ENTRENCHED MANAGERS & CORPORATE SOCIAL RESPONSIBILITY

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ABSTRACT

A growing number of academics have suggested U.S. corporate governance laws bestow too much power on managers. Much of the research focuses on the relationship between corporate governance arrangements, which supply a means to managerial power, and the financial performance of corporations. This exclusive focus on financial performance may be misguided. Although profits serve as a proxy for the benefits corporations provide society, they do not always adequately reflect the costs of the activities that generated them. In this sense, financial performance may not give an accurate, or at least complete, picture of the real value of corporations. Whether managers are too entrenched by the laws of corporate governance, therefore, depends not only on their profitability but also on how they spend their discretion. Importantly, entrenched managers could use their discretion to sacrifice profits in the public interest. Building on prior research, this Article compares six entrenching governance provisions with the appearance of corporations on two investment indexes based on "social responsibility," a measurement of performance along environmental, social and alternative economic factors. The results confirm a social psychological hypothesis of the Article: entrenchment–as measured by the presence of these six provisions–was negatively, and significantly, related to inclusion in the indexes. Although I offer competing explanations in addition to the hypothesis, the results tentatively support the conclusion that certain corporate governance arrangements entrench managers too much, leading to both poor financial and "social" performance.

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A growing number of academics have suggested U.S. corporate governance laws bestow too much power on managers. Much of the research focuses on the relationship between corporate governance arrangements, which supply a means to managerial power, and the financial performance of corporations. This exclusive focus on financial performance may be misguided. Although profits serve as a proxy for the benefits corporations provide society, they do not always adequately reflect the costs of the activities that generated them. In this sense, financial performance may not give an accurate, or at least complete, picture of the real value of corporations. Whether managers are too entrenched by the laws of corporate governance, therefore, depends not only on their profitability but also on how they spend their discretion. Importantly, entrenched managers could use their discretion to sacrifice profits in the public interest. Building on prior research, this Article compares six entrenching governance provisions with the appearance of corporations on two investment indexes based on "social responsibility," a measurement of performance along environmental, social and alternative economic factors. The results confirm a social psychological hypothesis of the Article: entrenchment–as measured by the presence of these six provisions–was negatively, and significantly, related to inclusion in the indexes. Although I offer competing explanations in addition to the hypothesis, the results tentatively support the conclusion that certain corporate governance arrangements entrench managers too much, leading to both poor financial and "social" performance.

INTRODUCTION

Self-interest governs the all-too-human managers of our public corporations. We should be wary of corporate laws that insulate them from accountability to shareholders and the external markets for corporate control. Without the discipline of accountability, executives pursue personal agendas adverse to the interests of the corporation and, in the end, society as a whole.[1] For corporate wealth means social wealth,[2] each of which is harmed by the accumulation of excessive incomes and self-aggrandizing empires, the theft of business opportunities, shirking of

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[1] *See* Lucian A. Bebchuk and Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. OF ECON. PERSP. 71, 72, 88-89 (2003); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COL. L. REV. 10, 12 (1991). *See generally,* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[2] *See, e.g.,* Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAGAZINE (Sept. 13, 1970).

responsibilities and just plain lame performance.[3] Such becomes the aggravated case when managers are left with more discretion than necessary, entrenched against the discipline of accountability to the interests of others.

Research, in fact, demonstrates a negative relationship between corporate governance arrangements that entrench managers and financial value. Staggered boards of directors, for example, which "stagger" the election of directors and make their wholesale replacement nearly impossible, have been associated with decadent financial performance.[4] As have limits on the rights of shareholders to amend corporate charters and bylaws, "poison pills" that preclude straightforward takeovers and "golden parachutes" that guarantee a profitable landing for departing executives.[5] Each of these arrangements entrench managers and have been statistically related to lower financial value for the corporations burdened with them. Use of these provisions, the research argues, should be curtailed.

But an exclusive focus on financial performance could be misguided. Self-interest comes in many forms. Managers, like people in general, respond to social and moral norms as well as financial incentives. Further, even with such an expanded understanding of self-interest, humans continue to confound the experts. In short, research also demonstrates a great deal of behavior cannot be explained in terms of the more rational and avaricious motivations assumed above.[6] And we should be thankful. Managers, at least, have some sense of human decency; corporations–the infamous sociopaths–do not.[7] For this reason, among others, corporate wealth does not always mean social wealth.[8] Thus, some discretion from accountability

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[3] *See* David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 591-598 (2005); Bebchuk & Fried, *supra* note 1, at 72, 88-89.

[4] *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. OF FIN. ECON. 409 (2005); Bebchuk, Coates & Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, 54 STAN. L. REV. 887 (2002).

[5] *See* Bebchuk, Cohen & Ferrell, *What Matters in Corporate Governance?*, HARV. L. SCH. OLIN DISC. PAPER 491 (2004). Practitioners note golden parachutes also incentivize managers to sell their corporations; thus, such provisions certainly allocate power to managers, but their effects on beneficial takeovers are more uncertain.

[6] *See, e.g.,* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 752-754 (2005).

[7] JOEL BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER (2004).

[8] Corporations, for example, require regulation for the purpose of managing negative externalities–those costs of corporate activities not reflected in corporate profits. *See, e.g.,* Frank H. Easterbrook, *Insider Trading as an Agency Problem*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS, 98 (John W. Pratt & Richard J. Zeckhauser eds., 1985)("there is no theoretical doubt about the propriety of legal intervention that requires firms to take account of the effects of their acts on third parties").

to shareholders and takeovers, and therefore some discretion from the cold maximization of profits, allows managers the freedom to act on social and moral obligations that could mitigate the otherwise unregulated costs of some corporate activities.[9] In some cases, managers could be spending their discretion on the sacrifice of profits for the public, rather than private, good. Financial performance, therefore, does not give us a complete picture of the social value of entrenchment and, accordingly, the wisdom of legally allowing the aforementioned governance arrangements.

Each of these perspectives likely bears some resemblance to the truth. Managers, like most everyone else, respond to selfish impulses, social norms, moral beliefs and inherent concern for other humans. Although conventional wisdom asserts selfish impulses run the best race, social psychological theory does not support such simplicity. Rather, context plays as much a role as anything in determining not only which motivations come to the fore, but also how these motivations are played out. For example, games–a type of context–bring competitive natures to the foreground. The rules of the games, whether they involve the accumulation of wealth or the scoring of goals, affect how the competition unfolds. Importantly, neither the games nor the rules are *a priori* necessary. For this reason, whether entrenched managers use their discretion for personal glory or public interest could depend, at least in part, on the contexts in which managers find themselves. Corporate governance arrangements are, of course, part of the context.

Context could produce some surprising results. Apart from a natural skepticism about the probability that entrenched managers would use their discretion for the public interest, I was interested in the possibility that managers accountable to shareholders and takeover markets might be accountable to broader social concerns because their context accentuates general accountability as a rule of thumb. Accordingly, I predicted entrenched managers–who are less accountable to profits–would also lead less socially responsible corporations. Building on the research negatively associating financial value with entrenchment, I compared the entrenchment provisions of those studies with inclusion in two established investment indexes of socially responsible corporations. As predicted, entrenchment was also negatively associated with inclusion in these indexes, further supporting the position that governance provisions, such as staggered boards, deserve careful scrutiny not only for their detraction from financial

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[9] *See*, Elhauge, *supra* note 6, at 747-749, 751-756 (social and moral norms supplement government regulation, which is inherently imperfect because of under- and over-inclusion problems, interest group influences and the imperfect aggregation of preferences); GEORGE J. STIGLER, MEMOIRS OF AN UNREGULATED ECONOMIST 119-120 (1988)(observing interest groups tend to corrupt government regulation).

value, but their potential implication for broader measures of social value as well.

Part I reviews the research suggesting a negative relationship between entrenching governance arrangements and financial value. Part II presents the results of my empirical study, suggesting a negative relationship between these provisions and social responsibility as well. Numerous explanations could be offered for the results. Part III reviews a sample, including the social-psychological theory that led to the study. Normative claims about entrenchment prove difficult. Plausible interpretations, for example, include the possibility that profitable corporations and managers merely "game" social responsibility indexes. Much of Part III, however, paints a rosier picture. Coupled with existing research on financial performance, the results of this study tentatively buttress claims that present corporate governance laws allow too much insulation from accountability. Nevertheless, the Article concludes with a discussion of problems that inhere in any practical changes to the laws of corporate governance. Entrenchment may present a dilemmafor financial and social value, but we should take care that any remedies do not cause more harm than good. In this way, areas for further research are also discussed.

In the background, this Article has two additional objectives unrelated to definitive normative conclusions. First, this Article hopes to address, through example, the significant lack of empirical research within corporate governance law, and business literature generally, concerning measurements of value apart from financial performance.[10] Second, this Article explores the use of "critical realism"[11] in conjunction with "law and economics" approaches. Among other things, such realism can inform law and economic models based on narrow conceptions of the human animal and its "self-interest." Each approach influences what follows, but we should understand that the former, more psychologically oriented, framework predicted the empirical results herein. In these respects, the Article hopes to serve as an example of how empirical research surrounding corporate law could be expanded and enriched through an amalgam of economics and psychology.

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[10] *See* Margolis, Walsh & Weber, *Social Issues and Management: Our Lost Cause Found,* 29 J. MGMT. 859, (2003)(after reviewing research published from 1958 to 2001, concluding scholarship has increasingly focused on financial performance and paid little attention to other effects on society).

[11] Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. PA. L. REV. 129 (2003).

I. ENTRENCHED MANAGERS CREATE LESS FINANCIAL VALUE

Shareholders of a corporation could respond to management shortcomings in several ways. Shareholders could publicly speak out; demand redress of grievances through shareholder proposals;[12] sell their stock and leave;[13] or oust the managers and start anew. Complete and effective response would likely require some combination of these forms.[14] However, good old-fashioned oustings of executives appear most favored.[15] Delaware, the grand dame of corporate law, has recognized the "shareholder

[12] *See* 17 C.F.R. § 240.14a-8.

[13] *See generally* Michael S. Knoll, *Ethical Screening in Modern Financial Markets: the Conflicting Claims Underlying Socially Responsible Investment*, 57 BUS. LAW. 681 (2002)(observing the rise of this option but discussing its inefficacy).

[14] *See generally* ALBERT HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970). With regard to corporations, Hirschman focuses on the response of consumers; his general theory applies to shareholders as well. Hirschman sorts responses into two broad types–"voice" and "exit"– that roughly refer to voicing opinions and leaving altogether. Each have limitations, necessitating a complex interplay of both for effective feedback. Shareholders, for example, may generally like their corporation and its management; responding with an "exit" to dissatisfaction with a particular aspect of the business, then, would be inappropriate. Under different circumstances, responding with "voice" to systemic dissatisfaction could prove futile and a waste of resources. Matters become much more complicated with the incorporation of timing into considerations of optimal responses. "Exit" options, for example, may occur too late; by the time a shareholder sells his ownership or ousts management, the damage may have already occurred beyond repair.

[15] Even with the rise of institutional investors, shareholders lack the interest, resources, expertise and incentives to adequately monitor corporate decisions at the level of shareholder proposals. Furthermore, there are reasons to believe exit strategies of selling shares and boycotting corporations have serious limitations as well. This leaves ousting as the most effective and appropriate response to perceived poor performance. *See, e.g.,* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 514-15 (2002) (observing scholarship that notes shareholders lack the interest, resources, expertise and incentives to monitor the details of corporate management); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453-464 (1991)(observing collective action problems of shareholders); Knoll, *supra* note 2, at 683-684, 710-713 (observing theoretical limitations of responding to dissatisfaction through selling shares). *But cf.* Rock, *supra* note 15, at 447, 452 (discussing rising role of institutional shareholders, opportunity for amelioration of collective action problems, but new level of agency problems); Knoll, *supra* note 15 at 685-686 (noting political efficacy of divestment campaigns in South African corporations during apartheid). Additionally, SEC regulations constrict shareholder proposals significantly. *See* 17 C.F.R. 240 § 14a-8(i). Further, such resolutions are precatory and regularly ignored by management. *See* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 876-877 (2005).

franchise" as the "ideological underpinning upon which the legitimacy of directorial power rests."[16] As the Delaware Supreme Court observed, "If the stockholders are displeased with the action of their elected representatives the powers of corporate democracy are at their disposal to turn the board out."[17]

Laws of corporate governance, on the other hand, provide numerous means with which the managers of public corporations can protect themselves from shareholder meddling.[18] With regard to that old-fashioned ousting, executive salvation often comes from limitations on the rights of shareholders and defenses against outside takeovers adopted by boards of directors.[19] These governance provisions entrench managers in their jobs, insulating them, to some extent, from accountability to shareholders and takeover markets.[20] For some, these provisions render the promise of the "shareholder franchise" a "myth."[21] Nevertheless, debate ranges as to the effects of entrenchment on the financial value of corporations. Although entrenchment provides the means to pursue harmful personal agendas,[22] entrenchment also allows for long-term strategies, cohesive boards of directors and reduced waste in the defense of takeovers.[23]

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[16] Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

[17] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985).

[18] Apart from corporate governance arrangements, prominent legal doctrines, such as the "business judgment rule," protect managers as well. *See, e.g.,* REV. MOD. BUS. CORP. ACT § 8.31(a)(2); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971).

[19] Bebchuk et al., *supra* note 5, at 2-3.

[20] Id. at 5.

[21] Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45 (2003).

[22] *See* Bebchuk et al., *supra* note 5 at 5-6 (reviewing literature); Lucian A. Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 793 (2002); Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981)(concern over effects on takeovers); Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965)(weakened discipline could lead to shirking, empire-building and extraction of private benefits by incumbents).

[23] *See* Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003)(noting, among other things, management discretion prevents special interest directors, balkanized boards and expensive proxy contests); Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003)(reduces need to pursue other, more inefficient anti-takeover strategies that are unregulated); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845 (December 2002)(*ex ante* analysis suggests anti-takeover provisions encourage non-shareholder groups to make extra-contractual investments in corporate team production); Bebchuk, *supra* note 21, at 43 (citing numerous SEC comment letters arguing against increased shareholder access to board elections); Lucian A. Bebchuk & Lars Stole, *Do Short-Term Managerial Objectives Lead to Under- or Over-Investment in*

Entrenched managers appear to be using their discretion more for personal agendas than corporate wealth. Empirical evidence supports the proposition that greater entrenchment, under the present balance of power within the corporate form, leads to lower financial performance.[24] For example, Professors Bebchuk, Cohen and Ferrell argue four constitutional governance provisions and two takeover defenses particularly entrench managers from shareholder and takeover accountability and, in the end, are strongly associated with lower financial value.[25] In short, there may be six particularly potent governance provisions executives can use to protect their jobs. Staggered boards, limits to shareholder amendments of the corporate bylaws, super-majority voting requirements for mergers and other acquisition transactions, and super-majority voting requirements for charter amendments compose the constitutional provisions; poison pills and golden parachutes compose the takeover defenses.[26]

Statistical data demonstrated a significant, negative relationship between the level of entrenchment–as measured by the aggregated presence of these six provisions–and the financial value of corporations–as measured by Tobin's Q, an increasingly standard economic indicator.[27] Bebchuk et al. also observed a significant, negative relationship between financial performance and each provision separately.[28] Underlying these results lurks the hypothesis that self-interested managers–agents of the shareholders of the corporation–shockingly divert corporate resources from the pockets of investors to other ends. With more entrenchment comes more diversion.[29]

Theory supports these results. Each of these provisions was expected to produce significant insulation from accountability to shareholders and external takeovers.[30] With such increased entrenchment, incentives to maximize profits relax, the interests of managers diverge from shareholders

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Long-Term Projects? 48 J. FIN. 719-729 (1993)(allows for long-term investment); Jeremy Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61-80 (1988)(allows for long-term investment); Rene Stulz, *Managerial Control of Voting Rights*, J. Fin. Econ., 20, 25-54 (1988)(allows incumbents to extract higher control premium for shareholders).

[24] *See* Bebchuk, *supra* note 15 at 852-853, 898-901 (2005); Bebchuk et al., *supra* note 5, at 11-12; Bebchuk, Coates & Subramanian, *supra* note 4.

[25] Bebchuk et al., *supra* note 5.

[26] Id. at 6-9.

[27] Id. at 16. They use the following measurement of "Q": market value of assets divided by the book value of assets, where the market value of assets is computed as the book value of assets plus the market value of common stock less the sum of book value of common stock and balance sheet deferred taxes. Id. at 17. They also present empirical data demonstrating a negative correlation between entrenchment and abnormal shareholder returns throughout the 1990s. Id. at 22-33.

[28] Id. at 20.

[29] Id. at 18-19.

[30] Id. at 6-7.

and the corporation suffers.[31] Empirically, the data suggests these costs outweigh any theoretical benefits from increased managerial insulation. A brief description of the provisions and their entrenching nature follows.

Having a *staggered board* means the directors of the board are divided into classes with only one class of directors coming up for reelection each year.[32] Consequently, shareholders cannot replace a majority of the directors in any given year regardless of support for such change.[33] Staggered boards are a powerful defense against removal in either a proxy fight or proxy contests.[34] Independent empirical evidence has observed negative relationships between the presence of staggered boards and susceptibility to takeover[35] as well as firm value.[36]

Boards may *limit the ability of shareholders to amend the bylaws* as well.[37] These limits, contained either in corporate charters or the bylaws themselves, usually take the form of super-majority voting requirements.[38] In addition, corporations may *limit the ability of shareholders to amend the charter* and *limit their ability to approve mergers and other acquisition transactions*.[39] Again, such limitations usually take the form of super-majority voting requirements.[40] Given the nature of shareholder ownership in large public corporations, such super-majority requirements greatly impede not only the ability of shareholders to affect change but also the success of even shareholder favored takeovers.[41]

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[31] Bebchuk, *supra* note 21, at 44 (shareholder power provides directors incentives to serve shareholder interests); Bebchuk & Fried, *supra* note 1, at 72 (managers can use discretion for empire building, retaining excess corporate cash and entrench themselves despite poor performance); id. at 88-89 (rent extraction, besides increasing executive pay, dilutes and distorts management incentives and harms corporate performance); FRANK H. EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 262 (1991)(presuming managers with power will "wring" as much from shareholders as possible); Frank Easterbrook & Daniel Fischel, *Corporate Control Transactions*, 91 YALE L. J. 698, 701 (1982)(financial incentives ameliorate agency costs due to diverging interests of managers and shareholders).

[32] *See, e.g.,* DEL. CODE ANN. tit. 8 § 141(d).

[33] Bebchuk et al. *supra* note 5 at 6-7.

[34] Bebchuk, Coates & Subramanian, *supra* note 4.

[35] Id.

[36] Bebchuk & Cohen, *supra* note 4.

[37] *See, e.g.,* DEL. CODE ANN. tit. 8 § 109.

[38] Such limits can make shareholder amendments to the bylaws virtually impossible. *See* Bebchuk et al. *supra* note 5 at 7 n. 2 (citing Chesapeake Corp. v Marc P. Shore).

[39] *See, e.g.* DEL. CODE ANN. tit. 8 § 102.

[40] Bebchuk et al., *supra* note 5, at 7.

[41] *See* Roe, *supra* note 1, at 26 (observing political origins of American corporate structure, which have constrained ability of institutional ownership, resulting in dispersed ownership and greater management discretion and control). *See also* Elhauge, *supra* note 6, at 816; Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520,

Poison pills, a takeover defense, preclude straight-forward hostile takeovers that would have simply accumulated stock for the purpose of attaining ownership control.[42] Such "pills", which "poison" the stock, usually render further acquisition of shares prohibitively expensive after a threshold of ownership.[43] *Golden parachutes*, another defense, provide departing executives cushy severance packages and thereby increase the cost of takeovers accompanied by the replacement of management.[44] Of course, a corporate board can create these two provisions at any time; thus, even corporations that do not have these provisions could be seen as having their shadowy versions.[45] At the same time, not all corporations do have them in place and shareholders have demonstrated an increasing distrust of their presence; in the end, then, the presence of these provisions may not reflect entrenchment itself but the attitude of corporate managers toward the practice.[46]

Although other corporate governance arrangements could contribute to entrenchment as well, there are theoretical reasons to doubt the significance of such contributions.[47] More importantly, however, Bebchuk et al. empirically reach the same conclusion. Their study evaluated a group of "other provisions" as well; these "other provisions" did not result in statistically significant relationships.[48] Such results support the hypothesis that staggered boards, limits to shareholder amendments of the bylaws, super-majority requirements for mergers and other acquisition transactions, super-majority requirements for charter amendments, poison pills and golden parachutes drive most of the negative relationship with financial value, and, by implication, contribute most significantly to the entrenchment of corporate managers.[49]

530–31, 542–53, 562–64, 567–68 (1990).

[42] Bebchuk et al., *supra* note 5, at 8.

[43] *See* Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. CORP. L. 381, 382-383 (2002)(describing "flip-over", "flip-in" and "back-end" pills, all of which, in the end, dilute the interests of an acquirer, rendering the takeover prohibitively expensive).

[44] Bebchuk et al., *supra* note 5, at 8. It should be noted that practitioners with whom I spoke expressed ambivalence about golden parachutes because such parachutes could, under the right circumstances, actually incentivize managers to sell the corporation and make a quick profit. Broadly speaking, golden parachutes are perhaps best characterized as provisions that allocate control to managers but do not necessarily reduce the likelihood of beneficial takeovers.

[45] Id. at 8-9.

[46] Id. *See also supra*, note 44, discussing an additional caveat regarding golden parachutes.

[47] Id. at 10-11.

[48] Id. at 17-22.

[49] Id. at 33. Bebchuk et al. go on to qualify that some of the relationship between entrenchment provisions and financial value could merely reflect the decision to entrench

II. ENTRENCHED MANAGERS CREATE LESS SOCIAL VALUE

Undoubtedly manager entrenchment has a variety of effects for different executives and corporations. Entrenchment provides managers discretion to pursue long-term profits in the face of short-term demands from self-interested shareholders;[50] but also pursue personal agendas at the expense of shareholder profits;[51] or, perhaps, sacrifice profits for the good of the public.[52] As should be emphasized, which of these outcomes usually accompanies entrenchment deserves empirical treatment; theoretical and anecdotal evidence support each.[53]

As Part I discussed, Professors Bebchuk, Cohen and Ferrell have observed, in the aggregate, a negative relationship between financial value and six governance provisions most associated with entrenchment. Although a statistical relationship does not necessarily mean entrenchment itself produces lower financial value, these results do suggest entrenched managers may use their discretion for ends independent of corporate and shareholder wealth.

That entrenched managers sacrifice *financial* value does not, however, indict entrenchment as a problem for *social* value. As noted above, entrenched managers may be sacrificing corporate profits for their own profits, for the sake of extra time on the golf course or *for the sake of the public*. This last possibility, explored by Professor Elhauge in *Sacrificing Corporate Profits in the Public Interest*,[54] presents an interesting, but overlooked,[55] challenge to those calling for changes to corporate

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by managers of already poorly performing corporations. Such an issue of causality, however, does not change the overarching claim that these provisions enable entrenchment. Id.

[50] Lipton & Rosenblum, *supra* note 23;Stout, *supra* note 23; Bebchuk & Stole, *supra* note 23; Stein, *supra* note 23.

[51] *See* Graef Crystal, *New CEO Pay-Outsourcing Study is Out of Bounds*, September 1, 2004 (though disagreeing with study, agreeing that CEO pay "borders on the obscene")(Bloomberg); GRAEF CRYSTAL, IN SEARCH OF EXCESS (1991); Bebchuk & Fried, *supra* note 1 (understanding present levels of executive compensation as an agency problem); John C. Coffee, Jr., *Shareholder Versus Managers: the Strain in the Corporate Web*, 85 MICH. L. REV. 1, 29 (1986)(noting preferences for greater compensation, greater psychic income, and greater security revealed in empire-building). Managers might also entrench themselves simply because they have inherited a corporation performing poorly independent of their own efforts.

[52] Elhauge, *supra* note 6.

[53] *See supra* notes 50-52. Empirical evidence has already discounted the possibility that entrenched managers predominately use their discretion to pursue long-term profits. *See, e.g.*, Bebchuk et al., *supra* note 5.

[54] Elhauge, *supra* note 6.

[55] *See* id. at 736-737.

governance laws in the form of increased accountability to shareholders and takeover markets. Granted entrenched managers probably employ their discretion to the service of self-interest. Self-interest, however, encompasses social and moral preferences, which, in the end, could lead managers to make socially valuable profit-sacrificing decisions.[56]

This possibility also reveals a conspicuous incompleteness in the academic assessment of the underlying value to society of corporate governance arrangements. As Professor Elhauge observes, the "canonical" obsession with profit maximization

> helps define the boundaries of the corporate law field. It leaves corporate law scholars free to ignore issues about any effects the corporation may have on the external world as topics best addressed by other legal fields, and to focus on more tractable models about which corporate rules would maximize shareholder value.[57]

This makes some sense. Corporations are, after all, the infamous, amoral sociopaths, obedient only to the pursuit of profits.[58] Only the managers at the helm bring the social norms of a human being to the wheel. Loosening the market shackles of these executives allows breathing room for the sacrifice of profits when their social and moral norms dictate.[59]

No doubt, on occasion, this occurs. But what happens more often? Do executives use their discretion for the money trough or the public alms? Economic theory and evidence focused on the association of entrenchment with financial value do not speak to an association with social value apart from equating financial wealth with social wealth. Ironically, however, social psychological theory, which usually departs from such analysis, also could support the assessment of entrenchment as a problem. As discussed in the Introduction, and discussed in greater detail in Part III, managers, like everyday people, respond to financial *and* non-financial incentives. Which incentives come to the foreground, and how these incentives unfold, depends in part on context. Because entrenchment against financial accountability creates a context of irresponsibility generally, I predicted entrenched managers would be less accountable to social concerns as well.

This Article undertakes an empirical assessment of the debate. Building on the work of Bebchuk et al., the remainder of Part II compares levels of entrenchment, as measured by the presence of their six entrenching provisions, with the appearance of corporations on two indexes used for socially responsible investing. As the results demonstrate, entrenchment was negatively associated with the appearance of corporations on these indexes, buttressing the conclusion that entrenchment not only harms

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[56] Id. at 796-818.
[57] Id.
[58] *See generally* BAKAN, *supra* note 7.
[59] Elhauge, *supra* note 6, at 740.

financial value, but, more broadly, social value as well.

A. Sources of Data

Our social responsibility indexes are mouthfuls: the Dow Jones Sustainability Index World (DJSIW)[60] and the Financial Times Stock Exchange For Good U.S. Index Top 100 (FTSE4GoodUS100).[61] Governance data came from the Investor Responsibility Research Center (IRRC).[62] Financial and ownership data came from ExecuComp and Compustat.[63]

1. Social Responsibility Data

DJSIW and FTSE4GoodUS100 were used for several reasons. First, each of these indexes aggregate data into coherent "scores" based on a wide range of social responsibility criteria.[64] Second, each generally takes best-of-class approaches, assessing corporations by industry specific, as well as general, criteria.[65] Third, Dow Jones and the Financial Times, providers of these indexes, are established investment institutions with considerable resources enabling thorough research and procedural safeguards like independent auditing;[66] accordingly, their social responsibility indexes lead the pack.[67] Fourth, DJSIW and FTS4GoodUS100 are based on research provided by peer-reviewed members of the social responsibility research industry, Sustainable Asset Management Research (SAM) and Ethical Investment Research Service (EIRIS), respectively.[68]

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[60] *See* Dow Jones Sustainability World Indexes Guide (September 2004)(on file with the author) [herinafter DJSWI Guide]. The most recent version can be found at http://www.sustainability-index.com.

[61] *See* FTSE4Good Index Series Inclusion Criteria (November 2003)(on file with the author) [hereinafter FTSE4Good Criteria]. The most recent version can be found at http://www.ftse.com. FTSE4Good was created in collaboration with UNICEF and the United Nations Children's Fund.

[62] Bebchuk et al., *supra* note 5, at 13. *See also* www.irrc.org.

[63] Bebchuk et al., *supra* note 5, at 13; Rajesh K. Aggarwal & Dhananjay Nanda, *Access, Common Agency, and Board Size* at 4-5 (October 2004)(unpublished, on file with author).

[64] DJSWI Guide *supra* note 60 at 9-13; FTSE4Good Criteria *supra* note 61 at 4-9.

[65] *See* DJSWI Guide *supra* note 60 at 9-10; FTSE4Good Criteria *supra* note 61 at 3.

[66] *See generally* www.dj.com; www.ftse.com.

[67] *See* John Buckley & David Monsma, *Non-financial Corporate Performance: The Material Edges of Social and Environmental Disclosure*, 11 U. BALT. J. ENVTL. L. 151, 190 (2004); Benjamin J. Richardson, *Enlisting Institutional Investors in Environmental Regulation: Some Comparative and Theoretical Perspectives*, 28 N.C. J. INT'L L. & COM. REG. 247, 289 (2002).

[68] *See generally* www.sam-group.com; www.eiris.org. *See also* Mistra, SustAinability

DJSIW tracks the top ten percent, in terms of a "Corporate Sustainability Assessment," of corporations followed by the Dow Jones World Index.[69] Data comes from volunteer reporting questionnaires, public company documents, external media, contact with stakeholders and direct contact with the corporations.[70] Assessment criteria are arranged in economic, environmental and social categories.[71] DJSIW continually monitors corporations along such criteria;[72] PricewaterhouseCoopers audits the data as well.[73]

FTSE4GoodUS100 tracks the largest one hundred corporations that have satisfied social responsibility "Inclusion Criteria";[74] the original source of corporations comes from the FTSE All-World Developed USA Index, which tracks the largest U.S. corporations in the world.[75] Data comes from company questionnaires, direct company contact, company reports and independent research.[76] Corporations must meet standards for a given number of criteria, also generally along economic, environmental and social categories.[77] FTSE4GoodUS100 also independently tracks human rights records.[78] FTSE4GoodUS100 regularly monitors its corporations but does not appear to employ external auditors.[79]

Observations for DJSWI and FTSE4GoodUS100 consisted of the years 2004, 2003, 2002 and 2001. Only U.S. corporations in the DJSWI were studied, meaning about 60 companies each year; FTSE4GoodUS100, of course, included 100 U.S. companies. For each index-year, dummy variables were assigned to corporations based on their presence, or lack thereof, on the relevant index.

2. Corporate Governance Data

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and onValues, *Values for Money, Reviewing the Quality of SRI Research*, (2004)(evaluating SAM as the best all-around social responsibility investment research organization, with EIRIS rated favorably), *available at* www.mistra.org.

[69] The Dow Jones World Index covers over 5000 of the largest publicly traded corporations in the world. *See* http://www.djindexes.com.

[70] DJSWI Guide, *supra* note 60, at 9.

[71] Id. at 9-13. DJSWI covers subjects such as codes of conduct, corporate governance, customer relationships; environmental performance, efficiency and reporting; and labor practices, human capital development and standards for suppliers.

[72] Id. at 16-18.

[73] Id. at 9.

[74] FTSE4Good Inclusion, *supra* note 61, at 4.

[75] *See* www.ftse.com.

[76] FTSE4Good Inclusion, *supra* note 61, at 4.

[77] Id. at 4-9. FTSE4Good covers subjects comparable to DJSIW.

[78] Id. at 7-9.

[79] Id. at 4.

Data regarding entrenchment was taken from the Investor Responsibility Research Center (IRRC). At the time of this study, the IRRC had published data in six volumes: September, 1990; July, 1993; July, 1995; February, 1998; November, 1999; and February, 2002.[80] Each volume follows roughly 1400 to 1800 corporations, which always have included the S&P 500.[81] Each year accounts for over ninety percent of U.S. market capitalization.[82] The IRRC tracks a great deal of corporate governance variables, including whether the corporations have the entrenchment provisions studied by Bebchuk et al. Each corporation was given an entrenchment score based, with equal weight, on the number of entrenchment provisions the corporation contained.

3. Control Data

Compustat, ExecuComp and IRRC provided control data. Control variables included the size of the corporation (in terms of total assets),[83] the level of insider ownership, the level of institutional ownership and the number of directors. Corporate size was expected to bear a strong relationship to presence on the indexes because these indexes only included large public corporations. Both inside ownership and institutional ownership could bear some relation to entrenchment in that levels of ownership reflect, to some extent, levels of control. The number of directors in a corporation has been related to the number of stakeholder interests with which the corporation concerns itself;[84] because each index tracks a range of social responsibility concerns, the number of directors could also bear some relation to its appearance on these indexes.

4. Methodology

For each year of each social responsibility index, dummy variables for inclusion on the index served as the dependent variables. This variable was regressed against the entrenchment scores, as well as the size of the corporation (in terms of total assets), the level of insider ownership, the number of directors and the level of institutional ownership. Because IRRC data was not available for every year studied, data for the remaining years were "filled";[85] the method of filling–either using a previous year or later

[80] *See also* Bebchuk et al., *supra* note 5, at 13.
[81] Id.
[82] Id.
[83] *See also* id. at 17.
[84] Aggarwal & Nanda, *supra* note 63.
[85] Bebchuk et al., *supra* note 5, at 13.

year of IRRC data–made no substantive difference in the results.[86] Corporations with dual classes of stock, as well as Real Estate Investment Trusts, were removed from the study because of their anomalous capitalization and corporate control structures.[87] Corporations with insider ownership greater than fifty percent were also excluded because such inside executives were *de facto* "entrenched" independent of any corporate governance arrangements.

B. Results

Bebchuk et al. provide thorough analysis of the incidence of corporate governance provisions, their rates of increase or decline over the years and general levels of entrenchment.[88] About half of the corporations studied had entrenchment scores of three or more, with the incidence of these levels slightly increasing over time,[89] suggesting entrenchment on account of these governance provisions represents a significant concern. Here we focus on the relationship between the entrenchment provisions and appearance on the two indexes of social responsibility. Tables I and II report the results from each social responsibility index. Each table reports the coefficients of all independent variables; statistical significance is reported in parentheses.

TABLE I: DJSIW

	2004	2003	2002	2001
ENTRENCHMENT	-.00966 (.018)	-.00858 (.044)	-.0091 (.016)	-.01024 (.025)
TOTAL ASSETS	4.97E-07 (.000)	4.15E-07 (.000)	2.61e-07 (.001)	3.55e-07 (.001)
NUMBER OF DIRECTORS	.00406 (.005)	.00517 (.003)	.0046 (.004)	.00525 (.010)
INSIDE OWNERSHIP	-.00853 (.004)	-.00907 (.003)	-.00589 (.008)	-.001 (.006)
INSTIT. OWNERSHIP	-3.79E-09 (.734)	-3.93E-09 (.736)	-3.60E-07 (.738)	-4.33e-09 (.726)
ADJ. R^2	.057	.0434	.025	.0289

[86] *See also* id.
[87] *See* id. at 13-14.
[88] Id. at 14-16.
[89] Id. at 15.

TABLE II: FTSE4GOODUS100

	2004	2003	2002	2001
ENTRENCHMENT	-.01666 (0.001)	-.01489 (0.003)	-.01451 (.003)	-.00808 (.131)
TOTAL ASSETS	8.21E-07 (.000)	8.48E-07 (.000)	8.43e-07 (.000)	7.67e-07 (.000)
NUMBER OF DIRECTORS	.01587 (.000)	.01921 (.000)	.01897 (.000)	.01513 (.000)
INSIDE OWNERSHIP	-.00072 (.048)	-.00092 (.011)	-.00071 (.011)	-.00107 (.011)
INSTIT. OWNERSHIP	-6.57E-09 (.635)	-6.62E-09 (.630)	-6.46e-09 (.637)	-5.31e-09 (.714)
ADJ. R^2	.1335	.1617	.1483	.0953

As the tables reflect, the results were rather consistent:

(i) *Entrenchment.* Every observation but one indicates a negative, statistically significant relationship between the level of entrenchment and appearance on these social responsibility indexes. Possible interpretations of these results are discussed below in Part III.

(ii) *Corporate Size.* Every observation indicates a positive, statistically significant relationship between the size of the corporation, in terms of assets, and inclusion in the indexes, owing most likely to the fact that the indexes consisted of the largest corporations in the U.S.

(iii) *Number of Directors.* Every observation indicates a positive, statistically significant relationship between the number of directors on the board and inclusion in the indexes. To the extent these indexes cover a range of social responsibility concerns, these results accord with other empirical work that has related the number of directors to the number of social interests with which a corporation engages.[90]

(iv) *Insider Ownership.* Every observation indicates a negative, statistically significant relationship between levels of insider ownership and inclusion in the indexes. Because ownership, to some extent, reflects control, inside ownership reflects, to some extent, entrenchment. In this sense, under most interpretations, an observed negative relationship between inside ownership and these indexes could comport with a negative relationship between entrenchment provisions and these indexes.

[90] Aggarwal & Nanda, *supra* note 63.

(v) *Institutional Ownership*. Insignificant, negative relationships were observed between institutional ownership and inclusion in the indexes. Greater institutional ownership could be expected to reduce levels of entrenchment.[91] Levels of institutional ownership, however, could have a range of effects on social responsibility inclusion, depending on the interests of the institutions, the relationship of social responsibility to financial value and the effects such institutional ownership has on management incentives and perceptions.

There exists the concern that the consistency of these results merely reflected consistency among the indexes and among the years of each index. Table III displays the percentage of corporations in the DJSIW that were also in the FTSE4GoodUS100 each year; Table IV displays the number of changes made to each index year-over-year.

TABLE III: NUMBER OF DJSIW COMPANIES IN FTSE4GOODUS100

2004	2003	2002	2001
22/64	20/64	16/57	18/68
34%	31%	28%	26%

TABLE IV: NUMBER OF CHANGES YEAR-OVER-YEAR

	2004-2003	2003-2002	2002-2001
DJSIW	17	30	44
	27%	53%	65%
FTSE4GOODUS100	41	0	38
	41%	0%	38%

As Tables C and D reflect, there were a great number of differences between the indexes themselves and within the indexes year over year. There was only one exception to the variation: FTSE4GoodUS100 made no changes in its index from 2002 to 2003. Thus, for the most part, consistency among the indexes and the years of each index does not explain the consistency of the regression results.[92] Indeed, the significant variation

[91] *But see* Roe, *supra* note 1.

[92] Such differences could reflect a number of things. Differences between the indexes could reflect: differences in methodology; differences in assessments of what constitutes socially responsible behavior; or the fact that U.S. corporations in the DJSIW are pooled against corporations internationally, whereas U.S. corporations in the FTSE4Good100 only compete among themselves. Differences year over year within each index ideally reflect accurate monitoring of the corporations involved, with changes made accordingly.

among the indexes and the years supports the robustness of the data. As evidenced below, however, normative interpretation of these results proves difficult.

III. THEORETICAL EXPLANATIONS FOR THE RESULTS

What follows offers a sample of interpretative frameworks. This does not constitute an exclusive list, nor a complete analysis from the frameworks herein. Rather, Part III provides an introduction to some of the issues raised by the results and the relationship between entrenchment–which, to some extent, boils down to insulation from accountability to profits–and inclusion in indexes of social responsibility. Each of the frameworks offers a glimpse into what the empirical data could reveal about entrenching corporate governance provisions. Although we are far from definitive normative conclusions, the gist of the analysis supports the argument that entrenching governance arrangements should be carefully scrutinized.

A. Doing Well By Doing Good

Without the protection of entrenchment, managers find themselves more accountable to shareholders and the market for takeovers. Because shareholders are most concerned with profits,[93] and takeovers discipline underperforming profitability,[94] these executives must be profitable to keep their jobs and increase their pay. That the corporations run by these managers also appear on social responsibility indexes therefore reflects the distinct possibility that a great deal of socially responsible behavior increases profits. Indeed, Dow Jones launched its responsibility indexes on the premise that "corporate sustainability" "create[s] long-term shareholder value by embracing opportunities and managing risks deriving from economic, environmental and social developments."[95] Dow Jones understands "sustainability as a catalyst for enlightened and disciplined management, and, thus, a crucial success factor."[96]

Perhaps we should be relieved to find that rigorous profit-maximization means rigorous social responsibility. Sound labor practices make more productive workers; "green" energy can be cost-effective. Undoubtedly this occurs. Ford Motor Company, for example, renovated its River Rouge

[93] Easterbrook & Fischel, *supra* note 31, at 718 (assuming shareholders prefer profit-maximization).
[94] Id. at 701.
[95] DJSWI Guide, *supra* note 60, at 8.
[96] Id.

manufacturing plant with a roof of living sedum plants, drainage swales, permeable pavement, skylights and restored natural habitats not only for the sake of the environment.[97] Rather, the sedum roof should out-last traditional tar-and-metal and provide better insulation, saving costs; the roof, swales and permeable pavement filter run-off and reduce liability for river pollution; and employees are healthier, happier and more productive.[98]

For the moment, assume these results present a best-of-~~all~~ possible worlds. Profitable managers are also socially responsible because such responsibility maximizes profits. Because our indexes provide a rough, but accurate, indication of such responsibility, and because such responsibility maximizes profits, appearance on these indexes does not indicate over-responses to social interests but an alignment of such interests with corporate wealth. Several concerns require elaboration with this in mind.

First, the explanation that managers "do well by doing good" does not, in itself, provide a normative claim against entrenchment because the explanation makes no claims as to causality.[99] *Ex post* we can describe the state of the world; *ex ante* we have not predicted how entrenchment has affected that state. In other words, accountable, as opposed to entrenched, managers could be socially responsible because the incentives of accountability to profits push them in that direction. On the other hand, profitable and socially responsible managers could be accountable because their performance has never necessitated the protection of entrenchment. In one form or another, this problem plagues any interpretation of the results. We do have reasons, however, to discount the issue. Entrenchment resulting from more permanent constitutional provisions, such as staggered boards and super-majority voting requirements, arguably supports a causal explanation because underperforming managers would find after-the-fact institution of these arrangements difficult.[100]

Second, assuming causality was not a significant problem, explaining the negative relationship between entrenchment and social responsibility in this manner requires the further assumption that the incentives to financially perform lead managers to perform in a socially responsible way as well. Some would have no qualms with this assumption because they see opportunities to make socially responsible profits as "twenty dollar bills lying on the sidewalk"; managers already have "ample incentives to

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[97] *See* www.ford.com/en/goodWorks/environment/cleanerManufacturing/rougeRenovation.htm

[98] *See* MICHAEL BRAUNGART & WILLIAM MCDONOUGH, CRADLE TO CRADLE 160-164 (2002). *See also* Andrew Wagner, *Corporate Consciousness*, Dwell Magazine 170-172 (October/November 2004).

[99] *See also* Bebchuk et al., *supra* note 5, at 33.

[100] Id. at 33-34. This does not, however, hold true with regard to poison pills and golden parachutes.

recognize and act on such profit-maximizing opportunities."[101] Such a perspective, however, may underestimate important characteristics of the business world. Managers face incredible complexity in the production of their goods and services. Accordingly, the production of comparable goods and services could, and probably does, occur through different but comparably profitable paths.[102] Concluding which of these paths maximizes social responsibility, in addition to the uncertain task of maximizing profits,[103] requires surmounting significant practical and cognitive hurdles, especially when the paths of social responsibility involve departure from the paths of custom and preconceived categories of possibility.[104]

For this reason, the assumption that managers would readily find those twenty dollar bills appears somewhat unrealistic. At the very least, we might conclude some corporations find the bills faster; our indexes might track those in the vanguard. Because no affirmative justification exists for assuming a union between the incentives to make profits and the incentives to act responsibly, we are left, at this point, with indeterminacy.

Third, and last, this explanation also does not account for the at least ostensible reasons executives would give for pursuing social responsibility with their corporations. Ben Cohen, chief executive of Ben & Jerry's, asserts, "It makes no sense to compartmentalize our lives — to be cutthroat in business, and then volunteer some time or donate some money to charity."[105] Although Ben & Jerry's was originally a maverick in this regard, integration of social responsibility principles into corporate decision-making has become a blueprint of sustainability reports for public companies.[106] Perhaps these corporate leaders are liars or delusional. At the same time, recall that managers are people and, unlike the corporations they run, are subject to very human concerns, such as social and moral norms.

This leaves us with the somewhat paradoxical possibility that managers accountable to shareholders and takeover markets could be accountable to

[101] Elhauge, *supra* note 6, at 744-745.

[102] *See generally* SUZANNE BERGER, HOW WE COMPETE (2005)(concluding paths to financial success are extremely diverse and complex after following over 500 case studies of international corporations).

[103] *See* Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 91-99 (2004)(describing clarity of profit-maximization as an illusion).

[104] Id. at 99; Jon Hanson & Ronald Chen, *Categorically Biased: The Influence of Knowledge Structures on Law and Legal Theory*, 77 S. CAL. L. REV. 1103, 1160-1164, 1180, 1186.

[105] Chen & Jon Hanson, *supra* note 103, at 94.

[106] Id. at 93-94.

social responsibility for reasons other than accountability to profits and yet nevertheless related to a lack of entrenchment. In reality, we can relax this tension with the observation that our investment indexes could be concerned with particularly conspicuous examples of socially responsible, profitable practices.[107] The tension further relaxes if we assume shareholders are sometimes concerned with social interests apart from profits, an increasingly realistic claim.[108] Managers accountable to such shareholders would particularly do well by doing good. In the end, however, the ambiguous nature of profit-maximization–which renders far from inevitable the aligning of corporate behavior with profitable, socially responsible practices–indicates more than this framework could be at work.[109]

B. Doing Well By Looking Good

A more skeptical take would suggest managers, pressed for profits, recognize the publicity value in performing well in indexes of social responsibility. Just as executives may "game" earnings for the sake of stock prices, executives concerned with the bottom-line could be "gaming" social responsibility performance as well.[110] Whether the indexes themselves have been captured by the corporations[111] or simply lack the resources to police them, such gaming goes unpunished. Undoubtedly this occurs as well. McDonalds may introduce salads to its menu, but the fries keep them in business. That social disclosure largely occurs on a voluntary basis in an unregulated context aggravates the problem.[112]

Of course, there will always be opportunists ready to game the system, even in a legally regulated world. Increased attention to the subject, as well as self-regulation,[113] has probably helped. Mandatory disclosure laws could

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[107] DJSIW not only espouses its relationship to success; the index outperformed its cousin, the Dow Jones Global Index, by 140% over an 8-year period. *See* Michele Sutton, *Between a Rock and a Judicial Hard Place: Corporate Social Responsibility Reporting and Potential Legal Liability under* Kasky v. Nike, 72 UMKC L. REV. 1159, 1163 (2004).

[108] *See* Social Investment Forum, *2003 Report on Socially Responsible Investing Trends in the United States* (December 2003)(socially responsible investing accounted for 11.3 percent of total investment assets managed by professionals in U.S.).

[109] Indeed, Dow Jones launched its sustainability indexes for the very reason that socially responsible profit-making does not come naturally and requires sustained research. *See* DJSIW Guide, *supra* note 60, at 5, 8.

[110] *See, e.g.,* The Economist, *The Good Company* (January 20, 2005).

[111] *See* STIGLER, *supra* note 9, at 119-120.

[112] Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1299-1306 (1999)(proposing possible models for regulated social responsibility disclosure).

[113] Angela J. Campbell, *Self-regulation and the Media*, 51 FED. COMM. L.J. 711, 715-

further the cause.[114] Probably some corporations in the indexes studied here do not belong there. But there are two reasons to discount the prevalence of gaming. First, enough independent eyes watch the largest corporations to ensure some degree of honesty in their communications to the public.[115] Second, these eyes presently have the support of at least some U.S. laws, particularly laws prohibiting fraud and, perhaps, even negligent disclosure.[116] Although an inherent problem, "gaming," or more euphemistically, "elevat[ing] form over substance,"[117] does not wholly undermine the legitimacy of social responsibility disclosure.

C. Doing Well by Being Good

That corporations with accountable executives find themselves in social responsibility indexes could reflect the fact that these corporations simply have good, responsible managers. Such managers could self-select themselves into situations of accountability (either through seeking corporations that already have such accountability in place or through creating such accountability on arrival) or are themselves selected because of their responsible dispositions. This explanation adequately describes the statistical observations, but suggests the social performance of corporations and their managers depends on the social preferences and dispositions of these executives, which are given. This perspective leaves no debate over the value of corporate governance arrangements because the arrangements merely reflect, rather than create, the underlying reality. "Good" managers lead "good" corporations, such that we can only hope our mothers, kindergartens, colleges and business schools produce and send them to the boardroom. Although an inherently difficult explanation to prove, as well as refute, such a dispositional perspective runs counter to the more contextual, social psychological interpretation that follows.

D. Doing as We're Told

Here we elaborate the underlying theory that led to the empirical hypothesis of the Article. Such a social-psychological interpretation could muster a rather different explanation for the results. Every executive, at

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717 (1999)(generally discussing the possibility and advantages of self-regulation).

[114] *See* Sutton, *supra* note 107, at 1181-1183; Williams, *supra* note 112.

[115] Sutton *supra*, note 107; James Weinstein, *Speech Categorization and the Limits of First Amendment Formalism: Lessons from* Nike v. Kasky, 54 CASE W. RES. L. REV. 1091 (2004).

[116] Sutton, *supra* note 107, at 1176-1177, 1183.

[117] Id. at 1183. The euphemism also implies a less malicious explanation: simple following the-leader leads to a perfunctory interest in social responsibility indexes.

least to some extent, experiences the same concerns as every other person: self-preservation and greater compensation, social status and power, conformity and obedience, moral obligations and compassion. Self-interest abides in each of these light and dark corners of the heart, leaving us to ponder which interests surface, when and how. As psychological research demonstrates, context plays an important role in bringing out the best and worst of us. Contrary to a "fundamental attribution error," which disproportionately understands behavior as the product of stable dispositions,[118] human behavior reflects a nuanced interaction between complex personalities and the contextual situations in which they find themselves. Importantly, such could be the case for managers in the context of certain corporate governance arrangements.

Herbet Blumer summarized the logic of this approach in his principles of symbolic interaction:

> Humans act toward a thing on the basis of the meaning they assign to the thing…Meanings are socially derived, which is to say that meaning is not inherent in a state of nature…There is no absolute meaning. Meaning is negotiated through interaction with others…The perception and interpretation of social symbols are modified by the individual's own thought processes.[119]

Such logic follows inexorably from a very human dilemma. Humans enter the world with a "bundle of passions."[120] Beyond the most basic interactions with the world, such as the search for food, these passions "cannot assess and direct [their] own behavior"[121] because meaning does not inhere in the state of nature. Social interaction provides the meaning and rules for the game. Accordingly, we must exist in a constant state of interaction with social contexts, which influence how, and when, our "passions" unfold. Indeed, even an anti-authoritarian needs the rules of authority.

Long before Blumer, Shakespeare understood this dilemma more colorfully. As MacBeth laments,

> Life's but a walking shadow, a poor player
> That struts and frets his hour upon the stage
> And then is heard no more: it is a tale
> Told by an idiot, full of sound and fury,
> Signifying nothing.[122]

Not surprisingly, dramaturgical images abound in the literature of symbolic interaction and social psychology generally.[123] Cognitive theory describes

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118 Hanson & Yosifon, *supra* note 11, at 136-137.

119 HERBERT BLUMER, SYMBOLIC INTERACTIONISM 2 (Prentice-Hall 1969).

120 JODI O'BRIEN & PETER KOLLOCK, THE PRODUCTION OF REALITY 34 (1997).

121 Id.

122 WILLIAM SHAKESPEARE, MACBETH act V, sc. 5.

123 *See, e.g.,* ERVING GOFFMAN, THE PRESENTATION OF SELF IN EVERYDAY LIFE (1959) (introducing the concept of social interaction as a dramaturgical performance).

context in terms of "schemas," such as "scripts," which construct, among other things, heuristic "roles" that provide meaning to the world. These schemas are knowledge structures that "influence all aspects of information processing," can be "useful under some circumstances" but also a "liability[y] under others."[124] Research has repeatedly confirmed Blumer's fundamentals concerning human nature.[125] Social meaning, through interpretation of the world, mediates the interaction of the "passions" with context and accordingly provides rules for behavior.

Laws, of course, act as explicit contexts and schemas. Corporate governance laws and rules are no different. These laws, often viewed in terms of sanctions and incentives, also provide a meaningful backdrop through which we understand the appropriate norms of behavior for roles within the corporate entity. Fiduciary duties, as a relevant example, apart from creating a framework of legal incentives also generate substance and meaning for interpretations of how boards of directors should behave. It seems likely that, regardless of the actual threat of sanctions, directors are influenced, to some extent, by their awareness of their roles as fiduciaries. In a similar vein, directors derive their "legitimacy" from the "shareholder franchise."[126] Such rhetoric further reflects a prominent cultural script in which directors, and by implication, managers, serve in the roles of fiduciaries for others.

It should come as no great surprise that governance provisions that undermine legitimacy undermine more than accountability to shareholders. Entrenched managers have broken from their legitimate social roles. We should not expect such managers, under such corrupted circumstances, to feel any great pressure to account to anyone but themselves. Indeed, entrenched managers not only experience less accountability to shareholders and takeover markets but also less reputational accountability to labor markets.[127] It is not necessarily the case that such managers are any more rotten than the rest of the bunch. Rather, entrenched managers find themselves in an insulated role that suggests as appropriate, or at least not unconscionable, the diversion of corporate resources for their more selfish

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[124] Chen & Hanson, *supra* note 103, at 1128.

[125] *See generally* Chen & Hanson, *supra* note 103 (reviewing research on the influence of context); Hanson & Yosifon, *supra* note 11 (reviewing research on the influence of context). *See also* Philip Zimbardo & Ken Musen, *Quiet Rage: The Stanford Prison Study* (Insight Video 1991)(following experiment in which students and a psychology professor, aware of their role-playing, nevertheless adopted their roles as prisoners, guards and the warden to such an extent that the experiment was cancelled only after the intervention of an outside observer).

[126] Blasius, 564 A.2d at 659.

[127] *See* Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theory and Evidence*, 9 DEL. J. CORP. L. 540, 543-544 (1984).

ends.

Academics themselves contribute to the same context. Scholars have held forth as appropriate compensation such illicit activities as insider trading and misappropriating corporate opportunities.[128] While debate over the effects of such activities on corporate wealth continues,[129] consideration of the broader social implications such context has on the role of managers gets swept under the rug.[130] Insider trading and misappropriation simply sound "unfair" to your average person, particularly when corporate law prohibits the practices. Regardless of the internal efficiency of such "compensation," the practices place managers in a less transparently accountable role vis-à-vis society.[131] It is no wonder entrenched managers might feel less remorse in their focus on personal, as opposed to public, gain. They have been told to.[132]

This interpretation has two important advantages. First, it requires no assumptions about the equation of profits with social responsibility; indeed, we could even believe inclusion in social responsibility indexes involves misguided, but well-intentioned, distraction from profit-maximization. In this descriptive form, the interpretation does not necessarily implicate a normative claim about the financial or social value of entrenchment.

Second, this interpretation permits a more realistic understanding of accountability to profits in the first place. Managers have discretion regardless of specific governance provisions because profit-maximization proves a concept as amorphous as social responsibility performance.[133]

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[128] Walker, *supra* note [], at 598-600 (reviewing the literature).

[129] *See generally* id. (reviewing arguments and concluding many non-traditional forms of compensation not only are inefficient but also additive in their ability to increase total managerial wealth).

[130] *See* Margolis et al., *supra* note 10.

[131] Such lack of transparency has efficiency implications for corporate welfare as well. *See generally* Bebchuk & Fried, *supra* note 1 (arguing managers use less transparent forms of compensation to hide egregious rent extraction).

[132] *See* Manda Salls, *Why We Don't Study Corporate Responsibility*, Harv. Bus. Sch. Working Knowledge (May 17, 2004)(interviewing Professor Margolis). Professor Margolis observes:

> Sustaining research attention on both the ethical and economic responsibilities of business, and on the tensions between them, shapes the orientation we inculcate to business school students about their role and responsibilities. They are not merely agents of shareholders. They are leaders and trustees of perhaps the most significant institutions in the contemporary era. How managers see themselves and understand their role is an important contributing factor to their ethical conduct. Scholarly attention to ethics and values does indeed have an impact on business leaders' self-conception and resulting behavior.

[133] *See* Chen & Hanson, *supra* note 103, at 91-99. Further, not all of our entrenching provisions necessarily lead to fewer beneficial control transactions. As discussed at note 44, golden parachutes may incentivize managers to sell their corporations. This leaves

Profits, as discussed above, come in many forms; profit-maximization, therefore, becomes more of an art than a science, with profit-maximization under social standards a supreme act of artistry. Often, general corporate laws ensure such discretion persists *across the board*. For example, both Delaware and the Revised Model Business Code provide only the directors can initiate and place on the shareholder ballot charter amendments and merger proposals.[134] This serious restriction to shareholder power applies regardless of whether the corporation has any of our "entrenchment" provisions. Thus, even managers "accountable" to shareholders, and therefore "accountable" to profit-making, probably can pursue social agendas within these confines if they perceive their roles in this manner.[135] A key element, then, could be the perception of accountability, and not just accountability itself.

As with other interpretations, introducing greater complexity raises questions. Managers operate in a much larger context than the presence of a few corporate governance provisions. How, for example, do the corporations of entrenched managers handle shareholder proposals? What kind of internal audits do they conduct? Where are their headquarters? What business schools did entrenched managers attend, if they attended any at all? To what social clubs do these managers belong? And so on. We might infer from our results the possibility that these six entrenching governance provisions are conspicuous indications of a much broader, as yet unexamined, situation that affects managerial accountability to shareholders and, perhaps, society as a whole. Much of this, however, remains conjecture, and takes its place alongside other interpretations as a plausible piece of the picture.

CONCLUSION

Managers accountable to shareholders, takeover markets and, in the end, profits, are also accountable to two prominent investment indexes based on social responsibility performance. Interpretations of such results range from hurrah to humbug. Perhaps socially responsible practices are also profitable. Perhaps managers accountable to shareholders also feel accountable to others generally. Or maybe these managers just *appear* socially responsible, having deceptively gamed the system. From the original, more social-psychological hypothesis, each of these interpretations likely reflects part of the picture, but the takeaway should be an overlooked

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open the question why such provisions necessarily reduce firm value.

[134] *See* Bebchuk, *supra* note 15, at 844-845 (citing DEL. CODE ANN. tit. 8 §242(b); MODEL BUS. CORP. ACT §10.03).

[135] *See also* Elhauge, *supra* note 6, at 776-783.

aspect of corporate governance–the extent to which governance arrangements might affect the social role of the manager playing his part. Given the amorphous nature of maximizing profits, managers face a range of profitable paths, and only some will pursue the more socially responsible possibilities. This Article suggests governance arrangements that help construct accountable roles provide some of the impetus toward, at the least, an awareness of accountability to social interests beyond shareholder wealth. This may be the case because managers unaccountable to shareholders have been divorced from their legitimate social roles as fiduciaries and representatives within the corporate democracy.[136] Perhaps such executives, perched atop the business world, begin to understand themselves as no longer accountable to anyone.

Regardless, the results underscore the problematic nature of thoroughly decoupling ownership from control with governance provisions like staggered boards and limits to amend the corporate charter. This understanding, however, leaves open the more practical question of reform. Some might suggest leaving things alone regardless of empirical evidence.[137] Corporations are systems of contracts, an important contractual relationship being the one between managers and shareholders. Such relationships reflect the bargains of an open market, and while not perfect, tinkering with these relationships could cause more harm than good. Others might simply call for a wholesale prohibition of entrenching arrangements, which undermine accountability and may not be the product of legitimate dickering but rather the result of managerial manipulation and power.[138] More nuanced reform might involve ensuring shareholders have real power, at the very least, to force changes in the underlying rules of the corporate charter.[139] A rather different approach could include greater judicial recognition of the problems associated with the governance provisions herein. For example, perhaps courts should be especially careful in applying doctrines like the business judgment rule in suits involving corporations with a plethora of entrenchment provisions that have *de facto* insulated their managers from accountability to the market.[140]

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[136] *See* Bebchuk, *supra* note 15, at 837.

[137] *See* id. at 875 (citing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, ch. 1 (1991)).

[138] LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 11 (2004)("arrangements that insulate directors from removal by either a proxy fight or a takeover should be eliminated or reduced").

[139] *See* Bebchuk, *supra* note 15, at 870-875.

[140] *See, e.g.,* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1293 (2001). Allen et al. argue for an intermediate standard of review when an "entrenchment motive" is involved. This speaks primarily to decisions to defend against

However, any conclusions drawn from these results, as well as results from prior studies on the financial performance of entrenched managers, need to be tempered with several caveats in mind. To begin, these results stem from the study of generally large, always public, corporations. Many reforms might apply to corporations in general, large or small, private or public. But private corporations, as well as smaller, public corporations, subside in an environment quite different from that of the public behemoths tracked by Dow Jones and FTSE.[141] At the same time, the largest of the behemoths exist in a unique environment as well–corporations like General Electric simply do not face many takeover threats because of their size alone. Extending the conclusions of research like mine to such corporations may not be appropriate without further inquiry.

Another caveat involves a lack of more in-depth case studies. Empirical evidence generally linking entrenchment with poor financial and social performance does not give us a complete picture of the actual impact entrenchment has on society. Although entrenchment may usually lead managers astray, entrenchment may also enable fundamental innovation in some cases. Such innovation may not have occurred if the innovators were tethered to prevailing norms of profit-making and social responsibility. Ben & Jerry's, to take an earlier example, was in the vanguard of corporate social responsibility. Historically, however, the company has been controlled by insiders through a dual class capitalization structure.[142] Ben & Jerry's serves as a particularly interesting example for two reasons. First, we ought to explore the trade-off between the contributions of insulated innovators and the more widespread decadence of our average entrenched manager. Second, with Ben & Jerry's in mind, we might learn that certain governance arrangements–such as dual classes of stock–are more often associated with "good" entrenchment, whereas other kinds of arrangements–such as staggered boards or poison pills–are associated with "bad" entrenchment.

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takeovers with mechanisms like a poison pill. Here I consider an extension of such intermediate review: judges should be wary of director behavior any time entrenchment provisions *de facto* insulate management from shareholder accountability and takeover markets. The practical effects of such an extension, however, would be limited because most derivative and direct suits likely involve the circumstances considered by the authors.

[141] For example, provisions like supermajority voting requirements balance the competing interests and views of active shareholder groups, such as founders and venture capitalists, within smaller corporations. As another example, golden parachutes incentivize otherwise wary managers to take on risky ventures for the very purpose of seeking control transactions.

[142] *See* Ben & Jerry's Homemade, Inc., Annual Report (Form 10-K) (1994) available at http://www.benjerry.com/our_company/research_library/fin/annuals.html, last visited March 1, 2006.

A final caveat, and perhaps the elephant in the room, regards the unproven relationship between profits or social responsibility performance and the slippery idea of societal welfare. Even assuming "maximizing" "welfare" has real normative meaning,[143] and even assuming we could gather accurate measurements of things like earnings, environmental pollution and human rights abuses, we would face the overwhelming task of weighing these interests together in an acceptable manner. Just as profits alone will not adequately reflect the costs and benefits of a business endeavor, neither will social responsibility performance. In short, the costs of doing business come with benefits, and neither profits nor social responsibility indexes can tell anyone exactly how the scales turn out. While this Article avoids the broader philosophical and pragmatic debates in this area, any empirical study should be understood with these questions in mind.[144]

These caveats, as well as the competing interpretations I offered earlier, by no means render policy suggestions about entrenching governance arrangements futile. As with all research, we are involved in a work in progress, but must make do with what we have. Thus far a strong case has been made that certain entrenchment provisions could lead to lower financial value. From this, among other things, some scholars have argued for reconsideration of the existing balance of power in U.S. public corporations. This Article has taken a different approach, linking certain entrenchment provisions with poor social performance, but has taken a small step toward reaching the same conclusion.

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[143] *See generally* LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002)(advocating a "welfare economics" perspective); Joseph W. Singer, *Something Important in Humanity*, 37 HARV. C.R.-C.L. L. REV. 103 (2002)(critiquing this perspective and advocating "fairness" concerns).

[144] I will say the seriousness and complexity of this problem, under a welfare economics perspective, range tremendously. This range depends on a matrix of three general directions: product and service functions, profitability and impacts on factors apart from profits, such as environmental pollution. With similarities in two directions, comparison along the third becomes more universally meaningful. But as similarities diverge among all the directions, comparison becomes exceedingly difficult.