

# The Devil Made Me Do It: Replacing Corporate Directors' Veil of Secrecy with the Mantle of Stewardship

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## I. INTRODUCTION

For the past several decades, we have been assailed by the mantra that the duty of corporate directors is to maximize shareholder value, even if doing so adversely affects others who have a stake in the enterprise, such as employees, customers, suppliers, creditors, the local community, and the environment.<sup>1</sup> The emergence and persistence of this incantation is puzzling in light of the consensus that it is in society's best interest for individuals to behave ethically and to use the resources under their control in a responsible manner, which implies a more global view of rights and responsibilities. Among other things, behaving ethically and responsibly means considering not only the effects of one's behavior on oneself, but also the effects of that behavior on others. In addition, many espouse the doctrine of stewardship whereby the ownership and control of property, or the power to affect the lives and fortunes of others, implies a duty to use that property and power wisely, for the benefit of others.<sup>2</sup> Why, then, are good men and women encouraged to hang up their ethical hat at the boardroom door when they assume the mantle of directorship?<sup>3</sup>

This Article argues that the nature of the corporate form<sup>4</sup> coupled with

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1. See Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 429-30 (1998). Although thirty states have enacted legislation specifically authorizing directors to take all constituencies into account, see *infra* notes 118-21 and accompanying text, finance scholars and economists repeat this refrain. See *infra* notes 12-19 and accompanying text.

2. For example, John D. Rockefeller stated in a speech on July 8, 1941, "I believe that every right implies a responsibility; every opportunity an obligation; every possession, a duty." MICHAEL C. THOMSETT, A TREASURY OF BUSINESS QUOTATIONS 130 (1990). Rockefeller also asserted that "the power to make money is a gift from God . . . to be developed and used to the best of our ability for the good of mankind." Paul Johnson, *God's Gift to American Industry*, WASH. POST, June 7, 1998, at X1.

3. As one chief executive officer stated, "As CEO I have a duty to do what's best for the shareholders. I can't let my own sense of right and wrong get in the way." R. EDWARD FREEMAN & DANIEL R. GILBERT, JR., CORPORATE STRATEGY AND THE SEARCH FOR ETHICS 23 (1988); see also Appendix A.

4. As English essayist, Sydney Smith, noted two centuries ago, "You never expected justice from a company, did you? They have neither a soul to lose, nor a body to kick." LOUIS E. BOONE, QUOTABLE BUSINESS 224 (2d ed. 1999). Sir Edward Coke

an exclusive focus on shareholder value leads to economically and socially inefficient results. The “profit maximization” view of directors’ duties ignores the historical reasons why corporations were given special privileges, such as limited liability, by the state.<sup>5</sup> This narrow view should be replaced with a doctrine of stewardship that imposes a more comprehensive view of the corporation’s and directors’ responsibility to manage the vast resources held in corporate form.<sup>6</sup> This broader view is consistent not only with the values of a free market economy, but also with modern corporate jurisprudence. It also reflects modern organizational theory that emphasizes the importance of systems thinking, or thinking about the whole rather than just the parts.<sup>7</sup>

In the spirit of stewardship, transparency, and self-regulation, this Article recommends an additional securities disclosure requirement that public corporations disclose the impact of major corporate decisions on affected constituencies, including shareholders, employees, customers, suppliers, creditors, communities, governmental entities, and the corporation’s management. In this manner, this Article proposes to replace the veil of secrecy with the mantle of stewardship.

## II. ECONOMICS, ETHICS, AND CORPORATE GOVERNANCE

The modern theory of the firm dates to Ronald Coase’s insight that

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similarly asserted, “[Corporations] cannot commit treason, nor be [ ] outlawed, nor excommunicate[d], for they have no souls . . . .” *Case of Sutton’s Hospital*, 77 Eng. Rep. 960, 973 (K.B. 1907).

5. *See infra* Part IV.

6. Corporations account for nearly 100% of all national output. *See* RALPH ESTES, *TYRANNY OF THE BOTTOM LINE: WHY CORPORATIONS MAKE GOOD PEOPLE DO BAD THINGS* 86 (1996).

7. *See generally* PETER M. SENGE, *THE FIFTH DISCIPLINE: THE ART AND PRACTICE OF THE LEARNING ORGANIZATION* (1990). Senge maintains that, like the interconnection between rain, groundwater, and the sky,

Business and other human endeavors are also systems. They, too, are bound by invisible fabrics of interrelated actions, which often take years to fully play out their effects on each other. Since we are part of that lacework ourselves, it’s doubly hard to see the whole pattern of change. Instead, we tend to focus on snapshots of isolated parts of the system, and wonder why our deepest problems never seem to get solved. Systems thinking is a conceptual framework, a body of knowledge and tools that has been developed over the past fifty years, to make the full patterns clearer, and to help us see how to change them effectively.

*Id.* at 7. In discussing leverage, Senge asserts that “small, well-focused actions can sometimes produce significant, enduring improvements, if they’re in the right place.” *Id.* at 64.

firms exist as a substitute for more costly modes of transacting.<sup>8</sup> According to Coase, transaction costs of negotiating, contracting, transacting, coordinating, enforcing, and discharging rights and obligations under a set of contracts can be reduced by creating a firm that facilitates transactions between the consumers and suppliers of inputs.<sup>9</sup> Coase's insight has been extended by several finance and organizational scholars who view the firm as a set of interrelated contracts among the various suppliers of the factor inputs and the purchasers of the final outputs.<sup>10</sup> From this perspective, the firm's claimants go beyond stockholders to include employees, customers, suppliers, creditors, and communities.<sup>11</sup>

Despite this conception of the firm as a set of relationships, of which investors are just one subset, economists and finance scholars assume that the sole purpose of a corporation is to create shareholder value.<sup>12</sup> This assumption has created its own reality to the point where the assumption has become a prescription.<sup>13</sup>

Milton Friedman goes even further with the claim that maximization of shareholder profits is not only economically responsible, but also socially responsible. He expressed this "social responsibility" view in an article whose title conveys its thesis, *A Friedman Doctrine - The Social Responsibility of Business Is to Increase Its Profits*.<sup>14</sup> In the body of his article, Friedman elaborates as follows:

[A] corporate executive . . . has direct responsibility to his employers. . . . That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied

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8. See Bradford Cornell & Alan C. Shapiro, *Corporate Stakeholders and Corporate Finance*, 16 FIN. MGMT. 5, 5 (1987).

9. See *id.*

10. See, e.g., Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 783 (1972); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 307 (1976); OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 3-4 (1975); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 303 (1983); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 297 (1978).

11. See Cornell & Shapiro, *supra* note 8, at 5.

12. See PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 39 (1992).

13. See, e.g., JAMES C. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 3 (11th ed. 1998) ("The objective of a company must be to create value for its shareholders.").

14. Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32. For an earlier and condensed version of Friedman's argument, see MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 133-36 (1962).

in ethical custom.<sup>15</sup>

Friedman does not explain what he meant by the phrase "ethical custom," though in a different piece he states the caveat differently, saying that the profit-maximizing goal should be pursued while "stay[ing] within the rules of the game," explained as "open and free competition, without deception or fraud."<sup>16</sup>

Friedman argues against any suggestion that managers have an obligation to use corporate resources to promote social goals or moral values in ways not required by law or ethical custom.<sup>17</sup> Providing employment, eliminating discrimination, reducing pollution, preventing inflation, and fighting poverty are mentioned by Friedman as examples of such goals.<sup>18</sup> Friedman further argues that by promoting social goals with corporate resources, corporate management is engaging in de facto "taxation without representation."<sup>19</sup>

Adolph Berle and Gardiner Means anticipate this argument by contending that maximization of shareholder profits is the only standard that can prevent irresponsible management.<sup>20</sup> The phenomenological genesis of this irresponsibility, according to Berle and Means, was the creation of passive ownership coupled with the strong, separate control that results from the sheer size of modern corporations.<sup>21</sup> This passive ownership would by its nature lead to inefficient use of the property.<sup>22</sup> As Berle and Means explain, were the owners of an enterprise to manage

15. Friedman, *supra* note 14, at 33; *see* FRIEDMAN, *supra* note 14, at 133.

16. FRIEDMAN, *supra* note 14, at 133; *see* Friedman, *supra* note 14, at 32; *see also* CHRISTOPHER D. STONE, *WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR* 75-76 (1975) (discussing caveat).

17. *See* Friedman, *supra* note 14, at 33.

18. *See id.* By social goals, then, Friedman appears to refer to every value not explicitly protected by law or ethical custom.

19. *Id.* at 122.

20. *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 122-23 & n.1 (rev. ed. 1932) (citing pervasive mismanagement of various railroads between 1900 and 1915 as evidence that management, left to its own devices, would choose personal profit even at cost of bankrupting corporation). The book was the product of a collaboration that started in 1928, when Adolf Berle, Jr. was appointed research director of a project funded by the Social Science Research Council of America to investigate the impact of corporations on American society. Gardiner C. Means was hired to conduct a careful statistical analysis of the growth of large corporations. *See* Robert Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 26 *J.L. & ECON.* 273, 274 (1983) (summarizing the history behind Berle and Means' collaboration).

21. *See* BERLE & MEANS, *supra* note 20, at 66.

22. *See id.* at 307-08.

the enterprise, they would have the classic profit motive to encourage efficient behavior—if they are not efficient, they do not prosper.<sup>23</sup> If owners are separate from managers, and the managers have effective control, then managers have less economic incentive to be efficient because profits are turned over to the owners.<sup>24</sup> Thus, they conclude, the only way to ensure that managers behave efficiently is to create an absolute duty to maximize shareholder profits.<sup>25</sup>

The essence of Berle’s and Means’ argument is that even if it might be socially desirable to consider other constituencies, it is not practical because the result is a situation in which directors are accountable to no one:

[Y]ou can not abandon emphasis on “the view that business corporations exist for the sole purpose of making profits for their stockholders” until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else. . . . Otherwise the economic power now mobilized and massed under the corporate form . . . is simply handed over, weakly, to the present administrators with a pious wish that something nice will come out of it all.<sup>26</sup>

The substance of this argument was articulated by Stanford Law School Professor Joseph Grundfest, then a Commissioner of the Securities and Exchange Commission (SEC), in a letter to Mario Cuomo, Governor of New York, with respect to New York’s proposed constituency legislation, which granted directors the right to consider other constituencies in their corporate deliberations:

[T]he grant of authority without accountability raises the real and present danger that boards will use [the constituency statute] as a fig leaf. Specifically, [the statute] may allow boards to rationalize decisions that they would not otherwise support in the name of constituencies who are powerless to monitor or challenge the actions that are purportedly taken in their interest.<sup>27</sup>

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23. See *id.* at 307-08, 345-51.

24. See *id.* at 345-51. This concept was not new. Adam Smith suggested:

[D]irectors of . . . companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnership frequently watch over their own. . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 700 (Modern Library 1937) (1776), quoted in Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1059 n.128 (1993).

25. See BERLE & MEANS, *supra* note 20, at 354.

26. Adolph A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367-68 (1932) (citation omitted).

27. Letter from Joseph Grundfest, Commissioner, Securities and Exchange Commission (SEC), to Mario Cuomo, Governor of New York (June 6, 1989), quoted in

The essence of these three arguments is that corporations must maximize shareholder profits because it is (1) efficient (economically responsible), (2) fair (socially responsible), and (3) practical (the only standard that will work). All three arguments, however, are victims of assumptions that do not comport with the realities of modern corporations.

### A. Market Failures

The efficiency, fairness, and practicality arguments share the classical economic assumption that there are no externalities in the system that would prevent efficient market outcomes. An externality is an action of one party that affects the welfare of others.<sup>28</sup> When externalities are present, efficient market outcomes may not be possible.<sup>29</sup> Toxic discharge from a nearby factory, which spoils the neighbors' environment and threatens their health, is an externality because it affects people and firms other than those making the decisions. Market inefficiencies occur to the extent that decision-makers do not take these externally imposed costs into account in their decision making.

A singular goal of profit maximization creates the potential for market inefficiencies by encouraging externalization of costs while retaining the benefits of corporate actions. A case in point is the 1986 leveraged buyout ("LBO") of Safeway. Prior to the LBO, Safeway's motto was "Safeway Offers Security."<sup>30</sup> This implicit promise of security induced Safeway employees to remain loyal to Safeway and to dedicate their working lives to the company. After the LBO, the motto was replaced with language that included "Targeted Returns on Current Investment."<sup>31</sup> The discharge of sixty-three thousand managers and workers ensued through layoffs and store sales.<sup>32</sup> Many thousands of Safeway employees wound up either unemployed or forced into the part-time

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Ron S. Davids, *Constituency Statutes: An Appropriate Vehicle for Assessing Transition Costs?*, 28 COLUM. J.L. & SOC. PROBS. 145, 178 (1995). Constituency statutes are discussed later. See *infra* notes 118-21 and accompanying text.

28. See MILGROM & ROBERTS, *supra* note 12, at 75.

29. See *id.* at 75; see also DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 202-205, 288-91 (1990).

30. Susan C. Faludi, *The Reckoning: Safeway LBO Yields Vast Profits but Exact a Heavy Human Toll*, WALL ST. J., May 16, 1990, at A1.

31. *Id.*

32. See *id.*

work force.<sup>33</sup> More than a year after the layoff, nearly 60 percent of former Safeway employees in Dallas still had not found full time employment.<sup>34</sup> Safeway employees saw their loyalty rewarded with a severance package that included one-half week's salary per year worked (up to eight weeks) and health benefits for two weeks.<sup>35</sup>

Prior to the LBO, Safeway had impressive financial results and was trimming expenses through controlled attrition and target reductions.<sup>36</sup> Thus, any value captured by shareholders was in large part at the expense of employees, suppliers, customers, and communities that served and were served by Safeway.<sup>37</sup> A purely legalistic view would suggest that these employees had no contractual right to continued employment.<sup>38</sup> However, even to the extent that any individuals had legal claims against Safeway for a breach of implied contract or breach of the covenant of good faith and fair dealing, the transaction costs of pursuing such claims were prohibitive because of the inability to recover punitive damages in contract cases.<sup>39</sup>

Even operations within legal and ethical constraints may have wide-ranging economic consequences not captured by narrowly defined values. As Stanford economists Paul Milgrom and D. John Roberts explain:

A firm's decisions about the design and placement of its factories can affect community housing values, traffic, and environmental quality; its choices of suppliers can affect the distribution of wages and profits among the potential suppliers; and its pricing policy affects both competitors and customers. . . .

With incomplete markets and imperfect bargaining, the way various interests are weighed in decisions can have consequences for the efficiency of the economic system that must not be ignored. For example, in the plant closing decision, investments by workers and others in houses near the factory may lose much of their value if the factory were to close. Such investments are cospecialized with the plant. Efficiency then requires that the homeowners' interests be given some weight in this decision. Similarly, the workers may have invested in firm-specific human capital that is, by its very nature, cospecialized with the plant. Closing the plant destroys the value of these investments. The township as a whole may have invested in roads, sewage-

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33. *See id.*

34. *See id.*

35. *See id.*

36. *See id.*

37. *See id.*

38. In the United States, absent an express or implied employment agreement, employees are employed at will and may be terminated without cause. *See* CONSTANCE E. BAGLEY, *MANAGERS AND THE LEGAL ENVIRONMENT: STRATEGIES FOR THE 21ST CENTURY* 422 (3d ed. 1999) (discussing the at-will doctrine and judicially created exceptions thereto).

39. Safeway did pay \$8.2 million to settle a wrongful termination class action suit and \$750,000 to settle an age discrimination suit, but these damages are not representative of the full externalities imposed on all constituencies by Safeway's actions. *See* Faludi, *supra* note 30, at A1.



treatment facilities, schools, and other assets whose value depends on the plant's continued operation.<sup>40</sup>

Although it can be argued that all such interests should be considered before any investments are made by any stakeholders, such a legalistic approach to transactions is neither realistic nor would it necessarily generate the most efficient result, because of the enormous transaction costs that would be incurred in bringing all affected parties to the bargaining table and negotiating all material terms with each of them.<sup>41</sup> These interests are, nonetheless, real, and have bestowed benefits on the corporation. Often, significant resources are committed by these stakeholders based on both explicit and implicit (though probably not legally enforceable) promises made by organizations.<sup>42</sup> This Article's argument is simply that management should not be able to unilaterally appropriate resources belonging to nonshareholder constituencies to enhance shareholder value. To do so, without at least acknowledging what they are doing, is misappropriation.

Jerry Sterner, businessman turned playwright, describes these situations as follows:

Just talk about restructuring as positive and investors will buy it . . . It's really an admission of failure: We're closing this operation and firing these people so that we can stay in business. But we ain't paying the price. The employees, the community, they pay the price. Meanwhile, the executives' salaries go up and their benefits increase because they are making the "hard decisions."<sup>43</sup>

Nevertheless, Friedman's formulation of strict duties of management compels these results by stating that any internalization of externalities to favor a party that has no claim under law or custom is contrary to the interests of the shareholders and therefore should be prohibited.<sup>44</sup>

40. MILGROM & ROBERTS, *supra* note 12, at 318-19.

41. *See id.* at 303-05.

42. Cornell and Bradford argue that "many of the claims issued by management to non-investor stakeholders take the form of tacit promises of continuing supply, timely delivery, product enhancement, and job security." Cornell & Shapiro, *supra* note 8, at 13. When promises are not kept, due to production delays, product recalls, litigation, or the like, shareholder wealth may decline more than the actual cash outlays involved because it will be harder for the firm to sell implicit claims (e.g., quality control). *See id.* Indeed, "stakeholders may even require that tacit 'understandings' be replaced by explicit contracts." *Id.*

43. Margot Slade, *We Forgot to Write a Headline. But It's Not Our Fault*, N.Y. TIMES, Feb. 19, 1995, §3, at 5.

44. *See supra* notes 14-19 and accompanying text.

More importantly, imperfections in mechanisms for internalizing and redirecting social impacts to the shareholder bottom line result in incentives to “cheat” in the short-run in order to improve shareholders’ short-term return. These actions in turn impose social costs that may, in the long-run, result in the imposition of more rigid legal and regulatory controls, which may more than offset the short-term gains to cheaters and harm all market participants in the process.<sup>45</sup> Even financier George Soros, who has earned hundreds of millions of dollars managing hedge funds to buy securities, currencies, and derivative investments, warns that “the untrammelled intensification of laissez-faire capitalism and the spread of market values into all areas of life is endangering our open and democratic society.”<sup>46</sup>

These incentives to cheat are all the more powerful in the modern industrial corporation, which not only separates decision-making power from the full economic consequences of the firm’s decisions, but also insulates shareholders from accountability for the consequences of those decisions. The sole proprietor of a hog feed lot will, in all probability, control its odors and contain its effluent so that both his or her appetite and drinking water are protected. The corporate manager is unlikely even to consult his or her shareholders, who in all probability live thousands of miles away. Moreover, because they can remain anonymous, shareholders are less likely to care so much either. At most, the decision is likely to directly affect only a small minority of the firm’s owners.

### B. *Economic Efficiency and Information*

The efficiency, fairness, and practicality arguments also assume that all material information is freely available in the market place. This assumption is essential because efficient choice requires timely and correct information regarding tastes, technologies, and resources.<sup>47</sup> Information, however, is neither free nor necessarily available. Moreover, the corporate form changes the availability and impact of

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45. See *supra* note 42. As Berkeley Professor Edwin Epstein stated, “being ethical heads off the law.” Andrew Stark, *What’s the Matter with Business Ethics?*, HARV. BUS. REV., May-June 1993, at 38, 39. The advent of the Occupational Safety and Health Act, the National Labor Relations Act, the Clean Air Act, and the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or Superfund) are examples of the consequences of firms not adequately considering other constituencies. As David Grier of the Royal Bank of Canada noted in 1989, “I do believe the community eventually catches up to the bad guys.” David Grier, Speech (Sept. 19, 1989), *quoted in* HENRY EHRLICH, *THE WILEY BOOK OF BUSINESS QUOTATIONS* 146 (1998).

46. George Soros, *The Capitalist Threat*, ATLANTIC MONTHLY, Feb. 1997, at 45.

47. See MILGROM & ROBERTS, *supra* note 12, at 26.

information in several ways.

Because people are highly social, much of their behavior is mediated by social expectations, both in the short and long run. Indeed, although there is evidence that some behaviors are "hard wired," much of an individual's ethos is socially inculcated, and to some degree is socially plastic, or subject to change due to social pressures.<sup>48</sup> An individual is most comfortable when operating within a social situation that is congruent with his or her internal value system, but can tolerate minor excursions from that situation.<sup>49</sup> Similarly, most individuals can tolerate minor discrepancies between their behavior and social expectations.<sup>50</sup> Ultimately, however, an individual who is aware that his or her behavior does not comport with social expectations becomes extraordinarily uncomfortable and must act to reduce that distress, either by modifying the behavior, withdrawing from the situation, or deploying some other psychological mechanism such as denial or rationalization.<sup>51</sup>

The influence of social situations has been found to be enormously important in the interpretation of information, with significant differences in behavior induced by the introduction of either neutral or biased participants in a setting requiring action.<sup>52</sup> In the context of market transactions among individuals, or even large organizations with identifiable owners, these social phenomena tend to create substantial safeguards against attempts to internalize gains while externalizing costs. People who persist in dumping their garbage in others' living rooms will experience a variety of social consequences, ranging from subtle suggestion to social ostracism, if not outright retaliation. The absentee and anonymous shareholder has little likelihood of experiencing such influences. Thus, important information is denied owners of corporations because of their social distance from the harm. This problem is even more acute when investments are made in remote countries far away from the investors' direct knowledge.

This social distance also affects how corporate managers receive, construe, and act upon information. In the Ford "Pinto" case, for example, managers made a decision about whether to produce the vehicles without safety modifications based on written estimates

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48. See LEE ROSS & RICHARD E. NISBETT, *THE PERSON AND THE SITUATION: PERSPECTIVES OF SOCIAL PSYCHOLOGY* 27-58 (1991).

49. See LEON FESTINGER, *A THEORY OF COGNITIVE DISSONANCE* 188-96 (1957).

50. See *id.*

51. See *id.* at 264-65, 271.

52. See ROSS & NISBETT, *supra* note 48, at 27-58.

presented by engineers and accountants.<sup>53</sup> Together, they construed the situation as one requiring a classic cost-benefit analysis;<sup>54</sup> this led to the only “sensible” decision—not to make a four to eight dollar alteration.<sup>55</sup>

Harley Copp, a former Ford engineer and executive in charge of the crash testing program, testified that the highest level of Ford’s management made the decision to go forward with the production of the Pinto, knowing that the gas tank was vulnerable to puncture and rupture at low rear impact speeds creating a significant risk of death or injury from fire and knowing that “fixes” were feasible at nominal cost. He testified that management’s decision was based on the cost savings which would inure from omitting or delaying the “fixes.”<sup>56</sup>

Had the social environment been different or the directors been forced to think about the broader impact of their decision, other factors might have been considered. Such factors include: what would be the moral or ethical thing to do in light of the impact their decision would have on the individuals who would surely die and the toll on their families; the damage to Ford’s reputation;<sup>57</sup> and the legitimacy of American corporations.

Ford’s desire to increase its bottom line at the expense of the consumers was made possible by the lack of information that was available in the market place. Had Ford revealed the design defect to the public with the cost of remediation, consumers could have made the choice between a vehicle that was a fiery death trap when rear-ended at low speeds<sup>58</sup> at a price of X dollars, and a vehicle that would withstand such collisions for X+8 dollars; it is fair to say that consumers would have paid the extra eight dollars.<sup>59</sup>

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53. See *Grimshaw v. Ford Motor Co.*, 174 Cal. Rptr. 348, 361-62 (Ct. App. 1981). Similarly, in July 1999, a Los Angeles jury ordered General Motors (GM) to pay \$4.8 billion in punitive damages and \$107.8 million in compensatory damages to six people who were burned in 1993 when their 1979 Chevrolet Malibu exploded after its fuel tank was ruptured in a rear-end crash. See Jeffrey Ball & Milo Geyelin, *GM Ordered by Jury to Pay \$4.9 Billion*, WALL ST. J., July 12, 1999, at A3. A memo written by a GM engineer in 1973 estimated that each burn death from a fuel-related fire in a GM vehicle cost the company \$200,000, or \$2.40 for every GM vehicle then on the U.S. roads, but noted that “a human fatality is really beyond value, subjectively.” *Id.* Following the decision, one of the jurors asserted, “It was a business decision that [GM] made to go ahead and fight lawsuits from fuel-set fires rather than fixing something that wouldn’t have cost them much at all.” *Id.* (alteration in original).

54. See *Grimshaw*, 174 Cal. Rptr. at 363.

55. These were the estimates of Ford’s engineers. See *id.* at 361. Plaintiffs’ experts estimated the costs of alterations to be anywhere from \$1.80 to \$15.30, depending on the methods used. See *id.*

56. *Id.* at 361.

57. A study found that the drop in shareholder wealth accompanying drug and automobile recalls was much greater than the direct costs of the recall, including expenses for public relations. See Cornell & Shapiro, *supra* note 8, at 13.

58. See *Grimshaw*, 174 Cal. Rptr. at 385.

59. Ford may also have been on firmer ground had it argued that it made a tradeoff between safety and price, which are both benefits to the consumer. It was clear from the

Some firms have attempted to design mechanisms to provide information about the integrity of the other party to a transaction to ensure that one's reputation is adversely affected by inappropriate behavior. For example, eBay, the leading Internet auction company, has set up a method for buyers to provide feedback regarding sellers to other potential buyers. eBay's "Tips for buyers" state:

If you see a number in parentheses next to a seller's UserID, that number is the seller's *feedback rating*. This rating is a summary of the comments that other users have made about this user. You can click on that number to take you to the actual comments, [sic] people have left about this user. It is a good idea to get to know a person's reputation, especially before you send money.<sup>60</sup>

This type of formal mechanism for feedback is rare in the corporate world, however.

### *C. Shareholder Preferences*

Implicit in the arguments in favor of a standard of maximization of shareholder value is the assumption that shareholders are willing and able to evaluate what the corporation is doing. If the corporation's actions do not comport with the shareholder's personal ethics, the shareholder can take the "Wall Street Walk"—sell that company's stock and buy stock in a company that better exemplifies the shareholder's ethical values.

However, this approach is unsatisfactory and generally unworkable for several reasons. First, it assumes that shareholders are provided with sufficient information regarding the corporation's decisions affecting other constituencies, which is not currently legally required. Second, it is not economically efficient for a shareholder with a small stake in a number of companies to do the sort of due diligence and research necessary to make an informed judgment about whether each company in the portfolio is acting in a socially responsible manner. Third, with the surge in 401(k) retirement plans and investments in mutual funds, an individual shareholder may have little or no control over which companies the plan fiduciary or fund manager selects for the portfolio.<sup>61</sup>

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evidence, however, that Ford made a tradeoff between safety and its own bottom line, with no thought as to the ramifications for the consumer.

60. *eBay Tips for Buyers* (visited Apr. 4, 1999) <<http://pages.ebay.com/aw/tips-buy.html>>.

61. See Nell Minow, *Value and Values: Whom Should Corporations Serve?*, in *RESPONSIVE COMMUNITY* 39, 42 (1996). Some retirement plans permit employees to

Fourth, fund managers of pension funds subject to the Employee Retirement Income Security Act of 1974<sup>62</sup> may be legally constrained to make decisions that maximize the return for plan beneficiaries, even if the beneficiaries themselves might (had they been asked) prefer more socially responsible investments. Thus, for example, a fund manager may not vote the plan's shares in favor of a shareholder proposal to stop doing business in countries using slave or prison labor, both because of the fear that the proposed action might adversely affect corporate profits and shareholder return, and because the fund manager does not know (and has no way to ascertain) what the plan beneficiaries would prefer.<sup>63</sup> Friedman assumes that it will be the desire of the corporate owners or their representatives to make as much money as possible, while conforming to law and ethical custom.<sup>64</sup> This is offered as dictum without entertaining the possibility either that corporate owners may wish to make as much money as possible without regard for law or ethical custom (the "robber baron" model),<sup>65</sup> or that they may instead prefer profit "sufficiency" rather than maximization (the Ben and Jerry's model).<sup>66</sup>

A fifth problem also exists. Many institutional investors (such as California Public Employees Retirement System ("CalPERS")) may have invested in accordance with a stock index (such as the S&P 500) and thus be incapable of taking the Wall Street Walk. Or a fund may own so many shares of an individual company that it cannot liquidate

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elect to have plan contributions invested in so-called "socially responsible" or "green" funds. But such funds often utilize very gross criteria for determining what is socially responsible that may be both over and under inclusive (e.g., sale of tobacco products or use of nuclear power). They may not exclude companies with far more subtle social responsibility issues, and they may exclude companies that are responsible members of an essential yet unpopular industry, such as oil and gas production. See, e.g., Paul Farrow, *Family Finance: Don't Be Green About Ethical Investment*, SUNDAY TELEGRAPH (LONDON), June 13, 1999, at 14. A Web site sponsored by the Council on Economic Priorities provides shareholders with ratings about 320 public companies' records on certain social issues. See *Council on Economic Priorities* (visited Nov. 11, 1999) <<http://cepnyc.org>>.

62. 29 U.S.C. §§ 1101-1381 (1994 & Supp. III 1997).

63. The Internet may provide a cheap and easy way to obtain more information regarding beneficiaries' preferences. For example, the Shareholder Activism Center is a new Web site developed by the Interfaith Center on Corporate Responsibility, a coalition of more than 200 religious institutional investors. The site provides investors and others a forum for sharing their views on more than 200 shareholder resolutions involving social issues and such topics as the environment and corporate accountability. See *Shareholder Activism Center* (visited Nov. 11, 1999) <<http://www.socialfunds.com>>.

64. See Friedman, *supra* note 14, at 33.

65. See Louise Shelley, *Post-Soviet Organized Crime and the Rule of Law*, 28 J. MARSHALL L. REV. 827, 833 (1995).

66. See, e.g., MARY SCOTT & HOWARD ROTHMAN, COMPANIES WITH A CONSCIENCE: INTIMATE PORTRAITS OF TWELVE FIRMS THAT MAKE A DIFFERENCE 46-61 (1992).

the position without driving down the stock price and thereby reducing the overall return on investment.<sup>67</sup>

#### D. *First Do No Harm*

Friedman primarily discusses vague social goods as advocated by undefined constituencies. This Article agrees with Friedman that it is not reasonable, or necessarily socially beneficial, for directors to mount their white chargers and engage in battle against general social woes. This was the message of *Dodge v. Ford Motor Co.*,<sup>68</sup> in which the court distinguished between “an incidental humanitarian expenditure of corporate funds for the benefit of the employ[ee]s, like the building of a hospital for their use and the employment of agencies for the betterment of their condition” (a permissible use of corporate funds), and a “general purpose and plan to benefit mankind at the expense of others” (an impermissible use).<sup>69</sup> However, even Adam Smith, long-revered proponent of the “invisible hand” and laissez-faire policies, argued only that “self-interested behavior *may* result in socially desirable outcomes *if* it is moderated by self-control and socially responsible adherence to other social rules and codes of behavior (Smith’s ‘self-command’ and ‘sense of duty’).”<sup>70</sup> Indeed, Smith’s first major work, *The Theory of*

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67. These dynamics prompted large pension funds, such as CalPERS, to try to improve performance by pressuring the independent directors to fire non-performing Chief Executive Officers (as happened at GM, American Express, Westinghouse, and International Business Machines). See CONSTANCE E. BAGLEY & DAVID J. BERGER, PROXY CONTESTS AND CORPORATE CONTROL: STRATEGIC CONSIDERATIONS A-27 (Bureau of Nat’l Affairs, Inc., Corporate Practice Series Portfolio No. 69, 1997).

68. 170 N.W. 668 (Mich. 1919).

69. *Id.* at 684. The court asserted that a “business corporation is organized and carried on primarily for the profit of the stockholders,” and ruled that “it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others.” *Id.* As shown *infra* Part III, however, to the extent that *Dodge* is read to preclude consideration of adverse effects of corporate actions on nonshareholder constituencies, *Dodge* is not in accord with modern jurisprudence.

70. Mathew B. Forstater, *Adam Smith Ain’t No Gordon Gekko* (visited Nov. 10, 1999) <<http://econwpa.wustl.edu/~tchecndg/archive/1995/2650.html>>; see Soros, *supra* note 46, at S1. Soros stated:

Adam Smith himself combined a moral philosophy with his economic theory. Beneath the individual preferences that found expression in market behavior, people were guided by a set of moral principles that found expression in behavior outside the scope of the market mechanism. Deeply rooted in tradition, religion, and culture, these principles were not necessarily rational in the sense of representing conscious choices among available alternatives.

*Moral Sentiments*, laid out the institutional framework necessary for a “society of perfect liberty” advocated in *The Wealth of Nations*.<sup>71</sup>

Just as Smith assumed the existence of responsibilities and duties embedded in an institutional framework, this Article contends that directors have a duty to consider the cadre of well-defined constituencies whose existence and interests are inextricably intertwined with the corporation. In particular, this Article concurs with Richard Nunan’s assertion that corporations have a minimal moral obligation to avoid creating social injury and to correct any past social injuries for which they can be held directly responsible.<sup>72</sup>

Edward Simon, president of Herman Miller, goes even further, stating, “Why can’t we do good works at work? . . . . Business is the only institution that has a chance, as far as I can see, to fundamentally improve the injustice that exists in the world.”<sup>73</sup>

Indeed, this Article argues that firms seriously considering ways to minimize the adverse effects of their decisions on other constituencies often can do so without requiring significant sacrifice by their shareholders. In a multi-billion dollar transaction, such as the Safeway LBO, the marginal cost (as a percentage of the deal and its expected returns to investors) of giving employees more generous severance might have been relatively small, yet its effect on the workers who were laid off could have been the difference between being able to make ends meet and not.

#### *E. The False Dichotomy Between Social Responsibility and Shareholder Value*

The arguments for maximization of shareholder value also assume that there is an inherent conflict between shareholder value and social responsibility. Friedman, for example, suggests that it approaches fraud

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*Id.*

71. Forstater, *supra* note 70. As Sylvia Nassar wrote in the *New York Times*, “Adam Smith Ain’t No Gordon Gekko.” Sylvia Nasar, *Defending the Father of Economics: Adam Smith Was No Gordon Gekko*, N.Y. TIMES, Jan. 23, 1994, at 6E. Gekko was a ruthless securities trader in the film *Wall Street* who asserted that “greed is good.” *Id.*

72. See generally Richard Nunan, *The Libertarian Conception of Corporate Property: A Critique of Milton Friedman’s View on the Social Responsibility of Business*, 7 J. BUS. ETHICS 891 (1988); see also Ira M. Millstein, *The Responsible Board*, 52 BUS. LAW. 407 (1997), in which Millstein argues that the “polestar” for board responsibility is enhancing shareholder value, but a board is properly concerned with “extrinsics” or negative effects on nonshareholder constituencies. For example, he suggests that even if a board concludes that employee layoffs are necessary to enhance shareholder value, the board should try to make them as painless as possible. See *id.* at 413-14.

73. SENGE, *supra* note 7, at 5.



to call profit-maximizing behavior “socially responsible.”<sup>74</sup> Indeed, some ethicists argue that a firm may not properly characterize any behavior as ethical or socially responsible if the decision will also, at least in the long term, maximize shareholder return.<sup>75</sup>

This Article rejects the notion that an act is socially responsible only if it hurts. Rather, it agrees with Ralph Larson, Chairman and Chief Executive Officer of Johnson & Johnson, who, when asked whether he would rather be a good corporate citizen or maximize profits, replied, “Yes.”<sup>76</sup> He rejected what he termed the “tyranny of the ‘or’” and refused to treat social responsibility and profit maximization as mutually exclusive.<sup>77</sup> Similarly, Gerald Levin, Chairman of Time Warner Inc., explained in his letter to shareholders, “These values [diversity, respect, and integrity] aren’t about feeling good. . . . They’re about performing well . . . there is an inseparable link between our values and the value creation we offer our shareholders.”<sup>78</sup>

Recent empirical research on the relationship between the social performance and the financial performance of corporations supports these views. Lee E. Preston, of the University of Maryland at College Park, and Douglas P. O’Bannon, of Webster University, analyzed sixty-seven companies that were rated in every corporate reputation survey conducted by *Fortune* magazine from 1982 to 1992 and for which the relevant financial information was available.<sup>79</sup> To arrive at its rankings, *Fortune* surveyed several thousand executives, directors, and analysts covering the largest firms in a number of industries.<sup>80</sup> The *Fortune* surveys gathered data on corporate reputation along eight dimensions, including Community and Environmental Responsibility (CERESP), Ability to Select and Retain Good People (PEOPLE), and Quality of Products and Services (PSQ).<sup>81</sup> Preston and O’Bannon took these three

74. Friedman, *supra* note 14, at 33.

75. See Stark, *supra* note 45, at 38-44 (quoting a participant in the symposium “Do Good Ethics Ensure Good Profits?” sponsored by the Business and Society Review: “To be ethical as a business because it may increase your profits is to do so for the entirely wrong reason.”). See also Dean Rieck, *Balancing Ethics and Profitability*, DIRECT MARKETING, Oct. 1998, at 53, 53-56.

76. Millstein, *supra* note 72, at 408-09.

77. *Id.*

78. Eben Shapiro, *Time Warner Defines, Defends System of Values*, WALL ST. J., Apr. 9, 1999, at B1.

79. See Lee E. Preston & Douglas P. O’Bannon, *The Corporate Social-Financial Performance Relationship*, 36 BUS. & SOC’Y 419 (1997).

80. See *id.* at 424.

81. See *id.*

dimensions to reflect the interest of three important stakeholder groups – employees, customers, and the community at large. They tested a variety of hypotheses by computing correlation coefficients between the social and financial performance variables, in both contemporaneous and trailing combinations.

Of the 270 correlations computed, there was not a single significant negative result.<sup>82</sup> The evidence suggested “that there is a positive correlation between social and financial performance in large U.S. corporations,” regardless of the financial performance measure (i.e., return on assets, return on equity, return on investment).<sup>83</sup> Thus, the data were “broadly consistent with the stakeholder theory,” which posits that “favorable social performance is a requirement for business legitimacy and that social and financial performance tend to be positively associated over the long-term.”<sup>84</sup>

The empirical results are consistent with the anecdotal evidence and ethical theory. For example, a survey by Deloitte Touche found that sixty-three percent of the respondents believed that high ethical standards strengthen a business’s competitive position.<sup>85</sup> Many of the Fortune 1000 corporations have formalized corporate ethics activities.<sup>86</sup> Harvard Business School Professor Lynn Sharp Paine argues that

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82. See *id.* at 426; see also JEFFREY PFEFFER, *THE HUMAN EQUATION: BUILDING PROFITS BY PUTTING PEOPLE FIRST* 32, 64-65 (1998) (stating that “[s]ubstantial gains, on the order of 40 percent or so in most of the studies reviewed, can be obtained by implementing high performance management practices” including employment security, self-managed teams and decentralized decision-making, and comparatively high compensation contingent on organizational performance).

83. Preston & O’Bannon, *supra* note 79, at 426.

84. *Id.* at 428. Prior studies had reached varying results. See, e.g., Phillip Cochran & Robert A. Wood, *Corporate Social Responsibility and Financial Performance*, 27 *ACAD. MGMT. J.* 42 (1984) (finding positive relationship between social and financial performance); Barbara A. Spencer & G. Stephen Taylor, *A Within and Between Analysis of the Relationship Between Corporate Social Responsibility and Financial Performance*, 18 *AKRON BUS. & ECON. REV.* 7 (1985) (same); Kenneth Aupperle et al., *An Empirical Examination of the Relationship Between Corporate Social Responsibility and Profitability*, 28 *ACAD. MGMT. J.* 446 (1985) (finding no relationship between social and financial performance); Kenneth Aupperle & Dean Van Pham, *An Expanded Investigation in the Relationship of Corporate Social Responsibility and Firm Financial Performance*, 2 *EMPL. RESPON. & RIGHTS J.* 263 (1989) (same); Jean B. McGuire, et al., *Corporate Social Responsibility and Firm Financial Performance*, 31 *ACAD. MGMT. J.* 854 (1988) (mixed results).

85. See *TOUCHE ROSS AND CO., ETHICS IN AMERICAN BUSINESS: A SPECIAL REPORT* (1988). See also *Good Takes on Greed*, *ECONOMIST*, Feb. 17, 1990, at 71.

86. See generally Gary R. Weaver et al., *Corporate Ethics Practices in the Mid-1990’s: An Empirical Study of the Fortune 1000*, 18 *J. BUS. ETHICS* 283 (1999) (stating that 98% of the firms have ethics-oriented policy statements; 30% have a specific office or department to deal with ethics issues; and 51% have telephone-based compliance reporting/advice systems). See also Gael McDonald, *Business Ethics: Practical Proposals for Organizations*, 19 *J. BUS. ETHICS* 143 (1999).

creating an organization that encompasses exemplary conduct may be the best way to prevent damaging misconduct.<sup>87</sup> Directors have a critical role to play in creating ethical organizations.<sup>88</sup> Yet their adoption of a code of ethics will mean nothing to managers if the board shows a lack of respect for the effect of its decisions on others.<sup>89</sup>

This Article asserts that boards should be encouraged to search for opportunities to conduct their affairs in ways that both are fair to all constituencies and generate the maximum return to investors. Shell Oil, for example, is taking special care to avoid harming the vulnerable Amazon rain forest as it proceeds with its three billion dollar, forty-year natural gas project in Camisea, Peru.<sup>90</sup> While Shell Oil's management may have been motivated by a desire to prevent political backlash and opposition,<sup>91</sup> its actions will still help protect the environment and the indigenous population. As such, Shell Oil is acting responsibly and deserves credit for doing so.

Perhaps the most frequently cited example of the positive public relations benefits that can accrue from ethical and socially responsible behavior is the recall of thirty million bottles of Tylenol by Johnson & Johnson in 1982, after several people died subsequent to taking Tylenol capsules that were tampered with and laced with cyanide poison.<sup>92</sup> The recall cost Johnson & Johnson approximately one-hundred million

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87. See Lynn Sharp Paine, *Managing for Organizational Integrity*, HARV. BUS. REV. Mar.-Apr. 1994, at 106, 117.

88. See Timothy B. Bell & Lawrence A. Poneman, *The Role of Corporate Directors in the Business Ethics Process*, NACD Governance Series, ETHICS AND THE BOARDROOM, 1996, at 5. Also, "The influence supervisors have on subordinates may stem from the supervisor's role in establishing the ethical climate of the workgroup, his or her control over subordinates, and the supervisor's own ethical behavior." James C. Wimbush, *The Effect of Cognitive Moral Development and Supervisory Influence on Subordinates' Ethical Behavior*, 18 J. BUS. ETHICS 383, 384 (1999). "If you have a CEO who says 'get results no matter how,' you'll promote fudging numbers," says Indiana University Professor Michael Metzger. Carol Hymowitz, *CEOs Set the Tone for How to Handle Questions of Ethics*, WALL ST. J., Dec. 22, 1998, at B1.

89. According to Metzger, "It's what you do, not say, that counts." Hymowitz, *supra* note 88, at B1.

90. See Jonathon Friedland, *Oil Companies Strive to Turn a New Leaf to Save Rain Forest*, WALL ST. J., July 17, 1997, at A1.

91. Thomas Lovejoy, a Smithsonian scientist and rain-forest expert, states that big companies are finally realizing "that if you do things right from the start, it will save you a lot of money and a lot of grief in the long run." *Id.*

92. See Michael Waldholz, *Johnson & Johnson Defends Emphasis on Long-Term Growth as Profit Surges*, WALL ST. J., Aug. 8, 1985, at 8; see also William Power, *Tylenol Maker Must Bear Cost of 1982 Recall*, WALL ST. J., Sept. 18, 1986, at 1.

dollars.<sup>93</sup> Although the short-term economic costs of the recall were enormous, within two years Johnson & Johnson was able to regain the market share it had lost.<sup>94</sup> Public relations should not be the determinative factor in deciding what is socially responsible, but good public relations resulting from public disclosure of positive corporate actions can be a carrot to help prompt socially responsible behavior.

Even though boards often can both maximize shareholder value and be fair to all corporate constituencies, there are times when honesty does hurt—when a board must do what it believes is morally right even if it reduces shareholder value. As Dr. Rieux in Albert Camus's *The Plague* explained when asked why he was working so hard and putting himself at risk to stop the plague that had struck his community, “[T]here’s no question of heroism in all this. It’s a matter of common decency.”<sup>95</sup>

For example, Ben & Jerry’s continued to pay its dairy producers above-market rates after prices were reduced due to cutbacks in the federal dairy purchase program. Co-founder Ben Cohen said, “We refuse to profit off the misfortune of our dairy suppliers due to some antiquated, misguided, convoluted federal system.”<sup>96</sup>

Peter M. Senge explains that compassion flows naturally from an understanding of the systems within which people operate:

We are used to [seeing] compassion as an emotional state, based on our concern for one another. But it is also grounded in a level of awareness. In my experience, as people see more of the systems within which they operate, and as they understand more clearly the pressures influencing one another, they naturally develop more compassion and empathy.<sup>97</sup>

This Article therefore rejects one CEO’s argument that he “can’t let [his] own sense of right and wrong get in the way” of doing what is best for the shareholders.<sup>98</sup>

#### F. *Common Goods and the Corporation’s Dilemma*

Individuals and firms that consider only their own self-interests are susceptible to what some theorists call the common goods problem or the Prisoner’s Dilemma.<sup>99</sup> In essence, firms may select sub-optimal

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93. See Power, *supra* note 92, at 1.

94. See Marc G. Weinberger & Jean B. Romeo, *The Impact of Negative Product News*, 32 BUS. HORIZONS 44, 49 (1989).

95. ALBERT CAMUS, *THE PLAGUE* 163 (Stuart Gilbert trans. 1948).

96. Daniel Seligman, *A Test for Bus Drivers, a Socially Responsible Ice Cream, Competing with the Mob, and Other Matters*, FORTUNE, June 3, 1991, at 247.

97. SENGE, *supra* note 7, at 171.

98. FREEMAN & GILBERT, *supra* note 3, at 23.

99. See generally AVINASH K. DIXIT & BARRY J. NALEBUFF, *THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE*

strategies because they fear that any self-sacrifice may be taken advantage of by another party who reaps the benefit for the sacrifice but does not pay for it.

Heads of nations, for example, may agree that curtailing fishing in international waters is necessary to sustain fish habitats for the indefinite future. However, if there is no binding contract among nations to limit fishing, the nation whose citizens might prefer to provide sustainability will be discouraged from doing so if other nations are likely to take advantage of that self-restraint by not only failing to limit their own catch, but also catching the incremental amount the socially responsible nation chose not to take.

Similar issues arise for firms considering investing in infrastructure, such as new roads to relieve the traffic gridlock caused by commuters to the firm's facilities or improved educational facilities to train better workers. If every firm contributed its pro rata share, then private industry might well be able to finance these improvements at a fraction of what the government would spend in tax dollars. Yet, even though every firm would benefit from such investments, no one company will rationally invest in infrastructure because its competitors will have every incentive to "free ride" by having its employees use the new roads and by hiring the better trained workers without contributing to the cost.

Governmental regulation, through restrictions or taxation, is often necessary to force firms to contribute to payment of the costs of these actions. But as efforts to privatize prisons and public schools suggest, the government often does not get the most bang for the buck. It tends to move slowly, is not nimble, and often imposes enormous transaction costs (also referred to as "red tape"). The government's solution to toxic waste sites, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980<sup>100</sup> (CERCLA), exemplifies the inefficiencies that accompany governmental attempts to force firms to internalize their externalities.<sup>101</sup>

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(1991); ANATOL RAPOPORT & ALBERT M. CHAMMAH, PRISONER'S DILEMMA: A STUDY IN CONFLICT AND COOPERATION (1965).

100. 42 U.S.C. §§ 9601-9675 (1994 & Supp. III 1997).

101. See Andrew R. Klein, *Hazardous Waste Cleanup and Intermediate Landowners: Reexamining the Liability-Based Approach*, 21 HARV. ENVTL. L. REV. 337, 345-53 (1997); John H. Cushman, *Superfund in Shambles: Indecision Fiscal Gridwork Taking Toll*, DENVER POST, Jan. 26, 1996, at A1.

Friedman's social responsibility argument appears to view both the law and ethical custom as fixed and readily definable standards of behavior. This ignores the reality that there is a dynamic and interactive relationship between economic behavior, law, and social norms that is inherent in business decisions. The existence of public relations, advertising, lobbying, and legal departments in modern corporations is clear evidence of this interplay.<sup>102</sup> A large portion of the resources of modern corporations is devoted to modifying or maintaining their operating environments by influencing consumers, legislatures, and the public at large. Indeed, manipulation of the law by the unscrupulous is a well recognized phenomenon. Similarly, the influence of corporate advertising on cultural norms is evident in a comparison of current popular TV shows with popular shows of the 1950s.<sup>103</sup>

Frederic Bastiat, 19th Century French political economist, noted the malleability of the law and the dangers of relying on it to provide the standard of proper conduct:

There is in all of us a strong disposition to believe that anything lawful is also proper. This belief is so widespread that many persons have erroneously held that things are 'just' because law makes them so. Thus, in order to make plunder appear just and sacred to many consciences, it is only necessary for the law to decree and sanction it. Slavery, controls, and monopoly find defenders not only among those who profit from them but even among those who suffer from them.<sup>104</sup>

The dynamism of the law is evident not only in shifting legislative enactments but also in judicial interpretation of those enactments. In

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102. As William W. Cook concluded in his treatise,

It is not remarkable that corporations seek to control government. The reason why they take part in politics; manipulate caucuses and conventions; use money, power, and votes in elections; bribe and influence national, State, and municipal officers, judges, and legislators; and often control States and cities is plain. Corporations do all this to protect and increase their property.

WILLIAM W. COOK, *THE CORPORATION PROBLEM* 246-47 (New York, G.P. Putnam's Sons 1891).

103. See generally Janet L. Dolgin, *The Fate of Childhood: Legal Models of Children and the Parent-Child Relationship*, 61 ALB. L. REV. 345 (1997).

104. DEAN RUSSELL, *FREDERIC BASTIAT: IDEAS AND INFLUENCE* 5 (2d ed. 1965). Consider, for example, the Ford Pinto case. There was no precedent under law or custom for Ford to engage in anything other than a classic cost-benefit analysis. While it is unclear what the actual financial impact its decision had on its shareholders, Ford made a very rational calculation and concluded that a few statistically probable deaths were less expensive than a massive recall. See, e.g., *THE FORD PINTO CASE: A STUDY IN APPLIED ETHICS, BUSINESS, AND TECHNOLOGY* (Douglas Birsch & John H. Fielder eds., 1994); FRANCIS T. CULLEN ET AL., *CORPORATE CRIME UNDER ATTACK: THE FORD PINTO CASE AND BEYOND* (1987).

1896, for example, the U.S. Supreme Court held in *Plessy v. Ferguson*<sup>105</sup> that legislative segregation of the races in transportation did not deprive African Americans of equal protection under the law.<sup>106</sup> The Court rejected the argument that segregation stamped “the colored race with a badge of inferiority.”<sup>107</sup> Yet 58 years later, the Supreme Court overruled *Plessy* in *Brown v. Board of Education*,<sup>108</sup> unanimously deciding that “segregation of children in public schools solely on the basis of race, even though the physical facilities and other ‘tangible’ factors may be equal, deprive the children of the minority group of equal educational opportunities.”<sup>109</sup>

Ultimately, in fact, Friedman’s insistence that the only interests that management can legitimately consider are those that are explicitly set forth in law and custom is an invitation for more legislation to ensure that externalities are in fact borne by the corporations that benefit from them.<sup>110</sup> Therefore, what appears to be in the short-term interests of the corporation’s shareholders may in fact be detrimental to the long-term interests of both those shareholders and other market participants, inasmuch as legislation often has its own unintended consequences.<sup>111</sup>

105. 163 U.S. 537 (1896).

106. *See id.* at 551.

107. *Id.*

108. 347 U.S. 483 (1954).

109. *Id.* at 493. Thirty-eight years later, the U.S. Supreme Court explained the role of precedent and changing societal norms in *Planned Parenthood v. Casey*, 505 U.S. 833 (1992). In deciding whether to overturn *Roe v. Wade*, 410 U.S. 113 (1973), and its holding that a woman has a constitutional right to terminate her pregnancy in the early stages, the Court considered:

[W]hether *Roe*’s central rule has been found unworkable; whether the rule’s limitation on state power could be removed without serious inequity to those who have relied upon it or significant damage to the stability of the society governed by it; whether the law’s growth in the intervening years has left *Roe*’s central rule a doctrinal anachronism discounted by society; and whether *Roe*’s premises of fact have so far changed in the ensuing two decades as to render its central holding somehow irrelevant or unjustifiable in dealing with the issue it addressed.

*Planned Parenthood*, 505 U.S. at 855.

110. Consider the issue of protecting privacy on the Internet. Because of the inability of the American Internet market to self-regulate, the Federal Trade Commission has proposed standards for privacy protections. *See, e.g.,* Maria Seminerio, *ZDNet: News: No Change to Privacy Status Quo* (visited Nov. 9, 1999) <<http://www.zdnet.com/zdnn/stories/news/0,4586,2246329-1,00.html>>. Microsoft Corporation responded by proposing new standards for privacy on-line. *See Microsoft Announces Steps to Strengthen Consumer Privacy Online* (visited Nov. 9, 1999) <<http://www.microsoft.com/presspass/press/1999/jun99/privacypr.html>>.

111. *See supra* note 45.

From a game theory perspective, a perverse incentive to be the first to exploit an externality before it is denied by law is but one adverse consequence of such single-minded criteria for organizational decision-making.<sup>112</sup>

#### H. Pragmatism and Corporate Governance

There is no question that Berle and Means have identified an important issue in corporate governance—how to minimize irresponsible management (if not downright opportunism). However, even if it can be agreed that there is a duty to maximize profits, there is no consensus as to what that means in practice. Whole curricula in business schools are dedicated to economic decision-making, including the advantages and disadvantages of discounted cash flow rate of return for choosing among different alternative investments, or the strategic advisability of sacrificing short-term profitability for increased market share or better relationships with long-term customers and suppliers.

Some have suggested that one escape from this difficulty would be use of shareholder value (capital appreciation plus dividends) as a measure of an organization's profitability.<sup>113</sup> However, neither the day-to-day pricing of corporate shares nor share value derived from traditional accounting methods is consistent with the traditional characteristics of highly efficient markets.<sup>114</sup> Delaware courts, among others, have continually expressed skepticism over the accuracy of viewing the trading prices of shares as a reflection of the corporation's "intrinsic value," and, consequently, the degree to which directors can use those trading prices as a guide to action.<sup>115</sup> To hold directors to a legal

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112. For a discussion of the dangers and unethical behaviors caused by a game theory approach to business, see Robert C. Solomon, *Game Theory as a Model for Business and Business Ethics*, 9 BUS. ETHICS QTLY. 11 (1999).

113. See, e.g., Marc S. Schwarz & Michael V. Ippolito, *The Key Gauges of Performance*, DIRECTORS & BOARDS, June 22, 1995, at 29.

114. See MILGROM & ROBERTS, *supra* note 12, at 470-71. See also Stephen F. Leroy & Richard D. Porter, *The Present-Value Relation: Tests Based on Implied Variance Bounds*, 49 ECONOMETRICA 555 (1981) (stating variations in stock prices are much too large to be explained as responses to changing expectations of future dividends); Robert J. Shiller, *Do Stock Prices Move Too Much to Be Justified by Subsequent Changes in Dividends?*, 71 AM. ECON. REV. 421 (1981) (same); Eugene F. Fama & Kenneth R. French, *Permanent and Temporary Components of Stock Prices*, 96 J. POL. ECON. 246 (1988).

115. See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 n.12 (Del. 1989) ("[I]t is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value . . ."); *Smith v. Van Gorkom*, 488 A.2d 858, 876 (Del. 1985) (stating need for directors to focus on intrinsic value and rejecting use of trading price); cf. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1385 (Del. 1995) (suggesting possibility of "ignorance or mistaken belief [on the part of shareholders] regarding the Board's assessment of the long-term value of



standard of maintaining or increasing shareholder value does not comport with the realities of the modern economic world, where the prices of key commodities may fluctuate wildly and entire national economies may collapse in a matter of weeks.

Moreover, to the extent that managers' salaries, bonuses, and stock options are tied to short-term performance in an attempt to align management's interests with those of the shareholders, management may be induced to take short-term measures that are harmful to other stakeholders, such as employee layoffs, or to long-term shareholders.<sup>116</sup> Such actions may have no positive long-term effect on the firm's profitability but may only boost short-term gains to management.<sup>117</sup>

### III. LAW AND CORPORATE GOVERNANCE

Thirty states have enacted statutes intended to permit (and, in the case of Connecticut,<sup>118</sup> to require) consideration of other constituencies, even in connection with a change in control.<sup>119</sup> For example, in an effort to

Unitrin's stock") (quoting *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 290 (Del. Ch. 1989)).

116. Recent studies support the proposition that "top managers consider their own interests of primary importance, or second only to those of customers, in corporate decision making." Preston & O'Bannon, *supra* note 79, at 423.

117. See, e.g., Kevin F. Hallock, *Layoffs, Top Executive Pay, and Firm Performance*, 88 AM. ECON. REV. 711 (1998) (stating firms that announce layoffs in the previous year pay their CEOs more and give their CEOs larger percentage raises than firms that do not have at least one layoff announcement in the previous year; moreover, there is a small negative share price reaction to layoff announcements).

Recognizing this danger of short-termism, CalPERS announced in 1994 its intention to take into account in its investment decisions how a company treats its employees. A study by the Gordon Group that found a correlation between corporate results and work force performance prompted the fund to consider such issues as whether companies offer employees training programs and give more responsibility to lower-level workers. See Asra Q. Nomani, *CalPERS Says Its Investment Decisions Will Reflect How Firms Treat Workers*, WALL ST. J., June 16, 1994, at A5.

118. Directors of a Connecticut corporation must consider employee interests in the context of hostile takeovers. See CONN. GEN. STAT. § 33-756 (1997).

119. The states that have other constituency statutes are as follows: Arizona, ARIZ. REV. STAT. § 10-1202 (1998); Florida, FLA. STAT. ch. 607.0830 (1998); Georgia, GA. CODE ANN. § 14-2-202 (1998); Hawaii, HAW. REV. STAT. § 415-35 (1998); Idaho, IDAHO CODE §§ 30-1602, 30-1702 (1998); Illinois, 805 ILL. COMP. STAT. 5/8-85 (West 1998); Indiana, IND. CODE ANN. § 23-1-35-1 (Michie 1998); Iowa, IOWA CODE §§ 490.1108, 491.101B (1997); Kentucky, KY. REV. STAT. ANN. § 271B.12-210 (Michie 1998); Louisiana, LA. REV. STAT. ANN. § 12:92 (West 1998); Maine, ME. REV. STAT. ANN. tit. 13-A, § 716 (West 1997); Massachusetts, MASS. ANN. LAWS ch. 149, § 20E (Law. Co-op. 1999); Minnesota, MINN. STAT. § 302A.251 (1998); Mississippi, MISS. CODE ANN. § 79-4-8.30 (1998); Missouri, MO. REV. STAT. § 351.347 (1997); Nebraska, NEB. REV.

thwart a hostile takeover bid by the Belzbergs of Canada for Armstrong, a major Pennsylvania employer, the Pennsylvania legislature amended the Pennsylvania Business Corporation Law in 1990 to, inter alia, permit directors to consider the “effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.”<sup>120</sup> The board is not required to regard any corporate interest or the interests of any particular groups as a dominant or controlling interest or factor.<sup>121</sup>

The American Bar Association’s *Corporate Director’s Guidebook* summarizes a corporate director’s responsibilities as follows:

Stated broadly, the principal responsibility of a corporate director is to promote the best interests of the corporation and its shareholders in directing the corporation’s business and affairs.

In so doing, the director should give primary consideration to long-term economic objectives. However, a director should also be concerned that the

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STAT. § 21-2432 (1998); Nevada, NEV. REV. STAT. ANN. § 78.138 (Michie 1999); New Jersey, N.J. REV. STAT. § 14A:10A-2 (1999); New Mexico, N.M. STAT. ANN. § 53-11-35 (Michie 1998); New York, N.Y. BUS. CORP. LAW § 717 (Consol. 1998); North Dakota, N.D. CENT. CODE § 10-19.1-50 (1999); Ohio, OHIO REV. CODE ANN. § 1701.59 (West 1998); Oregon, OR. REV. STAT. § 60.357 (1997); Pennsylvania, 15 PA. CONS. STAT. § 1715 (1998); Rhode Island, R.I. GEN. LAWS § 7-5.2-8 (1998); South Dakota, S.D. CODIFIED LAWS § 47-33-4 (Michie 1999); Tennessee, TENN. CODE ANN. § 48-103-202 (1999); Texas, TEX. BUS. CORP. ACT ANN. art. 13.06 (West 1999); Vermont, VT. STAT. ANN. tit. 11A, § 8.30 (1998); Virginia, VA. CODE ANN. § 13.1-727.1 (Michie 1998); Wisconsin, WIS. STAT. § 180.0827 (1997); Wyoming, WYO. STAT. ANN. § 17-16-830 (Michie 1999).

The “other constituency” provisions of Arizona, Texas and Virginia may be characterized as weak. The Texas statute merely states that

[i]n discharging the duties of director under this Act or otherwise, a director, in considering the best interests of the corporation, may consider the long-term as well as the short-term interests of the corporation and its shareholders, including the possibility that those interests may be best served by the continued independence of the corporation.

TEX. BUS. & COM. CODE ANN. § 13.06 (West 1999). Similarly, the Virginia statute states that

[e]xcept as expressly provided in this article, the provisions of this article shall not limit actions that may be taken, or require the taking of any action, by the board of directors or shareholders with respect to any potential change in control of the corporation. With respect to any action or any failure to act by the board of directors, the provisions of § 13.1-690 shall apply. In determining the best interests of the corporation, a director may consider the possibility that those interests may best be served by the continued independence of the corporation.

VA. CODE ANN. § 13.1-727.1 (Michie 1999).

120. 15 PA. CONS. STAT. ANN. § 1715(a)(1) (West 1998).

121. See *id.* § 1715(b); see also *AMP Inc. v. Allied Signal Inc.*, Nos. 98-4058, 98-4109, 98-4405, 1998 U.S. Dist. LEXIS 15617, at \*11 (E.D. Pa. Oct. 8, 1998) (holding directors of a Pennsylvania corporation owe a fiduciary duty solely to the corporation and have no specific duty to shareholders above or beyond those owed to other constituencies).

corporation conducts its affairs with due appreciation of public expectations, taking into consideration trends in the law and ethical standards. Furthermore, pursuit of the corporation's economic objectives may include consideration of the effect of corporate policies and operations upon the corporation's employees, the public, and the environment.<sup>122</sup>

The American Law Institute's (ALI) Project on Principles of Corporate Governance echoes these standards. It states as a general rule that "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."<sup>123</sup> Nevertheless, "[e]ven if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . [m]ay devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes."<sup>124</sup> The comment to the ALI principle elaborates:

It is now widely accepted that the corporation should at least consider the social impact of its activities, so as to be aware of the social costs those activities entail. By implication, the corporation should be permitted to take such costs into account, within reason. For example, the corporation may take into account, within reason, public-welfare concerns relevant to groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of the communities within which the corporation operates.<sup>125</sup>

The Business Roundtable, an association of the chief executive officers of leading U.S. corporations with a combined workforce of more than ten million employees in the United States, officially acknowledges the importance of considering nonshareholder constituencies:

There has been much debate in corporate governance literature about the parties to whom directors owe a duty of loyalty and in whose interest the corporation should be managed. Some say corporations should be managed purely in the interests of stockholders or, more precisely, in the interests of its present and

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122. AMERICAN BAR ASSOCIATION, CORPORATE DIRECTOR'S GUIDEBOOK 5 (2d ed. 1994).

123. 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(a) (1994). The comment notes that "reasonableness" is to be determined by considering factors such as:

the customary level at which resources are devoted to such purposes among comparable corporations in proportion to earnings and assets, and the strength of the nexus between the use of corporate resources and the corporation's business. In general, the greater the amount of corporate resources that are expended, the stronger should be the nexus.

*Id.* § 2.01 cmt. i.

124. *Id.* § 2.01(b)(3).

125. *Id.* § 2.01 cmt. i.

future stockholders over the long-term. Others claim that directors should also take into account the interests of other “stakeholders” such as employees, customers, suppliers, creditors and the community.

The Business Roundtable does not view these two positions as being in conflict, but it sees a need for clarification of the relationship between these two perspectives. It is in the long-term interests of stockholders for a corporation to treat its employees well, to serve its customers well, to encourage its suppliers to continue to supply it, to honor its debts, and to have a reputation for civic responsibility. Thus, to manage the corporation in the long-term interests of the stockholders, management and the board of directors must take into account the interests of the corporation’s other stakeholders.<sup>126</sup>

The ABA guidelines, the ALI principles, and the Business Roundtable statement are simply operative restatements of modern jurisprudence on the duties of directors with respect to shareholders and other constituencies even in jurisdictions, such as Delaware, with no constituency statute. This jurisprudence states that generally, informed decisions of directors will not be second-guessed by the courts under the business judgment rule. The business judgment rule is a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>127</sup> The presumption

can be overturned only if a plaintiff can show that a majority of the directors expected to derive personal financial benefit from the transaction, that they lacked independence, that they were grossly negligent in failing to inform themselves, or that the decision of the Board was so irrational that it could not have been the reasonable exercise of the business judgment of the Board.<sup>128</sup>

Under the business judgment rule, “legitimate concerns for [management’s] past conduct of the enterprise and its requirements need not be left to the goodwill of an unfriendly acquirer of corporate control in the jungle warfare involving attempted takeovers.”<sup>129</sup> The Supreme Court of Delaware has gone further, stating that a board has a *duty* to consider these other factors. Thus, in *Citron v. Fairchild Camera and*

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126. BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE 3 (Sept. 1997). Similarly, the Organisation for Economic Cooperation and Development’s blue ribbon report on international standards of corporate governance states that “it is more and more accepted that the corporate objective of maximizing shareholders’ value requires not only superior competitive performance but also responsiveness to the demands and expectations of employees, local constituencies, and other stakeholders.” OECD REPORT ON CORPORATE GOVERNANCE (1998).

127. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

128. *Sullivan v. Hammer*, No. CIV. A. No. 10823, 1990 WL 114223, at \*5 (Del. Ch. Aug. 7, 1990).

129. *GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1020 (S.D.N.Y. 1985); see also *Amanda Acquisition Corp. v. Universal Foods Corp.*, 708 F. Supp. 984, 1009, 1015 (E.D. Wis. 1989), *aff’d on other grounds*, 877 F.2d 496 (7th Cir. 1989); *Keyser v. Commonwealth Nat’l Fin. Corp.*, 644 F. Supp. 1130, 1148 n.34 (M.D. Pa. 1986).

*Instrument Corp.*,<sup>130</sup> the Delaware Supreme Court held:

The Fairchild board, actively led by its outside independent directors, had a right, indeed a firm *duty*, to consider a host of factors in determining whether to entertain Gould's offer. As we have recently said: "Circumstances may dictate that an offer be rebuffed, given the nature and timing of the offer; its legality, feasibility and effect on the corporation and the stockholders; the alternatives available and their effect on the various constituencies, particularly the stockholders; the company's long term strategic plans; and any special factors bearing on stockholder and public interests."<sup>131</sup>

Among Fairchild's concerns over the Gould offer were: (1) the inadequacy of the offer; (2) Gould's reputation and the likely result that employees would leave the organization; and (3) the probability that Gould's takeover would have an adverse effect on Fairchild's customers and suppliers.<sup>132</sup> The court characterized Fairchild's concerns as "classic factors upon which a board may base a proper business decision to accept or reject a proposal."<sup>133</sup>

However, because of the "omnipresent spectre" that a board adopting a defensive measure designed to thwart a hostile bid may be acting to entrench itself in office, the Supreme Court in Delaware, where a majority of major publicly traded corporations are domiciled,<sup>134</sup> now imposes a two-tier proportionality test.<sup>135</sup> The directors first must show that they had reasonable grounds for believing that there was a threat to corporate policy and effectiveness.<sup>136</sup> Then they must demonstrate that the defensive measures adopted in response to the threat were reasonable in relation to the threat.<sup>137</sup>

In making these determinations, the board must analyze "the nature of

130. 569 A.2d 53 (Del. 1989).

131. *Id.* at 68 (emphasis added) (quoting *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1285 n.35 (Del. 1989)).

132. *See id.* at 66-67.

133. *Id.* at 67.

134. A state Web site proclaims:

More than 295,000 companies are incorporated in Delaware including 60 percent of the Fortune 500 and 50 percent of the companies listed on the New York Stock Exchange. The Delaware Corporation Law, the Court of Chancery, and the customer service-oriented staff at the Division of Corporations are all sound reasons why Delaware leads the nation as a major corporate domicile.

*Delaware Division of Corporations* (visited Nov. 24, 1999) <<http://www.state.de.us/corp/index.htm>>.

135. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

136. *See id.*

137. *See id.*

the takeover bid and its effect on the corporate enterprise.”<sup>138</sup> In doing so, the directors may consider, among other things, “the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally).”<sup>139</sup> Directors are further authorized “to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected, and thus directors in pursuit of long run corporate (and shareholder) value may be sensitive to the claims of other ‘corporate constituencies.’”<sup>140</sup>

There are limits to this discretion, however. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>141</sup> the Delaware Supreme Court held that “[a] board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders.”<sup>142</sup> Consideration of non-stockholder interests “is inappropriate” when break-up of the corporation is “inevitable.”<sup>143</sup> Once the board decides to sell the company, the directors’ role changes from being “defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.”<sup>144</sup> As auctioneers, the directors have an obligation of acting reasonably to seek the transaction offering “the best value reasonably available to the stockholders.”<sup>145</sup>

This exception to the ability to consider other constituencies is very narrow and has been applied only in the following three situations:

- (1) “when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the

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138. *Id.*

139. *Id.* This discretion to consider the impact of corporate decision on nonshareholders is also evident in language discussing the importance of indemnifying officers and directors:

Delaware’s corporation code authorizes liberal indemnification provisions for officers and directors of its corporations for sound policy reasons that benefit all of a corporation’s constituencies. . . . Shareholder democracies want directors and officers to engage in broadly based decision making in order to enhance shareholder value by encouraging prudent risk taking to their and the other corporate constituencies’ advantage.

Scharf v. Edgcomb Corp., No. 15224, 1997 Del. Ch. LEXIS 169, at \*14 (Del. Ch. Dec. 2, 1997).

140. *TW Services, Inc. v. Crown*, No. CIV. A. Nos. 10427, 10298, 1989 WL 20290, at \*7 (Del. Ch. Mar. 2, 1989) (footnote omitted).

141. 506 A.2d 173 (Del. 1986).

142. *Id.* at 182.

143. *Id.*

144. *Id.*

145. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 49 (Del. 1994); *see also* *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1055 (Del. Ch. 1997) (stating that in a change-of-control situation, the board is required “to act reasonably to maximize current, not some future, value”).

company,” (2) “where, in response to a bidder’s offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company,” or (3) when approval of a transaction results in a “sale or change of control.” In the latter situation, there is no “sale or change in control” when “[c]ontrol of both [companies] remain[s] in a large, fluid, changeable and changing market.”<sup>146</sup>

In cases where a takeover is not inevitable, the business judgment rule applies and,

[c]ircumstances may dictate that an offer be rebuffed, given the nature and timing of the offer; its legality, feasibility and effect on the corporation and the stockholders; the alternatives available and their effect on the various constituencies, particularly the stockholders; the company’s long term strategic plans; and any special factors bearing on stockholder and public interests.<sup>147</sup>

Thus, in *Paramount Communications, Inc. v. Time Inc.*,<sup>148</sup> the Delaware Supreme Court held that the Time Inc. board had not put Time up for sale when it agreed to a stock-for-stock merger with Warner Communications, whereby the former shareholders of Warner would control sixty-two percent of the new combined entity.<sup>149</sup> Because both corporations were owned by a “fluid aggregation of unaffiliated shareholders,” dissolution of the Time corporate entity was not inevitable.<sup>150</sup> As a result, the Time directors were not required to “abandon a deliberately conceived corporate plan for a short-term shareholder profit”<sup>151</sup> and could rebuff a hostile takeover offer by Paramount to preserve Time’s “culture” of “editorial integrity.”<sup>152</sup> The court upheld the Time directors’ exercise of business judgment even though the holders of a majority of the Time stock preferred the Paramount offer.<sup>153</sup> In contrast, in a subsequent case, the Delaware Supreme Court ruled that Paramount’s agreement to merge with Viacom did constitute a change of control because more than ninety percent of Viacom’s stock was held by a single person, Sumner Redstone.<sup>154</sup> As a

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146. *Arnold v. Society for Sav. Bancorp.*, 650 A.2d 1270, 1290 (Del. 1994), *aff’d*, 678 A.2d 533 (Del. 1996) (alterations in original) (citations omitted).

147. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1285 n.35 (Del. 1989) (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-56 (Del. 1985)).

148. 571 A.2d 1140 (Del. 1990).

149. *See id.* at 1145-46.

150. *Id.* at 1150.

151. *Id.* at 1154.

152. *Id.* at 1152.

153. *See id.* at 1142.

154. *See Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 38 (Del. 1994).

result, the Paramount board had a duty to negotiate with hostile bidder QVC to get the best price available for its shareholders.<sup>155</sup>

Delaware developed its jurisprudence on other constituencies as a common-law reaction to the “takeover boom” of the 1980s.<sup>156</sup> The courts in several other states have similarly held that directors have a common-law right to consider other constituencies.<sup>157</sup> For example, in

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155. *See id.* at 49.

156. *See* Trevor S. Norwitz, “*The Metaphysics of Time*”: A Radical Corporate Vision, 46 BUS. LAW. 377, 384-86 (1990).

157. In *Burt v. Irvine Co.*, 47 Cal. Rptr. 392 (Ct. App. 1965), the plaintiff-minority shareholders called into question a real estate transaction entered into by some of the directors on behalf of the Irvine Company (a nonprofit charitable corporation), whereby the company exchanged land suitable for residential development for agricultural land in another county. *See id.* at 396. The plaintiffs claimed that the defendants

knowingly and willfully engineered a disposition of assets of the corporation to some favored persons, including respondent Long—an officer of the corporation—under terms and conditions less favorable than respondents knew could have been obtained from others and upon terms and conditions violative of the best interests and welfare of the corporation.

*Id.* at 408. In finding that the trial court abused its discretion in failing to permit the appellant-plaintiffs to amend their complaint, the court stated that “[t]here is nothing to show that the decision to sell these parcels rather than to hold them for lease was other than a question of business judgment.” *Id.* at 409. *Burt v. Irvine Co.* is cited for the proposition that “[c]ourts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.” *Id.* at 408 (quoting *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944)).

In the context of a dispute between minority and majority shareholders, the California Court of Appeals stated that

[a] director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. . . . Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.

*Efron v. Kalmanovitz*, 38 Cal. Rptr. 148, 154-55 (Ct. App. 1964) (quoting *Pepper v. Litton*, 308 U.S. 295, 306 (1939)). The court did not further expound on what is included in “those interested therein,” and the focus of the decision was on the consideration of the minority shareholders’ claim against the majority. Other courts have also used this language, noting that “[t]he rule that has developed in California is a comprehensive rule of ‘inherent fairness from the viewpoint of the corporation and those interested therein.’” *Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464, 472 (Cal. 1969) (quoting *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 75 (Cal. Ct. App. 1952)).

The New York Court of Appeals stated in *Pollitz v. Wabash R. Co.*, 100 N.E. 721 (N.Y. 1912):

[The acts of directors of a corporation] within the powers of the corporation, in the lawful and legitimate furtherance of its purposes, in good faith and the exercise of honest judgment, are valid and conclude the corporation and the stockholders. Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint,



and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.

*Id.* at 723-24.

In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986), the Second Circuit held that the New York business judgment rule protected directors acting in good faith and exercising honest judgment unless the duty of care was so "shallow in execution" or so half-heartedly exercised so as to constitute a "sham." *Id.* at 274. In this regard, directors must be found to act with "reasonable diligence" and "due care." *Id.*

Section 7015 of the New York Banking Law has been applied in the context of a potential bank merger. See *Minzer v. Keegan*, No. CV-97-4077(CPS), 1997 U.S. Dist. LEXIS 16445, at \*31 (E.D.N.Y. Sept. 22, 1997). Shareholders of The Greater New York Savings Bank (GNYSB) sued to enjoin a merger between GNYSB and Astoria Financial Corporation (AFC). The shareholders accused the GNYSB board of failing to meet its fiduciary obligations to its shareholders by approving the merger with AFC and rebuffing a bid by North Fork Bancorporation (NFB). Keegan, the Chairman of the Board of GNYSB, explained to the NFB his concern regarding NFB's apparent insensitivity to the community. See *id.* at \*2-6. The plaintiffs asserted that the directors were obliged "to seek transactions offering the best value to shareholders reasonably available." *Id.* at \*31. The court disagreed, stating that "[a] New York statute provides instead that in actions involving change of control, the directors of banks are free to consider not only short-term considerations such as merger price, but long-term factors as well." *Id.* at \*31 (citing N.Y. BANKING LAW § 7015(2) (McKinney Supp. 1997-98)).

In holding that GNYSB did not breach its fiduciary duty, the court first noted that "there is nothing in the record that suggests that The Greater was up for auction." *Id.* at \*34. The court then went on to explain:

Mr. Keegan credibly testified that he feels that "the combination between The Greater and Astoria is a terrific combination." The two banks have branches in complementary but not overlapping locations and "have the same strategic focus on the customer and the ethnic communities in both Queens and Brooklyn and some parts of Long Island." North Fork, on the other hand, is perceived by Keegan (and, perhaps, by some portion of the press) as having a "very direct approach to fee generation and service expansion, and sometimes the community focus suffers because of that." The question, then, is whether it is a valid business judgment for The Greater to believe that it will succeed better at banking in the melting pot of New York City if it joins forces with another market bank that does not care whether money is deposited in English or Chinese than if it merges with a more one size fits all institution. This Court finds that plaintiffs are not likely to convince a trier of fact that The Greater's decision to prefer a community-oriented bank was so beyond the pale of corporate decision-making as to be an invalid business judgment.

*Id.* at \*34-35 (citations omitted).

Section 7015 of the New York Banking Law was also cited in a bankruptcy case where the trustee of an estate being auctioned sold a controlling interest of Olympian Bank to Olympian Holdings, LLC. See *In re Bakalis*, 220 B.R. 525 (Bankr. E.D.N.Y. 1998). A rival bidder objected to the proposed sale. In approving the trustee's sale of the bank to Olympian Holdings, the court found that "[t]he Trustee carefully weighed the competing bids rather than mechanically recommending the facially higher bid." *Id.* at 532. The court quoted section 7015(2) of the New York Banking Law and continued to note that "Olympian Bank is a well run, profitable banking institution, experiencing growth, providing jobs, rendering services to its customers, and contributing to the

*A.P. Smith Manufacturing Co. v. Barlow*,<sup>158</sup> the New Jersey Supreme Court upheld the power of a corporation to transfer funds to charity.<sup>159</sup> In response to stockholders challenging a 1951 board resolution authorizing the company to transfer \$1500 to Princeton University,<sup>160</sup> the corporation instituted a declaratory judgment action. The court interpreted the implied or incidental powers of a corporation in light of changing social and economic conditions and upheld the transfer on both statutory and common law grounds.<sup>161</sup> The court reasoned:

When the wealth of the nation was primarily in the hands of individuals they discharged their responsibilities as citizens by donating freely for charitable purposes. With the transfer of . . . wealth to corporate hands and the imposition of heavy burdens of individual taxation, they have been unable to keep pace with increased philanthropic needs. They have therefore, with justification, turned to corporations to assume the modern obligations of good citizenship in the same manner as humans do.<sup>162</sup>

The court ultimately approved the transfer because it produced a benefit for the corporation by preserving the “free enterprise system,” reasoning that the “salvation [of corporations] rests upon [a] sound economic and social environment which in turn rests in no insignificant part upon free and vigorous nongovernmental institutions of learning.”<sup>163</sup>

Similarly, the Alabama Supreme Court upheld summary judgment for the defense in a derivative suit against the Alabama Power Company

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communities in which it does business.” *Id.* at 536. The court pointed out that “[a]lthough a trustee’s business judgment enjoys ‘great judicial deference,’ this discretion is not without limit. A duty is imposed upon the trustee to maximize the value obtained from a sale, particularly in liquidation cases.” *Id.* at 532 (citation omitted). Despite this duty of the Trustee “to maximize value,” the court applied section 7015(2) and found in favor of the Trustee. *See id.* at 531-32, 536, 538.

158. 98 A.2d 581 (N.J. 1953).

159. *See id.* at 590.

160. *See id.* at 582.

161. *See id.* at 585-87, 589-90.

162. *Id.* at 585-86. Peter Hall discusses changing social and economic conditions in similar terms and notes the rise of a managerial class without private fortunes of their own to benefit charities:

This separation of ownership and control led to major changes in business philanthropy. When owner-managers like Carnegie, Vanderbilt, or Pullman diverted corporate assets for charitable purposes, they were accountable to no one because they were, in effect, giving away their own money. Usually modest gifts from their firms were accompanied by generous ones from their private fortunes. The professional managers enjoyed no such discretion. They had no private fortunes. And, because they were dealing with other people’s money, they were not free to make corporate gifts unless these could be justified on grounds of corporate well-being.

Peter D. Doblan, *Business Giving & Social Investment in the United States*, in THE U.S. IN PHILANTHROPIC GIVING: STUDIES IN VARIETIES AND GOALS 227-28 (Richard Magat ed., 1989).

163. *A.P. Smith Mfg. Co.*, 98 A.2d at 586; *see also* MILGROM & ROBERTS, *supra* note 12, at 318.

brought by a shareholder and former employee who challenged the company's installation of six power poles on the Alabama Christian College campus free of charge.<sup>164</sup> The company viewed this act as part of the company's "civic rent."<sup>165</sup> The installation was not controlled by the company's contribution policy, but it was "consistent with long time Company policy of permitting free use of equipment to install light poles on Little League fields, helping cities hang Christmas decorations without charge, and installing flag poles at many of the schools throughout the state without charge."<sup>166</sup> A committee of independent directors, comprising three fourths of the entire board, concluded after an investigation that the derivative suit was not in the best interest of the company.<sup>167</sup> The Alabama Supreme Court affirmed summary judgment for the defense, reasoning that, "[t]o allow a suit under these circumstances would be to substitute the judgment of the court and the shareholder for that of the board of directors when it is obvious that the directors are best situated to make such a determination."<sup>168</sup>

In an extreme case, the Delaware Court of Chancery approved a non-monetary settlement of shareholder derivative and class action lawsuits challenging the Occidental Petroleum board's decision to spend more than eighty-five million dollars of Occidental's money to build and fund an art museum to house the art collected by founder and Chairman of the Board Armand Hammer, who had acquired much of it with Occidental's funds.<sup>169</sup> The court rejected claims that the gift was a waste of Occidental's assets, holding that given the net worth of Occidental, its annual net income before taxes (\$574 million), and the tax benefits to Occidental, the gift was within the range of reasonableness.<sup>170</sup> The court

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164. See *Roberts v. Alabama Power Co.*, 404 So. 2d 629, 635 (Ala. 1981).

165. *Id.* at 635.

166. *Id.*

167. See *id.* at 635-36.

168. *Id.* at 636.

169. See *Sullivan v. Hammer*, No. 10823, 1990 Del. Ch. LEXIS 119, at \*3 (Del. Ch. Aug. 7, 1990), *aff'd sub nom. Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991). The settlement agreement provided, inter alia, that (1) the museum name be changed from "The Armand Hammer Museum of Art and Cultural Center" to the "Occidental Petroleum Cultural Center Building"; and (2) all future charitable contributions by Occidental to the Armand Hammer Foundation or any other Hammer-affiliated charities be limited by the size of the dividends paid to Occidental's common stockholders. *Id.* at \*10-11.

170. See *id.* at \*19. Section 122(9) of the Delaware Corporation Code expressly authorizes charitable donations by Delaware corporations. Although section 122(9) places no limitations on the size of a charitable corporate gift, the Delaware Court of

held that the decision was protected by the business judgment rule even though, in the court's view, the shareholders would be warranted in electing different directors.<sup>171</sup> The court also approved the settlement's generous provisions limiting future contributions to Hammer-affiliated charities to an amount equal to the dividends paid to shareholders.<sup>172</sup>

Similarly, the Michigan Supreme Court upheld the decision of the directors of Ford Motor Company to pay above prevailing salary levels and to charge less for its cars than the market would bear.<sup>173</sup> Minority Ford shareholders had sued to block board-approved expansion plans and to demand that more special dividends be paid out of Ford's capital surplus of almost \$112 million.<sup>174</sup> In his answer to the complaint, Henry Ford (then the majority stockholder) argued that retaining large cash reserves to fund expansion and to prevent massive layoffs in bad times "ultimately redound to the best financial interests of the company and its stockholders."<sup>175</sup> The Michigan Supreme Court upheld the Ford directors' discretion to set employee wages and working conditions and car prices, and to spend more than twenty-four million dollars to expand the business to include the smelting of iron ore for use in the manufacture of Ford automobiles.<sup>176</sup>

However, the court held that at the outer limit "it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others."<sup>177</sup> In light of Ford's exceedingly strong cash position and the regularity and size of its cash flow going forward, the court ordered Ford to declare a special dividend of one half of the accumulated cash surplus, less the amount of special dividends (\$2,000,000) paid after the suit was filed, for a total special dividend of \$19,275,386.<sup>178</sup> This still left Ford with a cash surplus of more than thirty million dollars and a total surplus of more than ninety

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Chancery has construed the section "to authorize any reasonable corporate gift of a charitable or educational nature." *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969).

171. See *Sullivan*, 1990 Del. Ch. LEXIS 119, at \*12. The court characterized the settlement as "leav[ing] much to be desired" but stated that its role in reviewing it was quite restricted. *Id.* The court went on to add, "If the Court was a stockholder of Occidental it might vote for new directors, if it was on the Board it might vote for new management and if it was a member of the Special Committee it might vote against the Museum project." *Id.*

172. See *id.* at \*10-11.

173. See *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919). For further discussion of this case, see *infra* notes 194-201 and accompanying text.

174. See *Dodge*, 170 N.W. at 670.

175. *Id.* at 677.

176. See *id.* at 684-85.

177. *Id.* at 684.

178. See *id.* at 677.

million dollars.<sup>179</sup>

#### IV. STEWARDSHIP AND CORPORATE GOVERNANCE

The state gives shareholders of a corporation limited liability, yet the corporation derives power and resources from not just investors, but also from other sources, including employees and the community. Indeed, because the shareholders are often unable or unwilling to monitor corporate conduct, and no other constituency has any legal right to do so, we are left with the question, if not the directors, then who?<sup>180</sup>

The power of directors to consider the effect of their decisions on nonshareholder constituencies rationally flows from the history of the corporate form in America as an instrumentality of public good beyond the narrow limits of shareholder value.<sup>181</sup> Early corporations often were endowed with traditional state privileges such as eminent domain, monopoly, and limited liability.<sup>182</sup> Explicit in these quasi-public rights was the quid pro quo of social, not simply legal and economic, responsibility to interests broader than shareholders' profits.<sup>183</sup>

Ronald Seavoy makes it clear that corporate charters "assumed that corporations were legally privileged organizations that had to be closely

179. *See id.* at 685.

180. Rabbi Hillel asks, "If I am not for myself, who will be for me? If I am not for others, what am I? And if not now, when?" Rabbi Hillel, *Individuality* (visited Nov. 9, 1999) <<http://www.cyber-nation.com/victory/quotations/authors/quotes/hillel/rabbi.html>>. To which this Article would add, "If not me, who?" For a humorous answer to these questions, see Appendix B.

This Article recognizes, of course, that at the outer limits, if the directors make decisions that deviate too far from the wishes of the corporation's shareholders, then the shareholders can launch a proxy contest to replace the current board with nominees more to their liking. The Delaware Supreme Court struck down an attempt by the board of directors of a target company to thwart a hostile takeover by adopting a delayed hand poison pill, which could be redeemed immediately by only the directors in office immediately before the hostile acquirer obtained control. *See Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1292 (Del. 1998).

181. *See* WILLIAM G. ROY, *SOCIALIZING CAPITAL: THE RISE OF THE LARGE INDUSTRIAL CORPORATION IN AMERICA 41-77* (1997) (containing a comprehensive review of the history of the corporate form of organization in the United States).

182. *See id.* at 46-47, 51. Not all corporate statutes granted all of these benefits. The first true corporate statute, Massachusetts' Aquaduct Act of 1799, did not provide the proprietors with limited liability. Instead, it established that any claim that remained outstanding six months after dissolution could be pursued against the private estates of any of the proprietors. *See* EDWIN MERRICK DODD, *AMERICAN BUSINESS CORPORATIONS UNTIL 1860*, at 263-64 (1954).

183. *See* Harry J. Van Buren III, *Business Ethics for the New Millennium*, 93 *BUS. & SOC'Y REV.*, Spring 1995, at 51, 54.

scrutinized by the legislature because their purposes had to be made consistent with public welfare.”<sup>184</sup> Louis Hartz notes, for example, that in 1833 there was vigorous legislative opposition to Pennsylvania’s grant of a coal company charter on the grounds that the industry had become sufficiently developed that it could attract private capital and thus had no need for a charter.<sup>185</sup> Joseph Davis similarly describes the rigorous debates in which legislatures engaged on the subject of incorporation.<sup>186</sup> Another scholar, John Davis, confirms that “[e]arly in the [19<sup>th</sup>] century it was not considered justifiable to create corporations for any purpose not clearly public in nature.”<sup>187</sup>

The public purpose tradition of the corporation retained much of its legitimacy throughout the 20th century. President Theodore Roosevelt commented to Congress early in the century: “Business success, whether for the individual or for the Nation, is a good thing only so far as it is accompanied by and develops a high standard of conduct—honor, integrity, civic courage. . . . This Government stands for manhood first and for business only as an adjunct of manhood.”<sup>188</sup> President Woodrow Wilson voiced,

I hate that old maxim, ‘Business is business,’ for I understand by it that business is not moral. The man who says, ‘I am not in business for my health,’ means that he is not in business for his moral health, and I am the enemy of every business of this kind. But if business is regarded as an object for serving and obtaining private profit by means of service, then I am with that business. . . .<sup>189</sup>

Leaders of industry echoed these sentiments. Frank Abrams, speaking in 1951 as the chair of Standard Oil Company, said that the responsibility of management is “to maintain an equitable and working balance among the claims of the various directly interested groups—stockholders, employees, customers, and the public at large.”<sup>190</sup> The testimony in *A.P. Smith Manufacturing Co. v. Barlow*,<sup>191</sup> discussed

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184. RONALD E. SEAVOY, *THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784-1855: BROADENING THE CONCEPT OF PUBLIC SERVICE DURING INDUSTRIALIZATION* 5 (1982).

185. See LOUIS HARTZ, *ECONOMIC POLICY AND DEMOCRATIC THOUGHT: PENNSYLVANIA, 1776-1860*, at 59-60 (1948).

186. See JOSEPH STANCLIFFE DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS* 26 (1965).

187. 2 JOHN P. DAVIS, *CORPORATIONS: A STUDY OF THE ORIGIN AND DEVELOPMENT OF GREAT BUSINESS COMBINATIONS AND OF THEIR RELATION TO THE AUTHORITY OF THE STATE* 269 (1961).

188. Message to Congress, Dec. 5, 1905, *quoted in THE WILEY BOOK OF BUSINESS QUOTATIONS* 142 (1998).

189. *Call Gov. Wilson Man with a Future*, N.Y. TIMES, Apr. 25, 1911, § 1, at 3.

190. Robert L. Heilbroner, *Controlling the Corporation*, in *IN THE NAME OF PROFIT* 223, 241 (1972) (citation omitted).

191. 98 A.2d 581 (N.J. 1953).

above,<sup>192</sup> suggests the importance some corporate leaders have placed on the corporation's duty to the community:

Mr. Frank W. Abrams, chairman of the board of the Standard Oil Company of New Jersey, testified that corporations are expected to acknowledge their public responsibilities in support of the essential elements of our free enterprise system. He indicated that it was not "good business" to disappoint "this reasonable and justified public expectation," nor was it good business for corporations "to take substantial benefits from their membership in the economic community while avoiding the normally accepted obligations of citizenship in the social community." Mr. Irving S. Olds, former chairman of the board of the United States Steel Corporation, pointed out that corporations have a self-interest in the maintenance of liberal education as the bulwark of good government. He stated that "Capitalism and free enterprise owe their survival in no small degree to the existence of our private, independent universities" and that if American business does not aid in their maintenance it is not "properly protecting the long-range interest of its stockholders, its employees and its customers." Similarly, Dr. Harold W. Dodds, President of Princeton University, suggested that if private institutions of higher learning were replaced by governmental institutions our society would be vastly different and private enterprise in other fields would fade out rather promptly. Further on he stated that "democratic society will not long endure if it does not nourish within itself strong centers of non-governmental fountains of knowledge, opinions of all sorts not governmentally or politically originated. If the time comes when all these centers are absorbed into government, then freedom as we know it, I submit, is at an end."<sup>193</sup>

One of the earliest proponents of corporate policies designed to benefit employees and customers was Henry Ford, founder of the Ford Motor Company, the third largest automobile manufacturer in the United States. Originally, Ford's Model T sold for more than \$900. The price was lowered from time to time notwithstanding improvements made to the car, and in 1916 the car cost \$360.<sup>194</sup> In 1914, Ford built the first fully automated assembly line and cut the production time from twelve hours in 1908 to an hour-and-a-half.<sup>195</sup> When the new manufacturing facility opened, "Ford announced unprecedented wage increases—from an average of \$2.40 for a nine-hour day to a minimum of \$5.00 for an eight-hour day."<sup>196</sup> Even though Ford's cars were produced by the highest-paid industrial workforce in the United States, they cost only

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192. See *supra* notes 158-63 and accompanying text.

193. *A.P. Smith Mfg. Co.*, 98 A.2d at 583.

194. See *Dodge v. Ford Motor Co.*, 170 N.W. 668, 670 (Mich. 1919).

195. See JEFFREY L. CRUIKSHANK, *A DELICATE EXPERIMENT: THE HARVARD BUSINESS SCHOOL 1908 - 1945*, at 68 (1987).

196. *Id.*

half as much as the cars sold by Ford's nearest competitor.<sup>197</sup> Rather than follow suit, many manufacturers denounced Ford for driving up wage scales.<sup>198</sup>

Ford's policies of selling improved cars at lower prices and paying its workers well was driven by Henry Ford's business philosophy: "My ambition . . . is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes."<sup>199</sup> Ford was able to do this while still paying its founders cash dividends in the first thirteen years of the company's existence that were fifty times the original paid-in capital.<sup>200</sup> For the year ending on July 31, 1916, Ford's strategies of reducing price and increasing output resulted in profits of \$59,994,118 and capital surplus (assets minus liabilities and stated capital) of \$111,960,907.<sup>201</sup>

George W. Merck, Chair and CEO of Merck & Co., Inc. from 1925 to 1950, explained, "We try never to forget that medicine is for the people. It is not for the profits. The profits follow, and if we have remembered that, they have never failed to appear."<sup>202</sup> More recently, Raymond V. Gilmartin, CEO of Merck, echoed that sentiment:

We believe that our core values and adherence to high ethical standards are also important. They support our ability to innovate and create a favorable environment for innovation. They motivate our people and help to inspire confidence and trust among doctors who prescribe our medicines, regulators who approve them, health officials who decide whether or not to pay for them, and legislators and policy makers who can influence the cost and timeliness of their discovery.<sup>203</sup>

Numerous other recent examples of corporate stewardship abound. When 150-year-old Levi Strauss & Co., known as one of the industry's most benevolent employers, recently announced the closing of eleven U.S. plants and layoffs of 5900 employees because of the decreased demand for its goods and its decision to move more of its manufacturing

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197. *See id.*

198. *See id.* at 69.

199. *Dodge*, 170 N.W. at 671.

200. *See id.* In 1908, Ford amended its articles to increase the capital stock from the original paid-in capital of \$100,000 to \$2,000,000. *See id.* at 669. The difference of \$1,900,000 represented the shareholders' waiver of the right to previously declared dividends. *See id.* at 670. Thereafter, Ford paid regular dividends each year equal to 60% of the capital stock of \$2,000,000 (\$1,200,000) or 12 times the original paid in capital of \$100,000. *See id.* In addition, Ford paid \$41,000,000 in special dividends in the period from 1911 to 1915. *See id.*

201. *See id.* Indeed, Ford's phenomenal success prompted shareholders owning 10% of Ford's stock to sue in 1916 to demand more dividends. *See supra* notes 173-79 and accompanying text.

202. Raymond V. Gilmartin, *Innovation, Ethics and Core Values: Keys to Global Success*, 65 VITAL SPEECHES OF THE DAY 209, 210 (1999).

203. *Id.* at 209.



offshore, the company committed to providing a \$245 million employee package that included eight months' notice, as much as three weeks of severance pay for every year of service, up to eighteen months of medical coverage, an enhanced early retirement program, and a flexible allowance of up to six thousand dollars for training and start-up expenses.<sup>204</sup> This stands in sharp contrast to Safeway's grant of a maximum of four weeks severance and two weeks of medical coverage.<sup>205</sup> No doubt Levi's corporate values played a role in creating the severance package. Robert Haas, CEO of Levi's, has consistently expressed his ethical commitment and desire for corporate "aspirations" to guide all decisions.<sup>206</sup>

After the Malden Mills factory in Massachusetts, owned by Aaron Feuerstein, burned down in December 1995, Feuerstein continued to pay wages and benefits to workers who had no jobs as the new plant was being built. Since the completion of the new plant, worker productivity and quality have improved.<sup>207</sup> Feuerstein calls the gains "a direct result of the good will of our people."<sup>208</sup>

In the environmental arena, Sir John Browne, Chief Executive of British Petroleum Amoco (BP), expressed his company's philosophy on global warming as follows: "If we are all to take responsibility for the future of our planet, then it falls to us to begin to take precautionary action now."<sup>209</sup> Toward that end, BP instituted measurable objectives in 1997 to ensure that it was doing what it could to create a sustainable planet; these objectives included participating in the policy debate, searching for global solutions to the problem of global warming, developing alternative fuels for the long term, funding continuing scientific research, and controlling the company's own carbon dioxide emissions.<sup>210</sup>

204. See Miles Socha, *Bad Day at Levi's: 11 Plants to Close, Costing 5,900 Jobs*, WOMEN'S WEAR DAILY, Feb. 23, 1999, at 1.

205. See *supra* note 35 and accompanying text.

206. Gary R. Weaver et al., *Corporate Ethics Programs as Control Systems: Influences of Executive Commitment and Environmental Factors*, 42 ACAD. MGMT J. 41, 44 (1999).

207. See Bennett Daviss, *Profits from Principle: Five Forces Redefining Business*, FUTURIST, Mar. 1999, at 28, 30.

208. *Id.* Other examples include Interface, Inc., an environmentally responsible carpet manufacturer that saved \$40 million in costs, and Marriott International, whose multilingual employee help line helped cut turnover to 35%, compared with the industry average 100%. See *id.* at 28.

209. John Browne, *Breaking Ranks*, STANFORD BUS., Sept. 1997, at 18, 18.

210. See *id.*; see also Martha M. Hamilton, *British Petroleum Sets Goal of 10% Cut*

Other businesses are also coming forward and taking responsibility for sustaining the planet. Niagara Tomahawk Power, a New York state power-generation company, lowered its carbon dioxide emissions by 2.5 million tons. Then, under the U.S. emission trading program, it swapped those carbon dioxide emission rights for carbon dioxide allowances, which it gave to local environmental groups, who retired them.<sup>211</sup>

## V. RECOMMENDATIONS AND CONCLUSION

Corporate directors may (and often do), consistent with efficient markets and the spirit and the letter of the law, consider the effects of their decisions on constituencies other than shareholders. Indeed, directors often agonize over decisions to close plants or layoff workers.<sup>212</sup> The question remains how to encourage such behavior without jeopardizing the very freedom that such behavior is intended to protect.

This Article recognizes that the ability to consider nonshareholder constituencies, without more, is not sufficient either to ensure that directors consider such constituencies in their deliberations or to prevent management from using concern for other constituencies as a fig leaf to cover up mismanagement or entrenchment. As Professor Berle noted in 1932, "you can not abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else."<sup>213</sup>

This Article addresses this dilemma by following the example of proxy disclosures on executive compensation and the relationship between executive pay and corporate performance as a means of inducing change.<sup>214</sup> In the spirit of stewardship, transparency, and self-regulation,<sup>215</sup> this Article proposes that the SEC add a new item to

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in 'Greenhouse' Gases, WASH. POST, Sept. 18, 1998, at A6; William K. Stevens, *Deadline Set to Form Rules for Reducing Gas Emissions*, N.Y. TIMES, Nov. 15, 1998, § 1, at 1.

211. See John J. Fialka, *Breathing Easy: Clear Skies Are Goal as Pollution Is Turned into a Commodity*, WALL ST. J., Oct. 3, 1997, at A1.

212. For example, the chairman of Stride Rite, a shoe company recognized for its social commitments, described the decision to close its plant in New Bedford, Massachusetts, as "a difficult decision. . . . Our hearts said, 'Stay,' but our heads said, 'Move.'" Joseph Pereira, *Split Personality: Social Responsibility and Need for Low Cost Clash at Stride Rite*, WALL ST. J., May 28, 1993, at A1.

213. Berle, *supra* note 26, at 1367.

214. See 17 C.F.R. §§ 228, 229, 240, 249 (1998). For a more detailed discussion of these changes and the forces that played a role in the SEC's actions, see Tracy Scott Johnson, *Pay for Performance: Corporate Executive Compensation in the 1990s*, 20 DEL. J. CORP. L. 183 (1995).

215. The securities industry provides an excellent example of self-regulation that

Regulation S-K<sup>216</sup> requiring publicly traded companies to disclose in their annual reports on Form 10-K<sup>217</sup> all board-level corporate decisions made since the most recent Form 10-K that had a material impact on any constituencies, including shareholders, employees, management, customers, suppliers, creditors, the community, government entities, and the environment.<sup>218</sup>

This proposal would give all market participants, such as investors, employees, customers, and suppliers, the information they need to decide whether to invest in or do business with a particular company. Indeed, disclosure is the cornerstone of the Securities Act of 1933,<sup>219</sup>

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has been remarkably effective. With authority from Congress and the SEC, the National Association of Securities Dealers prescribes the eligibility criteria and registration requirements for broker-dealers and their employees, administers examinations to ensure minimum competency, and regulates the terms under which firms can underwrite securities offerings.

Perhaps the National Association of Corporate Directors, or some like organization, could perform a similar function for directors of publicly traded companies. In the United Kingdom, the Institute of Directors has proposed a director certification requirement, which it would administer. At a minimum, a self-regulatory organization could establish minimum standards for director education concerning business ethics and the fiduciary duties of loyalty, care, and oversight.

216. Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975. 17 C.F.R. §§ 229.10-229.19 (1998). Regulation S-K sets forth the disclosure requirements applicable to registration statements under the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994 & Supp. III 1997), and to periodic reports required to be filed under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78k (1994 & Supp. III 1997). For example, Item 103 requires, *inter alia*, disclosure of all pending administrative or judicial proceedings brought pursuant to federal or state environmental laws that are material to the company's business or financial condition. *See* 17 C.F.R. § 229.103; *see also infra* note 228 (discussing the definition of "material"). Other items include a description of the company's business and property, management's discussion and analysis of financial condition and results of operations, and selected financial data. *See id.* §§ 229.101, 229.102.

217. The annual report on Form 10-K contains detailed information called for by reference to the applicable items of Regulation S-K regarding the company's business and property, pending legal proceedings, audited financial statements for the fiscal year just ended, and management's discussion and analysis of financial condition and results of operations. *See* 17 C.F.R. §249.310 (1998). It must be filed with the SEC within 90 days of the end of the company's fiscal year, and is available to the public. *See id.*

218. In order to permit companies to keep certain decisions confidential for competitive reasons, the new item might give the board of directors discretion to delay public disclosure of confidential board decisions when the directors reasonably believe in good faith that disclosure would put the company at a competitive disadvantage. In such a case, disclosure would be required in the Form 10-K for the year in which the decision was made public.

219. 15 U.S.C. §§ 77a-77aa (1994 & Supp. III 1997).

which was a direct result of public and governmental outrage and distrust of the nation's financial markets that followed the stock market crash of 1929.<sup>220</sup> At the same time, our proposal would minimize the appeal of governmental intervention to protect such constituencies.<sup>221</sup>

The proposed disclosure requirement is akin to the National Environmental Protection Act's Environmental Impact Statement requirements with respect to major Federal actions,<sup>222</sup> government sunshine laws,<sup>223</sup> and laws requiring the registration of lobbyists and the reporting of political contributions.<sup>224</sup> This Article envisions a "balance sheet" approach suggested by other scholars in the past.<sup>225</sup> The extended balance sheet would take into account implicit promises that have been relied upon by other stakeholders but have not been reduced to writing.<sup>226</sup> Because of the nonexplicit nature of these promises, their legal enforceability is questionable; hence, they are generally ignored in financial statements and corporate decision making.<sup>227</sup>

Defining materiality in this context is somewhat problematic but it is a standard that has worked very well to protect securities holders from fraudulent misrepresentations and omissions by companies and their directors, officers, and underwriters.<sup>228</sup> The new Regulation S-K

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220. See LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 29 (1983). Congressman (later Speaker of the House of Representatives) Sam Rayburn stated during the congressional debate on what became the Securities Act of 1933, "Millions of citizens have been swindled into exchanging their savings for worthless stocks. . . . Safe from the pitiless publicity of Government supervision, unrestrained by Federal statute, free from any formal control, these few men [the hired officials of our great corporations], proud, arrogant, and blind, drove the country to financial ruin." H.R. 5480, 74th Cong., 77 CONG. REC. 2910, 2918 (1933), *reprinted in* 1 FED. SEC. L. LEGIS. HIST. 1933-1982, at 168, 176 (1983).

221. See Soros, *supra* note 46, at 45.

222. See 42 U.S.C. § 4332(C) (1994 & Supp. III 1997).

223. See, e.g., 5 U.S.C. § 552(a) (1994 & Supp. III 1997).

224. See 2 U.S.C. §§ 1603-1604 (1994 & Supp. III 1997).

225. See, e.g., Cornell & Shapiro, *supra* note 8, at 5-14. Cornell and Shapiro suggest the preparation of an extended balance sheet that would list the claims of non-investor stakeholders. In particular, they suggest including on the asset side of the balance sheet, organizational capital, which is the "current market value of all future implicit claims the firm expects to sell." *Id.* at 8. On the liabilities side of the balance sheet, they include organizational liabilities, or the "expected costs, from the firm's standpoint, of honoring both current and future implicit claims." *Id.*

226. See *id.*

227. See *id.*

228. See 17 C.F.R. § 240.10b-5 (1998). Rule 10b-5 provides in pertinent part: "It shall be unlawful for any person, directly or indirectly . . . (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." *Id.* Rule 10b-5 was promulgated by the SEC under its authority as established in section 10(b) of the Securities Exchange Act of 1934. See *Basic Inc. v. Levinson*, 485 U.S. 224, 230-31 (1988) (explaining background of 10(b)).

In Staff Accounting Bulletin No. 99, 1999 WL 1123073 (SEC Aug. 12, 1999), the

requirement could provide some bright-line examples of matters that must always be disclosed. There are several potential models of material effects, including the Worker Adjustment and Retraining Notification Act,<sup>229</sup> which compels employers with one hundred or more full-time workers to notify employees sixty days in advance of an intended plant closing or mass layoff, and Wyoming's plant siting law, which provides that no industrial facility exceeding a certain value may be constructed without a thorough assessment of the impact on nearby communities.<sup>230</sup> Similarly, a company could be required to disclose employee layoffs of more than a specified percentage of their workforce in the previous fiscal year. Or, if a company employs more than a specified percentage of a community's workers, it could be required to disclose layoffs involving more than a specified percentage of the company's employees in that community. A company might also be required to disclose any disposal of hazardous waste outside the United States that would be illegal if disposed of in that manner within the United States.

The Safeway LBO and subsequent store closing and layoff decisions are replete with examples of material impacts on constituencies. For example, management gained positive material benefits, as did the shareholders, at least in the short-term. Employees, suppliers, customers, and communities, on the other hand, suffered material negative effects. While it may be impossible to predict all of the costs and benefits of an action, thoughtful consideration and disclosure of the probable effects will allow for more informed, thoughtful, and (hopefully) ethical decisions.

Requiring companies to disclose the material effects of their decisions on all corporate constituencies would have several positive byproducts that address many of the deficiencies of the current model of corporate

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staff of the SEC's Division of Corporate Finance and the Office of the Chief Accountant cautioned companies and their auditors that the materiality of an item for purposes of preparation of the audited financial statements cannot be determined solely by reference to quantitative percentage thresholds or rules of thumb. *See id.* at \*2. "A matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important." *Id.* The staff indicated that this formulation is in substance identical to the formulation used by the courts in interpreting the federal securities laws. *See id.* (stating that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available") (citing *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

229. 29 U.S.C. §§ 2101-2109 (1994).

230. *See* WYO. STAT. ANN. §§ 35-12-102, 106 (Michie 1999).

governance described in this Article. Specifically, disclosure would address the issues of efficiency, fairness, and practicality that have been advanced as justifications of the current emphasis on shareholder value.

The disclosure requirement advances economic efficiency in three ways. First, it forces directors to consider any externalities they are imposing on others, and to examine whether those costs are in fact less than the expected benefits in the aggregate and whether the costs are borne by the group receiving the expected benefits. There seems to be a presumption that deals are either a positive sum or zero sum proposition. It is certainly possible that corporate transactions can destroy net economic and social value. This may have been the case with Safeway's LBO. While this proposal does not prohibit such transactions, it would be beneficial for this information to be made public.

Second, the disclosure requirement increases the quality and quantity of the information that shareholders receive with respect to their companies, and the quality and quantity of feedback that directors get from all affected constituencies, including the shareholders they purport to represent. In essence, disclosure helps close the social gap between directors and the constituencies that their decisions impact.

Third, disclosure relieves the societal inefficiency caused by the common goods problem. This Article's proposal would make it more likely that firms not free ride and instead contribute their fair share to the creation of public goods by illuminating attempts to "cheat." In this way, firms such as British Petroleum Amoco, which are led by persons willing to take the first step toward solving global problems, will not be forced to sacrifice shareholder value by behaving responsibly.<sup>231</sup>

The disclosure requirement advances fairness by leveling the playing field for corporations that behave ethically and those that do not. Under current standards, the first organizations to find new ways of exploiting externalities before social, market, legal, and regulatory pressures foreclose or reduce those opportunities are rewarded for their behavior, while all organizations suffer from the backlash that often follows. In addition, if the extent of externalization is concealed, the more responsible organizations may be forced to lower their standards as well, akin to the economic principle that when quality is uncertain, bad products drive out good.<sup>232</sup> Further, the longer the irresponsible behavior can be concealed, the greater the potential financial gain. Disclosure provides an earlier opportunity for counterbalancing forces to take effect.

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231. See *supra* note 209 and accompanying text.

232. See, e.g., George Akerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 J. ECON. 488, 488-500 (1970).

Finally, the disclosure requirement is pragmatic. It preserves board autonomy while allowing interested parties to make informed decisions about their relationship with the firm. It may also reduce the socio-economic costs borne by stakeholders affected by a corporate action by providing stakeholders earlier warning of the decision and the opportunity to alter their behavior to mitigate its adverse impact.

The efficacy of disclosure requirements in changing corporate behavior is demonstrated by the effect of the executive compensation disclosure rules.<sup>233</sup> These rules require that executive compensation and company performance be clearly presented and that the compensation committee of the board of directors explain how they arrived at their compensation decisions. Recent studies have shown that the disclosure requirements have increased the relationship between compensation and performance.<sup>234</sup>

In sum, disclosure would remove the veil of secrecy and make each director more visible to the various constituencies, as well as the directors' friends and relatives, for all of the consequences of the board decisions. In the same way that publications like the *Wall Street Journal* regularly include a box with the names of all the directors of a firm involved in a corporate failure or scandal, thereby threatening their reputational capital,<sup>235</sup> this Article's proposal would lead to the identification of the individuals behind decisions to close plants, lay off workers, dump toxic waste, or sell unsafe products. One can imagine the discomfort a director of Ford Motor Company might have experienced if asked at the breakfast table to explain why Ford chose to manufacture cars with known deadly defects that could have been eliminated for a few dollars.<sup>236</sup> At the same time, this proposal would empower those directors who want to vote their conscience and to act in a socially responsible manner to do so by making it harder for the "cheaters"—those who impose their social costs on others—to secretly attain a competitive advantage thereby.

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233. See 17 C.F.R. §§ 229, 240 (1998).

234. See, e.g., John Byrd & Kent Hickman, *Pay for Performance: Does Disclosure Matter?*, 21 *MANAGERIAL FIN.* 24 (1995).

235. See generally Gregg Jarrell & Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 *J. POLITICAL ECON.* 512, 512-36 (1985); David M. Kreps & Robert Wilson, *Reputation and Imperfect Information*, 27 *J. ECON. THEORY* 253, 253-79 (1982); Edward C. Prescott & Michael Visscher, *Organizational Capital*, 88 *J. POLITICAL ECON.* 446, 446-61 (1980); Carl Shapiro, *Consumer Information, Product Quality, and Seller Reputation*, *BELL J. ECON.*, Spring 1982, 20, 20-35.

236. See *supra* notes 53-59 and accompanying text.

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APPENDIX B



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