because shareholders could just make separate donations of their share of corporate wealth, they would not need any collective coordination on a unitary corporate decision. They thus would not face the same collective action problems they face regarding decisions on corporate operations or takeovers that affect the public interest. With decisions on corporate operations and takeovers, shareholders know that their individual investment or tender decisions will affect whether they individually sacrifice money but have little influence on the collective corporate decision that would affect the public interest.[205] With respect to donations, shareholders know that their individual donative decisions will definitely affect whether their money goes to the public interest cause or not.

If these arguments are persuasive, they raise a puzzle, for the power to make donations is legally the *clearest* of the corporate powers to sacrifice profits in the public interest.[206] One conventional answer to this puzzle is that shareholders who want to donate money do have another sort of collective action problem.[207] Although each shareholder 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 benefit 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 those individuals who happen to hold investments in corporate stock. It applies to every individual in society generally, and thus seems more aptly addressed by general governmental taxes or obligations to donate a minimum

204 *See supra* Part IV.B.1.

205 *See supra* Parts IV–V.

206 *See supra* Part III.

207 *See* CHOPER ET AL., *supra* note 46, at 40; Engel, *supra* note 44, at 63 n.231 (collecting sources); Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. TORONTO L.J. 299, 309 (1993).

share of income. Empirically, the problem is that individuals in fact donate at a *higher* rate than corporations.[208] Thus, free riding problems among individuals in fact don't lead to a greater tendency to underdonate.

Another explanation is that, compared to individual donors, corporations are better placed to monitor the use of donations by recipient charities.[209] 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 that are engaged in other lines of business 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 than ordinary business 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 that 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 thus seems to be no good reason to bundle the investment and charity-monitoring function by allowing business corporations to make donations on their shareholders' behalf.

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.[210] 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 cited tax advantage really does not flow 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

208 *See supra* notes 167–68 and accompanying text.

209 *See* CHOPER ET AL., *supra* note 46, at 40.

210 *See id.*; Engel, *supra* note 44, at 62 n.227 (collecting sources).

mainly consist of the appreciated value of the stock, on which shareholders will receive a deduction that is not 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,[211] this strategy actually has strong tax advantages over having the corporation itself make the donations.

For example, until recently the top U.S. corporate tax rate was thirty-five percent and the top individual tax rate was forty percent. Suppose a corporation had $100, and the issue was the most tax-effective way to donate it to charity. One possibility is to donate the $100 to charity directly from the corporation, which gives the charity $100 without the shareholders having taxable income or paying anything out of pocket. Suppose instead the corporation retains the money. The aggregate value of the corporation's stock should go up by $65, which reflects this $100 minus the $35 taxed by the government. The shareholders can then contribute that $65 in appreciated stock to the charity and add $35 from their own funds to give $100 to the charity. Because the shareholders get a forty percent deduction on the $100 donation, this lowers their taxes by $40, which is *more* than the $35 the shareholders had to add from their own pockets, meaning this method confers a $5 benefit on the shareholders as compared to having the corporation make the donation. Thus, shareholders can donate $100 to the charity *more* cheaply through corporate retention of income and shareholder donation of appreciated stock than by corporate 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 make profit-sacrificing donations thus all seem unsatisfactory, and fail to explain why such corporate decisions should bind dissenting shareholders. Nor can they explain the legal requirement, discussed below, that corporate donations have some nexus to corporate operations,[212] for none of these arguments depends in any way on such a nexus. Moreover, even if these arguments were persuasive, at best they would indicate that corporations should be able to make profit-sacrificing donations only with majority shareholder approval. After all, if corporations are allowed to make donations to solve a free rider problem, monitoring problem, or tax problem for those shareholders who wish to make donations, then one would think most shareholders would vote for them. Alternatively, one could address the free rider

211 *See* Clemens Fuest et al., Why Is the Corporate Tax Rate Lower than the Personal Tax Rate? 18 (Inst. of Econ., Working Paper), *available at* http://www.econ.ku.dk/epru/files/wp/00-17.pdf (last visited Mar. 9, 2005).

212 *See infra* Part VII.A.1.

or tax problems by having managers set the *amount* of corporate donation, with each shareholder choosing which donee receives his share, as Professors Brudney and Ferrell have proposed in a recent insightful article.[213] Why, then, doesn't the law prohibit corporations from making profit-sacrificing corporate donations, or at least require shareholder approval or direction for them?

One initial answer is that for donations, like operational decisions, it is too difficult for courts to distinguish which are profit-sacrificing and which are profit-increasing. The difference will generally turn on projections about what sorts of business returns can be expected from the increased goodwill associated with a particular donation, which is not something judges are well placed to assess. Thus, once managers are allowed to decide on profitable corporate donations, the business judgment rule necessarily creates de facto discretion to make profit-sacrificing corporate donations. There seems to be no way to create a judicially enforced duty to avoid profit-sacrificing corporate donations.

Likewise, there seems no administrable way to limit a shareholder approval or direction requirement to profit-sacrificing donations. One could instead require shareholder approval or direction for all corporate donations, but dispersed public shareholders would (like courts) be more poorly positioned than managers to decide which donations would enhance corporate profits. Professors Brudney and Ferrell conclude otherwise for what they call corporate "goodwill giving."[214] But in fact such donations seem to call for a quintessential business judgment about which sort of goodwill is most likely to draw a favorable reaction from that particular business's customers, employees, suppliers, or government regulators. Donating to the opera might create goodwill with one corporation's customers, and

213 *See* Brudney & Ferrell, *supra* note 85, at 1196, 1211–12.

214 *See id.* at 1198–1200. One difficulty with this proposal is that the distinction between goodwill donations and corporate donations seems difficult to draw since all of them could be described as increasing goodwill with someone in the hope of increasing corporate profits. Professors Brudney and Ferrell's distinction is apparently between donations that create goodwill with targeted persons like employees or customers versus goodwill with the general public. *See id.* at 1192–93 & nn.4–5. But it is unclear why they place a donation that associates a corporation with an environmental cause or sporting event in the former category and a donation that associates the corporation with a museum or university in the latter. *See id.* Nor is the normative distinction clear. Donations that increase profits by creating goodwill with the general public do so because that general public includes some set of actors (customers, employees, suppliers, government regulators) who affect the corporation's business. Maybe such goodwill is overinclusive, but one could say that about a lot of nationwide advertising. Why shouldn't the best scale and tailoring of goodwill, like advertising, be a business matter up to managers?

"badwill" with another's, and managers probably know that better than shareholders.

Collective action problems are also likely to mar any decision by dispersed public shareholders on the profitability of donations. If a shareholder vote is required, collective action problems will create the usual disincentives for shareholders to become informed before they vote. If each shareholder can individually direct her share of corporate donations, collective action problems would give each shareholder incentives to direct corporate funds to the charity she likes the best (perhaps to replace her individual donations) rather than to the one most likely to increase corporate profits because each individual decision has minimal effect on overall corporate profits but does definitely determine which charity gets its share of donated funds. We can imagine half the shareholders directing the donation of corporate funds to pro-life groups, and half to pro-choice groups, thus managing to create "badwill" with all the corporation's customers. Shareholder-directed corporate donations are thus less likely to be profitable than manager-directed ones.

Still, the law could ban *all* corporate donations without requiring courts or shareholders to make any profitability judgments. Indeed, that is precisely what courts did with the historical ban on *all* corporate donations as ultra vires. This was not an option with corporate operations, because operations cannot simply be banned without eliminating the reason for having corporations at all. Because some donations clearly are profit-increasing, such an absolutist doctrine would sometimes clearly reduce shareholder profits. On the other hand, such a doctrine might also ban some donations that would sacrifice corporate profits. For the following reasons, it seems to me that the net tradeoff suggests that allowing managers to make corporate donations on average increases shareholder profits.

Unless we think the ability to make corporate donations increases total agency slack, allowing corporate donations will definitely increase corporate profits. Such a doctrine would allow profit-enhancing donations, which by definition increase profits. And if agency slack is constant, then any profit-sacrificing donations allowed would result in no net decrease in corporate profits because they would 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, perks, or leisure time? Indeed, viewed as a substitute for manager (rather than shareholder) donations, corporate donations do have considerable efficiency and tax advantages. The efficiency advantage is that even profit-sacrificing corporate donations will have some goodwill effect that reduces the net outlay. Giving the same amount of money in salary or leisure to managers who make the donations will not have the same goodwill effect on future corporate sales, and thus will be more costly. The tax advantage is that, like all individuals, managers cannot get any tax deduction for personal charitable donations that exceed 50% of their individual income.[215] 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.

To be sure, there is a good argument that recognizing a power to make corporate donations is more likely to increase total agency slack than operational discretion could. While shareholders must confer operational power on managers and thus cannot avoid the burden of monitoring its exercise, recognizing a power to make corporate donations does create one more thing for shareholders to monitor. And all other things being equal, increasing the number of methods that managers might possibly use to divert corporate profits for personal gain will mean that sometimes they will be able to choose a method that is harder for shareholders to detect or more effective at garnering personal gain. For example, without a power to make donations, a manager might have a hard time conducting corporate operations in a way that benefits the local opera and makes it inclined to give her great opera tickets. If she can donate corporate funds to the opera, then she might be able to do so under the cover of saying it is really profit-enhancing, when the real reason she does it is to get better opera seats.

This effect seems likely to be marginal and to thus impose at most a modest increase in agency slack. One reason is that, when such personal gains are at issue, they generally can be adequately policed by the duty of loyalty, which unlike the duty of care really is capable of vigorous judicial enforcement.[216] Further, excessive managerial generosity with corporate funds will also still be constrained by nonlegal forces like managerial profit-sharing or stock options, shareholder voting on manager elections, and the product, labor, capital, and takeover markets. The constraining influence of these forces is strongly confirmed by the evidence that, despite managers' power to make corporate donations, the average corporation donates only 1.0–1.3% of corporate income, which is far less than the individual rate of

[215] 26 U.S.C. § 170(b)(1) (2000).

[216] *See supra* Part III; *infra* Part VII.

1.9–2.2%, especially when one considers that most of the corporate donations are profit-increasing.[217] There thus seems little evidence that the existing discretion to sacrifice profits has systematically made corporations excessively generous with shareholder assets. Indeed, to the extent shareholders and market constraints really just monitor overall corporate profitability rather than specific corporate decisions, the donative power will not affect total agency slack at all.

Thus it is likely that the legal doctrine creating a general managerial power to make corporate donations has not increased agency slack enough to offset the increased profits that resulted from allowing corporations to make profit-enhancing donations. However, the effects are sufficiently mixed and contingent that some stronger rationales seem necessary. Further, if the only argument for the corporate power to donate was that, on balance, it probably maximizes shareholder profits, then the easiest way to address that concern would be to allow corporations to adopt charter provisions authorizing such donations. Indeed, if that were the argument, such a solution seems preferable because the mixed effects would indicate that the donation rule that maximizes shareholder wealth likely differs for different corporations. Perhaps a particular corporation might conclude that giving its managers donative power will on balance decrease profits, or that Professors Brudney and Ferrell are correct that, at least for goodwill donations, its shareholders can decide which donations maximize corporate profits as well as its managers. But the fact is that charter provisions authorizing corporate donations by managers (with or without shareholder approval or direction) were not prohibited by the earlier decisions declaring corporate donations ultra vires. That doctrine relied instead on the interpretation that a standard corporate charter authorizing the conduct of a business for profit did not also authorize donations. Thus, while the ultra vires doctrine created a categorical rule, it did so only as a default matter, and thus did not bar corporations from opting out of it when doing so would maximize corporate profits. The profit-maximization rationale accordingly cannot fully explain why each state legislature felt compelled to adopt statutes overriding this ultra vires doctrine to authorize donations by corporate managers.[218]

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217 *See supra* notes 167–69 & accompanying text.

218 These states may have been motivated by a desire to simply change the default rule to one that would be profit-maximizing for most corporations. *See infra* Part VIII. But it is unclear why this would create a very strong political motivation given that any corporation that really cared about the issue could have adopted a charter provision opting out of the ultra vires doctrine. To my knowledge, no significant number of them even attempted to do so.

Instead, this strong statutory reaction seems explicable only if the same social and moral processes mentioned above are also important in molding the desire to donate. If so, dispersed public shareholders' social and moral insulation from the effects of corporate operations will incline them to make less socially desirable donative decisions than uninsulated managers. The manager who is confronted by the environmental harm she has caused will be more likely to feel social sanctions or moral guilt 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 will be more likely to want to make donations to benefit that local community. The manager who has experienced the enormous value of innovation in her industry will 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 because shareholders are largely insulated 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 because shareholders and managers are subject to different social and moral processes that will induce different sorts of donations. This provides a justification not just for authorizing corporate donations in general, but for managerial discretion to make profit-sacrificing donations in particular. It further explains why such managerial discretion might be desirable even without the approval or direction of dispersed public shareholders, and indeed precisely because such insulated shareholders are not involved.[219]

Donations also may often be a cheaper way of meeting social and moral obligations than altering corporate operations. Thus, given that the law does allow social and moral sanctions to affect managerial discretion over operations, it would lead to inefficient substitution effects if the law deprived managers 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 corporation's management to avoid clear-cutting a 100-acre forest even though that sacrifices $1 million in profits. Now suppose the cor-

[219] Where a controlling shareholder does exist and is thus not insulated from social or moral sanctions, that shareholder's approval should be required for the same reasons I would require it for operational profit-sacrificing discretion. *See supra* Part IV.B.2.c.

poration could, by making a $500,000 donation, help a nonprofit group preserve a different 150-acre forest that is environmentally more important. In that case, social and moral processes would (if donations were legally permitted) likely cause the corporation to make the donation instead of abstaining 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 pro bono obligations by having their own lawyers do the pro bono work. It is cheaper to instead have their lawyers work at $500 per hour and then donate some of those earnings to public interest firms whose lawyers are both far cheaper and have more specialized skill in the relevant sort of legal work. The result can save the law firms money and produce more and better pro bono lawyering. Thus, firm donations can often promote the public interest more efficiently than an alteration to firm operations.

In short, given that the law permits managers' discretion to make profit-sacrificing operational decisions, inefficient substitution would result if the law prohibited profit-sacrificing donations. Social and moral sanctions would cause managers to make profit-sacrificing operational decisions even when a donation could have advanced the same public interest objective more effectively or at lower cost. Nor can one eliminate this substitution effect by changing the law on operational discretion, for that law is both inevitable and affirmatively justifiable. These substitution effects create another affirmative reason to allow profit-sacrificing donations.

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. The puzzle thus remains: Why is it that corporate statutes are clearest about authorizing profit-sacrificing donations? The answer seems to be simply that it was only in the donative area that an explicit legal statement was necessary. For operational decisions, the managerial authority to run the corporation subject only to deferential business judgment rule review had historically given managers enough discretion to have their operational decisions molded by social and moral forces. An explicit legislative statement was thus not necessary to preserve this discretion. In contrast, because many courts were striking down corporate donations under the ultra vires doctrine, legislatures had to enact statutes making the corporate power to donate explicit if they wanted to preserve this profit-sacrificing managerial discretion. Such explicit statutes were not necessary for ordinary operational discretion until, as we saw above, the wave of hostile takeover bids in the 1980s made it necessary.

We can also conclude something else from the fact that statutes in every state do clearly authorize corporations to make donations in the public interest. We can conclude that, given that such donation authority clearly does exist, operational decisions in the public interest should also be authorized. Otherwise we would have the same sort of inefficient substitution noted above, but in reverse. If managers had donation authority but not operational authority, managers who wanted to advance public interest causes would simply substitute donations for profit-sacrificing 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. Accordingly, even if the other arguments above for recognizing profit-sacrificing operational discretion were not persuasive, it would still not make sense for judges to try to prohibit profit-sacrificing conduct through common law fiduciary duties. Given the statutes that authorize donations, any such judicial decisions would simply produce inefficient substitution toward donations even when they advance the public interest less effectively or at higher cost.

VII
Limits on the Discretion to Sacrifice Profits

A. *Limits on the Degree of Discretion*

The analysis above indicates that managers do and should have *some* discretion to sacrifice corporate profits in the public interest. It does not indicate that this discretion is or should be unlimited. To the contrary, it indicates that some limits on the degree of discretion will likely be desirable to prevent the risk of excess managerial generosity.

To say that limits are required is not necessarily to say that the limits have to be legal in nature. Normally, no legal limit on public-spirited profit-sacrificing is necessary. The discretion to sacrifice profits 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.[220] In the lion's share of cases, these market constraints are more than adequate to prevent corporate managers from being excessively generous without any need to employ legal restrictions.

220 *See supra* Part IV.B.2.

But in some special cases, legal limits do matter. One possibility is that some managers may have idiosyncratic views about the extent of the corporation's social and moral obligations that overwhelm the ordinary disincentives imposed by nonlegal constraints and cause them to make a profit-sacrificing decision that cannot readily be reversed. Imagine, for example, a corporation that finds itself run by a person who experiences a religious conversion that makes her decide to donate *all* corporate assets to her religion. If her moral convictions were sufficiently powerful, this might override the threat that this decision would lose her the 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 nonlegal constraints on excessive profit-sacrificing. Suppose, for example, a manager is retiring. None of the market constraints will be meaningful to her because she won't be there to experience them. And if she 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 in running the corporation (including multiple directors) that no single retiring manager can engage in excessive profit-sacrificing without the approval of others. Even the chief executive officer will, given her pending retirement, have relatively little ability to get the rest of the board of directors to go along. This is one reason corporations 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 decided to change prior corporate practice and donate away all corporate assets. Such a decision amounts to an end-of-career donation of that individual's share of corporate assets to some favorite charitable cause with a matching donation proportionately expropriated from the other shareholders contrary to their expectations about the likely degree of corporate profit-sacrificing. Such a shareholder could oust any directors who tried to get in her way, and thus some legal limit would be necessary to protect the minority shareholders.

The last-period problem that typically creates the greatest need for legal limits results when the corporation is up for sale because that can give *all* existing managers a last-period problem at the same time. Given that the firm is being sold, the existing managers' 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, managerial profit-sharing, or stock options may be insufficient to constrain excessive profit-sacrificing—or may be undermined if the buyer (or donee) provides outgoing management with new jobs or special payments. Thus, as we will see, profit-sacrificing discretion is more sharply limited when a corporation is up for sale.

1. General Limits on Discretion

The law limits profit-sacrificing discretion in various ways. Traditionally, the most common has been to take advantage of the fact that many legal authorities sustained public-spirited activities or donations on the theory that they conceivably maximized long run profits. Although the business judgment rule meant that in reality these cases gave managers effective discretion to sacrifice profits, the fact that many cases articulated such a test meant that, to be safe, managers had to be able to offer some plausible claim that their conduct could increase long-term profits.

Such business judgment rule review 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. 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 a corporation's assets, or stops clear-cutting even though that cuts corporate profits in half, it will be hard to claim plausibly that the increased goodwill could be large enough to offset this effect. Thus, the real constraint imposed by the test requiring a rational relationship to profitability was not that it imposed a duty to profit-maximize, but that it set a limit on the *degree* of profit-sacrificing.

However, this traditional approach was not always effective at preserving the necessary discretion, and (as discussed above in Part V) became much less so once takeover bids became prevalent and monetized how much in profits was actually being sacrificed. Thus, corporate law has had to become increasingly explicit in authorizing some discretion to sacrifice profits, rendering the traditional 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 devote only a "reasonable" amount of corporate resources to public interest purposes, and can consider ethical principles only to the extent they are "reasonably regarded as appropriate to the responsible conduct of business."[221] Likewise, the state statutes that authorize corporate donations are normally interpreted by courts to authorize only a "reasonable" amount of donation.[222] Such a reasonableness test would constrain management from stopping clear-cutting if it eliminated all profits, and presumably if it reduced profits by fifty percent. But what if stopping clear-cutting reduced profits by fifteen percent: Would that be reasonable? Alas, conclusory words like "reasonable" fail to resolve such issues. They serve more as placeholders for standards that are either implicitly applied or that one hopes will be provided later. This problem is only exacerbated by the fact that the ALI indicates reasonableness should be determined by considering "all the circumstances in the case."[223] This comes perilously close to a we-know-it-when-we-see-it test.

Somewhat more helpfully, the ALI suggests that 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.[224] The first factor presumably means to capture the notion that shareholders would expect customary profit-sacrificing when they bought their shares and thus not be harmed by it. Unfortunately, this first factor provides little clarity because there will always be corporations that are above average and below average in their profit-sacrificing levels. If all corporations that 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 1.0–1.3% 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. In any event, customary practice will reflect whatever the legal limits are, and thus cannot tell us what those legal limits should be. We thus have the usual circularity problem that expectations will reflect our legal rule, and thus can provide little guidance on what the rule should be.

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221 *See* PRINCIPLES, *supra* note 46, § 2.01(b)(2)–(3) & cmts. h–i.

222 *See* N.J. Stat. Ann. § 14A:3–4 (2003) (limiting donations to "reasonable amounts"); Kahn v. Sullivan, 594 A.2d 48, 61 (Del. 1991) (interpreting statute authorizing corporate donations to have reasonableness limit even though not explicitly provided in statutory language); Mem'l Hosp. Ass'n v. Pac. Grape Prods., 290 P.2d 481 (Cal. 1955) (holding that there is "reasonable" limit to corporate manager's power to donate that depends on particular facts of each case).

223 *See* PRINCIPLES, *supra* note 46, § 2.01 cmt. i.

224 *Id.*

The second factor of nexus 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.[225] 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 deem a donation with no nexus to business operations unreasonable if it constituted twenty percent of corporate income but not if it constituted less than 0.01%, but we don't know why.[226] The only explanation given is that small donations without any nexus to corporate operations are a common corporate practice, but that may simply reflect the fact that the law permits it or that such small donations can usually be justified with some claim of long run profitability.

The underlying problem has been that one cannot articulate a theory that helps determine what degree and nexus of corporate profit-sacrificing are 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 some headway on the issue. The affirmative reason to allow corporate management to temper profit-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 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 it provides some guidance about what to look at to determine the extent of profit-sacrificing that is reasonable. This standard also provides some help in choosing a more precise numerical limit, recognizing that any specific choice is inevitably arbitrary. In particular, because ten percent was the tithe that morally devout individuals were historically expected to contribute to their religious and social communities, one

225 *See* PRINCIPLES, *supra* note 46, § 2.01 illus. 15–16.
226 *Id.*

might conclude that managerial decisions to reduce corporate profits by over ten percent exceed their reasonable discretion. Consistent with this, cases have held that a helpful guide for determining whether a corporation's donation was for a "reasonable" amount is the limit that the tax code sets on the deductibility of corporate donations,[227] which is now ten percent of corporate income.[228] Likewise, the ALI illustrations indicate that it would be reasonable for a manager to forgo ten percent of corporate profits by not making a computer sale to a foreign country that would adversely affect national foreign policy,[229] or to forgo three to four percent of profits by refusing to sell an unprofitable plant to keep workers employed, but unreasonable to do the same act when it sacrifices more than twenty-five percent of profits indefinitely.[230] Whatever the chosen percentage limit, it makes sense to apply the same limit to both donative and operational profit reductions; otherwise, the law would produce inefficient substitution effects between the two.

Explicitly recognizing such a discretion to sacrifice up to ten percent of existing corporate profits seems likely to reduce not just uncertainty but the actual extent of discretion that exists under the alternative of a pseudo-profit-maximization standard that allows any action 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 in the public interest, 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. To the extent courts instead explicitly admit that profit-sacrificing discretion exists and limit it to ten percent of existing profits, courts can engage in more independent fact finding and thus be more likely to prevent management from exceeding the ten percent limit in reality.

Interestingly, this ten percent standard seems to have an inherent status quo bias. Managers cannot reduce corporate profits more than ten percent by making donations or altering corporate operations. But suppose a timber corporation has always abstained from clear-cutting, and its shareholders have all invested based on the profit-stream that policy produces. If clear-cutting would increase corporate

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227 *See Kahn*, 594 A.2d at 61.

228 26 U.S.C. § 170(b)(2) (2000). *Kahn* accordingly sustained a corporate donation of $50 million out of $574 million in corporate income. *See Kahn*, 594 A.2d at 51, 57, 61.

229 PRINCIPLES, *supra* note 46, § 2.01 illus. 21.

230 *See id.* § 2.01 illus. 19–20. *See also id.* § 2.01 illus. 6 (making profit-sacrificing loans to needy urban areas is not ethically justified or reasonable when it consumes twenty-four percent of profits.).

profits by twenty percent, would managers have an obligation to change corporate policy? No case or ALI illustration appears to have so held or suggested.

Why should this be? If corporate profit-sacrificing discretion is limited by an obligation not to reduce corporate profits by over ten percent, why shouldn't it also be limited by an obligation not to forgo decisions that could increase corporate profits by over ten percent? There are several reasons, it turns out, all of which boil down to the point that the reasons for the former limit do not apply to the latter sort of case. A duty to increase profits by over ten percent would be harder to police legally because there would be no historical baseline to turn to: Instead, courts would have to second-guess managerial judgments about how much profits would be increased by an alternative course of conduct. There is also much less need to police this problem legally because a decision to forgo a change in operations that would *increase* corporate profits will (unlike a decision to give away corporate assets) generally be reversible, and thus much easier to police with standard market forces.

Any duty to increase profits by over ten percent would also be less affirmatively justifiable. A ten percent limit on profit-reduction may accurately capture social and moral norms about the maximum tithe-like reduction in individual income. But social and moral norms governing individuals also prevented them from engaging in rapacious conduct that would have increased their profits by over ten percent. Substitution effects would be less relevant because donations necessarily come out of already earned income and thus any limit on them is inherently status quo oriented. And if managers are merely continuing corporate conduct that maintains the existing profit stream, then their decision cannot thwart shareholder expectations or cause a reduction in share price. Finally, any pre-existing pattern of corporate behavior will have reflected the existing set of social and moral sanctions as they have been policed by normal nonlegal constraints. When a manager simply continues that pattern, there is thus less reason to fear either that she has become possessed by idiosyncratic views about the public interest that caused her to alter corporate conduct, or that last-period problems have led to a change of conduct by lifting normal nonlegal constraints.

Thus, managerial profit-sacrificing discretion does face a legal limit on decisions that reduce profits by over ten percent, but not one on decisions that forgo increasing corporate profits by over ten percent. One interesting implication of this is that the most important profit-sacrificing behavior will consist not of decisions to reduce profits but of decisions to forgo the higher profits that could have been made with more rapacious conduct. This is true not only because the legal limits on the latter are looser, but also because we should not observe corporations changing their conduct to reduce corporate profits unless there were some change in social and moral sanctions. Thus, most exercises of profit-sacrificing discretion will mainly consist of profit-increasing behavior that we *don't* see but otherwise would have. This will necessarily make most corporate profit-sacrificing difficult to observe, especially because a decision to simply continue the sort of corporate activities indicated by unchanging social and moral sanctions might not even be conscious.

My theory can also explain both why the law requires a business nexus requirement for donations and what sort of nexus to look for. For profit-enhancing donations, the only nexus necessary is that it increases corporate profits. But for profit-sacrificing donations, the nexus requirement should be linked to the affirmative reason for allowing corporations to make such donations, which is both that the operational experiences of management subject them to social and moral processes that create special donative impulses and that banning corporate donations would lead managers to inefficiently substitute operational profit-sacrificing for donations. The relevant business nexus accordingly should be whether there is something about conducting corporate operations that increases donative impulses toward the sort of charity involved. Without that sort of business nexus, there is no good reason for the corporation (rather than its shareholders) to be making a profit-sacrificing donation. Such a nexus should accordingly be an absolute requirement for a profit-sacrificing corporate donation rather than (as the ALI suggests) a mere factor to be balanced against the extent of sacrifice, for that sort of nexus is necessary to affirmatively justify corporate donations at all.

For example, if a manager of our timber corporation decides to donate corporate money to a pro-life or pro-choice group, and there is no doubt that either donation will anger enough customers to decrease sales, then I would say that even a small profit-sacrificing donation cannot be justified. This is not because courts can determine that either cause is against the public interest. It is 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 sort of personal experiences that any nonmanager might have and thus should come out of her personal funds rather than corporate funds.

Finally, this sole proprietor benchmark also suggests what the *floor* on discretion to sacrifice corporate profits should be. In particular, many of the markets that constrain managerial profit-sacrificing would also constrain a sole proprietor's profit-sacrificing. Thus the market constraint imposed by, say, product markets, cannot be said to impede a reasonable degree of discretion to take social and moral considerations into account. In contrast, during the hostile takeover heyday, tender offers imposed a constraint on corporate managers that was not faced by sole proprietors because the latter could not be forced to sell their business against their will just because another way of running the business would increase its profits. This helps explain why the law reacted by impeding the ability of corporate takeovers to impose a market constraint: Takeovers threatened to reduce managerial profit-sacrificing discretion far below the historical levels that sole proprietors enjoyed. Similarly, state legislatures reacted sharply to the ultra vires doctrine because it set the degree of donative discretion at zero percent, a level clearly below the benchmark of what a sole proprietor had historically donated. Indeed, the statutes authorizing corporate donations generally emphasize that they give corporations the same power that individuals enjoy.[231]

2. *The Increased Legal Limits on Discretion When Last-Period Problems Vitiate Nonlegal Constraints*

Another strategy the law employs is to alter the legal limits depending on whether management has a last-period problem that undermines nonlegal constraints. This distinction has historical roots going back to old English case law, which sustained donations made by firms that were going concerns but invalidated donations of as little as two percent made by liquidating firms.[232]

More recently, Delaware case law has clarified that managers' discretion to consider nonshareholder interests does not apply when they are selling the corporation. When deciding to reject a takeover

[231] *See* ALA. CODE § 10-2B-3.02 (Michie 1975); ALASKA STAT. § 10.06.010 (2004); ARIZ. STAT. ANN. § 10-302 (West 2004); CAL. CORP. CODE § 207 (West 1990); COLO. REV. STAT. § 7-103-102 (2004); CONN. GEN. STAT. ANN. § 33-647 (West 1997); FLA. STAT. ANN. § 607.0302 (West 2001); GA. CODE ANN. § 14-2-302 (2003); HAW. REV. STAT. § 414-42 (Supp. 2003); IDAHO CODE § 30-1-302 (Michie Supp. 2004); IND. CODE ANN. § 23-1-22-2 (Michie 1999); IOWA CODE ANN. § 490.302 (West 1999); KY. REV. STAT. ANN. § 271B.3-020 (Michie 2003); NEB. REV. STAT. § 21-2026 (1997); ME. REV. STAT. ANN. tit. 13-C, § 302 (West Supp. 2004); MISS. CODE ANN. § 79-4-3.02 (1999); MONT. CODE ANN. § 35-1-115 (2003); N.H. REV. STAT. ANN. § 293-A:3.02 (1999); N.C. GEN. STAT. § 55- 3-02(a) (1990); OR. REV. STAT. § 60.077(2) (2003); S.C. CODE ANN. § 33-3-102 (Law Co-op. 1990); TENN. CODE ANN. § 48-13-102 (2002); UTAH CODE ANN. § 16-10a-302 (2001); VT. STAT. ANN. tit. 11A, § 3.02 (1997); VA. CODE ANN. § 13.1-627 (Michie 1999); WASH. REV. CODE ANN. § 23B.03.020(2) (West 1994); WIS. STAT. § 180.0302 (2003–04); W. VA. CODE ANN. § 31D-3-302 (Michie 2003); WYO. STAT. ANN. § 17-16-302(a) (Michie 2003).

[232] Phillip I. Blumberg, *Corporate Social Responsibility and the Social Crisis*, 50 B.U. L. REV. 157, 172 (1970) (collecting English cases).

bid to maintain corporate control, managers can consider nonshareholder interests and need not treat shareholder interests as "a controlling factor."[233] Because such managers will 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 managers' own profit-sharing incentives. But sometimes takeover bids respond to or result in a management decision to put the corporation up for sale. Then managers 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 corporation is up for sale, the important Delaware Supreme Court opinion in *Revlon* instead concluded:

> The duty of the board had thus *changed* from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly *altered* the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role *changed* from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company. . . . 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.[234]

Likewise, in *Mills Acquisition*, the Delaware Supreme Court stated that managers of a corporation put up for sale who are assessing 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."[235]

To be sure, some of the *Revlon* language suggests that the Delaware Supreme Court thought that normally nonshareholder interests could be considered only when rationally related to share-

[233] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955–56 (Del. 1985). *See also* Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1990); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341–42 (Del. 1987).

[234] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (emphasis added and citations omitted).

[235] Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1988).

holder interests, and was pointing out that such a rational relationship could no longer exist when shareholders were being cashed out. But this language apparently just reflects the incomplete waning of the prior incompletely theorized agreement, for (as shown above) Delaware case law 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 shareholders' financial interests. It thus makes sense to add a special requirement in sale of control cases that any management decision bear a rational relationship to shareholder interests.

Similar language requiring the maximization of shareholder interests does not appear in the Delaware Supreme Court cases about managerial decisions to block takeovers or sales of control. Instead, those cases emphasize the discretion of managers to consider nonshareholder interests without limiting such consideration to effects that indirectly benefit shareholders.[236] One of them even emphasized that "absent a limited set of circumstances as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[237] Moreover, *Revlon* itself repeatedly emphasized that this duty to profit-maximize was a "change" from the normal duty of managers. So have other Delaware Supreme Court cases applying the Revlon duty. They held that only a sale of corporate control or break-up of the corporation triggers "the directors' obligation . . . to seek the best value reasonably available to the stockholders."[238] They have also stated that, outside such a sale of control, managers may base their decisions on the "effect on the various constituencies, particularly the stockholders" but not limited to them, "and any special factors bearing on stockholder and public interests."[239]

Delaware cases have also made clear that, even when a corporation is being sold, it need not simply be sold to the highest bidder. Rather, as *Mills Acquisition* states, management need show only a

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[236] *See Paramount Communications*, 571 A.2d at 1153; *Ivanhoe Partners*, 535 A.2d at 1341–42; *Unocal*, 493 A.2d at 955–56.

[237] *Paramount Communications*, 571 A.2d at 1150.

[238] Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 48 (Del. 1993). *See also* Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985, 1006 (1995).

[239] *Mills Acquisition Co.*, 559 A.2d at 1285 n.35.

rational relationship to shareholder interests. Where some of the bids involve a mix of cash and securities, this allows some consideration of nonshareholder 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 auction was conducted, and 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.[240] 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.[241] 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."[242] The Delaware Supreme Court dismissed an appeal from this judgment, agreeing that "[n]o legal rights have been established here [as the] legal issues presented are being addressed by this Court in *Mills Acquisition* . . . ."[243]

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 discretion of three percent according to the securities' face value. 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. 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. Accordingly, the rejected bid necessarily must have had higher

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240 *See In re* RJR Nabisco, Inc. S'holders Litig., No. 10,389 (Consolidated), 1989 WL 7036, at *1–2, 9–10, 18 (Del Ch. Jan. 31, 1989). 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.* at *8–10.

241 *See id.* at *2, 9, 18.

242 *Id.* at *4 (concluding that where "the bids in hand were substantially equivalent in value" board could accept bid that "had non-financial aspects that permitted a reasonable person to prefer it"). *Accord* Block et al., *supra* note 8, at 812 (citing *In re RJR Nabisco, Inc. Shareholders Litig.* for proposition that "[b]oards conducting an auction . . . may consider the interests of non-shareholder constituencies such as employees in choosing between two 'substantially equivalent' offers for control").

243 *In re* RJR Nabisco, Inc. S'holder's Litig., No. 49, 1989 (Del. Feb. 2, 1989), 1989 WL 16907 (unpublished opinion reported in table at 556 A.2d 1070).

expected value to shareholders. The decision effectively holds that, even in the auction context, management can go beyond considering only those nonshareholder interests that bear a rational relationship to shareholder value. Management can in addition conclude that consideration of nonshareholder interests overrides small differences in shareholder value, amounting to less than one percent 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 sales of corporate control, management still enjoys some degree of discretion to sacrifice shareholder profits to further the interests of other constituencies. Management need only, if it wants to do so, make sure that the winning bid is structured to include some securities whose future value can be claimed to bear some rational relationship to effects on other constituencies. And management may not even need to do that if the difference in price is less than one percent.

However, this degree of discretion still reflects a sharp constriction from the discretion managers normally enjoy to sacrifice corporate profits in the public interest, and the courts seem far more ready to vigorously enforce legal limits in cases involving such a sale of control. 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 normal 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.

B. *The Limit That Profits Must Be Sacrificed to Benefit Others*

Another limitation is that profits must be sacrificed in the public interest rather than to further some private interest. By this I decidedly do *not* mean that courts should determine whether the social goal advanced by managers is truly in the public interest. Judges and juries should not be in the business of deciding whether to sustain a management decision to, say, refrain from clear-cutting based on whether the judge or jury agrees that clear-cutting is contrary to the public interest. They have no neutral standards for judging that sort of issue because, by definition, the issue must lie outside the bounds of legal prohibition. Nor do they have any other basis for second-guessing the views of managers and controlling shareholders. Unlike managers, judges and juries have not been involved in the sort of operational decisions that expose them to the social and moral sanctions that are likely to optimize their behavior. Nor are judges and juries exposed to the market forces that would constrain their decisions. And leaving this issue up to them would make the validity of each corporate decision to sacrifice profits in the public interest turn on the happenstance of which judge and jurors were drawn in after-the-fact litigation, which would be disruptive and fail to provide any guidance for corporate planning.

What I instead mean is that whatever public interest objective that managers cite for the profit sacrifice must involve conferring some general benefits on others, not conferring financial benefits on the managers or their friends and families. Where a corporation does sacrifice profits to financially benefit managers or their intimates, then their decision raises the sort of conflict of interest that vitiates business judgment review.[244] Instead, courts do and should apply the sort of nondeferential review employed under the duty of loyalty, which does actually require profit-maximization. Because managers in these cases have a conflict of interest likely to bias their decisions, even inexpert judicial assessments about profitability are a likely improvement. Further, because limited to cases where managers have such conflicts, such duty of loyalty review does not require ubiquitous management by the courts. Thus, unlike a general duty to profit-maximize, the duty to profit-maximize in conflict of interest cases is one that courts can actually enforce without increasing total agency costs.

Duty of loyalty review can police the sort of transactions that cause many to fear that profit-sacrificing discretion will be abused by managers to benefit themselves and thus increase agency slack. For example, suppose a CEO donated $1 million in corporate funds to a charity on whose board one of the independent directors sits. The CEO does so not because he really believes that charity advances the public interest but because he expects the donation will induce the independent director to favor the CEO on salary and job retention.[245] If the discretion to make profit-sacrificing donations permitted such a transaction, one might fear that would increase the ability of managers to divert corporate profits to their own pockets. But the simple solu-

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244 *See supra* Part III. In contrast, a conflict between a manager's desire to further his public interest views and the financial interests of shareholders does not raise a conflict of interest under current law. *Id.* One could imagine calling it a conflict of interest, but that would amount to a general duty to profit-maximize, which would be undesirable for all the reasons discussed above in this Article. Indeed, the major affirmative reason for managerial discretion is precisely to allow social and moral sanctions to encourage conduct that conflicts with shareholders' financial interests.

245 *See* Jayne W. Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem*, 41 N.Y.L. Sch. L. Rev. 1147, 1161–63 (1997); Melvin Aron Eisenberg, *Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure*, 28 Stetson L. Rev. 1, 22–25 (1998).

tion is to note that such a decision raises a conflict of interest problem outside the zone of any discretion to sacrifice profits in the public interest. So, too, does the corporate manager who donates corporate funds to a charity she runs or to an opera house that gives her the best seat in the house. Conflict of interest rules should thus be designed or interpreted in a way that subjects donations to any charity on which any manager sits, or that she or her intimates personally benefit from, to be subject to the same duty of loyalty review that applies to transactions with directors.

To be sure, there are questions about whether duty of loyalty standards are generally too lax, but those are issues that apply equally to nondonative cash or self-dealing transactions with directors. Likewise, while it may be difficult for courts to police subtle reciprocity, that is equally true when no profit-sacrificing donation is made. A CEO unable to make profit-sacrificing donations could instead be sure to select agreeable independent directors who know why they were selected by the CEO for the job, pay them a big salary, or engage in some business dealing that favors them, with the expectation of reciprocal treatment when the "independent" director decides on the CEO's salary. It is thus not clear why one would think the problem is increased by an ability to make profit-sacrificing donations, especially because no matter what the nominal rule was, a director who (by hypothesis) managed to escape duty of loyalty review would always be able to make the same donation by claiming that it might in some conceivable way increase long-run profits.

One might be tempted to have judges also engage in another form of substantive review—determining not whether the public interest view held by managers is correct, but whether it is held by enough other persons to reflect some general social or moral norm. The ALI comments appear to suggest courts should engage in such review when managers decide to sacrifice corporate profits based on ethical principles, with courts sustaining such decisions only when the cited ethical principles are reasonable because they are not "idiosyncratic" or personal to the manager, but "have significant support although less-than-universal acceptance."[246] An influential article by David Engel argued for a similar but tougher standard sustaining corporate social responsibility only when it was based on a clear broad social "consensus."[247]

Such review would help redress the concern that managers might be in a different social milieu than most people, and thus be subjected

[246] PRINCIPLES, *supra* note 46, § 2.01 cmt. h.
[247] Engel, *supra* note 44, at 4, 27–34.

to social and moral sanctions that cause them to behave in ways that most people would not regard as beneficial. Perhaps, for example, managers run in social circles that cause them to weigh the public interest advantages of operas and museums much more heavily than the average person would. If so, one might fear that managerial discretion would be exercised suboptimally to spend excessive corporate resources on operas and museums. Allowing managers to exercise profit-sacrificing discretion only when it furthers public interest views that are widely held by others would help assure that their decisions instead are responsive to social and moral norms that most of us would agree improve behavior.

I doubt, however, that courts can really conduct such a review effectively. To begin with, if they tried to do so, managers would simply camouflage their profit-sacrificing conduct as plausibly profit-enhancing. Courts would not be able to penetrate that camouflage without undermining business judgment rule deference in general.

Even if the profit-sacrificing were blatant, courts would have to determine how many others have to hold a social or moral norm to mean that it really reflects a widespread or consensus view of what conduct is beneficial. Such determinations would be hard to disentangle from judge or jury beliefs about whether the posited norm is substantively correct. Any norm shared by a judge and jury is unlikely to strike them as idiosyncratic, and any norm they don't share will more likely strike them as enjoying a support that is less than significant. The ALI Reporter, for example, concludes that a manager could not change a restaurant to a vegetarian menu because vegetarianism does not reflect a generally held ethical principle.[248] Although vegetarianism could not satisfy a consensus standard, it is not at all clear why vegetarianism is not sufficiently widespread to meet the ALI standard of reasonableness. Certainly, it seems no more idiosyncratic than Mr. Wrigley's passion for daytime baseball.

Further, if judges and juries were required to determine whether a view was sufficiently shared by others, they would not only have to assess the numerator (how many held that view) but also make normatively controversial judgments about what the right denominator should be (out of what relevant set of people). This problem has only been increased by the globalization of markets and shareholders. For example, if a Michigan corporation decided to refrain from a profit-maximizing decision to shift jobs to undeveloped nations based on a norm against outsourcing, should courts determine whether that norm is widespread by examining the views of others in Michigan, the U.S.,

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[248] *See* Eisenberg, *supra* note 163, at 11.

or the world generally? Or should courts just consider the views of those actually affected by the decision, or those who have devoted serious thought to the issue, and if so what constitutes a sufficient effect or serious thought? Any decision about which set of persons should be entitled to set the relevant norm will necessarily reflect views of the merits.

Even if one could overcome these issues, policing this problem cannot really be done effectively unless courts also reviewed the weight given to the public interest consideration. After all, divorced from any offsetting considerations, most public interest propositions would enjoy widespread support and even a consensus. Virtually everyone thinks it better to fund opera and museums than to burn the money, and better not to clear-cut if there were no cost. People mainly differ on how much weight to attach to those benefits, and on that people differ so extensively that courts cannot simply ascertain a single widespread view, let alone a consensus view. Perhaps recognizing this, the ALI in fact does not try to review the "weight" that managers give any ethical consideration.[249] But that seems to deprive the review of any significant constraining effect.

Further, when managers devote corporate resources "to public welfare, humanitarian, educational, and philanthropic purposes," the ALI does not purport to review whether those purposes are shared by a sufficient number of other persons.[250] Perhaps the ALI foresaw that trying to do so would embroil courts in normatively controversial judgments about whether funding, say, religion X, really advanced the public interest in the views of most people. Courts have correctly declined to get involved in such issues.[251] Because just about any ethical decision could instead be reframed as a decision to "devote corporate resources" to some cause (e.g., switching to a vegetarian format could be said to be devoting corporate resources to vegetarianism), this means that the ALI standard really does not effectively review whether managers are exercising their profit-sacrificing discretion to further causes widely viewed to be in the public interest or not.

Even if it were administrable, a standard that really required a social consensus on any social and moral norm would likely be undesirable. After all, many laws do not reflect a consensus but rather a majority (and often minority) view that has prevailed over the view of

249 PRINCIPLES, *supra* note 46, § 2.01 cmt. h.

250 *Id.* § 2.01(b)(3) cmt. i.

251 *See* Kahn v. Sullivan, 594 A.2d 48, 61 n.26 (Del. 1991) (rejecting claim that a corporate donation creating museum "served no social need" on grounds that "reasonable minds could differ" about that issue).

others, yet legal compliance is generally viewed as desirable.[252] The same should be true of social and moral norms that do not reflect a consensus. To assume otherwise is to put a higher burden on social and moral sanctions than on legal sanctions, and thus to bias the conclusion in favor of minimizing the role of the former in favor of the latter. My analysis instead assumes that allowing social and moral norms to influence management decisions is likely to improve corporate conduct because on balance such norms are desirable even without any consensus, or at least they are more desirable than the self-regarding ways in which the inevitable profit-sacrificing discretion of managers would otherwise likely be used.[253]

In short, the only sort of review that courts can and should exercise about the ends for which profits are diverted is to make sure that profits aren't being diverted to the financial gain of managers or their intimates or entities they represent. As long as managers can show that profits are instead being sacrificed for the benefit of others, that should suffice, assuming that the amount of any profit reduction is within reasonable limits given any last-period problems and that any nexus requirement is met for donations. Courts should not review the merits of the other-regarding purpose either in the sense of determining whether the court agrees with it or whether sufficient others in society do. Such bounded managerial discretion to sacrifice profits for other-regarding purposes is desirable because, on balance, allowing social and moral norms to influence management decisions is likely to improve corporate conduct, not because judges and juries can pick and choose which social and moral norms are best.

C. *Limits on Which Fiduciary Relations Allow Unauthorized Profit-Sacrificing*

If corporate managers have discretion to sacrifice corporate profits in the public interest, should that same discretion extend to other fiduciary relations? Should lawyers be able to sacrifice client profits to further public interest objectives? Should your trustee or personal investment manager be able to sacrifice your money to further some public interest objective? Should lower level corporate employees have discretion to give away corporate funds to further the public interest?

252 *See supra* Parts I–II; Elhauge, *supra* note 47, at 2042–43 (defending proposition that democratic choices are generally desirable even when they conflict with many persons' conceptions of public interest).

253 *See supra* Parts I and IV.

My response to all these questions would be "yes" only if (respectively) the client, investor, or corporate CEO has approved the profit-sacrificing conduct. Lawyers and investment managers certainly have no duty to engage in rapacious profit-maximizing conduct even when their client instructs otherwise. And managerial discretion to sacrifice profits in the public interest could not exist unless upper-level management could authorize such conduct by lower-level managers.

On the other hand, my answer would be "no" if no such approval were first obtained. This differs from my answer regarding the profit-sacrificing discretion of managers of public corporations, which I argued above does and should exist even when shareholders have not approved it.[254] The reason for the different answer is that the justifications noted above do not apply to these fiduciary relations. In particular, these cases do not raise the problem of a corporate structure that largely insulates the investor from social or moral sanctions and creates collective action obstacles to acting on any social or moral impulses. Social or moral sanctions for rapacious profit-maximizing conduct can be visited directly on the client as well as on the lawyer, on the investor rather than on his investment manager, or on the CEO rather than on the lower-level manager. As a single actor, the client, investor, or CEO lacks any collective action problem that would make it difficult for him to respond to such social or moral sanctions. Instead, the situation parallels that between a controlling shareholder and lower level managers, where (as I noted above) the lower-level manager should not be able to sacrifice profits in the public interest without some indication of approval by the controlling shareholder who is the best locus of social and moral sanctions.[255] Likewise, in a general partnership where every partner is equally affected by social and moral sanctions, no general partner should be able to sacrifice firm profits without the approval of the other partners. On the other hand, a general partner who runs a limited partnership should be able to sacrifice firm profits in the public interest without the approval of her limited partners because they are likely to be insulated from social and moral sanctions in the same way as shareholders.

Can mutual funds and other investment companies sacrifice profits by deciding to switch their investments away from socially irresponsible corporations to socially responsible ones? The answer would certainly seem to be "yes" when they have obtained investments by accurately advertising their investment philosophy, for then

[254] *See supra* Parts III and IV.B.2.

[255] *See supra* Part IV.B.2.c.

each investor has effectively approved the degree and sort of profit-sacrificing.

But can a normal investment fund that does not advertise its social responsibility also engage in such profit-sacrificing conduct? Arguably yes, on the theory that its investors are more insulated from the social or moral sanctions that might attend investment decisions, and have great collective action problems in acting on any social impulses they feel. However, there is less to gain from such an approach because fund managers will also be relatively insulated from social and moral sanctions given that they are not directly involved in corporate operations. Further, such funds have their own collective action problems because each fund's investments in any particular corporation are limited and thus its investment decisions are unlikely to affect corporate conduct. There is also more to lose from allowing such discretion by investment funds because, unlike corporate managers, it is unlikely that investment fund decisions that are short-term profit-sacrificing will induce goodwill that increases long-term profits or comply with some implicit contract that is ex ante profit-maximizing. Thus, investment funds do not inevitably enjoy the same large degree of latent profit-sacrificing discretion that corporate managers necessarily enjoy.

There is thus good reason to doubt that profit-sacrificing discretion should extend to the investment decisions of investment fund managers who lack investor approval. Even less justifiable would be a discretion to donate investment funds, for investment activities are less likely to involve the sort of social and moral processes that induce special donative impulses, and banning such donations is unlikely to create inefficient substitution effects.

VIII
Mandatory or Default Rule?

The above analysis has shown that, within certain legal limits, managers do and should have discretion to sacrifice corporate profits in the public interest. But to what extent is that legal doctrine a mandatory rule rather than just a default rule from which corporations can opt out with a contrary charter provision?

A. *Opting Out to Increase Profit-Sacrificing Discretion*

Suppose a corporation's initial charter includes a charter provision opting out of the standard legal limits on managers' profit-sacrificing discretion just described in Part VII. It seems clear that such an opt out should be legally permissible. After all, a corporation can clearly opt out by saying it will devote *one hundred percent* of profits to the public interest, for that 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 opt out in its initial charter at any figure between ten and one hundred percent. Because shareholders would have bought their shares with the provision already in place, the price they paid for those shares would reflect any 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 the provision in the initial charter.

The answer might be different if the corporation first sold shares under a charter that did not contain any provision lifting these limits, and then in midstream tried to amend the charter to include such a provision. Such a midstream amendment would presumably be in the interests of the majority of shareholders who approved it, but it would expropriate the investment of other shareholders, who invested based on the default rule that allows only a limited degree of profit-sacrificing. It is true that if shareholders know that the charter can be so amended at any time, their expectations will partly reflect that fact. Still, requiring controlling shareholders to pay off other shareholders for the value their shares held under the old provision would help assure that the change really increased shareholder welfare.[256]

What little law there is on the matter seems consistent with this conclusion. Delaware law generally allows corporate charters to contain "any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . if such provisions are not contrary to the laws of this State."[257] And most states have similar statutes.[258]

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256 *See supra* Part IV.B.1.

257 *See* DEL. CODE ANN. tit. 8, § 102(b)(1) (1974).

258 *See, e.g.*, ALA. CODE 1975 § 37-7-3 (1975); ALASKA STAT. § 10.10.030(a)(5) (Michie 2004); CAL. CORP. CODE § 204 (West 1990); COLO. REV. STAT. ANN. § 7-102-102(2)(b) (2004); CONN. GEN. STAT. ANN. § 33-636(b)(2) (West 1997 & Supp. 2004); IDAHO CODE § 30-1-202(2)(b) (Michie Supp. 2004); 805 ILL. COMP. STAT. ANN. 5/2.10 (West 1993); KAN. STAT. ANN. § 17-6002(b)(1) (1995); MD. CODE ANN., CORPS. & ASS'NS § 2-104(b)(1) (1999); MASS. GEN. LAWS ANN. ch. 156, § 6(h) (West 1992); MICH. COMP. LAWS ANN. § 450.1209 (West 2002); NEV. REV. STAT. 78.037 (2003); N.J. STAT. ANN. § 14A:2-7(1)(f) (2003); N.C. GEN. STAT. § 55-2-02(b)(2) (1990); OKLA. STAT. tit. 18, § 1006(B)(1) (Supp. 1996); R.I. GEN. LAWS § 7-1.2-202(a)(3) (Supp. 2004); S.C. CODE ANN. § 33-2-102 (Law. Co-op. 1990 & Supp. 2004); S.D. CODIFIED LAWS § 47-2-5(9) (Michie 2000); VT. STAT. ANN. tit. 11A, § 2.02(b)(2)(C) (1997); WASH. REV. CODE ANN. § 23B.02.020(5)(e) (West 1994 & Supp. 2004).

That would seem to permit a provision creating a greater power to sacrifice corporate profits in the public interest given that above-normal generosity is presumably not contrary to any other state law. Further, Delaware and forty other states have statutes allowing charter provisions that eliminate any managerial liability in damages for duty of care liability.[259] Where adopted, such charter provisions would seem to eliminate any plausible means of enforcing limits on operational decisions that sacrifice profits in the public interest, especially because injunctive relief is probably unavailable in such cases.[260]

This also likely reflects the common law that would operate in the absence of any statute. While ALI Principle § 2.01 does not itself address whether corporations can opt out of its limits on profit-sacrificing discretion, its Reporter's Note indicates there is "little doubt" such an opt out would be "permissible if agreed to by all the shareholders," and would then bind any subsequent shareholders who obtained those shares knowing about the opt out.[261] It also notes the law is unsettled on whether such an opt out would be permissible if adopted without unanimous shareholder consent.[262] Likewise, the comments to ALI Principle § 6.02 indicate that a charter or bylaw provision committing a corporation to environmental protection or community welfare would, if adopted before the shareholder obtained shares, permit management to sacrifice a greater degree of shareholder profits in blocking takeovers than otherwise would be permitted.[263]

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 their staff.[264] Under the above logic, such provisions should be deemed enforceable even if they required managers to reduce profits by over ten percent—say, by offending key advertisers. More generally, a 1995 study showed that 7.4% of corpo-

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259 *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1974); ALLEN & KRAAKMAN, *supra* note 53, at 255.

260 *See supra* at Part IV.B.1 (explaining why any duty to refrain from operational decisions that sacrifice profits should not be enforceable by injunctive relief); *supra* Part VII.B (noting that where managers or their associates garner personal gains from corporate profit-sacrificing, it is not within the "public interest" as I am using the term). Even with such a provision, managerial decisions to simply give away excessive amounts of corporate assets may be attackable under the doctrine of waste, and there would not be the same obstacle to injunctive relief because the funds could simply be restored to the corporation, with each shareholder using her share of increased wealth as she deems fit.

261 *See* PRINCIPLES, *supra* note 46, § 2.01 Reporter's Note 6.

262 *Id.*

263 *Id.* § 6.02(b)(2) cmt. c(2).

264 *See* BLOCK ET AL., *supra* note 8, at 822 n.1205.

rations had adopted charter provisions allowing directors to consider nonfinancial aspects of mergers,[265] 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 (which authorizes such considerations by common law) or in the majority of states that have enacted corporate constituency statutes authorizing such consideration. Finally, well over ninety percent of Delaware corporations have chosen to adopt charter provisions eliminating manager liability even under the weakly enforced duty of care.[266]

The latter set of opt outs indicates a widespread desire to avoid the possible risk that a court might impose a profit-maximization duty, and suggests that even shareholders desire such an opt out with relatively high frequency. This should not be that surprising. After all, for all the reasons noted above, enforcing a legal duty to profit-maximize would generally *reduce* shareholder welfare. It would reduce shareholder profits by increasing total agency costs because it would inefficiently jettison the business judgment rule, whose protections confer much more benefits to corporations than the costs of profit-sacrificing discretion.[267] It would also reduce expected shareholder profits to the extent that the existence of managerial discretion to engage in *ex post* profit-sacrificing can be ex ante profit-maximizing.[268] Finally, even when managers exercise their discretion to engage in real profit sacrifices, that will still increase shareholder welfare to the extent that managers act as loyal agents for most shareholders.[269] Shareholders thus have good reason to often prefer a charter provision eliminating or reducing the risk that some court will mistakenly enforce a duty to profit-maximize.

B. Opting Out to Eliminate the Discretion to Sacrifice Profits

The analysis that I have just summarized, explaining why a limited degree of profit-sacrificing discretion would generally benefit shareholders, certainly suggests that the legal doctrine conferring that discretion should be at least the legal default rule. And that conclusion seems confirmed by the evidence just recounted that over ninety percent of corporations have chosen to eliminate enforcement of a profit-maximizing duty. In contrast, I am not aware of any evidence that any significant number of corporations has ever attempted to

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265 *Id.* at 823. Corporations in IPOs also generally adopt charter provisions that increase, not decrease, manager discretion to block takeovers. *See supra* note 195.

266 *See* ALLEN & KRAAKMAN, *supra* note 53, at 255.

267 *See supra* Part IV.A.

268 *Id.*

269 *See supra* Part IV.B.1.

adopt a charter provision imposing an enforceable duty to profit-maximize.[270] If the current law giving managers some discretion to sacrifice profits really harmed shareholders, one would have expected at least some corporations to attempt to opt out of that discretion in their charter by adopting such a duty. 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 enforcing such a duty would not, on balance, increase shareholder wealth or welfare. Such unidirectional opt outs support the conclusion that, even if shareholder welfare were our only goal, the default rule should exclude any enforceable duty to profit-maximize.

But should some managerial discretion to sacrifice profits in the public interest be not just the default rule, but a mandatory rule from which corporations cannot legally opt out? Suppose, for example, a corporation did adopt a charter provision specifying that its managers had a duty to make whichever operational decision maximized corporate profits and that the corporation wished to make it an enforceable duty by abrogating any business judgment deference for those managers. Should such a provision be enforceable on the grounds that this corporation must have thought that something about its particular circumstances made such a provision profit-maximizing for it?

Existing law does not appear to have explicitly resolved this question. The conclusion that operational profit-sacrificing discretion is mandatory has statutory support in those states that have corporate constituency statutes. This is clearest in Connecticut because its statute requires that managers "shall" consider nonshareholder interests.[271] Even in the other states with discretionary corporate constituency provisions, such provisions are typically part of a statute stating that managers "shall" discharge their managerial duty in the manner they deem in the best interests of the corporation, which the statute states may include consideration of these nonshareholder interests.[272]

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270 *See* Stout, *supra* note 12, at 1207 (stating that she has "never heard of, much less seen, such a charter provision").

271 CONN. GEN. STAT. ANN. § 33-756(d) (West 1997).

272 *See, e.g.*, FLA. STAT. ANN. § 607.0830 (West 2001); IDAHO CODE §§ 30-1-830, 30-1702 (Michie 1999); IND. CODE ANN. § 23-1-35-1 (Michie 1999); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 1992); MINN. STAT. ANN. § 302A.251 (West 2004); MISS. CODE ANN. § 79-4-8.30 (1999); NEV. REV. STAT. § 78.138(1), (4); N.M. STAT. ANN. § 53-11-35(B), (D) (Michie 2001); N.Y. BUS. CORP. LAW § 717 (McKinney 2003); N.D. CENT. CODE § 10-19.1-50(1), (6) (2001); OHIO REV. CODE ANN. § 1701.59(B), (E) (Anderson 2001); OR. REV. STAT. § 60.357(1), (5) (2003); 15 PA. CONS. STAT. ANN. §§ 512, 515, 1712, 1715 (West 1995); R.I. GEN. LAWS §§ 7-1.2-801, 7-5.2-9 (1999 & Supp. 2004); WYO. STAT. ANN. § 17-16-830 (2003). Other state statutes likewise specify that managers are entitled to consider nonshareholder interests in discharging their "duties" but do not explicitly state that managers "shall" have such a duty. *See* 805 ILL. COMP. STAT. ANN. 5/8.85 (West 1993); WIS.

In most such states, these provisions thus probably preclude a corporate charter that limits managers' ability to consider information the state legislature has deemed relevant to carrying out a mandatory duty. On the other hand, state statutes also generally provide that any managerial power can be limited in the corporate charter unless contrary to law.[273] Whether such statutes would allow corporations to adopt charter provisions eliminating managerial profit-sacrificing discretion may turn on whether courts view such discretion as a "power" that shareholders may properly limit or as an aspect of a corporate "duty" that shareholders cannot properly modify because it reflects public policy.[274] But I could find no case that has ever addressed the issue, most likely because corporations have not attempted to include such charter provisions.

How should this unresolved question of law be answered? The theory developed in this Article provides four reasons to conclude that the legal answer should be that a provision eliminating managers' operational discretion to sacrifice profits would be unenforceable. First, even if the corporation finds it profitable to abrogate the business judgment rule, doing so may be socially inefficient, for it would amount to transferring the burden of management over that corporation to our publicly subsidized judiciary. Judges may thus appropriately decline to enforce any abrogation of the business judgment rule. And without such an abrogation, no such charter provision can really create an enforceable duty to profit-maximize.[275]

Second, after a business is in operation, any power to adopt a charter provision that requires managers to meet a standard of *ex post* profit-maximization would effectively interfere with managerial discretion to profit-sacrifice even when it is ex ante profit-maximizing. The reason is that when an implicit contract or social understanding that is ex ante profit-maximizing requires a later managerial decision that is profit-sacrificing,[276] shareholders would have perverse incentives to renege by amending or reincorporating to add a charter provi-

STAT. ANN. § 180.0827 (2003–04). Pennsylvania does allow opting out of its corporate constituency statute despite such "shall" language. 15 PA. CONS. STAT. ANN. §§ 511(b), 1711(b) (West 1995). Two states require corporations to opt in to their constituency statutes. *See* GA. CODE ANN. § 14-2-202(b)(5) (2003); TENN. CODE ANN. § 48-103-204 (2002).

273 *See* DEL. CODE ANN. tit. 8, §§ 102(b)(1), 141(a) (1974); REVISED MODEL BUS. CORP. ACT §§ 7.32, 8.01(b) (2002); *supra* notes 257–58 and accompanying text. In some states, provisions restricting managerial powers may require unanimous shareholder consent. *See* N.Y. BUS. CORP. LAW § 620(b) (McKinney 2003); MD. CODE ANN., CORPS. & ASS'NS §4-401 (1999).

274 *See* Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952).

275 *See supra* Parts III and IV.A.

276 *See supra* Part IV.A.

sion requiring *ex post* profit-maximization. The prospect of such reneging would itself deter others from engaging in profit-maximizing implicit contracts or social understandings with the corporation. Thus, shareholder profitability would be decreased by a power to adopt such a charter provision.[277] One might think this problem could equally be addressed by making the default rule profit-maximization and allowing corporations to opt out with unamendable charter provisions committing to profit-sacrificing discretion. However, even if the proper social goal were the maximization of shareholder welfare, this last solution seems dubious. It would change the default rule to one that probably would not maximize shareholder welfare for most corporations, and that default rule will wrongly stick to the extent corporate organizers find opting out too costly or do not foresee the need for it. Further, it is hard to see how the corporation could make such a commitment without also prohibiting any acquisition by another corporation that lacks such a provision, which would deter many efficient acquisitions and thus be costly to shareholders.

Third, offers to invest in a corporation with such provisions would present collective action problems for those shareholders who did care about corporate compliance with social and moral norms. Each investor would figure that her individual decision to invest in the corporation would determine whether she received the associated profits, which by hypothesis are higher for a corporation with the provision. At the same time, each investor would also conclude that her individual decision to invest in a corporation having such a provision would not meaningfully affect whether it operated in a way that caused the shareholder social and moral dissatisfaction. Thus investors acting individually would have incentives to invest in corporations having such provisions even when those provisions actually decrease overall shareholder welfare.

Fourth, and most important, such a provision would neutralize social and moral sanctions that exist to optimize corporate conduct and protect the interests of third parties who are not party to the corporate contract and who thus would not have consented to the corporate charter provision. Shareholders would have excess incentives to invest in a corporation with such a provision because their decisions to do so would be relatively insulated from social or moral sanctions. To

[277] This rationale for making such charter provisions unenforceable would not apply if the charter provision requiring *ex post* profit-maximization were in the charter from the outset. Nor would it apply to a provision that required only a showing that the managerial discretion was at least ex ante profit-maximizing. However, the other three rationales described in the text would continue to apply, and in particular the first one would indicate that such a provision could not possibly be made enforceable.

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 that apply to noncorporate businesses, then it should be legally mandatory that those charters allow the free exercise of that discretion. Thus, if corporations ever adopted a charter provision requiring profit-maximization for all operational decisions, it should be held unenforceable on the grounds that some managerial discretion to respond to social and moral considerations is mandatory, and not a mere default rule from which corporations can opt out.

Whether corporations should be able to opt out of the default rule authorizing corporations to make donations is a different matter because these same rationales are either inapplicable or weaker. To begin with, if such a provision simply eliminates all donative power, rather than trying to eliminate only profit-sacrificing donations, then it does seem legally enforceable without placing undo administrative burden on the judiciary. Nor would such a provision likely impede profit-maximizing social reciprocity, both because such reciprocity typically involves operational decisions and because eliminating the donative power would not prevent managers from switching from donative reciprocity to operational reciprocity. A charter provision prohibiting corporate donations at the same time that operational profit-sacrificing discretion existed would, to be sure, still raise problems of inefficient substitution. But that cost would largely be borne by shareholders and thus should already have been factored into the initial decision that such a provision would be profit-maximizing for this particular corporation. Further, in deciding whether to invest in a corporation with donative power, shareholders who have donative impulses do not have the same collective action problems as shareholders who care about the social consequences of operational decisions, for the simple reason that donations require no collective coordination, but operational decisions do.[278]

The problem of shareholder insulation from social and moral processes remains. But the effects of such insulation for conduct and donations are different. When a corporation structures itself in a way that, by eliminating the effect of social and moral sanctions, is likely to cause it to engage in *more* suboptimal behavior that harms third parties, then the state may justifiably bar such a structure in order to protect those third party interests. When a corporation instead structures itself in a way as to minimize the donative impulses its investors would otherwise feel, that may not be desirable, but it is harder for the state

278 *See supra* Part VI.

to justify insisting that shareholders structure their businesses in a way that makes them confer greater donations on others.

Thus, the doctrine authorizing corporations to make donations should be treated not as a mandatory rule, but as a default rule from which corporations can opt out in their charter. The relevant statutes are clearly consistent with this conclusion. In forty-one states, the statute that authorizes corporate donations itself states that this authority can be limited by a contrary charter provision.[279] While this is not true in the other nine states,[280] each of these states generally allows opt outs that limit corporate powers unless they are contrary to law.[281] These latter statutes thus would allow such an opt out unless it were judged to be contrary to the law creating the donative power, which is unlikely because the whole purpose of these sections appears to be to authorize corporations to limit powers like the donative power that corporate statutes would otherwise give corporate managers. While we do not see charter provisions imposing an operational duty to profit-maximize, we do occasionally see proposals to adopt provisions to eliminate the corporate power to make donations,

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[279] *See* Ala. Code § 10-2B-3.02 (1975); Alaska Stat. § 10.06.010 (Michie 2004); Ariz. Rev. Stat. Ann. § 10-302 (West 2004); Ark. Code Ann. § 4-26-204(a)(6) (Michie 2001); Cal. Corp. Code § 207 (West 1990); Colo. Rev. Stat. § 7-103-102 (2004); Conn. Gen. Stat. Ann. § 33-647 (West 1997); Fla. Stat. Ann. § 607.0302 (West 2001); Ga. Code Ann. § 14-2-302 (2003); Haw. Rev. Stat. Ann. § 414-42 (Michie Supp. 2003); Idaho Code § 30-1-302 (Michie 1999); Ind. Code Ann. § 23-1-22-2 (Michie 1999); Iowa Code Ann. § 490.302 (West 1999); Ky. Rev. Stat. Ann. § 271B.3-020 (Michie 2003); Me. Rev. Stat. Ann. tit. 13-C § 302 (West Supp. 2004); Md. Code Ann., Corps. & Ass'ns § 2-103 (1999); Mass. Gen. Laws Ann. ch. 156B, § 9 (West 1992); Mich. Comp. Laws Ann. § 450.1261 (West 2002); Minn. Stat. Ann. § 302A.161 (West 2004); Miss. Code Ann. § 79-4-3.02 (1999); Mont. Code Ann. § 35-1-115 (2003); Neb. Rev. Stat. § 21-2025 (1997); Nev. Rev. Stat. § 78.070 (2003); N.H. Rev. Stat. Ann. § 293-A:3.02 (1999); N.J. Stat. Ann. § 14A:3-4 (West 2003); N.Y. Bus. Corp. Law § 202 (McKinney 2003); N.C. Gen. Stat. § 55-3-02 (1990); N.D. Cent. Code § 10-19.1-26 (2001); Ohio Rev. Code Ann. § 1701.13(D) (Anderson 2001); Or. Rev. Stat. § 60.077(2) (2003); 15 Pa. Cons. Ann. Stat. § 1502(a) (1994); S.C. Code Ann. § 33-3-102 (Law Co-op 1990); Tenn. Code Ann. § 48-13-102 (2002); Tex. Bus. Corp. Act Ann. art. 2.02(A)(14) & (B) (2003 & Supp. 2004–05); Utah Code Ann. § 16-10a-302 (2001); Vt. Stat. Ann. tit. 11A, § 3.02 (1997); Va. Code Ann. § 13.1-627 (Michie 1999); Wash. Rev. Code Ann. § 23B.03.020(2) (West 1994); W. Va. Code Ann. § 31D-3-302 (Michie 1993); Wis. Stat. § 180.0302 (2003–04); Wyo. Stat. Ann. § 17-16-302(a) (Michie 2003).

[280] *See* Del. Code Ann. tit. 8, § 122 (1974); 805 Ill. Comp. Stat. Ann. 5/3.10 (West 1993); Kan. Stat. Ann. § 17-6102 (1995); La. Rev. Stat. Ann. § 12:41 (West 1994); Mo. Rev. Stat. § 351.385 (2000); N.M. Stat. Ann. § 53-11-4 (Michie 2001); Okla. Stat. tit. 18, § 1016 (2001); R.I. Gen. Laws § 7-1.2-302 (Supp. 2004); S.D. Codified Laws § 47-2-58 (Michie 2000).

[281] *See* Del. Code Ann. tit. 8, § 102(b)(1) (1974); 805 Ill. Comp. Stat. Ann. 5/2.10 (West 1993); Kan. Stat. Ann. § 17-6002(b)(1) (1995); La. Rev. Stat. Ann. § 12:24(C)(2) (West 1994); Mo. Rev. Stat. § 351.055(4) (West Supp. 2005); N.M. Stat. Ann. § 53-12-2(B) (Michie 2001); Okla. Stat. Ann. tit. 18, § 1006(B)(1) (West 2001 & Supp. 2004); R.I. Gen. Laws § 7-1.2-202(a)(3) (Supp. 2004); S.D. Codified Laws § 47-2-5(9) (Michie 2000).

though they have not had much success getting shareholder approval.[282]

Conclusion

Managerial discretion to sacrifice corporate profits is both inevitable and affirmatively desirable. It is inevitable because it cannot be disentangled from the discretion managers need to make profit-enhancing corporate decisions. It is affirmatively desirable because it allows social and moral sanctions to optimize corporate conduct.

One cannot of course expect too much from such discretion. Corporate managers may rarely choose to sacrifice profits given product market competition, future job prospects, stock options and other rewards for making corporate profits. It may also be true that shareholders would rarely (or to only a limited degree) allow managers to pursue unprofitable public interest objectives.

But although only a fool designs a system on the assumption that people will be public-spirited, only a cynical fool precludes the possibility. 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 try to restructure corporate duties to *guarantee* that the corporation's sense of social responsibility ends at the law's edge. The answer is not only that such a duty would likely be ineffective or harmful to shareholders, but 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 corporations from the social and moral processes that help regulate non-corporate business activity.

Further, the very factors that mean we cannot expect too much from corporate managers' discretion to engage in profit-sacrificing, public-spirited activity also mean we do not have that much to fear. Nor is there much evidence that managers, with their one percent donation rate, have in fact been excessively generous in exercising corporate discretion.

On the other hand, we should not confuse the fact that corporate profit sacrificing is necessarily limited with the conclusion that it is nonexistent and thus unimportant. Corporate profit sacrificing behavior will necessarily be difficult to spot because it mainly consists of corporations continuing to forgo some opportunities to engage in rapacious conduct that would increase their profits. Indeed, unless there were some change in social or moral sanctions, one would not

282 *See* Blumberg, *supra* note 232, at 177 & n.118.

expect corporate managers to exercise their discretion in a way that changed their conduct or decreased corporate profits because those social and moral sanctions would have already influenced the baseline level of activity. Instead, exercises of this discretion will mainly consist of rapacious profit-increasing behavior that we *don't* see but would see if we really had an enforceable duty to profit-maximize.