

# Part I: Defining Good Corporate Citizenship: What Defines a Company as a Responsible Member of Society?

Edward Fallone

Todd Kahn

Lawrence E. Mitchell

Reverend Robert A. Sirico

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attorney with the Miller Brewing Company, Barbara Burman, who is the Chief Deputy United States Attorney for the Eastern District of Wisconsin, and Frank DeGuire Jr., who is an attorney in private practice here in Milwaukee. The committee for the law school included Frank DeGuire Sr., who is a professor at the law school, Professor Andrea Schneider, Professor Jack Kircher, and Professor Ed Fallone, and they've all done a wonderful job in putting this program together. Patricia, being the good administrator that she is, said you can give as long a welcome as you like, but the first panel begins at 9:05, and so I'll continue my welcome at lunch and with that I'll give the dias over to my colleague Professor Ed Fallone for the first panel. Thank you all and thank you again for coming.

DEFINING GOOD CORPORATE CITIZENSHIP: WHAT DEFINES A  
COMPANY AS A RESPONSIBLE MEMBER OF SOCIETY?

**Professor Edward Fallone**

**Todd Kahn**

**Professor Lawrence E. Mitchell**

**Reverend Robert A. Sirico**

**Professor Edward Fallone:** Welcome again and thank you to the Dean. I am your moderator, Professor Ed Fallone from the faculty at Marquette University Law School. Welcome to what promises to be a very spirited and informative conference that we call "Corporate Citizenship: A Conversation Among the Law, Business, and Academia." I'd also like to thank Professor Patricia Bradford, the Chair of the organizing committee, for her tireless efforts in organizing this event.

As the Dean mentioned, the genesis of the conference was the criminal conviction of Michael Dawdle, a former K-Mart executive in a case that arose out of Mr. Dawdle being fingered by another individual, Frank Crivello, who in a plea bargain to separate bank fraud charges, gave up Mr. Dawdle as part of his cooperation. I do think that District Judge Rudolph Randa at sentencing was reacting a bit to the seaminess of the business practices—the seemingly casual use of kickbacks and bribes in business practices—when he ordered this public service payment to the Marquette University Law School and the University of Wisconsin Law School to fund programs in business ethics. I think that the sentencing order was unusual, and I think that the judge was

attempting in some way to address a broader concern that he could not address through the individual punishment in front of him. I think many people share the judge's concern about corporate responsibility—corporate social responsibility—and that's why we're here today.

Our first panel today asks the question, "What defines a company as a responsible member of society?" We are honored to have with us a very distinguished panel. Starting from my immediate right, we have with us the Reverend Robert Sirico, who is the President of the Acton Institute for the Study of Religion and Liberty and a graduate of the University of Southern California. He holds a Master of Divinity Degree from Catholic University of America. He is a prolific writer and has contributed to many publications, including the Wall Street Journal, the New York Times, Forbes, the National Review, and he has contributed to several books, including *Man and Marxism* and *A New Worldly Order*. To his left, is Todd Kahn, President and COO of Internet Cash Corporation, an Internet payment technology company. Prior to joining Internet Cash Corporation, Mr. Kahn was the executive Vice-President and COO of Salant Corporation, a publicly traded apparel company. He had experience as a corporate attorney specializing in mergers and acquisitions and securities law at Fried Frank Harris Schriver & Jacobson in New York. He received his law degree from Boston University Law School. We also have with us Professor Larry Mitchell of the George Washington University Law School where he is the John Theodore Faye Research Professor of Law. He is the Director of the Sloan Program for the Study of Business and Society. He is also the Director of the International Institute for Corporate Governance and Accountability and the author of several books including the forthcoming book entitled *Corporate Irresponsibility* from Yale University Press. With that, I'd like to begin with Professor Larry Mitchell.

**Professor Larry Mitchell:** Thank you. If that is the view of the panel's moderator, I think I'm going to be the panel's immoderator. The question that was posed to the panel was "What makes a good corporate citizen?" My answer is that as a structural matter, a corporation cannot be a good citizen, that in terms of the way American law and American practice have structured the modern public corporation, although it's theoretically possible to be a good citizen, it's practically quite difficult. I'm going to get a little technical, but before I do I want to make some preliminary remarks about the particular problem that I think leads to corporate irresponsibility, and that is short-termism in America. A lot has been written on it, I don't mean to

repeat what you already know, but I think it's important background to what I will say. Stockholder value is a pretty hot topic in the United States, hot in the sense not just among academics or business people but it's become quite a popular topic as the stock market has become such a popular entertainment vehicle for so many of us. It's not a universal topic. Germany, for example, does not have the term "stockholder value" in its language, and has used the English as American capital has exerted more pressure abroad. Briefly put, stockholder value means nothing more than a generalized expectation which is found nowhere in the law except in the rare case of contested cash takeovers: the job of corporate managers and the purpose of the corporation is to maximize stock price. I believe this expectation is not only inconsistent with law, it's inconsistent with basic morality. Moreover, it results in an extraordinarily short-term focus of American corporate managerial and investing behavior that I think in the long-run is going to destroy the prosperity that we now enjoy.

Stockholder profit is impatient profit. The push to maximize stock prices creates impatient investors, and as a result, it limits the managerial ability to work for the long-term well-being of the corporation. The average period for which investors held stock as recently as 1990 was two years. In 1999, that period had dropped to eight months, and five months for NASDAQ-listed stocks. Mutual fund holding periods have dropped from eleven years in 1990 to four years in 1999. Daytraders now comprise over fifteen percent of the market, and their attitude is well-captured by that of a daytrader the *Washington Post* quoted about a year ago, "Who cares whether it's a car company or a chemical company; who cares what they're going to be doing in 2000?" Well "who cares?" indeed. Caring is the first part of corporate citizenship. If investors don't care, corporations aren't going to care.

This is exacerbated by the raise in stock option compensation. Tax laws prohibit deductibility of executive salaries over \$1 million which has led to the increase in the use of stock options as a principal form of executive compensation. In 1999, almost fourteen percent of all outstanding shares were reserved for executive option compensation. Add that to the fifteen percent of daytraders, and almost thirty percent of the market is in the hands of people who are going to benefit immediately from increases in stock price. We'll get to the institutional investors who own fifty percent of the market in a minute. Option compensation now represents so much of the average CEO's pay that one study found that a decrease in sixteen percent of the stock price—a correction but not a disaster—would wipe out that executive's cash

salary. The attitude that this breeds is one that I think is well-captured by one particular CEO who boasted that he checked his firm's stock price ten times a day and then went to the trouble of having a large sign posted in the corporation's lobby on which the stock price was posted three times a day.

Institutional investors have joined in this fun as well. I said before that about fifty percent of all publicly held stock is now owned by financial institutions, pension funds, mutual funds, insurance companies, and the like. At one point in the early 1990s legal scholars saw this concentration of stock in institutional investors as holding out the promise of better directorial monitoring. We now have concentrated blocks of stock that could act like real owners. The reality is that, while most institutions are not active in corporate governance matters and so that promise has not been realized, money managers are compensated in terms of their short-term performance in the form of quarterly results. This leads to excessive trading, and pressure on management to keep stock prices high in order to avoid having the price traded down by institutions.

There are some institutions who are active in corporate governance. The most active are public pension funds. One would think that public pension funds would be the most likely of institutional investors to have a public-minded agenda, but the contrary is true. To the extent that public pension funds have been activist, their activity has been exclusively for the purpose of removing blocks to takeovers so that short-term stock price could be maximized, so that pressures to keep stock price up could be placed on corporate management. This is true, not only in public pension funds, but of the other kind of pension fund that has been active in corporate governance matters—labor union pension funds. If nothing else, one would expect the labor union pension fund to care at least as much about its workers' security as it does about its stock price, but in fact it doesn't.

The consequence of all of this is short-term management. In order to keep the stock prices high, in order to protect their jobs and increase their compensation, managers have no choice but to focus on the short-term. Of course, theoretically they have a choice, but in an environment where short-term price maximization is the winning strategy, the corporation that takes the long view is likely to be punished, as a number of corporate CEOs have experienced. There are a lot of facets of how this problem is created, and I have several suggestions as to how we can deal with it, as well as some observations on the effect of this on an increasingly globalized economy and corporate environment. To get

all the details let me just suggest that you buy my next book when it comes out in spring of 2002.

In the meantime, I want to focus briefly on two causative aspects of the problem, both of which are rooted in the structure of the corporation. The first is the role and the power of stockholders. No matter what we say about the purpose of the corporation, it's set up structurally to focus management's attention on stockholder interests, and this has always been true, and managers have always been able to manage for the long-term anyway. But in the current moral and market environment the structural problem is severely exaggerated. The second point is also a structural point, and that is the role of managers and employees within the corporate form. This is the issue I'll refer to as one of role morality. Each of these aspects of the corporate problem serves to create an environment in which all that matters is stock price. It is the third aspect of the structure I'll touch briefly upon that is a necessary condition of corporation irresponsibility, and that is limited liability. Limited liability allows the corporation to externalize the costs of maximizing stock prices onto everyone except the stockholders; that includes employees, the environment, consumers, suppliers, and the community at large.

Let me deal with the first structural issue, and that is the focus on stockholders. I can sum this up fairly quickly: stockholders vote, stockholders can sell, stockholders can sue. Even if we were to define the corporation's purpose more broadly, even if corporate management were to say we make cars or we make beer and we make the best product we can and we provide the best service that we can, the fact remains that all of this is done in an environment in which managers' jobs are dependent upon whether or not the stockholders are happy with them. As long as the stockholders take a short-term view, then managers are going to have short-term pressure as well. I've explained some of the data that shows that short-termism is increasing. There are lots of other causes of this that I can get into I suppose, but the simple fact is that because of the power stockholders and only stockholders have over management, management cannot operate without stockholders in mind.

To the extent that they depart from stockholder interests to take broader social interests into account that this is costly. Moral behavior is by definition costly, it is always costly. It's not moral if it's not contrary to what you feel like doing, unless you happen to have a preference for being particularly moral. Since it's costly, stockholders—at least as a blind faceless market—are going to react adversely to hits to

the bottom line caused by socially responsible behavior.

The second structural problem is one of role morality. The term may not be familiar to everybody but the concept surely is. It's the idea that almost every social role that we fill—lawyer, parent, spouse, teacher—carries with it certain defining norms and rules that tell us how we're supposed to act. Even though we have these roles, in almost none of them are we asked to give up our own moral compass, our own moral guidance in how we fulfill those roles, except in some very narrow cases. One of these cases is lawyers.

Take criminal defense lawyers. Criminal defense lawyers are subject, as all lawyers, to a set of ethical rules and a set of practices. I was recently listening to National Public Radio and Terry Gross was interviewing O.J. Simpson's lawyers. She asked them if they thought he had actually murdered his ex-wife, and they sounded puzzled. They said, "Well, we didn't ask." Well, they didn't ask because their role, as they saw it as criminal defense lawyers, is to work within the procedural rules of criminal defense designed for the purpose of keeping the excessive power of the state in check to acquit the defendant within the rules. Guilt or innocence doesn't matter. This may be repugnant to some people. You don't have to be a criminal defense lawyer if you don't want to do it. But the role itself is defined by that rule, and it's held in check by the power of the state and by the fact that it's in a broader system of criminal justice so that—even in roles in which the lawyer's morality is somewhat limited by the rules—the lawyer's behavior is kept in check by the system in general.

The role of corporate managers is different. The role of corporate managers is like that of the criminal lawyer. It's defined by the purpose of the corporation as we understand it. As we understand now, that purpose is to maximize stock price. However, it's not kept in check by a broader system because that corporation is competing in an economic system which is probably now as dominant as government—and as it goes globally, one that dominates governments. It's a system in which stock price maximization becomes the purpose of existing. It's the purpose of the corporation for existing and in acting for the corporation. That's what managers are to look to in fulfilling their responsibilities.

The important thing to note is that the creation of this role—the creation of a role that we accept that says managers can maximize short-term profit—creates an excuse for them as well. It creates an exemption for accountability because like O.J.'s lawyers who could say, "well, that wasn't our job," the corporate manager can say, "I'm just following orders . . . this is my job . . . I'm maximizing stock price, I'm sorry if that

hurts somebody, that's just the way it goes." We've created this role excuse by accepting the role as one that is legitimate in our society and all I want to do is raise as a question whether that's a role that ought to be considered to be legitimate in our society.

None of this would be possible without limited liability. Limited liability wouldn't be so bad necessarily if corporations weren't as bound to short-term maximization as they are or bound to stockholders as they are, but limited liability means limited responsibility. You might say, everyone has limited liability. You can only get what someone has, so why should the corporation be any different? The difference is that everybody else—that is everybody human, and the corporation pretty much has the same constitutional rights as any human—has a moral compass to guide him or her in her behavior. Yeah, you can only get what I have, but I'm not going to run you over in my driveway not because I've got insurance but because it's morally wrong for me to run you over in my driveway. When the corporation's limited liability is coupled with the mandate to maximize stock price, what you have is a situation where directors and managers are able to go after the maximization of stock price within a shield, and it's a shield that permits the costs of their maximizing stock price to fall on everybody else—except the stockholders that is.

So, the third point I want to make is that limited liability itself, by itself, might not be terrible but when coupled with all of the other things I've said, it creates a situation in which we have an artificial being who acts as a natural being, but without any of the restraints of a natural being. The corporation acts without any of the moral guidance of a natural being, with indeed a very limited moral universe. It acts also in an environment in which every incentive, even if it weren't the moral compass, every structural incentive of the corporation directs managers to look at short-term price maximization as their principal focus and this itself ultimately breeds corporate irresponsibility.

**Professor Fallone:** Thank you Professor Mitchell. I suppose what I take away from Professor Mitchell's talk is that we should not be surprised to find immoral corporate actors. In fact, we should be surprised to find any corporations that act morally given the incentives and pressures on corporate management. Our next speaker is Reverend Sirico.

**Reverend Sirico:** Perhaps, in some sense, my colleague and fellow Brooklynite Mr. Mitchell has hit the nail right on the head in stating that the American dream is nothing but a myth. For, indeed, statism seems to have gained the upper hand in American political conversation, an



ideology that was not part of the original American dream. I suspect, however, that Mr. Mitchell is not terribly disappointed by this. For he seems all too certain that federal regulation of corporate America would greatly enhance everyone's economic and social prospects.

I must admit that I find it disconcerting how many people express a fundamental distrust in the human capacity for doing good, and yet are so willing to entrust enormous amounts of coercive power to human beings *via* the government (which means *via* bureaucrats) in the name of "social betterment." It isn't as if the same type of person who abuses their so-called "power" in corporate America is going to somehow exude virtue in public office. In fact, history demonstrates just the opposite.

Mr. Mitchell's point concerning the vulnerability of human beings in his book *Stacked Deck*<sup>1</sup> is well taken. He is correct that individuals cannot thrive and prosper in social isolation. The vital and natural interdependencies that develop as a result of what he calls "human inequality," as well as our natural sympathies toward human vulnerability, are essential to human flourishing. However, I take issue with the confidence he places in government regulation as a means for securing economic justice, or what he calls "fairness" in the market place. I also object to his claim that corporate structure and corporate law lead to economic injustice on a grand scale.

One of the essential reasons the corporation *qua* corporation has brought such tremendous benefits to society—benefits I will elaborate upon in a moment—is because it is a *voluntary* commercial association that has been safeguarded by private property rights. Whatever wealth the corporation generates, it does so without coercion, and therefore in a manner far more in accord with human freedom than a command economy. While it is true that compensation will often vary dramatically between stockholders and employees, if property rights are upheld in accord with the dictates of justice, people's lives will generally be enhanced—either as stockholders, employees, or managers. But this is not to deny the fact that there is risk in life and therefore loss. (Were there not loss there would be no risk). In a sense, the old adage is correct—"life isn't fair." In other words, with any business venture, misfortune, error, and even sin are going to negatively affect human lives. The question is, What ought we to do about it? Is government regulation the answer, or are there better ways to handle these situations?

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1. LAWRENCE MITCHELL, *STACKED DECK* (1998).

Moreover, the corruption that does occur in corporate America is not so much the consequence of corporate structure as it is the result of fallen human nature. What we must understand is that government regulation has little power to reverse the effects of Original Sin. Government can only effectively provide a legal framework to protect rights and a legal mechanism for providing restitution when those rights are violated.<sup>2</sup> The statist position, however, assumes that regulatory law can somehow contain or for securing economic justice, or what he calls "fairness," reverse fallen human nature—that is, prevent people from being sinful. Yet what typically occurs with excessive regulation is that the negative effects of human sin and error are amplified because regulation produces perverse incentive structures that reward anti-social behavior. In short, if a company is driven by greed, it will transfer the costs associated with regulation to the consumer or to the employee, regardless, and thus everyone will suffer economic loss, or they simply won't remain in the industry. Regulation puts a drag on economic productivity, limits competition, and therefore adds fuel to the fire of economic injustice. If anything "stacks the deck" (you should pardon the expression) against the poor, it is government regulation of the economy.

Thus, I will demonstrate, in this short presentation, that the corporation contributes positively to the social order precisely because, as a model of voluntary association, it demonstrates the potential for ordering civil society—by upholding the right of association and the right to private property.

However—let me be clear from the outset—in defending the corporation, I am not attempting to justify any formal or informal system of exploitation, greed, or economic imperialism. Such criticisms, which are so often leveled against the modern-day corporate environment, emerge out of a fundamental misunderstanding of what corporations are, how corporations work, and what kinds of social structures contribute to corruption. What I do intend to justify, however, is a very successful and quite equitable system of commercial organization that is built upon the foundation of free association, the universal destination of material goods, and the right of private ownership.

That corporations have exercised so much social influence over the past century hinges on the fact that they have—in a strictly voluntary way—met the demands of the market and thus created enormous

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2. Pope John Paul II, Encyclical Letter, *Centesimus Annus*, n. 48 (May 1, 1991).

wealth. This requires a considerable amount of organized human capital, know-how, flexibility, innovation, and above all, risk—things no government agency can mobilize by virtue of its very nature.<sup>3</sup> As a result of the corporation's entrepreneurial nature, it can acquire tremendous purchasing power; but this is a very different mechanism for influencing society than is coercion—unless, of course, such purchasing power is used to employ political power to its own benefit. In other words, the corporation *qua* corporation does not coerce precisely because it has no political power—although it *can* employ the state to do its dirty work through buying off politicians and illegitimate lobbying. This, of course, is reprehensible and occurs all too often.

Yet can this be blamed on the nature of a corporation operating in a free market? Granted, bribery often wins the day, but perhaps this has more to do with political corruption than the free market. And, in the end, what is the alternative to free enterprise? Socialism? Statism? Those who think so fail to acknowledge that greed is just as prevalent in these other political contexts and yet infinitely more destructive to the social order.<sup>4</sup> When wealth is consolidated in the hands of those with coercive power, the result is almost always a violation of human rights. Perhaps this is why the Church, in accord with the principle of subsidiarity, has condemned collectivism and the "welfare state" and yet offered a nuanced and supportive voice to what she calls the "free economy."<sup>5</sup> The prosperity of the modern economy bears witness to the enormous success, effectiveness, and efficiency of the corporation.

The way one understands the nature of corporations is connected to one's beliefs about the moral and social responsibilities of business firms. For example, if one holds that corporations are private enterprises designed to make a profit, then one will likely have a narrower concept of how corporations relate to the social order. In contrast, those who hold that corporations are servants, (i.e., social organizations with an implied social contract to the rest of society) tend to have a broader concept of the social responsibilities of corporations. There are currently two dominant models used to provide an account of the nature and purpose of the corporation: the shareholder and the stakeholder models.

According to the shareholder model, the corporation is a collection of private property owned by those who hold its stocks. On this model,

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3. MICHAEL NOVAK, *THE FUTURE OF THE CORPORATION* 14-17 (1996).

4. F.A. HYEK, *FATAL CONCEIT* (1991).

5. *Centesimus Annus*, *supra* note 2, at nn. 42, 48.

the primary purpose of the corporation is to make a profit. The corporation is made up of various agents, each with its own role. The shareholders are those who own the corporation, and, in exchange for their investment, receive a share of the profits.

The shareholders elect a board of directors who act as fiduciaries for the owners and whose task it is to serve the best interest of those who hold stock. The board of directors has the power to appoint or to remove the upper management of the corporation, typically the Chief Executive Officer (CEO). On this model, the managers are seen as having the social responsibility of acting in the best financial interests of the stockholders—that is, of increasing profits.<sup>6</sup>

Perhaps the classic formulation of this understanding of the corporation is found in Milton Friedman's essay, "The Social Responsibility of Business is to Increase Its Profits."<sup>7</sup> Friedman argues that corporate executives are employees of the owners of the business. As such, the CEO has a responsibility to increase corporate profits while conforming to the basic rules of society, following the law and acting in a manner that is ethical. The force of his argument is directed against those who hold that corporations should be responsible for improving social life by using profits for charitable causes. Friedman argues that companies whose managers contribute the corporation's earnings to social causes will in fact spend the stockholders' money through reduced returns, spend the customers' money through increased prices, and spend the employees' money through lower wages. Friedman argues that investing in social causes may be worthwhile, but that the individuals whose money is being spent should make such decisions on an individual basis. According to the shareholder model, when corporate executives engage in promoting social causes, it can be a violation of property rights, and thus, a violation of the nature and purpose of the corporation, which is to generate wealth through the collective investment of individuals in a common enterprise.

The major strength of the shareholder model is the emphasis it places on the responsibilities of managers to make prudent financial decisions with the money of others. It is helpful for managers to remember that they are acting as stewards of the investments of others. The major weakness of the shareholder model, however, is that it can place too much emphasis on profits to the neglect of moral norms

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6. MICHAEL NOVAK, ON CORPORATE GOVERNANCE, 3-12 (1997).

7. Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N. Y. TIMES MAGAZINE (Sept. 13, 1970).

pertaining to employees and the community. In my estimation, Friedman fails to acknowledge that shareholders can delegate managers to determine appropriate social causes to support, which might enhance both the community, and the reputation of the corporation within the community—something an individual donor would be unable to do. Some have attempted to remedy what they see as a deficiency in Friedman's argument by an increased emphasis on the stakeholder model of corporate governance.

According to the stakeholder model, the corporation is a servant of the larger society.<sup>8</sup> Historically, the vocabulary of a "stakeholder" is newer than the shareholder model; it emerged with an increased recognition that a wide range of groups and individuals are impacted by the activities of the corporations. The stakeholder model acknowledges that corporations, while often efficient and productive forms of social organization for providing goods and services to the broader society, do not operate in a social vacuum. Many people have a *stake* in the activities of the corporation. In addition to the responsibilities that managers have to owners, the stakeholder model maintains that the corporation has a range of relationships and responsibilities, some of which are not immediately obvious. Stakeholders would include stockholders, individual employees, unions, the community in which the corporation is situated, customers, suppliers, trade associations, interest groups, government agencies, etc. In short, a stakeholder is any group or individual that affects or is affected by the corporation, its organization and work performance, and its products or services.<sup>9</sup> The nature of the bond between the corporation and its stakeholders can vary greatly. Though stockholders have a place of prominence in this model, the concerns of stockholders are not considered exclusively. The major strength of the stakeholder model is that it acknowledges the multiple relationships that corporations have. The stakeholder model brings to light the fact that many individuals and groups are effected by the activities of the firm, and hence this approach helps managers understand more fully how their decisions are part of a larger social whole.

The major weakness of the stakeholder model is that, by itself, it

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8. Anthony F. Buono & Lawrence T. Nichols, *Stockholders and Stakeholder Interpretations of Business' Social Role*, in *BUSINESS ETHICS*, 170-75 (W.M. Hoffman & J.M. Moore, eds. 1990).

9. R. EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* 46 (1984).

does not resolve some difficult questions concerning (1) who actually has a legitimate stake in the corporation; and (2) to what degree various interests connected to the corporation be allowed to determine the use of the corporations earnings. For example, if a company considers moving its manufacturing operations from Tennessee to Mexico, the stakeholder model holds that managers should consider the interests of stockholders, the workers in Tennessee (who will be displaced from their jobs), the workers in Mexico (who may find an increased level of pay), the community in Tennessee (which will suffer the loss of a manufacturing plant) and the community in Mexico (which will gain a manufacturing plant). Under this model, how exactly are managers to weigh the gains and losses to all parties involved? It would seem that the stockholder model is much more efficient in being able to make these difficult decisions.

While the stakeholder model provides a way for managers to reflect in a fuller way on the social effects of corporate decisions, the stakeholder model does not, by itself, offer a way to adjudicate the competing demands of various groups. Moreover, it raises serious questions concerning property rights. Should employees or the local community be able to determine legally how stockholders are to manage their capital? If so, what kind of precedent is set with regard to property rights?

The social teaching of the Catholic Church seems to favor a *revised* shareholder model in as much as she acknowledges the importance of private property, but also the need for corporations to adhere to moral norms in the pursuit of profits. The Church recognizes one of the central principles of social ethics—that private ownership is a sacred right to all persons and a firm foundation for a just social.<sup>10</sup> Private ownership of property, conducted according to the standard understanding of Christian stewardship and acknowledging the universal destination of material goods, actually leads to the fulfillment of the common good more effectively than does any other form of collective property distribution or management.<sup>11</sup> The weakness of the stakeholder model is that it often comprises the duties, functions, and obligations of those who actually own the corporation—the stockholder—in the name of some other social good. Ends do not justify means—thus, you cannot neglect or restrict valid and legitimate claims of private ownership to achieve certain social goods. Socially

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10. Pope Leo XIII, Encyclical Letter, *Rerum Novarum*, n.46 (May 15, 1891).

11. Pope Pius XI, Encyclical Letter, *Quadragesimo Anno*, n.46 (May 15, 1931).

responsible stewardship ultimately resides, not with the corporation, but with the individuals associated with the corporation and the fraternal organizations they support.<sup>12</sup>

Of course, Christian social teaching also teaches that private property rights are not absolute and must be mitigated by the virtue of charity. In other words, every person has an obligation to use their own surplus wealth for the good of those in need.<sup>13</sup> In effect, requiring *corporate* charity is another form of collectivism and, therefore, once again circumvents individual responsibility in much the same way as socialism does. Thus, as Christian churches have emphasized, the surest way to achieve the conditions of the common good in accord with human dignity is through respecting private ownership and encouraging personal virtues such as generosity, concern for others, and charity.

In his 1991 encyclical *Centesimus Annus*, John Paul II states that "the purpose of a business firm is not simply to make a profit, but is to be found in its very existence as a community of persons who in various ways are endeavoring to satisfy their basic needs and who form a particular group at the service of the whole of society."<sup>14</sup> On this account, "profit is a regulator of the life of a business, but it is not the only one; other human and moral factors must also be considered."<sup>15</sup> These other factors would include a just wage, adequate working conditions, transparency, and so forth. In short, human dignity cannot be violated in the pursuit of profits.

Thus, there is a kind of mingling of interests in the revised shareholder model. As a possible outcome of respecting property rights and yet being concerned about economic justice, one might consider the treatment of workers as a moral issue and thus refuse to invest in a company or buy its products. The same can be done in response to environmental concerns and other social issues. In this way, the social value that is upheld provides a market incentive for corporations to act responsibly. I would argue that this is a much more ethical way of applying social pressure to an irresponsible company than mandating by law that they comply with certain regulations. Granted, the fear that the consumer won't respond to these abuses is warranted. However, people are rarely aware of how regulations that are intended to compensate for individual virtue, in effect, worsen the economy, contribute to the causes

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12. *Centesimus Annus*, *supra* note 2, at n.48.

13. *Rerum Novarum*, *supra* note 10, at n. 22.

14. *Centesimus Annus*, *supra* note 2, at n.35.

15. *Id.*

of corruption, and do little to foster the social virtues that are necessary for a just social order.<sup>16</sup> Certainly law must exist for those instances when rights have been violated, but law can do little to prevent people from acting unjustly if they so choose. Those who are driven by greed will simply find new ways around the law, or will utilize the law—through bribery—to control their market. In short, the persuasive influence of consumer sovereignty is far more conducive to properly ordering the economy in accord with moral norms. Corporations suffer from a poor image in the popular culture. How many movies, news stories, social critiques, and the like blame many of our social and moral ills on evil and greedy corporations and multinationals? Corporations are blamed for everything from pollution and moral decay to family neglect and consumerism. I admit that corporations are made up of sinful individuals and will therefore exhibit the entire range of sins found in the human heart. Can people acting in the name of a corporate entity be greedy, selfish, or socially detrimental? Absolutely. However, do these sins follow axiomatically from the nature of a corporation or are they simply indicative of fallen human nature? I tend to believe that the popular image is somewhat undeserving because there are many positive contributions, useful social functions, and benefits of a corporation that are rarely given attention. Allow me to conclude by arguing for the social benefit of corporations.

Much of the debate concerning the shareholder versus the stockholder model of corporate governance revolves around the exact purpose of the corporation. Until recently, it has always been assumed that the end of business is profit. Yet asserting that profit is the primary end of a business or corporation is an upsetting claim for many social commentators. Somehow, talk of profit margins and good returns seems to offend the ethical sensibilities of many social thinkers. It is assumed that seeking profit is incompatible with higher ends such as the humane treatment of workers, fair wages, and other moral and cultural needs. In fact, it is often claimed that profits are earned in and through exploitation of workers and the environment.

The tone of many social theorists today would seem to imply that profits are somehow diametrically opposed to human dignity. But, in fact, just the opposite is true. Without having the time here today to expound on the economics of this proposition, I would like to argue that profits are the economic lifeline of any enterprise, and thus, the bread

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16. JAMES GWARTNEY & RICHARD STROUP, *ECONOMICS, PRIVATE AND PUBLIC CHOICE* 592-93 (8th ed. 1997).



and butter for everyone. A good profit margin indicates that people are benefiting from the enterprise. Why? First, profits demonstrate that scarce resources are being utilized efficiently and with little waste. Second, human needs are being fulfilled. Third, jobs are being created. Fourth, new discoveries are being made. Fifth, valuable information about ideas and scarce resources is being universally disseminated. And sixth, wealth is being created. Pope John Paul II affirms the important role that profit plays in economic life:

The Church acknowledges the legitimate role of profit as an indication that a business is functioning well. When a firm makes a profit, this means that productive factors have been properly employed and corresponding human needs have been duly satisfied.<sup>17</sup>

Consider for a moment that a firm does not make a profit. The results of economic loss are damaging on a human level. If a company sustains losses for long enough workers will have to be let go, salaries cut, production slowed, and research development of new products halted. Workers who are attempting to send children to school, provide for their families, and secure a decent standard of living are put at risk. Companies whose products serve immediate and evident social functions such as pharmaceuticals, cannot develop newer and better drugs since the money for such research is no longer available. Local communities, which depend on a certain firm or business for the community's economic well-being suffer if the company suffers. Without a profit, the business cannot survive and the loss to the workers, local community, and society as a whole can be highly damaging.

To a large extent those affected by a corporation have a common goal to provide for themselves, and thus, the economic viability of a corporation has far-reaching consequences—and not simply for the stockholders. A successful corporation creates goods and fulfills human need, and does these things more effectively than competing firms such as government enterprises and self-proprietors. This success is the natural consequence of respecting private property rights and allowing for the freedom of association. Corporations are able to pool together a variety of resources—both human and natural—in an effort to allocate them to some perceived need that the market has revealed.

Corporate structures have emerged somewhat unplanned and spontaneously. By this I mean that there is no *Platonic ideal* or pre-

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17. *Centesimus Annus*, *supra* note 2, at n.35.

established model for organizing corporate life. The corporation and its structures emerged and developed after the Industrial Revolution from the collective effects of human action in the market place. Recognizing this fact is really to make an argument for the intelligibility of corporate structure. In a sense, corporate structures—board of directors, stockholders, management, etc.—has evolved to its present state through a series of ongoing trial and errors involving efficient ways of organizing and operating business life.

Human behavior is generally rational and responds to incentives. Because of the organizational and incentive structures that are built into the stockholder model, corporations are able to respond efficiently and effectively to the constant changes that emerge with respect to human needs as well as available resources. A corporation must be very agile or it won't survive. As far as human need is concerned this is an enormous benefit.<sup>18</sup>

Another manner in which the corporation demonstrates its efficiency and cost effectiveness is in relation to the division of labor. As investors pool their money for a common enterprise, the resources necessary to advance down the road of specialization, invention, and new discovery is paved. Without the collective, and yet individual voluntary effort of stockholders, an industry would never get off the ground. The consequence is simply fewer jobs and fewer discoveries. Thus, it can be argued that the corporation has created more jobs and opportunity for more people than at any other time in man's economic history.

Another benefit of the corporation is the dissemination of ideas and the distribution of goods. By comparison to other institutions of society, the corporation has made valuable information available to almost everyone. Moreover, the corporation has brought about a general increase in the standard of living worldwide because of the efficiency with which it is able to utilize and mobilize resources from where they are abundant to where they are scarce.<sup>19</sup>

Consider the pharmaceutical industry. The concentration of knowledge and skill that is amassed in a corporation such as Pfizer or Merk greatly benefits society. The concentration of knowledge in this case leads to vast improvements in the health care of millions. Companies such as Pfizer pour millions of dollars into research and development of new and more effective medications. If it were not for

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18. See NOVAK, *supra* note 6, at 3.

19. F.A. HYEK, *THE USE OF KNOWLEDGE IN SOCIETY* (1977).

the profitability, concentration, and division of labor of the corporation, such money and intelligence would not exist in such an effective manner.

There are indirect benefits of corporate success as well. As a result of corporate efficiency and subsequent profitability, the corporation has been responsible for more public works and service projects than any other institution in society. Think of the libraries, gardens, museums, schools, and monuments that have been made possible by individuals who have profited from corporate investment. And because of the manner in which these funds have been generated, the fabric of the civil order has been built up by the exercise of virtue as opposed to the use of coercion.<sup>20</sup>

It should surprise no one that with the advent of the corporation, we have seen an unprecedented increase in standards of living and life expectancy, a decrease in infant mortality, the advent of mind-boggling technology, the explosion of art, education and many other positive cultural indicators. Of course, we have much to learn in terms of the moral responsibilities such progress demands, yet in spite of our learning curve, it is good to create wealth and envelop ourselves in prosperity. The answer is not to stifle this progress; rather we must learn how to place that wealth in the service of human dignity.

There are perhaps many ways in which the modern corporate model could be improved. However, it would be misguided to suggest that corporations by nature "stack the deck" against those who are more vulnerable. If anything, the corporation has done more than any other institution, *including charities*, to raise the general standard of living for all, and not merely the wealthy. While it is true that the contemporary business environment has not created an egalitarian society, certainly it can be demonstrated that the standard of living has been greatly improved—where the corporation has been active and vital—for the vast majority of those living in market economies.

Corporations are an illuminating demonstration of how voluntary associations build up the civil order. In addition to creating employment, they pool resources, respond to human need and serve as an effective means for disseminating information far better than any other institution within society. Moreover, corporations generate enormous wealth that typically furthers innovation, the arts, public works, and a whole host of other social benefits.

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20. See NOVAK, *supra* note 3, at 14-18.

As is the case with the market in general, the corporation is only as morally good as its individual members. The organizational structure of corporations is highly effective, but there can be no doubt that virtue is, as it has always been, a vital component of business. It does not seem to be the case that the corporate model needs to change, but rather, business has to be more properly ordered to the moral imperatives that can be derived from human dignity. From an economic perspective, the corporation is a highly efficient and effective model for distributing information, resources, and wealth. Thus, the greatest challenge that stands before the corporate world is the challenge of ordering business affairs in accord with the truth. This is best achieved by allowing moral and cultural institutions—such as the family, the Church, and voluntary and professional associations—to leverage the corporate world, rather than relying on government bureaucracy to regulate privately owned entities.

**Todd Kahn:** I really want to talk a little bit about practical implications for how decisions are made. I've had a unique experience for the last ten years being in the old economy as both a general counsel and as a business person and then the last year sort of in the new economy, and there's a lot of lessons to be learned there and some interesting challenges.

First, I fundamentally believe in a profound way that limited liability and shareholder accountability is the cornerstone for our economy and the growth and the prosperity we've seen. Without those two components the ability to raise capital would be completely stifled. I think where corporations run afoul isn't on the goal of promoting shareholder value. Corporations go wrong by not applying what shareholder value means, and because, unfortunately when people have to make decisions often they have to make decisions with imperfect information in a very short-term period.

A great example of that is what's going on now with Ford and Firestone. Since Ford has the recall issues and the catastrophe with the tires have come out, Ford has lost thirteen percent of its shareholder value. Had the management of Ford or Firestone initially taken what I think all of us would have considered the morally correct stance which is to recall the tires when they found out there was a problem, I can safely say you would not have seen diminution of thirteen percent of the value of Ford taking place. You wouldn't see 500 Ford employees and senior managers in crisis mode and trying to do damage control of the problem.

I think what happens in business often is that people want to be

morally good, but sometimes that doesn't go into their calculus. I don't think corporations are morally bad. I think what happens is people apply the analysis wrong, and sometimes that's the management, sometimes that's the lawyers. It depends who the gatekeepers are, and the issue is do you ask the right questions and do you take the right stance? I'm going to tell a little story demonstrating that in a minute.

Some other things I want to talk about that are important, if you look over the last ten years according to Forrester Research, all of the new jobs created in this country have come from new ventures. That's a phenomenal figure. It basically means all the companies that were in existence in 1990 to today have not created any new jobs. All the new jobs have been created on a net basis from companies that have basically been formed in the last ten years. One of the reasons we've experienced such prosperity and growth, I believe, is the flow of capital that our capital markets provide. Some of it may have been a little hyper and souped up and I think we've seen some valuations come down. I know we're seeing it in the space I work in right now, but that flow of capital and that focus on shareholder value has created so many innovations that if you think about our lives, they touch every aspect of our life.

The interesting issue is that while academics talk about profit as a motivator, actually the new nomenclature has to be, not profit, but shareholder value which I think Larry mentioned. The truth of the matter is that profit has had very little to do in the last couple years with creating shareholder value. If you look at some of the vehicles for the creation of shareholder value—AOL, Yahoo, Priceline—we're still waiting to see profit from those entities. So, those managers have not been focused on short-term profit. In fact, one of the amazing things about the economy we're in right now is it threw out all the old rules to some extent. Up to now, people said you couldn't raise capital unless you showed profitability quickly and short-term managers had to focus on profitability. Well, in fact they don't because if you have a market that will value—maybe in an absurd way sometimes—but value future results, then managers are free to focus on long-term strategies.

I would submit to you, in the real world managers have a great deal of pressure on short-term not solely because of shareholder value. It's important, it's key, but the other short-term pressures that we have are technology and competition. I was in an industry that was very slow to adopt technological changes, and that's the apparel industry, and it has hurt them greatly. I'm in an industry now where with technology—literally—a "day" is a week, a "week" is a month, a "month" is a year.

Innovation in keeping up, in going to market with new products, in evolving the company—there is no more luxury forgetting shareholder issues.

Just being in business today and addressing competition is about a very key focus on short-term issues. You have to get product to market quicker, you have to do it better, and you have to do it more efficiently. That's not just about value, that's about staying in business. There are huge challenges on managers to address short-term needs wholly apart from valuation of their stock. There's no question though, valuation of stock plays into people's judgments.

One of the things that the new economy has done is it's lowered the cost of business in some ways, it's lowered the cost of management; managers will take pay cuts in exchange for equity ownership. I would submit that that makes the management align with the capital of the company—which is important—and also ensures growth and prosperity. I think what happens is managers tend to lose a lot of accountability when they get a guaranteed paycheck regardless of the performance of the company. It doesn't necessarily make for better company or better profit. Also, one other side note, this issue has come up when I was in practice on Wall Street and when I was in a public company and a private company. I guarantee you, no executive ever, ever didn't get paid a million dollars because it wasn't deductible. If an executive was worth a million dollars and could negotiate a million dollar base salary, he or she got the million dollars and the deductibility factor or the disclosure factor that the S-K rules require has never stifled the individual greed, I can assure you of that. People find another way to deal with the problem.

I think what's important and what I want to use my time to talk about a little bit is how all of you—whether you're corporate attorney, whether you're going to be an attorney, whether you're a business person—how you deal with the challenges and the ethical challenges that you're faced with, given the existing rubric of promoting shareholder value. I would submit fundamentally that you can be a moral citizen and maximize shareholder value at the same time. The hard part is to ask yourself the right questions.

One story I want to share with you is something that took place in December of 1994. I was general counsel to Salant Corporation at the time. It was one of those last few days of the year that was pretty slow and half the people had already left to start their Christmas vacation. I went to lunch and it was one of the few times that I didn't have a phone or a beeper on me, and I got back and I looked at the stock, and the

stock was up forty percent which normally would be a very good thing; I would be very happy; I had a lot of stock. The only problem with it was it went up because Dan Dorfman, a reporter at the time, got on CNN and said "New Slant on Salant," and talked up the stock. Again, not necessarily a bad thing. The only problem was at that time I was writing a press release announcing to the world that we were not going to achieve our earnings projections. So, we had a problem. On the one hand, stock has gone up forty percent, we've created shareholder value. On the other hand, I know that we have an earnings problem and that in fact we're not going to make our numbers. We called the New York Stock Exchange and asked them to stop trading on the stock. We had a conference call with our Board shortly after the market closed. We had outside counsel there, myself, and another practitioner. A lesson for everyone out there, and if you can ever avoid a conference call to make an important decision do so because the lowest common denominator always controls the conference call. There is no accountability with a speaker on a desk versus looking people in their eyes and saying are you sure you want to do this.

At the time the board was adamant that we had to do whatever it takes to—what was the term they used—to support Dan Dorfman. Despite reservations from outside counsel and from myself, the Board said that's what we're gonna do, and how that would materialize is that we would come out with another live projection. While we would basically say we weren't going to achieve these earnings, we're confident about the future, and actually put out a number the market could track for the future. To help us in this process, members of the Audit Committee were going to come to the corporate offices that evening and help us write the press release. Talk about real involvement from your directors.

So, we were staying there about eight o'clock at night and I have the chairman, the CFO, the three members of the audit committee, and we write the press release and put in the live projection, and I am very much opposed to this. I haven't convinced anybody of the rightness of my position at that point. But at the end, right before we were all looking at the press release, I said to them the following: "We can go forward with this press release, but just remember, three months from now if we're wrong on the earnings projection, every person in this room will have to anticipate an SEC investigation and a shareholder strike suit, and in a deposition at either a government agency or in a private suit, each person in this room will have to defend and have to have a rational explanation for why it is they were comfortable with this

projection given the fact that the company had just missed its last projection. As long as everybody could articulate a good reason. And remember you're going to articulate it only in the time when in fact you were wrong, because it only comes up if you were wrong. But if everybody in this room is prepared to accept that and defend that, then we should go forward.

Fortunately, one of our directors was quite wise and said, "You know what, the press release reads pretty well without the projection," and they all said "yeah, we agree, we agree," and we scratched the projection. Sure enough we went out.

A couple things happened: The market eventually corrected gradually. We came out with a projection the next day and the stock didn't drop forty percent. It gradually went back down. There was no SEC investigation; there was no shareholder strike suit. Two months later in fact we would have blown that projection. There was a core problem that clearly wasn't addressed back then.

What I've learned from that moment in time and I've carried with me in lots of difficult decisions since that event have been a couple things. People do have limited time in making perfect decisions. Clearly what was in the best interests for our shareholders wasn't necessarily to support that forty percent rise in stock on that night. Clearly, what was in the best interest was a little bit long-term view. If the company was under an SEC investigation and had a shareholder lawsuit, it would've distracted management, the price would've corrected itself anyway, and the company would've had a lot of other problems.

The hard part, the truly challenging part for all of you when faced with these decisions is to take the horizon view, is to ask yourself the question "If exposed in the light of day, how would this look?" If someone at Ford or Firestone had really said to themselves, "If this gets on '60 Minutes' a year from now, what will this do for our company?" If people truly ask themselves those kinds of questions, ninety percent of them get to the right moral answer because our system as it stands right now has certain real-world restrictions on activity. There are private rights of action. There is public oversight. While I know a lot of CEOs who do look at the stock price twenty times a day and are very focused on that, they also understand that sometimes they have to look at building a business. AOL is one of the best examples of that in that although they really have not made any money, they are growing something unique. Time will tell whether that model makes sense, and I think one of the things that we talked about this morning was a little bit



more accountability to valuation issues, which I think is healthy.

But what I do truly believe is that our system, more than any other country and more than any other system, truly provides for a flow of capital. The flow of capital allows for growth and technological leaps that we have experienced, and it really has impacted our lives, and everyone's lives on a global basis. I use to go down to Mexico and the south in the U.S. and go tour a sewing factory. Now I've gone and talked to people in India and toured a Java script and DBA writing factory. Obviously our society is valuing that work at a better rate, but what it's done is that it's lifted the earnings and the lifestyle that that community has had. That would not be the case but for the ability for investors to have limited liability, to have managers focused on a return for those investors. I truly believe that our system, while imperfect, does promote a rise in overall standards for everyone. Thank you.

**Professor Fallone:** Thank you very much to the panel. I think we had an excellent discussion which I fully expected. I'm going to ask for a response, but in the meantime I want to invite members of the audience who have questions to line up at the microphone in the aisle and we'll have time to get to you. Professor Mitchell, I guess I'll start with you. A lot has been said since your presentation, and some of it relating to the possible remedies that you envision for this problem.

**Professor Mitchell:** Right and I'm actually delighted to say that neither of the other two panelists disagrees with me in the essentials at all, at least as their views have been presented. First, Todd, I want to pick on you just a little bit; first on a technicality and then on the lesson of your story. The technicality is, you said as follows: There was a news report on Salant stock price, the stock went up forty percent. We were happy; we created shareholder value. No you didn't. You got a higher stock price. That's precisely my point. The higher stock price does not mean shareholder value—but then look at the story you told. You told a story of a board of directors that was prepared to make what in essence was a misleading press release. A press release that they knew was misleading, and why were they going to make it? To support the stock price that bore no relationship to the actual performance of the company. Why would they do that? They did it because I assume they knew that their jobs and their wealth were integrally dependant upon the price of the stock, and they weren't about to risk that. That's my point.

By the way, I don't have any objection, I do have objections to limited liability as a moral matter. We're not going to get rid of limited liability, but my point is not that limited liability ought to be eliminated,

but that given limited liability and the other things I discussed, we can expect certain kinds of corporate behavior, and so the solution comes down to Reverend Sirico's ideas. I think—I'm delighted to hear the Pope agrees with me—and I think that much of what you say is right, but there's a technicality I'd like to quibble with on your presentation as well. That is the concept of the stockholder as owner. If stockholders were truly owners, if they truly behaved like owners of property behave, I'd have nothing to say because—and you're right Todd, some people are moral, some people aren't moral, people will do whatever they do—they are accountable for their behavior. If they behave badly the rest of us are going to blame them. If they behave illegally the rest of us are going to sue them.

Stockholders don't behave as owners. What's happened in our current capital markets is that what people are concerned about is what risk and what return does a particular security add to the portfolio. That's not ownership. Ownership implies responsibility and ownership implies accountability. From Adam Smith to David Hume it's clear that in order to act as an owner, one takes account of the thing one owns. Stockholders don't own anything. Stockholders own a piece of paper that entitles them to the residual profits of a corporation. They don't own the corporation in any meaningful sense.

I don't have time nor will it permit me to get into a disquisition on how modern finance theory has destroyed everything as well. The upside of modern finance theory is that you really shouldn't think about the corporation as anything other than that from the investor perspective. That's bred this attitude of what economists call "rational apathy." I call it irresponsibility. So, if they behaved as owners, I wouldn't have any problem at all. I'm not advocating a radical remake of the American corporate structure. You're right; it works efficiently. It probably works more efficiently than any other corporate structure. The problem is one of how you free managers to do what Todd does; to manage as a human being with an understanding of all the factors that have to come into account in the way the business is run, including the responsibility of the business to its constituents other than stockholders, and you don't do that in the current structure.

So, several suggestions are illustrative of things one might do to maintain the current structure and yet allow managers to be free to operate in the long run. I sound like a radical, but I wind up sounding like the business roundtable's chief spokesman. The first is that to give managers the opportunity to manage in the long-term. Maybe you don't have stockholder elections or maybe you only have them once every five

years, or maybe you have a self-perpetuating board of directors with some tight fiduciary rules and some tight securities rules that can be used to enforce their duties if they get out of line. But you don't put the kind of stockholder pressure on them that we do now to stand for any re-election.

Maybe you don't have quarterly reporting. Warren Buffett famously said, "Nothing that I know of any significance happens quarter to quarter. Our investors don't care about quarters; they don't care about years." A year is not the long-term; it may be technologically in your business a very long term and that's a different kind of short-termism than I was talking about. That's good short-termism; that's building value for the long-term. But when, in our SEC reporting system where you have disclosures on a quarterly basis, analysts fix on the quarterly numbers, stockholders fix on the quarterly numbers. That's what moves stock prices. That's not a long term. That's what puts pressure on management.

Maybe, we revise our capital gains tax laws. Instead of having a two-step capital gains tax with six months being considered long-term, maybe we have punitive taxation for daily turnover. Now some speculation is good; some speculation is important. There are paid speculators called market makers and specialists who serve an important function. Of course there are ways these laws could be drafted to exempt honest speculation, but if you're flipping stocks every day, maybe instead of paying twenty-one percent or twenty-eight percent you pay fifty percent or sixty percent or seventy percent on the assumption that what we want to do is encourage long-term investing and not short-term speculation. So that's the third suggestion I'd throw out is look to the tax laws. It's true that executives compensated in stock have their interests aligned with the stockholders, but to keep executives in for the long-term maybe you also have punitive taxation on executives who flip their options quickly so that there are financial incentives created to keep them in it for the long-term. If we look at solutions like that, these are ways I think we can maintain the efficiencies of the structure as you are talking about and at the same time we create incentives to ameliorate some of the problems I was talking about.

**Professor Fallone:** Todd, I think I heard reference to taxing your stock options. You may want to respond to that.

**Todd Kahn:** Actually I was willing to give that up if I don't have quarterly reporting, so he's turned me into a believer. Just one point of clarification. I think what was interesting about the story and living at

the moment was the board truly believed the projection at the time. It was based on our budget; the numbers were set three months before. It wasn't created at the time. I think what was morally challenging was, given the fact that we had just missed the number, how could we be so comfortable with the future number? So, they weren't doing anything morally bad. They really were believing what all the managers were telling the board, these were what the numbers were, the CEO was confident that he was going to achieve that number. He was ready to stand by that number. Everybody was ready to do it. I think the morally difficult issue was: Guys, you just missed the numbers, so why can you sit here with such confidence? So that's what made it challenging. So, I do want to clarify that because even though the statute of limitations has expired, I still have old friends on the Board.

**Reverend Sirico:** I really appreciated the insight into the great moral dilemma that you were confronted with. I could just see that boardroom and the cigar smoke curling in the air. But, the one question I had was when you got back from lunch and you saw the stock, did you sell your shares and then go into that meeting?

**Todd Kahn:** If I did then Karl in the audience would've had to defend me, and fortunately I never had to retain Karl.

**Reverend Sirico:** Let me just address two of Professor Mitchell's points. First of all, I disagree that stockholders don't behave as owners. I think they are owners in every real and, more importantly, moral sense of the word. It is their income, their future that they have invested. They have a moral right over that investment, over that property. I think they are behaving when they look for increased yield in the valuation of their stock, that that is what a property owner does. Whether it's stock of a house that you're renting to somebody or any other good or service that you're investing in, you want to see that it's doing something rather than just staying there. So, I think that's a very vague notion that they're not owners in any real sense of the word. Secondly, maybe I could propose this as a point of reconciliation as it were, and maybe there's something in the law that prevents this. What would prevent having competitive models operating? In other words, corporations as they currently exist, and then corporations with self-perpetuating boards of directors with no quarterly reports? I think that would be a far better thing than some blanket legislation that mandates certain things simply because stockholders have various priorities and goals that they're operating under and there's no one who can say to this family or that family that you can't drop out now. You can't maximize profit now for the particular reasons and priorities that you have in your

home.

**Professor Mitchell:** I think that's an interesting solution in some respect, I suppose, except for the SEC laws which mandate the reporting and the corporate statutes which mandate the annual elections, I don't see any reason why you couldn't come up with some sort of compromise by amending laws to permit corporations to choose to do those things. The problem that I see, in some respect it's a problem analogous to a problem that already exists, one could answer my entire argument by saying, "The business judgment rule which is the director's standard of behavior gives him wide latitude to behave morally. They're free to behave morally now, so what are you talking about?" You know, despite the structure and everything else there's no reason why they couldn't behave morally. The point is that in the current market environment, the competitive pressures are such that if you don't short-term price maximize you are going to find yourself on the street. So that even though the latitude exists, you don't have the freedom to—without being punished in the short-term, at least, if not losing your job—the freedom to invest in the long-term which might affect stock prices in the short-term. If you were to have a system of competing models of the corporation, you probably would wind up with much the same thing unless you change investors' psychology.

This is actually the global point that bothers me so much. What you see throughout much of Western Europe, much of Eastern Europe, and the emerging economies as well, are the pressures of American capital changing systems of corporate governance that have worked in those countries. Now, obviously the countries under communism may or may not, but they have no existing capitalist model of the corporation. They do have cultures that more or less emphasize the rather individualistic way American systems are set up. But, for example, Germany is a society in which the corporation has long been viewed as serving the public. Stock price is not the principle concern. France is sort of a hybrid, but also this idea of the corporation as public service is a very important view. The influx of American institutional capital in American investment banks is rapidly changing that so that the models aren't in a position anymore to compete because, although they might have been long-term successful models, and many of them have proven themselves to be long-term—Daimler-Benz now owns one of our three biggest companies—they're being forced to conform to American ways of thinking about the world which is not necessarily a good thing. So, I'm not confident that having competing models would necessarily result in the best ultimate end.

**Reverend Sirico:** Well, you know that this more social notion that you allude to in Germany and France, I know France better than Germany. The remarkable thing that strikes me about European business is you're right, they do have a kind of rhetoric and a sensibility of their kind of aristocratic obligations to society and all that. But, in terms of involvement in society and in culture, I find American corporate involvement far more pervasive in reality, may be not in rhetoric, but in reality, far more involved in the social and civic life of people. Let me also put a question to you. If you went to not having quarterly reports, how would you handle the problem of transparency?

**Professor Mitchell:** Well, a corporation could certainly choose to report on a quarterly basis if it wanted to, and the Akerlove argument for lemons would exist. If you didn't report maybe the risk would be that you had something to hide and so it would affect your stock price which is why my preference is not to have reporting at all. It doesn't make it nontransparent. It just makes the reporting periods longer. If there were a material adverse event, or a material positive event, that could be disclosed as it now is mandated to be disclosed. If something that really did affect the value of the business happened, you'd disclose it. But, simple quarter-to-quarter changes, I don't see that that level of transparency is helpful. You'd still have analysts following the company, meeting with executives, and business press covering companies. That probably provides enough transparency. I'd like to ask a return question. When you say American social and civic involvement, what do you mean? I know that it's lovely that Texaco sponsors the Metropolitan Opera. That's important. That doesn't solve the problem of poverty in America. It doesn't make work meaningful as German co-determination and worker's councils or Japanese job circulation tend to make it more meaningful. So, when you say social and civic involvement, what are we talking about?

**Reverend Sirico:** Well, I am talking about the donations to the poor and cultural institutions. In the United States it's far easier to approach a corporate board for a donation for a soup kitchen or for some other endeavor than it is the corporations in Europe. I'm not sure that these quasi-utopian collectivist work-share things really are owned and enjoyed by the people who exist under those systems. I think it takes New York intellectuals to see that.

**Professor Fallone:** Now that you've been called a collectivist, I have to cut us off. I apologize. I regret that we're out of time because I've truly enjoyed our discussion. I want to thank our panel very much for doing an excellent job.