January 1988

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Kenneth B. Davis Jr.

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Recommended Citation
Kenneth B. Davis Jr., Discretion of Corporate Management to Do Good at the Expense of Shareholder Gain--A Survey of, and Commentary on, the U.S. Corporate Law, 13 Can.-U.S. L.J. 7 (1988)
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Discretion of Corporate Management To Do Good at the Expense of Shareholder Gain—A Survey of, and Commentary on, the U.S. Corporate Law

Kenneth B. Davis, Jr.*

SECTION 1
INTRODUCTION

Although it was rendered relatively early in our experience with the public corporation, the widely cited decision by the Supreme Court of Michigan in Dodge v. Ford Motor Co. has continued for several decades to reflect the mainstream stance of formal American legal doctrine on the freedom of corporate managers to sacrifice shareholder gain in order to further various social welfare objectives. In informing Henry Ford that he did not enjoy unfettered discretion to withhold dividends and forego profits in the interests of reducing the price of the automobile to the consumer, the court stated:

There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his co-directors owe to protesting, minority stockholders. A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

The significance of this quotation lies in the way it succinctly captures both the letter and the reality of management’s obligations under the traditional American position. At one level are the formal constraints imposed by the core principle the court expresses: corporate powers are to be exercised “primarily for the profit of the stockholders”; no other goals, no matter how broad their general community acceptance, may compete. But at the same time the passage, through its recognition of management’s freedom to select the precise means to profit, the

* Professor of Law, University of Wisconsin, Madison, Wisconsin.
2 Throughout this paper, the term “managers” will be used to refer, collectively, to the board of directors and the officers of the corporation.
quotation signals the inherent mushiness of these constraints as applied to real-life fact situations. In the final analysis, considerable altruism may be accomplished under the banner of “enlightened” profit maximization.

At the level of the formal constraints, has much changed in the sixty-seven years since the Dodge case? The bedrock principle of U.S. corporate law remains that maximization of shareholder value is the polestar for managerial decisionmaking. True, over the intervening years, some room for incidental deviation has been formally permitted by the cases and statutes. The state statutes empowering the corporation to make charitable donations provide the most well-established example. But the amount of latitude these cases and statutes really concede is open to some question. While the authorities to date are too sparse to permit meaningful assessment of just how far the corporation may go in improving the world at the expense of its shareholders, it could have been said with confidence, as recently as ten years ago, that little exists to suggest that the level of expenditures contemplated by these express authorizations rises to what an accountant would describe as material in relation to the corporation’s overall financial condition. The recent discussion of management’s discretion to consider the interests of various non-shareholder constituencies in responding to takeover proposals, and the statutes seeking to codify that discretion, have called that conclusion into question. It is possible that these developments may result in a thorough rethinking of management’s role in balancing the financial interests of shareholders against competing social goals, and the prospects of such rethinking have led one respected commentator to describe this as “the golden age of corporate law.” But, at present, the lasting impact of these developments upon the general philosophy of U.S. corporate law remains to be seen.

These recent developments aside, however, it seems that most of the day-to-day game of corporate social responsibility is not being played on the field of the express authorizations. It is the second dimension of the Dodge passage quoted above—the recognition of management’s discretion to determine the best way to accomplish the goal of maximizing

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4 Even by the time of the Dodge case, some courts had begun to uphold the corporation’s power to expend assets or sacrifice profits for philanthropic, humanitarian, or public welfare purposes, but required—at the very minimum—that the objective of the expenditure be incidental and conducive to the purposes for which the corporation was formed. In Dodge, the court acknowledged several of such cases cited by Ford, but distinguished them, stating: “The difference between an incidental humanitarian expenditure of corporate funds for the benefit of employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious.” Id. at 506-07, 170 N.W. at 684.

5 These cases and statutes are discussed infra in section 4.

6 These statutes are discussed infra in subsection 3.3.3.

shareholder value—that realistically makes the greatest contribution to management’s latitude to further noninvestor social goals. The obvious reason for this is that, under the traditional position represented by Dodge, the touchstone for permissible management decisionmaking consists entirely of a subjective, state-of-mind test—was management motivated by the objective of profiting the shareholders?—and there is no practical way to require that management’s true motives for the decision be placed on the record. While it is often possible to make plausible inferences about the underlying motive for a decision from its content, this invokes the image of courts scrutinizing the quality of managerial decisionmaking, which runs hard up against another bedrock principle of American corporate law: the business judgment rule. In this sense it may be said that Mr. Ford’s legal setbacks were due not so much to the substance of what he wanted to do as to the transparency of his motives for wanting to do it. The court observed:

The record, and especially the testimony of Mr. Ford, convinces that he has to some extent the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give. His testimony creates the impression, also, that he thinks the Ford Motor Company has made too much money, has had too large profits, and that although large profits might still be earned, a sharing of them with the public by reducing the price of the output of the company, ought to be undertaken. We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr. Ford, had large influence in determining the policy to be pursued by the Ford Motor Company—the policy which has been herein referred to.  

Where does that leave us? Given the law’s reluctance to look too critically behind a business decision framed in traditional, for-profit terms, any evaluation of management’s latitude to deviate from the straight-and-narrow of profiting shareholders necessarily becomes somewhat artificial if it is confined to those authorities expressly sanctioning such deviation for its own sake. These likely represent but a small fraction of the total universe of corporate generosity. After all, why would corporate counsel cavalierly neglect the opportunity to create a record of all the economic benefits to the corporation of a decision that, in the process, furthers some social objective? As a result, the cases presenting the issue of deviation-for-its-own-sake will typically consist of situations where (i) the prospect of shareholder benefit is so remote that it is not even advanced; (ii) an expression of management’s true motives somehow comes to light (as was apparently the case in Dodge); (iii) the facts

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8 Dodge v. Ford Motor Co., 204 Mich. at 505-06, 170 N.W. at 683-84. Despite that, Mr. Ford still prevailed on some issues. The Michigan Supreme Court upheld the lower court order requiring the company to distribute approximately one-half of its earned surplus to the shareholders as a special dividend, but it declined to interfere with Ford’s proposed expansion of the business and reversed the lower court on this point.
are being used as a test case; or, and probably most frequently (iv) the deviation-for-its-own-sake rationale is advanced only as an add-on to other for-profit rationales, which might be sufficient in and of themselves.

The upshot of all this is that the assessment of management's power to sacrifice shareholder value in the interest of some greater good should properly take the form of two questions. First, to what extent does that power exist, sub rosa, by way of management's capacity to put a for-profit wrapper on a decision truly influenced by altruistic considerations, and then to protect that decision from scrutiny through the business judgment rule? Second, to what extent is this discretion then expanded (or contracted) by openly attributing the decision, in whole or in part, to that true (altruistic) motivation?

Much of the discussion on these points requires either speculation or extensive extrapolation from a very few published decisions. The literature on the general subject of corporate social responsibility is vast, but almost all of it deals exclusively with normative questions. The material on what the law really is, as opposed to what it should be, is quite thin. In addition, the ready availability of the business judgment rule has spared the legal system the need to develop a cohesive position on why managers should be permitted to stray from the confines of profit maximization.

Notwithstanding the general drought of authority on the issues embraced by this paper, an important attempt to articulate the relevant rules was recently made through the American Law Institute's Principles of Corporate Governance project. Part II of that project, which was one of the parts tentatively approved by the full Institute in May 1984, is entitled “The Objective and Conduct of the Business Corporation” and represents the first serious effort to detail the law in this area in a systematic fashion. It consists of a single section, which provides:

§ 2.01. The Objective and Conduct of the Business Corporation

A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain, except that, whether or not corporate profit and shareholder gain are thereby enhanced, the corporation, in the conduct of its business

(a) is obliged, to the same extent as a natural person, to act within the boundaries set by law,


Comparison with present law. Present law on the matters within the scope of § 2.01 [relat- ing to the objective and conduct of the business corporation] cannot be stated with precision, because the case law is evolving and not entirely harmonious, while the statutes cover only some of the relevant issues and leave open significant questions even as to the issues they do cover. However, there is direct or indirect authoritative support for all of the principles embodied in § 2.01.

(b) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and

(c) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes. 11

Extensive reference to this provision, and to the comments and illustrations accompanying it, will be made throughout this paper.

The organization of the balance of this paper is as follows. Section 2 will comment on some aspects of the normative debate over whether corporations should be permitted to give away shareholder value in the pursuit of some social goal. Section 3 will consider management's discretion to pursue nonshareholder interests in the formulation of business and operating policy, both in the name of profit under the business judgment rule and under express statutory and judicial authorization. The section will also consider the limited extent to which management is actually required to subordinate shareholder gain to other objectives. Section 4 will then review the specific setting in which managerial discretion to devote shareholder resources to competing goals has received the most attention by the legislatures and the courts: charitable and philanthropic donations.

SECTION 2

NORMATIVE DEBATE: SHOULD THE CORPORATION BE "RESPONSIBLE"?

"By pursuing his own interest [the individual] frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good."

— Adam Smith
The Wealth of Nations12

2.1 INTRODUCTION

By now, the notion that the business corporation, particularly the large public corporation, may conduct its activities with a view to the public good seems firmly woven into the fabric of public opinion. Against the classical view espoused in the Dodge case in the 1920s, the economic woes of the 1930s brought the very essence of the capitalistic system into question, with the result that the business corporation was called upon to assume some responsibility for the overall financial health

11 A.L.I. Principles—TD#2, supra note 9, § 2.01. For the text of § 2.01 as modified by changes adopted by the A.L.I., see Schwartz, Defining the Corporate Objective: Section 2.01 of the A.L.I.'s Principles, 52 Geo. Wash. L. Rev. 511, 512 n.4 (1984).
of the nation, almost as a matter of self-preservation. Later, the post-war industrial boom period created a margin of corporate affluence that managers were willing to share with constituencies in addition to the shareholders. Thus, a tradition of corporate voluntarism was already well in place when the social and political disquiet of the late 1960s and early 1970s again directed criticism at the public corporation and called for its management to make a social accounting. The arguments on behalf of corporate altruism that have emerged as a result of these events are, no doubt, quite familiar to any reader of this paper.¹³ And over the last roughly fifty years they have come to gain what is by now repeated acceptance by both courts¹⁴ and legislatures.¹⁵

Sometimes these considerations are framed in obligatory terms—"social responsibility." This line of reasoning—which presumably has the large corporation implicitly in mind—has a kind of noblesse oblige cast to it, based on the vastness of the discretionary resources at the corporation's command and the sheer volume of human activity likely affected by whatever business decisions its management happens to make.

Justifications are also premised on the corporation's "enlightened self-interest." Under this heading are activities or expenditures that serve to enhance the health, morale or education of the corporation's work force, the quality of life in the communities where it operates, or simply its general public image; all to the benefit of the corporation over the long-term. Enlightened self-interest reasoning is also employed to support the corporation's undertaking to address, on its own initiative, social problems either caused by its activities (such as environmental pollution) or closely related to them (such as hiring of minorities) in the interests of heading off negative publicity, scrutiny and attacks by powerful interest groups and possible governmental intervention. As has often been pointed out,¹⁶ social responsibility of this genre, if the rationales be taken at face value, does not really call for altruistic sacrifice but rather more astute profit maximization, in the sense of identifying opportunities whose aggregate return to the corporation over a sufficiently expansive time horizon warrants the immediate expenditure. Be that as it may, many of the activities advocated through such reasoning present prospective payoffs whose amounts, given the risky uncertainty attached to their

¹⁵ See, e.g., CAL. CORP. CODE § 207(e) (West 1977); MASS. ANN. LAWS ch. 156 B, § 9(k) (Michie/Law. Co-op 1979); N.Y. BUS. CORP. LAW § 202(a)(12) (McKinney 1986) (all grant the corporation express power to make donations for the public welfare or similar purposes, irrespective of any benefit to the corporation).
realization, raise serious doubt that the project would ever be seriously considered if it were purely a business deal.\textsuperscript{17}

In addition to these arguments, there is the pragmatic recognition that given the overall dominance of the corporate sector, we simply cannot permit the internal logic of corporate law to screen the resources of this sector from appeals to conscience, if we are to retain our preference for decentralized and privately initiated philanthropy. This is evident in the Supreme Court of New Jersey's opinion in the leading case upholding the corporation's power to make philanthropic donations:

Control of economic wealth has passed largely from individual entrepreneurs to dominating corporations, and calls upon the corporations for reasonable philanthropic donations have come to be made with increased public support.

\ldots

When the wealth of the nation was primarily in the hands of individuals they discharged their responsibilities as citizens by donating freely for charitable purposes. With the transfer of most of the wealth to corporate hands and the imposition of heavy burdens of individual taxation, they have been unable to keep pace with increased philanthropic needs. They have therefore, with justification, turned to corporations to assume the modern obligations of good citizenship in the same manner as humans do.\textsuperscript{18}

\subsection*{2.2 The Case Against Corporate Voluntarism}

The notion of the corporation's right to use shareholder resources for the benefit of others seems so well entrenched in our current thinking that most of the serious commentary over the last twenty years assumes the existence of this right as a given. Nonetheless, much—probably the preponderance—of this literature either criticizes the propriety of this right or counsels restraint in its exercise, and as a result reflects a rare coalition between the defenders of pure-form free enterprise on the right and the critics of big business power on the left. The arguments advanced in this literature may be clustered into three groups.

\textsuperscript{17} See, e.g., SEC DIVISION OF CORPORATION FINANCE, STAFF REPORT ON CORPORATE ACCOUNTABILITY, 96th Cong., 2d Sess. 268 (Comm. Print 1980) (quoting hearing witness as saying that the economic impact of the corporation's social performance "is so long range as to be in the real world, negligible"); H. MANNE \& H. WALLICH, supra note 16, at 55 (Wallich lecture) ("'[E]nlightened self-interest' tends to become a catchall phrase for a lot of things that redound to the benefit of the corporation, but which have no basis whatever in a cost-benefit calculation."); Schwartz, supra note 11, at 516 (noting that courts, when justifying managerial decisions based on long-term profits, have not really asked whether discounted present value of those profits exceed present cost).

\textsuperscript{18} A.P. Smith Mfg. Co. v. Barlow, 13 N.J. at 150, 153, 98 A.2d at 584, 585-86, appeal dismissed, 346 U.S. 861 (1953); see also A.L.I. PRINCIPLES—TD\#2, supra note 9, § 2.01 comment i, at 40 (invoking this rationale); Mundheim, \textit{A Comment on the Social Responsibilities of Life Insurance Companies as Investors}, 61 VA. L. REV. 1247, 1256 \& n.23 (1975).
2.2.1 Economic Efficiency

The first group deals with economic efficiency. The foremost social responsibility of business in our market economy, it is argued, is to produce and market desired goods and services in the most efficient and competitive way possible, which in the process will create jobs for labor, markets for suppliers, satisfaction for consumers and profits for the shareholders. By voluntarily holding its prices to sub-market-clearing levels or assuming responsibility for extraneous social programs as a part of its production or overhead costs, the corporation departs from this goal and contributes to an overall misallocation of resources.19

One type of social responsibility that may present an exception to this argument, however, relates to "negative externalities," that is, costs directly resulting from the corporation's operations that are borne by third parties rather than the corporation.20 Environmental pollution is the widely cited example. If, for whatever reason (the state of the substantive law, costs of litigation or some other factor), the corporation bears no financial responsibility for such side effects and therefore does not take them into account in production and pricing decisions, then the true costs of its output are being understated. Production is, in effect, being subsidized and the resulting price is artificially low. Thus, the case may be made that voluntary action by the corporation to "internalize" these costs by either restricting its pollution or compensating the victims—whichever is cheaper to the corporation—will actually enhance rather than distort efficient resource allocation. Critics of this argument have pointed to the practical difficulties involved in the corporation correctly identifying and measuring all of the byproduct costs of its activities21 and to the more fundamental underlying questions such as why free use of the air or water should be deemed in the first instance to be an entitlement of the pollution victims rather than the corporation.22 In addition, there is the overarching issue of whether the decision to invoke this kind of comparative welfare calculus shouldn't properly be left to a public body—court, legislature or administrative agency—that is charged with representing the interests of all parties concerned.23

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19 See, e.g., Rostow, To Whom and for What Ends is Corporate Management Responsible?, in THE CORPORATION IN MODERN SOCIETY 47, 63-67 (E. Mason ed. 1960).
22 See, e.g., Demsetz, supra note 21, at 5; Fischel, The Corporate Governance Movement, 35 VAND. L. REV. 1259, 1270 (1982).
23 See Engel, supra note 16, at 2, 27-85. The legislature always enjoys the power to compel the corporation to internalize some or all of the social costs of its activities by imposing financial penalties upon the underlying conduct. Why, therefore, should corporate managers voluntarily assume responsibility for some social activity when the legislature—the institution entrusted with the basic task of balancing competing social interests and carrying out the public will—has not seen fit to lay
Corporate social responsibility in the form of internalizing positive externalities presents a much more troublesome case from the standpoint of allocative efficiency. Positive externalities represent benefits resulting from corporate expenditures that are conferred on or shared by persons other than the corporation.24 Were an automobile manufacturing corporation to establish an extensive education and training program for the hard-core unemployed, for example, it would participate directly in some of the benefits by having better trained employees, but benefits would redound as well to the employees themselves, their subsequent employers and the general community. In a strictly for-profit decision the corporation would take into account only those benefits it stands to receive itself in determining whether the cost of the program is justified. This will likely lead to an "underinvestment" in job training from a total societal view and, as a result, management might decide (altruistically) to internalize some of these third-party benefits in considering whether to undertake the program. The excess of the costs of the program over its direct benefit to the corporation will then be passed through to consumers in the form of higher car prices and to company shareholders in the form of lower profits. Besides the just-distribution point of why these two groups should be billed for benefits received by others,25 there is the misallocation aspect that the job training program has inflated the costs of producing automobiles. Therefore, at the margin, some persons who would have purchased cars or invested in the company's shares, had the com-

24 For general discussions of the positive externality problem see Baumol, Enlightened Self-Interest and Corporate Philanthropy, in A NEW RATIONALE FOR CORPORATE SOCIAL POLICY 1, 11-18 (1970); H. MANNE & H. WALLICH, supra note 16, at 42 (Wallich lecture); id. at 100-02 (colloquy between Professors Aschheim and Wallich) (all discussing the problem of discerning social consensus and determining the appropriate trade off between shareholder wealth and public good in the absence of legislative guidance). But see Weiss, Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse, 28 UCLA L. REV. 343, 379-81 (1981) (suggesting that corporate managers are better equipped than government regulators to address externalities); cf. C. STONE, supra, at 93-110 (criticizing the adequacy of the law as a complete substitute for corporate-initiated social responsibility).

25 See R. POSNER, ECONOMIC ANALYSIS OF LAW 397 (3d ed. 1986) (fact that consumers bear some costs of corporation's social responsibility represents regressive taxation); Mashaw, Corporate Social Responsibility: Comments on the Legal and Economic Context of a Continuing Debate, 3 YALE L. & POL'Y REV. 114, 122-23 (1984). In response to the point made in the text, it has been argued that the shareholder's interests inevitably extend beyond the narrow economic fate of the particular corporation in which he or she happens to own shares. Accordingly, the shareholder should properly be seen as the owner of a "diversified portfolio" of claims and obligations. In this capacity, the shareholder may well participate in the external benefits produced by the corporation by virtue of his or her other diverse roles such as shareholder in other corporations, consumer of goods and services, taxpayer, breather of the air and so forth. See Wallich & McGowan, Stockholder Interest and the Corporation's Role in Social Policy, in A NEW RATIONALE FOR CORPORATE SOCIAL POLICY 39 (1970).
pany's expenses been limited to the direct costs of doing business, will spend their money on other things.

2.2.2 Corporate Managers as Arbiters of the Social Welfare

The second cluster of criticisms involves the propriety of corporate management assuming the responsibility for social welfare calculations. Two basic questions are raised. The first is one of ability and qualifications: Is there any reason to assume that senior corporate executives, by virtue of their typical backgrounds and experience, will possess the skill and perspective necessary to carry out the role of social policymaker? Even if so, how are the efforts of the diverse corporate managements who choose to assume this policymaking role to be coordinated? With both the choice of goals and the means to achieve them diffused among countless independent corporate decisionmakers, there is a serious risk of not only duplicated but also conflicting efforts.

Second, there are the basic philosophical questions of legitimacy and accountability. Necessarily, the executive's decision to apply corporate resources to the solution of social problems, and the selection of which problems to address, has implications extending beyond the corporation and its shareholders to a variety of other groups within society. Thus, the welfare of these groups is in the hands of a decisionmaker who they had no say in selecting and over whom they have no control. What standards exist to guide the executive in balancing the competing interests of these social groups? And, in the absence of clear-cut standards, shouldn't this task of setting social priorities be reserved to persons who are accountable to all impacted groups through the political process?

In sum, these questions reflect the belief that once the corporate manager steps outside the traditional role of business expert appointed by the shareholders to maximize profits on their behalf, he or she loses—in a

26 See, e.g., Manne, The "Higher Criticism" of the Modern Corporation, 62 Colum. L. Rev. 399, 414 (1962); Tabor, Let Corporation Law Stick to Its Last, in Commentaries on Corporate Governance and Structure 270, 271 (D. Schwartz ed. 1979); see also C. Stone, supra note 23, at 85-86 (discussing and responding to the argument); Fischel, supra note 22, at 1285 (discussing independent directors). But see Andrews, Public Responsibility in the Private Corporation, 20 J. Indus. Econ. 135, 141-42 (1972) (competence to deal with social problems can be developed through education and experience).

27 See Manne, supra note 26, at 416; H. Manne & H. Wallich, supra note 16, at 31 (Manne lecture) (example of corporation's abstention from pollution while others continue to pollute). Cf Mundheim, supra note 18, at 1255-57.

sense, renounces—the basic justifications for being entrusted with vast discretionary power over the corporation's resources in the first place.

2.2.3 Lack of Enforceable Standards

The final concern is the void in control over corporate and managerial conduct that would result from permitting management to freely choose among goals other than shareholder gain. This was the subject of the celebrated Berle-Dodd dialogue, written during the depression years of the 1930s, when the role of the free enterprise system generally was up for debate. Professor Dodd initiated the dialogue in response to a 1931 article by Professor Berle, in which Berle advocated the imposition of trustee-like obligations on corporate managers in transactions affecting shareholder interests. Dodd wrote that, while he was in general sympathy with Berle's attempts to restrict management from diverting the shareholders' profits into its own pockets, he thought it undesirable in so doing to give increased emphasis to the notion that business corporations exist solely to make profits for their shareholders. He added his belief that:

public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function, that this view has already had some effect upon legal theory, and that it is likely to have a greatly increased effect upon the latter in the near future.

In support of his thesis, Dodd cited statements by business leaders and scholars, what he saw as the increased judicial willingness to allow corporate management broad discretion as to what policies best promote the interests of shareholders, and the growth of corporate charitable giving.

Berle replied that Dodd's views represented theory, not practice. He argued that those in control of corporations did not assume responsibility for the community at large and that there was no mechanism for enforcing this responsibility upon them:

Now I submit that you can not abandon emphasis on "the view that business corporations exist for the sole purpose of making profits for their shareholders" until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone

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29 Berle, Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049 (1931); Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932); Berle, For Whom Corporate Managers Are Trustees: A Note, 45 Harv. L. Rev. 1365 (1932); Dodd, Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?, 2 U. Chi. L. Rev. 194 (1935); see also Dodd, Book Review, 9 U. Chi. L. Rev. 538, 546-47 (1942); A. Berle, The 20th Century Capitalist Revolution 169 (1954); Berle, Foreword to The Corporation in Modern Society at xii (E. Mason ed. 1960).
30 Berle, supra note 29, 44 Harv. L. Rev. 1049 (1931).
31 Dodd, supra note 29, 45 Harv. L. Rev. at 1147-48.
32 Id. at 1148.
else. . . . Either you have a system based on individual ownership of property or you do not. If not—and there are at the moment plenty of reasons why capitalism does not seem ideal—it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income is so apportioned and enforced that the community as a whole, or at least the great bulk of it, is properly taken care of. Otherwise the economic power now mobilized and massed under the corporate form, in the hands of a few thousand directors, and the few hundred individuals holding “control” is simply handed over, weakly, to the present administrators with a pious wish that something nice will come out of it all.33

Thus, Berle’s objection to Dodd’s thesis was not a concern for the preservation of the profit-maximization standard per se, but rather the fear that, if “reformed,” it would be replaced by a toothless ideal, with the likely result being simply an expansion of management’s unfettered discretion.34

The absence of enforceable standards raises substantive concerns at two levels. The first is a general socio-economic concern for controls over corporate power. Requiring that each corporate undertaking be profit-motivated, that is that it be rationalized as presenting a positive return on investment greater than the corporation’s cost of capital, and greater than the return available from alternative undertakings, necessarily supplies a key check on any expansion of the large corporations’ general role within society.35

At another level, and more central to the themes of this paper, are the implications for traditional fiduciary law notions of managerial ac-

33 Berle, supra note 29, 45 HARV. L. REV. at 1367-68 (footnote omitted).
34 In a sense, each man ultimately conceded the other’s position. Writing three years later, Dodd held to the view that a doctrine defining the business corporation’s sole function as obtaining maximum profits for its shareholders could not be expected to appeal strongly either to managers as a code of professional ethics or to the community as sound social policy. And, foreseeing the ultimate development of the law, he argued that the time had come for courts, in upholding corporate contributions to charity or provision of employee benefits, to recognize expressly the corporation’s social obligations rather than rely upon the premise that such actions make for greater profits over the long run. Dodd, supra note 29, 2 U. CHI. L. REV. at 206-07 n.30. But he admitted that Berle was correct in observing that no legal principles then existed to compel managers to serve the interests of persons other than investors. Id. at 205-06. Thus, he grudgingly concluded that “[p]rofit-making for absentee owners must be the legal standard by which we measure [managers’] conduct until some other legal standard has been evolved.” Id. at 206.

Berle, on the other hand, admitted many years later that public and legal opinion had come to accept Professor Dodd’s characterization of managerial responsibility. A. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954). As to the implications of this for managerial discretion, he made the somewhat ominous observation that “the only real control which guides or limits [the large, institutional corporations’] economic and social action is the real, though undefined and tacit, philosophy of the men who compose them.” Id. at 180.

35 For a somewhat alarmist view of the threat posed by corporate voluntarism to our pluralistic society, see Levitt, The Dangers of Social Responsibility, HARV. BUS. REV., Sept.-Oct. 1958, at 41, 44-47.
countability. Berle’s concern in his 1932 response to Dodd was that permitting management to be “socially responsible” in the absence of enforceable directives was a one-way street: a net increase in discretion without a matching increase in responsibility, with the result simply that management would have an easier time justifying whatever it chose to do with the shareholders’ money. Thus viewed, the social responsibility debate becomes not one between “society” on one side and “the corporation” (management and shareholders) on the other in a battle over the corporation’s property, but one between management, acting in the name of society, on the one side and the shareholders on the other in a battle over the shareholders’ property.

SECTION 3

SOURCES OF MANAGEMENT’S DISCRETION TO CONSIDER INTERESTS OTHER THAN SHAREHOLDER GAIN IN THE FORMULATION OF BUSINESS AND OPERATING POLICY

This section considers the general principles that govern management’s discretion to take considerations other than shareholder wealth maximization into account in making business and operating decisions. It is divided into three subsections. The first examines management’s discretion to entertain those interests, covertly, in the guise of enlightened profit maximization. The second explores the extent to which the law has evolved, in the days since *Dodge v. Ford Motor Co.*, to permit management to premise its decisions, overtly, on the interests of groups other than its shareholders. Both of these sections deal with what is permissible for management to do, should it choose to do so. The final subsection analyzes when it is mandatory for management to subordinate the enhancement of shareholder gain to other objectives.

3.1 DISCRETION IN THE NAME OF PROFIT AND THE BUSINESS JUDGMENT RULE

3.1.1 Introduction

Perhaps the most candid way to describe the response of U.S. law to the issue of management’s freedom to be socially responsible in the conduct of its business is that the law has found it most convenient to look the other way. By this means, the formal integrity of the proposition that management’s obligation is to maximize value for the shareholders is preserved, while management enjoys considerable de facto power to be altruistic with the shareholders’ money.

Explaining this response, first and foremost, is the recognition that in the large public corporation, decentralization of decisionmaking

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36 See 59 A.L.I. PROC. 429-32 (1982) (comments of Dean David Ruder on accountability concerns raised by section 2.01(c) of A.L.I. Principles of Corporate Governance).
means that many social responsibility decisions do not reach the level of senior management and therefore go unnoticed by the outside world.\textsuperscript{38} Hiring low-skilled ghetto youths over the summer, establishing adult education programs for employees, voluntarily reducing the level of pollution, each of these everyday business decisions may be motivated in part by voluntaristic considerations, but nonetheless go unchallenged because they fail to come to the attention of dissident shareholders or the derivative suit bar unless the corporation itself trumpets them.\textsuperscript{39}

3.1.2 The Business Judgment Rule and Wrigley

The principal legal device for sheltering everyday business decisions, however, is the business judgment rule. As noted in section 1 above, the combination of enlightened self-interest reasoning and the courts' unwillingness to second guess management means that management can typically supply some "for-profit" rationale to bolster its altruism. The courts will then accept this rationale at face value to foreclose further scrutiny.

The case most frequently cited as typifying this deferential attitude of the courts is \textit{Shlensky v. Wrigley},\textsuperscript{40} in which a minority shareholder in the corporation that owned and operated the Chicago Cubs baseball team brought a derivative suit challenging management's failure to install lights at Wrigley Field. Without the lights, the Cubs were required to play all their home games during the day and, therefore, the plaintiff alleged, forgo the greater receipts available from playing games during the week at night.\textsuperscript{41} The plaintiff attributed this policy to the personal preferences of Philip K. Wrigley, president and a director of the corporation and owner of approximately 80\% of its stock. Specifically, the plaintiff alleged that Wrigley resisted installing lights because of his belief that baseball was a daytime sport and his concern over the possible detrimental effect on the predominantly residential neighborhood surrounding the ballpark, and that Wrigley had elevated these considerations over the financial interests of the corporation.\textsuperscript{42}

\textsuperscript{38} Cf. Chirelstein, \textit{Corporate Law Reform}, in \textit{Social Responsibility and the Business Predicament} 41, 52 (J. McKie ed. 1974) (implying that business decisions that involve production techniques, research, marketing or product characteristics are rarely sufficiently visible to invite attack).

\textsuperscript{39} If the corporation does publicize these activities, it then may justify them as motivated in part by the traditional for-profit interests of public relations. See infra note 56 and accompanying text.

\textsuperscript{40} Shlensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968).

\textsuperscript{41} As an indication that during the week, night games were generally viewed as more profitable than day games, the plaintiff alleged that every major league club other than the Cubs scheduled substantially all of its home games at night, except for opening day, weekends and holidays. In addition, the plaintiff alleged that the Cubs weekend attendance figures were similar to those of the Chicago White Sox, but the White Sox weeknight games drew many more patrons than the Cubs weekday games. \textit{Id.} at 175-76, 237 N.E.2d at 777-78.

\textsuperscript{42} \textit{Id.} at 176-77, 237 N.E.2d at 778.
The court, however, held for the defendants and affirmed the dismissal of the complaint. Relying on the business judgment rule, it noted that the directors' motives, as alleged in the complaint, "showed no fraud, illegality or conflict of interest." It reasoned that the motives the plaintiff attributed to Wrigley and the other directors were not necessarily contrary to the best interests of the corporation, in that any deterioration of the neighborhood might affect the willingness of fans to attend the ballpark or the value of the ballpark as real estate. And while the directors' unwillingness to install lights for these reasons might not have been the "correct" decision, correctness of business decisionmaking was not a matter for the courts to assess.

This reasoning led the reporters for the *Principles of Corporate Governance*—willing to call a spade a spade—to cite Shlensky v. Wrigley as evidence that, on occasion, "the courts have in effect conclusively presumed that the utilization [of corporate resources] was for a profit-maximizing purpose, even where the evidence looked the other way." There are, to be sure, certain aspects of the case that may make it sui generis. The first is the 80% stake of the principal shareholder. In corporate law theory, the controlling shareholder's right to self-indulgence ceases when he or she sells one share to an outsider. Thus, the fiduciary obligations imposed on the 99.9% shareholder should be no less rigorous than those of the hired manager with 0.1% of the shares. While this may reflect business reality in the case of outright self-dealing, it is not the way business people—or, for that matter, most minority shareholders—likely think with respect to milder forms of self-indulgence such as the controlling shareholder's personal tastes and preferences as to selection of personnel or matters of business policy. The business judgment rule provides an under-the-table means to reconcile these widely shared expectations with corporate law orthodoxy. Further, the case for managerial self-indulgence based on widely shared expectations is strengthened considerably in a case like *Wrigley* given the nature of the business at issue. Businesses such as professional sports franchises, theat-

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43 Id. at 181, 237 N.E.2d at 780.
44 Id. at 180-81, 237 N.E.2d at 780.
45 A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 reporter's note 2, at 48.
46 This is, in effect, a by-product of the principle that unanimous shareholder consent is required to foreclose judicial review of an alleged waste of corporate assets. See, e.g., Rogers v. Hill, 289 U.S. 582, 591-92 (1933); Saxe v. Brady, 40 Del. Ch. 474, 478, 184 A.2d 602, 605 (1962); Continental Sec. Co. v. Belmont, 206 N.Y. 7, 17-18, 99 N.E. 138, 142 (1912); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 5.02 reporter's note 6, at 55 (Tent. Draft No. 5, 1986) [hereinafter A.L.I. PRINCIPLES—TD#5]. As a result, courts have been liberal in permitting a sole shareholder to deal freely with corporate assets or opportunities, free of traditional fiduciary restrictions. See, e.g., Martin v. Kagan (In re Tufts Elecs., Inc.), 746 F.2d 915, 918 (1st Cir. 1984); Anderson v. Benson, 394 N.W.2d 171, 175 (Minn. Ct. App. 1986).
47 I have written elsewhere about the role of the business judgment rule in sheltering these and other types of "bargained-for opportunism" by managers. See Davis, Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives, 80 NW. U.L. REV. 1, 75-82 (1985).
rical productions, newspapers and radio and television broadcasting offer the persons in control opportunities for nonpecuniary benefits, in the form of pleasure, prestige and influence, that often outweigh profits as a motive for investment.48 At the same time, these businesses by their nature have a distinct form of influence on the community, which makes them in some sense public utilities, with the result that courts may be especially willing to protect longstanding managerial policies, on which the community has come to depend, from the demands of wealth maximization for the benefit of shareholders.49

Finally, events following the Wrigley decision may corroborate the basic wisdom of the "management knows best" premise that underlies the business judgment rule. In June 1981 the Wrigley family sold the Cubs to the corporation that operates the Chicago Tribune. When Tribune Company management then began discussing the possibility of lighting Wrigley Field to accommodate night baseball, both the state of Illinois and the city of Chicago moved quickly to enact legislation to prevent it.50

3.1.3 Business Judgment and Enlightened Self-Interest Generally

The foregoing comments notwithstanding, the Wrigley case reveals the inherent limitations of corporate law's capacity to review managerial decisionmaking in situations where management’s motives are complex and mixed, as they will often be in the case of enlightened self-interest activity. This subsection will consider, in more detail, the hurdles to developing meaningful limits on management’s discretion to pass off voluntarism as enlightened long-term profitmaking, given the mechanics of the business judgment rule.

As a focal point for this analysis, let us consider the formulation of the business judgment rule adopted by the A.L.I. Principles of Corporate Governance, which requires that the decisionmaker “rationally believe[ ]

48 Cf. Demsetz & Lehn, The Structure of Corporate Ownership: Causes and Consequences, 93 J. Pol. Econ. 1155, 1161-62, 1167-68, 1170-71 (1985) (given the greater potential for consumption of firm-specific amenities in professional sports clubs or mass media firms, ownership structure is more concentrated in order to permit owners to take full advantage).

49 See, e.g., Herald Co. v. Seawell, 472 F.2d 1081, 1091, 1094-95, 1097 (10th Cir. 1972) (directors and officers of corporation publishing metropolitan newspaper have obligations to employees and public as well as to shareholders). Consider, for example, the likely response of a New York court to a hypothetical minority shareholder of the Brooklyn Dodgers who, had Walter O’Malley changed his mind in 1958 and decided to keep the team in Brooklyn out of loyalty to its fans, challenged O’Malley’s failure to take advantage of the admittedly higher long-term profitability of the Los Angeles market.

that his business judgment is in the best interests of the corporation."\textsuperscript{51} The reference to the best interests of the corporation implicitly embodies the philosophy of the first clause of section 2.01 of the \textit{Principles} that the corporation conduct its activities "with a view to enhancing corporate profit and shareholder gain."\textsuperscript{52} Thus, under the A.L.I. formulation, the court's review process comes down to a two-step inquiry: Does management subjectively believe that its decision will enhance corporate profit and shareholder gain and is that belief rational?\textsuperscript{53} As the following subsections will explore, both inquiries put severe strains on the institutional competence of the courts.

### 3.1.3.1 The Subjective Belief Component

Often, the only evidence of management's motivation will be what management proclaims it to be, a realization that creates obvious limits on what can be expected from the subjective belief component of the test. Consider, in this regard, an illustration included in the commentary to section 2.01 of the \textit{Principles of Corporate Governance}.\textsuperscript{54} Its facts involve a publicly held corporation engaged in the operation of a chain of small moderately priced restaurants. The holder of a fifty-percent controlling stock interest in the corporation dies, and her stock passes to her grandson, a vegetarian who believes it is improper to eat meat or fish. Because of these beliefs, he converts the restaurants to vegetarian menus, even though "it is admitted that the conversion will reduce [the corporation's] profits on both a long-run and a short-run basis." The illustration concludes that this is in derogation of the corporate-profit and shareholder-gain requirements of section 2.01.\textsuperscript{55}

The critical fact in the illustration is that the grandson "admitted" that he was imposing his personal dietary principles upon the corporation notwithstanding his appreciation of their negative impact on profits. But the future profitability of alternative courses of action is frequently open to debate. Had the grandson instead sought to justify the conversion as a means to take advantage of the significant portion of the dining public who shared his views—customers who would likely be more attracted to a restaurant featuring an exclusively vegetarian menu than one with only one or two vegetarian items—who is to say that this was not his true motivation for the change? In other words, in the absence of "smoking gun" evidence on the point, as contained in the illustration and

\textsuperscript{51} \textit{PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS} § 4.01(c)(3) (Tent. Draft No. 4, 1985) [hereinafter A.L.I. \textit{PRINCIPLES—TD#4}].

\textsuperscript{52} A.L.I. \textit{PRINCIPLES—TD#2}, \textit{supra} note 9, § 2.01.

\textsuperscript{53} See A.L.I. \textit{PRINCIPLES—TD#4}, \textit{supra} note 51, § 4.01(c) comment f, at 67.

\textsuperscript{54} A.L.I. \textit{PRINCIPLES—TD#2}, \textit{supra} note 9, § 2.01 comment b, illustration 13. The illustration is included by the reporters to demonstrate the rule regarding ethical considerations, but indirectly serves the present inquiry as well.

\textsuperscript{55} \textit{Id.} at 38-39.
as apparently existed in the *Dodge v. Ford Motor Co.* case, the subjective motive requirement test will typically be within management’s control.

Further, even if the grandson had made the admission, he might still have an opportunity, if threatened with liability, to recant and place his actions on a for-profit footing. He may, for example, be able to explain away the statement as mere public relations, designed to cull the favor of his prospective vegetarian clientele. He can then argue, ironically, that it was actually more in line with the profit-motivation requirement to publicize his actions in the name of principle than in the name of profit. 56

To generalize from the foregoing observations, we should recognize that the courts’ vulnerabilities on issues of subjective motive has been an important factor in shaping the law’s approach to reviewing fiduciary decisionmaking. 57 It consists of reducing the question to two strong presumptions, which underlie the familiar two-tier scope of review. If management has a pecuniary conflict of interest in the transaction, illicit motivation is, in effect, presumed, and management will be required to carry the burden of proof that the transaction is inherently fair. 58 Absent such a pecuniary stake, the law assumes that management shares a community of interest with the shareholders in the financial welfare of the corporation. Thus, good faith motivation is presumed and the manager’s decision is protected by the business judgment rule.

While corporate law can respond vigorously to the prospect of tainted motivation posed by a visible stake in the transaction, it typically lacks the capacity to detect less tangible forms of inducements. Furthermore the area of corporate voluntarism is rich with the opportunities for these nonpecuniary, or psychic, kinds of benefits. Whether the reward comes in the form of serving on a school’s or foundation’s board of trustees, being invited to the Governor’s office or simply being regarded by one’s peers and family as a concerned and thoughtful business citizen, the personal rewards are undeniably present. Corporate social responsibility may also provide the executive with a means to avoid personal unpleasantry, whether in the form of pressure from charitable and philanthropic organizations to make a contribution, 59 demands from public interest groups or the threat of negative publicity and public crit-

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56 See H. MANNE & H. WALLICH, supra note 16, at 10-12 (Manne lecture); Friedman, supra note 28, at 124.

57 See generally Davis, supra note 47, at 24-25, 42-44.


59 See, e.g., Richards, *Berkshire Hathaway Pleases Shareholders by Letting Them Earmark Corporate Gifts*, Wall St. J., Apr. 26, 1983, at 37, col. 4 (quoting a letter to shareholders by Berkshire Hathaway Corp. chairman Warren E. Buffett as noting that corporate “gifts tend to be based more on who does the asking and how corporate peers are responding than on an objective evaluation of the donee’s activities”).

icism. In all of these cases, the benefits inure to the executive himself or herself, not to the corporation and its shareholders who fund them. For many ambitious or image-conscious senior executives, these kinds of psychic rewards are likely to be at least as important as more conventional forms of compensation. And their existence compromises the validity of presuming that the executives' interests are aligned with the shareholders, simply because he or she has no tangible conflict of interest.

To be sure, opportunities for these kinds of psychic or indirect rewards exist across the scope of managerial activity, not only in the case of social responsibility. But where these subtle conflicts of interest arise out of more mainstream business operations, policing them necessarily comes at the risk of chilling good faith entrepreneurial activity. In other words, we may view the traditional ultra vires doctrine as representing, like the inherent fairness test, an easy-to-administer response to the risk of slippage by courts in discerning management's true motivation. Once an activity is ultra vires, it is prohibited and proof of illicit motive becomes unnecessary. Thus, the determination whether to declare a form of activity ultra vires should turn on a balancing of its business utility against its prospect for giving rise to the kinds of subtle conflicts of interest that are likely to evade detection through judicial review or other mechanisms, such as the market. The law's increased recognition, over the years, of the corporation's enlightened social self-interest is, therefore, only one half of the inquiry, and its implementation necessarily comes at the cost of a greater risk of managerial self-indulgence.

3.1.3.2 The Objective Rationality Component

The objective rationality component of the test is not likely to be a...
source of great restrictiveness either. At what point will the courts be willing to say that no rational person could believe that the potential benefits to the corporation over time justify the cost? Given this standard, actions predicated on the corporation's enlightened self-interest will be particularly immune from attack. If the plaintiff can ever overcome the presumption inherent in the business judgment rule, it is likely to be in the something-for-nothing kind of case, where what the corporation got and what it gave up can both be specifically identified and compared. 65 Where the gain to the corporation takes the form of elusive commodities such as goodwill, public relations, employee morale or the avoidance of governmental regulation, whose value over the years to come is incapable of measurement, any such comparison is necessarily quite speculative. While it may appear doubtful that the stream of benefits to be realized over time exceeds in present value to the corporation the near-term cost, it is at the same time often impossible to say for certain that it will not, given a sufficiently expansive time horizon. And the practical effect of the business judgment rule is that, absent such certainty, management wins.

Given this, many commentators have recognized that insofar as some sort of long-term benefit to the corporation may be cited in almost any instance where management interjects social responsibility considerations into its business and operating policy, the upshot of applying the business judgment rule is to endow management with considerable everyday power to pursue social good as a quasi-corporate objective. 66 In a similar vein, the commentary to section 2.01 of the A.L.I. Principles of Corporate Governance endorses the enlightened self-interest concept and observes that in most cases the kinds of conduct authorized by the three "exceptions"—obedience to the law, pursuit of generally recognized ethical principles and devotion of a reasonable amount of resources to public welfare, humanitarian, educational or philanthropic purposes—could be pursued even under the general directive of corporate profit and shareholder gain. 67

The reluctance of the A.L.I. reporters to speculate on what, if any, realistic limits are embodied in the objective rationality component is neatly revealed by the evolution of one of their illustrations. The initial tentative draft of the Principles, released in 1982, contained a pair of il-

65 An example is the classic case of Litwin v. Allen, 25 N.Y.S.2d 667, 696-700 (Sup. Ct. 1940), where the court held that the directors of a banking corporation breached their duties by causing the corporation to purchase convertible debentures at par and granting the sellers an option to repurchase them at the same price at the end of six months.


67 A.L.I. Principles—TD#2, supra note 9, § 2.01 comment f, at 28-29.
Illustrations involving a publicly held insurance company with annual earnings of approximately $100 million. In the first of the illustrations, its management decides to make 5% of the corporation's loans to finance inner-city projects that do not meet its normal risk standards "based on a belief that the continued health of the insurance industry depends on maintaining the vitality of urban areas in which the industry lends, and that some relaxation of traditional lending standards on the part of major lenders is essential if this vitality is to be maintained." Although this program will reduce profits by an estimated $3 million annually (that is, by 3%), management concludes that the present value of the increased profits over the long-run exceeds this initial reduction, a conclusion which the illustration upholds as consistent with the general economic objective of section 2.01. In the second illustration, however, the inner-city loans are increased to 40% of the corporation's portfolio, and its anticipated reduction in profits is $24 million—certainly an extreme case by any measure. Although management again makes a judgment that the present value of the long-run gain exceeds the cost, the illustration concludes that this decision is beyond the bounds of rationality and therefore (presumably) not protected by the business judgment rule.

During the consideration of this tentative draft by the full Institute in May 1982, however, the reporters' formulation of the business judgment rule came under criticism. District of Columbia attorney Lloyd N. Cutler, who had served as one of the consultants to the reporters, pointed to the second illustration above as an example and argued, notwithstanding its extreme facts, that he "cannot conceive that particular decision lacks a rational basis." Both illustrations were then retained when section 2.01 was again set forth, with minor revisions, as part of Tentative Draft No. 2 in 1984. While the first illustration was unchanged in substance, the facts of the second were revised to state that management made no judgment that the corporation's economic interests would be advanced by the program. As revised, therefore, the illustration was stripped of any pretense of for-profit motivation—no matter how unsound—and thus the decision fails to satisfy even the more basic subjective belief requirement discussed in the previous subsection.

Besides demonstrating the difficulties courts might have in declaring a particular enlightened self-interest calculation to be inherently irrational, even at the extremes, the redrafting of the illustrations also suggests what might be a more realistic form of judicial review in these cases. While the traditional deference of the business judgment rule may make courts unwilling to second guess the wisdom of the tradeoff management makes, it does not foreclose scrutiny of the decisionmaking pro-

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68 PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 2.01 comment e, illustration 5, at 23 (Tent. Draft No. 1, 1982).
69 Id. illustration 6, at 24.
71 A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 comment f, illustration 6, at 32.
cess that led to it. The recent decisions in Smith v. Van Gorkom\textsuperscript{72} and Hanson Trust PLC v. ML SCM Acquisition, Inc.\textsuperscript{73} establish that directors may not claim the protections of the business judgment rule if they have failed to reasonably inform themselves before reaching their decision. Admittedly, both of these decisions involved a board's evaluation of an acquisition offer for the entire company, a context that may be sui generis, but the logic of the analysis potentially applies across the entire universe of managerial decisionmaking.\textsuperscript{74} To be sure, the level of deliberation that is reasonable varies with the matter at issue, and the financial amounts involved in a corporate acquisition serve to warrant, from a simple cost-benefit perspective, more exhaustive board consideration. But from the same cost-benefit perspective, enhanced board or managerial involvement may also be called for as the decision at issue seems less and less plausible on its face, so that the anticipated benefits from additional scrutiny appear more substantial. Accordingly, in the type of case posed by the second illustration, a court may be expected to ask exactly how the insurance company's board came to conclude that the long-term benefits from making 40\% of its loans to inner-city projects warranted the increased risks and what information it obtained and used in reaching this conclusion. Certainly, however—as the commentary to the A.L.I. Principles suggests\textsuperscript{75}—this kind of informational backup will not be required in most cases of enlightened self-interest, just as it is not routinely required for more conventional operating expenditures.\textsuperscript{76} But judicial review of the quality of the decisionmaking process remains potentially available as the most realistic solution, consistent with the business judgment rule, to those extreme cases where the existence of for-profit motivation seems highly suspect but direct proof of an illicit motive is not

\textsuperscript{72}Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (en banc).

\textsuperscript{73}Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986).

\textsuperscript{74}The notion that the availability of the business judgment rule presupposes that the directors have discharged their duty of care to inform themselves adequately is not new to the case law. Various earlier opinions had contained discussions to that effect. See, e.g., Treadway Cos. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980); Evans v. Armour & Co., 241 F. Supp. 705, 713 (E.D. Pa. 1965); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Casey v. Woodruff, 49 N.Y.S.2d 705, 713 (Sup. Ct. 1944). See generally A.L.I. Principles—TD\#4, supra note 31, § 4.01(c)(2) comment e, at 64-66, and reporter's note 3, at 75. In none of these cases was this precondition applied to negate the rule's protection, however, as it was in the Van Gorkom and Hanson Trust cases.

\textsuperscript{75}See A.L.I. Principles—TD\#2, supra note 9, § 2.01 comment f, at 29: "Although the corporate decisionmaker... needs to meet a standard of care in making his decisions, that standard can be satisfied even when, as is often the case, a prospective profit cannot be particularized."

\textsuperscript{76}That courts are not—or at least have not traditionally been—inclined to inquire into the quality of the board's decisionmaking process just because the facts smack of nonprofit motivation is vividly illustrated by Shlensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968). In holding that the directors' failure to install lights at Wrigley Field was protected by the business judgment rule, the court did not discuss what factors, if any, the directors relied upon in adhering to that policy. The language in the opinion suggesting that this policy was not necessarily inconsistent with a for-profit motivation, see supra text accompanying note 40, seems to indicate that the court itself was supplying plausible rationales the directors may have had, rather than evaluating rationales actually advanced by the defendants. See 95 Ill. App. 2d at 180-81, 237 N.E.2d at 780.
available.\textsuperscript{77}

### 3.2 Market Discipline as a Check on Managerial Discretion

One possible response to the concerns raised in the preceding subsection—and it is a response that applies as well to the other topics discussed in this paper, but will be taken up here for convenience—is that notwithstanding the dilution of enforceable legal standards, market forces will operate to restrain executives from deviating too far from the path of profit maximization. This is a principal point that Professor Brickley makes in his paper.\textsuperscript{78} In particular, he lists the market for corporate control, the market for managerial labor, intracorporate monitoring mechanisms and incentive-based management compensation contracts as available control devices. In the cases of the market for corporate control and management compensation arrangements, he cites several empirical studies as support for his conclusions.

It is difficult to quarrel with Professor Brickley’s argument that each of these devices poses some potential for holding managerial discretion in check. The key question, though, is at what point do these devices come into play? The discussion that follows examines this question with respect to the market for corporate control and managerial compensation arrangements, and concludes that, given the level of flexibility conceded by these devices, the issue of legal standards to control managerial discretion retains its importance.

Let us consider first the market for corporate control, together with the product market in which the firm operates. In theory, if the firm’s product market was characterized by perfect competition—and assuming no “economic rents,” that is, special competitive advantages (such as a patent) possessed by the firm but not by its competitors—expending firm resources on social responsibility over the long run would drive the firm out of business. The firm could not increase its prices to recover these extra costs not shared by its competitors, and the resulting reduction in the firm’s return on investment would foreclose its ability to raise new capital.\textsuperscript{79}

\textsuperscript{77} One important implication, however, of using the objective rationality requirement to get at what are, in reality, cases of improper motive is that the plaintiff’s theory of recovery is shifted from bad faith and duty of loyalty to negligence and duty of care. Thus, the directors may be protected from personal liability for their decision in those jurisdictions that have recently enacted statutes limiting, or permitting the shareholders to limit, the liability of directors for ordinary or gross negligence. See, e.g., Del. Code Ann. tit. 8, § 102(b)(7) (1974 & Supp. 1986); Ind. Code Ann. § 23-1-35-1(e) (Burns Supp. 1986); Ohio Rev. Code Ann. § 1701.59 (Anderson Supp. 1987); Act of Nov. 28, 1986, Act No. 1986-145 § 1 (42 P.A. Cons. Stat. § 8364).


But the kinds of markets in which our large, publicly-held corporations do business do not typically exhibit free competition. David Engel has argued that, as the firm's product market becomes less and less competitive, the costs of the firm's social responsibility will be increasingly shifted from its shareholders to its customers, at least so long as the level of social responsibility is directly related to the level of the firm's operations.\[^{80}\] This has implications for the market for corporate control. No doubt at some point the amount of social responsibility expenditures becomes so great that outsiders could take over the firm, put it on a strictly for-profit basis, and reap a net gain for their efforts from the resulting increase in firm value. But given the expenses and the risk of takeover, and the fact that the acquirer does not receive the entire firm-wide gain—only that portion attributable to the share of the equity it purchases—the level of pre-takeover altruism must be quite substantial to make the gamble worthwhile. As a result, management typically enjoys discretionary control over a significant portion of corporate cash flow, which it is free to "waste" without creating a serious risk of takeover.\[^{81}\] And if the firm's market power allows it to pass on much of the costs of social responsibility to its customers or others, this freedom becomes all the greater.\[^{82}\]

Further, as Henry Manne and others have pointed out, by attributing some of his or her conduct to corporate altruism, the executive may attack the propriety of being judged solely on the basis of profits, and thereby subvert any performance evaluation confined to objective standards.\[^{83}\]

With respect to incentive compensation for management—and to a lesser extent this point applies to all of the control devices discussed by Professor Brickley—all that these arrangements can do is impose upon

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\[^{80}\] Engel, \textit{supra} note 16, at 25-26. Professor Mashaw has elaborated upon this point to illustrate how the allocation of the costs of social responsibility among the corporation's shareholders, customers and laborers will depend upon the corporation's relative market power in each of those markets and the nature of the expenditure. \textit{See Mashaw, supra} note 25, at 118-23. The assumption implicitly made throughout most of this paper, though, is that the costs of social responsibility fall upon the shareholders. This should be a harmless simplification. The fiduciary problems posed by management's diverting funds from shareholder wealth to other causes will not ordinarily be affected by whether the shareholders bear 100 cents on the dollar or only 75 cents, with consumers contributing the remaining 25. Where the prospect for such cost reallocation affects the logic of the analysis, however, it will be noted.

\[^{81}\] \textit{See, e.g.}, H. \textsc{Manne} \& H. \textsc{Wallich}, \textit{supra} note 16, at 15-20, 27-28 (Manne lecture).

\[^{82}\] \textit{See Engel, supra} note 16, at 25-26. But this is not to say that social responsibility activities are without cost to management. Under the theoretical view set forth in the text, the "cost" is that the portion of its purely discretionary funds management applies to social responsibility will not be available to provide other pro-management benefits such as excess compensation or perquisites. \textit{See H. \textsc{Manne} \& H. \textsc{Wallich}, supra} note 16, at 20-27 (Manne lecture).

management personally some of the loss associated with any reduction in corporate profits. If management were otherwise indifferent to social responsibility this might suffice to align management's self-interest with that of the profit-seeking shareholders. But as we saw in subsection 3.1.3.1 above, management's motivation is more complicated than that. So long as the psychic gratification it receives from the social responsibility activity remains greater that its pro rata share of the costs—and in the large, publicly-held corporation that share will likely be quite small—such arrangements will not alter management's behavior but simply reduce its net gain.

The limitation on Professor Brickley's theory, therefore, is that the linkage between market forces and managerial discretion is likely to be attenuated, both by competitive slack and the existence of competing managerial benefits. Professor Oliver Williamson has discussed, however, how the transformation of the modern corporation's organizational structure from a unitary (or U-form) to a multidivisional (or M-form) character may work to improve this linkage. Under Williamson's view, the general office of the M-form corporation operates as a small-scale capital market in allocating resources among the divisions. The implication for our purposes is that because the executives responsible for strategic planning are removed from functional and operating responsibilities, their psychic gratification from operating policies that seek to benefit employee, customer or local community interests at the expense of shareholder gain is much diluted, and they should therefore be inclined to monitor divisional performance and budgets with a less distracted eye to profit.

There are some recent developments suggesting that market discipline may be exerting a greater check on management than it has in the past. Among them are the prospect of enhanced foreign competition and the rise in hostile takeover activity. The takeover has a two-fold effect, First, pre-takeover, as noted above, pressures management of prospective target firms to keep profits up. Second, post-takeover, the target becomes a subsidiary of the takeover firm whose management lacks the loyalties to the target's employees and other constituencies that the target's management had previously held. One result may be a fall-off in corporate philanthropy along with other kinds of social volunteerism. For example, a recent study suggests that corporate charitable contributions for

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84 And keep in mind that the relevant costs here are not the total costs of the social responsibility activity in question, only that portion born by the corporation's shareholders rather than its customers and others. See supra note 80 and accompanying text.


86 See, e.g., Deutsch, The Ax Falls on Equal Opportunity, N.Y. Times, Jan. 4, 1987, at F1, col. 2 (describing how increased foreign competition and mergers have caused corporations to cut costs by reducing staff, and the negative effect on affirmative action programs).
1986 will be about 2.5% below those for 1985, which would represent the first decline in sixteen years. 87

3.3 DISCRETION TO CONSIDER, EXPRESSLY, OBJECTIVES OTHER THAN SHAREHOLDER GAIN

As we saw in subsection 3.1.3.1, by virtue of the subjective belief requirement, a decision that may be rational on purely business grounds is nonetheless subject to invalidation if management candidly admits that its motives were other than profit-based. In this sense, management's discretion is considerably narrowed when it chooses to act in the name of nonshareholder objectives. This was the thrust of the vegetarian restaurant illustration. 88 This subsection considers the opposite side of that issue. To what extent may a corporate decision, questionable as a purely business proposition, be nonetheless justified on the basis of other considerations? In other words, may the pursuit of nonshareholder objectives actually add to the scope of management's discretion on questions of operating policy?

The case law on management's authority to consider interests other than shareholder gain in the formulation of operating policy is virtually nonexistent. Nonetheless, the A.L.I. Principles of Corporate Governance has attempted to speculate, on the basis of the authorities that do exist, about management's discretion in this area, and we will use its conclusions as a basis for considering the relevant issues. Under section 2.01 of the Principles, management has the discretion to depart from the general objective of maximizing shareholder value in two instances: (i) It may devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purposes 89 and (ii) it may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business. 90 The first two subsections, below, will take these topics up in turn, and will focus upon the views of the A.L.I. reporters. The third subsection then examines the statutes recently enacted by several states, which expressly authorize directors to consider the interests of corporate constituencies other than the shareholders, and evaluates their potential effect on traditional doctrine.

87 Teltsch, "Drop Seen in Business Donations," N.Y. Times, Nov. 10, 1986, at 27, col. 1. Among the reasons given for the projected decrease were declines in profits, especially among the large oil companies, and the increase in corporate mergers, acquisitions, and restructurings.
88 See supra notes 54-55 and accompanying text.
89 A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01(c).
90 Id. § 2.01(b).
3.3.1 Public Welfare, Humanitarian, Educational and Philanthropic Purposes

Both the comments and the illustrations contained in the Principles make clear that the provision for devoting reasonable resources to public welfare, humanitarian, educational and philanthropic purposes is not confined to money donations to third parties but includes operating decisions as well. The reporters' direct authority for these conclusions is, however, quite thin. Their discussion centers on the statutory and case law involving charitable and similar donations to third parties, but various commentators have questioned whether those authorities should thus be extended, either as a matter of statutory construction or sound policy.

From the policy standpoint, the critical issue is whether the problems of managerial accountability and risk to the shareholders are aggravated by moving beyond conventional third-party donations, and the ready answer would seem to be that they are. Charitable and philanthropic donations necessarily are easily identifiable as such and typically involve a defined dollar commitment, so that both the objects and the scope of management's generosity are clearly displayed. As a result, shareholders can more readily monitor management's conduct and put mechanisms in place to regulate it, as by limiting charitable contributions to a fixed percentage of net income. With socially motivated operating decisions, on the other hand, both the goals and the costs become blended into the corporation's regular, for-profit activities. In a similar vein, Dean Robert Mundheim, writing with particular reference to public-welfare-oriented investments by life insurance companies, has noted that such investments, unlike traditional donations, have a potentially open-ended quality. The company therefore encounters difficulty in es-

91 "The term 'resources,' as used in § 2.01(c), refers not only to money contributions, but also to the provision of skills, manpower, physical facilities, and the like." Id. § 2.01 comment i, at 41.
92 See id. § 2.01 comment i, illustration 21, at 45, discussed infra at text accompanying notes 153-54; see also id. comment i, illustration 22, at 45-46, discussed infra at text accompanying notes 107-08.
93 See id. § 2.01, comment i; see also 61 A.L.I. Proc. 454-55 (1984) (comments by Professor Melvin A. Eisenberg, reporter for A.L.I. Principles—TD#2, supra note 9, § 2.01, stating that keeping a plant in Bedford Stuyvesant, rather than moving it to the South and thereby increasing profits, might be deemed appropriate under § 2.01(c) as a humanitarian purpose); Schwartz, supra note 11, at 517-18, 530-32 (discussing the Bedford-Stuyvesant example).
94 See A.L.I. Principles—TD#2, supra note 9, § 2.01 reporter's notes 2, 4, at 48-49, 50-51. These authorities are discussed in detail infra in subsection 4.1.
95 See Blumberg, supra note 13, at 174, 195-97; see also Engel, supra note 16, at 15.
96 See Mundheim, supra note 18, at 1254.
97 Professor Donald Schwartz has voiced related concerns. Discussing the example of management's decision to retain an uncompetitive plant in a depressed urban area, he has observed that management's decision to bear increased marginal costs, with no prospect of offsetting economic gain, may well be unreasonable under the A.L.I. Principles. In contrast, a program with confined expenditures and some prospect of gain, such as employing and training minority workers would be permissible in his view. See Schwartz, supra note 11, at 517-18, 530-32.
timating its potential loss exposure when deciding to make the commitment, and, once the commitment has been made, may face considerable pressure to invest additional funds to save the project if it flounders. 98

Good arguments can be made from the other side of the fence, though. Shareholders are free to make charitable contributions for themselves. Operating policy and its consequences are, on the other hand, unique to the corporation. 99 In addition, market discipline may supply a stronger check on managerial discretion in the case of operating policy. The costs of the corporation’s social welfare commitments—such as hiring the hard core unemployed, continuing to do business in depressed inner city areas, or utilizing pollution control equipment beyond the legal minimum—will be spread over time and will likely vary directly with its level of production. Thus, unlike the sunk costs of a one-shot charitable contribution, such expenses will become embedded in the firm’s marginal cost structure and thereby stand to influence its production and pricing decisions over time. 100 As a result, management will typically be required to reexamine these costs on an ongoing basis and will face recurring pressures (market and other) to hold them within tolerable bounds. 101

On reflection, therefore, the policy arguments do not appear to point

98 See Mundheim, supra note 18, at 1254. Dean Mundheim notes two additional differences between public-welfare investments and traditional donations. First, such investments often require substantial administrative time. Second, traditional donations are typically confined to organizations that satisfy the requirements for exemption under section 501(c)(3) of the Internal Revenue Code, which thereby provides some external screening, with criteria enacted through the political process, of the eligible beneficiaries of the corporation’s benevolence. Id. This last point is not as forceful as the others, however. Given the breadth of the section 501(c)(3) categories—they include organizations “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international sports competition . . . or for the prevention of cruelty to children or animals,” I.R.C. § 501(c)(3) (1982)—the resulting screen is necessarily of wide mesh. These criteria provide no real assurance that the recipients of the corporation's charity will be limited to organizations with broad-based public or shareholder support.

99 See Mashaw, supra note 25, at 121-22.

100 One consequence may be that a portion of the expenses will be passed on to the corporation's customers, laborers or suppliers, to the extent the corporation enjoys market power in any of those markets. See supra note 80 and accompanying text.

101 True, the very altruism that led the corporation to make the social welfare commitments in the first place could also cause managers to (in effect) subsidize the resulting costs by excising them from their decisionmaking and, as a result, undertaking kinds or levels of production that would be inefficient from a strictly financial point of view. But it is not inconsistent to expect management sometimes to engage in rational profit-maximizing behavior even when the matter at issue involves the corporation’s earlier social welfare commitments. Most basically, the production decision presently under consideration may be within the purview of a middle manager, who is compensated in part on the basis of financial performance, while the social welfare commitment had been made at the board level. In addition, since the decisions are made at different times, there is no assurance that the corporation’s dedication to the social goal will remain constant. Thus, for example, the fact that the corporation had earlier decided to retain its plant in an inner city location does not mean that a manager will subsequently choose to overlook its higher costs when deciding whether to produce a newly designed part there or at a more efficient plant the corporation has recently constructed in the south.
clearly in one way or the other. And one needs to be careful about taking too literal a view of the wording of the state charitable contributions statutes. As we shall see in subsection 4.1. below, these statutes were enacted with the view to confirming the legality of what had become widespread corporate practice, and courts have not tended to read them narrowly. It is plausible that their terms were typically limited to "donations" because such gifts, by their very nature, appear to conflict with the traditional goal of profit maximization in a way that more everyday operating policies, such as keeping a plant open or hiring a minority contractor, do not. Thus, the speculations by the A.L.I. reporters on these points seem sound. Necessarily, there are limits to managerial discretion in these matters—even once the statutory concerns are removed—and we will consider them in connection with the discussion of the recent statutes in subsection 3.3.3 below.

In any event, one area where the courts are likely to be particularly tolerant is conduct in support of a clearly defined governmental policy or program. What distinguishes these cases is that a judgment has been made by a decisionmaker accountable to the political process that the societal benefits of the policy or program warrant the cost of the corporation's contribution. Thus, concerns over the accountability of corporate management are reduced, as managerial discretion is limited to deciding whether to adopt the trade-off already made and endorsed by the governmental decisionmaker rather than fashioning the trade-off on its own initiative. As a result, such conduct, even though expressly premised on nonshareholder considerations, is likely to be protected, for all intents and purposes, by the business judgment rule.

The A.L.I. reporters appear to endorse this view in an illustration involving a computer manufacturer's proposed sales to a North African country. As negotiations were being completed, the U.S. State Department announced that further shipments of high-technology equipment to the country would be prohibited. While the ban would not become effective until after the proposed sale, the State Department

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103 See infra notes 235-46 and accompanying text.

104 See Wetzel & Winokur, supra note 61, at 241 (also reaching this conclusion). The reporters' position is also corroborated, in an indirect way, by the commentary on the recent statutes expressly permitting management to consider nonshareholder interests. As we shall see, these statutes have generally been characterized as simply confirming, not changing, the law. See infra notes 127-28 and accompanying text.

105 The fact that the same trade-off will be applied throughout the affected industry works to assure each individual firm that it will not suffer a competitive disadvantage due to its voluntarism. See Arrow, supra note 61, at 309-10 (discussing the advantages of institutionalizing social responsibility).

106 This point will be refined somewhat in subsection 3.3.3. See infra note 144.

107 A.L.I. Principles—TD#2, supra note 9, § 2.01 comment i, illustration 22, at 45-46.
urged voluntary compliance for pre-effective transactions. Although the corporation's projected earnings from the sale are $6 million—its total annual earnings are $60-$70 million—its management concludes not to sign the contract in view of the strong national policy. The reporters conclude that the decision is reasonable under the circumstances, although the amount of foregone income—10% of annual earnings—is high, and (by implication) a comparable sacrifice in the interests of other social goals might not be reasonable.108

Here, there is some authority to support the reporters' view. For example, in Sylvia Martin Foundation, Inc. v. Swearingen,109 a shareholder challenged Standard Oil Co. of Indiana’s 1965 decision to float a bond issue outside the U.S. in deference to the Johnson Administration's voluntary program for improving the U.S. balance-of-payments.110 The plaintiff alleged that management wasted corporate assets by causing the corporation to pay rates of interest higher than those prevailing in the U.S. markets. The court responded, in dicta—it dismissed the suit on jurisdictional grounds—that were it to reach the merits, it would find the complaint insufficient as a matter of law, in that it challenged the directors' business judgment and policy, which is not open to review "absent an allegation of fraud, personal profit or gain."111 Broad support for the corporation's compliance with governmental policy is also provided by the Model Business Corporation Act, which empowers the corporation

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108 Id. at 46. To be sure, "voluntary" compliance with a governmental program may often be a strictly business decision, motivated by the long-term profit implications of incurring the government’s disfavor. The 1962 confrontation between President Kennedy and U.S. Steel chairman Roger M. Blough over the steel industry's failure to honor the Administration's request to forego a price increase provides a well known example. U.S. Steel rescinded the price increase within a few days, in response to a variety of governmental pressures, including the threats of antitrust investigation and of being bypassed on government contracts and public opinion. See Ruder, supra note 66, at 219-21.

The commentary to the Principles of Corporate Governance indicates that activity in furtherance of governmental policy need not be limited to compliance with a specific program. It may include "activity that, although technically not required by statute, is designed to further the policy underlying a statute, such as activity designed to further policies concerning preservation of the environment or avoidance of discrimination in employment." A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 comment i, at 40. However, when the details of the activity become more a matter of management's own initiation and less a response to a clearly articulated governmental policy, concerns for managerial discretion are greater, and as a result the reasonableness of the resource commitment becomes more of an issue. In contrast to the illustration discussed in the text, for example, would it be reasonable for the corporation to spend 10% of its earnings on pollution control, over and above what it spends on legally mandated measures, simply because environmental protection is the subject of statutory regulation?


110 The court's opinion does not expressly attribute the company's decision to the existence of the voluntary program, but the connection is clear from contemporaneous accounts of the case. The company's vice president and general counsel acknowledged that the decision was "in part in response" to the program, and lawyers for the Commerce Department were concerned about the case's impact on the program. See Holders Unit Sues to Bar Indiana Standard Borrowing Overseas at "Excessive" Rates, Wall St. J., Feb. 8, 1966, at 4, col. 3; see also An Unwelcome Complication, Wall St. J., Feb. 21, 1966, at 14, col. 1 (editorial describing the case and criticizing the Johnson program).

"to transact any lawful business that will aid governmental policy," and similar statutes enacted by a few states.

### 3.3.2 Ethical Considerations

The A.L.I. *Principles of Corporate Governance* also breaks new ground by explicitly recognizing that the board and management may take into account "ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business." Here, the reporters candidly admit that there is very little direct authority to support their position. They argue, however, that it would be anomalous to permit corporations to make charitable donations but to prohibit them from acting ethically and that they believe the provision to be supported by modern corporate practice.

Few would contend that individuals are (or should be) foreclosed from acting ethically simply because they are acting in the capacity of corporate officers or directors. Not only would the everyday act of dealing with corporations be rendered tedious for all of us, but corporations would likely have substantial difficulty recruiting directors, officers and other managers willing to serve under such a regimen.

What is novel about the A.L.I. position is the apparent breadth of what it places under the heading of acceptable ethical considerations. The express requirement is that the ethical consideration at issue be "reasonably regarded as appropriate to the responsible conduct of business."

The illustrations reveal that this is not limited to such...
traditional matters as good faith and candor. Among the permissible exercises of ethics are the performance of a disadvantageous contract, even though a Statute of Frauds defense is available, the purchase of an annuity for a long-term employee who is forced to retire because of injuries sustained in an automobile accident, and the continued operation of an unprofitable plant for three months to cushion the transition of long-time employees who are about to be discharged.

What makes this expansive view of ethical conduct important is the fact that the sacrifice of profits in furtherance of ethical considerations (unlike public welfare or charitable purposes) is not subject to the express requirement of reasonableness. This makes good sense if the issue is confined to the narrow, more traditional, notion of ethics. The ethical prohibitions against a business's deliberately overbilling its clients are not mitigated by the likelihood that such a practice will succeed and generate substantial additional profits. Accordingly, the performance obligations of the business's hired managers do not require them to undertake the practice, no matter how much profit is thereby sacrificed.

What about broader social issues, however? Consider, for example, the current controversy surrounding business investments in South Africa. If the test for acceptable ethics is whether the consideration at issue "reflects a principle that is widely recognized by a significant portion of the community," disinvestment—ceasing to do business in South Africa in the interests of refusing to cooperate with apartheid—should qualify. After all, apartheid is directly at odds with principles at the heart of our constitution. But should courts therefore uphold disinvestment, at all costs, against a charge of waste? Suppose that most of the wealth of family X consists of a minority interest in a U.S. corporation whose principal and longstanding business is the sale of mining equipment in South Africa. Y, who is independently wealthy, inherits a controlling interest in the corporation and, because of his personal abhorrence of apartheid, so would violate the fair expectations of the shareholders as a group, which in turn will depend upon whether the consideration reflects a principle that is widely recognized by a significant portion of the community. Id. § 2.01 comment h, at 37.

119 Id. comment h, illustration 11, at 38.
120 Id. comment i, illustration 14, at 42.
121 Id. illustration 21, at 45.
122 Compare A.L.I. PRINCIPLES—TD#2, supra note 9 § 2.01(b) with id. § 2.01(c); see id. comment i, at 39-40. But see Comment, Corporate Ethics and Corporate Governance: A Critique of the ALI Statement on Corporate Governance Section 2.01(b), 71 CALIF. L. REV. 994, 1000 n.50 (1983) (concluding that section 2.01(b) may impose an implicit reasonableness requirement).
123 A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 comment h, at 37.
124 Cf, e.g., Dobris, Arguments in Favor of Fiduciary Divestment of "South African" Securities, 65 NEB. L. REV. 209, 222-24 (1986); Schwartz, supra note 11, at 515-16, 532. The conclusion in the text would appear particularly to be true in light of the reporters' observation that "principles may emerge over time, and a corporate official should therefore be permitted to take into account emerging ethical principles, reasonably regarded as relevant to the conduct of business, that have significant support although less-than-universal acceptance." A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 comment h, at 37.
causes the corporation to liquidate its South African operations for 30 cents on the dollar.125

Suppose family X brings suit to enjoin the sale on the grounds of waste. To recognize the quite real possibility that a court would grant the injunction is not to say that the law requires unethical conduct or to demean the legitimacy of disinvestment as an ethical act. But conduct by a fiduciary in the name of ethics—just like conduct in the name of philanthropy, compliance with governmental policy or, for that matter, making profits—must be subject to an overriding requirement of reasonableness.126 The nature of the social concern cannot control to the total exclusion of the financial consequences to shareholders, the alternatives available and other underlying circumstances. Presumably, as the economic impact of the ethical consideration becomes more adverse to the shareholders, the more traditional and widely held the consideration must be in order to justify it. The beauty of the fiduciary principle is that it provides the vehicle for weighing all of these considerations on a case-by-case basis. Inevitably, the A.L.I. reporters face an uphill battle when they seek to reduce the totality of these factors to a few black letter principles. Their attempt to bring greater certainty and guidance to these issues is praiseworthy, but some legal judgments may be, by their very nature, beyond ready codification.

3.3.3 The Effect of Recent Statutes

Beginning with Pennsylvania in 1983, several states—principally in the industrial North—have enacted statutes that expressly permit the corporation’s officers and directors to consider the interests of constituencies other than the shareholders, such as employees, customers and the community, in making decisions that may affect them.127 The circumstances surrounding the enactment of at least some of these statutes reveal that a principal motive for their adoption was to clarify the scope of management’s discretion in responding to a hostile acquisition offer.128

125 The hypothetical assumes that the sale results solely from Y’s personal moral beliefs, and not from economic considerations that may be related to the apartheid issue, such as concerns for the stability of the South African business climate or threats of boycott by the corporation’s suppliers or others.

126 See, e.g., MODEL BUSINESS CORP. ACT § 8.30(a)(2), (3) (1984) (requirements that director act with the care an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner he reasonably believes to be in the best interests of the corporation); A.L.I. PRINCIPLES—TD#4, supra note 51, § 4.01(a) (similar).


Nonetheless, with the exception of Missouri, the wording of these statutes extends across the scope of the directors' or the directors' and officers' obligations. This subsection will consider, therefore, what impact these provisions are likely to have on the general principles of managerial discretion to consider nonshareholder interests, as discussed in the two preceding subsections.

The critical difficulty in assessing these statutes is their silence as to the weights to be given the various nonshareholder interests in balancing them against shareholder gain. How should courts respond to the resulting indeterminacy? It seems clear, upon reflection, that the traditional business judgment rule would prove unworkable as the standard governing decisions under the statutes. As we have seen, that rule simply requires that the director or officer "rationally believe[ ]" that his or her business judgment is in the best interests of the corporation.129 When the shareholders are both giving up the quid and getting the quo, a uniform dimension for comparison exists. The issue comes down to the relative dollar values of both sides, and an objective standard of rationality provides meaningful limitations. If, however, the shareholders are giving up the "quid" but someone else is getting the "quo," inter-group welfare comparisons are required, and the subjective preferences of the decisionmaker become critical. Is $1 million in additional profits worth sacrificing one thousand jobs? One hundred jobs? Ten jobs? For such decisions, objective rationality means merely that some rational person somewhere—be it Ralph Nader or Milton Friedman—would believe the trade-off to be in the best interests of the various statutory constituencies, taken as a collective whole.

The inherent slipperiness in such a standard conjures up Professor Berle's concerns about the demise of managerial accountability.130 The potential reordering of traditional shareholder property rights implicit in such a diluted standard of review should require, at the very minimum, a clear legislative acknowledgment that this was what was intended. The very limited legislative history available suggests, however, that the recent statutes were seen as little more than codifications of the already-

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129 A.L.I. PRINCIPLES—TD#4, supra note 51, § 4.01(c)(3) & comment f.

130 See supra notes 33-36 and accompanying text.
held view. And commentary by lawyers within the respective states reinforces this conclusion.

But the existence of some managerial discretion to balance other interests against shareholder value, as confirmed by these recent statutes, cannot be dismissed. It is, after all, entirely consistent with the managerialist view of executive behavior as posited by various scholars and reflects the way big-business leadership has often characterized its mission in statements for public consumption. Consider, for example, the Statement on Corporate Responsibility published by the Business Roundtable in October 1981. Its premises are that “[c]orporations operate within a web of complex, often competing relationships” and that “[c]arefully weighing the impacts of decisions and balancing different constituent interests—in the context of both near-term and long-term effects—must be an integral part of the corporation’s decision-making and managerial process.” The Statement identifies the corporation’s key constituencies as customers, employees, communities, society at large, suppliers and shareholders, and illustrates how the interests of these constituencies may diverge with the “classic example” of management’s decision whether to establish, expand or close a plant:

Balancing the shareholder’s expectations of maximum return against

131 See, e.g., OHIO REV. CODE ANN. § 1701.59 note on 1984 committee report, at 78 (Anderson 1985) (stating committee’s belief that current law permits directors to consider other interests, but statute clarifies and specifies breadth of that discretion); 1983 PA. LEGIS. J.—SENATE 1434 (Dec. 6, 1983) (bill analysis submitted by Senator Fisher describing statute as eliminating any doubt on propriety of considering other interests); telephone interview with William K. Weisenberg, Director of Government Affairs, Ohio State Bar Association (Feb. 5, 1985) (Ohio statute was proposed to confirm position many corporate lawyers assumed to be the case even in the absence of statute).


134 The literature on corporate social responsibility is replete with quotations from business executives describing their role as balancing the interests of multiple constituencies of which the shareholders are merely one. See, e.g., M. HEALD, THE SOCIAL RESPONSIBILITIES OF BUSINESS 97 (1970) (quoting from 1926 speech by Gerald Swope, president of General Electric Co.); B. SHENFIELD, COMPANY BOARDS 12 (1971) (“balancing of interests” is most common explanation of board decisionmaking); Dodd, supra note 29, 45 HARV. L. REV. at 1154-55 (quoting from 1929 speech by Owen D. Young, chairman of General Electric Co.); Mason, The Apologetics of “Managerialism,” 31 J. BUS. 1, 3 (1958) (quoting chairman of Standard Oil Co. of New Jersey); Mundheim, supra note 18, at 1247-48 (quoting from 1971 speech by chief executive officer of Prudential Life Insurance Co. of America). But see Levitt, supra note 35, at 42-44 (dismissing such statements as, for the most part, fashionable public relations); see also Hetherington, supra note 83, at 277-78 (discussing the various purposes served by such statements).


136 Id. at 8.
other priorities is one of the fundamental problems confronting corporate management. The shareholder must receive a good return but the legitimate concerns of other constituencies also must have the appropriate attention.

Striving to reach the appropriate balance, some leading managers have come to believe that the primary role of corporations is to help meet society’s legitimate needs for goods and services and to earn a reasonable return for the shareholders in the process. They are aware that this must be done in a socially acceptable manner. They believe that by giving enlightened consideration to balancing the legitimate claims of all its constituents, a corporation will best serve the interest of its shareholders.137

Similar views had been advanced ten years earlier by another elite business group, the Committee for Economic Development.138

From the perspective of theory, therefore, a key issue is the extent to which the enactment of the recent statutes—whether they are read as making law or simply confirming it—signals the absorption of these managerialist views into modern U.S. corporate law. More specifically, contemporary corporate law has been confronted with two alternative views of the shareholder’s role. The traditional position, and still apparently the mainstream view,139 has of course been that the shareholders are the owners of the corporation and management’s role is simply to run it on their behalf. The alternative view sees the shareholder of the public corporation not as an owner but as the holder of a set of contract-like claims against the corporation.140 Under this view, the shareholder diff-

137 Id. at 9. This passage led former SEC Commissioner Bevis Longstreth to note that the Business Roundtable’s view “comes rather close to the position of Ralph Nader and his colleagues Mark Green and Joel Seligman, authors of Taming the Giant Corporation and promoters of the Corporate Democracy Act of 1980.” Address by Commissioner Longstreth, entitled “Defining the Corporate Objective and Implications for Philanthropy,” delivered to the Financial Executives Institute, North Carolina Area Conference, Hilton Head, S.C., at 3 (May 22, 1982). Other statements by the Business Roundtable have, however, reflected the more traditional view that shareholder interests are paramount. See Statement of the Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 Bus. Law. 2083, 2099-101 (1978).
138 COMMITTEE FOR ECONOMIC DEVELOPMENT, SOCIAL RESPONSIBILITIES OF BUSINESS CORPORATIONS 19-23 (1971). Professor James W. McKie has described this statement as “almost an official manifesto of the managerial view in its current phase of development.” McKie, supra note 133, at 30 n.15.
139 See, e.g., ABA Committee on Corporate Laws, Corporate Director’s Guidebook, 33 Bus. Law. 1591, 1606 (1978); Statement of the Business Roundtable, supra note 137, at 2099-101; A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 comment c (obligations of § 2.01 run to, and may be varied by, the shareholders).
140 This focus upon the realities of the shareholder’s position may be traced to the seminal work of Professors Berle and Means. See A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY bk. II, ch. VIII (1932). Leading examples of this view in the more recent legal literature include Hetherington, supra note 83, at 250-63; Manning, Book Review, 67 YALE L.J. 1477, 1490-94 (1958). This view is also consistent with a recent body of financial economics literature, which views the corporation as the nexus for a set of contracting relationships, with shareholders as merely one of the contracting parties, whose principal contribution is to bear residual risk. See, e.g., Fama & Jensen, Separation of Ownership and Control, 26 J.L. & ECON. 301, 302-04 (1983);
fers from other investors (such as bondholders) in the terms of his claims, but not in the essence of his economic position. Clearly, it is this latter view that seems closer to the direction of the recent statutes. Thus, the task for proponents of the traditional position is to find the means to reconcile the continuing conception of the shareholder as ultimate owner with the reality of management's position—now endorsed by statute—that it should nonetheless be free to balance shareholder gain against competing third-party interests.

In speculating on how this reconciliation might be effected, it is useful to conceive of any legal standard for reviewing managerial conduct as consisting of two essential components. The first is a referent—a hypothetical decisionmaker against whom to test management's decisions. The second is a confidence level—how certain must we be that our hypothetical decisionmaker would (or might) have responded as management actually did, in order to uphold management's decision?

In selecting our hypothetical decisionmaker, the two most obvious candidates are the director and the shareholder. But neither is completely satisfactory. A test predicated on what a reasonably prudent director would have done under similar circumstances has the virtue of coming closest to prevailing formulations of the director's obligation. The problem with extending this orientation to the current issue of trade-offs between shareholder value and the interests of other constituencies, however, is that it selects a decisionmaker who lacks the disciplining perspective supplied by a property interest in what is being given away. This is troublesome both as a matter of fiduciary law, in light of the prospect for psychic rewards and intangible conflicts of interest discussed above, and as a philosophical proposition, as it constitutes management as a kind of self-contained elite, with the mandate to develop its own normative code as to just how altruistic investors ought to be with their savings. In short, it belies the core premise from which this discussion emerged—that shareholders remain the ultimate owners of the corporation.

The ready solution to these concerns is to focus on the average shareholder—shareholders might, under certain circumstances, be willing to sacrifice some of their return in order to stave off significant hard-


141 Other commentators have noted the law's failure to consider which of these two is the appropriate referent in matters of social responsibility. See Brudney, supra note 28, at 641.

142 MODEL BUSINESS CORP. ACT § 8.30(a)(2) (1984) requires the director to act "with the care an ordinarily prudent person in a like position would exercise in similar circumstances." The Official Comment explains: "The phrase 'in a like position' recognizes that the 'care' under consideration is that which would be used by the 'ordinarily prudent person' if he were a director of the particular corporation." 2 MODEL BUSINESS CORP. ACT ANN. 929 (3d ed. 1985). See also A.L.I. PRINCIPLES—TD#4, supra note 51, § 4.01(a); CAL. CORP. CODE § 309(a) (West 1977); N.Y. BUS. CORP. LAW § 717 (McKinney 1986).

143 See supra notes 57-58 and accompanying text.
ship to other corporate constituencies—and to view management simply as the shareholders' agent in implementing their altruism.\textsuperscript{144} This experience is not necessarily relevant to our task, however. The conclusion that the shareholder's management of his or her own affairs is not the appropriate referent for measuring the level of attention the director should devote to the business should not foreclose resort to the tastes and preferences of the average shareholder as the appropriate referent in testing what comes down to a value choice among competing social interests. But if the referent that emerges is the passive investor (whether the individual or the institution) in the publicly-held corporation, the reasonable shareholder standard raises problems as well. Managing any business over time will typically create, in the minds of the manager, some sense of loyalty, responsibility and obligation to the persons and institutions dependent on the business or responsible for its success, including customers, suppliers, employees and the community at large. These "soft commitments" cannot be reduced to formal contract, but they are honored nonetheless. A legal standard that focuses upon the trade-offs that would be made by a shareholder with no personal involvement in the business will likely result in these commitments being ignored. Just as it seems inappropriate to subject the shareholders—because of their status as passive investors—to the personal tastes, preferences and philosophies of the directors, it seems equally inappropriate to permit that status to immunize the shareholders from the subtle commitments that typically accompany running a business.

The solution may be to look to the individual proprietor as the appropriate referent. This has the virtue of accommodating the manager's sense of accrued commitments to various interests in the business, but at the same time requiring that the commitment be of sufficient importance to the hypothetical decisionmaker that he or she would be willing to honor it from his or her own pocket. Looking to the decisions a reasonable proprietor would make thus provides a simple, but quite useful, perspective for preserving managerial accountability in the face of the open-ended recent statutes and for reconciling those statutes with the conception of the shareholder as owner.\textsuperscript{145}

Irrespective of whose tastes and preferences are selected as the appli-

\textsuperscript{144} Adoption of a reasonably prudent shareholder standard might appear to smack of a return to the traditional trust standard, which looks to the level of care an ordinarily prudent person would exercise in dealing with his or her own property, and which U.S. corporate law has generally abandoned as inappropriate for testing the decisions of corporate management. See, e.g., A.L.I. PRINCIPLES–TD\textsuperscript{#4}, supra note 51, § 4.01(a) reporter's note 3, at 30-31; N.Y. BUS. CORP. LAW § 717 note on legislative studies and reports (McKinney 1986); H. BALLANTINE, BALLANTINE ON CORPORATIONS § 63, at 158-59 (rev. ed. 1946); Adkins & Janis, Some Observations on Liabilities of Corporate Directors, 20 BUS. LAW. 817, 819-20 (1965); Dyson, The Director's Liability for Negligence, 40 IND. L.J. 341, 344-45 (1965).

\textsuperscript{145} This reasonable proprietor test is consistent with Professor White's recent argument that the corporation should be conceived not in strictly economic terms but as "a responsible citizen in its economic and other activities." See White, How Should We Talk About Corporations? The Lan-
cable referent, there remains the issue of the required confidence level. The business judgment rule simply represents one alternative form of confidence level—a very low confidence level, to be sure, for it requires merely that some rational decisionmakers (even though only, say, one in ten) might have reached the same decision management did. But the fact that corporate law has been content to require only this level of confidence for conventional, for-profit decisionmaking does not mandate its extension to other activities, such as the decision to consider non-shareholder interests. To do so, as we saw at the outset of this subsection, would be to endow management with virtually unlimited discretion to divert shareholder wealth to any other corporate constituency, no matter who was selected as the appropriate referent. Management need only demonstrate that there might be some rational decisionmaker within the designated category whose particular tastes and preferences would have led him to make a comparable trade-off. Thus, courts will almost certainly require a higher level of confidence for decisions premised on non-shareholder interests, whether under the recent statutes or the general principles discussed in the preceding two subsections. The inquiry should, therefore, be whether a substantial proportion of the hypothetical decisionmakers—say, one in two or one in three—would have been willing to make a comparable trade-off. And, given such an approach by the courts, it is questionable whether the recent statutes will have a significant practical impact on corporate decisionmaking generally. To the extent that the recent limitations on liability enacted by Delaware and other states reveal a climate of concern for the protection

146 Another illustration of the application of different confidence levels depending on the nature of the activity is illustrated by the Supreme Court of Delaware's decision in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), discussed supra at note 72 and accompanying text, and this perspective helps to explain the case's significance. The effect of the opinion was to isolate the board's information gathering and deliberative process as a separate element to be reviewed by the court, and to require (implicitly) a much higher level of confidence, for that element, that a hypothetical decisionmaker would have acted comparably, than has traditionally been required for the substantive decision itself.

147 The recognition that a higher confidence level should apply when nonshareholder interests are being advanced supplies a relatively straightforward device for rationalizing the results in a number of hypotheticals considered above. Thus, upholding the corporation's decision to forego a highly profitable sale to a North African country out of deference to a voluntary government program, see supra notes 107-08 and accompanying text, simply reflects the fact that, in the face of a clearly defined governmental request, a substantial number of rational decisionmakers would have done likewise. And once that threshold is reached, the result is tantamount to that under the business judgment rule. On the other hand, the speculation that a court would enjoin the sale of a close corporation's South African assets for 30 cents on the dollar, see supra notes 123-126 and accompanying text, represents the conclusion that, while some rational decisionmakers might have been led, by their ethical beliefs, to make such a sacrifice, the vast majority would not.

truly afforded by the business judgment rule, we cannot expect directors
and officers to be very aggressive in taking value from the shareholders
when subjected to an even more rigorous standard of review.\textsuperscript{149}

This leads us back to the alternative position, which sees the share-
holder simply as a contract-holder rather than an owner. Because no
shareholder can be expected to purchase a contract that permits manage-
ment to dissipate, at will, his economic rights in the interest of other
corporate constituencies, the task confronted by the adherents to this po-
position is to come up with an alternative source of limitations on manage-
rial discretion to replace the traditional fiduciary duty of single-minded
loyalty to the shareholder-owners. As an analytical approach to this
task, the contract-holder position may be seen as consistent with the
work of the behavioral economists who have characterized managerial
effort as "satisfying"—geared to meeting minimum performance goals—
rather than maximizing.\textsuperscript{150} Corporate law must therefore fill in the im-
licit terms of the shareholder's contract—in terms of a reasonable rate
of return, fair treatment and so forth—by specifying management's mini-
imum performance obligation.\textsuperscript{151} And the most likely determinant of this
obligation will be general business practice, inasmuch as this will typi-
cally shape the expectations of the shareholder upon entering into the
contract. Thus, notwithstanding the difference in their theoretical under-
pinnings, the practical results under the owner and contract-holder views
are likely to converge when it comes to deciding actual cases.

From this perspective, we can see the "reasonable amount of re-
sources" requirement of the A.L.I. \textit{Principles of Corporate Governance}\textsuperscript{152}
as the vehicle for embodying either the owner or contract-holder views.
Consider, in this regard, a pair of illustrations from the \textit{Principles} involv-
ing a publicly-held corporation with assets of $100 million and annual
earnings in the range of $13 to $15 million.\textsuperscript{153} The corporation owns
three profitable aluminum plants and one plastics plant, which is pres-
ently losing $4 million per year and shows no sign of ever becoming prof-
itable. In the first of the illustrations, the corporation sells the plant
property to a real estate developer, but to provide the plant's employees
with an adjustment period prior to its closing, the corporation agrees to
continue to operate the plant for a three month period, at a loss of

\textsuperscript{149} Further, the requirement that the directors or officers act with appropriate diligence in
informing themselves concerning the decision, see supra notes 72-77 and accompanying text, would
presumably apply to actions in furtherance of nonshareholder interests with at least the same rigor
that it applies to more conventional for-profit activity.

\textsuperscript{150} See, e.g., R. Cyert & J. March, \textit{A Behavioral Theory of the Firm} (1963); Simon, \textit{A

\textsuperscript{151} For a recent example along these lines, see Conard, \textit{Theses for a Corporate Reformation},
U.C. Davis L. Rev. 259, 290-91, 295-95 (1986) (arguing that shareholders should be assured a rate
of return comparable to that of other firms in the same industry, but management should otherwise
be free to pursue alternative objectives).

\textsuperscript{152} See A.L.I. \textit{Principles—TD\#2}, supra note 9, \$ 2.01(c).

\textsuperscript{153} \textit{Id.} \$ 2.01 comment i, illustrations 20-21.
$500,000. The reporters uphold this decision as a permissible application of both humanitarian considerations and generally recognized ethical principles. To the extent that this reflects a conclusion that a substantial number of hypothetical decisionmakers would be willing to make a comparable arrangement, we can square this conclusion with the above analysis. In this sense, the recent statutes may be viewed as providing a source of express validation for the A.L.I. reporters' speculations.

In the second illustration, the corporation rejects an offer to sell the plant and decides instead to continue operating the plant indefinitely for the purpose of preserving jobs. The reporters conclude that this decision cannot be justified out of humanitarian considerations, because the resulting losses are unreasonable in relation to the corporation's earnings, or as an application of generally recognized ethical principles, because such principles do not require an employer to make an indefinite sacrifice of more than one-quarter of its profits in the interests of preserving jobs. Would the illustration come out differently under the recent statutes? Again, the answer necessarily turns on confidence levels. No matter which of the alternative referents is selected, some rational decisionmakers within the group would be willing to make the sacrifice. But if the confidence level is set to require that a substantial proportion of the eligible decisionmakers must be willing—and particularly if the rational proprietor or shareholder standard is selected—the corporation's decision must be rejected as extreme. Inasmuch as the vast majority of persons would be unwilling to make a permanent sacrifice of more than one-quarter of their annual return in order to perpetuate present levels of employment, the result becomes the same as that reached by the reporters.

Approaching these issues as a question of confidence levels accommodates a distinction which was likely implicit in the concerns that led to enactment of the statutes, but is not reflected in their text. That is the distinction between foregoing potential gain by preserving the status quo and incurring new loss by changing it. In theory, a dollar of lost profit may be no different from a dollar of additional expense, but corporate executives and other corporate constituencies are likely to think differently. The impetus for the recent statutes was most likely a recognition that the employees, customers and others come to rely over time on the preservation of their relationship with the corporation even though they have no contractual entitlement. Management then, should enjoy considerably broader discretion when it is perpetuating the current level

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154 Id. illustration 21, at 45.
155 Id. illustration 20, at 44-45.
156 Theory and popular sentiment may be reconciled if one phrases the comparison in terms of utility rather than raw dollars, and recognizes diminishing marginal utility of wealth across the relevant range of decisionmaking, an issue which has drawn considerable attention from economists. See, e.g., Friedman & Savage, The Utility Analysis of Choices Involving Risk, 56 J. Pol. Econ. 279 (1948).
of shareholder profits in order to protect the status of other constituencies, rather than reducing profits to confer new benefits on that constituency.\textsuperscript{157} If most business leaders do in fact recognize such a distinction, the confidence level approach supplies the vehicle for grafting it on to the statutes.

As a final comment on these statutes, it has been suggested by one pair of commentators that, as a result of the Pennsylvania statute, non-shareholder constituencies may expect and demand that their interests be considered, and may take action if ignored.\textsuperscript{158} Clearly, reading the statutes to embrace such a mandatory component would involve a severe change in the law, and finds no support in either the language of the statutes or the legislative history.\textsuperscript{159} They simply provide one-way discretion for the board and officers to take into account the enumerated interests, if they choose to do so. Nonetheless, the statutes may supply an indirect source of pressure. Surely, community and employee relations operate as de facto limitations on the scope of managerial discretion, just as markets do. Traditionally, in the public forum, management could justify its decision to close a plant, for example, by explaining that it was required to act in the best interests of its shareholders.\textsuperscript{160} As civic and labor leaders become familiar with the recent statutes, they may readily rebut this justification by noting that the legislature has specifically endorsed management's right to balance the concerns of the community and employees against the prospects of shareholder profit.

3.4 When (If Ever) Is Management Obligated to Pursue Objectives Other Than Shareholder Wealth Maximization?

The final issue is the extent of any affirmative mandate that manage-

\textsuperscript{157} This observation is consistent with the decision in Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919), where the effect of Henry Ford's alleged plan was to improve the status of employees and car buyers rather than to maintain it.


\textsuperscript{159} Cf. e.g., Local 1330, United Steel Workers v. United States Steel Corp., 631 F.2d 1264, 1279-82 (6th Cir. 1980) (community interest did not require U.S. Steel to continue operations in Youngstown, Ohio, once board of directors determined they were unprofitable). An interesting point of comparison here is the U.K. company law, which provides that, in the performance of their functions, the directors are to have regard for "the interests of the company's employees in general, as well as the interests of its members," but then denies the employees any right to enforce this obligation. See Companies Act, 1985, § 309(1), (2).

I have been told that the reason the Ohio statute was amended in 1985 to require that shareholder interests be considered, see OHIO REV. CODE ANN. § 1701.59(D) (Anderson 1985) (amended 1986), was to negate any implication that it was intended as a "plant-closing" statute. Telephone interview with William K. Weisenberg, Director of Government Affairs, Ohio State Bar Association (Feb. 5, 1985).

\textsuperscript{160} Cf. Hetherington, supra note 83, at 272 ("Certainly managements on occasion find their announced role of servant of the shareholders convenient in discussions and disputes with other groups, such as labor unions.").
ment place some concerns above the goal of profit. Here the implications of the analysis are the opposite of those in the preceding subsections, for social responsibility considerations will have a restrictive rather than expansive effect on management's discretion to run the corporation as it sees fit.

Under the A.L.I. Principles of Corporate Governance, the only source of such an affirmative obligation is the requirement that the corporation act within the boundaries set by law, to the same extent as a natural person. The reference to natural persons is apparently intended to embody within the standard various commonly recognized exceptions to the duty to obey the law.

If the Principles are saying simply that the requirement of law obedience applies to corporations as well as natural persons, the point would hardly be worth discussion. But more is intended. A natural person may take a calculated risk to violate the law in the belief that the gains from violation exceed the prospect and penalties for being caught. In the case of corporations, on the other hand, the commentary to the Principles takes the position that compliance with the law is not a proper subject for cost-benefit analysis. As a result, a corporate officer or director who knowingly causes the corporation to violate the law breaches his or her duty of good faith. The fact that the director or officer made a business judgment that the violation was in the best financial interests of the corporation and its shareholders would, therefore, be no defense. Thus, it is improper, for example, for a trucking company's management to instruct its drivers to drive at 75 miles per hour, even when management has concluded, after due investigation, that operating at that speed would increase corporate profits by almost ten percent.

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161 A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01(a).
162 According to the comments, these exceptions include the concept of necessity, if obedience of the law would result in substantial harm to third parties but disobedience would not; the concept of desuetude, where disobedience is condoned by popular morality and by relevant government authorities; open violations of a law for the purpose of testing its validity or interpretation; violations such as breach of contract, where the underlying obligation does not necessarily derive independent support from the norm of law obedience; de minimis violations and isolated circumstances in which it is widely understood that liability is the price that may be paid for noncompliance. Id. comment g, at 33-34; see also id. illustration 9, at 35-36 (Sunday closing law as example of desuetude).
163 Id. comment g, at 32-33.
164 See A.L.I. PRINCIPLES—TD#4, supra note 51, § 4.01(a) comment d, at 21-23. See also Arsh, The Business Judgment Rule Revisited, 8 HOFSTRA L. REV. 93, 129-30 (1979) ("Bad faith may preclude application of the business judgment defense where directors knowingly violate a statute or comparable expression of public policy, even if such a violation is undertaken in the corporation's best interests.").
165 See A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 comment g, illustration 10, at 36. As another illustration of this proposition, Professor Melvin Eisenberg, reporter for this part of the Principles, has discussed the reported SEC investigation of Citibank's violations of European currency laws at its overseas branches. Applying the doctrine discussed in the text, he criticizes the SEC's decision not to bring an enforcement action to the extent that decision was premised on the view, reported by some, that Citibank's decision to violate the laws was a legitimate matter for

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Published by Case Western Reserve University School of Law Scholarly Commons, 1988
While this position would represent the view of many corporate law commentators and practitioners, a careful examination of the case law reveals that the issue may not be as settled as the Principles and commentary make it appear. The reporters rely chiefly upon the opinions in a series of shareholder derivative suits, under New York law, seeking to hold directors or officers liable to the corporation for causing it to engage in unlawful conduct. The most recent, *Miller v. American Telephone & Telegraph Co.*, challenged AT&T's failure to collect a $1.5 million debt owed the company by the Democratic National Party for communications services at the 1968 presidential nominating convention. The complaint alleged that this was a violation of federal election law and sought to compel AT&T to collect the debt and to surcharge AT&T's directors for the amount of the debt plus interest. The district court dismissed the action on the ground that AT&T's collection procedures were within the discretion of the directors, but the Third Circuit reversed. It reasoned that if the issue was simply the failure to pursue a corporate claim, the business judgment rule would protect the directors' exercise of discretion, but where the directors' decision is alleged to be an illegal act, business judgment protection is no longer available.

Had the analysis stopped there, the decision would provide strong support for the position taken by the A.L.I. Principles. But the court added that one of the recognized purposes of the statute at issue was to check the corporation's power to use its funds to benefit political parties without shareholder consent, and that this shareholder-protection aspect of the violation gave force to the argument that a cause of action should be available at the shareholders' behest. If this passage is read as critical to the court's conclusion, then the decision is akin to the cases holding directors liable for illegal loans or investments, also cited by the A.L.I. reporters as authority for their position, where the laws at issue are principally intended to protect corporate shareholders and creditors.

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166 A complicating factor is that virtually all of the decisions arise in response to a motion to dismiss for failure to state a claim, with the complaint often containing glowing but generalized allegations of the directors' and officers' misconduct. Thus, they provide no indication of the kind of facts necessary to warrant actual recovery.

167 Miller v. AT&T, 507 F.2d 759 (3d Cir. 1974).


169 Miller v. AT&T, 507 F.2d at 762. Subsequent decisions have observed that *Miller* is limited to the situation where the directors' conduct itself is alleged to be illegal. The business judgment rule still applies to the directors' decision not to pursue a corporate right of action to remedy allegedly illegal actions by others on behalf of the corporation. See *Rosengarten v. International Tel. & Tel. Corp.*, 466 F. Supp. 817, 824 n.8 (S.D.N.Y. 1979); *Gall v. Exxon Corp.*, 418 F. Supp. 508, 518 n.19 (S.D.N.Y. 1976).

170 Miller v. AT&T, 507 F.2d at 763 (citing United States v. CIO, 335 U.S. 106, 113 (1948)).

171 *Id.* at 763.

172 See A.L.I. *Principles—TD#4*, supra note 51, § 4.01(a) reporter's note 11, at 38 (citing Van Schaick v. Aron, 170 Misc. 520, 534, 10 N.Y.S.2d 550, 552 (Sup. Ct. 1938) (liability of insur-
from the directors' improvidence.173 These cases do not support the broader notion that management should be liable per se to the corporation for causing it—in the interests of profit—to violate laws protecting third persons generally, which is the essence of the trucking company example cited above.

Several cases demonstrate, however, that courts may review conduct by management that violates laws protecting third parties with a higher level of scrutiny than is traditionally associated with the business judgment rule. A leading example is the decision of the Court of Appeals of New York in Abrams v. Allen.174 As the comments to the A.L.I. Principles correctly state,175 the court in that case reversed the dismissal of a derivative suit alleging that the directors intentionally dismantled and removed corporate plants, equipment and machinery and curtailed production for the purpose of intimidating and punishing employees. But basic to the complaint, and ignored by the A.L.I. comments, were the plaintiffs' allegations that the directors did not take these actions for legitimate business reasons, but yielded to the malice and personal prejudice of the corporation's founder and president, and that the corporation suffered a great loss as a result.176 Thus, while the case demonstrates that when unlawful conduct is alleged, the court's traditional unwillingness to question the good faith and motives of the directors177 may no longer apply, the asserted basis for liability is not the unlawful conduct per se but the subordination of the best interests of the corporations to the personal whims of its president.178 Other cases, particularly in the antitrust area where violations may be redressed by treble damages, seem to rest upon the notion that the defendants' conduct in deliberately exposing the corporation to an obvious risk of financial liability, material in amount, gives rise to a strong presumption of mismanagement—strong

173 Cf. Coffee, Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 VA. L. Rev. 1099, 1163-64 (1977) (analyzing Miller as a negligence per se case).


175 See A.L.I. PRINCIPLES—TD#4, supra note 51, § 4.01(a) comment d, at 21.


178 Upon remand, the trial court held that the plaintiffs failed to prove that the directors dismantled the equipment and removed the plants solely to defeat the employees' strike, and dismissed the action. Abrams v. Allen, 113 N.Y.S.2d 181 (Sup. Ct. 1952). For other examples of cases where the court's conclusion that the directors could be held liable to the corporation for unlawful conduct appears to turn on allegations that the conduct was undertaken for personal purposes, see DiTomasso v. Loverro, 250 A.D. 206, 209, 293 N.Y.S. 912, 916-17, aff'd mem., 276 N.Y. 551, 12 N.E.2d 570 (1937) (contract to restrain competition that directors knew was unlawful and entered into for personal gain is void); Hill v. Murphy, 212 Mass. 1, 2-3, 98 N.E. 781, 782 (1912) (defendants required to reimburse corporation for libel judgment where libel was circulated for personal ends of defendants).
enough, at least, to survive a motion to dismiss for failure to state a claim.\textsuperscript{179}

But, for our purposes, it is one thing to say that a showing of unlawful conduct may lead courts to withhold the attitude of deference embodied by the business judgment rule, as the foregoing cases illustrate, and another to say that unlawful conduct is per se beyond the permissible discretion of corporate directors and officers, as the A.L.I. \textit{Principles} seem to suggest. The former proposition is still entirely consistent with shareholder wealth maximization as management’s polestar objective; the latter clearly is not. The A.L.I. position derives its strongest support from the cases involving illegal payments out of corporate funds. The leading case remains a 1909 lower court decision, \textit{Roth v. Robertson},\textsuperscript{180} where the manager of a corporation operating an amusement park paid “hush money” to permit the corporation to continue operating on Sundays, in violation of the blue laws. The manager testified that a large part of the corporation’s business occurred on Sundays and that he believed that making the payment was in the best interests of the corporation. Nonetheless, the court required him to reimburse the corporation. It reasoned that if it is unlawful to operate on Sunday, then it must be unlawful as well to pay money to silence opposition to the violation, so that any argument that the payment was made in the interests of the corporation is inadequate as a matter of law. It added that “[t]o hold any other rule would be establishing a dangerous precedent, and tacitly countenancing the wasting of corporate funds for purposes of corrupting public morals.”\textsuperscript{181}

That \textit{Roth} retains some continuing validity is illustrated by the Third Circuit’s reliance upon the opinion in \textit{Miller v. American Telephone & Telegraph Co},\textsuperscript{182} coupled with its conclusion that the allegation of the illegal payment, in itself, sufficed to show damage to the corporation.\textsuperscript{183} As we have seen, however, the significance of \textit{Miller} is diluted by

\textsuperscript{179} See, e.g., Wilshire Oil Co. v. Rifle, 409 F.2d 1277, 1285-86 (10th Cir. 1969); Parish v. Maryland & Va. Milk Producers Ass’n, 250 Md. 24, 80-81, 242 A.2d 512, 543-44 (1967); cf. Knopfler v. Bohen, 15 A.D.2d 922, 225 N.Y.S.2d 609 (1962) (excusing requirement that plaintiff make a pre-suit demand upon the board). In the \textit{Parish} case it was found, following remand, that the defendants were not guilty of gross negligence or culpable mismanagement, and this decision was upheld upon appeal. The antitrust cases have generated the most substantial literature upon the directors’ and officers’ liability to the corporation for unlawful conduct. See, e.g., Blake, The Shareholders’ Role in Antitrust Enforcement, 111 U. Pa. L. Rev. 143, 157-78 (1961); Forte, Liabilities of Corporate Officers for Violation of Fiduciary Duties Concerning the Antitrust Laws, 40 IND. L.J. 313 (1965); Harris, Derivative Actions Based Upon Alleged Antitrust Violations, 37 BROOKLYN L. REV. 337 (1971).

\textsuperscript{180} Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. (Sup. Ct. 1909).

\textsuperscript{181} \textit{Id.} at 346, 118 N.Y.S. at 353.

\textsuperscript{182} Miller v. AT&T, 507 F.2d 759, 762 (3d Cir. 1974).

\textsuperscript{183} \textit{Id.} at 762-63. In another relatively recent case, the court, without extensive analysis, required the corporation’s former general manager to reimburse it for illegal political contributions paid from its funds. Capital Elec. Power Ass’n v. Phillips, 240 So. 2d 133, 136-37 (Miss. 1970). Where the illegal payment is initiated by a corporate employee, recovery by the corporation will
the court's reliance on the shareholder-protection objectives of the statute at issue.184 Moreover, the Second Circuit's decision in Schwartz v. Romnes,185 decided in the same year as Miller, contains some interesting dicta that points in the opposite direction. The case was a derivative suit challenging, as illegal under the New York election law, a corporation's contribution in support of a state transportation bond issue. The district court held that the contribution was illegal and, as a result, granted summary judgment holding the corporation's directors and officers personally liable for the contribution.186 The Second Circuit reversed on the issue of illegality, but, noting the directors' claim of good faith belief that the contribution would benefit the corporation, the court added that even if it had found the contribution to be illegal, it would at a minimum remand the case for trial on the issue of the reasonableness of the directors' actions.187 Thus, it is unclear just how much of the Roth rule remains.

When we move from the illegal payments cases to the issue of management's liability for illegal corporate conduct generally, support for the per se approach is much weaker. The post-Roth cases—principally in the antitrust area—suggest that violation of the law does not itself establish breach of duty to the corporation188 or hold that the plaintiff must nonetheless prove that the violation caused independent injury to the corporation in the sense of damage exceeding any benefit.189

generally be consistent with the agency law doctrine that authority to do illegal acts is not readily inferred, unless customary in the principal's business. See Restatement (Second) of Agency § 34 comment g, at 121 (1957). In the Capital Electric Power case, however, the lower court had found that the contributions had been ratified by the board of directors, 240 So. 2d at 135, so that this rationale would not apply.

184 See supra notes 170-73 and accompanying text.
185 Schwartz v. Romnes, 495 F.2d 844 (2d Cir. 1974).
187 495 F.2d at 848 & n.5. The court noted that the directors' reliance on advice of counsel would also be an issue on remand. The wording of the passage suggests, however, that reasonableness might exist independent of such reliance.

The leading case on this issue is Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (Sup. Ct. 1942), aff'd mem., 267 A.D. 890, 47 N.Y.S.2d 589 (1944), where the court held that the directors were not liable to the corporation for causing it to violate the Sherman Act, so long as they acted with good faith and reasonable care. It rejected the argument that the violations rendered the defendants automatically liable, and stated:

Whether directors are personally liable for committing acts prohibited by statute depends upon the nature of the prohibited act; whether the statute is plain and unambiguous, and whether it contains a limitation or restriction on the powers of the corporation or the powers or duties of the directors themselves. Id. at 204, 38 N.Y.S.2d at 274. Because the court emphasized that the directors had no reason to believe their conduct was illegal, however, the decision is narrower than the discussion in the text.

Nonetheless, while the more recent cases may call into question whether a violation of law—even a knowing violation—constitutes a per se breach of the director's or officer's duty to the corporation, other corporate law doctrines make clear that unlawful conduct cannot be viewed as an eligible means of doing business simply because the projected benefits exceed the costs, and these doctrines provide indirect support for the A.L.I. position. For example, state indemnification statutes typically prohibit indemnification of the director's or officer's liability and defense expenses in a criminal proceeding unless he had no reasonable cause to believe that his conduct was unlawful.\textsuperscript{190} And the syntax of these statutes makes clear that this prohibition applies even though the director or officer acted in good faith, in a manner he reasonably believed was in the best interests of the corporation.\textsuperscript{191} Also, as a response to the illegal political contributions and questionable foreign payments episodes of the mid-1970s, the view has emerged that a principal monitoring function of the board of directors is to establish mechanisms to assure the corporation's ongoing compliance with the law.\textsuperscript{192} In other words, the asserted obligation of the director is not only to refrain from violating the law himself but also to affirmatively monitor for violations by others within the corporation, and no suggestion has been made that a distinction

\textsuperscript{n.5 (acknowledging, and distinguishing, this case law). The position represented by these cases has been referred to as the "net loss" rule. See, e.g., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, § 7.16 comment e, at 211-13, reporter's note 7, at 221 (Tent. Draft No. 6, 1986); Coffee, supra note 173, at 1215-22. Several of these decisions also suggest that the necessary damage to the corporation must be over and above any fines or litigation expenses that resulted from the violation.}

\textsuperscript{190} See, e.g., CAL. CORP. CODE § 317(b) (West Supp. 1986); DEL. CODE ANN. tit. 8, § 145(a) (1983); N.Y. BUS. CORP. LAW § 723(a) (McKinney 1986); MODEL BUSINESS CORP. ACT § 8.51(a)(3) (1984). Indiana's recent corporate law revision adopts a significant change in this scheme by permitting indemnification so long as a director had reasonable cause to believe his conduct was lawful. IND. CODE ANN. § 23-1-37-8(a)(3)(a) (Burns Supp. 1986). Thus, indemnification is not foreclosed simply because the director was aware of some risk that his actions would be found illegal.

\textsuperscript{191} CAL. CORP. CODE § 317(b) (West Supp. 1986); DEL. CODE ANN. tit. 8, § 145(a) (1983); N.Y. BUS. CORP. LAW § 723(a) (McKinney 1986); MODEL BUSINESS CORP. ACT § 8.51(a)(1),(2) (1984).

There is, however, an important distinction between the indemnification issue and the question of the manager's discretion to cause the corporation to break the law. Where the state has chosen to penalize the individual manager, indemnification operates to undo that penalty and, therefore, arguably frustrates public policy. Where, on the other hand, the state has chosen to penalize the corporation, these concerns are not present, and the only public policy question is whether the manager should be permitted to view the corporate penalty as another cost of doing business.

\textsuperscript{192} See, e.g., A.L.I. PRINCIPLES—TD#4, supra note 51, § 4.01(a)(1)-(2) comment c, at 47-50; ABA Committee on Corporate Laws, Corporate Director's Guidebook, 33 BUS. LAW. 1591, 1610 (1978); Leech & Mundheim, The Outside Director of the Publicly Held Corporation, 31 BUS. LAW. 1799, 1801-02 (1976); Small, The Evolving Role of the Director in Corporate Governance, 30 HASTINGS L.J. 1353, 1374-89 (1979); Statement of the Business Roundtable, supra note 137, at 2101 (1978); Veasey & Manning, Codified Standard—Safe Harbor or Uncharted Reef?, 35 BUS. LAW. 919, 929-30 (1980); additional authorities cited at A.L.I. PRINCIPLES—TD#4, supra note 51, § 4.01(a)(1)-(2) reporter's note 4, at 53.
should be drawn where the decision to disobey the law represents an informed business judgment.

Some commentators have questioned why a legislative decision to make an activity illegal should automatically operate to remove that activity from the corporate manager's discretion. Professor Fischel has pressed this reasoning to the point of concluding that if the benefits to the corporation exceed the statutory penalty, compliance with the law is "undesirable from a personal as well as social perspective." This extreme view has drawn criticism from management circles, and, as the A.L.I. Principles indicate, been rejected by the legal mainstream.

It is by no means clear that all violations of law should be lumped together and placed beyond the realm of cost-benefit calculations. Two rationales support the general norm of corporate law obedience at all costs. The first is the imputed tastes and preferences of the corporation's shareholders, who typically conform their personal conduct to the law notwithstanding opportunities to gain from violating it. They would presumably desire that they behave likewise. But shareholder sentiment will turn somewhat upon the moral turpitude implicit in the illegality. Driving at 75 miles per hour and armed robbery both violate the law, but most people would recognize a clear distinction between the two as eligible subjects for a cost-benefit evaluation. The second rationale is one of economic efficiency, and rests on the premise that the projected cost of the violation—in terms of the magnitude of the penalties and the probability of conviction faced by the corporation—generally understates the true cost to society. Commentators have discussed the factors which inhibit the law's ability to equate the expected sanction to the approximate social loss, including the problem of regulatory failure in general. Thus, the likely alternative to voluntary corporate law obedience is more intense investigation and prosecution, and with it substantial enforcement costs and the loss of personal freedom and discretion. But, again, the fact that society tends to "underprice" illegal activity does not mean that the social harms caused by such activity will inevitably exceed the private benefits. As David Engels has pointed out, if the implicit assumption is that society criminalizes only that conduct that it seeks to bar irrespective of cost, the corporation should be compelled to expend whatever resources are needed to eliminate any possibility of violations.

193 Fischel, supra note 22, 1271; see also Easterbrook & Fischel, Antitrust Suits by Targets of Tender Offers, 80 Mich. L. Rev. 1155, 1177 (1982).
195 See, e.g., Engel, supra note 16, at 43 n.141; Stone, The Place of Enterprise Liability in the Control of Corporate Conduct, 90 Yale L.J. 1, 24-27 (1980).
196 See, e.g., Clark, supra note 28, at 199-200, 205; Weiss, supra note 23, at 377-410.
197 See generally Andrews, supra note 26, at 138-39; Clark, supra note 28, at 203-05 (but also noting the collective action problems attendant to voluntary obedience); Mashaw, supra note 25, at 126-27; McKeen, Collective Choice, in SOCIAL RESPONSIBILITY AND THE BUSINESS PREDICAMENT 109, 127 (J. McKee ed. 1974).
by its subordinates. 198 To recognize this as an excessive burden is to acknowledge that there must inevitably be some point at which a cost-benefit decision to permit the risk of unlawful conduct is appropriate.

As a final note, let us consider whether there are obligations in addition to law obedience which operate as mandates upon managerial discretion. In Abrams v. Allen, 199 the court listed as one of the alternative grounds upon which liability might be based "using the corporation's property for the doing of an unlawful or immoral act" and it observed "[t]hat the public policy of this state and nation is opposed to the closing or removal of factories, for such purposes as are here asserted, is obvious."200 Some have read this to suggest that public policy, however defined, may supply an independent check on management.201 Others have argued that management is obliged to act ethically.202 From this perspective, the SEC's enforcement campaign against questionable foreign payments in the mid-1970s may be seen as an attempt, through the means of disclosure regulation, to impose a form of public policy or ethical limitation upon business conduct that might not be illegal in the particular countries involved.203 In any event, the A.L.I. Principles have sought to make clear that the mandatory component of the manager's obligation is limited to law obedience. The commentary recognizes that adherence to ethical considerations is permissible, not mandatory, because "such an obligation would be too onerous and imprecise to enforce fairly."204 On the other hand, the commentary also suggests that the norm of law obedience should be interpreted broadly, which opens the door to possible arguments of public policy: "[T]he corporation should not rest simply on past precedents or an unduly literal reading of statutes and regulations, but should give weight to all the considerations that the

198 Engel, supra note 16, at 44-45; see also Mashaw, supra note 25, at 125-26.
200 297 N.Y. at 56, 74 N.E.2d at 306-07.
201 See, e.g., Note, Use of the Derivative Suit by Groups Foreign to the Corporation to Prevent Corporate Violation of Law and Public Policy, 57 YALE L.J. 489 (1948); see also Coffee, supra note 173, at 1190-97.
202 See, e.g., Friedman, supra note 28, at 33 (presumed desire of shareholders is for management "to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom"). It is not as surprising as it might first appear that Professor Friedman advocates a mandatory ethical responsibility. Consistent with his general view that social responsibility should not be left to the manager's discretion, he apparently sees ethics as something that (if generally desired by shareholders) should be embodied in the standard obligation, rather than open to individual choice.
203 See Coffee, supra note 173, at 1250-56; REPORT OF THE SECURITIES & EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES 9-10 (Comm. Print 1976) (discussional policy statement that board of directors should issue); id. at 44-48 (discussion of response by business community). For additional discussions of the SEC's activities on this issue, see Freeman, The Legality of the SEC's Management Fraud Program, 31 BUS. LAW. 1295 (1976); Stevenson, The SEC and Foreign Bribery, 32 BUS. LAW. 53 (1976).
204 A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 comment h, at 38.
courts would deem proper to take into account in their determinations, including relevant principles, policies, and legislative purposes.\footnote{205} 

**SECTION 4**

**MANAGERIAL DISCRETION TO MAKE CHARITABLE AND PHILANTHROPIC DONATIONS**

**4.1 Historical Evolution**

This section considers, in detail, the area of corporate voluntarism that has received the fullest attention in the case law and statutes—corporate charity and philanthropy. The development of the U.S. law on this subject can be divided into four phases.\footnote{206} In the first, represented principally by cases decided during the last two decades of the nineteenth century, the courts took a strict view of the corporation's charter and applied the ultra vires doctrine to set aside corporate donations or pledges. The expenditures at issue in these cases did not involve charity in any conventional sense, but contributions to activities likely to promote business for the corporation. Thus, in a leading case, *Davis v. Old Colony R.R.*,\footnote{207} the court set aside as ultra vires agreements by a railroad and a musical instrument manufacturer to guarantee the expenses of a musical festival, with language suggesting that the possible existence of offsetting benefits was irrelevant.\footnote{208} Other decisions in this phase seem to rest on the court's belief that the business to be generated as a result of the contribution was too remote or speculative to permit the expenditure.\footnote{209}

The strict ultra vires position was not universal among courts, however. At the same time as this phase (and even before\footnote{210}), some courts were upholding, as incidental to the corporation's powers, contributions to funds and projects likely to generate business for the corporation.\footnote{211}

\footnote{205} Id. comment g, at 33. But cf. Everett v. Phillips, 288 N.Y. 227, 236, 43 N.E.2d 18, 21 (1942) (suggesting that corporate directors have no obligation to go beyond letter of law).

\footnote{206} For a comprehensive collection of the various statutory and case law developments through 1970, see generally Blumberg, supra note 13.

\footnote{207} Davis v. Old Colony R.R., 131 Mass. 258 (1881).

\footnote{208} Id. at 275-76. See also Brinson Ry. v. Exchange Bank, 16 Ga. App. 425, 85 S.E. 634 (1915) (donation to erect public school and to promote town along railroad line).

\footnote{209} See Military Interstate Ass'n v. Savannah, T. & I. of H. Ry., 105 Ga. 420, 31 S.E. 200 (1898) (subscription to stock of local festival); McCrory v. Chambers, 48 Ill. App. 445, 452-53 (1882) (contribution to fund to persuade local manufacturer to remain in town). Professor Blumberg notes that the corporations at issue in *McCrory* and other decisions between 1885 and 1908 that set aside contributions to attract or retain local business were banks, and the holdings might therefore be explained by a judicial tendency to construe bank charters narrowly. See Blumberg, supra note 13, at 186-87.

\footnote{210} See Vandall v. South San Francisco Dock Co., 40 Cal. 83 (1870) (upholding payment to railroad by corporation formed to improve real estate, for purpose of improving service and reducing fares); Whetstone v. Ottawa Univ., 13 Kan. 320, 339-41 (1874) (enforcing town development corporation's gift of land to private university).

\footnote{211} See, e.g., Richelieu Hotel Co. v. International Military Encampment Co., 140 Ill. 248, 263-
As characterized by courts and commentators over time, the essential test that emerged from these decisions—and what may be thought as the second phase of the case law—was whether the expenditure produced a direct or immediate benefit to the corporation.

While these early cases involved expenditures for business, the resulting direct benefit test led courts, beginning at the turn of the century, to allow one class of corporate activity that did have a philanthropic dimension—programs to benefit the welfare of the corporation's employees. Thus, in 1896, a New York court upheld the provision of employee housing by Steinway & Sons, the piano manufacturer, adjacent to its new factory site in a then remote area, along with the corporation's contributions to permit establishment of a church, school, library and bath in the community. And in 1909, an appellate court in the same state permitted a life insurance company to purchase land for a hospital to treat its employees with tuberculosis.

The direct benefit rule provided no authority, however, for corporate support of organizations that provided benefits that were dispersed among the community as a whole. This foreclosed support for higher education as well as national and local charities. To a considerable extent, corporations made contributions nonetheless to local institutions such as hospitals, to the YMCA, and, with the advent of World War I, to

65, 29 N.E. 1044, 1047-48 (1892) (contribution by Chicago hotel to military exhibition to be held in or near city); Huntington Brewing Co. v. McGrew, 64 Ind. App. 273, 278-82, 112 N.E. 534, 536-37 (1916) (donation by brewery to fund to attract other factories to town); Virgil v. Virgil Practice Clavier Co., 33 Misc. 200, 68 N.Y.S. 335 (Sup. Ct. 1900); (establishment of piano school by corporation that manufactured instrument to teach piano playing); cf. Steinway v. Steinway & Sons, 17 Misc. 43, 47, 40 N.Y.S. 718, 722 (Sup. Ct. 1896) (gifts of pianos to fairs and musical artists; court determined that it need not decide whether expenses exceeded just limits because plaintiff acquiesced in them). For an example of a case on the other side of the line, see Orpheum Theatre & Realty Co. v. Seavey & Flarsheim Brokerage Co., 197 Mo. App. 661, 199 S.W. 257 (1917) (setting aside donation by brokerage corporation to assist theater in relocating, because corporation owned no property near theater's new location).


One commentator, writing in 1921, described the limitation embodied in the direct benefit test as follows: "A corporation may not contribute to a charity as such nor donate from its funds to a community welfare enterprise or humanitarian undertaking from which it would only share in the benefits in common with the rest of the community." Davis, supra note 212, at 110.


People ex rel. Metropolitan Life Ins. Co. v. Hotchkiss, 136 A.D. 150, 120 N.Y.S. 649 (1909); cf. also Hutton v. West Cork Ry., 23 Ch. D. 654, 672-73 (1883) (dicta of Bowen, J., that railroad could provide reasonable benefits for its employees if it were continuing in business).

See Worthington v. Worthington, 10 A.D. 332, 336, 91 N.Y.S. 443, 445 (1905) (dicta that it was doubtful a gift to Columbia University could be satisfied with corporate funds).
wartime relief agencies such as the Red Cross. Further, following the war, local community chests emerged with the active involvement of the business sector.

With this growing call upon the corporate coffers as a source of charitable support, business and community leaders looked to the legislature for formal authorization. And some legislatures responded. In 1917, Texas became the first state to enact a statute expressly authorizing corporate donations. The other statutes of the decade were limited to the wartime emergency, however. In 1918, Congress authorized national banks to make contributions to the Red Cross, for the duration of the war, out of their net profits otherwise available for dividends, and New York permitted corporations to make contributions to further the war effort. The next year, Illinois, as a part of its new General Corporation Law, included an express power to aid governmental policy in time of war. But during the 1920s broader statutes were enacted. Three states—New York, Ohio and Tennessee—joined Texas in providing general authorizations for corporate charitable contributions.

There were case law developments as well during the 1920s. In Armstrong Cork Co. v. H.A. Meldrum Co., the court upheld a corporation's contribution to local colleges to help endow their business administration curricula. While the court found a direct benefit to the corporation, the benefits it cited—good will and the potential for better trained employees—have a community-wide character that distinguishes the decision from the prior law. And, in a 1924 decision upholding the constitutionality of a railroad regulatory statute that exempted ministers and employees of charities from prohibitions on free passes, the Supreme Court of Nebraska observed in dicta that it saw no reason why a railroad could not make reasonable donations of its funds to aid in

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217 See F. Andrews, Corporation Giving 22-32 (1952); M. Heald, supra note 134, at 50-52. Professor Heald notes that the YMCA "had pioneered in the promotion of company giving before the war." Id. at 50.

218 See M. Heald, supra note 134, ch. 5.


220 Act of May 22, 1918, ch. 80, 40 Stat. 558. This was a response to the "Red Cross Dividend" program, begun in 1917. Under that program, participating corporations declared a special dividend and sought authorization from each shareholder to pay his or her dividend directly to the Red Cross. See F. Andrews, supra note 217, at 26-28.

221 General Corp. Law § 6(12), 1919 Ill. Laws 312, 318; Act of Apr. 16, 1918, ch. 240, 1918 N.Y. Laws 885.


224 Consistent in result is an English case, decided two years earlier, which upheld a substantial gift by a chemical manufacturer to various universities to further scientific education and research. The court was willing to defer to the judgment of the board of directors that the gift was in the long-term profit interest of the corporation. Evans v. Brunner, Mond & Co., [1921] 1 Ch. 359, 367-69 (1920).
Collectively, these legislative and judicial developments were the end of the direct benefit phase and ushered in the third phase, in which the corporate charity and philanthropy could be justified on the basis of the corporation's long-term interest in acts that benefited the community as a whole.

Parallel trends may be seen in the federal income tax laws during the period. In creating the charitable deduction in 1917, the War Revenue Act limited its availability to individual taxpayers. The next year, Congress rejected a proposal to extend it to corporations, in part out of concerns over the propriety of recognizing the directors' right to make donations with the shareholders' money. In 1921, however, the Treasury adopted a regulation embodying the direct benefit rule as the test for permitting corporations to deduct charitable donations as ordinary and necessary business expenses. Under this standard, the courts upheld deductions for corporate donations to a hospital and to a community charitable fund where, in each case, the corporation was the largest employer in the town so that its employees would be the principal beneficiaries. In 1934, however, the Supreme Court determined that a corporation's contributions to the local community chest were not deductible given the absence of a finding of direct benefit. This decision worked to reintensify the push by community chest leaders to obtain an independent charitable deduction for corporations, and their efforts succeeded with the Act of 1935, which permitted corporations to deduct charitable contributions of up to five percent of their taxable income, a limit that was raised to ten percent in 1981.

Interest in clarifying management's power to make charitable de-

227 See 56 Cong. Rec. 10, 419-21, 426-28 (1918).
228 The regulation provided:
Corporations are not entitled to deduct from gross income contributions made to religious, charitable, scientific or educational corporations, even though such contributions are made to the Red Cross or other war activities. Donations made by a corporation for purposes connected with the operation of its business, when limited to charitable institutions, hospitals, or educational institutions conducted for the benefit of its employees or their dependents, are proper deductions as ordinary and necessary expenses. Donations which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its business are allowable deductions from gross income.
230 American Rolling Mill Co. v. Commissioner, 41 F.2d 314 (6th Cir. 1930).
Productions revived in the late 1940s. By 1948, only 15 states had enacted statutes on the issue. Nonetheless, corporate giving had blossomed into an established practice, questions of legal authority notwithstanding, with corporate donations in 1945 reaching $266 million, equal to 1.24% of net profits. Speaking to the American Bar Association's Section of Corporation, Banking and Mercantile Law in 1948, Ray Garrett, Sr., chairman of its Committee on Business Corporations (predecessor to the present Committee on Corporate Laws), observed that: "[S]ome of these donations can be justified on the common law basis of direct corporate benefit and some are sanctioned by recently enacted corporate statues, but the others rest solely upon public approval and the current general acceptance of the idea by stockholders." To remove any doubt regarding the propriety of such donations, Garrett proposed that the Committee on Business Corporations draft a model statute for use by state legislators interested in the topic. The Committee obliged and, in March 1949, circulated a memorandum to all secretaries of state and state bar associations recommending adoption of a statute empowering the corporation "[t]o make donations for the public welfare or for charitable, scientific or educational purposes." When the Model Business Corporation Act was published in September 1950, this provision was codified as the first clause of section 4(m). The combined backing of the corporate bar and charitable organizations proved a potent force at the state level, and by 1959, forty-one states had enacted statutes authorizing corporate giving.

The 1950s also saw the issue of corporate giving reach the courts for the first time in thirty years, and the result was to remove any remaining doubt concerning the corporation's power to contribute its funds to institutions that benefit the community generally. In what was to become the leading case on the subject, A.P. Smith Mfg. Co. v. Barlow, the Supreme Court of New Jersey upheld a manufacturing corporation's

\[\text{Published by Case Western Reserve University School of Law Scholarly Commons, 1988}\]
pledge of $1,500 to Princeton University on both common law and statutory grounds. The court first traced the history of the direct benefit test and concluded that the more recent cases "illustrate how courts, while adhering to the terms of the common-law rule, have applied it very broadly to enable worthy corporate donations with indirect benefits to the corporation," and that under this approach, expenses to support private education, could readily be justified as for the corporation's benefit.

The court also pointed out that the expenses were authorized by the New Jersey statute, first enacted in 1930, and rejected the plaintiff's constitutional challenge to the statute's application to corporations predating its enactment.

In 1955, the Supreme Court of California upheld a $5,000 pledge for the construction of a local hospital, signed by the corporation's president, who was also its general manager and 73% shareholder. The opinion is noteworthy because the court found it unnecessary to dwell upon the corporation's power to make the pledge per se and focused solely on the fact that the pledge could be binding upon the corporation in the absence of evidence of approval by the board of directors. Concluding that the pledge was within the president's implied authority, as a reasonable means of benefiting the corporation and promoting its business interests, the court observed in passing:

"It is a matter of common knowledge that the trend on the part of the prosperous business concern is steadily in the direction of making substantial charitable contributions in the community in which it is located and does business. Such donations are generally considered for its benefit as a means of increasing goodwill and promoting patronage."

Finally, in a 1958 test case, the Supreme Court of Utah found as within the corporation's implied powers a $5,000 contribution by the Union Pacific Railroad Co. to a foundation it had created for charitable, scientific, religious and educational purposes. The court's opinion

243 Id. at 151, 98 A.2d at 585.
244 Id. at 154, 98 A.2d at 586.
248 California had enacted a statute based upon the A.B.A. model in 1949. See Act of Jul. 18, 1949, ch. 997, § 3.5, 1949 Cal. Stat. 1829-30 (enacting CAL. CORP. CODE § 802(g)). The pledge predated the statute, however, and the court's opinion did not discuss the statute or its application.
249 Memorial Hosp. Ass'n v. Pacific Grape Prods., 45 Cal. 2d at 639, 290 P.2d at 484.
250 Id. at 638, 290 P.2d at 483.
251 Union Pac. R.R. v. Trustees, Inc., 8 Utah 2d 101, 329 P.2d 398 (1958). In addition to making the implied powers argument accepted by the court, the corporation had contended that the contribution was permitted by a 1955 Utah statute adopting the ABA model language. See Act of Feb. 10, 1955, ch. 22, 1955 Utah Laws 39, 40 (enacting UTAH CODE ANN. § 16-2-14(8)). The court declined to consider the statutory justification, however, in light of Utah's policy requiring a statute to include express authorization to be given retrospective effect, and therefore premised its holding...
smacks strongly of the business judgment rule. It reviewed the testimony of senior management concerning the benefits created by such contributions and the long-run benefits to the shareholders and concluded that, given the implausibility that experienced executives would make the contributions unless confident that the corporation would receive offsetting benefits over the foreseeable future, the matter should be left to their sound discretion.252

Thus, by the end of the 1950s the legal doctrine had caught up with the reality of the corporate philanthropic practices that had become prevalent in the years since the First World War. The vast majority of the states had enacted statutes authorizing corporate donations, with no requirement of a direct and immediate quid pro quo to the corporation. And several courts—in fact, every court presented with the question since the beginning of the 1920s—had reached the same result even in the absence of a statute.253

Benefit to the corporation was not irrelevant, however. The judicial opinions and most of the commentary emphasized the indirect benefits to the corporation, in the sense of good will and public relations, the ability to attract qualified employees, the long-run economic and social health of the communities in which the corporation operates and the like. Thus, the third phase of the law's development may be characterized as requiring the prospect of offsetting benefits in order to legitimate the corporation's power to make the donation, but not requiring any detailed showing of the nature and amount of those benefits or of the likelihood that they would suffice to pay for the donation.

Against this background, the important A.P. Smith254 decision may be read as what amounts to a fourth phase in the law's development, in which the corporation has the power to be altruistic and donate its funds irrespective of any prospect of quid pro quo, just as if it were an individual.255 The court observed:

exclusively on the corporation's implied power in the absence of the statute. Union Pac. R.R., 8 Utah 2d at 103-04, 329 P.2d at 399-400.

252 Union Pac. R.R. v. Trustees, Inc., 8 Utah 2d at 105-07, 329 P.2d at 401-02. There was a strong dissent by one justice, who argued that the contribution was beyond the corporation's implied power under traditional principles and that the 1955 statute could not be applied retroactively to uphold it. Id. at 107-14, 329 P.2d at 402-06 (Worthen, J., dissenting).

253 Nonetheless, some legal commentators remained cautious. Writing in 1958, Dean Elvin Latty described the state statutes and concluded: "Most of these statutory provisions, however, seem to leave an opening for a conservative court still to require a fairly direct benefit to the corporation; one cannot count always on the liberality and breadth of vision revealed in A.P. Smith Mfg. Co. v. Barlow." Latty, Some Miscellaneous Novelties in the New Corporation Statutes, LAW & CONTEMP. PROBS., Spring 1958, at 363, 369 (footnotes omitted).


255 This view of a fourth phase of the law also derives support from a literal reading of the various state statutes, which grant the corporation authority to make donations in absolute terms, and contain no mention of corporate benefit. Indeed, some specifically state that the authority exists irrespective of any corporate benefit. See, e.g., CAL. CORP. CODE § 207(e) (West 1977); N.J. STAT.
It seems to us that just 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.\footnote{256}

Whether most contemporary courts would be willing to regard a corporation's power to be philanthropic as entirely independent from its business self-interest will be discussed in subsection 4.3. For purposes of the present historical overview, it suffices to note that the most recent corporate charity case, while containing several distinguishing facts, is consistent with this view of a new, fourth phase. The case, \textit{Theodora Holding Corp. v. Henderson},\footnote{257} involved a challenge by a 27\% shareholder of a personal holding company to the company's gift of $528,000 in stock to a charitable trust controlled by the majority shareholder. The gift was to be used to help fund a western camp for underprivileged boys, for which the corporation had earlier donated the land as well. The Delaware Court of Chancery noted that the Delaware statute\footnote{258} (which followed the ABA model) contained no limiting language and must be "construed to authorize any reasonable gift of a charitable or educational nature."\footnote{259} While one may argue in support of this broad view that the concept of corporate benefit (as distinct from individual shareholder benefit) has little meaning in the case of a personal holding company, the opinion does not suggest that this should be viewed as a limiting factor. The court said simply that the governing test was one of reasonableness and, observing that the then applicable federal income tax limitation on corporate charitable deductions of five percent of net income furnished a helpful guide, upheld the gift with a brief discussion of how the general societal gains from the gift far outweighed its after tax cost to the shareholders.\footnote{260} We will have more to say about the \textit{Theodora} case in subsection 4.3 below.

4.2 The Limits of Management's Discretion to Make Corporate Donations—Some Thoughts on Basic Policy

Unlike the matters of operating policy considered in section 3, chari-
table contributions involve activity that the shareholders could, and typically do, undertake on their own. This leads to a fundamental question of policy. Why shouldn’t the law let the shareholders themselves decide the extent to which corporate resources should be devoted to charitable causes and what those causes should be? Consider the irony inherent in the following comments by the court in the *A.P Smith* case:

When the wealth of the nation was primarily in the hands of individuals they discharged their responsibilities as citizens by donating freely for charitable purposes. With the transfer of most of the wealth to corporate hands and the imposition of heavy burdens of individual taxation, they have been unable to keep pace with increased philanthropic needs.\(^{261}\)

Why should the wealth of the corporations permit them to preempt the charitable choices of the very shareholders to whom that wealth could otherwise be distributed? The choice of beneficiaries is often a question of personal taste, and there is no reason per se to favor the tastes of the managers over those of the shareholders.\(^{262}\) Further, to the extent there is an element of personal satisfaction in making a donation,\(^{263}\) it necessarily reaches the shareholder only in diluted form where the critical decision to make the gift is the corporate manager’s. And it will be that manager who basks in the charity’s gratitude. In response to questions such as these, Berkshire Hathaway chairman Warren E. Buffett adopted a plan in 1981 that permits shareholders to designate the recipients of the corporation’s charity. Each of the corporation’s 1,900 shareholders may allocate $2 for each share owned to three charities of his or her choice, and the corporation makes the gift in the name of the shareholder.\(^{264}\)

As an answer to these concerns, let us consider two views of corporate charitable giving, which may rationalize entrusting these choices to management. The first recognizes that some charitable objectives may, for any number of reasons, be closely tied to the corporation’s business


activities, so that management has a unique perspective, which should preempt the individual preferences of shareholders. Thus, for example, where the donation represents an implicit cost of doing business, it falls within management’s traditional expertise and discretion, and shareholders have no legitimate standing to interpose their personal charitable values. The second, in contrast, sees corporate donations as activity on behalf of the shareholders, with the donations made by the corporation merely because it enjoys some form of comparative advantage over the individual shareholders in being the donor. The issue is then whether the efficiencies that result from permitting management to make the donation outweigh the loss of individual shareholder choice and gratification, and the inevitable risk that management’s pattern of giving may depart from the composite preferences of the shareholders.

In terms of the first rationale, charity may represent a subject for management expertise for a variety of reasons. The commentary in the A.L.I.’s Principles of Corporate Governance observes, for example, that “a donation to public television may be made for reasons comparable to those for sponsoring a commercial, and a contribution to local Red Cross or Community Chest activities may be made for reasons of employee well-being and morale.” Consider, in this regard, the recent program by Scott Paper Co. to introduce a new line of “Helping Hand” paper goods by pledging to donate five cents to charity for each package sold.

Another instance for deferring to management’s perspective as opposed to the shareholders’ may be in the case of support for local charities, insofar as public and business opinion has come to recognize that a corporation has an obligation to the communities in which it maintains facilities. In subsection 3.3.3 we distinguished between the desires of the typical proprietor and those of the typical passive shareholder, and similar concerns may apply in the case of charitable donations. Consider the case of a manufacturing corporation with facilities in, say, Muncie, Indiana, and shareholders dispersed throughout the nation. While a reasonable proprietor (even an absentee proprietor) might feel a

265 A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01 comment i, at 39. The Principles add that one of the justifications for authorizing the corporation to make charitable gifts is while the underlying objective for the gift may be economic, the specific benefit to the corporation is often difficult to prove, and it is therefore desirable to provide the corporation with a “reasonable zone of flexibility” within which it may give away its resources without having to show specific resulting benefits. Id. at 41.


267 See, e.g., Shop Talk, Wall St. J., Jan. 26, 1987, at 21, col. 3 (describing decision by Unisys Corp. to maintain two corporate headquarters following Burroughs-Sperry merger and quoting CEO W. Michael Blumenthal as stating: “Now we have to support two symphonies instead of one and talk with two governors and two mayors.”).

268 See supra note 145 and accompanying text.
moral obligation to support the Muncie United Way or the local community college, we cannot expect a portfolio manager in New York or an individual investor in Los Angeles to share that commitment. This rationale would favor, therefore, corporate donations to local and other charities that have a specialized relationship with the corporation over ones to more general, national organizations, for with the latter there is little reason to believe that the tastes and moral obligations of the hypothetical proprietor would systematically depart from those of the passive shareholder. 269

The second rationale, on the other hand, would permit donations to organizations irrespective of their relationship to the corporation's business by reconceiving the corporation as, in part, the charitable agent for its shareholders, to the extent it enjoys a comparative advantage. What might be the sources of such comparative advantage? One strong candidate is the income tax law, which permits the corporation to deduct its charitable donations. 270 Inasmuch as dividends to the shareholders would not have been deductible, permitting the corporation to make donations from pre-tax dollars effectively increases the federal tax subsidy from one-to-one to three-to-one. 271 But is this necessarily a comparative advantage from a societal point of view? While the enhanced subsidy explains why any given group of shareholders might prefer having the corporation make a donation on their behalf, it does not, as Professor Brickley points out in his paper, 272 mean that a law permitting this practice results in a net gain to society as a whole. Rather, at issue is simply a zero-sum game between the government and the charities, and there is no

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269 Industry practice is to the contrary, however. A survey of corporate donations by 422 large U.S. corporation, undertaken by The Conference Board for 1984, reveals that 42% of the donations were made to national organizations, 26% to local organizations in the corporation's headquarters community and 32% to local organizations in other communities. Further, the proportionate share to national organizations has grown since the data were first compiled in 1978. See L. PLATZER, ANNUAL SURVEY OF CORPORATE CONTRIBUTIONS 16 (1986).


271 To see this point, assume that both the corporation and the shareholder are in the 50% tax bracket and charitable donations are not deductible. The corporation earns $500,000, plus $250,000 in income tax and distributes the remaining $250,000 to its sole shareholder as a dividend. The shareholder pays $125,000 in tax on the dividend, contributes $25,000 to her alma mater, Princeton, and retains $100,000. But once charitable donations are deductible, the shareholder may contribute $50,000 to Princeton, reduce her taxable income to $200,000, and thus retain the same $100,000 after tax. In effect, the government has matched her gift to Princeton by reducing her tax by $25,000. And if the corporation were to make the deductible gift, it could contribute $100,000 to Princeton, distribute $200,000 after taxes to the shareholder as a dividend, of which she would retain $100,000 after tax. Thus, the total tax is decreased from $375,000 in the case where the donation is not deductible to $300,000 in the case where it is deductible and made at the corporate level, and the effective rate of matching gift is increased to three-for-one.

272 See Brickley, supra note 78, at 79-80.
apparent policy reason for arguing that the net subsidy from the government to a particular charity should be tripled simply because the donation has come from a corporation as opposed to its shareholders.

A second possible comparative advantage for corporate giving is as a solution to the collective action problem that is inherent in coordinating the activities of any diffused group of small-stakes holders.273 Consider, as an example, Mobil Corporation’s support of public broadcasting and, in particular, the television show “Masterpiece Theater.”274 Suppose that Mobil has 400 million shares of stock outstanding, and that its annual support for public broadcasting is $10 million, the equivalent of 2.5 cents per share. The various individuals with an economic stake in Mobil’s shares—whether individual shareholders or the beneficiaries of institutional shareholders—might well derive far more than $10 million of collective pleasure from public television, and therefore should be willing to contribute at least that amount on a voluntary basis. But if the hat were passed among Mobil shareholders, each individual receives no assurance that his or her contribution would be matched by the others. Thus, the shareholder’s incentive to contribute is significantly eroded by the recognition that funds sufficient to purchase the desired programming might not be raised even if he or she does contribute, but might be raised even if he or she does not. By making the gift on its own, the corporation may resolve this collective action problem by simultaneously binding all of its shareholders to the common goal.275 At the same time, having one large contribution by the corporation take the place of thousands of small ones by its shareholders likely achieves a dramatic


274 To simplify the analysis, this example ignores the possible public relations benefits that Mobil derives from its support of public television as an alternative justification for permitting the donations.

275 See, e.g., Vickrey, Private Philanthropy and Public Finance, in ALTRUISM, MORALITY AND ECONOMIC THEORY 149, 163 (E. Phelps ed. 1975). Admittedly, by solving the collective action problem in this manner, the corporation creates a distributional problem in its stead. The owner of 10 shares is assessed 25 cents while the owner of 1000 shares is assessed $25, and there is no assurance that the latter would have been willing to contribute ten times as much—or for that matter, anything at all—if the matter were left to voluntary self-assessment on the basis of the pleasure each derived. One answer to this is the realization that both shareholders likely hold diversified portfolios of equity claims—direct and (through pension funds, whole life insurance, savings invested in mutual funds and the like) indirect—so that an overassessment by corporation A on behalf of a charitable cause the shareholder does not strongly favor might well be offset by an underassessment by corporation B on behalf of one he does. This is a variation of Professors McGowan and Wallich’s argument discussed in section 2, see Wallich & McGowan, supra note 25, but is narrower in that it rests simply on the shareholder’s status as a diversified holder on traditional financial claims.

Also, the example in the text involves a form of charity that supplies tangible benefits—entertainment—to the donor. The collective-action rationale is weaker where the donor’s motives are the pure joy of giving. See Calabresi, Comment, in ALTRUISM, MORALITY AND ECONOMIC THEORY 57, 58-60 (E. Phelps ed. 1975) (discussing the tension between the existence of altruistic pleasure in giving and the concurrent need for coercive solutions to the implicit problems of collective action).
reduction in the costs of fund-raising considerations and logically leads to an overarching issue. Wouldn’t the kinds of comparative advantages enjoyed by the large corporation also be realized, and to a much greater degree, by turning the matter over to the federal government, to serve as the central disperser of, and assessor for, charitable largesse. The traditional resistance to this idea, and preference for corporate giving in its stead, has stemmed both from concerns for big government and a preference for diversity and decentralization in philanthropic activity. While the prospect of concentrating the responsibility for charitable and educational support in the government is indeed troublesome, the claims of diversity and decentralization have a hollow ring when advanced to justify keeping the decision in an elite corps of corporate executives, with little true accountability to shareholders. This squarely invokes the various concerns for corporate managers serving as arbiters of the social welfare, which we surveyed in subsection 2.2.2. In addition, the implications of corporate managements’ potential influence over the policies of charitable and educational institutions have led commentator Bayless Manning to caution that unfettered corporate giving “may more conflict with than conform to our pluralistic preference.” At the same time, the recognized tendency of corporate giving programs to avoid smaller and more controversial causes, supports the speculation that passing the matter to government would, if anything, enhance the diversity of the recipients.

Thus, in the final analysis, legitimating corporate giving—the basis of the corporation’s comparative advantages over its shareholders—may open the door to philosophical problems that significantly undermine its forcefulness as a rationale.

4.3 WHAT LIMITS PRESENTLY EXIST ON THE NATURE AND AMOUNT OF CORPORATE DONATIONS?

With those policy perspectives in mind, let us examine the present


277 See also supra note 23. One response to some of these legitimacy concerns, as applied to the present line of analysis, is that it is the shareholders’ money that is being given away. Thus, if the philanthropic tastes of the average shareholder are more closely shared by the typical corporate executive than by the typical government administrator, a case may be made for keeping the decision within corporate channels. This, however, ignores the fact that the taxpayers are subsidizing the lion’s share of the corporate gift.

278 Manning, supra note 140, at 1494-95.

279 See Richards, supra note 59; cf. F. Andrews, supra note 217, at 126 (“[C]orporate giving is still traditional and custom-bound . . . more than half of the sampled companies gave from 90 to 100 per cent of their contributions to annually recurring drives.”). But cf. M. Fremont-Smith, supra note 261, at 58-59 (discussing trend of increasing corporate support for arts and solutions to urban problems).
state of the law limiting managerial discretion over the objects and the amount's of the corporation's philanthropy.

A threshold issue is whether the very state statutes that expressly authorize corporate donations serve, at the time, as an indirect source of limitation. That is, should the traditional statutory categories—"public welfare" and "charitable, scientific, or educational purposes" to use the Model Act formulation—be read as all-embracing. Professor Blumberg has reviewed the state statutes in detail and questioned whether these traditional categories are broad enough to assure complete coverage of corporate responses to contemporary social problems. The A.L.I.'s Principles of Corporate Governance has also deemed it desirable to paint with a broader brush than the state statutes and extend to any "public welfare, humanitarian, educational, and philanthropic purposes."

These concerns notwithstanding, it seems doubtful that the traditional statutory categories should be read narrowly to limit the objects of the corporation's philanthropy. Indeed, courts have found the categories flexible enough to shelter corporate expenditures which clearly did not represent conventional philanthropy. In Kelly v. Bell, the Delaware Court of Chancery applied that state's statute to uphold, as donations for the public welfare, payments to local governments that United States Steel Corporation had promised to make as part of a campaign to obtain repeal of a state ad valorem tax on its machinery. And in Schwartz v. Romnes, the Second Circuit held that the expenditure of $50,000 by New York Telephone Co. to promote passage of a state transportation bond issue was not ultra vires. It reasoned that to the extent the payment was prompted by the corporation's concern for the quality of transportation and its multiplier effects on the economy it was protected by the New York statute's authorization of donations for the public welfare or for civic or similar purposes.

This flexibility is not surprising in light of the background of the

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280 See MODEL BUSINESS CORP. ACT § 3.02(13) (1984).
281 This is closely linked to the issue, examined in subsection 3.3.1, of whether the statutory authorization of donations should be read broadly to embrace any commitment of corporate resources. See supra notes 95-101 and accompanying text.
282 See Blumberg, supra note 13, at 193-201. He proposed the addition of references to expenditures for "civic" purposes or for "the betterment of social, economic, or environmental conditions" to plug any possible gaps. Id. at 201.
283 A.L.I. PRINCIPLES—TD#2, supra note 9, § 2.01(c).
285 Id. at 74-75. The payments were equal to the tax U.S. Steel would have been required to pay on the existing value of its machinery at the time of the commitment. On appeal, the Supreme Court of Delaware stated that it had doubts about describing the payments as gifts, but it agreed with the lower court that the payments should be covered by the business judgment rule and affirmed on that basis. 266 A.2d at 879.
286 Schwartz v. Romnes, 495 F.2d 844 (2d Cir. 1974).
287 Id. at 854.
statutes. As we have seen,\textsuperscript{288} they were the product of a broad legislative sentiment to remove any doubt about the legality of what had become, by the time of their enactment, widespread corporate practice. This, coupled with the implications of the \textit{A.P. Smith},\textsuperscript{289} \textit{Pacific Grape Products},\textsuperscript{290} and \textit{Union Pacific}\textsuperscript{291} decisions, reviewed in subsection 4.1, that considerable corporate discretion to engage in philanthropy exists even in the absence of any statute, confirms the speculation that future courts are unlikely to be stingy in construing the scope of the various statutory categories of permissible donations.\textsuperscript{292}

Nonetheless, some limitation on management’s discretion under the statutes is essential. Thus, while the language of the statutes is unqualified, commentators have recognized that the corporation’s power to be charitable or philanthropic, like any of the corporation’s other powers, is to be exercised in furtherance of the corporate purposes and subject to fiduciary obligations.\textsuperscript{293} Consistent with this analysis are the opinions in \textit{A.P. Smith}\textsuperscript{294} and \textit{Theodora},\textsuperscript{295} where the existence of an unqualified state statute did not dissuade the courts from implicitly recognizing the additional requirement of reasonableness. And an express reasonableness limitation has been included in the A.L.I. \textit{Principles of Corporate Governance}.\textsuperscript{296}

But what does reasonableness mean in the context where the corporation is giving away its money? Necessarily, this inquiry has two components: the purpose of the donation and its amount. As to the first, commentators have emphasized that although the law no longer requires

\begin{itemize}
  \item \textsuperscript{288} See supra notes 235-41 and accompanying text.
  \item \textsuperscript{290} \textit{Memorial Hosp. Ass’n v. Pacific Grape Prods. Co.}, 45 Cal. 2d 634, 290 P.2d 481 (1955).
  \item \textsuperscript{291} \textit{Union Pac. R.R. v. Trustees, Inc.}, 8 Utah 2d 101, 329 P.2d 398 (1958).
  \item \textsuperscript{292} Cf. Blumberg, \textit{supra} note 13, at 200-01 (statutes should not be read to invalidate expenditures valid under liberal common-law benefit test).
  \item \textsuperscript{293} See, e.g., Chirelstein, \textit{supra} note 38, at 50; Garrett, \textit{Corporate Donations}, 22 Bus. LAW. 297, 301 (1967); Prunty, \textit{supra} note 237, at 474-76; see also Latty, \textit{supra} note 253, at 369. This argument is more difficult to make under those state statutes that expressly provide that the corporation’s power to make donations exists “irrespective of corporate benefit.” See \textit{GA. CODE ANN. § 14-2-21(b)(13)} (1982); \textit{MASS. ANN. LAWS ch. 156B, § 9(k)} (Michie/Law. Co-op. 1979); \textit{N.J. STAT. ANN. § 14A:3-4(1)} (West 1969); \textit{N.Y. BUS. CORP. LAW § 202(a)(12)} (McKinney 1986). Presumably, the intent of these clauses is to reject, unequivocally, the old direct benefit rule, see \textit{supra} notes 210-15 and accompanying text, and not to eliminate the requirement of corporate interest altogether. See \textit{N.Y. BUS. CORP. LAW § 202(a)(12)} note on legislative studies and reports, at 51 (McKinney 1986) (all vestiges of the corporate benefit rule are eliminated, but contributions remain subject to the business judgment rule); cf. \textit{N.J. STAT. ANN. § 14A:3-4(1)} commissioners’ comment—1968, at 159 (West 1969) (indicating that clause was “perhaps not necessary”). This interpretation is more readily apparent under the California statute, \textit{CAL. CORP CODE § 207(e)} (West 1977), which provides that the power to make donations exists “regardless of specific corporate benefit.”
  \item \textsuperscript{295} \textit{Theodora Holding Corp. v. Henderson}, 257 A.2d 398, 405 (Del. Ch. 1969).
  \item \textsuperscript{296} A.L.I. \textit{PRINCIPLES—TD#2, supra} note 9, § 2.01(c).  
\end{itemize}
a specific corporate benefit, some legitimate corporate objective or interest must be at stake. Ray Garrett, Sr., principal drafter of the Model Act provision, has described the limitations embodied in the state statutes as follows:

Donations should be reasonable in amount in the light of the corporation's financial condition, bear some reasonable relation to the corporation's interest, and not be so "remote and fanciful" as to excite the opposition of shareholders whose property is being used. Direct corporate benefit is no longer necessary, but corporate interest remains as a motive.

And, in a similar vein, the commentary to section 2.01(c) of the A.L.I. Principles of Corporate Governance notes that a factor in the calculus of reasonableness is the nexus with the use of the corporate resources and the corporation's business.

The tension implicit in these attempts to articulate the nature of the reasonableness requirement is between the desires to reject, at a philosophical level, the notion that management is free to substitute its own charitable preferences for those of the shareholders and to preserve, at a practical level, the board's discretion to make donations it reasonably deems to be in the corporation's interest, free of the need to create a record of offsetting corporate benefits. In the previous subsection, we proposed addressing this dilemma by limiting the corporation to philanthropy that bore a distinct connection to its business, so that management would likely have a unique perspective or experience, different from that of the shareholders as a whole. Presumably, the requirement of the corporate interest or objective advanced by the commentators would be broader and would permit contributions to general, national charities such as the American Red Cross or American Cancer Society, on the grounds that the corporation and its employees benefit from their activities, though that benefit is not distinct to the corporation. Moreover,
the A.L.I. *Principles* would go one step further (consistent with the fourth phase of development discussed above in subsection 4.1), and sanction charity for its own sake, albeit in very small doses.\(^{304}\)

Also, implicit in the reasonableness test is the requirement that the gift not involve a pet charity of management.\(^{305}\) To be sure, an exotic pet charity may be foreclosed by the requirement of corporate interest or nexus. But inasmuch as the pet charity restriction reflects the general fiduciary concept that management must subordinate its self-interest to the welfare of the corporation, it should logically be available to preclude a donation that would otherwise pass muster. For example, the reasonableness test would likely permit a corporation to make a practice of contributing 1% of its annual earnings to the United Way campaign in the city where it does business. But if the corporation’s traditional contribution had been only 0.1%, the pet charity limitation might preclude the corporation’s CEO from increasing its contribution ten-fold in the year he becomes chairman of the campaign.\(^{306}\)

Reflection upon the corporate interest requirement and the charity limitations calls into question the result in the *Theodora* case.\(^{307}\) There, the court upheld a personal holding company’s gift of its stock, equal in value to 2.8% of its annual earnings, to a foundation under the control of the corporation’s majority shareholder, to be used to fund a western camp for underprivileged boys, on whose grounds the shareholder had a home. The court dismissed the limiting language of the *A.P. Smith* case\(^{308}\) and stated that the Delaware statute authorized any reasonable corporate gift of a charitable or educational nature.\(^{309}\) This led Professor Blumberg to conclude simply that the case was “unsound,”\(^{310}\) and one

corporation, even though the likelihood of full payback seems remote. See, e.g., Ruder, *supra* note 66, at 218-19, 221-23; Schwartz, *supra* note 11, at 530-32. On its face, this reveals a willingness to extend the traditional deference of the business judgment rule from conventional business decision making to an area where management’s true motives are likely to be multi-textured and, as we have seen, the shareholders are capable of acting for themselves. But perhaps the true explanation for the distinction is the struggle to find some—any—framework for harmonizing management’s fiduciary obligations with the reality of corporate charitable practices.

\(^{304}\) A.L.I. *PRINCIPLES—TD#2, supra* note 9 § 2.01 comment i, illustration 17, at 43 (permitting anonymous gift of $2,000 to New York hospital by corporation with annual earnings of $13-$15 million and sales and operations only in western U.S.; contributions of relatively small amounts are normally reasonable even though a clear nexus to the corporation’s business is lacking).


\(^{306}\) An example is a recent suit by the minority shareholders of closely-held Beverly Hills Hotel Corp. against the controlling shareholders, Ivan F. Boesky (of recent insider trading notoriety) and his wife. The suit alleges that, for reasons of “personal self-aggrandizement,” Boesky caused the corporation to donate $750,000 to the United Jewish Appeal, of which $195,000 went to the appeal in Los Angeles, where the hotel was located, and $555,000 to the appeal in New York, where Boesky headed the fund-raising drive. Wall St. J., Apr. 23, 1986, at 10, col. 2.


\(^{308}\) See *supra* note 305 and accompanying text.

\(^{309}\) *Theodora Holding Corp. v. Henderson*, 257 A.2d at 405.

\(^{310}\) Blumberg, *supra* note 13, at 199 n.264.
cannot imagine the court reaching the same result were the corporation publicly held. Realistically, the case no doubt turns on the fact that it involved a personal holding company, with the court showing the same tolerance of the controlling shareholder’s self-indulgence as we saw in the Wrigley case.\textsuperscript{311} Thus, consistent with the comparative advantage rationale discussed in the previous subsection,\textsuperscript{312} the court was willing to permit the controlling shareholder to take advantage of the significant tax incentives to making the gift at the corporate level—its after-tax cost was only fifteen cents on the dollar\textsuperscript{313}—even though his charitable goals may not have been completely shared by the minority shareholders.\textsuperscript{314}

The final issue embodied in the reasonableness calculus is the amount of the corporation’s donation. The Theodora case suggests that the Internal Revenue Code’s limits on corporate charitable deductions—then five percent, and now ten percent, of income—provide a helpful guide,\textsuperscript{315} but this, too, must be viewed in light of the special features of the case. The commentary to the A.L.I. Principles of Corporate Governance states that the issue should turn on what is customary among comparable corporations in relation to their earnings and assets and the nexus between the contribution and the corporation’s business, with greater amounts requiring a stronger nexus.\textsuperscript{316} Thus, industry custom will typically supply the key factor. For larger corporations, information on industry custom is available through the detailed annual surveys on corporate giving prepared by The Conference Board, a business information service which break out and analyze the information by industry, corporate size, geographic location, nature of the beneficiary and other factors.\textsuperscript{317} And the ready availability of this information should assure that industry custom will typically be a critical consideration in a large corporation’s charitable giving program, as corporations with donations

\textsuperscript{311} See supra subsection 3.1.2.
\textsuperscript{312} See supra notes 270-79 and accompanying text.
\textsuperscript{313} Theodora Holding Corp. v. Henderson, 257 A.2d at 405.
\textsuperscript{314} In fact, previous donations to the foundation had been unanimously ratified by the shareholders. The real source of controversy was likely the corporation’s refusal to also make donations to the charitable corporations of the principal minority holder (who was the former wife of the majority holder) and her daughter. See id. at 402.
\textsuperscript{315} Id. at 405.
\textsuperscript{316} A.L.I. PRINCIPLES—TD\#2, supra note 9, § 2.01 comment i, at 41.
\textsuperscript{317} In 1984, the most recent year for which information is available, 2000 large U.S. corporations were surveyed and 422 responded. See L. Platzer, supra note 269, at vi. The data reveal that the median amount of 1984 contributions as a percentage of worldwide income was 0.85%, with a lower quartile of 0.53% and an upper quartile of 1.54%. Thus, half the respondents donated between 0.53% and 1.54% of their pre-tax income to charitable causes. Id. at 26. Based on Department of Commerce and Internal Revenue Service data, total 1984 contributions by all corporations, as a percentage of their estimated pre-tax income, was 1.61%. Id. at 25. Thus, the mean for all corporations was higher than the upper quartile for the large corporations in The Conference Board survey, a fact which suggests that the shareholders of small corporations may liberally use corporate assets to fund their personal charitable objectives—as in the Theodora case—at a reduced after-tax cost.
significantly below the norm for peer corporations will be likely targets for pressure from local and national charities to expand their giving and those with donations significantly above the norm will be vulnerable to shareholder criticism and, perhaps, lawsuits on the grounds that they were excessively generous. 318

Of course, industry custom may change over time. The Reagan Administration has called upon the private sector to assume greater responsibility for matters of social welfare. As part of this general goal, The President’s Task Force on Private Sector Initiatives recommended in 1982 that corporations double the level of their cash contributions to nonprofit organizations, with the goal of giving at least 2% of pre-tax income. 319 Based upon the discussion above, we can see these efforts as having a two-fold effect. They not only put pressure on corporate executives to expand their giving, but also may serve to change the overall climate of business and public opinion and thereby reduce the risk that such giving will be challenged. As we have seen, however, the trend, if any, is in the opposite charitable contributions for 1986 will show the first year-to-year decline in sixteen years. 320

318 An important factor in determining what is customary may be the location of the corporation’s headquarters. Some communities, such as Baltimore and Minneapolis, have strong traditions of corporate giving, with clubs comprised of local companies that have pledged to donate 2% or 5% of their annual earnings to charity. See S. Lydenberg, A. Marlin, S. Strub & Council on Economic Priorities, Rating America’s Corporate Conscience 20-21 (1986); Troy, Statistical Analysis of Corporate Philanthropy, in Council on Foundations, Corporate Philanthropy 136, 138 (1982).


320 Telisch, supra note 87.