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I. Introduction

In comparison to the policies of the Carter Administration, federal funding for social programs in the United States during 1985 under the Reagan Administration is projected to drop by $38.5 billion.[1] The decline in government spending on social programs has increased the pressures on corporations to play a major role in charitable donations.[2] Possibly due in part to this pressure, charitable donations by corporations have increased. During 1983, American corporations gave $3.1 billion, up from $2.36 billion in 1980.[3]

While corporations are giving more to charity than ever before, some argue it is not enough.[4] The view held by proponents of increased corporate giving is that corporations are an important member of society and have a responsibility to improve that society. Others argue that it is not desirable for corporations to be major contributors to charity. Their argument is based on the notion that corporations should maximize profits and let shareholders make charitable decisions at the individual level with investment profits.

In this paper, I present some economic arguments concerning the role of the corporation in a free market system. Normative implications for corporate policy on charitable donations are developed. Second, I consider the implication of the analysis concerning the role the legal system should play in settling disputes over proper managerial goals and behavior relating to charitable activities.

The major conclusion of this study is that corporations should not be major contributors to charity. For a number of reasons, I argue it is better for corporations to maximize profits and have charitable decisions made at the individual shareholder level. Corporations may still have

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1 Simurda, The Giving Habits of Corporate U.S., Salt Lake City Tribune, Oct. 21, 1984 at F1, col. 4.

2 *Id.*

3 *Id.*

4 *Id.*

some proper role in contributing to charity—to the extent the contribution increases a firm's profits (e.g., through increased goodwill from customers and government).

While I argue that shareholder wealth maximization is the proper managerial goal, I do not suggest that the court system play a major role in assuring that managers follow this goal. The costs for managers having to demonstrate to a court that their actions are wealth-maximizing appear greater than the benefits. Evidence from other studies suggest that there are market mechanisms (e.g., the takeover market) which help to assure that managers maximize wealth. The court system would appear to have a role only when those market mechanisms fail.

This paper is organized as follows: In Section II, I present a discussion of some apparent attributes of the free market system. In Section III, I discuss non-wealth-maximizing goals, such as charity and social action, within the context of the free market system. In Section IV, I present arguments concerning the role of the legal system in the area of managerial goals and actions. The study concludes with a brief summary.

II. Attributes of a Free Market System

It is common to hear terms like "greed," "money hungry," and "profit maximizer" in describing the modern corporation, and these conjure up a variety of evil images. However, before we condemn the capitalistic system as being heartless and non-socially beneficial, we should first reflect on some of the positive and socially productive incentives produced by this system.

The goal of wealth maximization produces at least four socially productive incentives. First, it encourages corporations to seek more efficient and less costly means of production. Organizations which survive in a free market system are those that are able to deliver a given product at the lowest price to the market.[5]

Second, wealth maximization encourages firms to target resources towards the products and services which are most highly valued by the consumer. For example, if there is a shortage of personal computers and the price increases, corporations with a competitive advantage in this area have an incentive to increase computer production. Conversely, if the computer market is glutted with an over-supply, there is an incentive to shift production to more profitable products.

Third, the wealth-maximizing system attracts capital to investment projects and encourages necessary risk-taking. Shareholders are "residual claimants"; they receive the profits which remain after the other firm claimants are paid off. If firms did not attempt to maximize

[5] *See* Fama & Jensen, *Agency Problems and Residual Claims*, 26 J. L. & Econ. 327, 333 (1983).

wealth, there would be less of an incentive for investors to assume the risk associated with being a residual claimant.

Finally, the free market system encourages creativity and entrepreneurship. Within the system, individuals have a strong incentive to develop new products and to search for new markets.

Through the capitalistic system, countries like Canada and the United States generally have produced desired goods and services without central planning. At the same time, these countries have maintained a high standard of living for their citizens.

III. The Role of Corporate Charity in the Free Market System

I have lauded the wealth-maximizing system for being effective in channeling resources to their most productive end use and in encouraging efficient production. However, what about socially oriented concerns? Aren't social and charitable objectives something that should be addressed by the modern corporation?

While charitable activities are embraced by many individuals, it is not clear that corporations should place a major emphasis on supporting those activities. It is more efficient for corporations to focus on wealth maximization and to let shareholders make individual charitable contribution decisions. This is true for at least three reasons.[6]

First, wealth maximization increases the "size of the total pie." By focusing on this objective, more wealth is created and, therefore, more can be given to charity if shareholders so choose. Second, there is not likely to be unanimity among shareholders as to which charities should be beneficiaries. Contributing at the individual level eliminates this problem.

Finally (and perhaps most importantly), if corporations are making major decisions on charitable contributions, the socially beneficial incentives which the free market system creates may be distorted. In particular, investors may have to consider the charitable policies of a corporation, as well as its economic returns, in making investment decisions. This focus may limit the channeling of resources to their highest valued end use. Increased "investment boycotts" (similar to the consumer boycotts on lettuce and the products of companies involved in South Africa) are easy to envision. Non-wealth maximization also will reduce the incentives for risk-taking among investors. An investor is more likely to invest as a residual claimant in a company if the value of his claim is being maximized.

This discussion does not mean that corporations should not engage in any socially conscious activities. Some charitable activities may benefit the corporation in terms of customer, government, employee, and gen-

[6] *See* M. Friedman, Capitalism and Freedom (1962).

eral public relations. These benefits may translate into economic profits, making charitable decisions justifiable, wealth-increasing decisions. The American Law Institute ("A.L.I.") gives the following example.[7] An ongoing company decides to give to a retiring employee who has been with the company for a long time an annuity to help cover expenses during retirement. It is possible that such a decision can be justified on purely economic grounds. For example, the morale among existing employees may be increased by this action ("by a company who cares") and the employees may work harder, thus increasing profits. But the A.L.I., while acknowledging that wealth maximization should be the primary goal, also argues that some corporate charity is justifiable on a purely "humanitarian basis." I strongly disagree with this view. For instance, the A.L.I. gives the same example as cited above, except that the company is now being liquidated.[8] Clearly, the action cannot be justified based on increasing employee morale. The A.L.I. argues that the action may be justified on "humanitarian" grounds. In the example, the employee was not covered by any company pension plan and had worked for the company for a long time. Giving him the annuity might be considered the fair and decent thing to do.

I would argue that this action, without shareholder approval, is very "nonhumanitarian." Perhaps the shareholders, from whom the money is being taken to give to the employee, are in the same situation as the employee (i.e., about to retire without a pension plan). In such a case, the shareholders may have planned for their retirement by investing in the company. Now the money is being taken from them, without their consent, and being given to an employee who may or may not have been wise enough to plan for his retirement (he presumably knew it was coming). Regardless of the actual situations of the shareholders, it is their money and they should be allowed to choose what to do with it.

IV. The Legal System and Corporate Goals

Given this discussion, one might think that I would favor a hard-core interpretation—that management must be able to demonstrate to the courts that all of its acts are wealth-maximizing. On the contrary, I favor the more liberal interpretation that appears to exist currently: that "reasonable" charitable and ethical activities are permitted by law to be undertaken by corporations.

As noted above, some charitable and social acts may be conducted for wealth-maximizing purposes. The direct-dollar benefits for specific acts are hard to document. It would be unreasonable and overly costly for managers to demonstrate quantitatively the benefits in each case to a court.

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[7] Principles of Corporate Governance: Analysis and Recommendations § 2.01 (Tent. Draft No. 2, 1984).

[8] *Id.* at 36-40.

In addition, a strict enforcement of the goal of wealth maximization by the courts may encourage additional lawsuits by groups of shareholders who own few shares, and simply wish to harass management. The increased likelihood of lawsuits might make managers overly risk adverse (i.e., they may forego a wealth-increasing charitable decision in fear of a lawsuit). Also, the firm's costs for indemnification and insurance for managers may increase.

The important point is that the legal system is not the only mechanism which protects shareholders and encourages managers to maximize wealth. There are at least three sets of control mechanisms which help to discipline managers.

First, there are market control mechanisms. These market mechanisms include the takeover market[9] and the managerial labor market.[10] If managers sub-optimize, their companies may be taken over and the managers may be fired. Also, sub-optimizing managers are likely, in the long run, to command lower wages in the managerial labor market.

A second set of control devices consists of internal monitoring mechanisms. First, there is the board of directors which acts to monitor managerial performance. Second, there is monitoring among managers from the top down as well as from the bottom up. Not only do managers monitor those below them, but they, too, are being evaluated and monitored by their employees.[11]

A third control device is a contract within the firm. For example, many forms of management compensation contracts are performance-contingent.[12] This performance aspect presumably increases the incentive for managers to maximize wealth.

There is a growing body of empirical evidence which supports the importance of these control mechanisms in disciplining managers. These studies (which I will summarize) are all "event studies." In an event study, the researcher examines the stock price reaction to a specific event. Typically, the researcher collects a large sample of observations for a given event (e.g., merger announcements). Then, after controlling for the general stock market movements at the time of announcement, he examines the average stock market reaction to the announcement of the event. If the sample is sufficiently large, the effects of random components on the stock returns cancel out and the researcher is left with the average "abnormal" return around the event in question. The idea behind this procedure is that stock prices are "forward looking." The average stock market reaction to a given event consists of the market's

[9] *See* Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965).

[10] *See* Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295-302 (1980).

[11] *See id.* at 292-95.

[12] *See id.* at 304-05.

assessment of the effects that the event has on the long run earnings, and hence the value of the firm.

Table 1 presents a summary of the results of the event studies which have been conducted on the takeover market.[13] Average abnormal returns for the acquired firm in successful mergers, tender offers, and proxy fights are presented. In all three cases, the average abnormal return is large and positive. These findings are consistent with the notion that the takeover market is an important factor in monitoring managers.[14] When the resulting stock market reaction is strong and positive, one explanation for the price increase is that the takeover is occurring to replace the management of a poorly operated company.

Another important control device for managers may be compensation contracts which align the interests of the shareholders and managers. Table 2 presents average abnormal returns for firms increasing their incentive-based compensations for managers.[15] The table summarizes the results of studies concerning long-term incentive compensation plans and short-term bonus plans.[16] The average abnormal return in each case is positive and statistically significant. The findings are consistent with the hypothesis that incentive-based compensation plans are an important factor in motivating managers to work in the interest of shareholders.[17]

While the evidence suggests that these mechanisms are important in disciplining managers, other evidence suggests that managers may, on occasion, take action which harms shareholders. Table 3 presents average abnormal returns around two events which appear to isolate managers from market control mechanisms.[18] These actions include the elimination of cumulative voting and targeted share purchases/stand-still agreements ("greenmail"). In both cases the average stock return is negative. The evidence suggests that managers may not be disciplined perfectly to work for the shareholders' interests by control mechanisms. These findings also suggest that the court system may provide, in some

13 Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 7-9 (1983).

14 These results are also consistent with other hypotheses. The positive returns, for example, may be due to synergy gains from the merger.

15 Brickley, Bhagat & Lease, *The Impact of Long-Range Managerial Compensation Plans on Shareholder Wealth*, 7 J. ACCT. & ECON. 115, 128 (1985); Tehranian & Waegelein, *Market Reaction to Short Term Executive Compensation Plan Adoption*, 7 J. ACCT. & ECON. 131 (1985).

16 Long-term incentive plans are based on performance over several years, while short-term bonus plans are based on a one-year performance.

17 The findings may also reflect tax benefits through tax-motivated sharing plans or positive information conveyed to the stock market by the managers' actions; *see* Brickley, Bhagat & Lease, *supra* note 15, at 129. For evidence that incentive effects are important, see generally Bhagat, Brickley & Lease, *Incentive Effects of Stock Purchase Plans*, 14 J. FIN. ECON. 195 (1985).

18 Bhagat & Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J. L. & ECON. 339, 353-55 (1984); Dann & D'Angelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 J. FIN. ECON. 275, 290 (1983); *see generally* Bradley & Wakeman, *The Wealth Effect of Targeted Share Repurchases*, 11 J. FIN. ECON. 301 (1983).

cases, an alternative means of settling managerial/shareholder conflicts which are not controlled by market forces.

TABLE 1

AVERAGE ABNORMAL STOCK RETURNS FOR ACQUIRED FIRMS IN SUCCESSFUL TAKEOVER ATTEMPTS*

MERGERS	20%
TENDER OFFERS	30%
PROXY FIGHTS	8%

TABLE 2

AVERAGE ABNORMAL STOCK RETURNS FOR FIRMS INCREASING MANAGERIAL INCENTIVE-BASED COMPENSATION*

LONG-TERM COMPENSATION PLANS	2.4%
SHORT-TERM BONUS PLANS	3.1%

TABLE 3

AVERAGE ABNORMAL STOCK RETURNS FOR MANAGERIAL ACTIONS TO ISOLATE THEMSELVES FROM MARKET CONTROL MECHANISMS*

ELIMINATION OF CUMULATIVE VOTING	−1.57%
STANDSTILL AGREEMENTS/TARGETED REPURCHASES	−4.52%

* ALL REPORTED ABNORMAL RETURNS ARE STATISTICALLY SIGNIFICANT.

V. CONCLUSION

There is increasing pressure for corporations to increase their level of charitable donations. This paper presents several economic arguments against corporations playing a major role in charitable activities. It is argued that corporations should maximize wealth and leave charitable decisions to individuals.

It is further argued that the courts should not play a major role in assuring that managers maximize wealth. The costs of enforcement are likely to be larger than the benefits. In addition, there are several important control mechanisms which appear to help discipline managers. These market forces reduce the need for the court system to discipline managers. However, there is some evidence that these market control mechanisms do not work perfectly, leaving some role for the court system.