January 1988

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Recommended Citation
Leon Getz, Discretion of Corporate Management to Do Good at the Expense of Shareholder Gain--Canadian Corporate Law, 13 Can.-U.S. L.J. 1 (1988)
Available at: http://scholarlycommons.law.case.edu/cuslj/vol13/iss/5
Discretion of Corporate Management To Do Good at the Expense of Shareholder Gain—Canadian Corporate Law

Leon Getz*

The preliminary observation is this: The relationship between the judicial material available on this subject and the speculative writing is totally out of proportion. There are no more than a handful of decisions concerning the extent to which managers may take into account non-investor objectives. In Canada, there is only one case directly dealing with the issue of charitable giving. Throughout the Commonwealth, there are no more than a dozen cases dealing with the subject.

But the material from scholarly reflections and speculative literature on the issues is now enormous. It is prodigious in the United States and while the Anglo-Canadian material may not yet have reached that status, it is certainly substantial. I take that to be significant, that is, the relative infrequency with which the issue has arisen as a matter for decision in English or Canadian courts. I think it is important at the outset to identify the kind of context in which this sort of question might arise, and I want to give you a number of specific contexts.

A number of years ago, Canadian National Railways decided to reorganize its rail system in the prairies. This involved abandoning some local branch lines and, in effect, deprived a number of small prairie communities of their reason for existence. When the railway ceased to stop there, they no longer had any justification for existence. This created a major disruption for these communities, and there was a major outcry about it. That gave rise to a commission of inquiry, which is the Friedman Commission of Inquiry on Railway Run-throughs in Canada. Justice Friedman, a very distinguished member of the Canadian judiciary, dealt with a variety of issues arising out of this proposal of the railway. One of the things he said was this: “They owe an obligation to the community. Something ought to be done about it.”

A second circumstance in which these issues have arisen occurred a number of years ago: Crown Zellerbach decided to close down one of its major pulp plants in British Columbia, in a place called Ocean Falls. The only justification for the entire community of about 5,000 to 7,000 people was the Crown Zellerbach plant. The government moved in and took over the Crown Zellerbach operation and continued to operate it, apparently with success. The government said that this was necessary to preserve employment.

* Freeman & Co. (Vancouver, B.C.)
There is another context. A number of years ago, in the famous Savoy Hotels\(^1\) affair, directors of an English company, who were apprehensive about the prospects of a takeover bid, took defensive measures designed to insulate the company from the possibility of an effective takeover bid, and justified this action in terms of the national interest and the balance of payments. An inspector was appointed, and he reported that it was not a proper matter to be taken into account. Nothing turned on that, but that's what happened.

In Canada, the question of the ownership of our resources has been a lively issue of debate for many years. Relying on the approach taken in the Savoy Hotels case, one might suppose that if a director of a Canadian company were to resist a takeover by an American company on the grounds that it would be contrary to the national interest, he would have some difficulty in defending his action in a court of law. We have foreign investment review legislation which has attempted to deal with this kind of question.

There also exists an altogether different context. A recent English case called Simmonds v. Heffer\(^2\) involved a so-called “company limited by guarantee,” which in our terms would be a non-profit corporation. This company had the delightfully English name of “The League Against Cruel Sports.” The League Against Cruel Sports is set up, aside from the question of its capital structure, in much the same way as any other English company. That is to say, it has a memorandum which defines its purpose. The purpose of the League Against Cruel Sports was to promote animal welfare. In the 1979 general election in England, the Labor Party committed itself through its manifesto to abolish, if elected, stag hunting, deer coursing, and other similar activities.

The League thought that was wonderful. So its directors agreed to make two donations. One for £30,000 and one for £50,000 to the Labor Party. The £30,000 donation was specifically for the purpose of propagating the Labor Party’s commitment to abolishing stag hunting. The £50,000 donation was for the general purposes of the Labor Party. A member of the League challenged this donation. It seems that it is one thing to be against cruel sports, and another to be a socialist against cruel sports. The court held that the donation, which was tied to propagating the objectives of the League, was a proper donation. The general contribution to the Labor Party funds, however, was improper. The analysis which was used was an ultra vires analysis. But the conclusion which was reached on that analysis was an improper use of funds.

Let me point out the variety of these contexts. What was at stake—in the railway run-through situation, in the Ocean Falls situation, and arguably in the foreign investment review situation—was how to formulate a position as a matter of public policy, and what reflection, if any, to

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give to that determination of what public policy is or should be. In *Simmonds v. Heffer*, however, the context was an entirely different one. It was a simple dispute between, in effect, two people, about how funds, to which at least one of them made a claim, were going to be distributed.

Is it possible to devise a formula which provides a workable system of rules—a decent set of standards—which can be applied by somebody as the basis for a system of rights and remedies? To raise the general question whether managers may sacrifice investor interests for non-investor objectives on the whole does not seem to me to be terribly helpful. The question is: For what purpose is one raising that as a matter of inquiry? Then you get into the issue whether it is possible, once you’ve come to a conclusion about these matters, to devise a workable set of rules.

This issue has always arisen in the judicial context as a claim that rights have been infringed upon and obligations breached. That is a very narrow context indeed. It always arises in a court and that is important too, because the material which courts have to deal with, which courts are capable of dealing with, is very limited. All of this is banal, but is not unimportant.

What principles have the courts identified? In understanding the English materials, one has got to bear in mind that the law is complicated and often quite Byzantine. The capacity of corporations, objectives, and powers (express powers and implied powers) are all being worked through in the English case law. I do not think that is any longer of any great significance. I think the essential principles are now clear. As far as Canadian law is concerned, at least, the ultra vires doctrine is irrelevant because Canadian statutes now uniformly provide that corporations have all the powers of a natural person.

What are the relevant principles? It comes down to a matter of direct distribution of duties. The principle is essentially that the power to make charitable contributions, like any other power apparently vested in corporation directors, is one to be exercised bona fide in the best interests of the company as a whole. That is the formula. The application of that formula is one about which it is not possible to say anything very useful at all.

The reason why it is not possible to say anything of use at least on the basis of the Canadian and English authorities, is that in the final analysis two questions are at stake. First, did the directors act in what they thought was the best interest of the company and for the benefit of the company; and second, was their belief in this matter reasonably grounded. That is, as I understand it, the sum and substance of Canadian law on this point.

If you take the issue of charitable contributions, it is permissible for directors to make contributions to charity where it can plausibly be ar-

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argued, applying only legal principles, that there is some possibility of benefit to the corporation. How one determines benefit from charitable contributions I do not know, which is why I assume the courts rely on the tests of bona fides and "the reasonable man test." In the leading English case on this point, Evans v. Brunner, Mond & Co., the company gave a charitable donation to the Imperial College for the training of scientists on grounds, which were accepted by the court, that the cultivation of a scientific attitude of mind would ultimately be of benefit to Imperial Chemical Industries, the donor company.

Now I can think of all kinds of "attitudes of mind" which might ultimately be of benefit to all kinds of companies. What I think is happening is that the courts first of all are extremely reluctant to intervene; and secondly, the issue on balance has not been sufficiently significant to warrant shareholder actions about them. So, where does that leave us? It leaves us in a position that, provided the demonstration of philanthropic commitment on the part of corporations is not so remarkable as to be worth anybody's time to litigate about it, it will not be litigated. Beyond that, if it is litigated, there are no serviceable standards which courts can apply, at least on the basis of the existing authorities, for determining the propriety of these kinds of activities. Bona fides is generally easy to establish in the charitable giving context. Benefit to the company is extremely difficult to establish in the charitable giving context. And so what we end up with is an almost complete and untrammeled license to corporations to pursue the philanthropic instincts of their managers.

Let me tell you a little story in this connection. I happen to be interested in renaissance music, and I prefer to hear it played on renaissance instruments. Now, that's a kind of archaic taste. Not everybody likes listening to a krummhorn and a viola da gamba, particularly in combination. There is a society for renaissance music in the city in which I live, and it survives on corporate charitable contributions. I recently asked the directors of a large corporation if they would make a contribution. They said: "You're a lawyer—tell us whether we're permitted to do so." I said: "On the one hand, and on the other hand, but please give me the money and don't tell anybody about it." I got the money and they did not tell anybody about it. It was quite a substantial amount of money, all things considered. It was, by the way, a machine tool company that gave me the money because one of their directors happens to like krumm-horns, too. I think it reminds him of the factory.

I cannot conceive of any legal justification for what he did. There is no available body of law to justify what he did. It has long been thought that the decision in the Evans case provided this general justification: that whatever is good for the community is, in some form or another,
good for the corporation which operates within it. But I think that *Simmonds v. Heffer*, a rather unusual English case, has thrown a bit of cold water on that. I have some considerable doubts now about the propriety, as a matter of corporate law, of much of what passes for charitable giving. I am not interested in the question of whether it is tax defensible; that’s a separate question in my view. The status of a lot of what passes for political contributions by corporations—direct contributions to the political process—now seems to me to be very much in question as a matter of corporate law.

Which leads me to the question: What next? First, ought we to have a set of rules governing this matter that is any more precise than the existing set of rules? Second, could that set of rules plausibly take the position, or start from the assumption, that anything other than fringe activity by corporations which relates to, or has the result of sacrificing investor objectives, is defensible? My answer to both is no. Number one, I do not think it is possible to have a set of rules which deals with anything more than fringe questions. Number two, I do not think that any set of rules can plausibly warrant the sacrifice of investor interest in any significant way.

As to the first point, I am hard-pressed in the context of a dispute between claims on a common fund (on the part of shareholders, creditors, corporations and their employees) on the one hand, and a vague public interest on the other, to identify a set of criteria which would enable the court to deal with the matter. As to the second question, I am hard-pressed to think of anything that could usefully emerge from a set of “normative rules” which would require corporations to sacrifice investor objectives in the context of either charitable political contributions or general philanthropic or social activities. I do not think that’s the way society works. I am not a political scientist. But I do not believe that we are capable of devising a set of rules which provides workable criteria. And I do not think there is any evidence to suggest that the successful pursuit of social goals is accomplished by corporate management any more efficiently than it is accomplished by a whole variety of other institutions in the community and by a lot of separate individual choices.

The points, then, are the following:

First, Anglo-Canadian law permits marginal non-investor-related activity. The test is: was it done bona fide in the best interest of the company as a whole, that is, bona fide with a view to the economic advantage of the corporation as an entity. There are some fuzzy edges to that formula.

Second, the conventional analysis of these issues in Canada and in England has been a mixture of the capacity analysis and the director duty analysis, but the capacity analysis is, for Canadian purposes, largely

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6 *Simmonds v. Heffer*, supra, note 2 at 298.
irrelevant and for English purposes is in the process of becoming irrelevant.

Third, the test is “benefit.”

Fourth, because the nature of the benefit test is one which largely immunizes it from effective scrutiny—because it is impossible to establish the kinds of relationships involved between a particular form of non-economic activity and the economic benefit of the corporation—the only recourse we have is to what the Americans refer to as the business judgment rule combined with the tests of bona fides and “reasonable man under the circumstances.”

Fifth, I do not believe that it is possible to devise an alternate set of rules, at least not without the complete restructuring of the fundamental assumptions of corporate law, which would permit or encourage the sacrifice of non-investor goals—which would be counter-productive.

And that gives rise to the final question which is, given that there is this activity, and given that the nature of the activity is one for which the existing rules are largely adequate, is there anything else that we ought to be concerned about? I think there is one other thing that we ought to be concerned about: that to the greatest extent this kind of activity (with one conspicuous exception) goes largely unpublicized by corporations. What they are actually up to is not a matter of public record. And they are extremely reluctant to talk about it in many instances.

The question then becomes, do we have an interest in public disclosure of these matters, and if so, how and where? There is now a requirement in England, though I am not sure what the position is in Canada, for publication in financial statements of charitable and political contributions, at least in the aggregate. A recent royal commission in Canada has recommended that there should be disclosure of this information.

The question is: Why? Is it because one wishes shareholders to know what is being done with their money, or is it because one is concerned about a broader set of social and political implications of this kind of activity. In that case, it seems to me that the issue is whether the financial statement mechanism—the shareholder democracy mechanism, the corporate responsibility mechanism within the corporation—is the appropriate vehicle for this.

I do not know the answer to that question. The English rule does not seem to go to the quality of management. And I am not sure that the interest of shareholders extends much beyond the quality of management. Given that the activity is largely peripheral, I wonder whether the appropriate method of disclosure is through the proxy system and the financial statement route, or is it something in the nature of baggage that the corporate law system ought not be forced to bear? I do not know the answer to that question. I go backwards and forwards over it. Maybe it is a problem about public policy formulation, in which case disclosure in conventional forms is not the right way of doing it. I raise it merely as a question.