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The Public Interest Derivative Suit: A Proposal for Enforcing Corporate Responsibility

Howard M. Friedman

Taking an overview of the historical development and current status of the law governing corporate behavior, the author makes an unorthodox proposal for a new method of enforcing federal standards of corporate responsibility — the public interest derivative suit. The author begins with a brief discussion of the elusive concept of "corporate responsibility." After describing the demise of both shareholder and state control over corporate activity, the author traces the development of the federal law of corporate responsibility. He then challenges the ability of existing groups to enforce this evolving law, and concludes that the public interest derivative suit is essential to the proper enforcement of the federal law.

I. INTRODUCTION

TWO AUTOMOBILES can be used to illustrate the development of American thought concerning corporate responsibility. The classic free-market concept was judicially enshrined in American case law in 1919 in *Dodge v. Ford Motor Co.*[1] Henry Ford instituted a wage and price policy that was directed toward maintaining but not maximizing shareholder profit in order to increase employment at good wages and reduce the price of his Model T to the public.[2] The court's reaction was:

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> A business corporation is organized and carried on primarily for the profit of 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.[3]

In 1965, using the General Motors Corvair as his primary ex-

[1] 204 Mich. 459, 170 N.W. 668 (1919).

[2] *See* H. FORD & S. CROWTHER, MY LIFE AND WORK 159-64 (1922).

[3] 204 Mich. 459, 507, 170 N.W. 668, 684 (1919).

ample, Ralph Nader focused the attention of the public on corporate responsibility to consumers by exposing corporate indifference to automobile safety.[4] The courts have yet to fashion an adequate response to this new concern.[5]

In recent years, corporations have increasingly undertaken projects to meet the social responsibilities that corporate management has identified.[6] But corporations have encountered some difficulty in attempting to reconcile these projects with what are thought to be legal duties to shareholders to maximize profits.[7] Often the justification offered is that the activity does maximize profits, either in the short or long run, or that the activity prevents public or governmental reaction that would impair future profit making potential.[8] Occasionally, corporate activities are justified by management in terms of broader social responsibilities;[9] even less often, courts justify corporate activities in these terms.[10]

The basic and unchanged structure of American corporate law has, however, been one of accountability of management to shareholders for their interests *qua* shareholders.[11] Little real progress

[4] R. NADER, UNSAFE AT ANY SPEED (1965).

[5] *Compare* Larsen v. General Motors Corp., 391 F.2d 495 (8th Cir. 1968) *with* Evans v. General Motors Corp., 359 F.2d 822 (7th Cir.), *cert. denied,* 385 U.S. 836 (1966).

[6] *See generally* N. CHAMBERLAIN, BUSINESS AND THE CITIES (1970); J. COHN, THE CONSCIENCE OF THE CORPORATIONS 4-7 (1971); CORPORATE POWER IN AMERICA (R. Nader & M. Green ed. 1973).

[7] *See* J. COHN, THE CONSCIENCE OF THE CORPORATIONS 4-7 (1971).

[8] Blumberg, *Corporate Responsibility and the Social Crisis,* 50 B.U.L. REV. 157, 158-66 (1970).

[9] *See, e.g.,* INTERNATIONAL TEL. & TEL. CORP. 1970 ANNUAL REPORT 23: "The year 1970 brought a spreading awareness of the social/environmental responsibility of all segments of society, including business. ITT has been a pioneer in recognizing and fulfilling this responsibility. . . ."

[10] The leading example is A. P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581, *appeal dismissed for want of a substantial federal question,* 346 U.S. 861 (1953): "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 required that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate." 13 N.J. at 154, 98 A.2d at 586; and Herald Co. v. Seawell, 472 F.2d 1081, 1091 (10th cir. 1972): "In this case we have a corporation engaged chiefly in the publication of a large metropolitan newspaper, whose obligation and duty is something more than the making of corporate profits. Its obligation is threefold: to the stockholders, to the employees and to the public." *See also* State *ex rel.* Sorensen v. Chicago, B. & O. R.R., 112 Neb. 248, 199 N.W. 534 (1924). *Cf.* Blumberg, *supra* note 8, at 173-78.

[11] The possibility of a shareholder backlash to the increasing social conscience of corporate management cannot be overlooked. See the shareholder proposal in the 1972 proxy statement of Westinghouse Electric Corp.

> RESOLVED: That the Corporation's Certificate of Incorporation be amended by adding thereto the following provisions: "No corporate funds of this cor-

has been made in identifying nonshareholder interests for which management is responsible. Even courts that have gone the farthest in articulating a social responsibility of corporate management have not suggested that this responsibility is one that can be enforced by any interested party.[12] Rather, the clear trend has been one of allowing management to be socially responsible if it so desires (with limited accountability to shareholders) or, to ignore social responsibility if it so prefers (with accountability to no one for its inaction). This article will attempt to outline a method for defining and enforcing the responsibility of corporate management to non-shareholder interests.

II. THE NOTION OF CORPORATE RESPONSIBILITY

A. *Traditional Theory of Management Responsibility*

The notion that management's undivided obligation is owed to shareholder interests arose from certain economic assumptions that are no longer valid. Traditionally, the corporation was viewed as a device for seeking out capital. Thus, in 1927, Professor Ballantine was able to write:

> Much of the industrial and commercial progress of the 19th and 20th centuries has been made possible by the corporate mechanism. . . . By its use men may combine their capital and participate in vast business enterprises with a risk limited to the capital contributed and without peril to their other resources and business. The amount of capital needed for modern business could probably be assembled and combined in no other way.[13]

Capital cannot be attracted unless sufficient profits are generated to pay investors the rate of return they demand.[14] When accumula-

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> poration shall be given to any charitable, educational or other similar organizations, except for purposes in direct furtherance of the business interests of this corporation and subject to the further provision that the aggregate amount of such contributions shall be reported to the shareholders not later than the date of the annual meeting."

Management responded, in part, that: "It is especially important that Westinghouse be a leader in meeting citizenship responsibilities in the communities in which it operates."

12 Indeed, the court in A. P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581, *appeal dismissed for want of a substantial federal question*, 346 U.S. 861 (1953), did not even suggest that "modern conditions" created an affirmative legal requirement that corporations discharge social responsibilities, much less that such a requirement could be enforced by non-shareholders.

13 H. BALLANTINE, PRIVATE CORPORATIONS 1 (1927).

14 Our accounting systems, however, do not reflect certain costs which ought to be borne by the corporation. Thus profit figures do not reflect the costs of pollution, injury, and human dislocation. E. MISHAN, GROWTH: THE PRICE WE PAY (1969); Parker, *Accounting and Ecology: A Perspective*, J. ACCOUNTANCY, Oct. 1971, at 41.

tion of capital was the critical economic need, the most desirable allocation of resources was one that attracted investment. Because the shareholder, as the ultimate supplier of capital, had to be satisfied at all costs, management's responsibility was traditionally owed to the shareholder.[15]

In the large modern corporation, however, the stockholder-king retains only a shadow of his former power. His importance to the corporation has diminished; he has lost interest in exercising power and his subjects have removed from him many of the tools of effective control. The capital-seeking function of the corporation has declined in importance. A large part of what Professor Berle termed "the twentieth-century capitalist revolution" was the freeing of corporations from the judgment of the financial markets through the use of internally generated capital.[16] Professor Galbraith refined this concept as he described the industrial planning techniques that permit capital formation without reliance upon competitive capital markets.[17] Even where recourse is had to the capital markets, the corporation has other options available. For example, capital funds ordinarily allocated for dividend purposes may be retained in the business.[18]

As the importance of the shareholder to the corporation has decreased, so has the shareholder's interest in the corporation. The increasing liquidity of the securities market coupled with the treatment accorded to capital gains under the Internal Revenue Code led the typical shareholder to vote with his feet — or more appropriately, with his broker.[19] Particularly when the opportunity to

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[15] *See* A. BERLE, JR. & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 333-39 (1933). *See also* Manne, *The Myth of Corporate Responsibility*, 26 BUS. LAW. 533, 538 (1970):

> There seems to be no overriding necessity for either encouraging or discouraging activity which might appear to be nonprofit oriented. If in fact, any corporation behaves uneconomically, the market will take care of it. It will either go bankrupt or control will be transferred to someone who will manage the corporate funds differently.

[16] *See* A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 35-42 (1954). *But cf.* Lintner, *The Financing of Corporations*, in THE CORPORATION IN MODERN SOCIETY, 166, 177-90 (E. Mason ed. 1959).

[17] J. GALBRIATH, THE NEW INDUSTRIAL STATE, 35-45 (1967).

[18] *Cf.* Brittain, *Federal Tax Laws and Corporate Dividend Behavior*, 28 OHIO ST. L.J. 427 (1967).

[19] Even the large institutional investors, who have the greatest incentive to control management activity, generally dispose of their holdings rather than give battle. *See* 5 SECURITIES AND EXCHANGE COMMISSION, INSTITUTIONAL INVESTOR STUDY REPORT 2749-70 (1971); Hetherington, *Fact and Legal Theory: Shareholders, Managers and Corporate Responsibility*, 21 STAN. L. REV. 248, 263-66 (1969); Rostow, *To*

sell one's holdings would result in a profit — as has generally been the case since World War II — selling is usually more appealing than attempting to turn management around.[20]

Finally, legal obstacles to shareholder supervision of management have increased, and self-perpetuation has virtually become the norm. Management's control over proxy solicitation machinery,[21] including access to the corporate treasury to finance solicitations,[22] has imposed formidable burdens upon the shareholder who wishes to mount a challenge. In nearly six thousand meetings for the election of directors held in the 1970 fiscal year by companies subject to the Securities and Exchange Commission's (SEC) proxy solicitation rules, proxy contests occurred in only 24 cases, and management emerged victorious more often than did insurgents.[23] This indicates that the enormous cost of compliance with the federal proxy rules does not generally make battle worthwhile.

The SEC's shareholder proposal rule,[24] while often touted as promoting shareholder democracy,[25] is so limited that it can hardly be taken as a serious attempt to subject management to shareholder supervision. In excluding shareholder nominations in election contests and relegating shareholders to their own solicitations with respect thereto,[26] and in excluding proposals that are not a proper subject for action by security holders under the laws of the issuer's domicile,[27] the rule provides little real supervision of management's

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Whom and For What Ends Is Corporate Management Responsible, in THE CORPORATION IN MODERN SOCIETY 46, 54 (E. Mason ed. 1959).

20 Hetherington, *Fact and Legal Theory: Shareholders, Managers and Corporate Social Responsibility*, 21 STAN. L. REV. 248, 263-66 (1969).

21 *See, e.g.*, J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970, 94-98 (1970); Caplin, *Proxies, Annual Meetings and Corporate Democracy*, 37 VA. L. REV. 653 (1951).

22 *See, e.g.*, Note, *Financing Proxy Contests with Corporate Funds*, 44 GEO. L.J. 303 (1956).

23 36 SEC ANN. REP. 46-48 (1970). Twenty of the proxy contests were for control of the board of directors. Of these, management won nine, two were settled by negotiation, three were won by non-management insurgents and six were pending as of June 30, 1970. The remaining four contests were merely for seats on the board of directors. Of these, management retained all the seats in one contest and non-management insurgents won a seat in the other three contests.

24 SEC Rule 14a-8, 17 C.F.R. § 240.14a-8 (1972).

25 *See, e.g.*, Gilbert, *An Independent Shareholder Appraisal*, 34 U. DET. L.J. 558 (1957).

26 SEC Rule 14a-8(a), 17 C.F.R. § 240.14a-8(a) (1972).

27 SEC Rule 14a-8(c)(1), 17 C.F.R. § 240.14a-8(c)(1) (1972). *See* Brooks v. Standard Oil Co., 308 F. Supp. 810 (S.D.N.Y. 1969). There is some indication, however, that the shareholder's lot may be improving. *See* Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403

stewardship. Similarly, shareholder access to the courts in attempts to supervise management action is severely limited by such procedural devices as security-for-expense statutes[28] and the requirement for demand upon the corporation as a prerequisite to filing a derivative action.[29]

But if the shareholder has abdicated his position of power, no one else has successfully assumed his control over management. While many groups have attempted to assume the supervisory role, none has yet succeeded. Rather, in the wake of the struggle, management has emerged as essentially autonomous. Both governmental and private interests have attempted to impose accountability upon management in a wide range of corporate activities.[30] Representatives of these interests have come to recognize the modern corporation as a significant center of control over social change, and consequently the corporation has become increasingly politicized.[31] But, despite conventional wisdom to the contrary, the corporation has become less "responsible" to any outside group, if responsibility assumes accountability. The owners of capital have lost control of management and no other group has legitimized its claim to succession.

B. *Sources of Corporate Responsibility*

Since Professor Dodd's landmark article[32] some forty years ago, commentators have referred to corporate responsibility as if it were a readily identifiable concept with clear guidelines and concrete goals.[33] Yet a realistic view indicates that corporate managers, no less

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(1972); and amendments to rule 14a-8, effective Jan. 1, 1973, 2 CCH FED. SEC. L. REP. ¶ 24,012 (1972).

[28] *E.g.*, CAL. CORP. CODE § 834(b) (West Supp. 1972); N.Y. BUSINESS CORP. LAW § 627 (McKinney Supp. 1972).

Some of these statutes in fact create new liabilities for attorney's fees on the part of shareholder-plaintiffs. *See generally* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 372 (2d ed. 1970).

[29] *See, e.g.*, W. CARY, CASES AND MATERIALS ON CORPORATIONS 887-911 (4th ed. 1969).

[30] For detailed accounts of a number of specific instances of private and governmental pressure upon corporations, see S. SETHI, UP AGAINST THE CORPORATE WALL (1971).

[31] *See* Blumberg, *The Politicalization of the Corporation*, 26 BUS. LAW. 1551 (1971).

[32] Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

[33] *See, e.g.*, Schwartz, *Corporate Responsibility in the Age of Aquarius*, 26 BUS. LAW. 513 (1970).

than the general run of mankind, have very different ideas regarding proper social goals. A classic example of this is the decision of Dow Chemical Company to manufacture napalm. Challenged by shareholders who wished "to have their assets used in a manner which they believe[d] to be more socially responsible but possibly less profitable" than existing company policy,[34] the company responded that:

> [T]he decision to continue manufacturing and marketing napalm was made not *because* of business considerations, but *in spite of* them; that management in essence decided to pursue a course of activity which generated little profit for the shareholders and actively impaired the company's public relations and recruitment activities because management considered this action morally and politically desirable.[35]

This exchange forcefully points out that a major problem of corporate responsibility is identifying the proper goals for the exercise of corporate power.

The issues upon which corporations have, both figuratively and literally, manned the barricades in recent years are legion. They have included minority hiring,[36] ending production of military weapons,[37] rebuilding the inner city,[38] environmental concerns,[39] and product safety[40] among others. Which of these are proper goals for corporations to pursue? Who is to make that decision?

The breakdown of shareholder control over management activities has given the choice by default to corporate management.[41] Yet, if the goal is to insure that corporate power is subjected to the overall policies that society in general has determined, it makes little sense merely to take the decision-making power from management and return it to shareholders. Were these the only alternatives,

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[34] Medical Comm. for Human Rights v. SEC, 432 F.2d 659, 681 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972).

[35] *Id.* at 681.

[36] *See, e.g.*, S. SETHI, *supra* note 30, at 50-186.

[37] *See, e.g.*, Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972); *Proxies for Protesters*, TIME, Jan. 26, 1970, at 69.

[38] *See, e.g.*, *Group Challenges S. & L. Board*, Wash. Post, Jan. 22, 1970, § B, at 1, col. 4.

[39] *See, e.g.*, S. SETHI, *supra* note 30, at 3-24.

[40] *See, e.g.*, R. NADER, *supra* note 4.

[41] *See, e.g.*, A. BERLE, JR., *supra* note 16, at 25-60; S. SELEKMAN & B. SELEKMAN, POWER AND MORALITY IN A BUSINESS SOCIETY 51-67 (1956).

we might more confidently predict that management would better heed societal goals than would shareholders.[42]

Reliance upon private pressure groups is also an insufficient means of vindicating public concerns. One need only examine some of the issues raised in recent years to become convinced that responsiveness to either shareholder groups or pickets is hardly a sufficient solution to the problem posed. For example, in 1967 a group of pickets urged the ousting of the management of R. J. Reynolds Tobacco Co. because the corporation was purchasing tobacco from Communist-dominated Yugoslavia.[43] In the same year, protesters objected to the Chase Manhattan Bank's lending policy in South Africa, alleging that it endorsed apartheid.[44] In later years, the targets of protests were often corporations manufacturing items used in the Viet Nam war.[45] These examples illustrate the fact that narrowly based pressure groups and shareholders are each subject to tunnel vision, and thus neither group can be relied upon to insure that society's goals are properly considered in corporate decisions.

Leaving this balancing to corporate management also poses problems, as Milton Friedman clearly pointed out in his frequently quoted attack on the doctrine of corporate social responsibility:

> If businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can self-selected private individuals decide what the social interest is? Can they decide how great a burden they are justified in placing on themselves or their stockholders to serve that social interest? Is it tolerable that these public functions of taxation, expenditure and control be exercised by the people who happen at the moment to be in charge of particular enterprises, chosen for those posts by strictly private groups? If businessmen are civil servants rather than the employees of their stockholders then in a democracy they will, sooner or later, be chosen by the public techniques of election and appointment.[46]

Although the legitimacy of corporate management as a decisionmaker can be supported in terms of its responsibility as a trustee

[42] *See, e.g.*, A. BERLE, JR., POWER WITHOUT PROPERTY 90-91 (1959); Donaldson, *Financial Goals: Management v. Stockholders*, 41 HARV. BUS. REV. May-June, 1963, at 116, 117-20.

[43] Dworsky, *New Annual Meeting Note: Social Protest*, N.Y. Times, May 28, 1967, § 3, at 1, col. 1; Rossant, *All You Need Is One Share*, N.Y. Times, May 7, 1967, § 4, at 6E, col. 1.

[44] Dworsky, *supra* note 43.

[45] *See An Activist Agenda for Annual Meetings*, BUSINESS WEEK, March 28, 1970, at 45-46.

[46] M. FRIEDMAN, CAPITALISM AND FREEDOM 133-34 (1962).

of shareholder capital,[47] a basic philosophical problem remains. A choice must be made between leaving considerable power in private hands[48] or subjecting centers of nongovernmental power to governmental control.[49] The virtue of the former course is to allow diverse approaches and conflicting values to exist.[50] This notion of pluralism is deeply imbedded in Western thought.[51] It is bottomed, however, upon the notions that a multiplicity of goals and a divergence of values are acceptable[52] and that numerous centers of power in fact promote diverse objectives.[53] Yet it has become increasingly clear that few societies have been able to tolerate divergent economic goals when centers of economic power obtained significant size.[54] In the United States, the modern corporation has not only grown into a center of immense power, but has increasingly joined with other large centers of power, both governmental and private, to adopt common policies and goals.[55] Under such conditions, the arguments of those critical of the pluralistic model of society are telling:

> [T]he pluralists naively imagined that private associations inevitably provided the individual with a far better opportunity for grass-roots democracy, for self-government and self-fulfillment, than he could find in the state. They completely ignored the likelihood that in many cases these associations could be even more oppressive than the state, because they were not subject to the restraints of formal procedure, judicial review, and public scrutiny, and because they could claim (often more plausibly than the state) that threats to the very existence of the association justified repression of dissent and concentration of power.[56]

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[47] *See* Berle, *For Whom Corporate Managers Are Trustees: A Note,* 45 HARV. L. REV. 1365 (1932).

[48] *See* Brewster, *The Corporation and Economic Federalism,* in THE CORPORATION IN MODERN SOCIETY 72, 75 (E. Mason ed. 1959).

[49] *See* Chayes, *The Modern Corporation and the Rule of Law,* in THE CORPORATION IN MODERN SOCIETY 25, 31 (E. Mason ed. 1959).

[50] *See* Brewster, *supra* note 48, at 75-76.

[51] *See* Chapman, *Voluntary Association and the Political Theory of Pluralism,* in VOLUNTARY ASSOCIATIONS: NOMOS XI 87 (J. Pennock & J. Chapman eds. 1969).

[52] *Id.* at 92-93.

[53] *Cf.* Brewster, *supra* note 48, at 75.

[54] A. Berle, Jr. & G. Means in their article on Corporation in IV *Encyclopedia of the Social Sciences* 414 (1931) trace this phenomenon in the Roman Empire and in Stuart England. The desire of the government to keep control over increasingly powerful associations was reflected in Roman licensing requirements and English doctrines that corporations must be created by state fiat.

[55] *See, e.g.,* M. MINTZ & J. COHEN, AMERICA, INC. (1971); C. PERROW, THE RADICAL ATTACK ON BUSINESS 13-16 (1972).

[56] Lakoff, *Private Government in the Managed Society,* in VOLUNTARY ASSOCIATIONS: NOMOS XI 170, 176-77 (J. Pennock & J. Chapman eds. 1969).

As the conditions that promote pluralism have disappeared, increasing concern has been expressed as to the necessity of subjecting centers of economic power to the overall goals which the society has enunciated through its political processes.[57] The debate over the proper scope of governmental control now moves to a different inquiry. In short, the question is whether the risk that the political process will not operate to impose the proper values on all of society outweighs the risk that unchecked corporate power will, in its admittedly more limited sphere, choose the wrong priorities.

The question has, however, largely been answered. Virtually without exception, the reaction to exercises of corporate power that conflict with broader societal goals has been resort to governmental regulation.[58] At least in theory, this development has been the most appropriate of possible alternative courses, since the politically elected organs of government are the only institutions structured to make the difficult policy choices at issue.

The fact that this resort to governmental policy-making has proceeded piecemeal makes it no less real.[59] The proliferation of regulatory programs, particularly at the federal level, has left few, if any, large corporations free from substantial governmental control in significant aspects of their business. While the growth of governmental regulation is universally acknowledged, its effect upon corporate responsibility has been less clearly perceived. In classical economic terms, extensive governmental regulation need not destroy management's obligation to shareholders. The cost of ignoring such regulations is merely a factor to be taken into account in pursuing profit maximization.[60] Violations will lead to fines, loss of goodwill, or other damage that will lessen profits. If the cost of compliance is greater than the cost of violation, classical economic considerations encourage violation.[61] Under this theory, there is no corporate responsibility beyond profit maximization.[62]

Such an approach, however, ignores the fact that while manage-

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[57] *See* Chayes, *supra* note 49, at 31; MacNaughton, *A Responsible Business*, 44 N.Y.S.B.J. 160 (1972).

[58] *See* A. BERLE, JR., POWER WITHOUT PROPERTY 113-14 (1959); Holton, *Business and Government*, 98 DAEDALUS 41 (1969).

[59] *See* J. HURST, *supra* note 21, at 108-09.

[60] *See* Gordon, *Pollutants or Profits*, 26 BUS. LAW. 541 (1970).

[61] *See* Blake, *The Shareholders' Role in Antitrust Enforcement*, 110 U. PA. L. REV. 143, 171-74 (1961). *Cf.* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

[62] *See* Friedman, *A Social Conscience for Business*, Chicago Tribune, Sept. 13, 1970, § 1A, at 1-2.

ment's obligations to maximize shareholder profits may have grown out of free-market economics, those obligations are imposed by state law, not by economic principles. Duties to shareholder interests cannot justify violation of regulatory statutes, regardless of the economic rationality of such action.[63] The content of corporate responsibility is not only what free-market economic theory demands, but also what state and federal law requires.

Under state corporate law, directors have fiduciary obligations to the corporation. If directors waste corporate assets, it is the corporation which has a cause of action.[64] It is mismanagement of the corporate entity that is the gravamen of any complaint. The assumption underlying traditional profit-maximization theories is that the corporation, as an entity, is concerned with profit-maximization. This pursuit of profits, however, is limited by other obligations imposed upon the corporation. As Milton Friedman phrases it, the goal of profit-maximization is the sole responsibility of the corporation "so long as it stays within the rules of the game."[65] The corporation is equally mismanaged when it ignores its obligations to act within the rules as when it ignores its obligation to maximize profits within the limitations of those rules.[66] Viewed in this manner, corporate social responsibility is merely responsibility to act within the rules.

Thus, the sources of corporate responsibility are two-fold. Not only does the corporation have an obligation to its shareholders, it also has an obligation to the community at large. The delineation of the scope of corporate social responsibility has increasingly been undertaken by the federal government. As a result, a federal common law of corporate responsibility is emerging which takes priority over the traditional fiduciary obligation of profit maximization. Even though the development of this law of corporate responsibility has come to rest with the federal government, as the discussion below will indicate, the application of this federal law to particular situations still requires corporate management to resolve some extremely complex policy issues.

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[63] *Cf. In re* Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961): "Moreover, while Gintel undoubtedly occupied a fiduciary relationship to his customers, this relationship could not justify any actions by him contrary to law."

[64] *See generally* H. HENN, *supra* note 28, at 457-59, 755-61 (2d ed. 1970).

[65] M. FRIEDMAN, *supra* note 46, at 133.

[66] *Cf.* Shawnee Compress Co. v. Anderson, 209 U.S. 423 (1908); Aiple v. Twin City Barge & Towing Co., 274 Minn. 38, 143 N.W.2d 374 (1966).

III. A VIEW OF THE EMERGING FEDERAL LAW OF CORPORATE RESPONSIBILITY

A. *Development of the Federal Law*

Political control of corporate responsibility was once a task undertaken by states. The period of incorporation by special act of a state legislature was a period of maximum political control. In 1799, for example, the New York legislature granted a charter to The Manhattan Company providing that the corporation should be dissolved unless within ten years it furnished a supply of water sufficient for the use of all citizens of New York City.[67] Both under specially granted charters and early general incorporation acts, states placed a ceiling upon the amount of capital that could be authorized in order to prevent problems resulting from concentrations of wealth and power.[68]

Had the states maintained this policy of control over corporate power, the present day problems of corporate responsibility might never have arisen. But the history to the contrary is well known. New Jersey, and then Delaware, led the way toward statutes that freed management from significant controls.[69] The twentieth century witnessed a race to eliminate restrictions on management's discretion. The revenue generated by incorporation fees and franchise taxes[70] plus the control over state legislatures exerted by pro-man-

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[67] *See* People v. President and Directors of the Manhattan Co., 9 N.Y. 351, 357 (Sup. Ct. 1832); E. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 at 182-83 (1954).

[68] A comprehensive review of state limitations upon the amount of authorized capital and scope of business activities is found in the dissent of Mr. Justice Brandeis in Liggett Co. v. Leo, 288 U.S. 517, 541, 550-64 (1933). *See also* Berle, *Historical Inheritance of American Corporations*, from 3 THE POWERS AND DUTIES OF CORPORATE MANAGEMENT (1950), *as reprinted in* W. CARY, CASES AND MATERIALS ON CORPORATIONS 1-3 (4th ed, unabridged, 1969); E. DODD, *supra*, note 67, at 232, 315.

[69] H. HENN, *supra* note 28, at 19-20 (2d ed. 1970). For a discussion of the philosophy underlying modern general incorporation statutes, see Katz, *The Philosophy of Midcentury Corporation Statutes*, 23 LAW & CONTEMP. PROB. 177 (1958); Latty, *Why Are Business Corporation Laws Largely "Enabling"?*, 50 CORNELL L.Q. 599 (1965).

[70] *See, e.g.*, Note, *Little Delaware Makes a Bid for the Organization of Trusts*, 33 AM. L. REV. 418 (1899):

> Meanwhile the little community of truck-farmers and clam-diggers have had their cupidity excited by the spectacle of their northern neighbor, New Jersey, becoming rich and bloated through the granting of franchises to trusts which are to do business everywhere except in New Jersey, and which are to go forth panoplied by the sovereign State of New Jersey to afflict and curse other American communities.

Id. at 418-19.

agement lobbyists[71] quickly led the states out of the business of controlling corporate responsibility.

State abdication of regulation led inevitably to federal action. What began as piecemeal legislation over various aspects of interstate commerce quickly became a widespread network of federal rules governing corporate responsibility.[72] A federal standard of corporate behavior was imposed upon institutions that were the creations of state law. The federal interest in corporate activity has become sufficiently pervasive to create a federal common law of corporate responsibility. This fact was clearly recognized by the New Jersey Corporation Law Revision Commission in its 1968 report:

> The modern corporation's business is frequently national or international in scope; its state of incorporation is largely incidental. Recognizing this fact, and seeking to attract corporations to establish their domiciles within their borders, most states in recent decades have been increasingly flexible and permissive in revising their corporation laws.
>
> Pursuing this policy perhaps further than any other state, the Commission believes it is following sound public policy for New Jersey. It is clear that the major protections to investors, creditors, employees, customers and the general public have come, and must continue to come, from federal legislation and not from state corporation acts. Whether it be anti-trust or securities regulation; wage and hour or social security laws; bankruptcy or corporate reorganization statutes; or even controls over personnel practices provided in the Internal Revenue Code, or controls over the methods of marketing and advertising products, provided both by statutes and by administrative agencies, the means of assuring such protections must be provided by the federal government. Any attempt to provide such regulations in the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to more hospitable jurisdictions.[73]

It appears that other drafters of state corporation statutes have also recognized that it is the federal government's function to prescribe standards of corporate social behavior. The early versions of the Model Business Corporation Act (MBCA) recognized a limited role for the federal government by providing that corporations had the power "in time of war to transact any lawful business in aid of the United States in the prosecution of the war."[74] The 1969 revi-

[71] *See* Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969).

[72] *See* Holton, *Business and Government*, 98 DAEDALUS 41 (1969).

[73] Corporation Law Revision Commission, *Preface* to N.J. STAT. ANN § 14A, at xi (1969).

[74] MODEL BUS. CORP. ACT § 4(n) (1960).

sion of the MBCA recognized the expanded role of the federal government by empowering corporations "to transact any lawful business which the board of directors shall find will be in aid of governmental policy."[75]

The development of a new federal common law — a post-*Erie*[76] common law in areas of federal concern — has been widely noted.[77] As Justice Harlan stated in *Banco Nacional de Cuba v. Sabbatino*: "[T]here are enclaves of federal judge-made law which bind the States. . . . Principles formulated by federal judicial law have been thought by this Court to be necessary to protect uniquely federal interests."[78]

Where Congress has expressed by statute a clear federal interest in specific areas, federal courts have been ready to fashion rules governing private disputes. Thus, in its famous *Lincoln Mills* decision, the Supreme Court found that section 301 of the Labor Management Relations Act authorized the federal courts to create a body of federal common law "which the courts must fashion from the policy of our national labor laws"[79] to enforce collective bargaining agreements.

In *Clearfield Trust Co. v. United States*,[80] the Supreme Court held that the liability of the United States on a check drawn by it is a question of federal common law, in the absence of specific congressional legislation. In *Sabbatino*,[81] the Court found that application of the "act of state" doctrine in the context of contract litiga-

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[75] MODEL BUS. CORP. ACT § 4(n) (1971). The provision has been adopted by Delaware, 8 DEL. CODE ANN. § 122(12) (Supp. 1970). The provision, in effect, reinforces the current trend, noted earlier, of allowing broader management-board of directors discretion to meet social responsibilities without any concomitant accountability for inaction.

[76] Erie R.R. v. Tompkins, 304 U.S. 64 (1938).

[77] *See* D. CURRIE, FEDERAL COURTS CASES AND MATERIALS 672-92 (1968); Friendly, *In Praise of Erie — And of the New Federal Common Law*, 39 N.Y.U.L. REV. 383, 405 (1964). In this regard the oft-quoted passage from Mr. Justice Jackson's concurring opinion in D'Oench, Duhme & Co. v. Federal Deposit Ins. Corp., 315 U.S. 447, 472 (1942) is appropriate:

> [Federal law] is found in the federal Constitution, statutes, or common law. Federal common law implements the federal Constitution and statutes, and is conditioned by them. Within these limits, federal courts are free to apply the traditional common-law technique of decision and to draw upon all the sources of the common law in cases such as the present.

[78] 376 U.S. 398, 426 (1964).

[79] Textile Workers Union v. Lincoln Mills, 353 U.S. 448, 456 (1957). *See also* Steele v. Louisville & Nashville R.R., 323 U.S. 192 (1944); Ivy Broadcasting Co. v. American Tel. & Tel. Co., 391 F.2d 486 (2d Cir. 1968).

[80] 318 U.S. 363 (1943).

[81] Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964).

tion was a question of federal law because of the "intrinsically federal"[82] nature of the problems involved.

The general question of corporate social responsibility has also become "intrinsically federal."[83] The individual states have become unwilling and unable to enforce limitations upon corporations required by the broader societal concerns of our times.[84] They have engaged in competitions to eliminate restrictions upon corporate management in order to attract corporations from elsewhere.[85]

State attempts to give shareholders supervisory control over the activities of management have given way to direct federal control over corporate behavior.[86] In place of shareholder control of profit maximization, the federal government has emphasized liquidity of the securities markets.[87] The modern thrust of federal securities legislation has been disclosure of information relevant to purchases and sales of securities.[88] Instead of providing federal remedies to insure profit maximization,[89] Congress has chosen to insure that

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[82] *Id.* at 427. *See also* Illinois v. City of Milwaukee, 406 U.S. 91 (1972); Note, *Federal Common Law and Interstate Pollution*, 85 HARV. L. REV. 1439 (1972).

[83] *Cf.* Note, *Stockholders' Derivative Suits: A Federal Question?*, 27 IND. L.J. 231 (1952).

[84] *See* Latty, *supra* note 69; *Law for Sale*, *supra* note 71. Occasionally states have imposed public interest limitations upon corporate activity which go beyond and do not conflict with federal policies. Insofar as the state-imposed policies are consistent with the broader federal requirements, they are, of course, also a source of normative requirements for corporate action. *Cf.* H. HART & H. WECHSLER, THE FEDERAL COURTS AND THE FEDERAL SYSTEMS 435-36 (1953).

[85] H. HENN, *supra* note 28, § 12; Latty, *supra* note 69, at 611-19.

[86] *See* J. HURST, *supra* note 21, at 82-111; Latty, *supra* note 69, at 616-17.

[87] *See* II REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, 13-18 (1963).

[88] *See* SEC, DISCLOSURE TO INVESTORS, A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (The Wheat Report) 10 (1969):

> Disclosure is and has from the outset been a central aspect of national policy in the field of securities regulation. The emphasis on disclosure rests on two considerations. One relates to the proper function of Federal government in investment matters. Apart from the prevention of fraud and manipulation, the draftsmen of the '33 and '34 Acts viewed that responsibility as being primarily one of seeing to it that investors and speculators had access to enough information to enable them to arrive at their own rational decisions. The other, less direct, rests on the belief that appropriate publicity tends to deter questionable practices and to elevate standards of business conduct.

[89] *See* Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968), in which plaintiff alleged that defendants, who were directors, officers and majority shareholders, had siphoned off the earnings of the corporation in order to depress the price of plaintiff's shares. Plaintiff had not sold his shares. The court affirmed the district court's granting of defendants' motion for summary judgment, saying: ". . . the plaintiff is not a seller and cannot invoke the civil remedy afforded by [rule 10b-5]. His recourse is to the minority stockholders' derivative action which he brought and which is now pending in the Supreme Court of the State of New York." *Id.* at 581-82. Thus, while state actions

shareholders can sell their shares at a price determined by informed judgment.[90]

Despite continuing efforts to undermine its holding,[91] *Birnbaum v. Newport Steel Corp.*[92] is still accepted by most courts as accurately stating the rule regarding standing under SEC rule 10b-5.[93] In *Birnbaum*, the Second Circuit pointed out that section 10(b) of the Securities Exchange Act of 1934,[94] under which rule 10b-5 was promulgated, "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that [rule 10b-5] extended protection to the defrauded purchaser or seller. . . ."[95] Thus, as long as *Birnbaum* retains its vitality no federal cause of action under the securities laws will lie to vindicate shareholders' interests that profits be increased at the expense of socially useful expenditures unless the shareholder can prove that he was a defrauded purchaser or seller. Even if *Birnbaum* is eventually overruled, the plaintiff, whether or not he is a purchaser or seller, will still have to prove "an injury as a result of deceptive practices touching" a purchase or sale of securities.[96]

Furthermore, although rule 10b-5 does provide a remedy for misappropriation if the purchaser-seller requirement is satisfied,[97] it was not directed primarily toward "transactions which comprise no more than internal corporate mismanagement."[98] Thus, in order to recover the plaintiff must show some fraudulent or deceptive practices on behalf of the defendant in connection with the purchase or sale of a security. Rule 10b-5 does not require profit maximization or socially useful expenditures. All the SEC requires is an

may remain for shareholder use in attempting to insure maximum profits, the focus of federal legislation has not been on profit maximization, but rather on the regulation of the marketplace in which the stockholder may disinvest. *See* notes 91-99 *infra* & accompanying text.

[90] *See generally* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

[91] *See, e.g.*, Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 234 (D. Neb. 1972); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968). In Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.10 (1971), the Supreme Court went out of its way to "express no opinion" on the continuing vitality of the *Birnbaum* doctrine.

[92] 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

[93] 17 C.F.R. § 240.10b-5 (1970).

[94] 15 U.S.C. § 78j(b) (1970).

[95] 193 F.2d at 464.

[96] Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971). *See* Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 234 (D. Neb. 1972).

[97] Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. at 11 n.7.

[98] *Id.* at 12. *See* text accompanying note 118 *infra.*

absence of such deceptive practices in securities transactions as nondisclosure of the costs that will be incurred in complying, for example, with anti-pollution requirements, or for not complying with the civil rights provisions in the law.[99]

In sum, absence of state control over corporate behavior has resulted in a pervasive, if piecemeal, pattern of federal legislation that forms the basis of a federal common law of corporate responsibility overlying traditional requirements of profit maximization.

B. *Examples of the Federal Law of Corporate Responsibility*

It is no longer possible to judge corporate actions solely within the narrow framework of state laws. Federal regulations, designed to reflect broad policy goals, have augmented state law and have established a network of standards with which corporations must comply. This federal law of corporate responsibility includes, *inter alia,* the express standards established by Congress, the policies supporting these standards, and judicial interpretation thereof. The interaction of these elements imposes upon the corporation the duty to act within their spirit as well as their letter. The scope of federal law relating to corporate social responsibility is so broad that the impact of federalization can be best examined in the context of several examples.

Case 1. Corporation X wishes to move its manufacturing plant from the center of a large metropolitan area to the suburbs. It has determined that such a move will create substantial savings. The real and personal property tax assessed on the corporation will be slightly lower in the suburban location. Because the suburban location is nearer its warehouses, transportation costs will be reduced. Because of lower crime rates in the new location, fewer plant guards will be needed. A newly constructed plant will embody new technological advances. Moreover, the corporation can sell its old plant to a company that desires to use the location for a parking lot. It will be able to realize an amount sufficient to purchase and construct its suburban plant.

What factors must the directors consider and may they authorize this move? Title VII of the Civil Rights Act of 1964[100] gives rise to an obligation to consider the effect of such a move on equal em-

[99] SEC Securities Act Release 5170, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,150 (July 19, 1971); SEC Securities Act Release 5253, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,524 (Feb. 16, 1972).

[100] 42 U.S.C. §§ 2000e to e-15 (1970).

ployment opportunity. In *Griggs v. Duke Power Co.*,[101] the Supreme Court construed broadly the obligation placed upon employers:

> What is required by Congress is the removal of artificial, arbitrary, and unnecessary barriers to employment when the barriers operate invidiously to discriminate on the basis of racial or other impermissible classification. . . . The Act proscribes not only overt discrimination but also practices that are fair in form but discriminatory in operation. The touchstone is business necessity.[102]

Relying upon such statements, the Equal Employment Opportunity Commission has suggested that corporations have an obligation under federal law not to transfer facilities in ways that will create employment barriers for minorities in the absence of some overwhelming business necessity.[103] The question of sufficient business necessity is apparently for the federal courts to determine. Applying this principle in another context, a federal district court has held invalid a company rule requiring the discharge of an employee after multiple wage garnishments. Because blacks tended to have their wages attached more often than whites, this was found to violate the 1964 Civil Rights Act.[104] The increased cost of the clerical work involved was found to be insufficient justification for dismissal since it was not related to job performance. Added expense to the employer was not a permissible rationale for policies that, although neutral on their face, had the effect of discriminating.[105]

Therefore management must consider the possible discriminatory effects resulting from a transfer of plant operations. In addition, if management's decision is challenged, it must show sufficient business necessity — mere economic advantage may not suffice — to justify its move in light of anti-discriminatory policies that are a part of federal corporate responsibility law.

Case 2. Corporation *Y* has been notified that one of its plants

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[101] 401 U.S. 424 (1971).

[102] *Id.* at 431.

[103] *See* Chapman, *EEOC Would Curb Moves to Suburbs*, Wash. Post, Aug. 27, 1971, at 1, col. 4.

[104] Johnson v. Pike Corp. of America, 322 F. Supp. 490 (C.D. Cal. 1971). *See also* EEOC Decision No. 72-1497, CCH EMPLOYMENT PRAC. GUIDE ¶ 6352 (March 30, 1972).

[105] Johnson v. Pike Corp. of America, 332 F. Supp. 490, 495-96 (C.D. Cal. 1971). The question of at what point, if any, added expense would be sufficient to constitute a "business necessity defense" is an issue with which courts are accustomed to dealing, much like the "business judgment" rule. *E.g.*, Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940).

is operating in violation of air pollution standards prescribed pursuant to the Clean Air Act.[106] The corporation proposes to close this plant in City *C* rather than comply with the regulations. The corporation is the major employer in City *C*, and the plant closing will create substantial unemployment. May the corporation close its plant?[107]

It can be argued that the Clean Air Act must be interpreted in light of other federal legislation, such as the Employment Act of 1946.[108] These statutes clearly set forth a federal policy encouraging full employment.[109] Congress, it seems, did not contemplate that pollution control should be accomplished at the expense of employment opportunity. Indeed Congress specifically provided that one of the purposes of the Clean Air Act was "to protect and enhance the quality of the nation's air resources so as to promote . . . the productive capacity of its population."[110]

An analogy may be drawn to the case of *Textile Workers Union v. Darlington Manufacturing Co.*[111] There, the Supreme Court held that the closing of a plant may violate the National Labor Relations Act when the purpose and effect of the closing is to chill unionism in other parts of the enterprise. In the case of corporation *Y*, closing the polluting facility, at least in the absence of major cost differentials, will both discourage those most affected — the local community — from exerting pressure for pollution abatement and violate the congressional intention of abating pollution without interferring with other important national objectives.

Case 3. Corporation *Z* manufactures electronic equipment for the United States Army. Orders for the company's civilian products have increased recently. Since its profit margins on civilian goods are higher than those produced under government contracts, the corporation plans to end its production of military goods upon expiration of its present contracts. May it do so?

The federal interest in adequately providing for the national defense can hardly be disputed. The Defense Production Act of

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[106] 42 U.S.C. § 1857(a)-(*l*) (1970).

[107] *See* Abel, *Smoke vs. Jobs — End of Myth*, 5 ENVIRONMENTAL SCIENCE & TECHNOLOGY 659 (1971).

[108] 15 U.S.C. §§ 1021-25 (1970).

[109] *See IBM Moves to Cut Back Work Force*, Wash. Post, Sept. 1, 1971, § C, at 9, col. 1. *Cf.* Parke v. Daily News Ltd., [1962] 1 Ch. 927.

[110] Clean Air Act § 101(b)(1), 42 U.S.C. § 1857(b)(1) (1970).

[111] 380 U.S. 263 (1965).

1950[112] has given the President broad authority to require private industry to perform government contracts or orders.[113] Despite such clear federal interest, the courts have hesitated to develop a federal common law going beyond this specific congressional mandate.[114]

These decisions, however, do not necessarily preclude an interpretation of the Defense Production Act that establishes a federal policy encouraging the acceptance of military orders. In light of the policy behind this Act and the fact that defense requirements cannot be met without the aid of private industry, federal corporate law may establish a responsibility to accept such orders in the absence of compelling reasons to the contrary.[115] Thus corporation *Z* may be required to evidence business reasons beyond higher profit margins in order to justify its refusal to accept government orders.

These examples serve to demonstrate the nature and breadth of the federal law of corporate responsibility. While it is clear that corporate activity should be subject to its restrictions, a standard must be developed to judge the validity of corporate activity, particularly when management is confronted with conflicting policy demands.

C. *Conflicting Policies and Business Judgment*

The piecemeal development of the federal law of corporate responsibility has led to conflicting policy demands. A striking example is presented in *Michigan Consolidated Gas Co. v. SEC.*[116] There, the corporation's attempt to finance low rent housing projects in the inner city conflicted with the policy of the Public Utility Holding Company Act of 1935[117] limiting diversification of utility holding companies. A myraid of other examples might be imagined. Purchasing an advanced piece of machinery from a foreign manufacturer might harm the American balance of payments, but using less advanced American-made devices might increase air or water

[112] 50 U.S.C. §§ 2061-2166 (1970).

[113] *Id.* § 2071. Furthermore, twenty-eight states and the District of Columbia have provisions in their corporate statutes specifically authorizing corporations in time of war to transact business in aid of the United States war efforts. I ABA-ALI MODEL BUS. CORP. ACT ANN., 182-85 (2d ed. 1971). In addition, Delaware has the broader provision discussed *supra* at note 75.

[114] *See* Perlman v. Feldmann, 219 F.2d 173, 177 (2d Cir. 1955); Acorn Iron & Supply Co. v. Bethlehem Steel Co., 96 F. Supp. 481 (E.D. Pa. 1951).

[115] *Cf.* Daynard, *The Use of Social Policy in Judicial Decision-Making*, 56 CORNELL L. REV. 919 (1971).

[116] 444 F.2d 913 (D.C. Cir. 1971).

[117] 15 U.S.C. §§ 79 to 79z-6 (1970).

pollution. Attempts to institute special job training programs for hard-core unemployed persons might increase the price of goods supplied to the federal government when such persons are employed on work under government contracts.

When conflicting policies are present, directors cannot be expected to exercise Solomonic judgment, but they can be expected to consider their decisions in the light of the conflicting policies. The fact that policies sometimes conflict is not reason to ignore the implications of all policies.

To ensure that the legal duties of corporate directors are not unreasonably harsh and that such duties are consistent with commercial needs, the courts long ago developed a "business judgment" rule that operates to vindicate directors if they make a good faith judgment between conflicting obligations. Just as a mere error in good faith business judgment has traditionally been a defense to shareholder charges of corporate mismanagement,[118] so should the business judgment rule provide a defense to charges of irresponsibility leveled by other interests.

The courts have imposed liability for negligence, not for poor business judgment. Thus failure to employ proper criteria for decisions may result in liability.[119] Directors should not be excused from failing entirely to consider the relevant policies. Perhaps what is needed is a requirement that directors consider a "social responsibility impact statement" in connection with each decision, much like the National Environmental Policy Act requirement that federal officials consider the environmental impact of proposed action.[120]

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[118] *See generally* H. HENN, *supra* note 28, at 482-83; N. LATTIN, THE LAW OF CORPORATIONS 272-74 (2d ed. 1971).

[119] *See, e.g.*, Hun v. Carey, 82 N.Y. 65 (1880). *See also* Cary & Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. SPECIAL ISSUE 61, 71-73 (1972); Forte, *Liabilities of Corporate Officers for Violations of Fiduciary Duties Concerning the Antitrust Laws*, 40 IND. L.J. 313 (1965).

[120] Section 102(C) of the National Environment Policy Act, 42 U.S.C. § 4332(C) (1970), provides that all agencies of the federal government shall:

> [I]nclude in every recommendation or report on proposals for legislation and other major Federal actions significantly affecting the quality of the human environment, a detailed statement by the responsible official on —
>
> (i) the environmental impact of the proposed action,
>
> (ii) any adverse environmental effects which cannot be avoided should the proposal be implemented,
>
> (iii) alternatives to the proposed action,
>
> (iv) the relationship between local short-term uses of man's environment and the maintenance and enhancement of long-term productivity, and
>
> (v) any irreversible and irretrievable commitments of resources which would be involved in the proposed action should it be implemented.

These are some, but by no means all, of the factors which a board of directors should

Recent studies have shown that all too often directors exercise little or no independent judgment upon recommendations made by the chief executive officer of the corporation.[121] A federal common law of corporate responsibility ought at least to require that directors use their positions to assess the social consequences of proposed action. Indeed their ability to evaluate more technical aspects of the action is at best limited.[122] This proposed function of social evaluation may be the only meaningful one that directors can perform.

The standard to be applied to determine whether directors have adequately carried out their social impact evaluation might very well be patterned after the standard imposed by section 11 of the Securities Act of 1933 (Securities Act) upon those who are responsible for the accuracy of registration statements.[123] Paraphrasing that test, the directors must, after reasonable investigation, have reasonable ground to believe and in fact believe that the action to be taken by the corporation is consistent with federal standards of corporate responsibility. Where there appear to be conflicting policy demands, the director should be required to exercise the same degree of care and skill in reconciling them or choosing between them as a prudent man would exercise under the circumstances in the conduct of his own affairs. This requirement resembles the duty placed upon trustees in cases of default under the Trust Indenture Act of 1939.[124]

Only by imposing the requirement of reasonable investigation by the directors is it likely that meaningful decisions will be made. Whether each director must conduct an independent investigation poses the same difficult problem as faced by an underwriting syndicate in connection with its obligations under section 11 of the Securities Act.[125] Whether or not it is reasonable to allow the managing underwriter in that context to carry out the investigative activities for the entire syndicate, it may be overly burdensome to

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consider in conjunction with any corporate decision. *Cf.* E. GOLDSTON, THE QUANTIFICATION OF CONCERN: SOME ASPECTS OF SOCIAL ACCOUNTING (1971).

121 M. MACE, DIRECTORS: MYTH AND REALITY 10-85 (1971); *cf.* Vanderwicken, *Change Invades the Boardroom*, FORTUNE, May 1972, at 156.

122 *See* J. GALBRAITH, THE NEW INDUSTRIAL STATE 72-85 (1967).

123 Securities Act of 1933 § 11(b)(3)(A), 15 U.S.C. § 77k(b)(3)(A) (1970). The application of this standard to all decisions of directors is suggested by George D. Gibson in Conard, Mace, Blough & Gibson, *Functions of Directors Under the Existing System*, 27 BUS. LAW. SPECIAL ISSUE 23, 43-45 (1972).

124 Trust Indenture Act of 1939 § 315(c), 15 U.S.C. § 77ooo(c) (1970). *See also*, remarks of George D. Gibson in Conard, Mace, Blough & Gibson, *supra* note 123, at 45.

125 *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 n.26 (S.D.N.Y. 1968).

require outside directors to conduct the factual investigations underlying social impact decisions. For that reason, at least the outside directors ought to be able to rely upon the facts presented in a social impact statement prepared for the board. Again, by analogy to section 11 of the Securities Act,[126] if such directors can show that they had no reasonable ground to believe and did not in fact believe that any part of the social impact statement was untrue or that it omitted material facts, they should not be held liable for judgments based upon the statement.[127] This, of course, should not relieve them of the obligation to make a good faith decision based upon careful consideration of the social impact statement.

IV. ENFORCING THE FEDERAL LAW OF CORPORATE RESPONSIBILITY — A PROPOSAL

A. *A Review of Presently Proposed Methods of Enforcement*

Proposals for enforcing notions of corporate responsibility have not been lacking. Most of the proposals to date have called for one of three basic approaches: (a) shareholder enforcement of social responsibility; (b) governmental appointment of public interest directors; or (c) direct legislative or administrative imposition of responsibilities on corporations.

The attempt at shareholder enforcement has found expression in Campaign GM,[128] and similar attempts to obtain shareholder votes for specific policies; in attempts to encourage investment in only socially responsible corporations;[129] and in proposals to modify shareholder voting power.[130] These methods have been largely un-

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[126] Securities Act of 1933 § 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(C) (1970).

[127] This standard would be analogous to state corporate law provisions protecting directors who rely in good faith upon financial statements represented as correct by corporate officers or by independent certified public accountants. *E.g.*, N.Y. BUSINESS CORP. LAW § 717 (McKinney 1963), and the somewhat more broadly worded provisons of 8 DEL. CODE ANN. § 141(3) (Supp. 1970). *See also* Conard, Mace, Blough & Gibson, *supra* note 123, at 42.

[128] *See, e.g.*, Hay, *The Shareholder's Role in Corporate Social Responsibility*, 5 U. MICH. J.L. REFORM 68 (1971); Wells, *The Greening of James Roche*, NEW YORK MAGAZINE, Dec. 21, 1970, at 35.

[129] *See, e.g., Social Dividends — A New Corporate Responsibility*, TRENDS IN MANAGEMENT INVESTMENT INVESTOR RELATIONS (No. 210, Oct. 1970). *See also* the shareholder proposal for proxy solicitation material of Fidelity Trend Fund, Inc., BNA SEC. REG. & L. REP. No. 97 at A10-11, E1-5 (April 14, 1971).

[130] *See, e.g.*, Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 16-21 (1969); Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"* 56 CORNELL L. REV. 1 (1970).

successful, first, because significant numbers of shareholders have been unwilling to forego profit maximization.[131] More basically, however, merely shifting the decision on social issues from management to shareholders in no way insures that a determination in the public interest will be made.[132]

Governmental appointment of public interest directors has been a more common method of attempting to promote corporate decisions in the public interest.[133] Apparently, its first use by the federal government was in the Second Bank of the United States. Twenty of the bank's directors were elected by private shareholders, while five were appointed by the President of the United States with the advice and consent of the Senate.[134] Later in the nineteenth century, the Union Pacific Railroad was organized with, at first, two out of fifteen,[135] and later five out of twenty[136] federally appointed directors.[137] In 1913, the device of government-appointed directors was used in making up part of the board of federal reserve banks.[138] Government-appointed directors were used again in 1962 when Congress, in setting up the Communications Satellite Corporation, provided for Presidential appointment (with confirmation by the Senate) of three of the corporation's fifteen directors.[139] The latest use of federally appointed directors appears to be in the 1968 transformation of the Federal National Mortgage Association into a privately owned corporation.[140]

Studies of the use of public interest directors have generally con-

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131 Despite the massive effort, Campaign GM did not obtain the votes of more than 2.73 percent of the outstanding shares on any one of their proposals. Blumberg, *supra* note 31, at 1561. Blumberg, however, feels that Campaign GM was a "considerable success" since GM responded by initiating serveral new programs in areas of public concern, including the creation of a public policy committee of its board of directors — one of Campaign GM's proposals. *Id.* at 1561-63. The GM results are not atypical. *See, e.g.*, Mintz, *Warner-Lambert Rejects Warning Notices Abroad*, Wash. Post, May 3, 1972, at A3, col. 6. For a provocative examination of the proper role of universities in voting portfolio shares, see J. SIMON, C. POWERS, & J. GUNNEMANN, THE ETHICAL INVESTOR: UNIVERSITIES AND CORPORATE RESPONSIBILITY (1972).

132 *See* note 42 *supra* & accompanying text.

133 States and municipalities employed this practice in the early development of canals and railroads. Schwartz, *Governmentally Appointed Directors in a Private Corporation — The Communications Satellite Act of 1962*, 79 HARV. L. REV. 350 (1965).

134 Act of April 10, 1816, § 8, 3 Stat. 266, 269.

135 Act of July 1, 1862, 12 Stat. 489, 491.

136 Act of July 2, 1864, 13 Stat. 356, 361.

137 *See* Schwartz, *supra* note 133, at 357-61.

138 Federal Reserve Act, § 4, 38 Stat. 251, 256 (1913).

139 47 U.S.C. § 733(a) (1970).

140 12 U.S.C. § 1723(b) (1970).

cluded that the use of such directors is not an effective means of protecting the public interest in corporate decision making. At the most basic level, such directors, where used to date, have always constituted a minority of the board and could thus easily be outvoted.[141] Second, in an attempt to appoint public interest directors of high caliber, the government has often chosen men without specific expertise in the technical areas in which the corporation operates.[142] In any event, the public interest director finds himself in the position of all outside directors — unfamiliar with the details that officers on the board, who devote full time to the company, have at hand.[143] Third, the exact duties of the public interest director have generally been inadequately spelled out so that the director experiences conflict between duties to the public and to shareholders.[144] Fourth, there is a danger that close relationships between public interest directors and other management personnel will lead the public interest representative to see problems in the same way as his colleagues.[145] Finally, it has been suggested that government-appointed directors may create even less corporate responsiveness by lessening the scope of regulation undertaken by regulatory agencies which would otherwise deal more firmly with the corporation.[146]

Proposals suggesting direct legislative or administrative imposition of social responsibilities on corporations have taken numerous forms. The creation of various regulatory agencies is, of course, a form of this approach.[147] Yet many advocates of corporate social responsibility have found this type of administrative agency to be inadequate. Its inadequacies have been attributed to a number of causes, not the least of which are the uneven funding of programs as political concern with the agency fluctuates, undue influence by the industry being regulated, and loss of responsiveness through over-formalization of procedures.[148]

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141 *See* Schwartz, *supra* note 133, at 354, 358-59.

142 *Id.* at 355-56.

143 *See* Weinberg, *A Corporation Director Looks at His Job*, 27 HARV. BUS. REV. 585, 588-90 (1949).

144 *See Protection of the Public Interest in the Structure and Operations of the Communications Satellite Corporation*, 18 RECORD OF N.Y.C.B.A. 630, 631-41 (1963); Schwartz, *supra* note 133, at 353-55, 358, 361-63; Vagts, *Reforming the "Modern" Corporation: Perspectives From the German*, 80 HARV. L. REV. 23, 82 (1966).

145 *See* Vagts, *supra* note 144, at 86-87.

146 Schwartz, *supra* note 133, at 364.

147 *See* J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 162-63 (1970).

148 *See* W. CARY, POLITICS AND THE REGULATORY AGENCIES 60-68 (1967).

In place of agencies that direct their activities toward specific industries, it has been suggested that broader regulation of the social activities of corporations be centralized. Proposals of this type have suggested continuous governmental supervision of corporate activities to insure a proper regard for the public interest,[149] sometimes suggesting federal incorporation of businesses as well.[150]

In fact, a system does exist at present that operates in this manner. The federal procurement system has been used regularly in recent years to insure that government contractors carry out specific social policies.[151] Federal procurement contracts require that contractors give preference to American suppliers,[152] that they agree to employ no convict labor,[153] and that they not discriminate against employees on the basis of race, color, religion, sex, or national origin.[154] Comprehensive assurances of equal employment opportunity are also required.[155] Depending upon the circumstances, federal procurement contracts must include clauses that encourage subcontracting to small business,[156] that require compliance with the Humane Slaughter Act of 1958[157] when livestock products are sold to the government,[158] or that give preference to subcontractors in areas of labor surplus.[159]

The use of the procurement system to carry out social objectives has generally been limited to conditions directly related to production of the goods or services that are the subject of the contract. Expansion of this regulation to other aspects of corporate activities might impose unmanageable administrative burdens.[160] Even if the administrative problems are manageable, past experience has indicated that significant dangers of arbitrary enforcement are present

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149 *See* Fischer, *The Lost Liberals*, 194 HARPERS 385, 391-95 (1947).

150 *See* M. MINTZ & J. COHEN, AMERICA, INC., 441-42 (1972); Wallich, *What Future for Corporations*, Sept., 1971, reprint from CITICORP. MAGAZINE.

151 *See* Hannah, *Government by Procurement*, 18 BUS. LAW. 997 (1963).

152 *See* Buy American Act, 41 U.S.C. 10a-10d (1970); 41 C.F.R. §§ 1-6.104-5, 1-7.101-14 (1972).

153 *See* Act of Feb. 23, 1887, 18 U.S.C. § 436 (1970); 41 C.F.R. §§ 1-7.101-15, 1-12.201 to 1-12.203 (1972).

154 *See* 41 C.F.R. § 1-7.101-18 (1972).

155 The Philadelphia Plan is a regulation promulgated pursuant to Exec. Order 11246, 3 C.F.R. 173 (1973), 42 U.S.C. § 2000e (1970). *See* Note, *The Philadelphia Plan: Remedial Racial Classification in Employment*, 58 GEO. L.J. 1187 (1970).

156 41 C.F.R. §§ 1-7.101-21, 1-1.710-3 (1972).

157 7 U.S.C. §§ 1901-1906 (1970).

158 41 C.F.R. §§ 1-7.101-24, 1-4.605 (1972).

159 41 C.F.R. §§ 1-7.101-25, 1-7.101-27, 1-1.805-3 (1972).

160 *See* Wallich, *supra* note 150, at 6-7.

when enforcement powers are placed in the hands of contracting officers.[161]

B. *The Public Interest Derivative Suit*

Numerous federal regulatory agencies have been established with a mandate to consider the "public interest" as a guide in rulemaking.[162] Exclusive reliance upon agency action, however, has proved to be inadequate. To check the exercise of agency discretion, courts have found statutory authority to permit interested private parties to question whether the "public interest" is in fact being served.[163] Particularly in connection with the granting of licenses and similar permits, the public interest has not been left solely to agency determination. Affected persons have been permitted to act as "private attorneys general" in order to vindicate the public's interest in compliance with standards enacted to control governmental action.[164]

A similar private check on governmental activities has developed in other areas through the taxpayer's suit. Initially as to local officials,[165] and increasingly at the federal level,[166] courts granted standing to taxpayers who wished to challenge governmental expenditures. Taxpayers were permitted to question the legality of official action and to enjoin illegal expenditures; they were not limited merely to receiving a refund of their tax payments.[167] The taxpayer became a private attorney general attempting to vindicate the public's interest in proper administration of tax revenues.

A third use of the private attorney general — although often not recognized as such — is the shareholder derivative suit. In free market economic theory, profit maximization is not an end in itself. Rather it is the method by which the most rational allocation of economic resources is maintained. Profit maximization is seen as

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[161] *See* Kaplan, *Equal Justice in an Unequal World: Equality for the Negro — The Problem of Special Treatment*, 61 Nw. U.L. REV. 363, 387 (1966).

[162] *E.g.*, 47 U.S.C. § 307(d) (1970) (Federal Communication Commission); 49 U.S.C. § 1302 (1970) (Civil Aeronautics Board); 15 U.S.C. §§ 78d, 78i(b), 78n(a) (1970) (Securities and Exchange Commission).

[163] *See, e.g.*, Scripps-Howard Radio, Inc. v. FCC, 316 U.S. 4, 14 (1942).

[164] Clean Air Act § 304, 42 U.S.C. § 1857h-2 (1970). *See* L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION, 459-500 (abr. student ed. 1965); K. DAVIS, ADMINISTRATIVE LAW TREATISE § 22.05 (1958 and Supp. 1970).

[165] *See* L. JAFFE, *supra* note 164, at 459-94; 4 E. YOKLEY, MUNICIPAL CORPORATIONS §§ 602-06 (1959 and 1972 Supp.).

[166] *See, e.g.*, Flast v. Cohen, 392 U.S. 83 (1968); D. CURRIE, FEDERAL COURTS 53-70 (1968); K. DAVIS, *supra* note 164, §§ 22.09 to .09-7 (1970 Supp.).

[167] *See, e.g.*, 4 E. YOKLEY, *supra* note 165, § 605.

a limitation that serves the public interest in determining the proper use of corporate wealth and power.[168] It is the public concern that societal limitations be enforced that traditionally permitted the attorney general of a state to demand forfeiture of the corporate charter in a quo warranto proceeding when the corporation had misused corporate powers.[169] The more common method of enforcing societal limitations upon the use of corporate assets, however, has been to permit a shareholder to "conscript the corporation as a complainant"[170] in a derivative action. Such actions permit the corporation, at the shareholder's behest, to insist upon proper management by its directors and officers.

The shareholder's interest in a derivative suit is much the same as a taxpayer's interest in his public action.[171] Just as the taxpayer will receive no refund, likewise the shareholder will receive no direct recovery of profits.[172] Rather, the corporation will be forced to redeploy its assets in the manner that society has prescribed. It is this principle which permits full recovery by the corporation even though some of its present shareholders are the wrongdoers who caused the misapplication of assets.[173] A number of courts have been troubled by the supposed reward given to wrongdoers in such suits and because of this have allowed individual recovery.[174] But the reward to wrongdoers is no greater than the reward to fellow taxpayers who have encouraged the illegal spending enjoined by a taxpayer's suit.

When the shareholder derivative suit is viewed as an action to vindicate the public interest in proper allocation of economic resources, the shareholder possesses standing in its traditional sense. It is the shareholder who generally has the greatest interest in corporate profit maximization. Since he is normally the beneficiary of a system which allocates resources according to market demands, he

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168 *See* M. FRIEDMAN, CAPITALISM AND FREEDOM 7-21 (1962); L. JAFFE, *supra* note 164, at 4-6.

169 *See* 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2332 (Perm. ed. rev. 1967). *Cf.* Highlander Folk School v. State, 208 Tenn. 234, 345 S.W.2d 667, *cert. denied*, 368 U.S. 840 (1961). *See also* Maddigan, *Quo Warranto to Enforce a Corporate Duty Not to Pollute the Environment*, 1 ECOLOGY L.Q. 653 (1971).

170 Smith v. Sperling, 354 U.S. 91, 99 (1957) (Frankfurter, J., dissenting).

171 *Cf.* Frothingham v. Mellon, 262 U.S. 447, 487 (1923).

172 *See* H. HENN, *supra* note 28, § 373. Some cases have, however, allowed recovery by individual shareholders. *Id.*

173 *See* Keenan v. Eshleman, 23 Del. Ch. 234, 2 A.2d 904 (1938).

174 *See* H. HENN, *supra* note 28, § 373.

is the party with standing to assert that the allocation rules are not being followed.

At times, however, as when claims of creditors far exceed any potentially recoverable assets, the shareholder has little interest in pursuing the corporation's cause of action. At other times as well, the shareholder's interest may be insufficient to insure that he is the best qualified party to maintain the suit. For this reason, rules have been promulgated to eliminate "strike suits."[175] In addition, non-shareholders have been permitted to vindicate corporate causes of action when they are the most interested party. Creditors, acting through trustees or receivers, vindicate such causes of action as a matter of course.[176] New York General Corporation Law prior to 1963 clearly recognized that an action against corporate directors to compel them to account for their official conduct[177] was not an action in which shareholders alone were interested. It permitted such an action to be brought "by the attorney general in behalf of the people of the state . . . by the corporation or a creditor, receiver or trustee in bankruptcy thereof, or by a director or officer of the corporation."[178]

Now that the shareholder's concern with profit maximization is no longer coextensive with the public interest in proper resource allocation, a new method of enforcing societal goals is needed. As has been shown above, allocation of corporate resources is now largely controlled by a new federal common law arising from a broad range of federal regulatory statutes. It is no longer the shareholder who has the greatest interest in enforcing these rules.[179] Today the worker, the consumer, or members of a larger public have become more interested in corporate compliance with these new duties.[180] Just as the receiver may have standing to insure proper

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[175] *See generally* H. HENN, *supra* note 28, §§ 361-67, 372.

[176] *See* W. CARY, *supra* note 29, at 865-66.

[177] N.Y. GEN. CORP. LAW § 60(1) (McKinney 1943).

[178] *Id.* § 61 (McKinney Supp. 1972).

[179] I am not suggesting that a shareholder no longer has a legitimate interest in securing a return upon his or her investment in the corporation or that a derivative action should no longer be available to the shareholder to ensure that management's duties to the corporation are fulfilled. Rather, I am asserting that existing regulation of corporations, both federal and state, does not have profit maximization as its sole, or even predominant, thrust, and therefore the shareholder's interest in enforcing these duties is minimal, if not antithetical to the thrust of the regulations altogether. Thus, these duties should be enforced by those most interested in enforcement, that is, those individuals most directly affected by management's misuse of corporate power.

[180] The words of Chief Justice Waite in Munn v. Illinois, 94 U.S. 113 (1876),

corporate management of the insolvent corporation, the worker should have standing to insure corporate compliance with employment programs. Residents of the affected area may be those most concerned with insuring that corporate assets are spent for legally required pollution abatement rather than diverted to shareholders.[181] When management has decided to act, or not to act, a dissatisfied member of the public should be able to bring a public interest derivative suit challenging the decision on the grounds that it does not comport with the federal law of corporate responsibility.[182]

Allowing such individuals to assert their causes of action through

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perhaps best capsulize the justification for enlarging the class of individuals to whom a corporation may be responsible:

> Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created.

Id. at 126.

While *Munn* dealt with the constitutionality of state regulation of common carriers, the evolution of the place of corporations in our society, discussed in the first part of this article, dictates that corporations also be "clothed with a public interest" and that control be exercised in part by those most closely affected by corporate decisions.

181 The possibility that community members may have conflicting interests does not negate the validity of the public interest derivative suit. In this instance, certain residents may advocate the installation of pollution equipment, while others may depend upon the corporation as an employer. *See* text accompanying notes 106-111 *supra.* Although it may be impossible to fashion an ideal solution, the public derivative suit will force the corporation to consider solutions other than violating the pollution laws or closing the plant. In this manner, the corporation may better serve the public interest within its goal of profit maximization.

182 Once this suit has been instituted, the directors would be able to defend on the basis that after reasonable investigation, they had reasonable grounds to believe, and, in fact, did believe that the decision was consistent with federal standards of corporate responsibility. *See* notes 123-24 *supra* & accompanying text. The reasonable investigation requirement would be satisfied by a showing that the directors had considered a complete and accurate NEPA-type statement outlining all possible consequences flowing from their decision. *See* note 120 *supra* & accompanying text. If the directors had failed to fulfill this requirement, the court could enjoin the corporation from beginning to implement or further implementing its decision.

The burden would also be upon the directors to meet the second, and more difficult, requirement of the defense. To do so, they would first have to prove that they exercised due care in considering the spectrum of federally-protected public rights which the corporation's action might affect, and, based upon the factors considered, there were reasonable grounds to believe that their decision was consistent with federal standards. Second, they would have to prove that they did in fact believe that their decision was reasonable in light of federal policies. The business judgment rule would be available to protect the directors by preventing the court from substituting its own judgment for that of the board. Therefore, the business judgment rule would protect directors from poor business judgments as long as they exercised due care in considering all the relevant factors. If the directors failed to meet this test, the court could hold them personally liable and order them to choose an alternative consistent with federal standards of corporate responsibility.

public interest derivative suits would avoid a number of the problems present in alternative methods of enforcing corporate social responsibility. Unlike shareholder enforcement, advocates would not have conflicting financial interests that might lessen their zeal for the exercise of corporate responsibility. Unlike administrative enforcement of accountability, the vagaries of congressional funding would not interfere with vigorous enforcement efforts. Unlike the case of minority public interest directors, the courts would have the power to coerce required changes.

More importantly, however, the proposed remedy may be implemented without further legislative action. Clearly, the corporation has a cause of action for mismanagement. Just as a corporation is mismanaged when the directors negligently fail to maximize profits, so too is it mismanaged when the directors cause the corporation to violate the law of corporate responsibility. When this mismanagement takes the form of a failure to maximize profits, the shareholders have a derivative suit to vindicate the corporation's cause of action. When the mismanagement results in a violation of the law of corporate responsibility, the public should be able to pursue the corporation's cause of action. Thus, sufficient precedent exists for immediate judicial validation of the public interest suit. This feature alone strongly recommends the approach over the more protracted legislative alternatives which have been suggested.

The public interest derivative suit would allow those most concerned to bring suit upon the corporation's cause of action. As this suit would be derivative its goal would not be to compensate the plaintiff for his injury, but rather to require, on behalf of the corporation, that the corporate management redirect corporate spending or modify other corporate decisions. The new public interest plaintiff would receive no direct recovery or relief. The remedy sought would benefit the plaintiff only collaterally, as the shareholder was benefitted collaterally in traditional derivative suits.

Why, though, cast the remedy in the form of a derivative action? Would the same result be achieved by implying private rights of action from various federal regulatory statutes? The derivative suit possesses a distinct advantage. By limiting enforcement of such public rights to an action brought on behalf of the corporation, a multiplicity of suits, with potentially conflicting outcomes, is avoided. A final judgment precludes relitigation of the same issues since the only permissible plaintiff — the corporation — is bound by res judicata.

Federal courts have traditionally been given wide latitude in shaping remedies for violations of federal law.[183] When the corporation is conscripted as a complainant to insure that its officers and directors do not misdirect its resources, the same latitude should be allowed. Where directors have failed to consider the social impact of proposed expenditures, directing them to give proper consideration to the relevant factors may be sufficient. In other situations, enjoining of expenditures or the order of expenditures for alternative purposes may be needed.

C. *Some Lingering Considerations*

Several potential objections to the public interest derivative suit remain. One objection posits that such suits will discourage governmental enforcement of appropriate statutes. Experience indicates, however, that while there is an interaction between private enforcement and governmental enforcement action, this relationship is by no means unidirectional. Private litigants may rely upon governmental enforcement efforts to develop the groundwork for their suits.[184] Where a private litigant files before the government has taken any enforcement action, the government may intervene as a party[185] or as amicus curiae,[186] rather than bring its own action. Where the result of litigation imposes burdens upon unsuccessful defendants which they find unreasonable, they may convince the appropriate regulatory agency to exercise its rule-making power to ameliorate the results of judicial enforcement.[187] Where private enforcement increases operating costs of selected businesses, they may encourage appropriate governmental officials to undertake industry-wide regulation in order to remove the competitive disadvantages resulting from selective enforcement.[188] On balance, then, private

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183 *See, e.g.*, J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

184 Clayton Act § 5, 15 U.S.C. § 16(a) (1970). For a discussion of the use of SEC stop order proceedings as a basis for later private suits, see 36 SEC ANN. REP. 34-35 (1970).

185 Clean Air Act § 304(c)(2), 42 U.S.C. § 1857h-2(c)(2) (1970).

186 *See, e.g.*, 36 SEC ANN. REP. 118-19 (1970).

187 *Cf.* SEC Securities Act Release No. 5336, CCH FED. SEC. L. REP. ¶ 79,108 (Nov. 28, 1972).

188 An example is the attempt to formulate a comprehensive program of water pollution control under the Federal Water Pollution Control Act, 33 U.S.C. § 466, *as amended*, 33 U.S.C. §§ 1151-75 (1970), rather than permitting selective governmental enforcement of the Refuse Act of 1899. *See Justice Department Guidelines of Litigation Under the Refuse Act*, 1 BNA ENVIR. REP. CURRENT DEVEL. 288 (July 17, 1970).

enforcement often encourages governmental enforcement action beyond that which would otherwise be undertaken.

The law of shareholder derivative actions has been obsessed with the problem of strike suits — actions brought solely to harass the defendant or for the personal gain of the plaintiffs or their attorneys. To prevent such suits, numerous procedural hurdles have been placed in the way of potential shareholder litigants. These include the requirement of stock ownership contemporaneous with the injury, the necessity of exhausting intracorporate remedies through demands upon directors and shareholders, security-for-expense statutes when the plaintiff owns a small amount of stock, and judicial approval of settlements.[189]

In considering the necessity for similar restrictions upon public interest derivative suits, factors unique to corporate shareholders should be noted. In particular, the ease with which shareholder status may be acquired is central to the problem of strike suits since it facilitates the purchasing of standing.[190] Similarly, the ease with which shareholders may sell out their interests may justify the imposition of procedural hurdles. The plaintiff in a public interest derivative suit is less likely to "litigate a purchased grievance."[191] In many instances it is difficult to purchase standing. No method is available without substantial cost or inconvenience to become a corporate employee or a resident of an affected city. Likewise, those injured by corporate activities may have no simple escape, as does the shareholder in selling his stock. The homeowner in an area of air pollution, the consumer of products of an oligopolistic industry,[192] or the unemployed worker has no easy means by which to escape the source of his injury.

Even where public interest standing may be easily purchased — for example by a consumer of an inexpensive article — other more effective methods are available to weed out inappropriate representatives of the public interest. Judge (now Chief Justice) Burger suggested two tests in *Office of Communication of United Church of Christ v. FCC*.[193] These are: (1) that the plaintiff be responsible and representative of the public interest, and (2) that he be willing

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[189] *See generally* H. HENN, *supra* note 28, §§ 361-67, 372, 374.

[190] *See* Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1308, 1310 n.8 (1934).

[191] Capitol Wine & Spirit Corp. v. Pokrass, 277 App. Div. 184, 98 N.Y.S.2d 291, 293 (1950), *aff'd*, 302 N.Y. 734, 98 N.E.2d 704 (1951).

[192] *See* J. GALBRATH, THE NEW INDUSTRIAL STATE 208-20 (1967).

[193] 359 F.2d 994 (D.C. Cir. 1966).

to shoulder the burdens and costs of litigation.[194] These tests could eliminate potential abuse of the device.

Other reasons underlying the imposition of restrictions on shareholder litigation may be inappropriate in public interest derivative suits. While it may be advisable to require shareholders to exhaust intracorporate remedies in some situations, that alternative may lead to excessive disruption of corporate life. For example, requiring labor unions to exhaust the collective bargaining route, perhaps including striking over the issue, merely in order to avoid litigation appears too high a price to pay. Moreover, disruptions and confrontations experienced by corporations in recent years reflect the general absence of reasonable intracorporate channels through which public interest demands can be made.[195]

Courts generally permit reimbursement of the successful plaintiff for expenses, including attorneys' fees, in a derivative action.[196] Since the corporation is the real plaintiff in interest, it should bear the costs of a successful suit in which it has benefited even though it has been brought in less than willingly as a party.[197] The availability of the corporate treasury as a source of attorneys' fees in the public interest derivative suit is likely to be the primary stimulus to the use of the proposed remedy,[198] as experience with private enforcement of prohibitions on retention of short swing profits under section 16(b) of the Securities Exchange Act would seem to indicate.[199]

It may be argued, of course, that the possibility of recovering attorneys' fees from the corporation will stir up unnecessary and frivolous litigation. As in the case of the traditional shareholder derivative suit, this contention is usually put forward by those who

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[194] *Id.* at 1005, *cited with approval,* Citizens Comm. for Hudson Valley v. Volpe, 425 F.2d 97 (2d Cir. 1970), *cert. denied,* 400 U.S. 949 (1970). Some support for the public interest derivative suit can be found in Sierra Club v. Morton, 405 U.S. 727, 734-35 (1972), which stated that standing would be permitted where an injury was widely shared so long as the plaintiffs were themselves injured by the challenged action. In the public interest derivative suit, both the corporation and the individual plaintiffs would be injured by the improper actions of officers and directors.

[195] The confrontation between Eastman Kodak Co. and FIGHT, and that between students and Dow Chemical Co. are examples of this problem. *See* S. SETHI, UP AGAINST THE CORPORATE WALL, 107-28, 236-66 (1971). *See also, An Activist Agenda for Annual Meetings,* BUSINESS WEEK, March 28, 1970, at 45-46.

[196] *See* H. HENN, *supra* note 28, § 377.

[197] *See, e.g.,* Bosch v. Meeker Cooperative Light & Power Ass'n, 257 Minn. 362, 363, 101 N.W.2d 423 (1960).

[198] *See* W. CARY, *supra* note 29, at 980-82.

[199] *See Policy Note on Champerty, and Enforcement of Section 16(b),* in W. CARY, *supra* note 29, at 812-13.

believe that any litigation which interferes with management's unrestricted freedom of action is "frivolous."[200] However, only the successful litigant will be awarded such fees, and then only if the victory was of benefit to the corporation.[201]

The settlement process may be a valuable tool for obtaining public interest objectives quickly and at less cost than would be involved in full scale litigation.[202] The settlement process may, however, be abused in two rather different ways. First, corporate management may find compliant or friendly plaintiffs who will agree to settle the derivative action — and thus bar further suits on the cause of action — on terms favorable to corporate management.[203] To forestall such action, the Federal Rules of Civil Procedure[204] and many state rules[205] require judicial approval of any settlement, along with notice to other shareholders of the proposed settlement terms, so that they may object if they desire.[206] The same rules should apply to the proposed public interest derivative suit. Notice to other potential plaintiffs of proposed settlement terms could be handled with the same flexibility as is now done in similar situations in the settlement of class actions.[207]

The requirement of judicial approval of settlements has led to the situation in which potential plaintiffs enter settlements before filing suit. The settlement demanded by the potential plaintiff may be extortionate, but corporate management may be willing to pay it rather than bear the costs of even a successful defense.[208] Courts have, however, begun to curb this abuse by considering any such amount recovered as being held in trust for the corporation and recoverable by it, or on its behalf, in a derivative suit.[209] The loss of the settlement to the corporation is likely to deter those who would

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[200] *See* Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COLUM. L. REV. 1, 3 (1947).

[201] Aiple v. Twin City Barge & Towing Co., 279 Minn. 22, 154 N.W.2d 898 (1967).

[202] H. HENN, *supra* note 28, § 374.

[203] *See* Rohrlich, *The New Deal in Corporation Law*, 35 COLUM. L. REV. 1167, 1185-89 (1935).

[204] FED. R. CIV. P. 23.1.

[205] For summary of state rules similar to FED. R. CIV. P. 23.1, see H. HENN, *supra* note 28, § 374, at 790 n.4.

[206] *See* H. HENN, *supra* note 28, § 374, at 790.

[207] FED. R. CIV. P. 23(e).

[208] *Cf.* W. CARY, *supra* note 29, at 930-32.

[209] *See, e.g.*, Clarke v. Greenberg, 296 N.Y. 146, 71 N.E.2d 443 (1947).

threaten suit merely in order to extort large settlements from potential defendants.

Many of the relevant federal statutes exempt small business concerns, defined, for example, by number of employees,[210] asset size and number of shareholders,[211] or sales volume.[212] The development of a federal common law of corporate responsibility may permit the courts to adapt the policies expressed by the various statutes to small businesses that were excluded from statutory coverage for reasons of administrative or enforcement convenience. The courts should, however, be somewhat hesitant to conclude that no policy other than convenience of enforcement dictated these small business exemptions, especially in light of the often expressed congressional concern for the preservation of small businesses free from costly restrictions.[213] Where Congress has excluded small businesses from statutory coverage in a conscious choice to subordinate the particular statutory policy to the policy of preserving small business, the courts should be bound by the coverage limitations imposed by Congress.

V. Conclusion

Profit maximization as the exclusive goal of corporate management served a social purpose in classical economic theory. It provided a check on allocation of corporate resources and use of corporate power. Changing conditions undermined this function, yet the procedural device for enforcing profit maximization — the shareholder derivative suit — remained. The federal government has largely pre-empted the regulation of corporate social responsibility, giving new direction to the exercise of corporate power. Methods of enforcing this new responsibility have not been adequately developed. It is for this purpose that the public interest derivative suit is proposed.

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[210] *E.g.*, Civil Rights Act of 1964, tit. VII, 42 U.S.C. §§ 2000e to e-15 (1970), *as amended*, Act of Mar. 24, 1972, Pub. L. 92-261, 86 Stat. 103 (Equal Employment Opportunity).

[211] *E.g.*, Securities Exchange Act of 1934, § 12(g), 15 U.S.C. § 78*l*(g) (1970).

[212] *E.g.*, Fair Labor Standards Act of 1938, 29 U.S.C. § 203(s) (Supp. 1972).

[213] Small Business Act, 15 U.S.C. § 631 (1970).