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Accountability and Responsibility in
Corporate Governance

Larry E. Ribstein*

*University of Illinois, ribstein@law.uiuc.edu

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Managers' accountability to shareholders and corporations' responsibility to society are two important objectives of corporate governance. Some scholars argue that managers who are accountable to shareholders must neglect society's interest. But loosening this accountability leaves managers free to serve themselves, thereby increasing agency costs. This article makes three main contributions to the debate on the appropriate roles of accountability and responsibility. First, it shows how modern markets cause managers who are accountable to shareholders also to attend to society's interests. Second, it shows that the debate is actually less important than it might first appear because the logistics of publicly held corporations substantially free managers from accountability to shareholders irrespective of whether society's needs should compel that freedom. Third, the paper shows that the debate may be joined over whether partnership-type devices compelling distributions and allowing owner cash-out should be imported into publicly held firms. These devices would provide for more managerial accountability to shareholders, and therefore less flexibility to serve society's interests, than standard corporate governance mechanisms. The main impediment to use of these devices is the double corporate tax, which provides tax benefits for earnings retention and thereby encourages managerial control over corporate earnings. The future of the corporate tax may depend at least in part on the debate over accountability and responsibility in corporate governance.

ACCOUNTABILITY AND RESPONSIBILITY IN CORPORATE GOVERNANCE

Larry E. Ribstein, University of Illinois College of Law*

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ABSTRACT

Managers' accountability to shareholders and corporations' responsibility to society are two important objectives of corporate governance. Some scholars argue that managers who are accountable to shareholders must neglect society's interest. But loosening this accountability leaves managers free to serve themselves, thereby increasing agency costs. This article makes three main contributions to the debate on the appropriate roles of accountability and responsibility. First, it shows how modern markets cause managers who are accountable to shareholders also to attend to society's interests. Second, it shows that the debate is actually less important than it might first appear because the logistics of publicly held corporations substantially free managers from accountability to shareholders irrespective of whether society's needs should compel that freedom. Third, the paper shows that the debate may be joined over whether partnership-type devices compelling distributions and allowing owner cash-out should be imported into publicly held firms. These devices would provide for more managerial accountability to shareholders, and therefore less flexibility to serve society's interests, than standard corporate governance mechanisms. The main impediment to use of these devices is the double corporate tax, which provides tax benefits for earnings retention and thereby encourages managerial control over corporate earnings. The future of the corporate tax may depend at least in part on the debate over accountability and responsibility in corporate governance.

*Corman Professor of Law. Prepared for presentation at UCLA-Sloan Research Program on Business Organizations Conference on the Means and Ends of Corporations on January 28 and 29, 2005. Thanks to Einer Elhauge and other participants at this conference for helpful comments.

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Corporate social responsibility theorists maintain that corporate managers who are forced to respond to shareholders' interests may not maximize social welfare.¹ They argue that markets alone cannot adequately discipline corporate conduct, and that even regulation of corporate conduct does not redress all social harm because these harms are difficult to detect, regulation is difficult to design, and sanctions may be ineffective. Shareholders care only about profits in the narrow accounting sense rather than social welfare and take no moral responsibility for social harm.² Advocates of more socially responsible governance accordingly argue for empowering or compelling managers to run their companies with a view to society's interests as well as those of shareholders. In one prominent account, Blair & Stout view the corporate board of directors as "mediating hierarchs" who do, and should, respond to the interests of the various parties to the corporate contract, including creditors, suppliers, and workers.³

But enabling or requiring socially responsible governance collides with the need to make managers accountable to shareholders. Berle & Means argued seventy years ago that the central problem with corporate governance is that corporate managers are essentially free from effective shareholder discipline.⁴ Enron and other recent corporate misdeeds have shown that this problem has not disappeared. Freeing managers from meaningful control by owners risks exacerbating this agency cost problem.

The collision between responsibility and accountability was not evident at first. Berle & Means saw the main problem of corporate governance as lying in the fact that Adam Smith's "invisible hand" works only where property owners are effectively looking out for their own interests, which is not the case if a significant portion of the nation's wealth is effectively controlled by non-owner corporate managers. Berle initially suggested fixing the problem by ensuring that managers' powers were held in trust for the shareholders.⁵ But this means little if managers cannot be effectively be made accountable to shareholders. The problem of lack of accountability is what led to the idea, first prominently promoted by Dodd, that managers should seek to manage with a view to the public welfare.⁶ Recognizing the inherent problem of constraining corporate

¹ See Joel Bakan, *THE CORPORATION* (2004); Douglas Litowitz, *Are Corporations Evil?* 58 U. MIAMI L. REV. 811 (2004); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, forthcoming N.Y.U. L. REV.; Lawrence E. Mitchell, *CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT* (2001); Ralph Nader, Mark Green & Joel Seligman, *TAMING THE GIANT CORPORATION* (1976); Christopher Stone, *WHERE THE LAW ENDS* (1975).

² See Elhauge, *supra* note 1; Ralph Estes, *TYRANNY OF THE BOTTOM LINE: WHY CORPORATIONS MAKE GOOD PEOPLE DO BAD THINGS* (1996); Marjorie Kelly, *THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY* (2001); Mitchell, *supra* note 1; Bakan, *supra* note 1.

³ See Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

⁴ See Adolf A. Berle & Gardiner Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

⁵ See Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

⁶ See E. Merrick Dodd, *For Whom are Corporate Managers Trustees*, 45 HARV. L. REV. 1145 (1932).

management, Berle ultimately agreed with Dodd.⁷ Under this analysis, the social responsibility problem would disappear if managers were made accountable to shareholders and therefore were like other property owners.

In the 1980's the development of a powerful market for corporate control suggested for the first time that accountability to shareholder interests could be feasible. It was then that the modern social responsibility debate took form. Now that it looked like the Berle-Means problem might be solved, many people did not like what this entailed. The problem they saw was that the shareholders themselves are narrowly focused on profits and not subject to the moral constraints that apply to other property owners.

On the other hand, there is substantial theory and evidence indicating that governance in the shareholders' interests is broadly compatible with broader social interests. Markets can reflect all political and social tastes and socially relevant information. This suggests that even managers who closely attend to shareholders' interests have incentives to produce socially efficient results.

Even if reforming corporate governance to reduce managers' accountability to shareholders is warranted, it is not clear what the reform might be because corporate managers already have significant freedom. The governance of large corporations is best described by the general principle of "board primacy," which reposes basic management power in corporate directors, through the executives they control.⁸ Shareholders exercise some control powers, but the significant costs of coordinating shareholder action ensure that these powers will only lightly constrain managers. The business judgment rule, which sharply restricts managers' liability for faulty business decisions, reflects the courts' limited capacity to engage in corporate management. The inherent limits on the ability of large groups or courts to control managers of large firms apply irrespective of who holds control powers or to whom managers are deemed to owe judicially enforced duties. Board primacy does not imply that directors' power should be unlimited. In order for director primacy to work, managers must be accountable to shareholders. As Stephen Bainbridge has said, "[e]stablishing the proper mix of discretion and accountability . . . emerges as the central corporate governance question."⁹ The challenge is finding a way to constrain managers while recognizing the inherent constraints on courts and shareholders that underlie the principle of board primacy.

The problem of defining a role for socially responsible governance is further complicated by the legal framework of corporate governance. A state corporation law that mandates less accountability to shareholder interests than current corporate norms provide for would be ineffective as long as firms are free to incorporate in states that provide for more accountability. The social responsibility question, then, narrows to whether federal law or the choice of law regime should be modified to mandate significantly less managerial responsibility to shareholders than under current norms. Given both the relatively modest dimensions of the social responsibility problem and the significant costs of loosening managerial accountability to shareholder interests, major

⁷ See Adolf A. Berle, *THE 20TH CENTURY CAPITALIST REVOLUTION*, 169 (1954).

⁸ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547 (2003).

⁹ See Stephen M. Bainbridge, *CORPORATION LAW AND ECONOMICS* at 207 (2002).

changes seem unwarranted.

This analysis suggests that the issue of socially responsible governance occupies a small domain. Except on the radical fringe,¹⁰ most social responsibility theorists agree that the shareholders should have a more important role in governance than other stakeholders. Indeed, any attempt radically to reduce shareholders' role would surely have disastrous effects on the capital markets. The socially responsible governance issue therefore is circumscribed by the need to make managers at least somewhat accountable to shareholders, the logistics of large firm governance, and the nature of the law of corporate governance.

Whether socially responsible governance matters depends significantly on whether there is some way to make managers truly accountable to shareholder interests despite the constraints on effective management by shareholders or courts. One possibility is to weaken managers control over the cash generated by the business by mandating distributions and permitting cash-out by dissatisfied owners. While these mechanisms are common in partnerships, they have not been used as tools of corporate governance. The explanation lies in the corporate tax, which makes distributions to owners unattractive despite their potential role in reducing managerial agency costs. In deciding whether the corporate tax should be changed or eliminated to make mandating distributions more financially feasible, some role for socially responsible governance, and therefore for the social responsibility issue, finally becomes evident. If revising the tax laws might increase managers' accountability to shareholder interests, this raises the question whether such additional accountability would be consistent with the social interest.

The article proceeds as follows. Part I analyzes the socially responsible governance issue, defining the terms of the debate for the remainder of the article. In general, socially responsible governance restricts shareholders' ability to contract for management in the shareholders' interests rather than those of non-shareholder "stakeholders," including customers, employees and the general community, rather than solely to maximize shareholder wealth. This Part discusses theorists' arguments favoring stakeholder management, and provides an overview of how these arguments might matter to corporate governance.

Part II critically evaluates the arguments for socially responsible governance. Social responsibility theorists assume that attending to shareholders' interests requires managers to maximize accounting profits in the narrow sense, and therefore to ignore costs and benefits that are not included in accounting profits. However, there are well-developed markets for corporate responsibility, including social consuming, social investing and organizations concerned with worker welfare. Activists can inflict economic sanctions on firms that ignore their social responsibilities. Accordingly, managers who carefully attend to the firm's bottom line will also seek at least to some extent to further society's interests.

This does not mean that managers who attend to shareholders' interests will be completely aligned with society's interests. But Part III emphasizes that any social costs of shareholder-oriented governance must be compared with the social costs of managerial slack under a socially responsible governance regime. Unless managers are constrained to act in the interests of shareholders or some other specific group in the firm, they will

¹⁰ See, e.g., Bakan, *supra* note 1; Mitchell, *supra* note 1.

have a strong incentive to act in their own interests. Moreover, it is not clear that unconstrained managers will act in society's interests, not only because they may prefer to act in their own interests, but also because they are unlikely to know what is best for society.

Part IV discusses the implications of this tension between accountability and responsibility for corporate governance. Even if managers should act in shareholders' interests, neither the shareholders nor the courts can effectively force them to do so. However, managers theoretically can be constrained by limiting their power over corporate assets. The practical problem is that managerial power is indirectly protected by the double corporate tax, which traps earnings in the corporation. A move toward eliminating this tax would encourage more firms to loosen managers' control over corporate cash. On the other hand, the resulting stricter accountability to shareholder interests might be said to force managers to ignore society's interests. Here, at last, the socially responsible governance issue is joined.

Part V concludes.

I. THE SOCIAL RESPONSIBILITY DEBATE

The question regarding socially responsible governance is whether legal rules should mandate mechanisms of corporate governance intended to ensure that corporate managers act in the interests of society. In order to understand what this question involves, it is helpful to begin by delineating what the question does not concern. First, although social responsibility is often referred to as a "corporate" concept, it has no coherent meaning detached from the specific mechanisms by which corporations are governed. An artificial corporate entity cannot have a "responsibility." Second, there can be no debate about whether the corporation or any of the individuals who manage it should care about society – of course they should. Third, there is no question whether the contracts that comprise the firm do or should take society's interests into account. The parties to the firm are largely free to make whatever contracts they want, and these contracts potentially can protect the interests of all of those who contract with the firm. Fourth, the specific question regarding corporate social responsibility is *not* whether the managers should "maximize profits," but rather in whose interests they should manage. Managers can maximize shareholder interests but not maximize profits if the shareholders have some objective other than profit maximization.

The socially responsible governance question focuses on what contracts shareholders and managers can make with the firm. Specifically, what limitations should there be on the firm's ability to contract to force managers to attend to shareholders' interests? It follows from the social responsibility arguments that excessive accountability to shareholders would cause managers to ignore social costs and benefits in favor of the sort of short-term accounting profits that are reflected in share price. Thus, social responsibility theory implies that participants in firms should not have unfettered power to contract in ways that would restrict managers' ability to act in society's interests.¹¹ Indeed, the key legal significance of the social responsibility issue is that it is the main justification for regulating corporate governance contracts. Unless corporate social

¹¹ See Elhauge, *supra* note 1 at [83] (arguing that contracts compelling managers to maximize profits should be unenforceable); Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 1000-02 (1983) (discussing the mandatory nature of the ALI Code's social responsibility duty).

responsibility supports such a legal rule, it has significance only as management science – that is, how managers should use whatever discretion the law gives them.

Subpart A defines the social responsibility issue in terms of the various participants' roles in corporate governance. Subpart B discusses the specific legal framework for corporate social responsibility. Subpart C summarizes the arguments for structuring corporate governance to permit or require managers to act in non-shareholders' interests.

A. SOCIAL RESPONSIBILITY AS A GOVERNANCE ISSUE

In a publicly held corporation, day-to-day *management* decisions are made by executives. The board of directors *monitor* these decisions through their power to approve major transactions or initiate them for shareholder approval, and hire, fire and compensate the managers.¹² The owners have *control* powers, specifically including the power to elect the board and to approve extraordinary matters such as mergers and charter amendments that the board has initiated.¹³ Non-shareholder stakeholders exercise power under specific agreements, such as credit and employment agreements and supply contracts, as well as by their ability to decide whether to deal with the firm.

This general structure suggests three potential foci for managers' social responsibility. First, non-shareholder stakeholders can be given powers to control managers. Second, managers' judicially enforced fiduciary duties can be adjusted to give them more or less discretion to manage in non-shareholders' interests, or a duty to manage in stakeholders' interests. Third, shareholders' power to control managers can be adjusted to make managers more or less accountable to shareholders. These general options are discussed in the following subsections.

1. Stakeholder power

Managers might be made more socially responsible by giving more power to non-owner stakeholders. For example, one proposal is to let employees vote equally with shareholders and serve on the board of directors.¹⁴ The primary alternative to giving owners exclusive powers of control is the European system of codetermination, which gives employees some representation on the board.¹⁵ While such proposals might seem to be most obvious routes to corporate social responsibility, they do not seem to be high on the responsibility theorists' agenda. The reason is the obvious costs and obscure benefits associated with radical restructuring favoring non-shareholder stakeholders.

First, because of the open-ended nature of equity holders' contract with the firm –

¹² The function of the board is summarized in Del. Code Ann. Tit. 8 §141(a), which provides that the corporation is managed “by or under the direction of a board of directors.”

¹³ See, e.g., DEL. CODE. ANN. tit. 8, §§141 (director election); 242 (charter amendment), 251 (merger), 271 (sale of assets), 275 (dissolution) (2004).

¹⁴ See Kelly, *supra* note 2 at 156.

¹⁵ See Reinier Kraakman, Paul Davies, Henry Hansmann, Gerard Hertig, Klaus J. Hopt, Hideki Kanda, and Edward B. Rock, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, 62-65 (2004).

they have a claim only to what is left after other stakeholders have been paid off – shareholders gain more than other stakeholders from having voting powers and being the beneficiaries of fiduciary duties. Thus, restructuring corporate governance to favor non-shareholder stakeholders could significantly increase these stakeholders' ability to extract wealth from shareholders.¹⁶ Shareholders could be expected to demand a significantly higher risk premium for their capital contributions to reflect this appropriation risk. In other words, shifting power to stakeholders “solves” the problem of shareholder opportunism to stakeholders by creating a potentially more serious problem of stakeholder opportunism to shareholders.

Second, stakeholders might gain little from their increased power. Given the heterogeneous objectives within stakeholder groups, their effectiveness in governance may be significantly reduced by internal dissension. By contrast, the Capital Assets Pricing Model, which despite detractors¹⁷ is still the dominant model of securities pricing, assumes that shareholders have homogeneous expectations.¹⁸ To be sure, some shareholders may have social objectives.¹⁹ But this means that, if there are serious differences among shareholders, it is because they reflect stakeholders' concerns, thereby reducing the benefit of giving direct governance powers to non-shareholder stakeholders.

Third, even if stakeholders would gain more than shareholders would lose from a shift in control rights, they would lose on net because this form of governance would be inefficient for the firm as a whole. Making managers responsible either to multiple constituencies or to specific constituencies (such as employees) with multiple internal objectives would reduce managers' accountability, thereby increasing agency costs and reducing firm value.²⁰ Stakeholders would bear the brunt of this cost if it caused firms to pay less for stakeholder contributions that are made contingent on receiving control powers.

If shareholder-oriented governance entailed significant social costs by encouraging substantial disregard of stakeholders' interests, the costs discussed above might be outweighed by the benefits. However, the analysis below in Parts II and III casts doubt on whether this case can be made.

2. Fiduciary duties

Whoever has the main power to control managers, there will be significant gaps in this group's ability to ensure that managers act in its interest. This follows from the free-

¹⁶ See Alan Meese, *The Team Production Theory Of Corporate Law: A Critical Assessment*, 43 WM & MARY L. REV. 1629 (2002).

¹⁷ See Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2004) (summarizing arguments against CAPM).

¹⁸ See Roberta Romano, *A Comment on Information Overload, Cognitive Illusions, and Their Implications for Public Policy*, 59 S. Cal. L. Rev. 313, 325 (1986) (noting that "the capital asset pricing model . . . collapses the investment choice into one attribute - the security's sensitivity to changes in the expected rate of return on the market portfolio (the stock beta)").

¹⁹ See *infra* sections II.A.2-3.

²⁰ See *infra* text accompanying note 138.

rider problem inherent in the exercise of control by any large, dispersed group of owners or stakeholders. Thus, control powers must be supplemented to some extent with some judicial power to monitor management through the application of fiduciary duties. The social responsibility issue then shifts to how the courts apply and enforce these duties. Specifically, managers might have an affirmative duty to serve the interests of groups other than the shareholders, or their basic duty to serve shareholders' interests might be qualified by giving managers' discretion to act to some extent in non-shareholders' interests.

The problem with addressing the corporate social responsibility issue through the courts is that judges, like the stakeholders and shareholders they are protecting, are inherently limited in their ability to monitor and control managers' business decisions. First, courts are not business experts, and therefore are prone to err if they interfere in corporate decision-making. When they review a business decision that has turned out badly, it is very difficult for them to determine whether the bad result was attributable to an error of decision-making or simply the fortunes of business. Second, imposing liability on directors for bad decisions deters them from making risky but value-increasing moves that diversified shareholders would want them to make. Unlike shareholders, managers bear the brunt of bad outcomes while capturing little of the gain from good outcomes.

These are the basic intuitions underling the business judgment rule.²¹ While courts can second-guess business judgments that are in the managers' own interests or that completely disregard corporate interests, they clearly are not capable of making fine distinctions between judgments that are, and are not, in the corporation's or shareholders' interests.

These inherent difficulties are reflected in the most notable attempt to define social responsibility duties is that in the American Law Institute's Principles of Corporate Governance:

Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.²²

This section makes clear that managers are not subject to liability for breach of fiduciary duty if they devote "reasonable" resources to public welfare and similar purposes "even if corporate profit and shareholder gain are not thereby enhanced."²³ Moreover, since the section does not define "reasonable" with reference to any standard, it seems likely that a court would interpret the standard with reference to the only measure courts are familiar with – that is, shareholder wealth maximization.

²¹ See Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 93, 98-99 (1991); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 *VAND. L. REV.* 83 (2004); E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key Developments*, 153 *U. PA. L. REV.* 1399 (2005). For a further discussion of limits on judicial supervision, see *infra* subpart IV.A.2.

²² American Law Institute, *PRINCIPLES OF CORPORATE GOVERNANCE*, §2.01(b).

²³ For an analysis of this provision, see Ribstein, *supra* note 11.

To be sure, the ALI Code may have gone beyond prior law in clearly permitting managerial decisions that do not enhance corporate or shareholders' interests.²⁴ But it probably makes little, if any, difference in practice because a manager's decision to devote "reasonable" resources to a non-"corporate" purpose usually would be protected by the business judgment rule even apart from this Code provision. The Code's business judgment rule insulates from judicial scrutiny an informed and disinterested director decision that the director "rationally believes . . . is in the best interests of the corporation."²⁵ There may be situations where the directors do not rationally believe that a decision would help the corporation, but the decision involves a "reasonable amount of resources." But since "reasonable" must refer to the deviation from shareholder or corporate wealth, this is likely to be an extremely narrow category. Moreover, even if the legal standard did not let the directors depart from shareholder wealth-maximization, the only effective change would be to require the board to find some "rational" way that the decision helps the corporation. This would constrain only the most unimaginative board, since virtually any "reasonable" use of resources could plausibly enhance the firm's goodwill. Thus, the social responsibility provision in the ALI Code can be viewed as little more than a reinforcement of the business judgment standard that would and must be applied in light of the inherent limitations on judicial decision-making.

An example of how the social responsibility issue fades into the business judgment rule is provided by the famous case of *Shlensky v. Wrigley*,²⁶ in which the court dismissed a complaint for mismanagement brought by minority shareholders of a baseball firm based on the management's failure to install lights after every other major league team had done so, despite strong allegations indicating that the team was injured by the failure. The majority shareholder allegedly had defended the decision on the grounds "that baseball is a 'daytime sport' and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood."²⁷ The court reasoned:

[W]e are not satisfied that the motives assigned to Philip K. Wrigley, and through him to the other directors, are contrary to the best interests of the corporation and the stockholders. For example, it appears to us that the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating. By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.²⁸

²⁴ See Ribstein, *supra* note 11 at 1001-02.

²⁵ ALI Code, §4.01.

²⁶ 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968).

²⁷ *Id.* at ___

²⁸ *Id.* at ___.

In other words, the court dismissed the complaint because the question of whether the managers should have installed lights was simply beyond its competence as long as it had some rational basis.²⁹ The specific “social” basis for the decision was not a reason for refusing to permit it, but rather was not a justification for declaring the business judgment rule to be inapplicable in the absence of “fraud, illegality or conflict of interest.”

Because the problems with the formulation of the business judgment rule in the ALI Code and *Shlensky* are inherent in the need for a broad judicial standard, they cannot be fixed simply by adjusting the verbal formulation. For example, Michael Jensen has suggested an alternative standard that looks to maximizing the value of the firm rather than shareholder interests specifically.³⁰ Specifically, he proposes that, “in implementing organizational change, managers must have a criterion for deciding what is better, and better should be measured by the increase in long-term market value of the firm.”³¹ Jensen reasons that a rationally managed organization must have a “single-valued objective,”³² or else the managers are left unaccountable. Moreover, a firm that maximizes its long term value also produces social surplus through its transactions over time. Jensen’s approach appears to be a more fully specified version of shareholder wealth maximization.

Would Jensen’s standard provide significantly more guidance to courts and managers than the one in the ALI Code? Unlike the ALI definition, Jensen’s standard clearly excludes value as measured from the perspective of any non-shareholder stakeholder except to the extent that these stakeholders are also owners. Also, Jensen notes that “long-term stock value is an important determinant. . .of long term firm value.”³³ But value is not *equated with* stock price. Thus, while the definition avoids at least some of the problems with using stock price as a guide,³⁴ it also loses the specificity of such a standard. Moreover, Jensen’s standard looks to the market value of the “firm,” and therefore encompasses value to individual stakeholders except to the extent that helping one group would cause a larger detriment to another. This sort of balancing is at least arguably inherent in the Code’s “reasonable amount of resources” test.

In short, the main constraints on managers’ duties are those inherent in the business judgment rule. Short of drastically changing the rules to provide for an explicit duty to maximize *only* or *mainly* stakeholders’ interests, it is unlikely that a specific formulation of the business judgment rule would have a significant effect on court-enforced duties. As long as the managers are conceived to owe a business-judgment-type

²⁹ For an analysis of the decision as an example of courts’ abstaining from second-guessing business judgments, see Bainbridge, *supra* note 21 at 95-99.

³⁰ See Michael C. Jensen, *Value Maximization, Stakeholder theory, and the Corporate Objective Function*, 12 BUS. ETHICS QUART. 235 (2002).

³¹ *Id.* at 235.

³² *Id.* at 237.

³³ See Jensen, *supra* note 30 at 246.

³⁴ See Lynn A. Stout, *Share Price as a Poor Criterion for Good Corporate Law*, UCLA School of Law, Law & Economics Working Paper 05-7 (January 2005), available at http://papers.ssrn.com/paper.taf?abstract_id=660622.

duty to the firm, or mainly to the shareholders, they will have significant discretion within that standard to help themselves, stakeholders or shareholders, as they prefer.

3. Managers' accountability to shareholders

If direct powers of control are not given to stakeholders, and if the business judgment rule necessarily gives significant discretion to the managers irrespective of the precise social responsibility formulation, the socially responsible governance issue matters mainly in adjusting the extent to which managers should be accountable to shareholders.³⁵ For example, the law might loosen shareholders' control over the board by giving directors five-year terms.³⁶ Short of such radical suggestions, the limits of shareholder control are built into the logistics of the publicly held firm.³⁷ For example, while shareholders' power to transfer control to hostile bidders is significant, any attempt to adjust this power must confront managers' inherent power to impede control transfers, and limitations on courts' ability to monitor exercise of this power.³⁸ Thus, as with managers' judicially enforced duties, there is only a limited space in which social responsibility reforms can operate.

B. THE LEGAL FRAMEWORK

Assume for the moment that corporate governance should be legally restricted to enable socially responsible management beyond the restrictions that are inherent in making public corporation managers accountable to shareholders. How might such socially responsible governance be legally effectuated? The basic problem is that regulation of internal corporate governance is largely a matter of the law of the incorporating state. The "internal affairs rule" in U.S. law lets firms choose the particular state's law that applies to their internal governance irrespective of where the business conducts its operations.³⁹ Accordingly, if a state restricts the extent to which a firm can provide for management accountability to shareholders, the firm is free to incorporate in any other state.

This means in effect that restrictions on managerial accountability to shareholders must be provided for either by a radical move to federal internal governance law, a radical rejection at the state level of the internal affairs rule, by federal securities laws that apply to firms irrespective of where they are incorporated, or by non-organization

³⁵ Another way of expressing this is in terms of legal theories of the corporation – aggregate, artificial entity and real. The aggregate view disregards the entity entirely and looks directly to the owners. Under the artificial entity view, the corporation derives its powers and structure from the state. The real view detaches the entity from its owners, and effectively views the managers as in control. Thus, the level of corporate social responsibility can be tied to the extent to which the law adheres to the "real entity" view. See Reuven S. Avi-Yonah, *The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, Michigan Law and Economics Research Paper No. 05-003 (February, 2005), available at http://papers.ssrn.com/paper.taf?abstract_id=672601.

³⁶ See Mitchell, *supra* note 1 at 129, 161.

³⁷ See *infra* subpart I.A.

³⁸ See *infra* section IV.A.3.

³⁹ See Restatement (Second) of Conflict of Laws § 302(2) (1971).

law such as tax law or regulation of business practices.⁴⁰ As discussed below in Part IV, the latter alternative – particularly federal tax law – is in fact the most significant constraint on accountability to shareholders.

C. ARGUMENTS FOR MANAGERIAL SOCIAL RESPONSIBILITY

This subpart summarizes the arguments favoring reform of corporate governance to ensure that managers run the firm in the interests of non-shareholder stakeholders, setting aside for the moment the logistical and legal problems with such a reform discussed above in this Part.

As a starting point in the inquiry, it is important to ask why it is not enough to impose external regulation on the firm, without having to manipulate the firm's internal governance. This could be done directly through civil liability or other penalties levied against the corporate entity or against individuals in the firm. Indirect regulation would include legal rules that, in effect, channel business behavior or organizational form by making certain types of behavior or organizational forms more costly than others. A prime example is tax law, which may tax some forms or behaviors differently than others.⁴¹ In either case, lawmakers rely to some extent on the internal governance framework to achieve socially desirable results by responding to the external stimulus.⁴² At the same time, either type of external regulation can be viewed as reducing the effective discretion of those who hold power within the firm's governance structure.⁴³

External regulation may be inadequate to correct market imperfections, and therefore to align corporate profits with social welfare.⁴⁴ Among other problems, regulation is shaped by interest groups whose power depends on their coordination costs – that is, their ability to prevent free riders who gain from the regulation but do not contribute to the costs of securing it. The costlier it is for groups to organize, the less effectively they can lobby politicians and regulators.⁴⁵ Because of the free rider problem, smaller groups with lower organization costs may be able to out-lobby and therefore

⁴⁰ See Larry E. Ribstein, *The Important Role of Non-Organization Law*, __WAKE FOR. L. REV.__ (2005).

⁴¹ See Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, U of Michigan Law, Public Law Research Paper No. 40 (March 2004), available at http://papers.ssrn.com/paper.taf?abstract_id=516202.

⁴² For an overview of some regulatory strategies, see Edward L. Rubin, *Images of Organizations and Consequences of Regulation*, 6 THEO. INQ. LAW no. 4 (2005).

⁴³ See Thomas F. McInerney, *Putting Regulation Before Responsibility: The Limits of Voluntary Corporate Social Responsibility*, GWU Law School Public Law Research Paper No. 123 (January 31, 2005), available at http://papers.ssrn.com/paper.taf?abstract_id=658081.

⁴⁴ See, e.g., Elhauge, *supra* note 1 at 43-44.

⁴⁵ See generally, Mancur Olson, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GOODS* (1965); Robert E. McCormick & Robert D. Tollison, *POLITICIANS, LEGISLATION AND THE ECONOMY: AN INQUIRY INTO THE INTEREST GROUP THEORY OF GOVERNMENT* (1981).

receive greater benefits than larger groups, such as voters or consumers generally.⁴⁶ Also, business corporations can avoid organization costs by supporting political activities out of the profits generated by their non-political activities – in other words, they can gain political benefits as a "byproduct" of their organization for non-political reasons.⁴⁷ Multi-national corporations may be able to escape regulatory consequences in places where they cause harm.

The next step in the analysis is to ask whether market and other non-regulatory constraints can ensure that managers take into account the interests of non-shareholders. According to social responsibility theorists, there are several reasons why managers who seek to maximize shareholder wealth may not act in society's interests. First, those dealing with or affected by the firm may lack adequate information to make socially efficient bargains. Firms know more about the ingredients, risks, benefits and methods of production of their own products than anyone else. Thus, drugs or other products may succeed on the market even if their social value is lower than that of other available products.⁴⁸

Second, even if information is widely available, costs may be imposed on, or benefits incurred by, parties who cannot cheaply bargain with the firm. An oil tanker delivering oil from a seller to a buyer imposes risks on fishermen along the way. Given high transaction costs, and in the absence of legal regulation, oil prices will not reflect these risks.

Third, the firm may have significant market power. This may be due to several factors that impede entry of new businesses into the relevant industry. For example, firms may have legal rights, including from patents, trademarks or other intellectual property. "Network" effects, such as those connected with a computer operating system, may make it difficult to introduce a competing product. The effect of this market power is usually distributional in the sense that it enables the firm to set prices so as to leave little or no consumer surplus. Those transacting with the firm may not be worse off after the transaction than before, but they do not derive as much benefit from the transaction as they would if the market were structured differently. Some economically disadvantaged customers may be denied the opportunity to buy the product, or customers may be deterred by the high price from engaging in transactions that would have been socially efficient. Thus, managers who seek to maximize shareholder wealth may not produce as much social wealth, or as "fair" a distribution of that wealth, as would managers who decline to press the firm's advantage to the fullest extent.

Fourth, in addition to inadequate market discipline of corporate transactions, there also may be inadequate discipline of corporate owners by norms and reputational sanctions. This argument distinguishes publicly held from closely held firms. It has been argued that shareholders of public corporations are morally insulated from the consequences of corporate acts, and therefore are not subject to the non-economic sanctions of shame and guilt that supplement market sanctions for individuals and owners

⁴⁶ See generally, Gary Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 QUART. J. ECON. 371 (1983); Olson, *supra* note 45; Robert Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988).

⁴⁷ See Olson, *supra* note 45 at 132-67.

⁴⁸ See, e.g., Elhauge, *supra* note 1; Stone, *supra* note 1.

of closely held firms.⁴⁹

Fifth, corporations may be distinguished from non-corporate firms – either publicly or closely held – by the entity theory that endows the firm itself with some legal rights, including the right to hold property and sue, and First Amendment protection for business speech and political activities.⁵⁰ By contrast, the partnership traditionally has been viewed as an “aggregate” of the members.⁵¹ Since corporations are not human, and therefore are not subject to the moral or ethical concerns that constrain humans, they seem to have rights without responsibilities. It arguably follows that those who wield power on behalf of corporations are detached from the constraints that would bind them if they were exercising personal rights.⁵²

In short, corporate responsibility theorists argue that social, market and regulatory constraints are inadequate to cause a shareholder-wealth-maximizing firm to act in the public interest. It follows from this reasoning that the law should attempt to structure firm governance so that it responds to social interests and not exclusively shareholder interests, assuming that this is feasible.

II. SOCIAL RESPONSIBILITY AND MARKETS

Part I shows that whether we should want or encourage managers to act in a socially responsible way depends on the consequences of managers seeking to act in the shareholders’ interests. If, as corporate social responsibility theorists argue, maximizing

⁴⁹ See Elhauge, *supra* note 1.

⁵⁰ See Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON PARTNERSHIP (1988 and supp), §1.03; Thom Hartmann, UNEQUAL PROTECTION: THE RISE OF CORPORATE DOMINANCE AND THE THEFT OF HUMAN RIGHTS (2002).

⁵¹ Although this is the traditional characterization, a partnership is viewed as a legal entity for many purposes. See RUPA §201 (1997); Bromberg & Ribstein, *supra* note 50, §1.03. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organization Law*, 110 YALE L.J. 387 (2000) describe entity features that support business activity through all types of firms, including partnerships. What Hansmann & Kraakman call “affirmative asset partitioning” (or “entity shielding” in Henry Hansmann, Reinier Kraakman, and Richard Squire, *Law and the Rise of the Firm* (April, 2005)) separates business property from that of the owners. Hansmann and Kraakman contrast this with “defensive asset partitioning,” or limited liability (“owner shielding” in *id.*), discussed in more detail below, which protects firm owners’ individual property from business creditors’ claims. The partnership form has a weaker form of “affirmative asset partitioning” or “entity shielding” than the corporation. But it is not clear why this technical distinction should matter for purposes of constitutional law.

⁵² Note, however, that the law compensates for this problem by devaluing the firm’s rights. As discussed in *supra* note 35, the “real entity” theory of the corporation provides at least conceptual support for uncoupling managerial power from the owners and linking it to the entity, and therefore for managerial social responsibility. In other words, given the corporation’s characterization as an entity for purposes of holding legal rights, the law permits managers to exercise rights on behalf of this vague legal construct rather than on behalf of the shareholders specifically. Moreover, entity characterization rationalizes giving the firm a lower level of constitutional protection than if rights had been ascribed to individual owners or managers. See Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95 (1995); Larry E. Ribstein, *Corporate Political Speech*, 49 WASH. & LEE L. REV. 109 (1992). Corporate speech may receive an even lower level of protection when it is characterized as “commercial.” See *supra* text accompanying note 78.

shareholder wealth involves ignoring society's interests, then social welfare might be improved by laws that make managers less responsive to shareholders. On the other hand, if markets help ensure that social costs and benefits are substantially reflected in corporate share prices, then shareholder wealth-maximization would also tend to maximize social wealth. Also, if shareholders themselves are not interested solely in profits, then managers acting in shareholders' interests may also be acting in society's interests even if profit-maximization and social wealth maximization diverge. And any difference between shareholders' and society's interests might be justified by the agency and other costs of weak constraints on managers discussed below in Part III.

This Part shows that managers who are accountable to shareholders do, in fact, have significant incentives to maximize social wealth rather than just profits. Indeed, distinctions between the "owners" of a firm and outsiders are artificial to a significant extent.⁵³ This casts doubt on the basic assumption of the social responsibility theorists that managers must be free of owner constraints in order to maximize social wealth. Many social responsibility theorists, in fact, emphasize the congruence of social and financial performance.⁵⁴ Even leading pro-stakeholder theorists leave the difference between social wealth and shareholder wealth unclear. Blair & Stout argue that their "mediating hierarch" model of corporate management serves the corporation's long-term interests by solving opportunism problems faced by the firm's multiple constituencies.⁵⁵ If that is the case, we would expect that corporations focused on maximizing corporate value, as recommended by Jensen,⁵⁶ would adopt the mediating hierarch model.

These arguments for congruence must, however, be accepted with caution because it is difficult fully to distinguish normative and positive claims. The stakeholder literature often glides from descriptions of how value-maximizing corporations can best cater to multiple constituencies to normative aspirations for "responsible" management without clearly acknowledging potential distinctions between these views.⁵⁷ This is not surprising, since an argument that managers should be socially responsible is obviously more palatable to all constituencies if it can be shown that it is unnecessary to make difficult choices between social and shareholder wealth maximization.

There is, however, significant theory and evidence showing that it may often be necessary for corporate managers to choose between serving the corporation's

⁵³ See G. Mitu Gulati William A. Klein Eric M. Zolt, *Connected Contracts*, 47 U.C.L.A. L. REV. 887 (2000).

⁵⁴ See, e.g., Ruth V. Aguilera, Deborah Rupp, Cynthia A. Williams and Jyoti Ganapathi, *Putting the S Back in Corporate Social Responsibility: A Multi-level Theory of Social Change in Organizations*, University of Illinois College of Business Working Paper No. 04-010, July 2004 (reviewing the literature); M. Orlitzky, F.L. Schmidt & S.L. Rynes, *Corporate Social and Financial Performance: A Meta-Analysis*, 24 ORGANIZATION STUDIES 403 (2003) (arguing that, in light of recent data, government regulation is unnecessary to produce corporate social responsibility).

⁵⁵ See Blair & Stout, *supra* note 3.

⁵⁶ See Jensen, *supra* note 30.

⁵⁷ See Thomas Donaldson & Lee E Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACADEMY OF MANAGEMENT REVIEW, No. 1, p. 65 (1995).

stakeholders and serving the shareholders.⁵⁸ In other words, there is a distinction between “strategic” social responsibility, where a firm’s “social performance” correlates with its financial performance, and “altruistic” social responsibility, where social performance exceeds financial performance.⁵⁹

The following subparts discuss specific markets that encourage even managers who are responsive to shareholders’ demands to attend to the interests of non-shareholder stakeholders. This Part assumes throughout, despite the contrary considerations discussed in Part I, the potential for some legal reform that would make managers more accountable to shareholders than is inherent in the logistics of corporate law and corporate governance. Part IV will analyze further how this issue might arise.

In analyzing the markets that impinge on corporate decision-making, it is important to keep in mind that they are potentially complementary rather than being substitutes. In other words, firms operate in multiple capital, labor, product and location markets each with different characteristics. For example, a given firm may face no demand for social responsibility in its product market, but might face such a demand when selling equity, hiring employees, or locating its headquarters.

It is also important to keep in mind that the relevant issue is *not* whether markets force shareholder-maximizing managers to be social wealth maximizing. Rather, the question is whether permitting firms to contract to make managers accountable to shareholders is *more likely* to maximize social wealth than forcing them to serve non-shareholder stakeholders. The answer depends both on the degree of congruity of firm and social interests discussed in this Part, and on the agency costs associated with stakeholder management discussed below in Part III.

A. SHAREHOLDERS

Social responsibility theorists argue that owners of publicly held corporations care mainly about short-term stock prices rather than long-term value. Managers may be more likely than remote owners to feel responsibility for the firm’s acts, and thus to be subject to the same social norms and moral scruples that influence individuals in their personal lives. Some social responsibility theorists accordingly argue against subjecting managers to rigorous control by socially disinterested shareholders.⁶⁰ However, as discussed in this Part, there is substantial reason to conclude that shareholders are concerned about social harms caused by the firms in which they invest.

1. The social incentives of profit-motivated shareholders

Even assuming that shareholders are as narrowly interested in profit-maximization as social responsibility theorists conjecture, it is nevertheless the case that, as part of this interest in profit-maximization, shareholders will care about harms to society. Given the existence of present and potential government regulation and civil

⁵⁸ See A. McWilliams & D. Seigal, *Corporate Social Responsibility: A Theory of the Firm Perspective*, 26 ACADEMY OF MANAGEMENT REVIEW 117 (2001); Anant K. Sundaram and Andrew Inkpen, *The Corporate Objective Revisited*, 15 ORGANIZATION SCIENCE 350 (May-June 2004).

⁵⁹ See Baron, *supra* note 102.

⁶⁰ See Elhauge, *supra* note 1.

remedies, corporate harms can trigger substantial costs that can reduce share prices. Indeed, there is evidence that the share price penalty that occurs when a specific problem is revealed may exceed the projected costs from that problem because of the market's concern that additional problems may be lurking.⁶¹

This suggests that even the most narrowly focused shareholders would want firms to avoid activities that will trigger substantial penalties, liabilities and future regulation, at least unless the firm gains enough from the activity to offset the potential cost. They would also want the firm to disclose regulatory risks unless the disclosure increases the possibility of eventual detection. To be sure, rigorously profit-maximizing managers might have incentives to engage in some nefarious activities if they were sure of not being caught or of not being substantially penalized, and might want to hide even substantial risks if they thought they could do so forever. But the pervasiveness of litigation and regulation, and the open-ended risk of additional regulation that might result from a notoriously anti-social act, mean that there is a broad category of social harms that even a rigorously profit-maximizing firm would want to avoid.

It has been argued that without mandatory disclosure of socially harmful acts, firms cannot credibly commit to ongoing disclosure of regulatory risks, except in the case of the largest firms with the greatest regulatory exposure.⁶² Assuming this argument is correct, it follows that, without a way to credibly commit to future disclosures, firms' cost of capital will reflect exposure to unknown future risks. In other words, this is not an argument that socially irresponsible firms will escape market penalties, but rather that firms themselves would want government to help them credibly commit to disclosure.

2. Perverse incentives of sole proprietors

Even if impersonal owners lack non-financial incentives to do social good, their financial incentives may lead them to be more socially responsible than sole proprietors. That is because public corporation shareholders who, by hypothesis, hold diversified portfolios of shares, may actually have incentives that are more consistent with social wealth-maximization than the non-financial incentives of morally engaged sole proprietors.

To illustrate the relevant considerations, consider the stylized anecdote presented by the film *Save the Tiger*. Jack Lemmon portrays a partner in a women's wear business who faces a dilemma of whether to save his firm by burning down a factory for the insurance money. This is probably not social wealth-maximizing because the loss would be imposed on the insurance company, on insureds generally because of the effect of

⁶¹ See Greg Jarrell and Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 J. POL. ECON. 512 (1985); Jonathon M. Karpoff and John R. Lott, *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J. LAW & ECON. 757 (1993). See also William D. Bradford, *Discrimination, Legal Costs and Reputational Costs* (November 30, 2004), available at http://papers.ssrn.com/paper.taf?abstract_id=679622 (showing evidence that firms sued for discrimination incur a reputational penalty reflected in the reduced value of their equity in addition to the legal costs of the suit);

⁶² See Jason Scott Johnston & Robert G. Fuller, Jr., *Signaling Social Responsibility: On the Law and Economics of Market Incentives for Corporate Environmental Performance*, http://papers.ssrn.com/paper.taf?abstract_id=725103 (May 11, 2005) (arguing that, in the absence of mandatory disclosure, most firms will engage only in "cheap talk" that does not permit meaningful comparisons between firms in an industry).

moral hazard on fire insurance rates, or on people who suffer uncompensated losses in the fire. But for Lemmon's character, the cost of sanctions discounted by the chance of not getting caught may be outweighed by the significant benefit of saving his wealth and livelihood. Lemmon's character struggles with moral concerns. Though his partner resists the temptation, for Lemmon, and surely for other sole proprietors, the prospects of financial gain end up outweighing these concerns.

By contrast, the profit-maximizing remote owners of a publicly held firm probably would not want their managers to engage in arson. The shareholders have invested in a portfolio of shares that includes the defrauded insurance companies, and they have diversified away the risks of specific types of firms. Thus, the shareholders would tend to gain less on net from purely wealth-destroying or wealth-redistributing acts like arson than would Lemmon's character, all of whose assets are tied up in one firm. To be sure, the firm's managers might gain individually from preserving their jobs, a risk they cannot diversify away. Thus, the managers might face a dilemma similar to that faced by Lemmon's character, though they are likely to have less of their wealth on the line than the sole proprietor. But the financial incentives of the diversified owners of a publicly held corporation would tend to constrain the firm from acts like arson.

Moreover, the non-financial incentives of sole proprietors do not necessarily lead them to be more socially responsible than morally disengaged owners who seek only to earn as much money as possible. To illustrate the relevant considerations, consider Spike Lee's *Do the Right Thing*. A white pizzeria owner sacrifices his business when he becomes locked in a racially tinged battle with his customers and neighborhood. The owner acted just as he would have if the pizzeria were his home, including putting pictures of his Italian heroes on the walls of a business in the middle of a black ghetto. Because this is his home, the owner stands on principle and resists a customer boycott. By contrast, the hired manager of a Pizza Hut is less likely to have indulged his personal preference in this way, but rather would have submitted to the boycott in order to maximize profits, or not have provoked the boycott in the first place. The pizzeria might therefore have been more socially productive if it had simply sought to maximize the wealth of remote shareholders rather than making the sole proprietor feel at home. Similarly, a manager-owner might want employees as sex objects while the anonymous public owners simply want efficient employees who will maximize financial profits.

3. The implications of social investing

Social responsibility theorists' assumption that public corporation shareholders are morally removed from corporate actions ignores the implications of shareholders' investment decisions. Socially responsible shareholders do derive direct utility from socially responsible investments, or disutility from social irresponsible investments, and therefore can be expected to demand information that bears on firms' social responsibility. Investors therefore may invest in mutual funds that investigate and monitor the social responsibility of portfolio firms. This arguably gives even managers who are responsive solely to shareholders an incentive to engage in socially responsible behavior that differs from behavior that would be dictated by other performance factors.⁶³

⁶³ See Ian Lee, *Corporate Law, Profit Maximization and the Responsible Shareholder*, forthcoming STAN. J. L. BUS. FIN. (2005); Arthur A. Small & Joshua Graff Zivin, *A Modigliani-Miller Theory of Corporate Social Responsibility*, http://papers.ssrn.com/paper.taf?abstract_id=325921 (August 2002).

Michael Knoll shows, however, that social investors cannot simultaneously earn market returns comparable to those of other investors *and* affect corporate governance.⁶⁴ The reason is that social investing has a positive effect only if it increases firms' cost of capital, and the resulting reduction in stock price would hurt investors in the targeted companies. Moreover, Knoll discusses significant evidence that demand curves for shares traded in efficient markets are horizontal, meaning that long-term stock prices are not affected by screening the stock out of social investment funds. Thus, even if investors were willing to make sacrifices to achieve social goals, their sacrifice likely would have a lower payoff in terms of influencing corporate managers than if they earned higher returns and donated the difference to charity. This analysis suggests that social investing is unlikely to play much of a role in pressing managers to make socially responsible decisions, and that managers therefore should be free to exercise their own judgment rather than having to be strictly accountable to shareholders.

However, social investing is likely to put at least some pro-social-responsibility pressure on managers despite the problems Knoll discusses. First, it is significant that there is a substantial amount of social investing despite the lack of evidence of impact. As "remarkable" as this may be,⁶⁵ this indicates that investors do have non-instrumental concerns about society, contrary to arguments that they are morally unconcerned. It has been argued that the fact that social investment funds are explicitly operated so as to impose little financial burden on the investors suggests that the funds are intended mainly to help investors "symbolically distance themselves from corporations who engage in socially undesirable conduct."⁶⁶ But even if this is true, the fact remains that shareholders evidently do feel the need for such moral distancing. This indicates that public corporation shareholders are not immunized from non-financial concerns, but rather are able to "arbitrage" these concerns through social investing. This is a weaker claim for moral indifference that depends on the cost and effect of arbitrage. The existence of a socially concerned investor group is relevant to social governance, as discussed below and in the next subsection.

Second, although social investing does not inflict financial penalties on most investors, this is not true of all investors. Socially responsible entrepreneurs such as Ben & Jerry can commit the firm to non-profit-maximization on selling shares to the public without affecting the returns of public investors.⁶⁷ Reduced expected profitability is then capitalized into the share price, and the public investors thereafter receive normal returns.⁶⁸ Thus, social responsibility may depend to some extent not on morally insulated public investors but on the existence of morally responsible sole proprietors.⁶⁹ This will

⁶⁴ Michael S. Knoll, *Ethical Screening in Modern Financial Markets*, 57 BUS. LAW. 681 (2002).

⁶⁵ See Elhauge, *supra* note 1 at [37] (noting that, in light of the considerations raised by Knoll, it is "remarkable" that anybody invests in these funds).

⁶⁶ Elhauge, *supra* note 1 at [54].

⁶⁷ Note that Google also promised social responsibility, but these promises arguably were consistent with developing goodwill in a business that depended heavily on public trust. [cites]

⁶⁸ See Knoll, *supra* note 64 at ___. These returns may be subject to a slight discount to the extent that socially responsible portfolios do not diversify away unsystematic risk. *See id.* at ___.

⁶⁹ Firms theoretically could switch from conventional to socially responsible in midstream on

produce at least some socially responsible corporations even on the assumption that public shareholders are morally disengaged.

Third, even financially innocuous social investing may influence management. The fact that a corporation's stock is held by a significant fraction of social investors signals that managers will not be subject to discipline from shareholders, including through a successful hostile takeover, if they depart to some extent from strict profit-maximization, as by acting consistently with the investment guidelines of the socially responsible investment funds that are the nominal holders of corporate stock. Thus, social investing may be a mechanism not for penalizing irresponsible or rewarding responsible firms, but for permitting the establishment of clienteles of social investors with specific non-profit-oriented goals. These clienteles may influence governance both indirectly by indicating a tolerance for socially responsible management, and directly through the mechanisms discussed in the next section.

All of this is not to say that social investing is likely to be a major force in corporate governance. However, the relevant question is whether it is appropriate to restrict corporations from contracting for more managerial accountability to shareholders than is inherent in the logistics of corporate governance discussed above in Part I. Given these logistics, the vast majority of publicly held firms can be expected to give their managers sufficient discretion to enable them to engage in a substantial amount of socially responsible management, assuming they are inclined to do so.⁷⁰ Social investors therefore do not have a enough of a choice among firms regarding the degree of social responsibility that their investment decisions could be expected to affect share prices in a world of generally horizontal demand curves. It follows that social investors are unlikely to be able to pressure managers to engage in greater social responsibility than the managers otherwise would be inclined to do.⁷¹

But assume it is feasible for a firm to adopt a governance rule that tightened its accountability enough to significantly reduce its ability to respond to social concerns below the level preferred by most social investors. Would the existence of these social investors in the market be likely to preclude such a move? An individual firm's transition to this form of governance probably would require a shareholder vote (because it would at least require a charter amendment) and possibly appraisal rights in some states. This raises a question whether the pro-accountability majority should be required to pay the pro-social responsibility minority for their loss of utility in moving to stricter accountability. Analogously, an outside bidder might pay a premium to existing shareholders that reflects the financial benefit of moving to stricter accountability. In either case it has been argued that the pro-social responsibility holders would face a prisoner's dilemma problem: the pro-social-responsibility holders would assume that

shareholder vote. Elhauge argues that coordination problems would impede this from occurring even if there are a significant number of morally engaged shareholders. *See* Elhauge, *supra* note 1. For present purposes I make the strong assumption that this is the case.

⁷⁰ Managers' incentives to engage in socially responsible management are discussed below in subpart III.

⁷¹ Elhauge shows that collective action problems would inhibit managers or controlling shareholders from moving toward more social responsibility because they could not secure the necessary shareholder consent. *See* Elhauge, *supra* note 1 at 34-35. But the example he gives – the *Shlensky* decision to refuse to install lights in a ballpark – actually shows the unimportance of the problem because it involves a decision that corporate law already permits, and under this Article's analysis should permit, managers to make. *See supra* text accompanying note 26,

their position would attract too little support to prevail, and therefore would sell out at the higher financial price, disregarding their social interests.⁷² This means that socially responsible managers might have reason to fear a hostile takeover even if the firm supposedly has a clientele of socially responsible shareholders.

A similar analysis applies to social investors' decision whether to invest in the increased-accountability firm. Again, the question is whether a pro-social responsibility majority would assume that there is no such majority and therefore decline to incur a financial penalty, or accept a financial reward, for accepting the pro-accountability position and investing in the pro-accountability firm.

These conclusions, however, depend on the aptness to the classic game theory example of the prisoner who confesses believing his colleague in the next room is also cutting a deal though both would have gone free if they had remained silent. This requires the questionable assumptions *both* that there is in fact a majority of pro-social-responsibility shareholders who individually oppose stricter accountability (since otherwise this is a matter of shareholder preferences rather than a collective action problem) *and* that these shareholders assume their fellow responsible shareholders would sell out for the higher financial price if offered the opportunity. In fact, a move to the sort of significantly increased accountability that this example envisions would probably involve enough publicity to preclude the lack of transparency necessary to make the prisoner's dilemma analogy work.

Given the inherent constraints on restricting managers' discretion to be socially responsible, these scenarios do not seem to have much practical importance. Even hostile takeovers did not bring these issues to a head.⁷³ But these issues become relevant if the stricter accountability mechanisms discussed in Part IV⁷⁴ do become feasible. In this event, the question is whether the existence of social investors would constrain moves to strict accountability that invites social irresponsibility. The existence of significant numbers of social investors and the unlikelihood that their voice is muted by collective action problems suggest that this is unlikely.

4. The role of social governance

Apart from investment decisions and major shifts toward managers' accountability, there are questions concerning whether socially responsible have any influence in ongoing management. Given that managers have substantial discretion to engage in social responsibility, and assuming that there are inherent constraints on managers' accountability to shareholders, what role is there for socially responsible shareholders?

In fact, there are significant opportunities for shareholder voice that suggest that shareholders are not as morally remote from corporate affairs as the social responsibility theorists suggest. While social investors are unlikely to significantly change managers' approach to social issues, they can use these opportunities to educate managers on society's needs and prod them on particular issues. These opportunities include

⁷² See Elhauge, *supra* note 1 at [34-37, 59-60].

⁷³ See *infra* §IV.A.3.

⁷⁴ See *infra* subpart IV.B.

shareholder proposals, which federal law effectively requires firms to subsidize, thereby enabling even minority holders to exercise power with minimal investment, and thereby addressing the free rider problem that would otherwise impede action by shareholders with small ownership stakes.⁷⁵ Also, the federal securities laws compel firms to disclose at least some of the societal implications of their operations.⁷⁶ These rules force shareholders to confront the moral implications of their investments.⁷⁷ They are, if anything, slanted against firms to the extent that the First Amendment protects the “political” speech of activists more than it does the corporation’s “commercial” speech in response.⁷⁸

Institutional shareholders are potentially influential in spurring socially responsible governance. Although these large shareholders often sell rather than fight, they have some incentive to engage in informed voting, particularly given the costs of selling large blocks, and the ability to engage in a common strategy across their portfolios. They may use their power to encourage portfolio firms to engage in long-term profit-maximization. Institutional shareholders may be especially concerned about firms’ maintaining the value of their brands.⁷⁹ To be sure, most managers of most institutional investors have duties to maximize financial returns.⁸⁰ But this would not apply to managers of social investment funds, as well as to managers of public or union pension funds may have political incentives to further a social agenda, particularly including labor’s interests.⁸¹

To be sure, there are questions concerning the potential effectiveness of social governance. Socially relevant shareholder proposals have had so little effect in relation to their cost that they seem mainly intended to signal the social commitment of their

⁷⁵ See SEC Rule 14a-8.

⁷⁶ See Johnston & Fuller, *supra* note 62; Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

⁷⁷ See *infra* text accompanying note 110.

⁷⁸ This issue was raised in *Nike, Inc. v. Kasky*, 27 Cal.4th 939, 45 P.3d 243, 119 Cal.Rptr.2d 296 (2002), in which the Supreme Court granted certiorari but then dismissed the writ as improvidently granted. See Larry E. Ribstein, *High Court Cases May Shape First Amendment’s Application to Federal Securities Laws*, Washington Legal Foundation, February 14, 2003.

⁷⁹ See Gordon L. Clark & Tessa Hebb, *Why Do They Care? The Market for Corporate Global Responsibility and the Role of Institutional Investors*, Working paper, Oxford University School of Geography (2004).

⁸⁰ See Elhauge, *supra* note 1 at [52].

⁸¹ See R.A. Johnson & D. W. Greening, *The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance*, 42 ACADEMY OF MANAGEMENT JOURNAL 564 (2004); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 479-81 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 801-19 (1993); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1033-34 (1998).

proponents rather than to effect change in portfolio firms.⁸² Moreover, monitoring firms for social performance requires significant investments in information, and therefore a collective action problem in sharing the burden.⁸³ But these considerations do not prevent socially motivated investors from using the shareholder proposal rule to bring social issuers to managers' and shareholders' attention and obtain an indication of popular support for the issue.

5. The effect of limited liability

Social responsibility theorists argue that shareholders' limited liability exacerbates the impersonality of corporate ownership, and thereby increases corporate irresponsibility, because the owners need not take all social losses into account. However, the implications of limited liability for corporate social responsibility depend on whether markets efficiently force corporations to internalize creditors' costs. Some of these market devices are discussed in the next subpart.

In situations where markets do not force firms fully to internalize risk, it does not necessarily follow that individual liability for corporate harms would lead to more efficient results because vicariously liable owners might not fully internalize the benefits of corporate acts. Also, just as owners of closely held firms may compromise their morality because they have more at stake, vicariously liable owners may have more incentive than limited liability owners to cover up misconduct, or engage in serious misbehavior if this is the only way to avoid financially disastrous bankruptcy.

B. EFFECT OF CREDIT AND ASSET MARKETS

Social responsibility theorists have argued that profit-maximizing managers can cause social harm because neither markets nor regulation can cause these harms to be fully accounted for in profits.⁸⁴ In situations such as environmental harms there is no apparent interaction between the firms that cause the harms and the victims. Regulators may be captured by industry, and victims, regulators and courts may lack critical information about the nature and scope of the harms.

These arguments, however, do not account for market and private contractual devices that operate together with and magnify the internalizing effects of regulation.⁸⁵ Asset purchases are often motivated in part by buyers' scale or other advantages in minimizing regulatory risks; potential sellers have incentives to minimize the buyer's risk by being knowledgeable about potential problems; buyers have incentives to investigate sellers; and more efficient and knowledgeable purchasers have access to cheaper capital.⁸⁶ Analogous monitoring, investigation and disclosure occurs in commercial

⁸² See Johnston & Fuller, *supra* note 62 at ___,

⁸³ *Id.* at ___.

⁸⁴ See, e.g., Stone, *supra* note 1.

⁸⁵ See Johnston & Fuller, *supra* note 62; Michael P. Vandenbergh, *The Private Life of Public Law: Accounting for the Influence of Private Agreements on Public Regulation*, 105 COLUM. L. REV. ___ (2005).

⁸⁶ See Johnston & Fuller, *supra* note 62. See also Vandenbergh, *supra* note 85 (discussing

lending and real estate transactions.⁸⁷

As with the public securities markets,⁸⁸ mandatory disclosure requirements may be needed to supplement these market and contractual devices. But it does not follow that, in the absence of such laws, it is socially efficient to restrict managers' accountability to shareholders. The monitoring and information provided by asset and credit transactions depend on managers' incentives to engage in value-maximizing transactions. It is possible that fewer such transactions would occur if managers were less accountable to shareholders. Moreover, there is no reason to believe that less accountable managers of sellers or borrowers would increase their monitoring or disclosure in the transactions that did occur, since this monitoring and disclosure is demanded by buyers and lenders. By the same token, since managers of buyers and lenders engage in monitoring in order to maximize the value of their firms, there is no reason to believe that making such managers less accountable would increase buyers' and lenders' monitoring.

C. EMPLOYEES

Like shareholders, employees can insist on socially responsible behavior both by contract and by choosing where to work. Employees can contract not only about wages and working conditions, but also concerning their employers' social responsibility. A corporation's reputation for social responsibility can attract and retain employees.⁸⁹ For example, one study shows that more than ninety percent of MBAs in the relevant sample were willing to forgo financial benefits to work for firms with better reputations for corporate social responsibility.⁹⁰ Employees derive satisfaction from being associated with, and expect better treatment from, responsible firms.⁹¹

To be sure, firms can easily hire and replace unskilled workers. Workers also face competition from foreign labor markets. Workers with firm-specific skills may have more job protection, but they also may be locked into specific employers. But these problems may overstate workers' vulnerability. First, many firms must rely on knowledge workers whose skills are highly marketable, and who therefore can insist on good working conditions and assurances that the firm will behave responsibly.⁹² Second, firms must

monitoring through asset purchase agreements).

⁸⁷ *Id.*

⁸⁸ See *supra* text accompanying notes __.

⁸⁹ See D. W. Greening & D.B. Turban, *Corporate Social Performance as a Competitive Advantage in Attracting a Quality Workforce*, 39 BUSINESS AND SOCIETY 254 (2000).

⁹⁰ See David B. Montgomery and Catherine A. Ramus, "Corporate Social Responsibility Reputation Effects on MBA Job Choice" Stanford GSB Working Paper No. 1805 http://papers.ssrn.com/paper.taf?abstract_id=412124 (May, 2004).

⁹¹ See Aguilera, et al, *supra* note 54.

⁹² For example, Hyperion promised to subsidize employees' purchases of fuel efficient automobiles, citing among other reasons the sophistication of its workforce. See Erin White & Jeffrey Ball, *Green Perk Offered for Green Car*, WALL ST. J., November 29, 2004 at B4, available at http://online.wsj.com/article/0,,SB110168949687785266,00.html?mod=todays_us_marketplace.

not only hire and contract with workers, but also motivate them to work hard and provide friendly service. Disgruntled workers can erode a firm's goodwill. Third, workers are also consumers, and therefore may prefer to buy from worker-friendly firms. Workers also may be shareholders through their pension and profit-sharing plans. These funds may exert pressure on behalf of current workers. Indeed, these workers may get more attention than retirees who are concerned mainly with share value.⁹³

C. CONSUMERS

Firms contract and transact business directly with their customers as well as with workers and shareholders. Consumers demand not only better designed and manufactured products and lower prices, but also that the product be made in a socially responsible way. This means not only products that are safer and better for the environment, but also manufacturing processes that are safe, clean and worker-friendly. Consumers may not want to influence how products are made, but also may derive utility from "voting" on particular practices.⁹⁴ Thus, consumer markets can cause at least some convergence of social and financial performance, so that even managers who serve shareholders' interests in maximizing long-term profits have an incentive to attend to society's interests.

Social responsibility theorists argue that consumers lack information concerning these matters and leverage to insist on improvements.⁹⁵ However, as with the other stakeholders discussed above, markets are now more sophisticated than they were when concerns for social responsibility first arose. Much information is available on the Internet and accessible through sophisticated search engines.

Brands are a critical aspect of selling social responsibility to consumers.⁹⁶ In general, brands have been increasingly important in international markets. Trademarks enable firms to post "reputational bonds" in the form of advertising and other expenses in maintaining the brand.⁹⁷ If the firm shirks on the quality promise inherent in the brand, it stands to forfeit some or all of its investment in the brand. Trademark law protects the integrity of this brand information.⁹⁸

⁹³ This is distinguishable from workers' direct participation as such in corporate governance. There is evidence that, when this happens, it causes firms to diverge from shareholder wealth-maximization. See Olumbunmi Faleye, Vikas Mehrotra and Randall Morck, *When Labor Has a Voice in Corporate Governance*, NBER Working Paper No. W11254 (April 2005), available at http://papers.ssrn.com/paper.taf?abstract_id=697179.

⁹⁴ See Douglas A. Kysar, *Preferences for Processes: The Process/Product Distinction and the Regulation of Consumer Choice*, 118 HARV. L. REV. __ (2005).

⁹⁵ See Stone, *supra* note 1.

⁹⁶ See A. McWilliams & D. Seigal, *Corporate Social Responsibility: A Theory Of The Firm Perspective*, 26 ACADEMY OF MANAGEMENT REVIEW 117 (2001); R. Harrison, *Corporate Social Responsibility and the Consumer Movement*, 13 CONSUMER POLICY REVIEW 127 (2003).

⁹⁷ See Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).

⁹⁸ See Sidney A. Diamond, *The Historical Development of Trademarks*, 65 TRADEMARK REP.

The social responsibility component of branding is increasing. For example, Nike seeks through its brand to sell not only shoes but a socially responsible method of producing them.⁹⁹ This serves consumers who increasingly seek to express themselves politically through market decisions.¹⁰⁰ Moreover, while the Internet gives consumers much of the general quality information they used to get from brands, information as to products' social impact and the processes by which they are made is less available. Social responsibility is therefore a kind of "credence" good for which reputational bonding through brand names is particularly important.¹⁰¹ Consumers buying branded goods can be more confident that the firm has paid attention to social characteristics, and will react quickly to protect the brand if social responsibility issues arise. Indeed, firms now have an incentive not only to meet but also to *create* a consumer demand for social responsibility so that they can distinguish their goods in the market and earn competitive rents.

Branding works together with other market mechanisms to encourage sale of socially responsible products. First, social responsibility entrepreneurs, including the nongovernmental organizations discussed in the next subpart, can provide information, urge voluntary disclosures, and seek enforcement of the legal rules discussed below. Thus, organizations have promoted consumer awareness of, for example, dolphin-friendly tuna and working conditions in foreign factories. Second, social activists can organize boycotts, thereby reducing the free rider problem and putting significant market pressure on firms to be socially responsible.¹⁰² These activities help overcome consumers' inability to take coordinated action against suppliers. Third, some institutional investors, particularly including pension funds, may be inclined toward a long-term perspective regarding their portfolio firms and force managers to consider potential damage to the firm's brands from socially irresponsible conduct.¹⁰³

The extent to which profit-maximizing firms serve consumers' interests may depend on the amount of competition in the firm's product market. A firm that has some monopoly power may be able to skimp on quality, charge high prices, or otherwise frustrate consumers' preferences, while maximizing profit, at least in the short-run. The price or quality issues impinge on customers who cannot get a comparable product

265 (1975).

⁹⁹ The "commercial" nature of Nike's speech was at issue in the *Nike* case discussed in *supra* note 78. The use of social responsibility as a branding device arguably supports characterizing the speech as commercial and therefore as entitled to a lower level of constitutional protection. See Johnston Fuller, *supra* note 62 at __.

¹⁰⁰ See Kysar, *supra* 94.

¹⁰¹ See Johnston & Fuller, *supra* note 62 at __. For a general discussion of credence goods, see Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67 (1973).

¹⁰² See David P. Baron, *Private Politics, Corporate Social Responsibility, and Integrated Strategy*, 10 J. ECONOMICS OF MGT. STRATEGY 7 (2001); Timothy J. Feddersen & Thomas W. Gilligan, *Saints and Markets: Activists and the Supply of Credence Goods*, 10 J. ECONOMICS AND MANAGEMENT STRATEGY 149 (2001).

¹⁰³ See Gordon L. Clark & Tessa Hebb, *Why Do They Care? The Market for Corporate Global Responsibility and the Role of Institutional Investors*, Working paper, Oxford University School of Geography (2004).

elsewhere.¹⁰⁴ There is, therefore, a potential divergence between financial and social performance in this situation. But the effect of limited competition is mitigated by the fact that there is likely to be significant competition at some point in every supply chain. For example, even if there are few manufacturers of a given product or type of product, the product is likely to have comparables or substitutes that wholesalers and retailers can sell. Thus, opponents of genetically modified foods were able to gain leverage by exerting pressure on retailers.¹⁰⁵

Indeed, monopoly power in product markets may actually encourage investments in social responsibility. First, managers of dominant firms may have more freedom than those in firms operating in perfectly competitive markets to manage altruistically without the sort of decline in profitability that would threaten their jobs. Second, firms that face some competition but do not operate in perfectly competitive markets may have more incentive to make investments in goodwill and therefore long-term profitability than firms that operate in more competitive markets.¹⁰⁶ Third, even firms in perfectly competitive markets might want to invest in goodwill, including goodwill generated by social responsibility, in order to build a brand name that would insulate them to some extent from competition by new entrants. Fourth, even in markets with dominant firms, competitors may be able to seize on dominant firms' shortcomings by investing in goodwill. Dominant firms, in turn, have an incentive to avoid becoming vulnerable.

The market alone will not necessarily produce the information necessary to facilitate consumer choice as to social responsibility. Firms may lack an incentive to disclose negative information voluntarily.¹⁰⁷ They may face little consumer pressure for information because consumers may *want* to remain ignorant to preserve their "moral wiggle room."¹⁰⁸ So firms may engage in "cheap talk" that does no more than highlight problems in an industry rather than differences among firms.¹⁰⁹ These factors argue for a government role in ensuring the provision of process-type information to consumers.¹¹⁰ Indeed, firms' misrepresentations and incomplete statements already may trigger liability

¹⁰⁴ See Engel, *supra* note 148.

¹⁰⁵ See Rachel Schurman, *Fighting 'Frankenfoods': Industry Opportunity Structures and the Efficacy of the Anti-Biotech Movement in Western Europe*, 51 SOCIAL PROBLEMS 243 (2004).

¹⁰⁶ See Mark E. Bagnoli & Susan G. Watts, *Selling to Socially Responsible Consumers: Competition and the Private Provision of Public Goods*, 12 J. ECONOMICS & MANAGEMENT STRATEGY, No. 3 (2003); Orace Johnson, *Corporate Philanthropy: An Analysis of Corporate Contributions*, 39 J. BUS 489 (1966).

¹⁰⁷ See Michael J. Fishman & Kathleen M. Hagerty, *Mandatory Versus Voluntary Disclosure in Markets with Informed and Uninformed Consumers*, 19 J. L. ECON. & ORG. 45 (2003).

¹⁰⁸ See Jason Dana, Roberto A. Weber and Jason Xi Kuang, *Exploiting Moral Wiggle Room: Behavior Inconsistent with a Preference for Fair Outcomes*, available at http://emlab.berkeley.edu/users/webfac/dellavigna/e218_f03/Fair.pdf (June 24, 2003).

¹⁰⁹ See Johnston & Fuller, *supra* note 62.

¹¹⁰ See Kysar, *supra* note 94. See also Johnston & Fuller, *supra* note 62 (arguing for mandatory disclosure of other socially relevant information to consumers and investors).

under the federal securities laws¹¹¹ and consumer laws.¹¹² If consumers care about how goods are manufactured they, or social responsibility entrepreneurs, will exert political pressure for more such laws.

Even assuming mandatory disclosure laws are efficient, it does not follow from the absence of these laws that there should be restrictions on managers' accountability to shareholders. To the extent that consumers demand socially relevant information, firms might gain value from offering credible information. And even if they would lose to competitors, shareholders holding diversified portfolios would not gain from this transfer of wealth among firms.

To be sure, there are limits to the effectiveness of social consuming in ensuring corporate social responsibility. The evidence indicates that, while effective boycotts may coalesce over significant social problems, consumer action is much less effective in promoting ongoing social responsibility.¹¹³ Most consumers arguably are indifferent to the social responsibility attributes of the products they buy because they are morally insulated from the problems these products create.¹¹⁴ Assuming this is the case, or at least that this is generally perceived to be the case, even socially engaged consumers generally would assume their individual purchases would have no effect on the actions of the firms they deal with and accordingly would not take social consequences into account in their purchase decisions.¹¹⁵ In any event, social consuming is likely to be ineffective because social consumers will be unable to focus the mass purchasing power of the market on particular product attributes.

The amount of social consuming that has been observed,¹¹⁶ however, indicates that there is a significant demand for socially responsible products. Moreover, through advertising, producers can make the social responsibility characteristics salient, thereby breaking through consumers' moral shielding, as well as assisting in the coordination of consumer action around particular product characteristics. As long as there are significant numbers of consumers who are interested in products' "social" characteristics, producers have economic incentives to market to them. While some sellers may cut corners and engage in cheap talk, their competitors have incentives to do better and be more transparent. Indeed, firms may have an incentive to create niche markets for social responsibility attributes as to which they have a cost or recognition advantage over their

¹¹¹ See *United Paperworkers International Union v International Paper Company*, 985 F.2d 1190 (2d cir. 1993)

¹¹² These laws may have constitutional implications. See *Nike, supra* note 78; *International Dairy Foods Association v. Amestoy*, 92 F.3d 67, 73-74 n. 1 (2d Cir. 1996) (holding that Vermont lacked a sufficient state interest in requiring disclosure as to whether rBST was used in the production of milk and milk products). For discussions of social disclosure laws and their constitutional implications see Johnston & Fuller, *supra* note 62 at ___; Kysar, *supra* note 94 at ___.

¹¹³ See Johnston & Fuller, *supra* note 62 at ___.

¹¹⁴ See Elhauge, *supra* note 1 at ___.

¹¹⁵ See *id.*

¹¹⁶ See Johnston & Fuller, *supra* note 62; Kysar, *supra* note 94 at ___ (collecting evidence of consuming based on processes by which products are produced).

rivals,¹¹⁷ just as they do for other product attributes or process characteristics.

D. SUPPLIERS

Markets are reducing the need for the conventional hierarchically-organized corporation. The large vertically integrated firm that Alfred Chandler studied¹¹⁸ was suited for a time when markets were thinner and less adaptable. The need for this structure is being reduced by new technologies and markets.¹¹⁹ For example, Dell can assemble computers just in time from parts provided from its network of independent suppliers.¹²⁰ Modern firms may rely on contracts with their suppliers instead of owning assets or hiring employees. These trends are unwinding the classic firm.

This new business structure potentially raises the concern that firms will be able to avoid the market pressures discussed above by contracting out risky or questionable activities to thinly capitalized, obscure or off-shore entities. In particular, workers might be employed by the “irresponsible” entities and consumers who would buy from, and have sole recourse against, only these entities.

The international networked firm would, however, remain subject to market forces in many respects. The above discussion focused on reputational constraints that transcend legal niceties concerning the boundaries of firms and attach to brands. The Internet can gather information about suppliers and ensure that market pressure can be applied at the appropriate places.¹²¹ Indeed, firms that contract out their supply and distribution functions depend more on the value of their brand names now that they can no longer reap significant competitive advantage from their unique and extensive set of integrated assets. The value of these brands, in turn, is vulnerable to disreputable conduct by suppliers or distributors that social activists can tie to the brand. An example is the “sweatshop” allegations involving Kathie Lee Gifford products and Wal-Mart. As discussed above, the brand can be viewed as a kind of bond that the firm has posted, and that is forfeited by socially irresponsible conduct. Thus, a firm that contracts out its supply functions remains just as subject to reputational penalties in the product market for social irresponsibility as a firm that internalizes these operations.¹²² Outsourcing firms

¹¹⁷ See *infra* text accompanying note 151.

¹¹⁸ See generally Alfred D. Chandler, Jr., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977).

¹¹⁹ See John Micklethwait & Adrian Wooldbridge, *THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA* 131, 142-46, 183-84 (2003); Naomi R. Lamoreaux, Daniel M.G. Raff and Peter Temin, *Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History*, 108 *AM. HISTORICAL REV.* 404 (2003); Richard N. Langlois, *Chandler in a Larger Frame: Markets, Transaction Costs, and Organizational Form in History* (2003).

¹²⁰ See Lamoreaux, et al, *supra* note 119 at ___; Gary Rivlin, *How Dell Became Efficient*, *NY Times*, December 19, 2004, available at <http://www.nytimes.com/2004/12/19/business/yourmoney/19dell.html?hp>.

¹²¹ Note that Nike has aided this process by voluntarily disclosing its suppliers. See Johnston & Fuller, *supra* note 62 at ___.

¹²² See Johnston & Fuller, *supra* note 62 at ___; Vandenberg, *supra* note 85 at _.

therefore have significant incentives to contract with their suppliers to ensure against embarrassing social irresponsibility.¹²³ Brand owners can negotiate provisions in its supply contracts specifying standards and providing for damages and termination for non-compliance.¹²⁴ The increased depth of markets makes it feasible for firms to shop for suppliers and terminate unsatisfactory ones.

In some cases the benefits of avoiding significant liabilities through outsourcing might seem to outweigh the reputational costs. However, even in these situations, there may be significant internal costs to moving the transactions outside the firm, just as cost-savings initially justified bringing the transactions inside the firm.¹²⁵ For the remaining transactions, the liability avoided may be less than the reputational cost to the outsourcing firm from shirking the cost, the risk of liability under a successor or other theory, or the risk of additional regulation.¹²⁶

E. LOCAL COMMUNITIES

Firms have economic incentives to be on good terms with the communities in which they have main offices and factories. Firms can be subjected to annoying local taxes and regulations and irresponsible firms may find it difficult to recruit and retain loyal workers. Communities may be willing to reduce taxes to attract “cleaner” firms.¹²⁷ Localities that can offer significant amenities may have the leverage in the location market to insist on agreements with firms regarding their activities in the community, and firms may compete for good locations. Firms have entered into “good neighbor” agreements with local communities to ensure friendly relations with local government and employees.¹²⁸

To be sure, some communities in depressed areas may have little market power and may seek to offer firms a lax zoning and environmental controls. But even in these situations firms need to consider their long-term standing with local government and workers. Economic conditions and government officials may change, and a firm that seeks to exploit the community will have no reserve of goodwill, or “social license,” with workers and local officials.¹²⁹

¹²³ See Robert E. Spekman, Patricia Werhane and D. Eric Boyd, *Corporate Social Responsibility and Global Supply Chain Management: A Normative Perspective*, Darden Business School Working Paper No. 04-05, available at http://papers.ssrn.com/paper.taf?abstract_id=655223.

¹²⁴ See Vandenberg, *supra* note 85.

¹²⁵ See Johnston & Fuller, *supra* note 62.

¹²⁶ *Id.*

¹²⁷ Relationships between firms and their home communities might be threatened by a recent ruling that a state investment tax credit and local property tax exemption to encourage local investment violated the commerce clause. See *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738, 6th Cir. 2004), rehearing en banc denied (Jan 18, 2005).

¹²⁸ See Vandenberg, *supra* note 85 at ___.

¹²⁹ See Neil Gunningham et al., *Social License and Environmental Protection: Why Businesses Go Beyond Compliance*, 29 LAW & SOC. INQUIRY 307 (2004).

F. NON-GOVERNMENTAL ORGANIZATIONS

The arguments in this Part rely mostly on the ability of individuals who deal with corporations to protect their interests or enforce their views of appropriate corporate behavior. But individuals may lack adequate information, leverage and ability to coordinate. Government regulation may be inadequate to remedy market failures because the same information and coordination problems that infect markets also constrain political action.¹³⁰ Also, governments are subject to territorial limitations, while firms are mobile and operate in international markets.

An alternative to markets and government regulation is action by non-governmental organizations (NGOs). These include organizations that focus on corporate social responsibility, such as World Business Council for Sustainable Development and SustainAbility, those with a more general scope, such as Oxfam and Christian Aid,¹³¹ or social investment mutual funds that perform the monitoring functions of NGOs. Even very small and sparsely organizations, by using the Internet and other organizations, can wield significant influence in anti-corporate campaigns, sometimes even gaining more attention than attempted rebuttals by the corporate targets.¹³² Acting through NGOs, social responsibility entrepreneurs can gather and disclose information about social harms, develop standards for socially responsible conduct, provide certification services, organize boycotts and lobby for political action. These organizations transcend national boundaries to the same extent as the firms they seek to influence.

NGOs' actions translate social harms into effects on firms' profits. NGOs' supporters can buy from, sell to or invest in those companies, and only those companies, that the relevant NGO approves. The "bad" companies not only lose business, but must be concerned about the threat of NGO-induced government regulation or sanction.

To be sure, NGOs are not a perfect solution to the information and organization problems of individual investors and consumers. NGOs, like the firms they monitor, have credibility problems. They may have their own agendas that do not mesh with the goals of their clients, may have conflicts of interest because of economic ties with or reliance on the firms they monitor, or simply fail to follow through on promised monitoring. Accordingly, it has been argued that NGOs should be subject to mandatory disclosure or other regulation.¹³³ On the other hand, at least the largest NGOs can be expected to build sufficient reputational capital to be reliable even in the absence of government regulation.

G. CONCLUSION: MARKETS AND SOCIAL RESPONSIBILITY

This Part has shown that there are numerous market mechanisms that reduce the

¹³⁰ See *supra* text accompanying note 45.

¹³¹ See Aguilera, et al, *supra* note 54.

¹³² An interesting example is the anti-Coke campaign in India spearheaded by a one-man NGO, which has significantly hampered Coke's activities in India. See Steve Stecklow, *Virtual Battle: How a Global Web of Activists Gives Coke Problems in India Mr. Srivastava Uses Internet*, Wall St. J. June 7, 2005, p. A1, available at http://online.wsj.com/article/0,,SB111809496051452182,00.html?mod=todays_us_page_one.

¹³³ See Johnston and Fuller, *supra* note 62.

apparent divergence between managing for shareholders and managing for society. A firm's profits may depend in the long run on satisfying the social demands of consumers, employees and local communities. Moreover, firms must also comply with legal regulation that not only internalizes the costs of socially harmful conduct, but also indicates the behavior that the market is likely to punish or the government to regulate, all of which profit-rationalizing managers would take into account. And even if profits diverge from social wealth, some shareholders may want managers to choose the latter.

The existence of these market devices does not prove that managers who are accountable to shareholders will maximize social wealth. As noted above, markets arguably need disclosure or other regulation to work effectively. The existence of such regulation would weaken arguments for limitations on holding managers accountable to shareholders. The important question is whether the law should restrict such accountability in the absence of market-supporting regulation.

As discussed below in Part III, however, there is no assurance that managers freed from accountability to shareholders will seek to maximize social wealth rather than their own interests, or will be successful in maximizing social wealth even if they are well-motivated. Even apart from the costs of reduced accountability, there is a further question whether restricting managers' accountability to shareholders is likely to compensate for any deficiencies that might exist in the markets discussed above.

With respect to the capital markets, if firms cannot be relied on to fully disclose information concerning potential liabilities and fines, they may have to pay more for capital to reflect regulatory risk. It follows that shareholder-maximizing managers have significant incentives to find some way to credibly commit to regulatory disclosures, and therefore that freeing managers from accountability to shareholders would not increase these incentives. Even if firms would gain competitive advantage in the capital markets by failing to disclose, investors holding diversified portfolios would not gain from the resulting transfer of wealth among firms in their portfolios.

As for consumer markets, since consumers clearly do have tastes for social responsibility, firms have a potential market opportunity in exploiting these tastes. The fact that consumers are unable effectively to coordinate to press their demands should not be determinative. In this sense, social responsibility is similar to any other demand that firms create or identify through advertising rather than simply serving consumers' demand. If firms fail to exploit these opportunities, this may produce less long-term value for shareholders, and therefore lower share prices, than if firms took full advantage of the opportunity. Again, reduced accountability does not solve the problem.

If social consuming or investing creates shareholder value, it follows that increasing managers' accountability to shareholders would increase rather than decrease firms' social responsibility. The reason why managers may not commit to credible disclosure to consumers or investors or other mechanisms for serving the social responsibility market is that such disclosures, and the long-term risk management they would foster, might negatively affect short-term share prices, and therefore managerial compensation such as stock options that is linked to short-term prices. Compensation that does not adequately align managerial and shareholder wealth may be an aspect or symptom of lack of managerial accountability to shareholders.¹³⁴ If so, restricting managerial accountability would not be an appropriate response to market deficiencies

¹³⁴ See *infra* text accompanying notes ___.

that impede effective investors or consumers from pressuring sluggishly managed firms.

It may be that markets and regulation are so defective that social costs are never reflected in profits. In this case we might want to ensure that managers need not strictly account to shareholders, but only if the social benefits of such freedom outweigh the costs. This is discussed in Part III.

III. COSTS OF RESTRICTING ACCOUNTABILITY

The analysis in Part II indicates that even tightly binding managers to serving shareholders' interests does not mean that managers will ignore other stakeholders' interests. On the other hand, it remains the case that markets do not prevent shareholder-maximizing managers from ignoring costs and benefits to other groups. The question is whether, in light of these market defects, restricting accountability to shareholders will make society better off than a regime in which managers are less accountable to shareholders and more accountable to, or at least freer to serve, stakeholders other than shareholders. Thus, for example, Blair & Stout suggest that the current corporate structure efficiently lets managers act as "mediating hierarchs" by, for example, protecting managers from fiduciary liability under the business judgment rule even if they depart somewhat from short-term profit maximization.¹³⁵ Elhauge similarly defends managerial leeway to be socially responsible under the current system.¹³⁶

In order to determine whether restricting managers' accountability to shareholders would produce more social wealth than permitting strict managerial accountability it is necessary to consider the potential costs of reduced accountability. This Part shows that these costs may be substantial. As discussed in subpart A, managers left to their own devices may not have appropriate incentives to maximize social welfare, as distinguished from themselves directly or indirectly. Subpart B shows that even the best motivated managers may not have enough information to better serve society's interests than those who account strictly to shareholders. Subpart C suggests that managers who are less accountable to shareholders may exercise poor judgment about what society needs even if they are well-motivated and well-informed.

Finally, throughout this discussion, it is important to keep in mind that the question is not whether managers should be forced to be accountable to shareholders. Rather, as discussed in Part I, the issue is whether corporate social responsibility supports mandatory governance rules restricting the extent to which corporate governance arrangements can hold managers accountable.

A. INCENTIVES

The main question for corporate social responsibility theory concerns the incentives of managers who are freed from strict accountability to shareholders. Social responsibility theorists argue that managers freed of constraints to serve the faceless, morally disengaged, shareholders of publicly held corporations could exercise their liberated judgment for the benefit of society, subject to the norms, morals and other extra-legal constraints that bind people generally. Thus, for example, Larry Mitchell proposes

¹³⁵ See Blair & Stout, *supra* note 3 at ___.

¹³⁶ See Elhauge, *supra* note 1.

making boards self-perpetuating.¹³⁷ However, managers released from a duty to account to shareholders would be freer to serve *both* their own interests and those of society.¹³⁸ It is not clear that managers freed from the shareholders would serve society rather than themselves.

Elhauge argues, in effect, that there is a principle of conservation of slack – that is, allowing managers to help society will not give managers more leeway to help themselves, so that any discretion that they devote to society will have to come out of discretion managers otherwise would have used to serve themselves.¹³⁹ Elhauge is led to this principle by his assumption that there is no “realistic legal option” to give managers less discretion than they have under current law.¹⁴⁰ But then the whole corporate social responsibility debate would be beside the point, since managerial slack reduces to an issue of governance logistics. On the other hand, if managers’ discretion can realistically be reduced, the question is what managers do with the extra discretion they get from legally restricting this option. In other words, do they help themselves or society?

Note that agency costs are a problem even if managers *purport* to be serving society rather than themselves. For example, managers may contribute corporate funds to pet charities or the schools they graduated from in order to get personal credit or visibility, where those managing their own funds would have contributed to different causes.¹⁴¹ Less directly, but more consequentially, managers may make business decisions in operating the company that gratify their personal preferences as to the firm’s goals or increase their personal power or prestige under the guise of social responsibility. For example, in *Paramount Communications, Inc. v. Time Incorporated*,¹⁴² managers pursued a combination with Warner in the face of a significantly higher bid from Paramount because the former transaction supposedly would allow them to retain the “Time Culture.” It is unclear whether the social value of the “Time Culture” exceeded the extra value from a Paramount takeover, as measured by that transaction’s much higher market price.

It may be unclear whether managers who say they are helping society are mainly enhancing their prestige or reaping some more tangible gain. For example, in *Dodge v.*

¹³⁷ See Mitchell, *supra* note 1.

¹³⁸ See Jonathan Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991); Meese, *supra* note 16; Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002).

¹³⁹ See Elhauge, *supra* note 1 at [46].

¹⁴⁰ See *id.* at [51].

¹⁴¹ See Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195 (1999); Eric Helland & Janet Kiholm Smith, *Corporate Philanthropy*, http://papers.ssrn.com/paper.taf?abstract_id=472161 (November 22, 2003); Faith Stelman Kahn, *Pandora’s Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 U.C.L.A. L. REV. 579 (1997).

¹⁴² 571 A.2d 1140 (Del. 1990).

*Ford Motor Co.*¹⁴³ in which Henry Ford, the controlling shareholder, refused to continue special dividends from a massive pile of accumulated cash, purportedly to enable consumers, who already wanted more cars than the firm could produce, to buy at a lower price. However, hoarding cash may have served Henry Ford's interests in minimizing the price at which he would have to buy out the minority shareholders, the Dodge brothers, or keeping these shareholders from using their investment in the firm to fund their competing firm.¹⁴⁴

There is little specific evidence about managers' tradeoffs between social and selfish concerns. Elhauge cites only one set of data on this point – Alexander and Cohen's finding that criminally convicted corporations have lower levels of managerial ownership than those which are not in this category.¹⁴⁵ Elhauge says that this indicates that managers with higher levels of ownership take greater personal responsibility for the actions of their companies than those with lower levels. But the authors' own interpretation – that firms with higher levels of managerial ownership have lower agency costs regarding "hidden" conduct such as crime – is at least as plausible. In particular, it is not clear why marginal differences in ownership alone, divorced from other mechanisms for identifying managers with their firms, would have a significant effect in triggering social sanctions.

One might draw an inference into what managers would do with any additional power from evidence of what they do with the power they already have. For example, Lucian Bebchuk and Jesse Fried argue that managers use their power to construct compensation arrangements that reward them out of proportion to their contributions to firm value.¹⁴⁶ Thus, Bebchuk & Fried propose increasing managerial accountability to shareholders. While some have criticized Bebchuk & Fried's attack on executive compensation,¹⁴⁷ these criticisms suggest only that the problem is not as serious as

¹⁴³ 204 Mich. 459, 170 N.W. 668 (1919).

¹⁴⁴ See Edward Rock, *Corporate Law Through an Antitrust Lens*, 92 COLUM. L. REV. 562, 619-23 (1992). This should be distinguished from the issue of whether the majority should be free to disregard the views of more socially oriented minority shareholders. See Elhauge, *supra* note 1. This would depend on whether the firm's governance structure provides for input by minority shareholders in this regard. In *Dodge*, the minority shareholders arguably sought only to receive the share of the firm's wealth to which they were entitled under the applicable governance rules.

¹⁴⁵ See Cindy R. Alexander & Mark A. Cohen, *Why Do Corporations Become Criminals? Ownership, Hidden Actions, and Crime as an Agency Cost*, 5 J. CORP. FIN. 1, 18 (1999); Elhauge, *supra* note 1 at [16-17].

¹⁴⁶ Lucian Bebchuk & Jesse Fried, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (Harvard University Press, 2004); Lucian Arye Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 117 HARV. L. REV. __ (2004); Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction In The Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

¹⁴⁷ John Core, Wayne R. Guay and Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay without Performance?* (January 13, 2004), Vanderbilt Law and Economics Research Paper No. 05-05; U of Penn, Inst for Law & Econ Research Paper 05-13, <http://ssrn.com/abstract=648648>; Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for 'Compensation Disclosure and Analysis'*, __ J. CORP. L. __ (2005), Columbia Law and Economics Research Paper No. 273; Columbia Law School Pub. Law Research Paper No. 05-90; ECGI - Law Working Paper No. 35/2005,

Bebchuk & Fried suggest, not that reducing managers' accountability to shareholders would be wealth-maximizing.

B. INFORMATION

Even if managers clearly would be better motivated if they were freer from shareholder control, there would still be a question whether the managers knew what action to take – that is, how to best use corporate resources to maximize social wealth. Yet, except in a few clear situations, the standard imposed by the shareholders, even if this is the narrow profit-maximization standard, may be the best or only guide to socially beneficial behavior.¹⁴⁸ Thus, Milton Friedman has asked

[c]an 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?¹⁴⁹

The issue is complex even if the managers are sure that their goal should be to maximize social wealth. For example, would the U.S. economy be better off if firms did not outsource jobs to India or other countries? This depends on such tradeoffs as the benefits of creating wealthier consumers abroad for US products and the uses to which greater corporate wealth is put in this country. Also, should firms sell genetically modified (GM) foods? There is scientific evidence supporting the value and safety of GM foods.¹⁵⁰ Surely a socially responsible manager ought to consider, among other things, whether GM foods address world hunger; whether, given the current state of the scientific evidence, such a benefit is outweighed by the long-term costs, including potential genetic contamination; and the types of genetic manipulation that they should be concerned about in their sales or manufacturing decisions. But the shareholder-maximizing manager need only make the simpler (though still difficult) calculation of whether the firm would gain or lose from selling GM foods. Given the analysis in Part II, this would include the social costs of GM food that the firm internalizes because of socially concerned consumers.¹⁵¹

Distributional issues further complicate the problem. At a given level of social wealth, should the managers help the poor, or help consumers at labor's expense, or vice

available at http://papers.ssrn.com/paper.taf?abstract_id=686464.

¹⁴⁸ See Engel, *An Approach to Corporate Social Responsibility*, 32 STAN L. REV. 1 (1979).

¹⁴⁹ See Milton Friedman, *CAPITALISM AND FREEDOM*, __ (1962).

¹⁵⁰ See Henry I. Miller & Gregory Conko, *THE FRANKENFOOD MYTH: HOW PROTEST AND POLITICS THREATEN THE BIOTECH REVOLUTION* (2004).

¹⁵¹ See Schurman, *supra* note 105. Note that firms might have self-interested reasons for refusing to sell GM products. See Thomas P. Lyon 'Green' Firms Bearing Gifts, 26 REGULATION, No. 3, pp. 36-40 (Fall 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=511366 (noting that DuPont supported regulation of chloro-fluorocarbons after developing alternatives, and that Alcoa supported emission control after having developed emission reduction materials).

versa? This could involve perplexing questions of distributive justice.¹⁵² For example, with respect to the outsourcing issue just discussed, it is not even clear whether the US rather than the world economy should be the appropriate measure of social welfare.

These examples indicate that, as difficult as are ordinary business decisions, at least shareholder wealth-maximization provides a familiar metric by which the success or failure of these decisions can be tested. Once managers eschew this metric, they may need to acquire much new information and expertise. Given inherent constraints on managerial resources, this is likely to divert managers' efforts from the kinds of business decisions they are better able to make. While these decisions might be denigrated because they "merely" produce profits, the fact that the company is selling products for more than it cost to produce them is an important, even if not conclusive, signal that they are creating social wealth.¹⁵³

C. JUDGMENT

Even the best-motivated and best-informed managers may be subject to judgment biases such as the "availability heuristic" or cascade or reputation effects that would cause them to reach faulty judgments.¹⁵⁴ Consider the example of a U.S. company with factories or suppliers in foreign countries. Assume that paying workers in these factories more than the going wage would help these workers but hurt others because it would cause the company to hire fewer workers than it otherwise would. However, the wages of workers in the foreign plants of U.S. companies receives more media attention than does the even worse plight of the unemployed in these countries because the connection to U.S. companies attracts the attention of U.S. readers. Under these circumstances the availability heuristic might cause altruistic corporate managers to be especially sympathetic to its own workers rather than the even worse off unemployed. Managers might also be influenced to help these workers by "cascade effects," which cause them to rely on mistaken judgments of others, enhanced by "reputation effects," or a concern for protecting their reputations from criticisms that come from rejecting majority opinion.

Even apart from its effect on managers' standing in the community, paying higher than the going wage to factory workers outside the U.S. might become a social norm, which would arise out of a social consensus, deviation from which can subject corporate managers to shame or guilt.¹⁵⁵ However, the underlying social consensus is not necessarily efficient.¹⁵⁶ For example, it could arise from an inefficient law, or from the availability, cascade or reputation effects discussed immediately above. Thus, the fact

¹⁵² See Robert A. Phillips, R. Edward Freeman and Andrew Wicks, *What Stakeholder Theory is Not*, 13 BUSINESS ETHICS QUARTERLY, no. 4, pp. 479.

¹⁵³ See Jensen, *supra* note 30 at ___.

¹⁵⁴ For discussions of these problems, see generally Cass R. Sunstein, *Cognition and cost-Benefit Analysis*, 29 J. LEG. STUD. 1059 (2000); Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683 (1999).

¹⁵⁵ See generally Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997).

¹⁵⁶ See *id.*; Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. Pa. L. Rev. 1697 (1996).

that corporate managers are more subject to influence by social norms than are morally disengaged shareholders does not necessarily lead them to make socially wealth-maximizing decisions, as social responsibility theorists have suggested.¹⁵⁷

D. SUMMARY

Based on the analysis in Parts II and III, whether a legal rule that has the effect of mandating reduced manager accountability to shareholders would increase social wealth depends on (1) the extent to which markets cause costs and benefits to non-shareholder stakeholders to be reflected in corporate profits; (2) the extent to which shareholders insist that profits be maximized even if this ignores stakeholders' interests; and (3) the incentives, information and judgment managers will bring to bear when exercising their judgment. Contrary to the social responsibility theorists' arguments, there are significant doubts on all these issues, and therefore on whether legal interference with corporate governance to benefit society can maximize social wealth.

The implications of this analysis for corporate governance are not obvious, however. The social responsibility issue is often difficult to extricate from the general structure of corporate governance, which turns on logistical considerations that are separate from the social responsibility debate. In particular, in publicly held firms it is usually not productive for courts and shareholders to be closely involved in management decisions. Accordingly, though this disengagement is sometimes rationalized on the ground that managers should be left free to use their discretion for social good, the result would often be the same even if the social good were left out of the calculus. The next Part will consider how the social responsibility issue might arise by examining the feasibility of governance moves that increase managerial accountability.

IV. HOW TO MAKE MANAGERS MORE ACCOUNTABLE

Some gaps in accountability are inherent in the need to centralize management power in publicly traded firms. Shareholders holding diversified portfolios necessarily delegate significant power to managers and only rarely intervene, other than by selling their shares. The courts inherently lack the business expertise to second-guess managers' decisions, and in any event should hesitate to impose liability that would effectively transfer business risks to managers from the diversified shareholders. Hence the system of board primacy that characterizes public firm management.¹⁵⁸ Absent any effective way to make managers more accountable, it is not clear why the social responsibility issue matters. If the managers must in any event be left free, social responsibility is not needed to rationalize that freedom.

Subpart A discusses the accountability devices available in the corporate form, as well as legal restrictions on these options. While some of these restrictions inhere in the governance requirements of publicly held firms, others may be attributable to a concern for non-shareholder stakeholders, and therefore should be rejected under this article's analysis.

Subpart B expands the analysis to consider the additional devices that are theoretically available to publicly held firms simply by electing to be partnerships. The

¹⁵⁷ See *supra* text accompanying note 60.

¹⁵⁸ See *supra* text accompanying note 8.

fact that these devices for increasing managerial accountability are theoretically feasible raises the issue of whether they should be barred on corporate social responsibility grounds.

Subpart C highlights the legal context of this issue by showing that use of these partnership devices, particularly including a distribution constraint, is impeded by the entrenchment of the corporate form through the double corporate tax on both corporate earnings and distributions of those earnings, and the earnings retention it encourages. Accordingly, debate over corporate social responsibility should focus on the extent to which the double corporate tax should continue to reinforce managerial discretion over earnings.

A. MANAGERIAL DISCRETION AND THE CORPORATE FORM

Three aspects of managers' power are particularly important for present purposes. First, managers have significant power to approve transfers and distributions of assets in the ordinary course of business without shareholder approval, including distributions, asset purchases and sales, deployment of corporate property, contributions to charity and, most importantly, managerial compensation.¹⁵⁹ Second, directors can decide whether to recommend extraordinary transactions to the shareholders, including sale of substantially all the corporate assets, mergers, dissolution and charter amendments. Thus, the shareholders are limited to choosing from options the board presents. Third, the board not only can screen corporate-level transactions, but also can decide when shareholders can transfer control through sale of their own shares. Fourth, while shareholders elect the directors, the incumbent managers have significant power to determine shareholders' options because of their effective control over the proxy machinery. Fifth, directors have been able to enact strong takeover defenses, including poison pill stock rights, that effectively prevent transfer of shares to an acquirer of control except on terms the board approves.

The important question is whether managers can be made accountable to the shareholders or anyone else in exercising their substantial powers within the constraints of the corporate form. As discussed in the following subsections, accountability essentially turns on the shareholders' ability to vote, sue or sell. This analysis notes problems with each of these mechanisms, as well as with contractual variations.

1. Voting

While shareholders can approve major corporate transactions, the free rider problem inhibits effective shareholder action. Shareholders owning bits of firms in diversified portfolios have little incentive to inform themselves or determine the appropriate course of action. This problem is significant in shareholders' simply voting on transactions the managers propose. But even if shareholders could propose transactions, they could not practicably act as a group to choose which transactions to pursue and to structure and negotiate these deals. For the same reason, the shareholders as a group cannot effectively screen director candidates. Because these constraints inhere in actions by large groups of shareholders, they are not readily susceptible to simply giving more default legal power to the owners as some have proposed.¹⁶⁰ One possible response

¹⁵⁹ See *supra* text accompanying note 146.

¹⁶⁰ See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 117 Harv. L. Rev. ___

is to rely on monitoring by institutional shareholders.¹⁶¹ But even institutional shareholders face obstacles in managing details of each portfolio firm. In any event, there is significant evidence that institutional investor activism has had little effect on firm performance.¹⁶²

Firms might tweak shareholder voting rights to make managers more accountable to shareholder interests. For example, corporations could provide in their bylaws for director election based on a majority of all votes cast, including withheld votes.¹⁶³ This would let shareholders register dissatisfaction with current management in nominating directors, yet without giving them possibly disruptive power to nominate specific directors as the SEC has proposed.¹⁶⁴ But these devices still leave managers with substantial freedom of action since shareholders are unlikely to incur the costs of coordinating a revolt short of significant management problems.

Another possible approach to the free rider problem in shareholder voting is to concentrate equity ownership through a highly leveraged capital structure. A conventional firm can convert to this structure through a leveraged buyout.¹⁶⁵ A highly leveraged capital structure can be an effective monitoring mechanism in that the firm's duty to make principal and interest payments constrains managers from self-interested retention of earnings.¹⁶⁶ Also, the firm's debt is covered by bond indentures that typically include negative covenants forbidding specific activities and providing for enforcement by an indenture trustee. High leverage can, however, be disadvantageous for many firms. Debt-heavy firms face high agency costs because the owners have incentives to take risks for which they will capture the payoffs while the creditors bear the risk of non-payment.¹⁶⁷ And firms that fail to pay their substantial debt face the risk of potentially costly bankruptcy proceedings.

(2004).

¹⁶¹ See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS* 233-53 (1994); Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 *UCLA L. Rev.* 811 (1992).

¹⁶² See Bernard Black, *The Value of Institutional Investor Monitoring; The Empirical Evidence*, 39 *UCLA L. Rev.* 895 (1992); Romano, *supra* note 81.

¹⁶³ See Michael Schroeder, *CEOs Fight Making It Easier For Holders to Stop Board Picks*, *Wall St. J.*, May 27, 2005 at C4, available at http://online.wsj.com/article/0,,SB111715964804544874,00.html?mod=todays_us_money_and_investing (discussing moves in this direction by some firms).

¹⁶⁴ See Security Holder Director Nominations, 68 *Fed. Reg.* 60784 (proposed Oct. 23, 2003)

¹⁶⁵ For a general discussion of leveraged buyouts, see Larry E. Ribstein & Barry E. Adler, *Debt, Leveraged Buyouts and Corporate Governance* (Cato Inst. 1989).

¹⁶⁶ See Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 *AM ECON. REV. PAPERS & PROCEEDINGS* 323 (May, 1986).

¹⁶⁷ This is in fact the basic situation that Jensen & Meckling described in their classic article about agency costs. See Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976)

2. Suing and fiduciary duties

Shareholders can hold managers accountable by suing them for breach of fiduciary duty. The power to sue has been emphasized by social responsibility theorists because of the issue of whether managers should have a duty to non-shareholder groups, or whether their duty to shareholders should leave discretion to manage on behalf of these groups. However, the social responsibility issue essentially merges into the general business judgment rule.¹⁶⁸ This follows from the inherent constraints on courts' ability to interfere in corporate management.¹⁶⁹ Courts, therefore, only rarely interfere in board decision-making under the business judgment rule. A prominent recent example is *Brehm v. Eisner*,¹⁷⁰ where the Delaware supreme court declined to intervene in a decision to hire a chief executive, give him a lucrative contract with generous termination provisions and fire him only 14 months later, paying him more than \$140 million for admittedly ineffective management during his brief tenure.¹⁷¹

Courts do discipline business decisions when managers engage in certain types of self-dealing or, in limited circumstances, fail to act carefully, which effectively means failing to follow court-prescribed procedures. But courts probably are no better able to second-guess procedures than they are to review substance. For example, in *Smith v. Van Gorkom*,¹⁷² an experienced and knowledgeable board approved sale of the company for a significant premium over market, but was held liable because it failed to obtain an outside appraisal. The costs of such consulting services do not obviously exceed the benefits.¹⁷³ Not surprisingly in light of these problems, directors' potential liability for breach of the duty of care largely has been mooted by corporations' ability to opt out of the duty in the charter.¹⁷⁴

Even if courts could effectively second-guess business decisions, the procedural mechanisms for doing so are problematic. The decision to sue must be left either to the board itself, which generally makes such management decisions but is biased when deciding whether to sue its own members, or to a volunteer shareholder plaintiff who

¹⁶⁸ See *supra* § I.A.2.

¹⁶⁹ See *supra* text accompanying note 21.

¹⁷⁰ 746 A.2d 244 (Del. 2000) (en banc) (holding that questionable employment contract nevertheless met loose business judgment standard).

¹⁷¹ The complaint was upheld on remand. In re the Walt Disney Company Derivative Litigation, 825 A.2d 275 (Del. Ch. 2003).

¹⁷² 488 A.2d 858 (1985).

¹⁷³ Thus, in *Brehm*, the Delaware supreme court exonerated the board mainly because it relied on a compensation expert although this expert had made the seemingly obvious mistake of failing to add up the termination benefits under the contract. On remand the amended complaint was upheld mainly because it alleged that the board had not, in fact, relied on the expert. In re the Walt Disney Company Derivative Litigation, 825 A.2d 275 (Del. Ch. 2003).

¹⁷⁴ See Del. Gen. Corp. L. §102(b)(7); Veasey, *supra* note 21 at 1428 (noting that "personal liability of directors solely for due care violations has largely become moot by reason of section 102(b)(7) of the DGCL").

brings a derivative action. The derivative remedy creates conflicts between the plaintiff and other shareholders. The plaintiff is a nominal holder and the real party at interest is the lawyer who stands to receive a contingency fee by winning or (more often) settling the case. This substitutes the agency costs of managerial discretion for those inherent in the relationship between the plaintiff's attorney and the corporation.¹⁷⁵ For example, the attorney may choose to sue because he does not bear the costs the litigation imposes on the corporation, may bring a strike suit solely to provoke a strategic settlement, or may settle a good claim for less than it is worth because does not want to risk losing at trial. Recognizing these problems with derivative suits, courts have, among other things, required plaintiffs to make demand on the board and permitted a board litigation committee to block the suit. As a result of these rules, derivative suits are increasingly rare, and have effectively been replaced by class actions under federal disclosure laws.¹⁷⁶

The problems of suing are not easily fixed to provide for more accountability because they inhere in the corporate structure. Given delegation of substantial power to the board, courts and lawyers are no more likely to be able effectively to constrain this power than are outside shareholders or bidders for control. Thus, for example, if courts or legislatures increase the board's power to scrutinize transactions, or a derivative plaintiff's power to sue, this would trigger the costs that the current constraints are intended to control without significantly improving board decision-making.

It follows from this analysis that no conclusions can be drawn about the actual or appropriate level of corporate social responsibility from the fact that shareholders apparently cannot impose on managers an explicit duty to maximize profits.¹⁷⁷ The lack of such a duty is attributable to the inherent constraints on court-supervised duties, and not to a perceived need to permit managers to engage in socially responsible management.

3. Selling and the market for control

Shareholders' power to sell their shares when they are dissatisfied with management is worth little unless shareholders can transfer control. Some restrictions are imposed by state statute, but the Delaware anti-takeover provision, which applies to most large publicly held firms, is relatively mild.¹⁷⁸ There is also a federal law, the Williams Act, which impedes hostile takeover in various ways.¹⁷⁹ But despite these laws, managers could be made accountable to shareholders if the courts recognized and enforced corporate default rules that maintained the viability of shareholders' power to transfer

¹⁷⁵ See John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (No. 3, 1985).

¹⁷⁶ See Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004).

¹⁷⁷ See Elhauge, *supra* note 1 at [83] (observing that opting out of managers' discretion to maximize profits would be unenforceable).

¹⁷⁸ See Del. G.C.L. §203.

¹⁷⁹ See 11 U.S.C. §13(d) and 14(d) (requiring disclosure and regulating the substantive terms of a bid primarily to mandate a minimum offer period).

control over the objection of incumbent managers.¹⁸⁰ In fact, the default that the courts appear to have adopted is one focusing on the shareholders' ultimate *voting* power rather than on their power to *sell*.¹⁸¹ One basis for the courts' and legislatures' constraints on the shareholders' power to transfer control is the managers' right to consider non-shareholder constituencies in deciding whether to permit a hostile takeover. The Delaware supreme court first recognized this right in the *Unocal* case,¹⁸² and later confirmed the right in the *Paramount*.¹⁸³ Some legislatures have clarified managers' right to consider the interests of non-shareholder constituencies.¹⁸⁴

The courts and legislatures may have changed the applicable default in the late 1980's, and this change arguably breached shareholders' constitutional rights under the contracts clause.¹⁸⁵ Even this constrained default rule, whether or not it was appropriately changed, might be workable as long as shareholders can change the default rule to prohibit or reverse poison pills or other significant restrictions on their power to transfer control. However, there is significant debate over whether the shareholders have this power.¹⁸⁶

¹⁸⁰ See Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L. J. 71 (1989).

¹⁸¹ Robert Thompson and Gordon Smith, *Toward A New Theory Of The Shareholder Role: "Sacred Space" In Corporate Takeovers*, 80 TEX. L. 261 (2001).

¹⁸² See *Unocal Corporation v. Mesa Petroleum Co.*, 493 A.2d 946, ___ (Del. 1985) (permitting directors opposing a takeover to consider "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise").

¹⁸³ See *supra* text accompanying note 142.

¹⁸⁴ See Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 Mich. L. Rev. 846 (1989). For a more general non-shareholder constituency provision, see Ohio Rev. Code Ann., § 1701.59:

Authority of directors; bylaws; standard of care. . . .(E) For purposes of this section, a director, in determining what he reasonably believes to be in the best interests of the corporation, shall consider the interests of the corporation's shareholders and, in his discretion, may consider any of the following: (1) The interests of the corporation's employees, suppliers, creditors, and customers; (2) The economy of the state and nation; (3) Community and societal considerations; (4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

¹⁸⁵ See Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767 (1989); Henry N. Butler & Larry E. Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611 (1988). Whether this is a constitutional violation depends at least partly on the nature of the corporate "contract," and specifically whether it can be deemed to be with or among the shareholders. This, in turn, depends on the nature of the corporation for purposes of applying constitutional rights. See Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95 (1995). However, given the practical constraints shareholders' ability to transfer control discussed in the text, it is unnecessary to resolve this issue for purposes of the present analysis.

¹⁸⁶ Compare Lawrence A. Hammermesh, *Corporate Democracy and Shareholder-Adopted By-*

Whatever the reasons for and legality of strong takeover defenses, it is not clear that shareholders themselves have a strong preference for takeovers as a disciplinary device. This is arguably indicated by their willingness to accept takeover defenses even in initial corporate charters.¹⁸⁷ Although it has been argued that such initial charter provisions reflect information problems,¹⁸⁸ they may also reflect, among other things, the capital structure of particular firms,¹⁸⁹ shareholders' preference for managers as "mediating hierarchs,"¹⁹⁰ or the inherent practical limits on takeover defenses discussed immediately below.

Apart from shareholders' preferences or the limits on shareholders' power to decide the limits on managers' takeover defenses, the potential for managerial defense against takeovers inherently limits takeovers as an effective way to ensure more manager accountability. The problem is that courts have limited ability to supervise takeover defenses through managerial fiduciary duties. To protect the market for control, courts must identify in particular cases precisely those devices or transactions whose costs in preventing beneficial control transfers exceed their benefits in facilitating efficient management. The courts are likely to have the same difficulty in doing this that they have second-guessing other management decisions, since the power to impede control transfers is closely tied to, and therefore difficult to distinguish from, the general power to manage. For example, once the Delaware supreme court upheld the selective repurchase in *Unocal* as within the board's power, they were effectively bound to approve the poison pill in *Moran*,¹⁹¹ which had a similar effect in penalizing a hostile bidder who had acquired target stock. And once the court upheld the poison pill, it was left with the task of trying to figure out exactly when the board must lift the pill.¹⁹²

This illustrates the dynamic nature of the takeover defenses problem. If the court outlaws a defense, managers are likely to be able to find another defense that has a

Laws: Taking Back the Street? 73 TULANE L. REV. 409 (1998) (arguing that shareholders do not have this power) with Jonathan Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFTSTRA L. REV. 835 (1998) (arguing in favor of shareholder power).

¹⁸⁷ Robert Daines and Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L. ECON AND ORG. 83 (2001).

¹⁸⁸ See Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. Pa. L. Rev. 713 (2003).

¹⁸⁹ Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003) (discussing possible roles of institutional shareholders and private equity).

¹⁹⁰ Lynn A. Stout, *The Shareholder as Ulysses: Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667 (2003).

¹⁹¹ *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985),

¹⁹² Ribstein, *supra* note 180, attempts to distinguish appropriate from inappropriate exercises of board power to defend against takeovers. The point of that exercise was to attempt to guide court decision-making in this difficult area. While I continue to believe these guidelines are soundly based on the contractual framework laid out in that article, this is not inconsistent with a recognition that the courts have a difficult task. Moreover, the lines drawn in that article would still have left significant leeway for boards to defend against takeovers, and therefore significant constraints on the market for control as a mechanism for controlling managers.

similar defensive effect but, perhaps, even more negative consequences for the corporation than the outlawed defense. In other words, courts risk effectively channeling managers' actions toward conduct that is worse for the shareholders than what a board would do if it were freer to act.¹⁹³ Similar problems apply to shareholders who try to specify in the charter actions, such as poison pills, that managers may not take. Given these logistical problems with limiting takeover defenses, it is not surprising that courts have settled on a bright-line rule that essentially preserves only some power shareholder power to vote on control changes.

B. THE PARTNERSHIP OPTION: STRONG-FORM ACCOUNTABILITY

The above discussion suggests that the problem of managerial slack inheres in the combination of two features of the corporate structure – strong centralized management and the absence of effective devices for ensuring that managers are accountable to owners in exercising their powers. Management by non-owner executives is an unavoidable aspect of specializing management and ownership functions in large, publicly held firms.¹⁹⁴ The separation of management and ownership, in turn, inevitably creates agency costs.¹⁹⁵ Although these circumstances in themselves do not dictate any particular level of accountability, devices for increasing accountability confront against the logistics of shareholder voting and judicial supervision of management.

But it is not clear that owners need to be relegated to the ineffective protections of suing, selling and voting. An alternative would be for publicly held firms to organize in the partnership form – for example, as limited partnerships or limited liability companies. Managers of publicly held partnerships, often called “master limited partnerships” (MLPs), might be expected to share the problems of publicly held corporations discussed in subpart A. However, the publicly held partnership form has several potential advantages over the corporation, detailed in the following subsections. These advantages amount to substituting a stronger form of accountability for the weak accountability of the corporate form discussed in subpart A. Rather than empowering managers to use corporate assets subject to oversight by courts and shareholders, partnership-type rules limit the assets under managers' control by imposing specific requirements to make distributions compelling distributions and by allowing dissatisfied members to cash out of the firm. Unlike limits on director discretion, including those on takeover defenses, these accountability devices do not require ongoing supervision by courts, or collective action by shareholders.

These potential advantages of partnership do not suggest that the partnership form should replace the corporate form, that a significant fraction of corporations should become partnerships, or that these devices would be a panacea even in the firms that adopt them. But they fill gaps left by the corporate accountability devices discussed above, indicating that at least some publicly held firms would be better off if they adopted some of these partnership devices.

¹⁹³ See Jennifer Arlen & Eric L. Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003).

¹⁹⁴ See generally, Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

¹⁹⁵ See generally, Jensen & Meckling, *supra* note 167.

1. Committing to distributions

Given corporate shareholders' unsatisfactory options in dealing with managerial slack discussed in subpart A, there may be significant benefits in reducing managers' discretion over retained earnings and requiring them to distribute cash periodically.¹⁹⁶ The problem with this alternative in corporations is that there are limits to the contractual commitment managers can make because of prohibitions on usurping the directors' role.¹⁹⁷ Even if managers make general promises to pay dividends, there is a question as to the extent to which courts will be willing to police such inroads on managers' broad discretion. Such constraints also would conflict with the corporate norms of retaining earnings under managerial control and distributions that do not fluctuate with earnings.¹⁹⁸

If managers are not bound to distribute dividends, they may tend to do so mainly when it is in their personal interests and not necessarily when it is in the shareholders' interests. For example, firms were more likely to increase dividends following the 2003 dividend tax cut¹⁹⁹ if their managers held stock than if they held stock options, in each case reflecting the effect of dividends on the value of their holdings.²⁰⁰ Also, while firms generally increased dividends following the imposition of an undistributed profits tax in 1936, the increase was lowest for firms with the highest expected agency costs.²⁰¹

Partnership law facilitates firm's commitments to distributions, thereby addressing the agency costs associated with retained earnings. A detailed study of MLP agreements²⁰² shows how general partners of MLPs provide these assurances by promising to distribute "available cash" (net cash less reserves), giving general partners significant incentives to maintain high distribution rates, and restricting specific actions such as issuance of additional equity that might reduce distributions. Such provisions prod managers to serve the owners' interests, including by avoiding excessive compensation, more effectively than corporate shareholders' lower-powered rights discussed in subpart A, or easily manipulated earnings-based compensation. As one

¹⁹⁶ See Frank Easterbrook, *Two Agency Cost Explanations of Dividends*, 74 Am. Econ. Rev. 650 (1984) (proposing this idea).

¹⁹⁷ See Larry E. Ribstein, *Why Corporations?*, 1 BERK. BUS. L. J. 183,___ (2004).

¹⁹⁸ See Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH & LEE L. REV. 1159 (2004).

¹⁹⁹ See *infra* text accompanying note 247.

²⁰⁰ See Jeffrey R. Brown, Nellie Liang and Scott J. Weisbenner, *Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut* (December, 2004), available at http://papers.ssrn.com/paper.taf?abstract_id=631182.

²⁰¹ See William G. Christie & Vikram Nanda, *Free Cash Flow, Shareholder Value, and the Undistributed Profits Tax of 1936 and 1937*, 49 J. FIN. 1727 (1994). Note that the effect of the Act was somewhat ambiguous because it was the first to impose double taxation. See *infra* text accompanying notes —.

²⁰² John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471 (2005).

analyst noted, “[i]t’s hard to fake cash payments to shareowners.”²⁰³

The partnership-type commitment to distributions differs critically from the functionally similar commitment to repay debt of a leveraged buyout firm.²⁰⁴ First, the partnership does not trigger significant agency costs between creditors and debtors. The partners entitled to the payments not only bear the risk of nonpayment but also, as residual claimants, capture at least some of the benefit of the firm’s success.²⁰⁵ Second, if the firm does not meet its payout obligations, the partners are relegated to contract rights and cannot force the firm into costly bankruptcy proceedings.

While distribution requirements effectively discipline managers, they do so without requiring interference by courts or owners in the management of the firm. The managers, in effect, are subject only to a constraint on output – they must produce a certain level of distributions or they are subject to penalties or a lower level of benefits. This constraint can be set *ex ante* in the agreement and revised periodically. Neither the owners nor the courts need to dictate what specific actions the managers should take in order to achieve the target output.

To be sure, distribution requirements may seem appropriate only for firms with passively managed assets, which are the only publicly traded firms that are entitled to use single-level taxation.²⁰⁶ Because a firm commitment to a high level of payouts requires stable and predictable earnings, many MLPs own gas pipelines, which essentially just charge rents for oil moving through, and therefore are not subject to significant fluctuations in business.²⁰⁷ Firms that have more actively managed assets and less predictable earnings may want to make a weaker commitments to distributions. But even such firms might gain from limiting managers’ control over the firm’s cash. Mandatory distributions do not block expansion or increased investment, but only managers’ access to retained earnings. Managers can still grow the firm or redeploy assets by raising new equity, borrowing, or getting owners’ consent to waive the agreement’s distribution or buyout provisions. Managers therefore must submit expansion decisions to continuous market scrutiny.²⁰⁸

2. Member cash-out rights

A second partnership-type way to reduce managerial slack is to permit owners to cash out of the firm in situations other than the fundamental changes that trigger corporate appraisal rights. For example, general partnership statutes provide for a right to

²⁰³ *Id.* at 479 (quoting Chuck Saletta, *Fool on the Hill: Growth in the Pipeline*, MOTLEY FOOL, Jan. 31, 2003, at www.fool.com/news/foth/2003/foth030131.htm).

²⁰⁴ *See supra* text accompanying note 165.

²⁰⁵ [check MLP agreements]

²⁰⁶ *See* Internal Revenue Code §7704(a).

²⁰⁷ *See* Goodgame, *supra* note 202 at 480-82 (discussing tax and business considerations relating to nature of MLP assets).

²⁰⁸ *See* Easterbrook, *supra* note 196 at 654 (noting that “[n]ew investors are better than old ones at chiseling down agency costs”); Goodgame, *supra* note 202 at 501-04.

cash out at will.²⁰⁹ Though many limited partnership statutes, including the 2001 version of the Uniform Limited Partnership Act,²¹⁰ do not provide for default cash-out rights, this can be linked to the fact that such a right affects valuation for estate and gift tax purposes in family limited partnerships.²¹¹ In any event, cash-out rights clearly are consistent with the norms of partnership law. The question is whether they are appropriate for publicly held firms.

Like distribution provisions, cash-out provisions reduce managerial control over the firm's cash, in this case through an owner-initiated right rather than a duty pre-specified in the agreement. Cash-out rights may give owners more than they would get from merely being able to sell their interests on the market to the extent that the price is determined by the value of the underlying assets without any discount for current managers' suboptimal use of the earnings. This owner right could also be more valuable than the owners' rights to sue and vote, since it does not involve any free rider problems or the costs of coordinating with other owners. At the same time, like mandatory distributions, cash-out rights do not let courts or shareholders interfere with managers' discretion. Rather, they are a type of output-based control, where the output is determined *ex post* by the owners' individual judgments rather than specified *ex ante* through a duty to make distributions.

The benefits of letting owners cash out must be balanced against the potential costs of such a right. Corporate law has been said to have facilitated the creation of the modern corporation by solving problems associated with partnership dissolution at will.²¹² The strong corporate entity arose because spot markets were unavailable to provide the sort of coordination large firms needed. Thus, in order to ensure that parts were ready for assembly, and that manufactured units showed up for delivery, all in time to meet customer demand, firms internalized these functions and subjected them to the command and control of top executives and midlevel managers.²¹³ This need to keep assets together necessitated the creation of a strong corporate entity, or "entity shielding."²¹⁴ The partnership structure described above would compromise these objectives by facilitating breakup of the firm and threatening managers' control over retained earnings. This, in turn, could destroy going concern value and invite hold-up of owners who wanted to continue the firm.

²⁰⁹ See UPA §31; RUPA §701(a).

²¹⁰ ULPA (2001) §601(a).

²¹¹ Under Internal Revenue Code §2704(b), taxation of intra-family transfers of business organization interests depends on state statutory exit rights.

²¹² See Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003).

²¹³ See Chandler, *supra* note 118; Blair, *supra* note 212; Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression*, http://papers.ssrn.com/paper.taf?abstract_id=618582, NBER Working Paper No. W10900 (November 2004) (observing that parties formed corporations during the late nineteenth and early twentieth century where they expected high profitability that might be jeopardized by untimely dissolution, despite the risk of controlling owner opportunism facilitated by corporate continuity).

²¹⁴ See Hansmann, et al, *supra* note 51.

It is no longer clear, however, that even large publicly held firms need this strong entity protection. Instead of owning large pools of assets whose value might be significantly reduced by breakup, many large businesses today are simply sets of contracts, as markets have solved some of the opportunism problems that once were thought to compel organization of traditional firms.²¹⁵ The value of these networked firms increasingly lies in their brand names rather than in the bundle of assets assembled to produce the branded products.²¹⁶ The brand, in turn, depends on intellectual property and human capital, and is not threatened by the possible need to liquidate assets triggered by significant distribution or cash-out obligations. Sears, for example, once one of Chandler's classic examples of the integrated firm,²¹⁷ is today mainly a real estate play in combination with Kmart, and a set of branded products manufactured by other firms.

More generally, the tradeoffs between the higher agency and opportunism costs of strong corporate continuity and the liquidity benefits of partnership have been analyzed in the traditional partnership setting,²¹⁸ and in the choice between the corporate and partnership forms.²¹⁹ Litvak shows that many venture capital funds are structured to give owners what essentially amounts to the option to put their investments back to the firm, subject to a wide variety of potential penalties.²²⁰ Notably, options and associated penalties in such firms depend mainly on the funds' access to other methods of controlling agency costs rather than on liquidity considerations.

Although publicly held firms might seem categorically different from small firms regarding the appropriateness of partnership-type liquidity, cash-out rights are not necessarily inefficient for all publicly held firms. Though publicly-held firms are likely to own larger pools of assets than closely held firms, any firm stands to lose going concern value if it must liquidate. Even venture capital funds, which do not have going operations, could be exposed to costs from having to make distributions, since they may miss significant opportunities if they lack funds to invest.²²¹ The main difference between public and closely held firms involves owners' ability to exit into a public market. But such a market may only give the owners the ability to sell at a price discounted by inefficient management, with the discount depending on whether there is an active control market. Moreover, the existence of a public market for the firm's shares indicates that the firm may be able to deal with liquidity constraints more easily than closely held firms because public ownership enables them to raise funds in efficient securities

²¹⁵ See Ribstein, *supra* note 197.

²¹⁶ See *supra* subpart I.D.

²¹⁷ See Chandler, *supra* note 118.

²¹⁸ See Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987).

²¹⁹ See Lamoreaux and Rosenthal, *supra* note 213.

²²⁰ See Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, U of Texas Law and Economics Research Paper No. 34 (October 2004) http://papers.ssrn.com/paper.taf?abstract_id=613142.

²²¹ See *id.*

markets, including through new types of securitization.²²² Even as these markets helped account for the rise of the corporation in the last century, now they may reduce the need for the corporate form, or at least for its “entity shielding” feature.

Although cash-out rights may be appropriate for some publicly held firms, the form of these rights is likely to differ from those in closely held firms. Firms’ choices are not limited to the traditional unstable partnership and the traditional super-stable corporation. For example, publicly held firms might provide for cash out at a formula price based on earnings or cash flow that does not require complex determination of “value,” but that gives owners access to more of the underlying value of the firm’s assets than is available in traditional corporations. Also, these rights need not be available at will, but might be triggered by specific events, including the firm’s failure to make distributions. The agreement might thereby trade cash-out rights for rights to distribution. In firms with less stable earnings than the typical MLP, the distribution obligation might nevertheless be set at a high level, with the penalty for failing to satisfy the obligation being a trigger of the cash-out right.

Litvak observes that the current regime of no cash-out rights in corporations must be attributable to the fact that other governance mechanisms work well enough to control agency costs. This seems unlikely in view of the shortcomings of the corporate form discussed above.²²³ A more likely explanation is that current tax rules give firms an incentive to use the corporate form despite the agency costs of owner lock-in.²²⁴

3. Interrelation with corporate shareholders’ rights

The rights to compel distributions and to cash out provide for a potentially more stringent level of accountability than the traditional corporate rights to vote, sue and sell. While managers might be able to manipulate assets over the short term to provide cash for distributions or cash-outs, this manipulation would have to involve real assets and money, and therefore must be more transparent than mere accounting devices.

Because these devices involve stronger accountability, they also reduce or eliminate the need for the conventional corporate forms of accountability. Thus, MLPs commonly take advantage of provisions in Delaware partnership law (the law applicable to all exchange-listed MLPs) to broadly opt out of fiduciary duties.²²⁵ In MLPs, limited partners have only minimal voting rights²²⁶ and hostile takeovers that involve replacing (rather than changing control of) the general partner are virtually impossible.²²⁷ Because corporate accountability devices potentially let courts and shareholders intrude into

²²² See Hansmann, et al, *supra* note 51.

²²³ See *supra* subpart IV.A.

²²⁴ See *infra* subpart IV.C.

²²⁵ See Del. Code Ann. Tit. 6 §17-1101; Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004). The use of these provisions in MLPs is discussed in Goodgame, *supra* note 202 at 485-90, 494-98.

²²⁶ *Id.* at 491-94.

²²⁷ *Id.* at 498-99.

corporate management, the partnership-type devices may be more consistent than the corporate devices with the goals underlying “director primacy.”

The increased accountability under partnership-type rules leaves less slack for managers to engage not only in self-interested conduct, but also in “socially responsible” conduct that does not produce more cash for owners. This result is not achieved by tinkering with managers’ fiduciary duties, as in corporations.²²⁸ As just noted, fiduciary duties, hostile takeovers and even owner voting rights are minimal or non-existent in MLPs. Thus, there is no doctrine of “partnership” social responsibility that mitigates partnership managers’ duty to maximize profits on behalf of the owners. Rather, maximization of profits is compelled by the simple fact that MLP managers have much less power to dispose of the firm’s cash than do corporate managers.²²⁹

4. Limitations on public firms’ use of partnership accountability devices

MLP accountability devices can be used by all publicly held firms except to the extent that there are limitations on both the ability of corporations to adopt these devices and the ability of publicly held firms to use the partnership form. Some limitations on devices that restrict board power are inherent in the regulatory nature of the corporate form.²³⁰ An important rationale for regulation of the corporate form is the perceived need to preserve managerial discretion to respond to the needs of non-shareholder stakeholders.

This social responsibility rationale for restricting governance became especially important when in the 1980’s with the development of powerful devices that facilitated non-coercive takeovers. Elhauge argues that these devices “monetized the mushy” – that is, made the financial costs of social responsibility salient – and thereby forced courts and legislatures to confront the issue of whether managers could block hostile takeovers that clearly produced more financial value for shareholders.²³¹ This history predicts that courts and legislatures will block corporations’ use of partnership accountability devices that produce the same effect in diminishing managers’ discretion to engage in socially responsible management. Lawmakers might even limit the extent to which public firms can adopt the MLP form either in their initial charter or by converting midstream.

On the other hand, use of the MLP device might fit Delaware’s rule of “independent legal significance,” which permits firms to do under one provision of business association law what they cannot do under another.²³² This approach is

²²⁸ See *supra* text accompanying notes 182-184.

²²⁹ Since the social responsibility issue does not arise in MLPs as a matter of fiduciary duty, it follows that it would not constrain any power the members do have to transfer control. *Cf.* *Marriott Hotel Properties II Limited Partnership*, 2000 WL 128875 (Del. Ch. Jan. 24, 2000) (holding that, given the structure of the limited partnership, the general partner did not have a *Unocal* duty to protect the limited partners in connection with a tender offer by the general partner's parent).

²³⁰ See Ribstein, *supra* note 197 at ___.

²³¹ See Elhauge, *supra* note 1 at [54].

²³² See Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and its Implications for Corporate Law*, 17 J. CORP. L. 299 (1991) (discussing use of the publicly held limited

bolstered by the practical consideration that permitting greater accountability in the partnership form would enable the development of distinct shareholder clienteles regarding social responsibility.²³³

C. TAX PROTECTION OF THE CORPORATE FORM

Subpart B suggests that the value of at least some publicly held firms might be increased if the firms switched from standard corporate governance norms to stronger partnership-type forms of managerial accountability to shareholder interests. Even if such a switch did not increase social welfare, it would seem that firms would have a significant incentive to reduce their cost of capital. Nevertheless, there has been no major move in this direction. Does this indicate that such a move would not be in the interest of firms or society?

I have elsewhere presented several explanations of why we have not observed a move to publicly held partnership forms.²³⁴ These include the opposition of politically powerful managers who seek to preserve their power and perks under the existing regime, and the ‘network’ costs of creating a new legal structure, including case law, statutes and standard forms. Despite these considerations, if the increased value from restructuring is evident, it seems likely that some large firms would move in this direction, particularly if managers or substantial shareholders can share in the gains. Moreover, incumbent managers could not prevent entrepreneurs from forming new firms with these structures. Thus, if there are significant benefits from this new structure, it is likely that at least some firms would attempt to capture these benefits.

The main impediment to switching to the partnership-type accountability mechanisms discussed above is tax-related. The corporate income tax system – which applies to all publicly traded firms except for partnerships that engage in “passive” (asset-management) activities²³⁵ – taxes corporations on their income, and then owners on the firm’s earnings when they receive distributions or cash in on earnings by selling their shares. The second-level tax in effect “traps” earnings in the firm by penalizing owners when they take cash out of the firm. Given the penalty on distributions, owners are less likely to contract to press managers for distributions dividends, cash-outs, restructuring or other methods even if this might reduce agency costs by loosening managers’ grip on corporate cash.

Recognizing how the corporate tax affects owners’ preference for distributions, corporate managers have not pressed for a move to eliminate double corporate taxation and open the earnings trap.²³⁶ Indeed, there is persuasive evidence that double taxation was initially introduced at the behest of corporate managers as part of a political deal in

partnership to avoid restrictions on opting out of fiduciary duties).

²³³ This is consistent with Elhauge’s argument for clarifying that corporate managers can engage in socially responsible decision-making. *See* Elhauge, *supra* note 1 at [39].

²³⁴ *See* Ribstein, *supra* note 197.

²³⁵ Internal Revenue Code §7704.

²³⁶ *See* Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325 (1995).

1936 to avoid an undistributed profits tax.²³⁷ President Roosevelt had pushed for such a tax, partly at the best of Adolf Berle, one of his main advisors.²³⁸ Berle, consistent with his views on the separation of ownership and control,²³⁹ had argued that managers were using large corporate surpluses for personal gain.²⁴⁰ Roosevelt's proposal would have eliminated both the corporate tax and the dividend exemption and imposed the double tax only on firms that had undistributed profits.²⁴¹ But managers saw that this would significantly increase pressure to make distributions and strongly opposed what they viewed as a potential constraint on their power.²⁴² In order to fight the proposal, corporate managers agreed to a compromise that traded a reduction in the undistributed profits tax for retention of the corporate tax and elimination of the dividend exemption – in other words, double taxation.²⁴³

There has been recent pressure to eliminate the double corporate tax during both the George H.W. Bush²⁴⁴ and George W. Bush administrations.²⁴⁵ But managerial opposition also continues.²⁴⁶ Thus, the proposal for elimination became a more modest scaling back in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRR), which merely reduces the tax on most dividends to 15%.²⁴⁷

Reducing but not eliminating double taxation is unlikely to achieve a significant change in managerial behavior. Under JGTRR, there might still be enough tax benefit from retaining earnings to preserve the current system, depending on the corporate and

²³⁷ See Steven A. Bank, *The Story of Double Taxation: A Clash over the Control of Corporate Earnings*, in BUSINESS TAX STORIES (Steven A. Bank and Kirk J. Stark, ed., Foundation Press, 2005) (“*Story*”) (discussing the adoption of double taxation in 1936); Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167 (2002) (“*Agency Costs*”).

²³⁸ *Id.* at 184-85.

²³⁹ See *supra* text accompanying note 4.

²⁴⁰ See Bank, *Agency Costs*, *supra* note 237 at 184-85.

²⁴¹ *Id.* at 198-99.

²⁴² *Id.* at 200-03.

²⁴³ *Id.* at 222-23.

²⁴⁴ The proposal involved a Comprehensive Business Income Tax (CBIT). See U.S. Dep't of Treasury, *Integration of the Individual and Corporate Tax System--Taxing Business Income Once* (1992), available at <http://www.treas.gov/offices/tax-policy/library/integration-paper/>.

²⁴⁵ U.S. Department of the Treasury, News Release, “Fact Sheet: The President’s Proposal to end the Double Tax on Corporate Earnings” (14 January 2003), online: U.S. Department of the Treasury, available at <http://www.ustreas.gov/press/releases/kd3762.htm>.

²⁴⁶ See Bank, *Story*, *supra* note 237.

²⁴⁷ Pub.L. 108-26, § 1, May 28, 2003.

individual income tax rates and the capital gains rate.²⁴⁸ More importantly, managers have strong incentives to retain earnings and shareholders have a limited ability to effect changes in corporate governance. Thus, while the JGTRR caused some increase in dividend payouts and in firms initiating dividends,²⁴⁹ there is survey evidence that distribution policies are not sensitive to tax or agency cost considerations,²⁵⁰ and direct evidence that increases in dividends depended on whether managers were shareholders.²⁵¹ Managers may be increasing payouts through repurchases rather than dividends as a way of covering the cost of stock options and facilitating earnings management.²⁵²

Nor would eliminating dividend and capital gains taxes and raising the corporate rate necessarily solve the problem of excessive earnings retention. Although public corporation shareholders would then be tax-indifferent between payout and retention, imposing the tax at the corporate level makes it less salient to shareholders than a single partnership-type tax at the individual level would be. To be sure, the higher corporate level tax directly reduces the resources under managers' control by the amount of the tax.²⁵³ By contrast, owners who directly incur a tax on corporate earnings would be more likely to exert pressure for distributions.

Even if these moves toward eliminating double taxation or imposing the tax directly on owners would reduce managerial agency costs, there are questions whether

²⁴⁸ See William Wilson Bratton, *The New Dividend Puzzle*, forthcoming 93 GEORGETOWN LAW JOURNAL, No. 3 (2004), Georgetown Law and Economics Research Paper No. 535462, available at http://papers.ssrn.com/paper.taf?abstract_id=535462.

²⁴⁹ See Nadarajan Chetty and Emmanuel Saez, *Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut*, NBER Working Paper No. 10572 (June 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=557206 (showing that nearly 150 firms initiated dividend payments after the tax cut, that these were mostly regular rather than special dividends, that firms that had been paying dividends increased them, that these effects are significant relative to company size and occur across differences regarding profits and other firm characteristics, and that the effects are more marked than for the Tax Reform Act of 1986, which reduced the top individual tax rate on dividends significantly but led mainly to a temporary increase in special dividends); Jeff D. Opdyke, *Tax Cut, Shareholder Pressure Stoke Surge in Stock Dividends*, Wall St. J., January 18, 2005 at A1, available at http://online.wsj.com/article/0,,SB110599926403228151,00.html?mod=todays_us_page_one (noting that in 2004, following enactment of JGTRRA, dividends were up 12% and 1288 companies increased their dividends, and that since the dividend-tax cut S&P 500 companies announced 421 dividend increases, 24 companies started paying dividends for the first time, the greatest increase ever in dividend initiations).

²⁵⁰ See Alon Brav, John Robert Graham, Campbell R. Harvey and Roni Michaely, *Payout Policy in the 21st Century*, Tuck Contemporary Corporate Finance Issues III (June 14, 2004), http://papers.ssrn.com/paper.taf?abstract_id=571046. The experience after JGTRR noted in the Text immediately above indicates that managers may be more sensitive to tax considerations than Brav, et al, survey would suggest. Brav, et al reported that only one percent of managers surveyed said their firms would definitely initiate dividends in response to JGTRRA.

²⁵¹ See Brown, et al, *supra* note 200.

²⁵² See Bratton, *supra* note 248.

²⁵³ See Avi-Yonah, *supra* note 41.

the benefits of corporate taxation exceed the costs.²⁵⁴ Whatever the other costs and benefits of the corporate tax, the main point for present purposes concerns the role of double corporate taxation in reducing corporate managers' accountability to shareholders. Like other agency-cost-control devices, the cost of direct taxation may outweigh the benefits. Just as shareholders may want to contract to give managers freedom to exercise discretion, as by providing for strong takeover defenses or weak shareholder voting rights, so they may want to continue some version of the retained earnings trap. This suggests that it may be efficient to extend the "check the box" approach to publicly held firms.²⁵⁵ This might be done in a revenue-neutral way by permitting firms to choose between a single level tax on the corporation and a single level tax at the owner level.

Apart from individual firm preferences, there is an additional question whether the law should continue to mandate double taxation for publicly held firms precisely because it increases managers' accountability to shareholders. Given the limits on other accountability mechanisms discussed in this Part and the effect of the double tax in deterring the sort of strong form accountability involved in reducing managers' control over corporate assets, the corporate tax can be seen as a possible focal point of the social responsibility debate.

It is therefore with respect to this tax issue that the arguments for and against restricting managers' accountability to shareholders discussed above come into play. As discussed in Part II, markets and other extra-legal considerations encourage managers who are accountable to shareholders also to attend to the interests of non-shareholder stakeholders. Though there is inevitably a gap between shareholders' and stakeholders' interests, the social costs of pro-shareholder management may not exceed the costs of unaccountable managers discussed in Part III.

Assuming abolition of the double taxation is normatively attractive, there is a large question of political feasibility. Corporate managers are likely to oppose a tax change that would threaten their power over corporate assets. They opposed takeovers in partly on the ground that they needed the freedom to protect jobs, securing the passage both of state anti-takeover statutes in the 1980's,²⁵⁶ and of the earlier federal Williams Act which significantly impeded the effectiveness of hostile takeovers.²⁵⁷ Managers welcomed the introduction of double taxation, arguing that they needed the discretion to

²⁵⁴ See Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASHINGTON UNIV. LAW QUARTERLY 417 (1992) (reviewing and criticizing arguments supporting the corporate tax). A more recent defense of the corporate tax is that it assists the state in regulating corporations by imposing tax penalties. See Avi-Yonah, *supra* note 41. However, tax penalties may be effective in controlling certain types of corporate conduct, but are not obviously more effective than fines or liability. Also, imposing the tax at the corporate level might actually leave more assets under managerial control than would imposing the tax at the owner level, with the accompanying owner demand for distributions.

²⁵⁵ See Simplification of Entity Classification Rules, 26 C.F.R. pt. 1, 301, 602 (December 10, 1996, effective January 1, 1997).

²⁵⁶ See Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS.L.REV.365.

²⁵⁷ See *supra* text accompanying note 179.

retain earnings in order to protect jobs.²⁵⁸ Managers are likely to make similar arguments today that the tax law needs to protect managers' discretion to serve the interests of non-shareholder stakeholders.²⁵⁹

Despite expected manager opposition, abolition of the double tax may be politically feasible, at least in the long run. First, publicly held partnerships that are not subject to the corporate tax exist even under pre-JGTRR law. This has encouraged the development of contracts designed to accommodate these firms. Increased familiarity with this form may spur broader recognition of the benefits of partnership-type accountability and direct taxation beyond the limited realm of passive asset partnerships permitted under current law. These developments, in turn, may spur pressure for tax and other legal changes to facilitate broader use of these vehicles.

Second, the growing use of MLPs creates a clientele for loosening constraints on this form. For example, a significant problem with MLPs is that there is a tax disincentive to institutional investment in publicly held partnerships by tax-exempt vehicles such as mutual funds because they might be subject to "unrelated business tax on income" from such investments.²⁶⁰ This reduces the availability of institutional shareholder monitoring in such firms. However, the recently enacted American Jobs Creation Act,²⁶¹ perhaps spurred in part by the growing MLP industry, enables mutual funds to invest in MLPs.²⁶² This facilitates greater shareholder monitoring of MLP managers, and therefore may invite increased voting power and decreased restrictions on hostile takeovers in such firms. To be sure, the inherent limits on dispersed owners' powers in publicly held firms apply here too. But increased shareholder monitoring might permit less reliance on, and therefore some loosening of, distribution constraints, and therefore make MLPs more feasible for managing more variable cash flows. This could, in turn, create political demand for widening the application of direct taxation beyond the passive asset category.

Third, the demand for broader availability of single-level taxation already has been shown to be sufficient to break through some regulatory and tax barriers. The Subchapter S corporation initially was the only way firms could obtain the benefits of limited liability together with the benefits of direct taxation. But state law development of the limited partnership put pressure on the tax definition of the corporation. One result was the eventual adoption of the "check-the-box" rule, which let closely held firms decide for themselves whether they wanted to be taxed as corporations or partnerships, thereby opening up the escape hatch from the corporate tax.²⁶³ Another result was making

²⁵⁸ See *supra* text accompanying note 237.

²⁵⁹ The corporation's reduced First Amendment rights (*see supra* note 50) have not stopped managers from lobbying effectively through political action groups like The Business Roundtable. Rather, restrictions on corporate speech seem mainly to apply to managers' efforts to defend the corporation itself, and specifically the owners' interests, from attacks by non-shareholder stakeholders. See *supra* note 78.

²⁶⁰ See I.R.C. §511(a)(1); Goodgame *supra* note 202 at 474, n. 18; Ribstein, *supra* note 40 at ___.

²⁶¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

²⁶² See *id.* §331; Goodgame, *supra* note 202 at 506.

²⁶³ For a discussion of the evolution of check-the-box, see Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819 (2001).

direct partnership taxation available to publicly traded partnerships. This initially created the possibility that firms might be able to escape double corporate taxation on a broad scale.²⁶⁴ Congress closed the loophole by extending the corporate tax to all but passively asset publicly traded partnerships.²⁶⁵ But this history at least suggests that there is political pressure for changes in the tax system. While Congress or the IRS may provide for loopholes or escape hatches like Subchapter S or check-the-box to reduce the demand for direct taxation,²⁶⁶ these devices might not fully stem the political demand.

Fourth, a move toward broader availability of single-level or direct taxation might be seen as a way to provide necessary additional managerial accountability in the post-Enron era. Enron at least may have reduced the persuasiveness of managers' arguments that they need discretion to help society by focusing on the costs of managerial discretion. As concerns about the costs and effectiveness of criminal liability and the Sarbanes-Oxley Act increase, public demand may build for alternative accountability mechanisms.

It may be that neither reform of the corporate tax system nor any other reform designed to increase managerial accountability is warranted because of the non-governance-related costs of such reforms, or because the reforms might discourage efficient levels of earnings retention. But if that is the case, it would only provide additional evidence of the irrelevance of corporate social responsibility to corporate governance. Just as rules regarding managers' fiduciary duties and takeover defenses can be largely explained by the inherent logistics of governing publicly held firms, so also the use of this accountability mechanism may not turn on the social responsibility issue. The main point here is that, to the extent that corporate social responsibility is offered as an argument for opposing increased managerial accountability, this argument should be rejected for the reasons discussed above in Parts II and III.

V. CONCLUDING REMARKS.

Although the corporation's role in society is undeniably important, corporate social responsibility as a distinct topic in corporate governance is not. Markets and regulation of corporate conduct help ensure that managers who are accountable to shareholders can also be expected to attend to society's interests. Even if alignment of corporate and social interests is imperfect, the logistics of public corporation governance ensure that managers will have significant discretion to deviate from shareholders' interests whether or not the deviation is rationalized on corporate social responsibility grounds. Thus, attempting to reduce the divergence through drastic reforms that restrict managers' accountability to shareholders are likely to increase rather than reduce social costs.

The main remaining role for corporate social responsibility in corporate governance lies not in corporate law but in the role of the double corporate tax in helping to preserve managerial control over corporate earnings. Changing this law undoubtedly would face strong opposition from corporate managers, who would argue that retaining control over corporate earnings is the only way they can serve the public and be insulated

²⁶⁴ See Ribstein, *supra* note 232.

²⁶⁵ See I.R.C. §7704.

²⁶⁶ See Arlen & Weiss, *supra* note 236 at 367-68 (explaining check-the-box along these lines).

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from narrow shareholder demands. But a century of fits and starts in corporate governance reform should at least have demonstrated the intractability of the corporate agency cost and responsibility problems and the need for more radical solutions. A change in the tax laws would create new opportunities for solving the central problem of corporate governance – that is, accountability, not responsibility.