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Corporate Law, Profit Maximization and the "Responsible" Shareholder

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Introduction

This Article explores the relationship between shareholder ethical responsibility and corporate law. Shareholder responsibility is a neglected aspect of the debate about corporate social responsibility. In that debate, conservatives defend the view that corporate law obligates management to pursue stockholders’ profit without regard to ethical considerations or social responsibility except insofar as the latter might affect profits. Even some critics of profit maximization concede the accuracy of the conservatives’ description of management’s corporate law duties, and blame those duties for corporations’ antisocial behavior. The truth is, however, that corporate law does not preclude the independent consideration of ethics or social responsibility. In this Article, I argue that if the critics are correct that corporate power is used unethically and irresponsibly in the pursuit of greater profits, it is not so much because of corporate law as because of the self-interest and inertia of shareholders, for whom the maximization of their profits is congenial.

The “responsible” shareholder is therefore important because with such shareholders, rather than with corporate managers alone, rests any hope one might have for greater corporate social responsibility.

Curiously, however, many academic corporate lawyers are dismissive or suspicious of the notion of ethical investment decision-making, by which I mean the making of investment decisions at least partly on the basis of considerations other than profit or other self-interest. Ethical investment decision-making is, I argue, unimpeachable from the standpoint of the conception of the corporation that now predominates in the corporate law academy — the view that the corporation is best thought of as a "nexus of contracts" among the various participants. However, ethical investors are awkward for those academic corporate lawyers who subscribe to the view that corporations *should* be managed exclusively with a view to the maximization of stockholder profits, a normative position not entailed by the "nexus of contracts" conception. In this Article, I suggest that it is misguided to respond to this tension, as some prominent theorists of the corporation have done, by disparaging ethical investment decision-making.

The Article is organized as follows. In Part I, I outline the debate concerning the legality and desirability of corporate social responsibility and discuss the underlying theoretical framework. In Part II, I articulate the view that shareholders have a degree of responsibility for the conduct of incorporated business, because they are the people for whose benefit the conduct occurs and no one forces them to invest. In Part III, I discuss the relationship between shareholder responsibility and the conventional theoretical framework for the normative analysis of corporate law.

In Part IV, I discuss the implications of the foregoing for three specific questions arising in the context of ethical investing, namely (a) whether corporate management should be permitted (or required) to take into account the expressed ethical views of groups of shareholders; (b) whether corporate law should filter out ethically-motivated shareholder proposals; and (c) whether disclosure of matters relevant to ethical analysis of corporate conduct should be mandatory.

Two qualifications about the scope of this Article are in order before proceeding further. First, the focus of this Article is on shareholders in widely-held corporations, and so I will not discuss "socially responsible" investments in anything other than publicly traded shares. Second, I assume an individual shareholder investing for his or her own account, and do not discuss pension funds, socially responsible mutual funds, or other intermediaries, as I want to focus on corporate law issues and leave to one side, for present purposes, issues arising under the law of trusts.

Part I — Corporate law and profit maximization

The persistently ambiguous state of the law

In the corporate law academy today in the United States, the dominant view is that corporate law requires managers to pursue a single aim: the maximization of stockholder profits.[1]

One sign of the dominance of the view is a certain triumphalism on the part of those who believe that stockholder profit maximization is normatively desirable. For example, in a provocative article, Henry Hansmann and Reinier Kraakman have announced "the end of history

[1] Blair and Stout are prominent dissenters from this view. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 303-05 (1999). Although sometimes the goal is stated as the maximization of the "corporation's" profits, it is important to bear in mind that, by accounting convention, the profits of the corporation are calculated in such a manner as to correspond exactly to the increase in the shareholders' equity in the corporation.

for corporate law":[2] they argue that it is settled that the main purpose of corporate law is to maximize "long-term shareholder value,"[3] and they claim that legal systems in other nations are converging towards this position, or will slowly but surely be drawn to it, in large part because of its inherent superiority.[4]

Moreover, even some of those who support broader conceptions of corporate aims concede defeat on the descriptive question whether corporate law requires an exclusive focus on profit maximization. A recent example is Joel Bakan's book, *The Corporation*, and the related documentary film, in which corporations are "diagnosed" as psychopathic.[5] Bakan argues that corporations are that way because of corporate law, which he says *obligates* corporate managers to exploit workers, communities and consumers if it will increase profits.[6]

In my view, both those who praise an exclusive focus on shareholder profit maximization and those who deplore it exaggerate its claim to describe accurately the state of corporate law in the United States. The legal situation is, in fact, persistently ambiguous.

In describing the duties of directors, U.S. corporations statutes typically refer to "the interests of the corporation."[7] It is far from clear that the plain meaning of these words requires that the interests of the corporation be understood as synonymous with the maximization of the shareholders' profits from the venture.[8] Indeed nearly half of the states have adopted so-called

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[2] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001).
[3] *Id*.
[4] *Id.* at 468. Other examples include Roberta Romano and Jonathan Macey. Romano has written, without providing arguments in support, that "the objective of U.S. corporate law . . . is to maximize share value." Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 186 n.30 (2001) [hereinafter Romano, *Less is More*]; *id*. at 246; *see also* Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 363 n.21 (2004) (arguing that U.S. corporate law obligates management to pursue the maximization of the value of the shareholders' investment, and no other interest); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure and Enron*, 89 CORNELL L. REV. 394, 403 n.49 (2004) (same).
[5] JOEL BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER 56-57 (2004); *The Corporation* (Big Picture Media Corporation 2004).
[6] BAKAN, *supra* note 5, at 1-2 ("The corporation's legally defined mandate is to pursue, relentlessly and without exception, its own self-interest, regardless of the often harmful consequences it might cause to others."); *id*. at 39 ("The rule that corporations exist solely to maximize returns to their shareholders is 'the law of the land' . . . ."). Robert Hinkley argues, similarly, that because "the people who run corporations have a legal duty to shareholders, and that duty is to make money, . . . [c]orporate law thus casts ethical and social concerns as irrelevant, or as stumbling blocks to the corporation's fundamental mandate." *See* Robert Hinkley, *How Corporate Law Inhibits Social Responsibility*, BUS. ETHICS: CORP. SOCIAL RESP. REPORT (Jan.-Feb. 2002), *at* http://www.commondreams.org/views02/0119-04.htm (last accessed on Mar. 25, 2005).
[7] *See, e.g*, CAL. CORP. CODE § 309(a) (West 2004) ("in the best interests of the corporation and its shareholders"); N.Y. BUS. CORP. LAW § 717(b) (McKinney 2004) ("the long-term and the short-term interests of the corporation and its shareholders"); NEV. REV. STAT. 78.138(1) (2004) ("interests of the corporation"); 805 ILL. COMP. STAT. ANN. 5/8.85 (West 2004) ("best long term and short term interests of the corporation"); N.J. STAT. ANN. § 14A:6-1 (West 2004) ("best interest of the corporation").
[8] French corporate lawyers know this, working as they do with the analogous concept of *intérêt social*, which goes beyond the interests of the shareholders. *See* ASSOCIATION FRANÇAISE DES ENTREPRISES PRIVEES & CONSEIL NATIONAL DU PATRONAT FRANÇAIS, LE CONSEIL D'ADMINISTRATION DES SOCIETES COTEES (RAPPORT VIENOT I) 8 (1995); Lauren J. Aste, *Reforming French Corporate Governance: A Return to the Two-Tier Board?,* 32 GEO. WASH. J. INT'L L. & ECON. 1, 27 (1999); *see also* Dominique Schmidt, *De l'intérêt social*, 38 LA SEMAINE JURIDIQUE ENTREPRISE ET AFFAIRES 488 (1999).

"constituency" statutes, which permit the board of directors to consider the interests of non-shareholder constituencies in forming a judgment as to the best interests of the corporation.[9]

Directors' duties were originally articulated by the courts as a matter of common law.[10] The starting-point for any discussion of the case law is the 1919 decision of the Michigan Supreme Court in *Dodge v. Ford*, in which the Court wrote:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself.[11]

Although the case is often interpreted as announcing an uncompromising position on profit maximization, subsequent case law has been more nuanced. Thus, for example, the Delaware courts have held that corporate charitable contributions are permissible provided that they are reasonable in amount and purpose.[12] The reasoning of the leading judicial decision on this point provides support both for the position that the law recognizes the intrinsic appropriateness of

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Similarly, in interpreting the provision of the Canada Business Corporations Act that requires directors and officers to act with a view to the "best interests of the corporation," the Supreme Court of Canada recently held that that phrase "should be read not simply as the 'best interests of the shareholders.'" Peoples Department Stores (Trustee of) v. Wise, [2004] SCC 68, ¶ 42 (October 29, 2004).

[9] CONN. GEN. STAT. § 33-756(d) (2003); FLA. STAT. ch. 607.0830(3) (2003); HAW. REV. STAT. § 414-221(b) (2003); 805 ILL. COMP. STAT. ANN. 5/8.85 (West 2004); IND. CODE ANN. §23-1-35-1(d) (Michie 2004); KY. REV. STAT. ANN. § 271B.12-210(4) (Michie 2004); LA. REV. STAT. ANN. § 92(G)(2) (West 2004); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 2004); MINN. STAT. § 302A.251(5) (2003); MISS. CODE ANN. § 79-4-8.30(f) (2004); NEV. REV. STAT. § 78.138(4) (2004); N.J. STAT. ANN. § 14A:6-1(2) (West 2004); N.M. STAT. ANN. § 53-11-35(D) (Michie 2004); N.Y. BUS. CORP. LAW § 717(b) (McKinney 2004); N.D. CENT. CODE § 10-19.1-50(6) (2003); OHIO REV. CODE ANN. § 1701.59(E) (Anderson 2004); OR. REV. STAT. § 60.357(5) (2003); 15 PA. CONS. STAT. § 515 (2004); R.I. GEN. LAWS § 7-5.2-8(a) (2004); S.D. CODIFIED LAWS § 47-33-4(1) (Michie 2003); VT. STAT. ANN. tit. 11A, § 8.30(a) (2003); WIS. STAT. § 180.0827 (2003); WYO. STAT. ANN. § 17-16-830(e) (Michie 2003). *See* Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992). Many commentators, especially (but not exclusively) advocates of shareholder primacy, have criticized the statutes on the ground that, despite their portrayal as "progressive," their permissive formulation serves only to enhance managerial discretion and to facilitate managerial entrenchment without any substantial benefit to non-shareholder constituents. *See, e.g.*, Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 911 (2005) (discussing the permissive wording of constituency statutes and their origins in pro-management political activity); Joseph W. Singer, *Jobs and Justice: Rethinking the Stakeholder Debate*, 43 U. TORONTO L.J. 475, 503-06 (1993) (expressing doubt that constituency statutes will be of much benefit to the non-shareholders whose interests they purport to protect).

[10] *See* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 288 (1998). In the all-important state of Delaware, there remains no statutory statement of the entity or individuals to whom directors owe their duty of loyalty. In *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939), the common-law duty is articulated as one of "undivided and unselfish loyalty to the *corporation*" (emphasis added).

[11] Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

[12] Theodora Holding Corp. v. Henderson, 257 A.2d 398, 405 (Del. Ch. 1969) (construing Delaware law as "authoriz[ing] any reasonable corporate gift of a charitable or educational nature").

corporate support for public causes,[13] and for the seemingly contrary position that corporate donations are legitimate only because they are ultimately beneficial to the shareholders.[14]

It is commonly observed that, as a practical matter, courts will not interfere with corporate social responsibility because there is almost always a plausible argument that actions considerate of a corporation's employees, customers or creditors or the environment are in the long-term interests of the corporation's stockholders. It has been easier, because of this fact, for courts to preserve the ambiguity of the legal standard.

This is not to deny that there may be situations where the interests of shareholders and non-shareholders diverge in a manner that makes it more difficult to rationalize an act undertaken for the benefit of a non-shareholder constituency as being also, ultimately, in the interests of the shareholders. For instance, when a corporation is in financial distress, the stockholders' interests might well be served by the taking of severe risks that, if they pay off, will produce profits for the corporation and its shareholders but, if they fail, will leave creditors unpaid. In such circumstances, however, Delaware law does not require corporate management to prefer the stockholders' interests. To the contrary, the leading case holds that "a board of directors is not merely the agent of the residue [sic] risk bearers, but owes its duty to the corporate enterprise."[15]

The other paradigmatic situation of conflict between shareholders and non-shareholders' interests is in connection with a hostile takeover, since the economic interest of the shareholders lies in having access to an above-market bid for their shares even if the takeover is expected to be detrimental to employees or another non-shareholder constituency. The Delaware courts have not unequivocally held in this context, either, that management must prefer the interests of shareholders. In the 1985 case of *Unocal v. Mesa Petroleum*, the Delaware Supreme Court held that management may take into account the impact of the takeover on its non-shareholder constituencies.[16] In a series of cases over the following eight years,[17] the Court qualified its position by stating that consideration of non-stockholder interests was conditioned on the presence of "rationally related benefits accruing to the stockholders"[18] and that a focus on obtaining the best price for the stockholders must prevail over other considerations once the directors have decided to abandon their "long-term strategy" or have decided to sell the business.[19] Significantly, however, the requirement to set aside a "long-term strategy" reconciling the interests of non-shareholder constituencies and "benefits accruing to the stockholders" does not arise unless management has

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13 *Id.* at 404 ("The recognized obligation of corporations towards philanthropic, educational and artistic causes is reflected in the statutory law of all of the states, other than the states of Arizona and Idaho.").

14 *Id.* at 405 ("[T]he relatively small loss of immediate income otherwise payable to . . . [the shareholders because of the donation] is far out-weighed by the overall benefits flowing from . . . [the donation, which in providing] justification for large private holdings, thereby . . . [benefits the shareholders] in the long run.").

15 Credit Lyonnais Bank Nederland N.V. v. Pathé Communications Corp., No. 12150, 1991 Del. Ch. LEXIS 215, 108 (Dec. 30, 1991) (board of directors of a corporation in financial distress was not liable to shareholders for refusing to pursue a high-risk strategy preferred by the shareholders but harmful to the interests of the corporation's creditors).

16 Unocal v. Mesa Petroleum 493 A.2d 946, 955 (Del. 1985).

17 Revlon v. MacAndrews, 506 A.2d 173, 193 (Del. 1986); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989); Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994).

18 Revlon v. MacAndrews, 506 A.2d at 176.

19 Paramount v. QVC, 637 A.2d at 43.

already decided to pursue a sale of the business or a change of control.[20] That threshold decision, of course, may be made in the usual manner and with due regard to non-shareholder interests.

In light of this case law, one can easily understand why the respected former chief justice of Delaware's specialist corporate law court has described the legal conception of the corporation as "schizophrenic," and predicted that it would likely continue indefinitely to be so.[21] It is, to say the least, an overstatement to claim that corporate law makes the interests of the corporation synonymous with the maximization of the shareholders' profits.

Profit maximization and the stock market

If the law does not obligate management to focus exclusively on the maximization of the stockholders' profits, there is nonetheless a mechanism which ensures that management's conduct is at least somewhat responsive to shareholders' wishes: the stock market.

If a corporation is managed in a way that is congenial to current and potential shareholders, the result will be a higher stock price. If management departs from what shareholders want, the stock price will suffer and management will be punished either through the operation of equity-based compensation, or, in more extreme cases, because a depressed stock price makes the corporation a takeover target.[22] In this way, to a degree of approximation, it is the aggregated preferences of stockholders that ultimately determine management's freedom to act responsibly, just as the aggregated preferences of consumers ultimately determine whether cosmetics are "cruelty-free" and whether the tuna fishery is "dolphin-safe."

I want to be careful not to overstate the case for market discipline of management. Takeovers are costly, and, in addition, management has some ability to blunt the disciplinary force of the market for corporate control through the adoption of takeover defenses or golden parachutes.[23] As for equity-based compensation, Bebchuk and Fried have suggested that it is often structured in ways that reduce its sensitivity to the firm's financial performance.[24] Still, to say that the

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[20] *See* Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1289 (Del. 1994). In addition, the Delaware Supreme Court has held that a similar focus on shareholder value-maximization applies where a majority shareholder has proposed a transaction in which all of the corporation's stock would be sold to a third party. *See* McMullin v. Beran, 765 A.2d 910 (Del. 2000).

[21] William T. Allen, *Our Schizophrenic Conception of the Corporation*, 14 CARDOZO L. REV. 261, 280 (1992).

[22] The argument that a stock price decline exposes the corporation to a hostile acquisition of control, and that this prospect constrains management, originates with Henry Manne. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) [hereinafter Manne, *Market for Corporate Control*]. Manne recently reprised his argument in Henry G. Manne, *A Free Market Model of a Large Corporation System*, 52 EMORY L.J. 1381, 1389 (2003) [hereinafter Manne, *Free Market Model*] (advocating an "unfettered market for corporate control"). Manne's argument has been influential. *See, e.g.*, Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY. BUS. L.J. 1, 33 (2004) (describing the widespread acceptance of Manne's argument within "the legal and finance faculties of leading universities"); William J. Carney, *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215, 225 (1999) (Manne's 1965 article is the most-cited corporate law article of all time).

[23] For commentary skeptical of the disciplinary value of the market for corporate control, see John C. Coffee Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984).

[24] LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004). The book extends an argument previously made by Bebchuk, Fried, and

mechanism works approximately is not to say that it does not work at all. Indeed, academic commentary skeptical of the disciplinary effect of market mechanisms has focused on its incapacity to deter managerial decisions involving substantial transfers of value from the corporation to the managers.[25] This literature does not, accordingly, cast doubt on the notion that the stock market, via the market for corporate control, operates as a constraint upon profit-reducing decisions that would primarily benefit employees, the environment, society at large, or, indeed, any non-shareholder constituency other than the managers themselves. The basic point is unchallenged: the stock market makes management sensitive to the aggregate preferences of current and potential stockholders.

To be sure, the influence of the stock market over the conduct of corporate management is itself attributable to provisions of corporate law.[26] Of particular importance is the shareholder franchise, a necessary condition for the functioning of the market for corporate control. Nonetheless, corporate law does not impose upon management an exclusive profit-maximizing duty, but merely links management's fate to the stockholders' pleasure. The aggregated choices of participants in the stock market will determine the extent of management's freedom to pursue goals apart from profit-maximization. In other words, if the critics are right that management pursues stockholder profits to the exclusion of all considerations of ethics, decency and social responsibility, it is not so much because corporate law requires it as because it suits the stockholders.

The normative debate

I have argued that the self-interest of stockholders is a significant reason why there is not greater corporate social responsibility. I realize that many readers will be unwilling to take for granted that corporate social responsibility is necessary or desirable, and it is to this contested question that I now turn. I disclaim any ambition here to resolve what has become a somewhat unproductive debate between entrenched positions. I do want to suggest that the debate, as it pertains to corporate law, is ultimately over whether the limits to corporate profit maximization should be solely external to the corporation (such as substantive regulation or consumer market

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David I. Walker in Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

[25] *See* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1462 (1992). Bebchuk observes that the market for corporate control creates incentives to avoid "unnecessary reductions in share value." *Id.* He acknowledges that it therefore discourages value-reducing decisions, except where the decision effects a substantial transfer of value from the corporation to the manager, in which case the manager's benefit from the transfer will outweigh the incentives created by the market for corporate control. *Id.* According to Bebchuk, examples of decisions that are significantly redistributive in this manner include executive compensation, insider trading and self-dealing transactions. *See* BEBCHUK & FRIED, *supra* note 24, at 53 (discussing executive compensation); Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1841 (1989) (mentioning insider trading and self-dealing).

[26] Lawrence E. Mitchell makes this argument in his book, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT (2001). Mitchell describes the concept of stock price maximization as a "dictate that arises from the legal structure of the American corporation and the rules of corporate law," *id*. at 4, by which he means not simply management's legal duties, about which Mitchell is unspecific, but also management's accountability to shareholders through the ability to elect and dismiss directors, shareholders' exclusive right to bring derivative litigation, the takeover market and equity-based compensation. *Id*. at 99-111. Mitchell's proposal is to reduce the accountability of management to shareholders, for example, by lengthening directors' terms, *id*. at 129-31, and to encourage or force shareholders to invest for the long term rather than with a view to short-term profits. *Id*. at 157-64.

pressure) or whether there should be any internal limits. In my view, there is a strong argument for at least some internal limits.

Conceptual and pragmatic arguments

The argument about corporate social responsibility has taken place on two planes, the conceptual and the pragmatic.

On the conceptual plane, the argument for profit maximization is based on the notion that the shareholders, as owners of the corporation, are entitled to expect that *their* assets would be deployed to this end. Milton Friedman is a well-known defender of this view, which he first articulated in 1962, in arguing that the only "social responsibility" of business is "to make as much money for their stockholders as possible,"[27] for reasons that include the fact that "[the] corporation is an instrument of the stockholders who own it."[28]

It is important to recognize that the notion that shareholders are the "owners" of the corporation cuts both ways in the debate about corporate social responsibility and, in particular, can be invoked in support of a demand for responsibility by the shareholders themselves. For instance, when Dow Chemical's management refused a request by a Dow shareholder, the Medical Committee for Human Rights, to include in its proxy circular a proposal to amend Dow's charter to restrict the corporation's manufacture and sale of napalm, the Medical Committee argued in response that "the company's owners have not only the legal power but also the historic and economic obligation to determine what products their company will manufacture."[29] In granting review of a decision by the Securities and Exchange Commission that had upheld Dow's decision to exclude the proposal, the D.C. Circuit Court of Appeals adopted the Medical Committee's characterization of the shareholders as owners.[30] The Court further indicated that as owners they were entitled to "control . . . important decisions" affecting them, including those concerning the socially responsible conduct of corporate business.[31]

The arguments from ownership correspond to a theory of corporate personality known as the "aggregate" theory. According to the aggregate theory, the corporation is to be regarded as an extension of its shareholders,[32] corporate property is the property of the shareholders in special

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[27] MILTON FRIEDMAN, *Monopoly and the Social Responsibility of Business and Labor*, *in* CAPITALISM AND FREEDOM 119, 133 (1962).
[28] *Id*. at 135; *see also* Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAGAZINE, Sept. 13, 1970, at 32.
[29] Med. Comm. for Human Rights v. SEC, 432 F.2d 659, 662 (D.C. Cir. 1970).
[30] *Id.* at 680-81 ("[The statutory proxy mechanism's] overriding purpose is to assure to corporate shareholders the ability to exercise their right — some would say their duty — to control the important decisions which affect them in their capacity as stockholders and *owners of the corporation*." (emphasis added)).
[31] *Id.* at 681 ("No reason has been advanced in the present proceedings which leads to the conclusion that management may properly place obstacles in the path of shareholders who wish to present to their *co-owners*, in accord with applicable state law, the question of whether they wish to have their assets used in a manner which they believe to be more socially responsible but possibly less profitable than that which is dictated by present company policy." (emphasis added)).
[32] Dartmouth College v. Woodward, 17 U.S. 518, 667 (1819) (Story, J. describing corporations as "collection[s] of individuals"); *see also* STEWART KYD, A TREATISE ON THE LAW OF CORPORATIONS 13 (Garland Publishing Inc. 1978) (1793) ("A corporation then, or a body politic, or body incorporate, is a collection of many individuals, united into one body, . . . and vested, by the policy of the law, with the capacity of acting, in several respects, as an *individual*, particularly of taking and granting property, of contracting obligations, and of suing and being sued . . . ."); *see* William W. Bratton, Jr., *The "Nexus of*

form, and corporate acts are acts on behalf of the shareholders. Corporate personality is, on this view, merely a fiction adopted by the law for convenience.

The aggregate theory held sway with legal writers and judges from the emergence of modern incorporation statutes in the mid-19th century through to the end of that century. However, by the turn of the 20th century, the emergence of large-scale enterprises, in which shareholders played a passive role, made it difficult to attribute corporate acts to the shareholders themselves or to conceive of shareholders as owners rather than investors.[33] Under the influence of German theorists who suggested that corporate legal personality translated the corporation's existence as a real entity separate from its shareholders,[34] the corporation came increasingly to be viewed as an institution in its own right, rather than as the shareholders in special form. This institution might have, as its purpose, the pursuit of profit for its stockholders,[35] or it might have broader purposes. E.M. Dodd defended the latter position in his famous debate with A.A. Berle in the pages of the Harvard Law Review.[36]

As illustrated by Friedman's argument and by the *Medical Committee* decision, the aggregate theory did not completely disappear from the scene. However, most commentators now regard as inconclusive, and even unhelpful, arguments for shareholder profit maximization based on the concept of ownership.[37] In the first place, the metaphor of ownership does not reflect the legal relationship of shareholders to the corporation. In legal terms, shareholders are not the owners of the corporation.[38] Rather, they own shares of the capital stock of the corporation, meaning that they own choses in action giving them certain rights (determined by corporate law and the corporate charter) with respect to corporate governance and the assets of the corporation. These rights typically include the right to elect or remove the members of the board of directors,[39] to approve or reject fundamental changes, such as mergers or amendments to the charter,[40] and, if and when the

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Contracts" Corporation: A Critical Appraisal, 74 CORNELL L. REV. 407, 424 (1989) (describing the aggregate theory); Allen, *supra* note 21, at 266-70 (describing this conception, which Allen refers to as the "property" conception); Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 182 (1985).

[33] *See* Horwitz, *supra* note 32, at 223; Bratton, *supra* note 32.

[34] *E.g.*, OTTO FRIEDRICH VON GIERKE, POLITICAL THEORIES OF THE MIDDLE AGE (Frederic William Maitland trans., 1958).

[35] Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders.").

[36] *See* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931) (arguing that managers' powers should be viewed as "exercisable only for the ratable benefit of all the shareholders"); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148, 1161 (1932) (responding that the corporation was increasingly viewed as "an economic institution which has a social service as well as a profit-making function" and arguing that managers should consequently be permitted to conduct the corporation's business "in a manner appropriate to a person practising a profession and imbued with a sense of social responsibility"); *see also* A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

[37] *See* Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002); Allen, *supra* note 21, at 269; Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1416 (1993) ("[S]hareholders are not property owners."); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1427 (1993) [hereinafter Bainbridge, *In Defense of Shareholder Wealth Maximization*] (agreeing with Green on this point); MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 5 (1995).

[38] *See* Stout, *supra* note 37, at 1191.

[39] *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141(k), 211(b) (2004).

[40] *See, e.g.*, *id*. §§ 242(b), 251(c).

corporation is ever liquidated, to receive whatever assets remain after all of the creditors have been paid.[41] Importantly, however, shareholders have no property rights in the corporation's assets: a shareholder of Wal-Mart Stores, Inc., can be prosecuted for shoplifting from Wal-Mart. Moreover, they do not have the legal power to dispose of those assets or to direct management's actions. Corporate law firmly vests this power in the board of directors[42] and insulates the latter from direct interference by the shareholders.[43]

More fundamentally, the argument from ownership is unhelpful because it takes for granted that shareholders are analogous to owners, while obscuring the more pertinent inquiry into what grounds of analogy, if any, there are, between shareholders and property owners, and whether those grounds justify imposing a duty on the part of the management to maximize the shareholders' profits. As William Allen put it, "the premise of 'ownership' simply assumes but does not justify an answer."[44]

And so, the debate about profit maximization also takes place on a more pragmatic level, where the basic question is: is the power wielded by those who manage corporations better channeled by imposing legal duties to serve only the financial interests of shareholders or by requiring or permitting them also to consider the broader impact of their activity? In support of a broader duty, one can cite the harm to non-shareholder interests that may be caused by single-minded profit maximization. In support of a narrower duty, it is argued that replacing profit maximization with a more amorphous goal of social responsibility effectively liberates management to pursue its own interests, under the guise of social responsibility, at the expense of shareholders and non-shareholders alike.[45]

The practical difference between these positions might be smaller than at first appears. On the one hand, as the proponents of profit maximization often point out, even a profit-maximizing firm will act responsibly to the extent that responsibility is a profit-enhancing strategy.[46] On the other hand, one must be careful not to overstate the constraining value of a legal duty upon management

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[41] *See, e.g.*, *id.* § 281.
[42] *See, e.g.*, *id.* § 141(a).
[43] Continental Sec. Co. v. Belmont, 99 N.E. 138, 141 (N.Y. 1912); Peter V. Letsou, *Shareholder Voice and the Market for Corporate Control*, 70 WASH. U. L.Q. 755, 760-61 (1992) (detailing shareholders' lack of power under state corporate law to direct corporate actions); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) [hereinafter Bainbridge, *Director Primacy*] (same); Blair and Stout, *supra* note 1, at 290 (same).
[44] Allen, *supra* note 21, at 269.
[45] Stout, *supra* note 37, at 1200; Friedrich A. Hayek, *The Corporation in a Democratic Society: In Whose Interest Ought It and Will It Be Run?*, *in* MANAGEMENT AND CORPORATIONS 1985, at 99, 100 (Melvin Anshen & George Leland Bach, eds., 1960) (arguing that management's power can be limited only by confining it to a single goal, namely the maximization of profits); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001); Stephen M. Bainbridge, *Director Primacy, supra* note 43, at 581; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (1991) ("[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither.").
[46] *See* Michael E. Murphy, *Dispelling TINA's Ghost from the Post-Enron Corporate Governance Debate*, 43 SANTA CLARA L. REV. 63, 117 (2002); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629, 1639 (2002) (arguing that profit-seeking corporations refrain from opportunism to avoid increasing the costs of securing firm-specific investments from non-shareholders).

to maximize profits, especially in light of courts' reluctance to second-guess management's business judgment.[47]

Despite claims of victory by the proponents of profit maximization,[48] the normative debate is inconclusive. To some, the debate may appear to be an as-yet unresolved empirical question,[49] requiring a sufficiently ingenious policy analyst to measure and compare two types of social cost, namely the costs associated with increased managerial discretion, on the one hand, and the cost to non-shareholders of profit-maximizing activity minus shareholders' benefit from the activity, on the other hand. In my view, however, the problem is not purely empirical, because the weighing of the two types of social cost ultimately depends on a value judgment rather than on an objective measurement.[50]

External versus internal constraints on profit maximization

As I have noted, the proponents of profit maximization take pains to argue that the profit-maximizing corporation acts responsibly in spite of itself, much as Smith argued that individuals serve the public good indirectly by pursuing their self-interest in market transactions.[51] It is argued, for example, that the interests of shareholders and non-shareholders are often aligned,[52] both because in a profitable corporation the claims of creditors, employees and other non-shareholders are more secure[53] and because cooperation is usually a profit-enhancing strategy when there are unlimited future periods.[54] Moreover, as noted above, the demands of consumers and business partners for corporate social responsibility will often provide a profit-oriented reason for the corporation to act responsibly. If all else fails, external regulation – including legal liability – can be used as a method of aligning the interests of shareholders and the requirements of social responsibility.[55] Regulation and liability, the conditions of which are set through the political

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[47] Bainbridge, *Director Primacy, supra* note 43, at 582 (anticipating this argument and describing the profit maximization rule as nonetheless valuable as an "ever-present goad"); Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation,* 84 CORNELL L. REV. 1195, 1225 (1999) (describing legal constraints on uneconomic corporate philanthropy as "largely irrelevant").
[48] Hansmann & Kraakman, *supra* note 2.
[49] Stout, *supra* note 37, at 1201 ("[T]he question ultimately cannot be answered except on the basis of empirical evidence.").
[50] The measurement of non-Pareto-improving changes in social welfare is virtually never purely empirical, because of the incommensurability of costs and benefits visited upon different people.
[51] ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 184 (J. Shield Nicholson intro., T. Nelson and Sons 1887) (1776) ("By pursuing his own interest, [an individual] frequently promotes that of the society more effectually than when he really intends to promote it.").
[52] Jonathan R. Macey & Geoffrey P. Miller, *Corporate stakeholders: a contractual perspective*, 43 U.T.L.J. 401, 415 (1993); Bainbridge, *In Defense of Shareholder Wealth Maximization, supra* note 37, at 1439 ("In most situations, shareholder and nonshareholder constituency interests coincide"); EASTERBROOK & FISCHEL, *supra* note 45 ("Frequently the harmony of interest between profit maximization and other objectives escapes attention.").
[53] *See* Stephen M. Bainbridge, *Corporate Decisionmaking and the Moral Rights of Employees: Participatory Management and Natural Law*, 43 VILL. L. REV. 741, 828 (1998) ("[A] rising tide lifts all boats."); EASTERBROOK & FISCHEL, *supra* note 45 (arguing that better working conditions and environmental quality accompany higher corporate profits); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1269 (1982) (argument along the same lines).
[54] *See* Murphy, *supra* note 46. *See also* Meese, *supra* note 46.
[55] Hansmann & Kraakman, *supra* note 2, at 442 (asserting that "the most efficacious legal mechanisms for protecting the interests of nonshareholder constituencies . . . lie outside of corporate law" in, for example, labor and employment law, consumer protection law, environmental law and tort law).

process, are said to be preferable to counting on managers to determine for themselves what social responsibility requires, a task for which managers lack both legitimacy and expertise.

In the final analysis, the debate is not so much about whether there should be limits on corporate profit maximization as about what form the limits should take. The question is whether the limits should be entirely external to the corporation—imposed upon the corporation by markets or by regulation—or whether there should also be internal limits—accommodated within corporate law.

There are, in my view, two unanswered arguments for the existence of at least some internal limits. The first argument is that there appears to be something ethically corrupt in the notion that one should do right only when one is compelled to do so or when it pays. Consider the case of a multinational manufacturer of data processing machinery that has a profitable line of business selling equipment and supplies to a genocidal dictator.[56] If the managers decide to discontinue the line of business, should they be held to violate corporate law? Does the answer to the foregoing question depend solely on whether the profits from the activity are greater than the sum of the loss of business from socially conscious customers and the legal liability, if any, that management expects the corporation to incur as a result of its activity? We should have misgivings about a position that would answer these questions in the affirmative.

The second argument is that an exclusive reliance on external limits creates a situation where management's duty to maximize corporate profits leads it to seek to influence external regulation — for example, through lobbying, political contributions or election advertising — in an effort to reduce the constraints on the pursuit of profits.[57] These activities are socially harmful whenever the social interest and corporate profit maximization conflict. If there are no internal limits to profit maximization, legal compliance itself can become contingent — something which it is beyond management's power to indulge in except to the extent that it would result in greater profits for the stockholders.[58]

These arguments point, in my view, to the desirability of some internal limits to the corporation's mandate to maximize its profits, not as a substitute for, but in addition to, external regulation and the operation of markets. These well-known arguments cause even some prominent opponents of corporate social responsibility to back away from the implications of their position.[59]

We should also be careful not to accept too readily the claim that shareholder and social interests are aligned. That claim is based on the insight that, through the market mechanism, the people affected by corporate activity can cause the impact of corporate activity on them to be taken into account by corporate decision-makers. If unsafe products adversely affect consumers' interests, the consumers will not be willing to pay as much for the products or will simply purchase from competitors; if workplace harassment affects the interests of employees, the corporation is likely to face demands for higher wages or difficulty in retaining or attracting employees.

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[56] *See* EDWIN BLACK, IBM AND THE HOLOCAUST: THE STRATEGIC ALLIANCE BETWEEN NAZI GERMANY AND AMERICA'S MOST POWERFUL CORPORATION (2001) (examining IBM's profitable business of selling machinery, design services, and supplies to the Third Reich).

[57] BAKAN, *supra* note 5, at 85 ch.4 (describing corporate efforts to free themselves of regulatory constraints on profit making).

[58] *See, e.g.*, Fischel, *supra* note 53, at 1271 (describing legal non-compliance as privately advantageous for corporations and socially desirable where the corporation's gains from the violation exceed the "social costs (as reflected in the penalty)").

[59] For example, Friedman, *supra* note 28, at 33, acknowledges that corporate conduct should conform to "the basic rules of the society, both those embodied in law and those embodied in ethical custom."

The claim amounts to an expression of confidence in the ability of markets to determine the "right" amount of product safety, workplace respect and so on. As Coase taught us, markets can even determine the socially optimal quantity of pollution: the persons affected by pollution can offer to pay a polluter to discontinue it, and if the harm to the affected persons exceeds the polluters' profits from the activity, the offer is likely to be accepted.[60]

Leaving aside the practical problems of negotiating costs, collective action and asymmetric information, there is another reason, of principle, not to rely solely on markets for the protection of the interests of non-shareholders. That reason is that a person's ability to cause the corporation to internalize the costs incurred by him or her is in proportion to the person's resources. This observation is a specific application of the more general observation that markets, as a clearinghouse for individual needs and preferences, weight those needs and preferences by the individual's ability to pay. In concrete terms, the stockholders' interests are likely to be more responsive to the desires of, for example, wealthy consumers in developed countries, than they are to even the urgent needs of the peasants who live downstream from the corporation's factories in the Third World.

I mention this last point, not because it unequivocally supports the case for internal limits to corporate profit maximization — external regulation may be equally or more appropriate — but simply to caution against complacent acceptance of the assertion that markets miraculously "align" the profits of shareholders with the interests of non-shareholders.

Profit maximization and the contractual conception of the corporation

The supporters of corporate profit maximization do not tend to be central-planners. Although they view the economic arguments for profit maximization as compelling, the implementation of their viewpoint in law requires additional reasoning. As we shall see, in this additional reasoning, it is crucially assumed that contractual participants, including shareholders, act exclusively out of self-interest.

The corporate contract

Since the middle of the last century, economists have emerged as the leading theorists of the corporation, and the "nexus of contracts," or "contractarian," conception has become the dominant metaphor among academic corporate lawyers.[61] The contractarian conception focuses on the microeconomic aspects of the arrangements entered into between the various participants in the corporation – shareholders, other investors, the board of directors, management, employees, suppliers, customers and so on. The corporation is merely the "nexus" of all of these voluntary arrangements, or "contracts," as the legal economists refer to them.

The nexus-of-contracts conception has two ambitions: to interpret the conduct of corporate participants and to provide a normative justification for corporate law.

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[60] *See* R.H. Coase, "The Problem of Social Cost," 3 J. L. & ECON. 1 (1960); for this reasoning in action, see EASTERBROOK & FISCHEL, *supra* note 45, at 39 (in dealing with pollution "[the] task is to establish property rights so that the firm treats the social costs as private ones, and so that its reactions, as managers try to maximize profits . . . duplicate what all of the parties (downstream users and customers alike) would have agreed to were bargaining among all possible without cost").
[61] Allen, *supra* note 21, at 265 n.7 (describing the "contract metaphor" as the "dominant academic paradigm of the corporation").

Contractarians seek to rationalize the observed terms on which corporate participation occurs. They observe that a shareholder willingly purchases shares rather than keeping her money in a bank account or investing in real estate or bonds; that a manager chooses to work for a particular corporation rather than its competitor (or becoming a golf pro); that a supplier voluntarily provides goods and services to the corporation rather than to another customer. The terms on which each of these participants deals with the others (through the corporation) are determined through the operation of markets. The relative supply of, and demand for, equity capital determine the shareholders' expected return on their investment and the other terms of their participation; the relative supply of, and demand for, the services of executives and line workers will determine their respective compensation levels; the relative supply of and demand for the other factors of production determine their prices and the terms on which they are supplied; and so on.

The contractarian reasons that, since people voluntarily invest and accept employment in corporations on the terms observed in practice, there must be some reason why it is in their interest to do so. Thus, for example, while scholars in the mid-20th century bemoaned the diminished control exercised by shareholders in widely-held corporations,[62] contractarian analysis has sought, by contrast, to rationalize it. Why would shareholders agree to make equity investments in firms in the governance of which they could not practically participate? The answer posited by contractarians is that the separation of the functions of risk-bearing and management facilitates investment:

> Those who have wealth can employ it productively even if they are not good managers; those who can manage but lack wealth can hire capital in the market; and the existence of claims that can be traded separately from employment allows investors to diversify their investment interests . . . [, making] investment as a whole less risky and therefore . . . more attractive and more efficient.[63]

The price of these benefits is the divergence of interest between managers and suppliers of capital. The costs imposed by this divergence – termed "agency costs" – take the form of imperfectly loyal and less-than-diligent performance by management and the resulting impairment of firm profitability, together with costs incurred on behalf of the shareholders in monitoring management's performance. In the contractarian view, dispersed shareholders willingly invest in corporations, despite having little or no control, when the benefits associated with the separation of risk-bearing and management exceed the agency costs.

Contractarianism has a number of implications for the normative analysis of corporate law. First, the corporate contract draws on the justifications for the institution of contract more generally. As a means of allocating resources (or, with respect to a business venture, roles, risks and possible rewards), contract is attractive because of its characteristic respect for individual preferences and individual choice. Each party, by choosing to enter into a contract, demonstrates that he perceives that he is better off participating in the contract on its terms than pursuing any alternative course of conduct available to him. The same is true of participants in a business venture, including participants in a corporation.

A second conclusion is that the imposition of mandatory terms is presumptively counterproductive because the overall balance of advantage in the transaction is determined by the

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[62] *See, e.g.*, ADOLF A. BERLE AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (New York: Harcourt, Brace & World, 1968) (1932).
[63] EASTERBROOK & FISCHEL, *supra* note 45, at 11. *See also* Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99, 107 (1989).

parties' endowments (including available alternatives) and preferences; the incorporation of a mandatory term merely creates the risk that, among various packages of terms reflecting the existing balance of advantage, the package both parties would have preferred will be excluded because it does not contain the mandated term. If the preferred package does not contain the mandated term, the mandatory character of the term defeats the parties' common preference and is counterproductive. If the package preferred by both parties does contain the mandated term, then the mandatory character of the term is superfluous. This argument is well-known inside and outside corporate law;[64] in corporate law, it informs the view that corporate law should be enabling, not mandatory.[65] For instance, suggestions that greater participation by workers in corporate governance would be "more democratic" are met with the response that worker participatory rights would come at the expense of other worker benefits, and if we do not already see such rights provided for in labor agreements, it is because workers value these rights less than they value the benefits that would have to be sacrificed in order to obtain them.[66]

On the other hand, it is appropriate for the architects of corporate law to try to anticipate the terms which most participants in the corporation would reasonably be expected to settle on, and to include these in a corporation's statute as "default terms," to be applied to the corporation unless the original incorporators agree otherwise.[67] By providing suitable default terms, a corporate law jurisdiction reduces the costs associated with negotiating and organizing an incorporated business venture.

From contractarianism to profit maximization

It should be clear that the contractual conception of the corporation does not entail the proposition that corporate management should be legally obligated to manage the corporation with a view to maximizing the stockholders' profits. Shareholder profit maximization is not an essential feature of a contractual relationship. It is not even an essential feature of a contract of investment: no one would argue that management promises to maximize bondholders' profits, for example.

Yet, most contractarians argue that corporate law should contain a default rule requiring corporate management to maximize corporate profits and, thereby, the profits of the stockholders.[68] Easterbrook and Fischel, for example, write:

> The role of corporate law here, as elsewhere, is to adopt a background term that prevails unless varied by contract. And the background term should be the one that is either picked by contract expressly when people get around to it or is the operational assumption of successful firms. For

[64] *See, e.g.*, 3-4 RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 363, 515-17 (5th ed., Aspen Law & Business 1998); Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 954-55 (1984); Charles J. Meyers, *The Covenant of Habitability and the American Law Institute*, 27 STAN. L. REV. 879, 890 (1975); Edward H. Rabin, *The Revolution in Residential Landlord-Tenant Law: Causes and Consequences*, 69 CORNELL L. REV. 517, 558 (1984).
[65] *See, e.g.*, Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530, 1536-37 (1989) ("From the contractarian standpoint, provisions that cannot be overridden by private agreement are generally undesirable.").
[66] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 45, at 21 ("One cannot tinker with one term in a contract confident that the change will make any party better off after other terms have been adjusted."); Joseph William Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611, 720 (1988) (acknowledging that the parties are likely to "bargain around" legally imposed obligations to workers, resulting potentially in lower wages or in other terms ultimately less favorable for workers).
[67] *See* EASTERBROOK & FISCHEL, *supra* note 45, at 15, 34.
[68] A recent articulation of the argument is Bainbridge, *Director Primacy, supra* note 43, at 577-79.

> most firms the expectation is that the residual riskbearers have contracted for a promise to maximize long-run profits of the firm, which in turn maximizes the value of their stock. Other participants contract for fixed payouts — monthly interest, salaries, pensions, severance payments, and the like.[69]

There is no evidence that "when people get around to it," they choose to provide explicitly for a promise to maximize corporate profits.[70] Therefore, Easterbrook and Fischel's claim rests on the view that having a unique group of "risk-bearers" – the shareholders – to whom the other participants promise to maximize the corporation's profits is an ingredient of a "successful firm." Easterbrook and Fischel do not say why shareholder profit maximization is an ingredient of "success." One possibility is that success is intended as simply another word for profit, but this seems improbable, as it would make Easterbrook and Fischel's argument circular. Instead, Easterbrook and Fischel's reference to "successful firms" was likely included for its Darwinian overtones. Without a promise to maximize corporate profits, agency costs and unprofitable activities would be a drag on the corporation's financial performance. Firms that permit potential cost reductions to go unrealized or that indulge in unprofitable activities are unlikely to survive in a competitive market.[71] By contrast, firms in which the participants are focused on profits and adopt arrangements that keep agency costs to a minimum will be "successful," not only because they will survive, but because their practices will be emulated by other firms.

A slightly different argument holds that a venture is worth more in aggregate if there is a single group of residual claimants, because of the reduction in agency costs compared to a venture in which there are multiple residual claimants.[72] Whatever the other participants forgo in having to settle for fixed claims is more than compensable out of the enhanced value of the arrangement for the sole residual claimants. It follows that if all of the participants are acting rationally and in their own interest, they will agree that (a) one of the groups (let us call them shareholders) will enjoy the status of sole residual claimant; (b) management's powers should be exercised towards the end of maximizing the value of the shareholders' investment; and (c) the other participants will receive fixed terms that compensate them prospectively for agreeing to (a) and (b).

These two arguments share the same basic point. All of the participants in the corporation maximize their expected gain from the venture if they agree, in advance, to designate one group with homogeneous interests to be pursued exclusively. If profit is the goal of the venture, the maximizing strategy is for this group (let us call them the shareholders) to be entitled to the residual profit from the venture, with the other participants receiving fixed returns on their

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[69] Frank H. Easterbrook and Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1446 (1989). *See also* EASTERBROOK & FISCHEL, *supra* note 45, at 36.

[70] Stout, for example, points out that corporate charters never explicitly provide for shareholder primacy. *See* Stout, *supra* note 37, at 1207.

[71] Survival is a recurring theme in Easterbrook and Fischel's writing. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 45, at 4, 32, 71, 218; Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 691 (1984) (arguing that corporate law rules that "survive" interjurisdictional competition are those that are beneficial to investors). *See also* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 857, 881 (1983) (repeated use of "survival" metaphor in discussion of utility of corporate policies against insider trading).

[72] Compare Macey & Miller, *supra* note 52, who argue that the reason for exclusive duties to maximize the value of the shareholders' claim is that the aggregate value of a duty of loyalty to the members of a particular group decreases as the number of groups to whom the duty is owed increases. In addition, shareholders (as a group) value the duty more than any other group, because non-shareholder constituencies can more effectively protect their interests through contracts or regulatory activity.

contributions. This is because a less clear mandate or a more complicated promise, requiring the interests of two or more disparate groups to be balanced against one another, would impair the firm's overall wealth creating potential, creating a dead-weight loss. To believe that the corporate participants would choose to structure their arrangement to avoid this dead-weight loss requires, of course, the assumption that the participants prefer, all other things being equal, to have more (expected) wealth rather than less. This is not, in my view, a very demanding assumption. However, it is important to recognize that the argument also rests on a highly abstract, stylized picture of the way in which a business venture is likely to affect the participants' interests. It also assumes that the participants, if fully rational, are ruthlessly self-interested and, consequently, do not care about the impact of the venture on non-participants.

Reality intrudes in two ways, in particular, that lead me to question the appropriateness of presuming that corporate participants have agreed in advance to the pursuit of profit to the exclusion of all other considerations. In the first place, there is no reason to believe that an exclusive profit motive is always necessary for the survival of a firm. That being the case, the range of default rules compatible with the firm's survival includes rules that would qualify the pursuit of stockholder profit depending on the circumstances and the other interests at stake. It is not clear that we have reason to presume that the corporate participants would opt to exclude all ethical or other considerations not designed to increase the firm's chances of survival under hypothesized conditions of perfect competition. To vary the metaphor, we should not presume that people adopt for ordinary life the standard of conduct they think would be most conducive to their survival on an overfull lifeboat.

In the second place, it may be uneconomical to compensate non-shareholders ex ante for damage to their interests that might arise as a result of shareholder profit-maximizing activity, to the extent that the damage relates to unlikely, but high-stakes events or to other risks that are difficult to estimate. Fully rational, risk-averse non-shareholders may require a level of fixed compensation for exposure to high-stakes losses such that it would make more sense for the parties simply to agree that the profit maximization norm will not be applied if it exposes non-shareholders to such losses.[73] We might also worry that the non-shareholders have underestimated the risks, as it seems human beings are wont to do.[74] As a result, it seems unrealistic to take for granted that non-shareholders have agreed to assume all risks to which an unrestricted profit-maximizing norm exposes them, let alone that they have been fully compensated ex ante.

I might add that the explicit or implied understandings of voluntary corporate participants are incapable of justifying a standard of corporate behavior that precludes independent consideration of the impact of corporate activities on persons who are not in a voluntary relationship with the corporation. Thus, for example, even assuming that Union Carbide's employees bargain for what they receive, the same cannot be said for the thousands of other inhabitants of Bhopal.[75]

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[73] Proponents of unqualified profit maximization argue that the parties might have agreed to such a qualification explicitly if they had wanted it; yet they could equally easily have made explicit an unqualified commitment to maximize stockholder profits. The parties' silence is no reason to assume that they meant that the pursuit of shareholder profit maximization should be unqualified.

[74] *See* Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1524-25 (1998), and the literature referred to in n.152 therein (suggesting that individuals tend to underestimate the likelihood that bad events will happen to them). *Id.* at 1524 n.152.

[75] A similar argument arises in the context of limited liability. Some have questioned limited liability in the case of tort claimants on the ground that, even if parties in a voluntary relationship with the corporation have explicitly or impliedly accepted limited liability, the same cannot be said of tort claimants, who are "involuntary creditors." *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An*

However, even leaving aside the interests of non-participants in the corporation, I do not believe that we have reason to presume that the participants in the "corporate contract" have agreed that the mandate to maximize profits should be unqualified.

Part II — Shareholder responsibility and "bounded empathy"

> "There is no such thing to my mind . . . as an innocent stockholder. He may be innocent in fact, but socially he cannot be held innocent. He accepts the benefits of the system."
>
> —- Louis Brandeis[76]

It is not difficult to see why shareholders' sense of responsibility might be engaged by the activities of the corporation in which they have invested. It is not necessary that shareholders perceive themselves as "owners" of the corporation, as the Medical Committee did.[77] It is sufficient that when the corporation harms third parties, it does so for the purpose of earning profits for the stockholders, and that shareholders invest willingly, thereby voluntarily assuming their role as the beneficiaries of the corporation's activities. As such, they incur some responsibility for the impact of those activities.

It may be idealistic, but not unreasonably so, to hope that shareholders would care about the ethical implications of their investment decisions. This is not to deny that the main purpose of investing, for most people, is to achieve personal financial goals (i.e., to make money). Even people whose main goal is to profit financially from their investment will, one would expect, at least sometimes be influenced in their decisions by non-financial aspects of their investment. To draw an analogy, the fact that the main purpose of a car is to provide transportation between any two points A and B does not mean that when purchasing a car, suitability for transportation is the sole criterion; or that in operating a car—in deciding whether to accelerate, brake or turn—the sole consideration is whether the passengers and cargo are brought more quickly to point B. Car buyers may care about creating jobs domestically or rewarding a local dealership's sponsorship of an amateur hockey team. A driver may swerve to avoid a pedestrian at least in part, one hopes, in order to avoid harming that person and not only because a collision would make the driver late. Similarly, even individuals whose main purpose in investing in shares is to provide for their retirement may be influenced by the knowledge that that the issuer of the shares earns some portion of its profits from, say, the sale of tobacco to children, and such investors may rationally be influenced by this factor in their investment decision.

But there are reasons why they might not. Behavioral economists have reminded us that people are "boundedly rational."[78] I want to suggest that people are, similarly, characterized by "bounded empathy." For example, the geographic remoteness of the victims of corporate irresponsibility dulls our empathy in this setting,[79] while the opacity of the corporate world somehow tricks us into forgetting that the corporation's activities are undertaken for our benefit as shareholders.

Economic Analysis of Limited Liability in Corporation Law, 30 U. TORONTO L.J. 117, 148-49 (1980) (advocating directorial liability toward involuntary creditors).

[76] LOUIS D. BRANDEIS, *On Industrial Relations*, *in* THE CURSE OF BIGNESS: MISCELLANEOUS PAPERS OF LOUIS D. BRANDEIS 70, 75 (Osmond K. Frankel ed., 1965) (1934).

[77] *See supra* text accompanying note 29.

[78] *See*, *e.g*., Jolls et al., *supra* note 74, at 1477 (discussing bounded rationality).

[79] Mitchell argues that "separation and distance" diminish executives' empathy for those harmed by corporate activity. *See supra* note 26, at 39-41. Of course, remoteness can limit shareholders' empathy as well. Adam Smith famously made a more general point when he wrote that even catastrophic harm to "a hundred

Moreover, many people's sense of responsibility is attenuated because of the miniscule practical influence that any individual shareholder expects to have over that activity. We may understand this as an instance of the well-known collective action problem that plagues large groups, whereby no individual "rationally" acts in the way that would serve the interests of the group, in part because the individual's action, taken in isolation, has only a negligible impact on the group's success.[80] While I am not persuaded that this logic succeeds in absolving us, as shareholders, of responsibility for corporate actions undertaken for our benefit and with which we are voluntarily associated, I acknowledge that it may, in practice, account for our inertia.

We do not know, ultimately, to what extent shareholders invest conscientiously, although there are reasons to be cautious about overly optimistic intuitions.[81]

That said, one should not interpret the fact that shareholders' conduct often deviates in practice from a fully conscientious ideal as necessarily providing comfort to the contractarian argument that shareholders should be presumed to demand unqualified profit maximization as a term of the corporate bargain. I argue for the interpretation of thoughtless conduct as reflecting the boundedness of empathy, not an endorsement of selfishness as a principle. In drawing up terms ex ante for the corporate venture, we should not assume that an individual would want the terms to reflect his or her situational weaknesses rather than his or her ideals.[82]

Moreover, it may be useful, in understanding the position being advocated here, to recall the competing views of human nature that Stephen Bainbridge ascribes to "conservatives" and "progressives." According to Bainbridge, himself a self-described conservative:

> The basic bone of contention between conservative and progressive scholars . . . remains the old problem of the perfectibility of human nature. Conservatives blame human misery on causes which lurk naturally within the souls of men: pride, vanity, jealousy, greed, and insatiable or unruly desires. Conservatives are skeptical about the prospect of human perfectibility and suspicious of utopian projects, mostly because they must be "conducted by imperfect . . . human beings, [who are] always dangerously unfit to remake the world." In contrast, progressives "believe that education, positive legislation, and alteration of

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millions" of people far away moves any of us far less than a "paltry misfortune" to ourselves. *See* ADAM SMITH, THE THEORY OF MORAL SENTIMENTS ¶ III.I.46 (1759).

[80] *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 44 (1971).

[81] Relevant statistics include the very low rates of shareholder support for social proposals (see *infra* note 117), and the fact that investment in ethical funds, although growing, is still only an estimated 9% of the total funds under management. *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1268 (1999). However, the low rates of voting in support of shareholder social proposals could reflect either an indifference to important ethical concerns or else a belief that the proposals in question were misguided. (Special considerations may also apply to proxy voting decisions made by pension fund trustees and other intermediaries.) Similarly, the low investment in social mutual funds could reflect either an unwillingness to sacrifice profit for principle, or else a belief that one's ethical responsibilities are not best discharged by delegating them to a fund manager. These are questions on which future empirical research might well shed some light.

[82] In any event, one would still have to answer the other objections to the contractarian argument for an exclusive profit-maximization norm – in particular, that it is not realistic to take for granted that non-shareholders have agreed to assume and been compensated for assuming all risks to which unrestricted profit maximization exposes them and that the contractual metaphor is powerless to justify harm caused to third parties. *See supra* text accompanying notes 73-75.

> environment can produce men like gods; they deny that humanity has a natural proclivity toward violence and sin."[83]

According to Bainbridge, this difference of opinion leads progressives to favor a regulatory approach to corporate law, under which good conduct would be legally defined and enforced, whereas conservatives, who believe that regulators are as imperfect as the rest of us, advocate private ordering.

Like Bainbridge's conservatives, I do not deny that human nature is, in practice, not perfectible. This Article does not call into question the merits of private ordering, nor does it advocate the regulation of corporate relationships by the state. My argument is that we should not design corporate law in a way that cannot comprehend and accommodate the exercise by individuals of our ethical faculties, however infrequently or frequently it may occur. In the next Part, I criticize the approach taken by several leading economic theorists of the corporation towards the concept of ethical shareholder decision-making, as suffering from precisely this failing.

Part III — The responsible investor and the economic interpretation of the corporation

The responsible investor and the corporate contract

The normative grounding of the "nexus of contracts" approach in respect for individual preferences and individual choice suggests that in the exercise of their contractual freedom, parties, including shareholders, may be governed by whatever motivations operate upon them – the ethical or altruistic no less than the selfish. This point is recognized implicitly by Easterbrook and Fischel, who write:

> If the New York Times is formed to publish a newspaper first and make a profit second, no one should be allowed to object. Those who came in at the beginning actually consented . . .[84]

What goes for the original incorporator is equally valid for anyone making a decision whether to invest in the corporation. A purchaser of shares in the secondary market is no less free to make the decision based on ethical rather than self-interested grounds than was the person who decided originally to supply the corporate enterprise with equity capital.

Contractarians should also be opposed to interference with the exercise of acquired contractual rights, since such interference tampers with a bargain that both parties desired when it was made and therefore compromises people's ability to make voluntary exchanges of binding commitments. Thus, an investor exercising her contractual rights, for example in voting her shares or in selling them to a willing buyer, may make her decision on whatever grounds she sees fit, whether congenial or objectionable to the other participants and without interference from "strangers to the bargain." In the exercise of her rights, the investor is not bound to have regard to her fellow investors' interests; still less is she bound to have regard only to her own.

However, in spite of contractarianism's neutrality with respect to investor motivation, socially responsible investing is awkward for some economic theorists of the corporation because it

[83] Stephen M. Bainbridge, *Book Review: Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 886-87 (1997).
[84] EASTERBROOK & FISCHEL, *supra* note 45, at 36.

contradicts the assumption of investor single-mindedness that informs the normative argument for internally unconstrained shareholder profit maximization. As I explain below, these theorists typically respond to ethical investing either by dismissing it as an aberration or else by recharacterizing it as self-interested and potentially pernicious.

Socially responsible investors versus "true investors"

To some economic theorists of corporate law, social investors are not "true investors." For example, Daniel Fischel claimed that "[p]rohibiting sensitive payments and having a clean environment are undoubtedly of great interest to some, but not to investors *qua investors*,"[85] while Henry Manne responded, equally dismissively, as follows, to an author who argued that investors were interested in both profit and social justice:

> It is difficult to reconcile [that author's] two statements about shareholder motivation. When [he] refers to shareholders wanting to make money, he is probably referring to the mass of true investors . . . . When he refers to shareholders who want to make social policy, he is then talking about himself and company.[86]

It is difficult to know what to make of Fischel and Manne's statements, which amount to bare assertions that an exclusive profit motive is intrinsic to the concept of an investor. It is not clear why this must be so. It is true that economists' models of the corporation and of capital markets assume that shareholders are interested only in wealth and risk avoidance.[87] But deviations in reality from this assumption call into question the validity or robustness of the models, rather than the credentials of the shareholders concerned. All models, we know, are simplifications. Simplification has its uses, but scholars must be careful not to mistake the model for reality, not to "[reconstruct] the world to fit the theory," to use Wishart's phrase.[88]

The likelihood is that Manne does not believe that any particular policy prescription flows from his assertion that socially responsible investors are not "true investors."[89] Manne is well-known for his deregulatory approach to corporate and securities law, believing that the market for corporate control protects investors from an inefficient or self-serving management better than can

[85] Fischel, *supra* note 53, at 1280 (emphasis added).
[86] Henry G. Manne, *Shareholder Social Proposals Viewed by an Opponent*, 24 STAN. L. REV. 481, 492 (1972) [hereinafter Manne, *Shareholder Social Proposals*]. This is not merely an empirical claim about "most" investors. Manne's claim is conceptual. He believes that there are two distinct ("difficult to reconcile") types of investor: those who are interested in money ("true investors"), and those who are interested in "social policy." Manne's determination to draw a sharp distinction between the motivations of activists and those appropriate to shareholders is also illustrated by the paragraphs surrounding the quoted excerpt, for example at 491 ("[it] was never evidence of [the shareholder activists'] interests as citizens that was lacking; rather, it was evidence of sufficient interest as owners of the corporation").
[87] *See, e.g.*, THOMAS E. COPELAND & J. FRED WESTON, FINANCIAL THEORY AND CORPORATE POLICY 194 (3d ed. 1988) (describing assumption of the Capital Asset Pricing Model that investors are risk-averse wealth-maximizers).
[88] David Wishart, *Arguing against the Economics of (say) Corporations Law*, 26 U.N.S.W. L.J. 540, 546 (2003).
[89] This cannot be said of all economic theorists. Thus, for example, Roberta Romano argues that the raising of social matters by shareholders is "not compatible with the objective of U.S. corporate law." Romano, *Less is More*, *supra* note 4.

governmental regulation.[90] Presumably, he would rely on the same mechanisms to protect "true investors" from social activist shareholders.

As for Fischel, his view that such individuals' social concerns do not arise in their capacity as investors presumably informs his belief that the terms of the investment should include, by default, the "usual" commitment to profit maximization unless all of the original investors agree otherwise at the outset.[91] Socially responsible investors cannot vary unilaterally the corporation's objective after the fact. In defending this view, Fischel does not need, of course, to persuade us of the importance of honoring bargains; but he does need to give us a reason to presume that corporate participants have agreed to be bound to a norm of exclusive profit maximization, even when (as is always the case) they have not explicitly agreed to the term. He needs to persuade us to reject all other possible presumed bargains, especially those according to which profit maximization would be bounded by ethics and social responsibility. As I have argued, this case has not been made out. Simply asserting that social and ethical considerations are extraneous to investment does not prove that they are.

A taste for social responsibility?

A second typical response is to adopt a conception of self-interest broad enough to accommodate social preferences and altruism, and then to "proceed as usual."[92] On this approach, "socially responsible" portfolio selection amounts to a consumption decision, by which those investors who are so inclined willingly sacrifice financial returns to obtain some other desired benefit, such as the promotion of a particular social cause or even the provision of material aid to a favored stakeholder group.[93]

The "soft" version of rational choice theory reflected in this approach is not without its detractors from within the neoclassical tradition; these detractors argue that opening up the concept of self-interest to include altruism and other unselfish values makes the hypothesis of self-interest tautological.[94] To adopt an inclusive conception of self-interest amounts, in other words, to a concession of defeat.

This concern aside, an inclusive approach to self-interest entails indifference to socially responsible portfolio selection by individual shareholders.

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[90] Henry G. Manne, *The Limits and Rationale of Corporate Altruism: An Individualistic Model*, 59 VA. L. REV. 708 (1973). *See also* Manne, *Market for Corporate Control*, *supra* note 22; Manne, *Free Market Model, supra* note 22, at 1392 (arguing that, with an unregulated takeover market, "many arguments about duties of care and duties of loyalty and the like would disappear into the nether world").
[91] EASTERBROOK & FISCHEL, *supra* note 45, at 36.
[92] This is how Richard Posner recommends dealing with "irrational preferences." *See* Richard A. Posner, *Rational Choice, Behavioral Economics and the Law*, 50 STAN. L. REV. 1551, 1554 (1998) ("A preference can be taken as a given, and economic analysis proceed as usual, even if the preference is irrational.").
[93] John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts,* 79 MICH. L. REV. 72, 74-75 (1980). Under this approach, the practice becomes diversion when it is done by intermediaries, such as pension funds, without the consent of the principals or beneficiaries.
[94] *See* George J. Stigler, *Economics or Ethics?*, 2 THE TANNER LECTURES ON HUMAN VALUES 143, 189 (Sterling M. McMurrin ed., 1981). Critics of psychological egoism make a similar point. *See* Joel Feinberg, *Psychological Egoism*, *in* REASON AND RESPONSIBILITY: READINGS IN SOME BASIC PROBLEMS OF PHILOSOPHY 529, 537-38 (Joel Feinberg ed., 4th ed. 1978).

But while indifferent to socially responsible portfolio selection, defenders of an inclusive egoism take a dim view of socially responsible investors' attempts to influence corporate behavior through means such as advocacy and shareholder proposals. For if social investors' aims are properly thought of as self-interested, then investor activism is pernicious because it seeks to divert the resources of the firm – which are supposed to be used for the benefit of all of the shareholders – to satisfy the activists' own taste for social responsibility. The following statement by Milton Friedman exemplifies this position:

> [Concerning the] phenomenon of calling upon stockholders to require corporations to exercise social responsibility[, . . . in] most of these cases, what is in effect involved is some stockholders trying to get other stockholders (or customers or employees) to contribute against their will to 'social' causes favored by the activists. Insofar as they succeed, they are again imposing taxes and spending the proceeds.[95]

Daniel Fischel's take on social shareholder activism is along similar lines:

> [L]et us assume a corporation decides to modify its behavior—say, discontinuing investment in South Africa or ceasing manufacture of war munitions—in direct response to a defeated [shareholder] proposal. While reformers would no doubt be ecstatic about this result, shareholders as a class have little to be excited about. What has occurred is that a tiny minority, subsidized by the vast majority of shareholders, has caused the corporation to abandon a wealth-maximizing strategy favored by the very majority of shareholders who are forced to provide the subsidy. A less "democratic" result or one more inconsistent with the goal of maximizing shareholders' welfare is hard to find.[96]

It is not clear to me that the "vast majority" of shareholders are all that vulnerable, something that becomes apparent when their situation is compared to that of the silent political majorities of public choice theory.[97] To a greater extent than political electorates, shareholders can vote with their feet. Shareholders' ability to terminate at will their relationship with the corporation and place their capital elsewhere severely limits their susceptibility to "exploitation" at the hands of a socially responsible minority.[98]

There is, in addition, a more fundamental objection to the conceptualization of social responsibility as a "taste." Although I do not wish to engage the philosophical debate over egoism,[99] there seems to be something counterintuitive in the beliefs that are necessary to defend

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[95] Friedman, *supra* note 28, at 124.
[96] Fischel, *supra* note 53, at 1279.
[97] *See* OLSON, *supra* note 80, 165-66 (describing large groups with common interests but unable to organize so as to protect their interests).
[98] I recognize that a shareholder's exit option does not provide complete protection, since the shareholder may only be able to sell his or her shares at a reduced price, if a particular shift in corporate policy makes them less desirable to current and potential investors. Regarding the vulnerability of shareholders, *see* Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984); Meese, *supra* note 46, at 1657-58. Still, Fischel himself writes that "[t]he ability freely to sell one's shares, . . . the so-called 'Wall Street Rule,' is without question the single most important safeguard to all shareholders that managers will act in their best interests." Fischel, *supra* note 53, at 1278.
[99] *See, e.g.*, Joel Feinberg, *Psychological Egoism*, *in* REASON AND RESPONSIBILITY: READINGS IN SOME BASIC PROBLEMS OF PHILOSOPHY 529 (Joel Feinberg ed., 4th ed. 1978); Hugh LaFollette, *The Truth in Psychological Egoism*, *in* REASON AND RESPONSIBILITY: READINGS IN SOME BASIC PROBLEMS OF PHILOSOPHY 500 (Joel Fienberg ed., 7th ed. 1989); Elliott Sober, *Psychological Egoism*, *in* THE BLACKWELL GUIDE TO ETHICAL THEORY 129 (Hugh LaFollette ed., 2000).

the egoist thesis that underlies this conceptualization. One has to believe, implausibly in my view, that there is no moral difference between caring for others and caring for one's self and that the concept of right has no meaning apart from "good for me." If there is a sensible distinction between unselfish and self-interested motivation, then responsible investing is not best understood as an act of consumption, but as an act of conscience. On this view, advocacy by socially responsible investors need not be interpreted as rent-seeking behavior. It may instead represent an effort to engage the ethical faculties of managers and fellow shareholders, or an attempt to persuade them by argument; or it may simply be "moral entrepreneurship,"[100] an attempt to increase managers and shareholders' empathy through "arational" persuasion.[101]

Corporate law should, at worst, be indifferent to socially responsible investing. Although socially responsible investors are awkward for proponents of a profit maximization norm, the argument of this Part has been that it is misguided to respond to them, as some scholars have, by either exceptionalizing them or recasting their motivations as self-serving. We should not be so blinded by our own model that we are incapable of dealing with departures from it in reality, nor so committed to the assumption of self-interest that we are incapable of comprehending conscience.

Let me not be mistaken for an optimist. The available evidence does not permit one to be confident that all, or even very many, investors have a keen sense of social responsibility.[102] But I do suggest that this fact may have more to do with the "boundedness" of empathy than it reflects upon the irrelevance of empathy or ethical judgment to the act of investing. Furthermore, when we encounter exceptions to the model, we should acknowledge the model's limitations rather than reinterpreting, as selfish, a person's use of her empathetic and ethical faculties, when they occur. The risk, for us, is that reality will come to conform still more to the model, and we would all be the poorer for it.[103]

Part IV — Concrete questions

Socially responsible investing is a neglected topic in the corporate law literature,[104] except for two issues: (1) whether the proxy mechanism should be available to circulate, at corporate expense, proposals by shareholders on matters of social responsibility; and (2) whether disclosure of certain information relative to the corporation's "social performance" should be made mandatory.[105] In this Part, I will comment on the implications of my analysis for these two issues.

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[100] This is Posner's term. Richard A. Posner, *The Problematics of Moral and Legal Theory*, 111 HARV. L. REV. 1637, 1667 (1998).
[101] *Id.*
[102] *See supra* note 81.
[103] As Arendt wrote, "[t]he trouble with modern theories of behaviorism is not that they are wrong but that they could become true." *See* HANNAH ARENDT, THE HUMAN CONDITION 322 (1958).
[104] There is, by contrast, an extensive finance literature about socially responsible investing. *See, e.g.*, J. David Diltz, *Does Social Screening Affect Portfolio Performance?*, 4 J. INVESTING 64 (1995); J. David Diltz, *The Private Cost of Socially Responsible Investing*, 5 APPLIED FIN. ECON. 69 (1995); Christopher Luck & Nancy Pilotte, *Domini Social Index Performance*, 2 J. INVESTING 60 (1993); James J. Angel & Pietra Rivoli, *Does Ethical Investing Impose a Cost Upon the Firm? A Theoretical Perspective*, 6 J. INVESTING 57 (1997); David A. Sauer, *The Impact of Social-Responsibility Screens on Investment Performance: Evidence from the Domini 400 Social Index and Domini Equity Mutual Fund*, 6 REV. FIN. ECON. 137 (1997).
[105] It is interesting to note that in the United States the relevant rules with respect to the first two of these issues are, or would be, found in federal securities law rather than in state corporate law. There is also literature on the question whether social investment by pension funds is legally permissible or socially desirable, an issue concerning the law of trusts. *See, e.g.*, Langbein & Posner, *supra* note 93.

I begin, however, with a more fundamental question, namely whether management should be permitted, or even required, to modify its behavior in response to or in anticipation of the actions of socially responsible shareholders.

Corporate management and the socially responsible shareholder

There is little controversy in the notion that corporate management may employ corporate resources in a "socially responsible" manner if irresponsibility would impact negatively on the corporation's profitability, for example by causing the defection of customers, suppliers or employees, or by attracting legal liability or external regulation. Even the hardest-core advocates of shareholder primacy recognize the legitimacy of this kind of social responsibility.[106]

It is a different question whether management can act responsibly in order to avoid defections by socially responsible *shareholders.* On one formulation of the stockholder profit maximization rule, management's responsibility is construed as an obligation to maximize the stock price.[107] Presumably, such an obligation would require the avoidance of conduct that makes the corporation unattractive to large numbers of existing or potential shareholders.

According to another view, management's responsibility should not be to maximize the stock price, which represents only the intersection of supply of and demand for the corporation's equity capital, but rather to maximize the total value of the enterprise. As discussed in Part I, many economic analysts believe that reasonable corporate participants would organize their venture such that the total value of the enterprise would be maximized by the maximization of a single residual claim — the value of the shareholders' interest[108] — but even this is not the same thing as maximizing the stock price.

Ultimately, however, this may be something of a moot point as the reality seems to be that even substantial defections of shareholders because of social responsibility concerns have a negligible impact on the stock price.[109]

Another issue concerns the manager's own ethical responsibilities. It is, as I have argued, an open question whether the law authorizes management to act ethically in a non-instrumental sense, i.e., for reasons other than the impact that the particular conduct would have on the corporation's

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[106] For example, Milton Friedman has acknowledged that social responsibility is legitimate when it is a means to the end of maximizing shareholders' wealth. *See* BAKAN, *supra* note 5, at 34 (describing interview with Friedman).

[107] *See, e.g.*, Romano, *Less is More*, *supra* note 4, at 186 n.30 ("the objective of U.S. corporate law . . . is to maximize share value"); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1165 (1990) (arguing against corporate pursuit of objectives other than "stock price maximization").

[108] *See supra* text accompanying notes 68-71.

[109] The theoretical explanation is as follows: For investors who are concerned only with risk and return, all securities are perfect substitutes, and all of these investors would be available to take up the slack left by the defection of even a significant number of shareholders from one security. Consequently, as long as the very large majority of investors in the market are "socially indifferent," the defection of even significant numbers of investors from any particular stock can be expected to be compensated by an immediate influx of capital from socially indifferent investors, with no material impact on the stock price. For an empirical study, see Siew Hong Teoh, Ivo Welch & C. Paul Wazzan, *The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott*, 72 J. OF BUS. 35 (1999), finding that divestment had "little discernible effect" on the cost of capital of firms doing business in South Africa.

profitability. On a normative level, I have argued that the better view is that management should be permitted to act ethically, for several reasons. For one thing, the affirmative argument for exclusive profit maximization rests on a presumed bargain among highly stylized hypothetical bargainers. Moreover, the negative argument — that a more vague mandate is insufficiently constraining of management — overlooks the relatively weak contribution that a profit maximization rule would make to constraining management compared to other mechanisms, such as the stock market. This is to say nothing of the anomalous character of a position that would hold, for example, that the management of a U.S. corporation would violate its corporate law duties by discontinuing supplying equipment to a genocidal dictatorship, in the absence of reasons connected to profit.

In consequence, I conclude that corporate law should not preclude ethical behavior by management even if it qualifies the goal of maximizing profits. In the exercise of managers' ethical faculties, the views of shareholders are, in my view, relevant because the shareholders have money at stake in a departure from profit maximization: the profits would otherwise be for their benefit.

Shareholder social proposals

Pursuant to Rule 14a-8 under the Exchange Act of 1934,[110] an eligible shareholder is entitled to require that management include in the annual proxy circular, sent to shareholders at the corporation's expense, a "proposal" submitted by the shareholder together with a brief supporting statement. The idea underlying Rule 14a-8 was that management's proxy circular would be misleadingly incomplete if it omitted information about a matter that a shareholder proposed to raise at the general meeting.[111]

In the late 1960s and early 1970s, activist shareholders in the United States "discovered" the possibilities offered by Rule 14a-8. Two famous uses of Rule 14a-8 involved Dow Chemical and General Motors. In 1968, the Medical Committee for Human Rights received a gift of five shares in the Dow Chemical Corporation and submitted a proposal calling for Dow's charter to be amended so as to restrict the sale of napalm.[112] Although Dow's management initially balked at including the proposal and the SEC upheld management's refusal to include a slightly revised proposal by the Medical Committee in 1969, the Medical Committee won review before the D.C. Circuit and Dow decided to include the resolution in 1971, while its appeal was pending before the Supreme Court. Contemporaneously, a shareholder group led by Ralph Nader and owning twelve shares in General Motors submitted a series of proposed resolutions on issues that included product safety, environmental impact and minority board representation.[113] Two of these resolutions ultimately were included in the proxy circular, and although neither of the resolutions obtained as much as 3 percent support, one concrete result of the campaign was GM's appointment of the Rev. Leon Sullivan to its board of directors.[114]

Since then, shareholders' use of the proxy mechanism to make social responsibility proposals has expanded dramatically. In the 2004 proxy season, according to Institutional Shareholder

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[110] 17 C.F.R. § 240.14a-8 (2004).
[111] Manne, *Shareholder Social Proposals, supra* note 86, at 484 n.13.
[112] *See* Securities and Exchange Commission v. Medical Committee for Human Rights, 404 U.S. 403, 404 (1972).
[113] *See* Donald E. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419 (1971).
[114] The Rev. Leon Sullivan, a noted social activist, was later the author of the Sullivan Principles for companies doing business in South Africa.

Services, shareholders filed 270 social responsibility proposals,[115] and approximately one-quarter of all shareholder proposals were on social responsibility matters.[116] Many social proposals are withdrawn before reaching a vote, often following negotiations with management. Proposals that do reach a vote are almost always defeated by the shareholders by overwhelming margins,[117] particularly if, as it usually does, management has recommended that shareholders vote against the resolution.

Shareholder social proposals come in for strong criticism by many economic theorists of corporate law. Roberta Romano has denounced social proposals as hostile to the "objective of U.S. corporate law," i.e., the maximization of corporate profits.[118] Henry Manne, Frank Easterbrook and Daniel Fischel have characterized social proposals as an attempt by activist critics of the corporation to obtain publicity at corporate expense, meaning (ultimately) at the expense of shareholders generally.[119]

It must be said that, for many opponents of social shareholder proposals, the shareholder proposal mechanism itself (never mind proposals directed at social responsibility) seems anomalous.[120] For one thing, the mechanism is in tension with the separation of ownership and control, which economic theorists of the corporation believe produces gains through the specialization of functions.[121] Moreover, shareholders have no reason to vote on a shareholder proposal, or for that matter any other matter submitted to shareholders,[122] since they rationally have no expectation that their vote will be pivotal. For both of these reasons, economic theorists of the corporation typically have difficulty accounting for the existence of a shareholder proposal mechanism.

I do not have the same discomfort with the shareholder proposal mechanism, particularly as it relates to shareholder social proposals. In analyzing the issue, it is useful to reflect separately on two questions: first, whether there is any reason for shareholders to vote on matters of corporate social responsibility; and, second, if the answer to the first question is affirmative, whether the proxy mechanism should be available for communication on such matters.

In answer to the first question, I refer to my argument, above, that shareholders have an ethical stake in the conduct of the business, as they occupy voluntarily the position of ultimate

[115] *Shareholder Proposals 2004: A Snapshot* (June 18, 2004), *available at* http://www.issproxy.com/articles/2004archived/079.asp (last accessed on Aug. 24, 2004).

[116] Based on 270 social responsibility proposals and "over 1,000" proposals submitted across all subject-matters during the 2004 proxy season. *See 2004 Proxy Season Trends* (June 4, 2004), *available at* http://www.issproxy.com/articles/2004archived/066.asp (last accessed on Aug. 24, 2004).

[117] In 1998, human rights proposals put to a shareholder vote attracted, on average, under 6 percent of votes cast, while labor-oriented and environmental proposals attracted just over 9 percent support. *See* Paul Redmond, *Transnational Enterprise and Human Rights: Options for Standard Setting and Compliance*, 37 INT'L L. 69, 74 n.33 (2003).

[118] Romano, *Less is More*, *supra* note 4.

[119] Fischel, *supra* note 53, at 1279; EASTERBROOK & FISCHEL, *supra* note 45, at 85-86; Manne, *Shareholder Social Proposals, supra* note 86, at 491 (criticizing activist shareholders for "spend[ing] a few dollars merely to 'buy a ticket' . . . to publicly criticize a company"). *See also* Susan W. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984) (criticizing Rule 14a-8 for permitting activist investors to free-ride and for promoting corporate social responsibility).

[120] Liebeler, *supra* note 119 (advocating the rescission of Rule 14a-8).

[121] *See supra* text accompanying note 63.

[122] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 45, at 33 ("Investors are rationally uninterested in votes . . . ."). Many economic theorists of the corporation believe that voting is relevant in only one situation: the ousting of an incumbent board of directors by a new majority shareholder following a change of control.

beneficiaries of that conduct.[123] A shareholder, in the exercise of her responsibilities, may wish to dissociate herself from unethical conduct by supporting a proposal recommending its discontinuance; or to participate in collective shareholder action aimed at influencing the conduct.[124] For these reasons a shareholder may not be content to abstain from providing input on the ethical management of the corporation. The expectation of non-pivotality provides reasons not to vote, but not overriding reasons if an individual values the opportunity to participate in or dissociate herself from a collective activity. In any event, the paradox of voting is probably more of a challenge for rational choice theory than an argument against the shareholder franchise, just as no one takes the paradox to be an argument for the abolition of elections in the political sphere.[125]

The answer to the second question turns on whether the dissemination of the relevant communications is beneficial to the shareholders as a whole, in which case the costs should be subsidized by the corporation, or only to the proposing shareholder, in which case the costs should not be subsidized. Arguments against shareholder social proposals tend to presuppose that the communications are of no benefit to shareholders as a whole,[126] but I am not so certain. By enabling informed shareholders to alert others to possible sources of ethical concern in relation to their investment, the mechanism reduces the costs of gathering and analyzing this information for all shareholders.

My support for the availability of the proxy mechanism for shareholder social proposals is also influenced by two other factors. The first is that the costs are modest: Alan Palmiter estimated in 1994 that corporations spent an aggregate of $15-million in dealing with Rule 14a-8 proposals, and the SEC estimated its own costs at one staff-year.[127] The second is that although some proportion of the other shareholders may, upon reading the communication, conclude that the information does not affect their own investment decision, little harm will have been done because the communications are brief[128] and shareholders are not prevented from voting against the proposed resolution. There may, of course, be some shareholders who feel that *no* communication on social

[123] *See supra* text accompanying note 76.
[124] An alternative, of course, would be to register disapproval by simply selling her shares. Regarding the relationship between "voice" and "exit," see ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970) and John C. Coffee Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991), for a discussion of voice and exit in the context of institutional investors.
[125] *See, e.g.*, John H. Aldrich, *Rational Choice and Turnout*, 37 AM. J. POL. SCI. 246 (1993) (describing the challenge posed by voting for rational choice theory).
[126] *See, e.g.*, the argument made by Fischel *supra* note 96 and accompanying text.
[127] Proposed Amendments to Rule 14a-8, Exchange Act Release No. 34-19135, 47 Fed. Reg. 47420, at 47423 n.15 (Oct. 26, 1982). Concerning the costs associated with shareholder proposals, see also Daniel E. Lazaroff, *Promoting Corporate Democracy and Social Responsibility: The Need to Reform the Federal Proxy Rules on Shareholder Proposals*, 50 RUTGERS L. REV. 33, 82 (1997) (suggesting that the costs of Rule 14a-8 "may be considerably smaller than potential alternatives," such as more vigorous substantive regulation of corporate activities). Susan Liebeler suggested in 1984 that compliance costs relating to Rule 14a-8 were in the order of $95,000 per submission. Liebeler, *supra* note 119, at 454. Liebeler disputed that this amounted to an "insignificant" amount, but argued that the "more fundamental" costs occasioned by Rule 14a-8 "flow from the unrealistic concepts of corporate social responsibility and corporate governance which the rule fosters." *Id.* Dent also contests the idea that Rule 14a-8 is "costless." *See* George W. Dent, Jr., *Response: Proxy Regulation in Search of a Purpose: A Reply to Professor Ryan*, 23 GA L. REV. 815, 819-20 (1989).
[128] Rule 14a-8 limits the length of a proposal, including the supporting statement, to 500 words. 17 C.F.R. § 240.14a-8(d) (2005).

matters will ever be of interest to them. If they were sufficiently numerous,[129] however, one would expect to see states enacting legal provisions authorizing or requiring corporations to exclude shareholder resolutions on social matters.[130]

Mandatory social disclosure

Cynthia Williams has been a prominent advocate of the position that the SEC should adopt rules requiring "social disclosure" by public corporations, including disclosure of the corporation's pattern of compliance with domestic and foreign law and of information concerning employment practices and the earning of income from "controversial products."[131] Williams argues that such information is relevant both to the purely economic aspect of an investment decision — because a company's social and environmental practices can affect its profitability — and to investors' social concerns.

I agree with an important premise of Williams' argument — the rejection of a compartmentalization of human values which would deny the relevance of social considerations to an investment decision. I also acknowledge that making "social disclosure" mandatory might have some beneficial impact; for example, it may increase investors' empathetic engagement to a level that has not been achieved by leaving investors to their own devices.

However, I have some misgivings about mandatory social disclosure that I do not have in relation to shareholder social responsibility proposals. These misgivings relate to the fact that there is a market in social information. People who are interested in social information can currently obtain it from commercial social information services or can invest in mutual funds that add value in part by obtaining and analyzing information about corporations' social impact. Although some investors are interested in social information, others are not, and those who are interested in social information vary in the value they attach to the disclosure and in the types of social information they value. The characteristics of supply — notably the cost of collecting and communicating the information — and investors' demand for the information determine the amount, type and quality of the information that is produced. Williams' proposal amounts to a suggestion that this determination should instead be made by the SEC.

The debate about mandatory social disclosure is a variant of the more general debate about mandatory disclosure by capital-raising corporations. In this debate, an important argument against mandatory disclosure is that the operation of the capital market in any event ensures that corporations disclose information valued by investors.[132] In this connection, it is worth noting that even largely unregulated securities offerings, such as offshore or institutional offerings, are

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[129] *See* Dent, *supra* note 127, at 820 (asserting that "[m]ost shareholders have no love for" Rule 14a-8 and, if given the choice, would likely prefer to restrict or eliminate shareholder proposals).

[130] If a proposal were inadmissible under state law, Rule 14a-8 would not oblige management to circulate it. *See* 17 C.F.R. § 240.14a-8(i)(1) (2005). Recall Fischel's argument that, since "states also have incentives to adopt efficient rules of corporate law to attract incorporations [, . . . state] rules that have survived over time, therefore, are entitled to at least a weak presumption of efficiency." Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of* Dirks v. Securities and Exchange Commission, 13 HOFSTRA L. REV. 127, 135 (1984). By the same token, if states have not seen fit to rule out shareholder social resolutions and spare corporations the expense of circulating them, it casts doubt on the proposition that investors are ill served by the status quo.

[131] Williams, *supra* note 81, at 1275. The rules would be adopted pursuant to the SEC's authority under section 14(a) of the Exchange Act.

[132] *See* EASTERBROOK & FISCHEL, *supra* note 45, at 280-83.

typically accompanied by extensive disclosures by the issuer. The type and amount of information disclosed voluntarily will, of course, deviate from the ideal, especially to the extent that the information would be useful to third parties (for example, shareholders in other corporations in the same industry)[133] or that managers' incentives are not perfectly responsive to the preferences of investors as revealed in the capital market.[134] However, some information that is not forthcoming directly from issuers but that is valued by investors is likely to be provided by analysts and other private actors.[135] Opponents of mandatory disclosure claim that the mix of information resulting from voluntary and third-party disclosure is likely to more faithfully reflect what investors want (and are willing to pay for) and, therefore, be more successful than a regulator's assessment of the optimal type, quality and quantity of information.

This well-known and influential argument in the more general debate has not been adequately addressed by the proponents of mandatory social disclosure. Williams, for example, argues that the current, voluntary regime is inadequate in that it provides professional money managers with better "access" to information than individual investors, and that the information currently available is "incomplete."[136] However, in relation to access, Williams takes for granted that informational disparities among stock market participants are intrinsically bad, without acknowledging that such disparities might simply reflect investors' varying decisions in the market for information.[137] Do professional money managers have better access than individual investors, or is it just that professionals subscribe to research newsletters whereas individual investors choose to spend their money on other things? In relation to completeness, although Williams clearly believes that more (and higher-quality) social information ought to be available, she does not explain why the type, quality and amount of social information currently produced in the market does not adequately reflect its value to investors.

A good argument can often be made for regulatory adjustment of market outcomes based on a market failure, such as a collective action problem. For instance, proponents of mandatory disclosure sometimes argue that, in the absence of a disclosure obligation, information valued by all shareholders would be underproduced because none of them would be willing to bear, alone, the costs of obtaining information that can then be used, for free, by everyone.[138] This argument

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[133] *See* EASTERBROOK & FISCHEL, *supra* note 45, at 290-91.
[134] The authors of a note in the Harvard Law Review concerning mandatory social disclosure suggest that managerial incentives are a significant obstacle to voluntary social disclosure. Note, *Should the SEC Expand Nonfinancial Disclosure Requirements?*, 115 HARV. L. REV. 1433, 1449 (2002) [hereinafter Harvard Note]. They argue that corporations do not provide social information, even if investors desire it, because managers prefer to avoid the hassle of "responding to shareholders' political concerns." *Id.* In my view, this is unlikely to be a significant factor. As I argued in Part I, management has incentives to cater to shareholders' preferences. While some argue that these incentives may be outweighed if a manager has the opportunity to obtain a significant wealth transfer at the shareholders' expense, I doubt that the avoidance of hassle qualifies as a significant wealth transfer. *See supra* note 25 and accompanying text.
[135] *See* EASTERBROOK & FISCHEL, *supra* note 45, at 292-93.
[136] Williams, *supra* note 81, at 1289-91. She also argues that the status quo is unsatisfactory because it results in information that is not comparable across firms. *Id.* I discuss the latter argument in the text accompanying note 141 *infra*.
[137] This is a well-known argument in the debate about insider trading. *See*, *e.g.*, Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309 (1981) (criticizing the notion that the wrongfulness of insider trading resides in insiders' "unequal access" to information).
[138] Morris Mendelson, *Economics and the Assessment of Disclosure Requirements*, 1 J. COMP. CORP. L. & SEC. REG. 49, 53-54 (1978) (justifying mandatory corporate disclosure on the ground that the value of information cannot be confined to those users who have paid for it); Mark Blair, *The Debate over Mandatory Disclosure Rules*, 15 U. NEW S. WALES L.J. 177 (1992).

applies, however, only to information the shareholders would have to obtain from third parties and not to information that the corporation can produce and provide to investors itself.[139] Moreover, if information were being substantially underproduced because of its "public goods" aspect, one would expect to observe some potential purchasers of social information instead obtaining it second-hand without paying for it. I doubt that free-riding by social investors is the reason why the Investor Responsibility Research Center and other similar providers do not have more customers.[140]

Another possible collective action problem relates to the desirability of standards for social information that would enable comparisons between companies.[141] This argument, too, is made in support of mandatory disclosure generally,[142] the idea being that no firm can capture the full benefit of any investment it might make in developing comparable measures of performance because the measures could be copied by other firms without compensation. There is something to this argument, which might support public investment in the creation of a standard for disclosure.[143] However, the argument falls short of explaining why the disclosure itself should be mandatory rather than optional.

Another argument is that, in the absence of a mandatory regime, no corporation is likely to move first in producing and disclosing social information. Potential first-movers will be dissuaded by the fear of being singled out for criticism by investors (and consumers) even though other corporations have equally poor, or worse, social performance.[144] Although this argument might appear, at first glance, to describe a collective action problem, it is in reality a claim about bounded investor rationality. The underlying assumption is that investors are under a misapprehension that

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[139] *See* EASTERBROOK & FISCHEL, *supra* note 44, at 286-90 (for discussion on this point).

[140] The authors of the Harvard Note, *supra* note 134, have suggested that a different free-riding problem may contribute to justifying mandatory social disclosure. They argue that corporations might underdisclose information about the social impact of their activities because the information would be useful to the corporation's competitors to the extent that it is "closely linked to [the] firm's actual processes." Note, *supra* note 134, at 1452 (drawing an analogy to Coca-Cola's reluctance to reveal its "secret formula"). I do not find this argument persuasive. Even assuming (implausibly) that information about the corporation's social and environmental impact is akin to a trade secret, this would not establish the desirability of mandatory disclosure. Proponents of mandatory disclosure need to show that the value to investors and the corporation's rivals of knowing the information exceeds the value to the corporation of keeping the information private, and that transaction costs or market dysfunctionality prevent all of these parties from reaching an appropriate bargain.

[141] Williams argues that there is a need for comparable information, although she does not characterize the problem as one of collective action. *See supra* note 81, at 1293.

[142] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 45, at 292.

[143] This acknowledgment is subject to the concerns expressed below about conformism. *See infra* text accompanying note 146. I also note that there is no shortage of private and public-sector initiatives directed towards articulating standards for responsible corporate conduct; these can serve as "templates" for disclosure. For a description of these initiatives, see David Weissbrodt & Muria Kruger, *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights*, 97 AM. J. INT'L L. 901, 902-03 (2003).

[144] Note, *supra* note 134, at 1452 ("No investor wants her firm alone to disclose antisocial behavior, because that firm would bear the brunt of the costs in the form of consumer and investor backlash. But all investors may desire that all firms disclose . . . ."); Cyrus Mehri et al., *One Nation, Indivisible: The Use of Diversity Report Cards to Promote Transparency, Accountability, and Workplace Fairness*, 9 FORDHAM J. CORP. & FIN. L. 395, 444 (2004). Jonathan Macey previously suggested a similar argument in support of mandatory financial disclosure. *See* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 415-17 (2004) (describing as a collective action problem the incentive of firms to conceal negative information).

corporate profits are made in an acceptable manner and will misinterpret any one firm's disclosure as a reflection only upon that firm. Or perhaps investors are simply in denial.

Ultimately, the arguments for overriding the market in social information seem to rest, not on a collective action problem, but on paternalism. The underlying normative idea is that investors *ought to* want social information more than the preferences they reveal in the market suggest that that they do.

Accordingly, the substitution of a regulatory regime for the current market in social information would entail the problems that one might expect of a paternalistic project. For example, given a diversity of views among investors as to the type and quantity of social information they want, and how much they are willing to pay for it, how would a regulator determine what information to require?[145] There is, in my view, a real risk that an SEC social disclosure regulation would resemble a laundry-list of fashionable causes, which could contribute to a certain ethical conformism. Although this risk is also present in an unregulated solution where disclosure is driven by investor demand, the market has the advantage of easy adaptability, with the quantity and type of information provided evolving in response to changes in investors' values, priorities and willingness to pay. The risk of conformism is, I might add, not present in the case of the shareholder proposal rule, since the latter relies entirely on investor initiative to bring questions of ethical or social responsibility to the attention of shareholders.[146]

A mandatory rule would also impose the costs of producing social disclosure on many shareholders who do not want the information. The compliance costs of a mandatory social disclosure regime, unlike those of the shareholder proposal mechanism, are likely to be considerable.[147] Even the option of incorporation or reincorporation in a jurisdiction that prohibits shareholder resolutions on social matters, available hypothetically if sufficient numbers of investors decided that the cost and nuisance of shareholder social proposals were too much to bear, would not be available in the case of a federal social disclosure regime designed to be mandatory.

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[145] I share the concerns expressed by Donald Langevoort, who warns of "intensely political and ideological" balancing exercises within the SEC if its mandate were expanded to include consideration of non-investor interests. Donald C. Langevoort, *Commentary: Stakeholder Values, Disclosure and Materiality*, 48 CATH. U. L. REV. 93, 98 (1998).

[146] Admittedly, there is the opposite risk, that shareholders may advocate distasteful ethical positions. In this connection, I note that a white supremacist organization has been among the users of Rule 14a-8. *See* American Telephone & Telegraph Co., SEC No-Action Letters, 1990 WL 285826 (Jan. 19, 1990), 1991 WL 176529 (Jan. 16, 1991) and 1992 WL 18815 (Jan. 30, 1992).

[147] I recognize that this claim is somewhat speculative, and depends to an extent on the nature of the disclosure. It may be that some information that is already collected and reported confidentially to another government agency could be disclosed at relatively little incremental cost, a point made by the authors of the Harvard Note. Note, *supra* note 134, at 1451. However, I suspect that this describes a very limited category of information: the Harvard authors cite only one example of information meeting this description, namely employment statistics reported to the Equal Employment Opportunity Commission. *Id.* at 1452-53. For most information likely to be covered by a mandatory social disclosure rule, information would have to be collected, verified and collated; the idea is to produce information of a high quality and for which an issuer would be prepared to accept legal responsibility. This is likely to be an expensive proposition, judging from the expenditures currently incurred in complying with existing mandatory disclosure requirements and new institutional and certification requirements of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 78d-3, 78o-6, 1348-1350, 1514A, 1519-1520, 7201-7202, 7211-7219, 7231-7234, 7241-7246, 7261-7266 (2002)). Total compliance costs associated with mandatory disclosure were estimated at $1 billion in 1980. *See* Note, *supra* note 134, at 1451. Those associated with Sarbanes-Oxley have been estimated at $12 billion per year. Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 280 n.41 (2004).

Without a widespread belief on the part of investors that the information is useful to them, I fear that the result is likely to be perfunctory compliance by management and resentment on the part of the majority of investors.

As much as one might like for investors to be more interested than they are in information about the social impact of corporate activities, it might be misguided to implement a costly new disclosure regime on the theory that their better selves would want the information.[148]

Conclusion

This Article has focused on the relationship among corporate law, shareholder responsibility and corporate social responsibility.

I have argued that corporate law is, at worst, ambiguous as to the legality of departures from profit maximization on account of corporate social responsibility. In practice, the law is permissive of corporate social responsibility. As a result, if corporations are in fact “pathological” profit-maximizers, it is not because of corporate law, but because of pressure from shareholders.

To a corporate lawyer, the foundation of socially responsible investing — the source of investors’ ethical obligations and of their authority to translate these obligations into modifications of corporate conduct – is not the notion that shareholders are the “owners” of the corporation. Rather, their obligations rest on the fact that shareholders voluntarily occupy their position as the beneficiaries of corporate activity. Their authority rests both on their contractual rights, and on the fact that the shareholders have money at stake in any decision by corporate management to depart from profit maximization on account of ethical considerations.

Economic theorists of the corporation have constructed a model of the corporation from which some of them derive the conclusion that corporate law should contain at least a default rule requiring management to pursue, exclusively, the maximization of stockholder profits. But the so-called contractarian model does not, by itself, entail profit maximization. I have argued that additional assumptions are necessary, in particular highly stylized assumptions about the impact of corporate activity on non-shareholders and about the ruthless self-interest of shareholders.

The ethical investor contradicts, by his or her motivation and actions, the assumption of self-interest and creates awkwardness for defenders of the profit maximization norm. These defenders respond by exceptionalizing ethical investors or by recasting their motivations as selfish. The first strategy fallaciously seeks to reconstruct the world to fit a preferred model. The second strategy is, I have argued, inappropriate because it requires one to believe, implausibly, that there is no difference between trying to do right and trying to improve one’s position.

In applying these theoretical reflections to certain concrete questions of corporate law, I concluded that the continued availability of the proxy mechanism for shareholder social responsibility proposals could be supported on the basis that it is presumptively beneficial to all

[148] On the other hand, an argument along different lines may be capable of justifying mandatory disclosure, for example, as a regulatory device for achieving particular public goals. The idea would be that requiring disclosure of, for example, minority employment levels, might provide an indirect means of discouraging systemic discrimination without full-blown substantive regulation. However, the intended audience for these disclosures would not be shareholders alone and the logical source of such disclosure requirements would not be the SEC, but rather the legislator or agency with regulatory responsibility for the particular subject-matter.

shareholders for them to be able to alert one another to possible sources of ethical concern in relation to their investment, and that the relatively modest costs of the mechanism are therefore appropriately borne by the corporation. I have argued, however, that the case for introducing mandatory social disclosure as a matter of corporate or securities law is weaker because there is a functioning market in social information for investors. If the prevailing levels and quality of social information appear to some scholars to be too low, it is not clear to me that there is any market failure justifying the substitution of a regulated outcome.

The bottom line is that we need not be hopelessly idealistic to believe that shareholders have, and are capable of recognizing, ethical responsibilities in relation to their investment decisions. In practice, corporate law is accommodating of these responsibilities, as it should be. That prominent corporate law scholars cannot make sense of shareholder responsibilities is a reflection, not of the irrelevance of ethical and social responsibility to the shareholder's decision, but of the limitations of the dominant theoretical framework.