Notre Dame Law Review

Volume 81 | Issue 4 Article 5

5-1-2006

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Recommended Citation

Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 Notre Dame L. Rev. 1431 (2006).
Available at: http://scholarship.law.nd.edu/ndlr/vol81/iss4/5

ACCOUNTABILITY AND RESPONSIBILITY IN CORPORATE GOVERNANCE

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INTRODUCTION

The debate over corporate social responsibility is often vague or unrealistic or both. The participants speak in terms of how corporations ought to be run, without specifying the legal changes that will produce these results. When social responsibility advocates recommend legal fixes, they typically focus on their aspirations for how these changes will function without fully analyzing how the proposals will actually operate in the context of real world constraints on governing large firms.

This Article attempts to sharpen the corporate social responsibility debate by specifying the available legal options for socially-responsible governance and the conditions that must be met in order for these options to be socially beneficial. The Article's main contribution is to establish a clear framework for evaluating issues relating to corporate social responsibility, rather than to recommend or oppose particular proposals.

The relevant legal issues for corporate social responsibility concern whether and to what extent legal rules should mandate or restrict mechanisms of corporate governance in order to ensure that corporate managers act in society's interests rather than those solely of the shareholders. It is helpful to begin the analysis by delineating what the relevant questions do *not* concern. First, although social responsibility is often referred to as a "corporate" concept, it has no coherent meaning detached from the specific mechanisms by which corporations are governed.

Second, the legal issue is not whether the corporation or any of the individuals who manage it *should* care about society. There may be strong ethical or moral arguments for socially-responsible governance. The question addressed here is whether the law should mandate such governance, given lawmakers' inherent limitations, the potential costs of legal rules, and disagreements about appropriate social objectives.

Third, there is no question whether the parties to the firm *may* contract to take society's interests into account. The question is the extent to which the law should *mandate* contracts intended to produce more socially-responsible governance or *prohibit* contracts that constrain socially-responsible management.

Fourth, the specific question regarding corporate social responsibility is *not* whether the managers should maximize profits, but rather in whose interests they should manage. Managers can promote shareholders' interests without maximizing profits to the extent the shareholders have some objective other than profit maximization.

The argument for laws intended to ensure more socially-responsible management is that corporate managers who are forced to respond to shareholders' interests may not maximize social welfare.[1] Social responsibility theorists argue that markets alone cannot adequately discipline corporate conduct, and that regulation of corporate conduct does not redress all social harm because these harms are difficult to detect, regulation is difficult to design, and sanctions may be ineffective.[2] Shareholders care only about profits in the narrow accounting sense rather than social welfare and take no moral responsibility for social harm.[3] Advocates of more socially-responsible governance accordingly argue for empowering or compelling managers to run their companies with a view to society's interests as well as those of shareholders. Directors are "mediating hierarchs" who do, and should, respond to the interests of the various parties to the corporate contract, including creditors, suppliers, and workers.[4]

One response to this argument is that society's interests are not as inconsistent with those of shareholders as social responsibility theorists assume. Markets can reflect political and social tastes and socially-relevant information. It follows that managers who closely

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1 *See generally* JOEL BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER (2004); LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT (2001); RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976); CHRISTOPHER STONE, WHERE THE LAW ENDS (1975); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005); Douglas Litowitz, *Are Corporations Evil?*, 58 U. MIAMI L. REV. 811 (2004).

2 Litowitz, *supra* note 1.

3 *See* BAKAN, *supra* note 1; RALPH ESTES, TYRANNY OF THE BOTTOM LINE: WHY CORPORATIONS MAKE GOOD PEOPLE DO BAD THINGS (1996); MARJORIE KELLY, THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY (2001); MITCHELL, *supra* note 1; Elhauge, *supra* note 1.

4 *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

attend to shareholders' interests have incentives to maximize social wealth.

Another response concerns the costs of legally compelling socially-responsible governance—that is, of reducing managers' accountability to shareholders. Berle and Means argued seventy years ago that the central problem with corporate governance is that corporate managers are essentially free from effective shareholder discipline.[5] Enron and other notorious corporate scandals demonstrate that this agency cost problem has not disappeared. Substantially restructuring corporate governance to reduce managers' accountability to shareholders could exacerbate these problems. Adopting recommendations by some commentators to make managers accountable to nonshareholders[6] could have similar consequences because empowering stakeholders leaves managers effectively accountable to nobody.

If corporate managers should not be made significantly *less* accountable to shareholders, the main remaining corporate social responsibility issue is whether firms ought to be able to make them *more* accountable to shareholders. The initial question is whether such a move is feasible. The governance of large corporations is based on the general principle of "director primacy," which reposes basic management power in corporate directors.[7] The conventional mechanisms for controlling this power—shareholder voting, fiduciary duties, and the market for corporate control—all have significant gaps that inhere in the difficulty of controlling managers' discretion in publicly held firms.

One type of accountability mechanism that might be considered is to weaken managers' grip on the firm's cash through partnership-like devices that mandate distributions and permit dissatisfied owners to cash out. These mechanisms have not been used as tools of public corporation governance at least partly because the corporate tax makes distributions to owners unattractive. Other factors also may play a role, including large firms' need for financing flexibility in the light of changing business needs, which in turn may require that managers decide distributions. In other words, greater managerial accountability to shareholders might be infeasible because it would increase operating costs more than it would reduce agency costs. If

5 *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

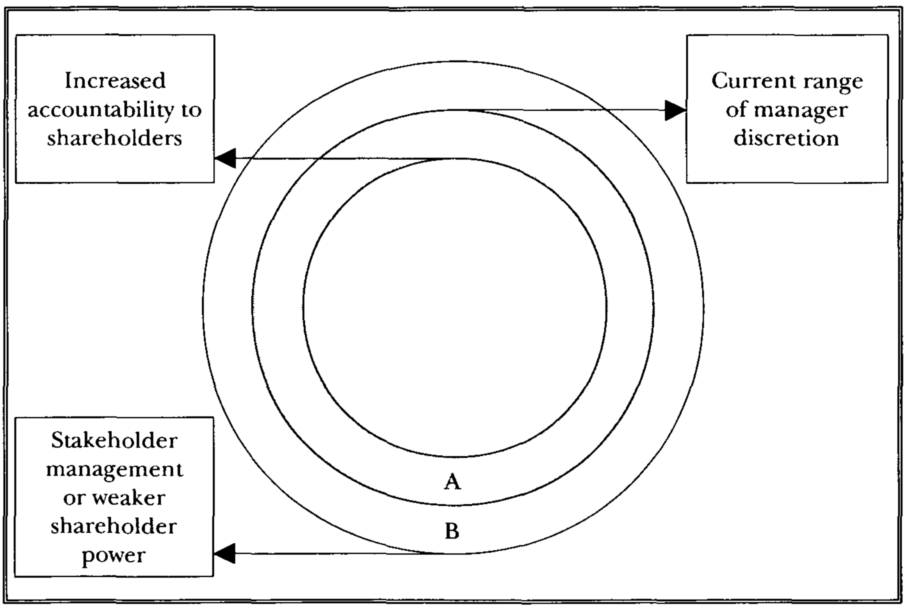
6 *See, e.g.*, BAKAN, *supra* note 1; MITCHELL, *supra* note 1.

7 *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

so, it is unnecessary even to reach the issue of whether these mechanisms are otherwise socially desirable.

Fgure 1 illustrates the above policy choices. The solid line indicates the extent of managerial discretion under current law.[8] Territory B represents the increased discretion managers would have to serve social objectives under governance laws that reduced managers' accountability to shareholders or enabled stakeholder management. The inner circle represents managers' reduced discretion to serve social objectives under governance and tax rules that enable increased managerial accountability like those discussed below in Part IV.B. The specific question this Article addresses is whether the law should move corporate governance to either Territory A or Territory B.

FIGURE 1. THE MANAGERIAL ACCOUNTABILITY ISSUE



The Article proceeds as follows. Part I discusses arguments favoring socially-responsible management based on the inability of markets and regulation adequately to ensure that firms managed in the shareholders' interests will serve social needs. It also provides an overview of how these arguments might matter to corporate governance.

Part II considers whether attending to shareholders' interests requires managers to ignore costs and benefits that are not included in accounting profits. It shows that there are well developed markets for corporate responsibility, including social consuming, social investing,

8 *See infra* Parts I.B, IV.A.

and organizations concerned with worker welfare. Activists can inflict economic sanctions on firms that ignore their social responsibilities. Accordingly, managers who carefully attend to the firm's profits also must seek at least to some extent to further society's interests.

Even if markets cannot perfectly align corporate management with society's interests, Part III shows that any social costs of shareholder-oriented governance must be compared with the social costs of increased managerial slack under a socially-responsible governance regime. Unconstrained managers cannot be expected to act in society's interests not only because they may prefer to act in their own interests, but also because they are unlikely to know what is best for society.

It follows from Parts II and III that managers need not be made significantly *less* accountable to shareholders. Part IV considers whether there is any remaining tension between accountability and responsibility in corporate governance. This depends on the feasibility of making managers *more* accountable through such partnership-type devices as mandatory distributions and owner cash-out rights. The final Part concludes.

I. THE SOCIAL RESPONSIBILITY DEBATE

The relevant legal questions for the corporate social responsibility debate focus on what contracts shareholders and managers should be allowed to make with the firm. Specifically, what limitations should there be on contracts in the firm that force managers to attend to shareholders' interests? Social responsibility theorists argue that excessive accountability to shareholders causes managers to ignore social costs and benefits in favor of the sort of short-term accounting profits that are reflected in share price. This implies that participants in firms should not be able to contract for governance mechanisms that would restrict managers' ability to act in nonshareholders' interests.[9] Unless corporate social responsibility supports such legal rules, it has significance only as management science—that is, how managers should use whatever discretion the law gives them.

A. *Arguments for Socially-Responsible Governance*

In stating the case for socially-responsible governance, we must first ask why it is not enough to impose external regulation on the

9 *See* Elhauge, *supra* note 1, at 863–66 (arguing that contracts compelling managers to maximize profits should be unenforceable); Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 1000–02 (1993) (discussing the mandatory nature of the ALI Code's social responsibility duty).

firm without having to manipulate the firm's internal governance. This could be done directly through civil liability or other penalties levied against the corporate entity or against individuals in the firm. Indirect regulation would include legal rules that, in effect, channel business behavior or organizational form by making certain types of behavior or organizational forms more costly than others. A prime example is laws that tax some forms or behaviors differently than others.[10] Lawmakers rely on those responsible for internal governance to achieve socially-desirable results by responding to the regulation.[11] In other words, external regulation can be viewed as an important limitation on the discretion of those who hold power in the firm to decide whether to be socially responsible.[12]

External regulation may, however, be inadequate to align corporate profits with social welfare.[13] Among other problems, regulation is shaped by interest groups whose power depends on their ability to prevent free riders who gain from the regulation but do not contribute to the costs of securing it. The costlier it is for groups to organize, the less effectively they can lobby politicians and regulators.[14] Because of the free rider problem, smaller groups with lower organization costs may be able to out-lobby and therefore receive greater benefits than larger groups, such as voters or consumers generally.[15] Also, business corporations can avoid organization costs by supporting political activities out of the profits generated by their nonpolitical activities—in other words, they can gain political benefits as a "byproduct" of their organization for nonpolitical reasons.[16]

The next step in the analysis is to ask whether market and other nonregulatory constraints on government can ensure that managers

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10 *See* Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1218–25 (2004).

11 For an overview of some regulatory strategies, see Edward L. Rubin, *Images of Organizations and Consequences of Regulation*, 6 THEORETICAL INQUIRIES L. 346 (2005), *available at* http://www.bepress.com/til/default/vol6/iss2/art4.

12 *See* THOMAS F. MCINERNEY, INT'L DEV. LAW ORG., PUTTING REGULATION BEFORE RESPONSIBILITY: THE LIMITS OF VOLUNTARY CORPORATE SOCIAL RESPONSIBILITY (2005), *available at* http://www.idli.org/DLRC/vdj/vdj3_2005.pdf.

13 *See, e.g.*, Elhauge, *supra* note 1, at 802–03.

14 *See* ROBERT E. MCCORMICK & ROBERT D. TOLLISON, POLITICIANS, LEGISLATION AND THE ECONOMY: AN INQUIRY INTO THE INTEREST GROUP THEORY OF GOVERNMENT (1981); MANCUR OLSON, JR., THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).

15 *See* OLSON, *supra* note 14; Gary Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983); Robert Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988).

16 *See* OLSON, *supra* note 14, at 132–67.

take into account the interests of nonshareholders. According to social responsibility theorists, there are several reasons why managers who seek to maximize shareholder wealth may not act in society's interests. First, those dealing with or affected by the firm may lack adequate information to make socially-efficient bargains. Firms know more about the ingredients, risks, benefits, and methods of production of their own products than anyone else. Thus, drugs or other products may succeed on the market even if their social value is lower than that of other available products.[17]

Second, even if information is widely available, the firm may impose costs on parties who are not in a position effectively to bargain with the firm for compensation, such as widespread victims of pollution. If the applicable legal rule denies compensation, the firm will have little incentive to take appropriate steps to minimize the risk.

Third, the firm may have significant market power. This may be due to several factors that impede entry of new businesses into the relevant industry. For example, firms may have legal rights, including from patents, trademarks or other intellectual property. "Network" effects, such as those associated with a computer operating system, may make it difficult to introduce a competing product. The effect of this market power is usually distributional in the sense that it enables the firm to set prices so as to leave little or no consumer surplus. Those transacting with the firm may not be worse off after the transaction than before, but they do not derive as much benefit from the transaction as they would in a more competitive market. Some economically disadvantaged customers may be denied the opportunity to buy the product, or customers may be deterred by the high price from engaging in transactions that would have been socially efficient.

Fourth, in addition to weak market constraints on firms, there may be weak discipline of corporate owners by norms and reputational sanctions. This argument distinguishes publicly held from closely held firms. It has been argued that shareholders of public corporations are morally insulated from the consequences of corporate acts, and therefore are not subject to the noneconomic sanctions of shame and guilt that supplement market sanctions for individuals and owners of closely held firms.[18]

Fifth, corporations may differ from both publicly and closely held noncorporate firms because of the entity theory that endows the firm with such legal powers as the ability to own property and sue, and gives it First Amendment protection for business speech and political

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17 *See* STONE, *supra* note 1.

18 *See* Elhauge, *supra* note 1, at 758–59, 797–99.

activities.[19] By contrast, the partnership traditionally has been viewed as merely an "aggregate" of the members, with no rights or powers of its own.[20] Since corporations are not subject to humans' moral or ethical concerns they seem to have rights and powers without responsibilities.[21]

In short, corporate responsibility theorists argue that social, market, and regulatory constraints are inadequate to cause a shareholder-wealth-maximizing firm to act in the public interest. It follows from this reasoning that the law should attempt to structure firm governance so that it responds to social interests and not exclusively shareholder interests, assuming that this is feasible.

B. Social Responsibility and Corporate Governance

Whether corporate governance should be restructured to enable or require managers to respond to the interests of stakeholders in the firm other than shareholders implicates an analysis of existing corporate structure. Executives make day-to-day management decisions in a publicly held corporation. The board of directors monitors these decisions through their power to approve major transactions or initiate them for shareholder approval, and to hire, fire, and compensate the

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19 *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 1.03 (1988 & Supp. 2006); THOM HARTMANN, UNEQUAL PROTECTION: THE RISE OF CORPORATE DOMINANCE AND THE THEFT OF HUMAN RIGHTS (2002).

20 Although this is the traditional characterization, a partnership is viewed as a legal entity for many purposes. *See* UNIF. P'SHIP ACT § 201, 6 U.L.A. 91 (1997); BROMBERG & RIBSTEIN, *supra* note 19, § 1.03. Henry Hansmann and Reinier Kraakman describe entity features that support business activity through all types of firms, including partnerships. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000). What Hansmann and Kraakman call "affirmative asset partitioning" separates business property from that of the owners. *Id.* at 394–95. Hansmann and Kraakman contrast this with "defensive asset partitioning," or limited liability, discussed in more detail below, which protects firm owners' individual property from business creditors' claims. *Id.* at 395–96. The partnership form has a weaker form of "affirmative asset partitioning" than the corporation. It is not clear, however, that this technical distinction matters for purposes of constitutional law and other implications of entity characterization.

21 Note, however, that the law compensates for this problem by devaluing the firm's rights. Entity characterization rationalizes giving the firm a lower level of constitutional protection than if rights had been ascribed to individual owners or managers. *See* Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95 (1995); Larry E. Ribstein, *Corporate Political Speech*, 49 WASH. & LEE L. REV. 109 (1992). Corporate speech may receive an even lower level of protection when it is characterized as "commercial." *See infra* text accompanying note 54.

managers.[22] The owners exercise control through their power to elect the board and to approve extraordinary matters such as mergers and charter amendments that the board has initiated.[23] Nonshareholder stakeholders exercise power under specific agreements, such as credit and employment agreements and supply contracts, as well as by their ability to decide whether to deal with the firm.

This general structure suggests three potential legal tools for increasing managers' social responsibility. First, nonshareholder stakeholders can be given power to control managers. For example, employees might vote equally with shareholders and serve on the board of directors.[24] The primary alternative to giving owners exclusive powers of control is the European system of codetermination, which gives employees some representation on the board.[25]

While such proposals might seem the most obvious routes to corporate social responsibility, radical restructuring favoring nonshareholder stakeholders may entail high costs and obscure benefits. Because equity holders have a claim only to what is left after other stakeholders have been paid off, shareholders gain more than other stakeholders from voting powers and fiduciary duties. Restructuring corporate governance to favor nonshareholder stakeholders therefore could significantly increase these stakeholders' ability to extract wealth from shareholders.[26] Shareholders could be expected to pay less for their shares to reflect this appropriation risk. In other words, shifting power to stakeholders solves the problem of shareholder opportunism to stakeholders by creating a potentially more serious problem of stakeholder opportunism to shareholders.

Stakeholders also might gain little from their increased power. Given stakeholders' heterogeneous objectives, internal dissension might seriously compromise their effectiveness in governing the firm. By contrast, shareholders simply want to maximize risk-adjusted profits, perhaps qualified by generalized social objectives. Thus, empower-

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22 The board's function is summarized in DEL. CODE ANN. tit. 8, § 141(a) (2001) (providing that the corporation is managed "by or under the direction of a board of directors").

23 *See, e.g.*, *id.* § 141 (2001 & Supp. 2005) (director election); *id.* § 242 (2001) (charter amendment); *id.* § 251 (2001 & Supp. 2005) (merger); *id.* § 271 (sale of assets); *id.* § 275 (dissolution).

24 *See* KELLY, *supra* note 3, at 156.

25 *See* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 62–65 (2004).

26 *See* Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002).

ing stakeholders might effectively leave managers accountable to nobody.

Second, courts or legislatures could adjust managers' judicially enforced fiduciary duties. Managers might have an affirmative duty to serve the interests of groups other than the shareholders, or their basic duty to serve shareholders' interests might be qualified by giving managers some discretion to act in nonshareholders' interests. However, as discussed below,[27] courts are inherently constrained in the extent to which they can supervise corporate managers. This limits what can be accomplished by fine-tuning fiduciary duties.

Third, shareholders' power to control managers can be reduced. For example, the law might loosen shareholders' control over the board by giving directors five-year terms.[28] Short of such radical suggestions, the limits of shareholder control are built into the logistics of the publicly held firm.[29] For example, managers' ability to fend off takeovers is inherent in their ability to exercise control in other ways, and courts are no more able to monitor exercise of this power than they are to supervise other managerial activities.[30]

Finally, any legal moves to reform corporate governance in the U.S. must confront the constraints imposed by the federal system. The "internal affairs rule" lets firms choose the particular state's law that applies to their internal governance irrespective of where the business conducts its operations.[31] Accordingly, if a state restricts the extent to which a firm can provide for management accountability to shareholders, the firm is free to incorporate in any other state. This means in effect that restrictions on managerial accountability to shareholders must be provided for either by a radical move to federal internal governance law, a radical rejection at the state level of the internal affairs rule, federal securities laws that apply to firms irrespective of where they are incorporated, or by nonorganization law such as tax law or regulation of business practices that are not subject to the inter-

27 *See infra* Part IV.A.2.

28 *See* MITCHELL, *supra* note 1, at 129, 161.

29 *See supra* Part I.A.

30 *See infra* Part IV.A.3.

31 *See* Vantagepoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1116 (Del. 2005) (reaffirming the internal affairs rule and applying Delaware law to a Delaware corporation doing business in California); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302(2) (1971).

nal affairs rule.[32] Indeed, this is why the corporate tax emerges as a major factor in corporate governance.[33]

The following two Parts discuss the considerations that relate to evaluating social responsibility constraints on corporate governance. Part IV addresses whether the issue arises at all by considering the feasibility of adjusting managers' accountability to shareholders apart from corporate social responsibility.

II. Social Responsibility and Markets

Part I shows that whether we should want or encourage managers to act in a socially-responsible way depends on the consequences of managers seeking to act in the shareholders' interests. If, as corporate social responsibility theorists argue, maximizing shareholder wealth involves ignoring society's interests, then laws that make managers less responsive to shareholders might improve social welfare. On the other hand, if markets help ensure that social costs and benefits are substantially reflected in corporate share prices, then shareholder wealth maximization would also tend to maximize social wealth. Also, if shareholders themselves are not interested solely in profits, then managers acting in shareholders' interests may also be acting in society's interests even if profit maximization and social wealth maximization diverge.

Part I also shows that managers of publicly held corporations necessarily have significant freedom to exercise their discretion, including by attending to nonshareholders' interests. A material increase in this discretion would require an overhaul of corporate governance that gives nonshareholders a direct role in governance, probably dictated by federal law. The case for such a radical move depends on whether the move would significantly increase social wealth compared to the current system based on powerful managers accountable to shareholders.

This Part casts significant doubt on whether such a case can be made. It shows that managers who are accountable to shareholders have significant incentives to maximize social wealth rather than just accounting profits. Indeed, distinctions between the "owners" of a firm and outsiders are largely artificial.[34] This undercuts the basic assumption of some social responsibility theorists that managers must be free of owner constraints in order to maximize social wealth. Many

32 *See* Larry E. Ribstein, *The Important Role of Non-Organization Law*, 40 WAKE FOREST L. REV. 751 (2005).

33 *See infra* Part IV.C.

34 *See* G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887 (2000).

social responsibility theorists, in fact, emphasize the congruence of social and financial performance,[35] leaving the difference between social wealth and shareholder wealth unclear. Blair and Stout argue that their "mediating hierarch" model of corporate management serves the corporation's long-term interests by solving opportunism problems faced by the firm's multiple constituencies.[36] This is equivalent to Jensen's recommendation that managers should focus on maximizing corporate value.[37]

The following sections discuss specific markets that encourage even managers who are responsive to shareholders' demands to attend to the interests of nonshareholder stakeholders. In analyzing the markets that impinge on corporate decisionmaking, it is important to keep in mind that they are potentially complementary. A firm that faces no demand for social responsibility in its product market, for example, might face such a demand when selling equity, hiring employees, or locating its headquarters.

Markets do not necessarily create complete congruence between the firm's and society's objectives. The stakeholder literature often glides from descriptions of how value-maximizing corporations can best cater to multiple constituencies to normative aspirations for "responsible" management without clearly acknowledging potential distinctions between these views.[38] This meshes with reformers' political objectives, since they can better sell their arguments for social responsibility if firms need not choose between social and shareholder wealth maximization. In fact, managers often may have to make this choice.[39] In other words, "strategic" social responsibility, where a firm's "social performance" correlates with its financial performance,

35 *See, e.g.*, Ruth V. Aguilera et al., *Putting the S Back in Corporate Social Responsibility: A Multi-Level Theory of Social Change in Organizations*, 31 ACAD. MGMT. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=820466 (reviewing the literature); M. Orlitzky et al., *Corporate Social and Financial Performance: A Meta-Analysis*, 24 ORG. STUD. 403 (2003) (arguing that, in light of recent data, government regulation is unnecessary to produce corporate social responsibility).

36 *See* Blair & Stout, *supra* note 4.

37 *See* Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235 (2002).

38 *See* Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 65 (1995).

39 *See* Abagail McWilliams & Donald Siegel, *Corporate Social Responsibility: A Theory of the Firm Perspective*, 26 ACAD. MGMT. REV. 117 (2001); Anant K. Sundaram & Andrew Inkpen, *The Corporate Objective Revisited*, 15 ORG. SCI. 350 (2004).

may differ from "altruistic" social responsibility, where social performance exceeds financial performance.[40]

The relevant issue, however, is *not* whether markets force shareholder-maximizing managers to maximize social wealth. Rather, the question is whether permitting firms to contract to make managers accountable to shareholders leads to greater social wealth than forcing them to serve nonshareholder stakeholders. The answer depends both on the congruity of firm and social interests discussed in this Part and on the costs associated with stakeholder management discussed below in Part III.

A. *Shareholders*

Social responsibility theorists argue that owners of publicly held corporations care mainly about short-term stock prices rather than long-term value. Managers may be more likely than remote owners to feel responsibility for the firm's acts, and thus to be subject to the same social norms and moral scruples that influence individuals in their personal lives. Some social responsibility theorists accordingly argue against subjecting managers to rigorous control by socially-disinterested shareholders.[41] However, as discussed in this Part, there is substantial reason to conclude that shareholders are concerned about social harms caused by the firms in which they invest.

1. The Social Incentives of Profit-Motivated Shareholders

Even if shareholders are as narrowly interested in profit maximization as social responsibility theorists conjecture, they should care about harms to society. Given present and potential government regulation and civil remedies, corporate harms can trigger substantial costs that can reduce share prices. Indeed, there is evidence that the share price penalty that occurs when a specific corporate wrong is revealed may exceed the projected costs from that wrong because of the market's concern that additional problems may be lurking.[42]

40 *See* David P. Baron, *Private Politics, Corporate Social Responsibility, and Integrated Strategy*, 10 J. ECON. & MGMT. STRATEGY 7 (2001).

41 *See* Elhauge, *supra* note 1, at 814–18.

42 *See* Greg Jarrell & Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 J. POL. ECON. 512 (1985); Jonathon M. Karpoff & John R. Lott, *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757 (1993); *see also* William D. Bradford, Discrimination, Legal Costs and Reputational Costs (Nov. 30, 2004) (unpublished study, on file with the University of Washington Department of Finance and Business Economics), *available at* http://ssrn.com/abstract=679622 (showing evidence that firms sued for discrimination incur a reputational penalty reflected in the reduced value of their equity in addition to the legal costs of the suit).

This suggests that even the most narrowly focused shareholders would want firms to avoid activities that will trigger substantial penalties, liabilities, and future regulation, at least unless the firm gains enough from the activity to offset the potential cost. It follows that they would also want the firm to disclose regulatory risks. To be sure, rigorously profit-maximizing managers might engage in nefarious activities if they were sure of not being caught or substantially penalized, and might want to hide even substantial risks if they thought the corporation could do so forever. But the pervasiveness of litigation and regulation, and the open-ended risk of additional regulation that might result from a notoriously antisocial act, mean that there is a broad category of social harms that even rigorously profit-maximizing shareholders would want their firms to avoid.

It has been argued that, without mandatory disclosure of socially harmful acts, only the largest firms with the greatest exposure to regulation could credibly commit to ongoing disclosure of regulatory risks.[43] But if firms could not credibly commit to future disclosures, their cost of capital would reflect exposure to unknown future risks. In other words, this is not an argument that socially-irresponsible firms will escape market penalties, but rather that firms themselves would want government to help them credibly commit to disclosure.

Managers may have incentives to hide negative information in the hope that they can ultimately avoid responsibility. While this conduct may be in the managers' interests, investors would tend to avoid firms with hidden risks and inflated prospects. To the extent that firms engage in or fail to adequately disclose harmful activities, it is often not because the managers are excessively accountable to shareholders, but because they are not accountable enough.

2. Perverse Incentives of Sole Proprietors

Even if impersonal owners lack nonfinancial incentives to do social good, their financial incentives may lead them to be more socially responsible than sole proprietors. That is because the incentives of public corporation shareholders who hold diversified portfolios of shares may be more consistent with social wealth maximization than the nonfinancial incentives of morally engaged sole proprietors.

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43 *See* Jason Scott Johnston, *Signaling Social Responsibility: On the Law and Economics of Market Incentives for Corporate Environmental Performance* (Univ. of Pa. Inst. for Law & Econ., Research Paper No. 05-16, 2005), *available at* http://ssrn.com/abstract=725103 (arguing that, in the absence of mandatory disclosure, most firms will engage only in "cheap talk" that does not permit meaningful comparisons between firms in an industry).

To illustrate the relevant considerations, consider the anecdote presented by the film *Save the Tiger*.[44] Jack Lemmon portrays a partner in a women's wear business who faces a dilemma of whether to save his firm by burning down its factory for the insurance money. This is probably not social wealth maximizing because the loss would be imposed on the insurance company, on insureds generally because of the effect of moral hazard on fire insurance rates, or on people who suffer uninsured losses in the fire. But Lemmon's character may stand to gain enough from saving his wealth and livelihood to outweigh potential sanctions discounted by the chance of not getting caught. By contrast, the profit-maximizing remote owners of a publicly held firm probably would not want their managers to engage in arson. They own portfolios of shares that include the defrauded insurance companies, and they have diversified away the risks of specific types of firms. These owners would tend to gain less on net from purely wealth-destroying or wealth-redistributing acts like arson than would Lemmon's character, all of whose assets are tied up in one firm.

Moreover, the nonfinancial incentives of sole proprietors do not necessarily lead them to be more socially responsible than morally disengaged owners who seek only to earn as much money as possible. Vicariously liable owners might not make socially-desirable decisions because they bear the risk of bad outcomes while not fully internalizing the social benefits of good outcomes. Also, owners of closely held firms might make socially-harmful business decisions based on perverse personal preferences that owners of publicly held firms would avoid. Consider Spike Lee's *Do the Right Thing*,[45] in which a white pizzeria owner sacrifices his business when he becomes locked in a racially tinged battle with his customers and neighborhood. The owner acted as he would have if the pizzeria were his home, including putting pictures of his Italian heroes on the walls of a business in the middle of a black ghetto. Because this is his home, the owner stands on principle and resists a customer boycott. By contrast, the hired manager of a Pizza Hut is less likely to have indulged his personal preference in this way. The manager likely would have submitted to the boycott in order to maximize profits, or not have provoked the boycott in the first place. The pizzeria might therefore have been more socially productive if it had simply sought to maximize the wealth of remote shareholders rather than making the sole proprietor feel at home. Similarly, a manager-owner might want employees as

44 SAVE THE TIGER (Paramount Pictures 1973).

45 DO THE RIGHT THING (Universal Pictures 1989).

sex objects while the anonymous public owners simply want efficient employees who will maximize financial profits.

3. The Implications of Social Investing and Governance

Though social responsibility theorists assume that public corporation shareholders are morally removed from corporate actions, this does not take into account that shareholders make individual decisions to invest in particular firms. Socially-responsible shareholders derive utility from socially-responsible investments or disutility from socially-irresponsible investments. Investors therefore may invest in mutual funds that investigate and monitor the social responsibility of portfolio firms. This arguably gives even managers who are responsive solely to shareholders an incentive to engage in socially-responsible behavior that differs from behavior that would be dictated by other performance factors.[46]

Michael Knoll shows, however, that social investors cannot simultaneously earn market returns comparable to those of other investors *and* affect corporate governance.[47] In any event, Knoll discusses significant evidence that demand curves for shares traded in efficient markets are horizontal, meaning that long-term stock prices are not affected by screening the stock out of social investment funds.[48] It follows that social investing is unlikely to play much of a role in pressing managers to make socially-responsible decisions.

Social investing may put at least some pro-social-responsibility pressure on managers despite Knoll's analysis. First, socially-responsible entrepreneurs such as Ben & Jerry's can commit the firm to nonprofit-maximization on selling shares to the public without affecting the public investors' returns.[49] Share prices capitalize reduced

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46 *See* Ian Lee, *Corporate Law, Profit Maximization and the "Responsible" Shareholder*, STAN. J.L. BUS. & FIN., Spring 2005, at 31; Joshua Graff Zivin & Arthur A. Small, *A Modigliani-Miller Theory of Altruistic Corporate Social Responsibility*, 5 TOPICS IN ECON. ANALYSIS & POL'Y, No. 1 (2005), *available at* http://www.bepress.com/cgi/viewcontent.cgi?article=1369&context=bejeap.

47 Michael S. Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment*, 57 BUS. LAW. 681 (2002). For recent evidence on returns of social investment funds, see Meir Statman, *Socially Responsible Indexes: Composition, Performance, and Tracking Errors*, 32 J. PORTFOLIO MGMT. (forthcoming 2006), *available at* http://ssrn.com/abstract=705344 (showing that social responsibility investment indexes did better than the S&P 500 during the stock market boom of the late 1990s but lagged during the bust of the early 2000s).

48 Knoll, *supra* note 47, at 706–07.

49 *See* David P. Baron, *Corporate Social Responsibility and Social Entrepreneurship*, (Stan. Graduate Sch. of Bus., Research Paper No. 1916, 2005), *available at* http://ssrn.com/abstract=861145 (discussing how entrepreneurs' ability to invest in "corporate

expected profitability, and the public investors thereafter receive returns unaffected by the level of social responsibility.[50] Social responsibility therefore may depend to some extent not on morally insulated public investors but on the existence of morally responsible sole proprietors. This produces at least some socially-responsible corporations even on the assumption that public shareholders are generally morally disengaged.

Second, even financially innocuous social investing may influence management. The fact that social investors hold a significant chunk of a corporation's stock signals that managers will not face discipline from shareholders if they depart to some extent from strict profit maximization, as by following the investment guidelines of socially-responsible investment funds. Social investing therefore may be a mechanism not for penalizing irresponsible or rewarding responsible firms through the capital markets, but for establishing clienteles of shareholders with nonprofit-oriented goals who may play a role in governing the firm.

Third, socially-responsible investors may influence ongoing management. While social investors are unlikely to significantly change managers' approach to social issues, they have opportunities to educate managers on society's needs and prod them on particular issues. These opportunities include shareholder proposals, which federal law effectively requires firms to subsidize, thereby enabling even minority holders to exercise power with minimal investment.[51] Also, the federal securities laws compel firms to disclose at least some of the societal implications of their operations,[52] and thereby force shareholders

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social responsibility" firms may increase opportunities for social giving). Another possible example of this phenomenon is Google which, like Ben & Jerry's, explicitly promises social responsibility. These promises arguably were consistent with developing a brand in a business that depended heavily on public trust, indicating the difficulty of distinguishing market-driven from altruistic behavior. *See* Victor Fleischer, *Brand New Deal: The Google IPO and the Branding Effect of Corporate Deal Structures* (UCLA Sch. of Law, Law & Econs. Research Paper No. 05-18; Geo. Univ. Law Ctr., Law & Econs. Research Paper No. 790928, 2005), *available at* http://ssrn.com/abstract=790928.

50 *See* Knoll, *supra* note 47, at 718. These returns may be subject to a slight discount to the extent that socially-responsible portfolios do not diversify away unsystematic risk. *See id.* at 695–96.

51 *See* 17 C.F.R. § 240.14a-8 (2005).

52 *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999); Johnston, *supra* note 43, at 104–08.

to confront the moral implications of their investments.[53] These rules are, if anything, slanted against firms to the extent that the First Amendment protects the "political" speech of activists more than it does the corporation's "commercial" speech in response.[54]

Fourth, institutional shareholders are potentially influential in spurring socially-responsible governance. Although these shareholders often sell rather than fight, they have an incentive to engage in informed voting, particularly given the costs of selling large blocks. They also face lower costs of acting than individual shareholders because they can adopt common strategies across their portfolios. Institutional shareholders may use their power to encourage portfolio firms to engage in long-term profit maximization. While managers of most institutional investors have duties to maximize financial returns, this would not apply to managers of social investment funds. Also, public or union pension funds often seek to further particular social causes, such as pro-labor workplace policies.[55] Indeed, these objectives may be the primary motives of investor activism.[56]

Elhauge argues that socially-motivated investors are unlikely to be influential not only because most public shareholders feel insulated from moral constraints,[57] but because even those investors who are socially-motivated face collective action problems in asserting their will.[58] Specifically, the social shareholders will assume their position will not prevail, and so have little reason not to go for financial gain. For the same reason, even socially-motivated shareholders may accept

53 *See infra* text accompanying note 83–85 (discussing how, in the absence of regulation, consumers may prefer "moral wiggle room," which firms might supply by engaging in "cheap talk").

54 This issue was raised in *Kasky v. Nike, Inc.*, 45 P.3d 243 (Cal. 2002), *cert. dismissed*, 539 U.S. 654 (2003), in which the Supreme Court granted certioriari but then dismissed the writ as improvidently granted. Nike, Inc. v. Kasky, 539 U.S. 654 (2003). *See also* Legal Opinion Letter by Larry E. Ribstein, Wash. Legal Found. (Feb. 14, 2003), *available at* http://www.wlf.org/upload/021403LOLRibstein.pdf.

55 *See* R.A. Johnson & D.W. Greening, *The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance*, 42 ACAD. MGMT. J. 564 (1999); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 479–81 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 801–19 (1993); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1033–34 (1998).

56 *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 634 n.88 (2006) (noting that "the most activist institutions—union and state and local employee pension funds—may have interests that diverge substantially from those of other investors").

57 *See supra* text accompanying note 41.

58 *See* Elhauge, *supra* note 1, at 799–800.

a financial premium from an outside bidder that ignores the social cost of moving to stricter accountability.[59] Socially-responsible managers therefore might have reason to fear a hostile takeover even if the firm supposedly has a clientele of socially-responsible shareholders.

These arguments, however, require significant speculation about shareholders' motives and actions. Most importantly, they assume that social investors will put aside their social incentives when financial push comes to moral shove, or take it for granted that their fellow shareholders will do so. It is at least equally plausible that socially-motivated shareholders would balk at investing in or approving adoption of governance mechanisms that make managers significantly more accountable to shareholders. Some socially-motivated institutional shareholders, such as pension funds, as well as corporate managers themselves, could be expected to make salient both the business and the social consequences of the move, making it both harder for socially-engaged shareholders to ignore the moral implications of their actions, and easier for them to see that that they would not be alone in their opposition.

B. *Effect of Credit and Asset Markets*

Credit and asset markets can operate with regulation to cause firms to internalize harms even when they do not deal directly with their victims.[60] Among other relevant factors, firms may buy assets because of their scale or other advantages in minimizing regulatory risks; potential sellers have incentives to minimize the buyer's risk by learning about potential problems; buyers have incentives to investigate sellers; and more efficient and knowledgeable purchasers have access to cheaper capital.[61] Analogous monitoring, investigation, and disclosure occurs in commercial lending and real estate transactions.[62]

Mandatory disclosure requirements may be needed to supplement these market and contractual devices.[63] But the absence of such laws does not necessarily make it socially efficient to restrict managers' accountability to shareholders. The monitoring and information provided by asset and credit transactions depend on managers' incentives

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59 *See id.* at 787–92, 827–28.

60 *See* Michael P. Vandenbergh, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029, 2043–66 (2005); Johnston, *supra* note 43.

61 *See* Johnston, *supra* note 43; *see also* Vandenbergh, *supra* note 60, at 2045–51 (discussing monitoring through asset purchase agreements).

62 Vandenbergh, *supra* note 60, 2043–66.

63 *See* Johnston, *supra* note 43, at 103–10.

to maximize value. Firms might engage in fewer such value-increasing transactions if their managers were less accountable to shareholders because unaccountable managers might squander funds on less productive activities. Moreover, making managers of sellers or borrowers less accountable to shareholders is unlikely to increase their monitoring or disclosure in the transactions that did occur. Because buyers and lenders demand this monitoring and disclosure, accountable managers have incentives to provide it. By the same token, since managers of buyers and lenders monitor in order to maximize the value of their firms, making such managers less accountable to shareholders is unlikely to increase buyers' and lenders' monitoring.

C. *Employees*

Like shareholders, employees can insist on socially-responsible behavior by choosing where to work. A corporation's reputation for social responsibility can attract and retain employees.[64] For example, one study shows that more than ninety percent of MBAs in the relevant sample were willing to forgo financial benefits to work for firms with better reputations for corporate social responsibility.[65] Employees derive satisfaction from being associated with, and expect better treatment from, responsible firms.[66] Employee-friendly policies also appeal to shareholders and customers.[67]

Labor market discipline may be imperfect. Firms can easily hire and replace unskilled workers, workers face competition from foreign labor markets, and skilled workers may be locked into specific employers. But these problems may overstate workers' vulnerability. First, many firms must rely on knowledge workers whose skills are highly marketable, and who therefore can insist on good working conditions and assurances that the firm will behave responsibly.[68] Second, firms must not only hire and contract with workers, but also motivate them to work hard and provide friendly service. Third, workers are also

64 *See* Daniel W. Greening & Daniel B. Turban, *Corporate Social Performance as a Competitive Advantage in Attracting a Quality Workforce*, 39 BUS. & SOC'Y 254 (2000).

65 *See* David B. Montgomery & Catherine A. Ramus, *Corporate Social Responsibility Reputation Effects on MBA Job Choice* (Stan. Graduate Sch. of Bus., Working Paper No. 1805, 2004), *available at* http://ssrn.com/abstract=412124.

66 *See* Aguilera et al., *supra* note 35 (manuscript at 8–17).

67 *See* Steven Greenhouse, *How Costco Became the Anti-Wal-Mart*, N.Y. TIMES, July 17, 2005, § 3, at 1.

68 For example, Hyperion promised to subsidize employees' purchases of fuel efficient automobiles, citing among other reasons the sophistication of its workforce. *See* Erin White & Jeffrey Ball, *Green Perk Offered for Green Car*, WALL ST. J., Nov. 29, 2004, at B4.

consumers, and therefore may prefer to buy from worker-friendly firms. Fourth, workers may be shareholders through their pension and profit-sharing plans, which may exert pressure on behalf of current workers. Indeed, these workers may use their leverage to get more attention than the larger group of retirees concerned mainly with share value.[69]

D. Consumers

Some consumers demand not only better designed and manufactured products and lower prices, but also that the product be made in a socially-responsible way. This means products that are safer and better for the environment and manufacturing processes that are safe, clean, and worker-friendly.[70] Consumer markets therefore can cause at least some convergence of social and financial performance.

Social responsibility theorists argue that consumers lack information concerning these matters and leverage to insist on improvements.[71] However, as with the other stakeholders discussed above, markets are now more sophisticated than they were when concerns for social responsibility first arose. Much information is available on the Internet and accessible through sophisticated search engines. Branding has also become a critical aspect of selling social responsibility to consumers.[72] For example, Nike seeks through its brand to sell not only the quality of its shoes, but also a socially-responsible method of producing them.[73] Firms post "reputational bonds" in the form of

69 This is distinguishable from workers' direct participation as such in corporate governance. There is evidence that, when this happens, it causes firms to diverge from shareholder wealth maximization. *See* Olubunmi Faleye et al., *When Labor Has a Voice in Corporate Governance*, 41 J. FIN. & QUANTITATIVE ANALYSIS (forthcoming 2006), *available at* http://ssrn.com/abstract=697179.

70 *See* Douglas A. Kysar, *Preferences for Processes: The Process/Product Distinction and the Regulation of Consumer Choice*, 118 HARV. L. REV. 525 (2004) (discussing how consumers may derive utility from "voting" on particular practices); *see also* Ray Fisman et al., *Corporate Social Responsibility: Doing Well by Doing Good?* (Preliminary Draft Paper, 2005), *available at* http://ssrn.com/abstract=813286 (presenting data showing that corporate social responsibility is more prevalent in consumer-oriented industries).

71 *See* STONE, *supra* note 1, at 88–92.

72 *See* Rob Harrison, *Corporate Social Responsibility and the Consumer Movement*, 13 CONSUMER POL'Y REV. 127, 128 (2003); McWilliams & Siegel, *supra* note 39, at 119–22.

73 The "commercial" nature of Nike's speech was at issue in the *Nike* case, discussed *supra* note 54 and accompanying text. The use of social responsibility as a branding device arguably supports characterizing the speech as commercial and therefore as entitled to a lower level of constitutional protection. See Johnston, *supra* note 43, 111–15.

advertising and other expenses in maintaining the brand.[74] A firm that shirks on the quality promise inherent in the brand stands to forfeit some or all of its investment in the brand.[75]

The social responsibility component of branding is increasing. While the Internet gives consumers much of the general quality information they used to get from brands, it is harder to get information as to products' social impact and the processes by which they are made. Social responsibility has become a kind of "credence" good for which reputational bonding through brand names is particularly important.[76] Consumers buying branded goods can be more confident in the firm's attention to social characteristics, and that firms will react quickly to protect the brand if social responsibility issues arise. Firms even have an incentive to create a consumer demand for social responsibility so that they can distinguish their goods in the market and earn competitive rents.

Branding works together with other market mechanisms to encourage sale of socially-responsible products. First, social responsibility entrepreneurs, including the nongovernmental organizations discussed in the next section, can provide information, urge voluntary disclosures, and seek enforcement of legal rules. Such organizations have promoted consumer awareness of, for example, dolphin-friendly tuna and working conditions in foreign factories. Second, social activists can organize boycotts, thereby exerting market pressure on firms to be socially responsible and helping overcome consumers' inability to take coordinated action against suppliers.[77] Third, some institutional investors, particularly including pension funds, may take a long-term perspective regarding their portfolio firms and force managers to consider potential damage to the firm's brands from socially-irresponsible conduct.[78]

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74 *See* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).

75 Trademark law protects the firm's property right in this brand information. *See* Sidney A. Diamond, *The Historical Development of Trademarks*, 65 TRADEMARK REP. 265, 288–90 (1975).

76 *See* Johnston, *supra* note 43, at 70–72. For a general discussion of credence goods, see Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67 (1973).

77 *See* Baron, *supra* note 40, at 7; Timothy J. Feddersen & Thomas W. Gilligan, *Saints and Markets: Activists and the Supply of Credence Goods*, 10 J. ECON. & MGMT. STRATEGY 149, 153–54 (2001).

78 *See* Gordon L. Clark & Tessa Hebb, *Why Should They Care? The Role of Institutional Investors in the Market for Corporate Global Responsibility*, 37 ENV'T & PLAN. A 2015 (2005).

The extent to which profit-maximizing firms serve consumers' interests may depend on the amount of competition in the firm's product market. A firm that has some monopoly power may be able to skimp on quality, charge high prices, or otherwise frustrate consumers' preferences, while maximizing profit, at least in the short-run.[79] Financial and social performance therefore may diverge in this situation. But the existence of significant competition at some point in every supply chain mitigates the effect of limited competition at other points. For example, even if there are few manufacturers of a given product or type of product, the product probably has comparables or substitutes that wholesalers and retailers can sell. Thus, opponents of genetically modified foods were able to gain leverage by exerting pressure on retailers instead of on manufacturers.[80]

Sellers' power in product markets may actually encourage investments in social responsibility. First, managers of dominant firms may have more freedom than those in firms operating in perfectly competitive markets to manage altruistically without the sort of decline in profitability that would threaten their jobs. Second, firms with market power may have more incentive to make investments in long-term profitability than firms that operate in more competitive markets.[81] Third, regardless of market power, managers might want to invest in goodwill generated by social responsibility in order to build a brand name that would help protect their firms from competition by new entrants.

The market alone will not necessarily produce a socially optimal amount of firm information. Firms may lack an incentive to disclose negative information voluntarily.[82] They may face little consumer pressure for information because consumers want to preserve their "moral wiggle room" by not being confronted with the social conse-

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79 *See* David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1, 69 & n.266 (1979). Conversely, firms facing more competition have more incentive to differentiate themselves from their competitors, including through socially-responsible behavior. *See* Fisman et al., *supra* note 70 (showing evidence that corporate social responsibility has a greater effect on profitability in competitive industries).

80 *See* Rachel Schurman, *Fighting "Frankenfoods": Industry Opportunity Structures and the Efficacy of the Anti-Biotech Movement in Western Europe*, 51 SOC. PROBS. 243, 253–56 (2004).

81 *See* Mark E. Bagnoli & Susan G. Watts, *Selling to Socially Responsible Consumers: Competition and the Private Provision of Public Goods*, 12 J. ECON. & MGMT. STRATEGY 419, 434 (2003); Orace Johnson, *Corporate Philanthropy: An Analysis of Corporate Contributions*, 39 J. BUS. 489, 494–95 (1966).

82 *See* Michael J. Fishman & Kathleen M. Hagerty, *Mandatory Versus Voluntary Disclosure in Markets with Informed and Uninformed Customers*, 19 J.L. ECON. & ORG. 45, 48, 52–55 (2003).

quences of their purchases.[83] So firms may engage in "cheap talk" that does no more than highlight problems in an industry rather than disclose differences among firms.[84] These factors argue for a government role in ensuring the provision of process-type information to consumers.[85] Indeed, firms' misrepresentations and incomplete statements already may trigger liability under the federal securities laws[86] and consumer laws.[87] If consumers care about how goods are manufactured they, or social responsibility entrepreneurs, will exert political pressure for more such laws.

Apart from disclosure problems, there are limits to the effectiveness of social consuming in ensuring corporate social responsibility. While effective boycotts may coalesce over specific social problems, consumer action has been shown to be much less effective in promoting ongoing social responsibility.[88] Most consumers arguably are indifferent to the social responsibility attributes of the products they buy because they are morally insulated from the problems these products create, or at least assume that others are so that their individual purchase decisions would not affect producers' actions.[89] In any event, social consuming is likely to be ineffective because uncoordinated consumers will be unable to focus mass purchasing power on particular product attributes.

The amount of social consuming that has been observed nevertheless indicates that there is a significant demand for socially-responsible products.[90] Moreover, producers seeking market advantage can make the social responsibility aspects of their products salient, thereby breaking through consumers' moral shielding, as well as assisting consumers to coordinate action around particular product characteristics.

83 *See* Jason Dana et al., Exploiting Moral Wriggle Room: Behavior Inconsistent with a Preference for Fair Outcomes (June 24, 2003) (unpublished manuscript, on file with the Harvard Law School Library), *available at* http://emlab.berkeley.edu/users/webfac/dellavigna/e218_f03/Fair.pdf.

84 *See* Johnston, *supra* note 43, at 78–79. For an example, see Holman W. Jenkins, *How It Became Safe to Embrace Global Warming*, WALL ST. J., July 6, 2005, at A15.

85 *See* Kysar, *supra* note 70, 579–80; *see also* Johnston, *supra* note 43, at 103–10 (arguing for mandatory disclosure of socially-relevant information to consumers and investors).

86 *See* United Paperworkers Int'l Union v. Int'l Paper Co., 985 F.2d 1190 (2d Cir. 1993).

87 For discussions of social disclosure laws and their constitutional implications, see Kysar, *supra* note 70, at 574–79; Johnston, *supra* note 43, at 107.

88 *See* Johnston, *supra* note 43, at 69, 84–88.

89 *See* Elhauge, *supra* note 1, at 750–51.

90 *See* Kysar, *supra* note 70, at 601–24 (collecting evidence of consuming based on processes by which products are produced); Johnston, *supra* note 43, at 82–84 (same).

As long as many consumers are interested in products' social characteristics, producers have economic incentives to market to them and adopt a policy of making credible disclosures. While some sellers may cut corners and engage in cheap talk, their competitors have incentives to do better, be more transparent, and promote these differences. Social responsibility is similar to any other consumer taste that firms create or identify through advertising rather than simply serving consumers' demand. Firms have a particular incentive to create niche markets for social responsibility attributes as to which they have a cost or recognition advantage over their rivals.[91] If firms fail to exploit these opportunities, they may produce less long-term value for shareholders and therefore lower share prices. Reduced manager accountability to shareholders therefore would not necessarily help society.

E. Suppliers

The large vertically integrated firms that Alfred Chandler studied[92] were suited for thinner and less adaptable markets. Developing markets and technologies reduce the need for vertical integration.[93] For example, Dell can assemble computers just in time from parts provided by its network of independent suppliers.[94] Modern firms may rely on contracts with their suppliers instead of owning assets or hiring employees. These trends are unwinding the classic firm.

Thinner business structures potentially raise the concern that firms will avoid the market pressures discussed above in this Part by contracting out risky or questionable activities to thinly capitalized, obscure, or off-shore entities. Workers might be employed by and consumers would buy from the "irresponsible" entities and have recourse against only these entities.

The international networked firm would, however, remain subject to market forces in many respects. The above discussion focused on reputational constraints that transcend the legal boundaries of firms and attach to brands. The Internet can gather information

91 *See infra* text accompanying note 124.

92 *See* ALFRED D. CHANDLER, The Visible Hand: The Managerial Revolution in American Business (1977).

93 *See* JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA 131, 142–46, 183–84 (2003); Naomi R. Lamoreaux et al., *Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History*, 108 AM. HIST. REV. 404 (2003); Richard N. Langlois, *Chandler in a Larger Frame: Markets, Transaction Costs, and Organizational Form in History*, 5 ENTERPRISE & SOC'Y 355 (2004), *available at* http://es.oxfordjournals.org/cgi/reprint/5/3/355.

94 *See* Gary Rivlin, *Who's Afraid of China?, How Dell Became the World's Most Efficient Computer Maker*, N.Y. Times, Dec. 19, 2004, § 3, at 1.

about suppliers and apply market pressure at the appropriate places.[95] Indeed, firms that contract out their supply and distribution functions depend more on the value of their brand names now that they can no longer reap significant competitive advantage from owning an extensive set of integrated assets. The value of these brands, in turn, is vulnerable to disreputable conduct by suppliers or distributors that social activists can tie to the brand, such as the "sweatshop" allegations involving Kathie Lee Gifford products and Wal-Mart.[96] As discussed above,[97] firms post a bond through investing in brands that they forfeit by socially-irresponsible conduct.

A firm that contracts out its supply functions accordingly remains just as subject to reputational penalties in the product market for social irresponsibility as a firm that internalizes these operations.[98] Outsourcing firms therefore have significant incentives to contract with their suppliers to ensure against embarrassing social irresponsibility.[99] Brand owners can negotiate provisions in supply contracts specifying standards and providing for damages and termination for noncompliance.[100] Deeper markets enable firms to shop for socially-responsible suppliers and terminate unsatisfactory ones.

The benefits of avoiding substantial liabilities through outsourcing sometimes may outweigh the reputational costs. But even in these situations firms may incur significant internal costs in moving some transactions outside the firm.[101] For the remaining transactions, the liability avoided may be less than the reputational cost to the outsourcing firm from shirking the cost, the risk of liability under a successor or other theory, or the risk of additional regulation.[102]

F. Local Communities

Firms have economic incentives to be on good terms with the communities in which they have main offices and factories. Undesirable firms can face annoying local taxes and regulations and irrespon-

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95 Note that Nike has aided this process by voluntarily disclosing its suppliers. *See* Johnston, *supra* note 43, at 121.

96 Glenn Burkins, *Government Links Retailers to Sweatshops*, WALL ST. J., Dec. 15, 1997, at B5A.

97 *See supra* text accompanying note 74.

98 *See* Vandenbergh, *supra* note 60, at 2060–61; Johnston, *supra* note 43, at 34.

99 *See* Robert E. Spekman et al., *Corporate Social Responsibility and Global Supply Chain Management: A Normative Perspective* 9 (Darden Bus. Sch., Working Paper No. 04-05, 2005), *available at* http://ssrn.com/abstract=655223.

100 *See* Vandenbergh, *supra* note 60, at 2058–59.

101 *See* Johnston, *supra* note 43, at 34–35.

102 *Id.*

sible firms may find it difficult to recruit and retain loyal workers. Communities may be willing to reduce taxes to attract "cleaner" firms.[103] Localities that can offer significant amenities may have the leverage in the location market to bind firms to agreements regarding their activities in the community, and firms may compete for good locations. Firms accordingly have entered into "good neighbor" agreements with local communities to ensure friendly relations with local government and employees.[104] While depressed communities may have little market power and may seek to offer firms lax zoning and environmental controls, even firms in these areas need to consider their long-term standing with local government and workers. Economic conditions and government officials may change, and a firm that seeks to exploit its home community will have no reserve of goodwill, or "social license," with workers and local officials that can help it through difficult situations.[105]

G. *Nongovernmental Organizations*

The arguments so far in this Part rely mostly on individuals' ability to protect their interests or enforce their views of appropriate corporate behavior. But individuals may lack adequate information, leverage, and ability to coordinate. Government regulation may be inadequate to remedy market failures because the same information and coordination problems that infect markets also constrain political action.[106] Governments are also subject to territorial limitations, while firms are mobile and operate in international markets.

An alternative to market and government regulation is action by nongovernmental organizations (NGOs). These include organizations that focus on corporate social responsibility, such as the World Business Council for Sustainable Development, those with a more general scope, such as Oxfam and Christian Aid,[107] or social investment mutual funds. Even very small organizations can wield significant influence in anti-corporate campaigns through the Internet and

103 Relationships between firms and their home communities might be threatened by a recent ruling, pending before the Supreme Court as this Article goes to print, holding that a state investment tax credit to encourage local investment violated the Commerce Clause. *See* Cuno v. DaimlerChrysler, Inc., 386 F.3d 738 (6th Cir. 2004), *cert. granted sub nom.* DaimlerChrysler Corp. v. Cuno, 126 S. Ct. 36 (2005), *and* Wilkins v. Cuno, 126 S. Ct. 36 (2005).

104 *See* Vandenbergh, *supra* note 60, at 2064–66.

105 *See* Neil Gunningham et al., *Social License and Environmental Protection: Why Businesses Go Beyond Compliance*, 29 LAW & SOC. INQUIRY 307 (2004).

106 *See supra* text accompanying note 14.

107 *See* Aguilera et al., *supra* note 35 (manuscript at 32–37).

other organizations.[108] Acting through NGOs, social responsibility entrepreneurs can gather and disclose information about social harms, develop standards for socially-responsible conduct, provide certification services, organize boycotts, and lobby for political action. These organizations transcend national boundaries to the same extent as the firms they seek to influence.

To be sure, NGOs are not a perfect solution to the information and organization problems of individual investors and consumers. NGOs may have agendas that do not mesh with the goals of their clients, may have conflicts of interest because of economic ties with or reliance on the firms they monitor, or simply fail to follow through on promised monitoring. Accordingly, it has been argued that NGOs should be subject to mandatory disclosure or other regulation.[109] On the other hand, at least the largest NGOs can be expected to build sufficient reputational capital to be reliable even in the absence of government regulation.

H. Conclusion: Markets and Social Responsibility

This Part has shown that there are numerous market mechanisms that reduce the apparent divergence between managing for shareholders and managing for society. A firm's long-run profits may depend significantly on satisfying the social demands of consumers, employees and local communities. Firms must also comply with legal regulation that both internalizes the costs of socially-harmful conduct and indicates the behavior that the market is likely to punish or the government to regulate. Even if profits diverge from social wealth, some shareholders may want managers to choose the latter.

If firms operate in various markets that reflect social concerns, increasing managers' accountability to shareholders might increase rather than decrease firms' social responsibility. The reason why managers may not commit to socially-desirable practices such as credible disclosures to consumers or investors is that such practices might reduce short-term share prices, and therefore managerial compensation such as stock options that are linked to these prices. Compensation that does not adequately align managerial and shareholder wealth indicates lack of managerial accountability to shareholders. Further re-

108 An interesting example is the anti-Coke campaign in India spearheaded by a one-man NGO, which has significantly hampered Coke's activities in India. *See* Steve Stecklow, *Virtual Battle: How a Global Web of Activists Gives Coke Problems in India*, WALL ST. J., June 7, 2005, at A1.

109 *See* Johnston, *supra* note 43, at 103–10.

stricting managerial accountability therefore may only exacerbate those problems.

This Part has noted the imperfections in markets for social responsibility. Managers who are accountable to shareholders therefore may not engage in socially-optimal management. The important question for this Article concerns the implications of these imperfections for the law of corporate governance. The defects in the social responsibility market may not be sufficient to justify the significant risk of opportunism to shareholders entailed in making managers accountable to stakeholders.[110] The next Part considers additional costs of significantly restricting managers' accountability to shareholders.

III. COSTS OF RESTRICTING ACCOUNTABILITY

In order to determine whether restricting managers' accountability to shareholders would produce more social wealth than permitting strict managerial accountability, it is necessary to consider not only whether markets align corporate and social interests, but also the potential costs of reduced accountability. This Part shows that these costs may be substantial. As discussed in Part III.A, managers left to their own devices may not have appropriate incentives to maximize social welfare, as distinguished from helping themselves directly or indirectly. Part III.B shows that even the best motivated managers may not have enough information to better serve society's interests than those who account strictly to shareholders. Part III.C suggests that managers who are less accountable to shareholders may exercise poor judgment about what society needs even if they are well motivated and well informed.

A. *Incentives*

Social responsibility theorists argue that managers freed of constraints to serve the faceless and morally disengaged shareholders of publicly held corporations could exercise their liberated judgment for the benefit of society, subject to the norms, morals, and other extralegal constraints that bind people generally.[111] However, managers released from a duty to account to shareholders would be freer to serve *both* their own interests and those of society.[112] It is not clear

110 *See supra* text accompanying note 26.

111 *See* MITCHELL, *supra* note 1, at 3; Elhauge, *supra* note 1, at 739–40.

112 *See* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991); Meese, *supra* note 26; Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002).

that managers freed from the shareholders would serve society rather than themselves.

Managers may act selfishly while purporting to serve society. For example, managers may contribute corporate funds to pet charities or their alma maters in order to get personal credit or visibility.[113] Less directly, managers may make business decisions in operating the company that gratify their personal preferences as to the firm's goals or increase their personal power or prestige under the guise of social responsibility. For example, in *Paramount Communications, Inc. v. Time Inc.*,[114] managers pursued a combination with Warner in the face of a significantly higher bid from Paramount ostensibly because the former transaction supposedly would allow them to retain the "Time Culture." However, it was unclear whether the social value of the "Time Culture" exceeded the significant extra shareholder value from a Paramount takeover indicated by that transaction's much higher market price.

Managers who say they are helping society actually may be personally benefiting. For example, in *Dodge v. Ford Motor Co.*,[115] Henry Ford, the controlling shareholder, refused to continue special dividends from a massive pile of accumulated cash, purportedly to enable consumers, who already wanted more cars than the firm could produce, to buy at a lower price. But hoarding cash may have served Henry Ford's interests in minimizing the price at which he would have to buy out the minority shareholders, the Dodge brothers, or keeping these shareholders from using their investment in the firm to fund their competing firm.[116]

There is little specific evidence about managers' trade-offs between social and selfish concerns. Elhauge cites only one set of data on this point—Alexander and Cohen's finding that criminally convicted corporations have relatively low levels of managerial ownership.[117] Elhauge says this indicates that managers with higher levels of

113 *See* 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 (1999); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997); Eric Helland & Janet Kiholm Smith, *Corporate Philanthropy*, 12 J. CORP. FIN. (forthcoming 2006), *available at* http://ssrn.com/abstract=472161.

114 571 A.2d 1140 (Del. 1989).

115 170 N.W. 668 (Mich. 1919).

116 *See* Edward B. Rock, *Corporate Law Through an Antitrust Lens*, 92 COLUM. L. REV. 497, 519–23 (1992).

117 *See* Elhauge, *supra* note 1, at 760–61 (citing Cindy R. Alexander & Mark A. Cohen, *Why Do Corporations Become Criminals? Ownership, Hidden Actions, and Crime as an Agency Cost*, 5 J. CORP. FIN. 1, 18 (1999)).

ownership take greater personal responsibility for the actions of their companies than those with lower levels.[118] But the authors' own interpretation—that firms with higher levels of managerial ownership have lower agency costs regarding "hidden" conduct such as crime[119]—is at least as plausible. In particular, it is not clear why there should be a direct relationship between social sanctions and managerial ownership, which may not be well known publicly, particularly given other ways of identifying managers with their firms.

One can infer what managers would do with any additional power from evidence of what they do with the power they already have. For example, Bebchuk and Fried powerfully argue that managers use their power to construct compensation arrangements that reward them disproportionately to their contributions to firm value.[120]

B. *Information*

Even if managers clearly would be better motivated if they were freer from shareholder control, it is still not clear that managers know what action to take—that is, how to best use corporate resources to maximize social wealth. Accountability to shareholders accordingly may be the managers' best guide to socially-beneficial behavior.[121] Thus, Milton Friedman has asked whether

> self-selected private individuals decide what the social interest is? Can they decide how great a burden they are justified in placing on

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118 *Id.* at 761.

119 *See* Cindy R. Alexander & Mark A. Cohen, *Why Do Corporations Become Criminals? Ownership, Hidden Actions, and Crime as an Agency Cost*, 5 J. CORP. FIN. 1, 31 (1999).

120 LUCIAN A. BEBCHUK & JESSE A. FRIED, PAY WITHOUT PERFORMANCE (2004); Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002). Bebchuk and Fried's critics argue that the problem is not as serious as Bebchuk and Fried suggest or reject Bebchuk and Fried's proposed solutions. *See* Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005) (reviewing BEBCHUCK & FRIED, *supra*); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1143–44 (2005) (arguing that Bebchuck and Fried identified isolated, and not systematic, problems); Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Disclosure and Analysis,"* 31 J. CORP. L. 695 (forthcoming 2006), *available at* http://ssrn.com/abstract=686464. These critics do not, however, refute Bebchuk and Fried's point that managers are using their power to reward themselves.

121 *See generally* Engel, *supra* note 79, at 70 (stating that "management cannot be expected to discern, on a regular basis and with any degree of certainty, that particular acts of substantive altruism are called for by consensus social goals" (footnote omitted)).

> themselves or their stockholders to serve that social interest? Is it tolerable that these public functions of taxation, expenditure, and control be exercised by the people who happen at the moment to be in charge of particular enterprises, chosen for those posts by strictly private groups?[122]

A few questions illustrate the complexity inherent in a social wealth maximization standard. For example, would the U.S. economy be better off if firms did not outsource jobs to other countries? This depends on such tradeoffs as the benefits of creating wealthier consumers abroad for U.S. products and how this country would use greater corporate wealth. Should firms sell genetically modified (GM) foods? What weight should managers give to scientific evidence supporting the value and safety of GM foods?[123] Should a socially-responsible manager consider, among other things, whether GM foods reduce world hunger or whether, given the current state of the scientific evidence, such a benefit is outweighed by the long-term costs, including potential genetic contamination? What types of genetic manipulation should managers be concerned about in their sales or manufacturing decisions? By contrast, a profit-maximizing manager need only make the simpler (though still difficult) calculation of whether the firm would gain or lose from selling GM foods. Given the analysis in Part II, this would include the social costs of GM food that the firm internalizes because of markets for social responsibility.[124]

Distributional issues further complicate the problem. At a given level of social wealth, should the managers help the poor, or help consumers at labor's expense, or vice versa? This could involve perplexing questions of distributive justice.[125] For example, with respect to outsourcing, should the U.S. rather than the world economy be the appropriate measure of social welfare?

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122 *See* MILTON FRIEDMAN WITH ROSE D. FRIEDMAN, CAPITALISM AND FREEDOM 133–34 (2002).

123 *See* HENRY I. MILLER & GREGORY M. CONKO, THE FRANKENFOOD MYTH: HOW PROTEST AND POLITICS THREATEN THE BIOTECH REVOLUTION 117 (2004).

124 *See generally* Schurman, *supra* note 80, at 245 (arguing that particular industrial vulnerabilities played a key role in recent successes by the antibiotech movement against agricultural corporations selling GM foods in Europe). Note that firms might have self-interested reasons for refusing to sell GM products. *See* Thomas P. Lyon, *'Green' Firms Bearing Gifts*, 26 REGULATION, Fall 2003, at 36, 37–38, *available at* http://ssrn.com/abstract=511366 (noting that DuPont supported regulation of chloro-fluorocarbons after developing alternatives, and that Alcoa supported emission control after having developed emission reduction materials).

125 *See* Robert Phillips et al., *What Stakeholder Theory Is Not*, 13 BUS. ETHICS Q. 479 (2003).

These examples indicate that, as difficult as are ordinary business decisions, at least shareholder wealth maximization provides a familiar metric by which the success or failure of these decisions can be tested. Once managers eschew this metric, they may need to acquire much new information and expertise. Given inherent constraints on managerial resources, this is likely to divert managers' efforts from the kinds of business decisions they are better able to make. While commentators might denigrate decisions that "merely" produce profits, the fact that the company is selling products for more than they cost the company to produce is an important signal that it is creating social wealth.[126]

C. *Judgment*

Even the best motivated and best informed managers may be subject to judgment biases such as the "availability heuristic" or cascade or reputation effects that would cause them to reach faulty judgments.[127] For example, a U.S. company might pay workers in its foreign factories more than the going wage but hire fewer workers than it otherwise would because the wages in the foreign factories of U.S. companies gets more media attention than does the even worse plight of the unemployed in these countries.

Paying higher than the going wage to factory workers outside the United States also might become a social norm, deviation from which can subject corporate managers to shame or guilt.[128] The underlying social consensus is not necessarily efficient.[129] For example, consensus could arise from an inefficient law or from the availability, cascade, or reputation effects discussed immediately above. Thus, the fact that corporate managers are more subject to influence by social norms than are morally disengaged shareholders does not necessarily lead them to make socially-wealth-maximizing decisions.[130]

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126 *See* Jensen, *supra* note 37.

127 For discussions of these problems generally, see Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683 (1999); Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059 (2000)

128 *See generally* Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997) (discussing an esteem theory of norms).

129 *Id.* at 409–12. *See* Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697 (1996) (discussing problems that arise from faulty individual and social cognition).

130 For the contrary argument, see *supra* text accompanying note 41.

D. Summary

Whether a legal rule that has the effect of mandating reduced manager accountability to shareholders would increase social wealth depends not only on the extent to which markets and regulation cause costs and benefits to nonshareholder stakeholders to be reflected in corporate profits, but also on managers' incentives, information, and judgment where they are not accountable to shareholders. Even assuming imperfect regulation and markets, the costs discussed in this Part raise a question whether managers who are not accountable to shareholders would maximize social wealth.

It follows from this analysis that managers' basic accountability to shareholders under current law should not be drastically revised. In other words, the law should not promote a move into Territory B in Figure 1. The remaining question is whether social responsibility concerns justify law promoting a move into Territory A. This depends on the feasibility of making managers more accountable to shareholders, an issue discussed in the next Part.

IV. Can Managers Be Made More Accountable?

This Part focuses on the role of corporate social responsibility in determining whether managers may be made more strictly accountable to shareholders than they are under the current regime. Other commentators have recognized but not highlighted the possibly limited relevance of corporate social responsibility to a change in corporate governance. For example, Blair and Stout, who argue that managers should act as "mediating hierarchs," recognize that the current corporate structure enables them to do so.[131] For instance, the law protects managers from fiduciary liability under the business judgment rule even if they depart somewhat from short-term profit maximization.[132] Elhauge similarly defends managerial leeway to be socially responsible under the current system partly by observing that there is no "realistic legal option" to give managers less discretion than they have under current law.[133] Social responsibility does not, however, play a distinct role in corporate governance unless there is an alternative to the status quo that would be feasible but for the need to enable managers to serve society. If the law must protect managers discretion in order to maximize corporate wealth, corporate social re-

131 *See* Blair & Stout, *supra* note 4, at 276–87.
132 *See id.* at 303–05.
133 *See* Elhauge, *supra* note 1, at 813–14.

sponsibility cannot be viewed as an independent constraint on accountability.

Part IV.A discusses the accountability devices currently available in the corporate form, as well as legal restrictions on these options. Part IV.B expands the analysis to consider additional accountability devices that have long been available in partnerships. Part IV.C considers potential impediments to adopting such devices, particularly including the double corporate tax, and whether these impediments alone bar consideration of these devices.

A. *Managerial Discretion and the Corporate Form*

Four aspects of managers' power are particularly important for present purposes. First, directors and executives have significant power to approve transfers and distributions of assets in the ordinary course of business without shareholder approval, including distributions, asset purchases and sales, deployment of corporate property, contributions to charity, and managerial compensation.[134] Second, directors can decide whether to recommend extraordinary transactions to the shareholders, including sale of substantially all the corporate assets, mergers, dissolution, and charter amendments. Third, the board not only can screen corporate-level transactions, but also can impede the shareholders from transferring control by enacting strong defenses to hostile takeovers. Fourth, managers have significant power to control director elections because of their effective control over the proxy machinery.

The important question is how managers of public firms can be made accountable to the shareholders or anyone else in exercising their substantial powers within the constraints of the corporate form. As discussed in the following subsections, accountability essentially turns on the shareholders' ability to vote, sue, or sell. This analysis notes problems with each of these mechanisms.

1. Voting

While shareholders can approve major corporate transactions, individual shareholders owning bits of firms in diversified portfolios have little incentive to inform themselves or determine the appropriate course of action because they would expend their own time and money while other shareholders take a "free ride" on their actions. Even if shareholders could propose transactions, they could not practicably act as a group to choose which transactions to pursue and to

134 *See supra* text accompanying note 120.

structure and negotiate these deals. Because these constraints inhere in actions by large groups of shareholders, they cannot be solved simply by giving more default legal power to the owners as some have proposed.[135]

One possible response is to rely on monitoring by institutional shareholders. But even institutional shareholders face obstacles in managing details of each firm in their portfolios. Moreover, activist shareholders have personal incentives that may conflict with those of passive shareholders.[136] In any event, institutional investor activism has had little effects on firm performance.[137]

Firms might tweak shareholder voting rights to make managers more accountable to shareholder interests. For example, corporations could provide in their bylaws for director election based on a majority of all votes cast, including withheld votes.[138] This would let shareholders register dissatisfaction with current management in nominating directors, yet without giving them possibly disruptive power to nominate specific directors as the SEC proposed.[139] These devices would, however, still leave managers with substantial freedom of action since individual shareholders are unlikely to be able to coordinate a revolt even in the face of significant management problems.

135 *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing that shareholders should be allowed "to initiate and vote to adopt changes in the company's basic corporate governance arrangements"); Lucian Arye Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=891823 (making arguments for increased shareholder power). For responses to Bebchuk, see Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=808584 (arguing that if shareholder empowerment were value enhancing, shareholders would insist on such rights, and that in publicly held firms even institutional investors have strong incentives to remain passive); Leo E. Strine, Jr., *Towards a True Corporate Republic: A Traditionalist Response to Lucian's Solution for Improving Corporate America*, 119 HARV. L. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=883720 (arguing that Bebchuk's proposal may undermine managers in favor of unaccountable institutional intermediaries and suggesting reforms to address Bebchuk's concerns that are more consistent with current American system of corporate governance).

136 *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Bainbridge, *supra* note 56, at 634 n.88.

137 *See* Bainbridge, *supra* note 56, at 629–30.

138 *See* Michael Schroeder, *CEOs Fight Making It Easier for Holders To Stop Board Picks*, WALL ST. J., May 27, 2005, at C4 (discussing moves in this direction by some firms).

139 *See* Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003). The rule faced strong opposition and has not been adopted.

Another possible approach to the free rider problem in shareholder voting is to concentrate equity ownership through a highly leveraged capital structure. A capital structure consisting of a high ratio of debt to equity combines concentrated equity with an additional duty to make principal and interest payments that constrains managers from self-interested retention of earnings.[140] Also, bond indentures typically include negative covenants forbidding specific activities and providing for enforcement by an indenture trustee.[141] However, debt-heavy firms face high agency costs because the owners have incentives to commit the firm to speculations for which they will capture the payoffs while the creditors bear the risk of nonpayment.[142] This risk is reflected in the interest firms pay on their debt and in protective covenants that creditors negotiate. Firms that fail to pay their substantial debt face the risk of potentially costly bankruptcy proceedings.

2. Suing and Fiduciary Duties

Shareholders can hold managers accountable by suing them for breach of fiduciary duty. This raises questions from a social responsibility standpoint about whether managers should have a fiduciary duty to nonshareholder groups, and whether their fiduciary duty to shareholders should leave them discretion to manage on behalf of these groups.

The problem with addressing the corporate social responsibility issue through the courts is that judges have a limited ability to monitor and control managers' business decisions. Courts are not business experts, and therefore are prone to err if they interfere in corporate decisionmaking. When judges review a business decision that has

140 *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. (PAPERS & PROC.) 323 (1986).

141 Even outside the specific context of leveraged buyout, creditors can exercise significant control, or influence governance because of the general threat of control, through covenants in loan agreements. *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance* 4 (Vanderbilt Law & Econs., Research Paper No. 05-08, Univ. of Chi. Law & Econs., Olin Working Paper No. 247, 2005), *available at* http://ssrn.com/abstract=692023. This type of control is more important in disciplining serious waste and mismanagement of assets than in controlling ineffective use of assets through accumulation of excess cash. Indeed, these creditor protections may even impede strong controls on excess cash like those discussed *infra* Part IV.B.

142 This is in fact the basic situation that Jensen and Meckling described in their classic article about agency costs. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

turned out badly, it is very difficult for them to determine whether the bad result was due to an error or bad luck. Also, imposing liability on directors for bad decisions deters them from making risky but value-increasing moves that diversified shareholders would want them to make. Unlike shareholders, managers bear the brunt of bad outcomes while capturing little of the gain from good outcomes. These are the basic reasons for the business judgment rule.[143] While courts can second-guess business judgments that are in the managers' own interests or that completely disregard corporate interests, it is harder for them to distinguish disinterested business judgments that are, and are not, in the corporation's or shareholders' best interests.

These inherent difficulties are reflected in applying the rule on social responsibility management in the American Law Institute's *Principles of Corporate Governance*:

> Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . .
>
> . . . .
>
> (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
>
> (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.[144]

This provision arguably went beyond prior law in clearly permitting managerial decisions that do not enhance corporate or shareholders' interests.[145] But its phraseology probably makes little difference in practice because a manager's decision to devote "reasonable" resources to a noncorporate purpose usually would be protected by the business judgment rule even apart from this ALI provision. The *ALI Principles*' business judgment rule insulates from judicial scrutiny an informed and disinterested director decision that the director "rationally believes . . . is in the best interests of the corporation."[146] Though directors theoretically might make a decision that involves a "reasonable amount of resources" even if they do not rationally be-

143 *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 93, 98–99 (1991); *see also* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004); E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1421–28 (2005). For a further discussion of limits on judicial supervision, see *infra* text accompanying notes 163–65.

144 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 2.01(b), at 55 (1994) [hereinafter ALI PRINCIPLES].

145 *See* Ribstein, *supra* note 9, at 1001–02.

146 ALI PRINCIPLES, *supra* note 144, § 4.01(c)(3).

lieve that a decision would help the corporation, it is unlikely that a court could make such a fine distinction in a real case. Moreover, even under the standard business judgment rule unmodified by the *ALI Principles'* social responsibility provision, directors who seek to depart from shareholder wealth maximization need only find some "rational" way that the decision helps the corporation. This would constrain only the most unimaginative board that is unable to show how a "reasonable" use of resources could plausibly enhance the firm's goodwill.

The famous case of *Shlensky v. Wrigley*[147] illustrates how the social responsibility issue merges with the business judgment rule. The court dismissed a complaint for mismanagement brought by minority shareholders of a baseball firm based on the management's failure to install lights after every other major league team had done so, despite strong allegations indicating that the team was injured by the failure. The majority shareholder allegedly had defended the decision on the grounds "that baseball is a 'daytime sport' and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood."[148] The court reasoned:

> [W]e are not satisfied that the motives assigned to Philip K. Wrigley, and through him to the other directors, are contrary to the best interests of the corporation and the stockholders. For example, it appears to us that the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating. By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.[149]

In other words, the court dismissed the complaint because the question of whether the managers should have installed lights was beyond its competence as long as the managers' decision had some rational basis.[150] The specific "social" basis for the decision was neither

147 237 N.E.2d 776 (Ill. App. Ct. 1968).

148 *Id.* at 778.

149 *Id.* at 780.

150 For an analysis of the decision as an example of courts' abstaining from second-guessing business judgments, see Bainbridge, *supra* note 143, at 95–99.

a reason for refusing to permit it nor a justification for declaring the business judgment rule to be inapplicable in the absence of "fraud, illegality or conflict of interest."[151]

The inherent problem in *Shlensky* therefore was no different from that in *Brehm v. Eisner*,[152] where the Delaware Supreme Court, applying the business judgment rule, declined to intervene in a decision to hire a chief executive, give him a lucrative contract with generous termination provisions, and fire him only fourteen months later, paying him more than $140 million for admittedly ineffective management during his brief tenure.[153] The Chancery Court ultimately dismissed the complaint after trial.[154]

Because the problems with the formulation of the business judgment rule in the *ALI Principles* and *Shlensky* inhere in the need for a broad judicial standard, adjusting the verbal formulation does not solve them. For example, Michael Jensen has suggested an alternative standard that looks to maximizing the value of the firm rather than shareholder interests specifically.[155] Jensen proposes that "in implementing organizational change, managers must have a criterion for deciding what is better, and better should be measured by the increase in long-term market value of the firm."[156] Jensen reasons that the organization must have a "single-valued objective"[157] to make managers accountable. But Jensen's standard would not give courts and managers significantly more guidance than that in the *ALI Principles*. Note particularly that Jensen's standard looks to the market value of the "firm," and therefore encompasses value to nonshareholders except to the extent that helping one group would cause a larger detriment to another. This sort of balancing is at least arguably inherent in the *Principles*' "reasonable amount of resources" test.

The Delaware Supreme Court once tried to implement a rule that second-guessed directors for not following reasonable procedures. In *Smith v. Van Gorkom*,[158] an experienced and knowledgeable board that approved the sale of the company for a significant pre-

151 *Shlensky*, 237 N.E.2d at 780.

152 746 A.2d 244 (Del. 2000) (holding that questionable employment contract nevertheless met the loose business judgment standard).

153 *Id.* at 253.

154 *See In re* Walt Disney Co. Derivative Litig., No. Civ.A. 15452, 2005 WL 1875804 (Del. Ch. Aug. 9, 2005) (entering judgment for defendant after trial); *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003) (denying motion to dismiss).

155 *See* Jensen, *supra* note 37.

156 *Id.* at 235.

157 *Id.* at 237.

158 488 A.2d 858 (Del. 1985).

mium over market was held liable primarily because it failed to obtain an outside appraisal.[159] But the courts probably are no better able to second-guess procedures than they are to review substance. For example, the costs of an outside opinion such as the one missing in *Van Gorkom* do not obviously exceed the benefits.[160]

Not surprisingly in light of these problems, directors' potential liability for breach of the duty of care largely has been mooted by corporations' ability to opt out of the duty in the charter.[161] The operative duty now is one of loyalty or good faith. Breach of the latter duty has been held to require a showing that directors "consciously and intentionally disregarded their responsibilities."[162]

Even if courts could effectively second-guess business decisions, the procedural mechanisms for doing so are problematic. The decision to sue must be made either by the board itself, which generally makes such management decisions but is biased when deciding whether to sue its own members, or by a volunteer shareholder plaintiff who brings a derivative action. The derivative remedy creates conflicts between the plaintiff or plaintiff's attorney and other shareholders, like the class-attorney conflicts in any class action. The plaintiff is a nominal holder while the real party at interest is the lawyer who stands to receive a contingency fee by winning or (more often) settling the case. This substitutes the agency costs of reposing discretion in managers with those of reposing discretion in the plaintiff's attorney.[163] For example, the attorney may choose to sue because he does not bear the costs the litigation imposes on the corporation, may bring a strike suit solely to provoke a strategic settlement, or may settle a good claim for less than it is worth because he

159 *Id.* at 880–82.

160 Thus, in *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), the Delaware Supreme Court exonerated the board mainly because it relied on a compensation expert although this expert had made the seemingly obvious mistake of failing to add up the termination benefits under the contract. *Id.* at 261–62. On remand the amended complaint was upheld mainly because it alleged that the board had not, in fact, relied on the expert. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003). The court entered judgment for the defendant after trial. *In re Walt Disney Co.*, No. Civ.A. 15452, 2005 WL 1875804 (Del. Ch. Aug. 9, 2005). As this Article goes to press, the case is pending on appeal.

161 *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); Veasey, *supra* note 143, at 1428 (noting that "personal liability of directors solely for due care violations has largely become moot by reason of section 102(b)(7) of the DGCL").

162 *See In re Walt Disney Co.*, 2005 WL 1875804, at *51 (entering judgment after trial because plaintiff had failed to make the requisite showing of bad faith).

163 *See* John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 79–81.

does not want to risk losing at trial. Recognizing these problems with derivative suits, courts have, among other things, required plaintiffs to make demand on the board and permitted a board litigation committee to block the suit. These impediments to suit have reduced the role derivative suits play in corporate governance.[164]

The courts' difficulties in second-guessing business decisions mean that the business judgment rule necessarily leaves managers significant discretion to help themselves, stakeholders, or shareholders, as they prefer. It follows that no conclusions can be drawn about the actual or appropriate level of corporate social responsibility from the fact that managers have no duty to maximize profits.[165] The lack of such a duty is attributable to the inherent constraints on court-supervised duties rather than to a perceived need to permit managers to engage in socially-responsible management.

3. Selling and the Market for Corporate Control

Shareholders' power to sell their shares when they are dissatisfied with management is worth little unless shareholders can transfer control and therefore the power to fix the problem. State statutes impose some restrictions. The Delaware antitakeover provision, which applies to most large publicly held firms, merely restricts business combinations with acquirers without disinterested director approval,[166] and therefore is milder than many poison pills that effectively prevent hostile bidders from acquiring shares even without effecting a combination. Many provisions go further, clarifying managers' right to consider the interests of nonshareholder constituencies.[167] There is

164 *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747 (2004) (analyzing the prevalence of derivative litigation). Although Thompson and Thomas find little evidence of costly strike litigation in the few remaining suits, the small number of cases indicates that such suits are not performing a large role in corporate governance. They found a more salutary effect in the smaller subgroup of derivative litigation involving suits by minority against controlling shareholders. Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004). However, Vice-Chancellor Strine had a considerably less favorable appraisal of such suits in *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005), in which he disparaged the role of plaintiff's counsel and accordingly significantly reduced a fee request.

165 *See* Elhauge, *supra* note 1, at 862–63 (observing that opting out of managers' discretion to maximize profits would be unenforceable).

166 DEL. CODE ANN. tit. 8, § 203 (2001 & Supp. 2002).

167 *See* Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 700–05 (2004) (reviewing these statutes and the voluminous commentary).

also a federal law, the Williams Act,[168] which impedes hostile takeover in various ways.

Despite these laws, managers could be made accountable to shareholders if the courts recognized and enforced corporate default rules that maintained the viability of shareholders' power to transfer control over the objection of incumbent managers.[169] The courts instead appear to have adopted a rule focusing on the shareholders' ultimate *voting* power rather than on their power to *sell.*[170] Moreover, there is significant debate concerning whether shareholders can use their voting power to prohibit or reverse poison pills or other significant restrictions on their power to transfer control.[171]

One reason for the prevalence and durability of strong takeover defenses is that courts have limited ability to supervise takeover defenses through managerial fiduciary duties. To protect the market for control, courts must identify in particular cases precisely those devices or transactions whose costs in preventing beneficial control transfers exceed their benefits in facilitating efficient management. The courts are likely to have the same difficulty in doing this that they have second-guessing other management decisions, since the power to impede control transfers is closely tied to, and therefore difficult to distinguish from, the general power to manage. For example, once the Delaware Supreme Court upheld the selective repurchase in *Unocal Corp. v. Mesa Petroleum Corp.*[172] as within the board's power, it was effectively bound to approve the poison pill in *Moran v. Household International, Inc.*,[173] which had a similar effect in penalizing a hostile bidder who had acquired target stock. And once the court upheld the poison pill, it had to figure out exactly when the board must lift it to permit a takeover.

An additional problem with monitoring takeover defenses is that, if the court outlaws a defense, managers probably can find another defense that has a similar effect but, perhaps, even more negative con-

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168 Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)–(e), 78n(d)–(f) (2000)).

169 *See* Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989).

170 Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001).

171 *Compare* Lawrence A. Hamermesh, *Corporate Democracy and Shareholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409 (1998) (arguing that shareholders do not have this power), *with* Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835 (1998) (arguing in favor of shareholder power).

172 493 A.2d 946 (Del. 1985).

173 500 A.2d 1346 (Del. 1985).

sequences for the corporation than the outlawed defense. Courts therefore risk effectively channeling managers' actions toward conduct that is worse for the shareholders than what a board would do if it were freer to act.[174] Similar problems apply to shareholders who try to specify in the charter actions, such as poison pills, that managers may not take. Given these logistical problems with limiting takeover defenses, it is not surprising that the *Unocal* test has been applied to give managers wide latitude in defending against takeovers.[175]

Shareholders themselves do not seem to have a strong preference for takeovers as a disciplinary device, as they are willing to accept takeover defenses even in initial corporate charters.[176] Although it has been argued that such initial charter provisions reflect information problems,[177] they may also reflect, among other things, the capital structure of particular firms,[178] shareholders' preference for empowering managers to serve as "mediating hierarchs,"[179] or the inherent practical limits on limiting takeover defenses discussed immediately above. Moreover, shareholders might recognize the need to lock control over corporate assets in a strong board.[180]

To what extent does corporate social responsibility explain legal rules permitting strong takeover defenses? The Delaware Supreme Court recognized managers' right to consider nonshareholder constituencies in deciding whether to permit a hostile takeover in the *Unocal*

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174 *See* Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003).

175 *See* Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. (forthcoming 2006) (manuscript at 65–99), *available at* http://ssrn.com/abstract=796224 (reviewing cases decided under *Unocal* and concluding that the test gives courts a useful mechanism for determining when directors have abused their power).

176 Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001).

177 *See* Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 739–45 (2003).

178 Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 762 (2003) (discussing possible roles of institutional shareholders and private equity).

179 *See* Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 711 (2003).

180 *See infra* Part IV.C (discussing this consideration as a reason for not adopting partnership-type accountability mechanisms).

case,[181] and later confirmed the right in *Paramount.*[182] Elhauge explains the passage of nonshareholder constituency statutes as a reaction to the need to preserve managers' discretion to act responsibly after sophisticated takeover techniques of the 1980s demonstrated the financial value of increased managerial accountability.[183] But the above logistical and governance explanations for giving managers discretion to defend against takeovers make this explanation questionable. Although corporate managers, state and federal legislators, and courts made corporate social responsibility arguments against takeovers, the story almost certainly would have ended the same even without this argument. Indeed, these statutes have mattered little in the litigation over managerial takeover defenses.[184] Corporate social responsibility did not matter to takeover defenses because the logistics of corporate governance prevented takeovers from being a feasible method of providing managerial accountability.

The hostile takeover has to some extent been replaced by substantial equity investments through hedge or other private equity funds. Private equity funds take significant short-term minority positions and use these positions to pressure managers to make changes, often involving sale of weak divisions and distribution of more cash to shareholders.[185] Private equity has added a significant disciplinary force. Although it so far has not had a fundamental effect on corporate governance, private equity funds could be the mechanism for provoking changes like those discussed in the next section.

B. *The Partnership Option: Strong-Form Accountability*

Part IV.A suggests that the problem of managerial slack inheres in two features of the public corporation structure—strong centralized management and the absence of effective devices for ensuring that managers are accountable to owners in exercising their powers. Delegating decision functions to nonowner executives is inherent in

181 *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (permitting directors opposing a takeover to consider the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)).

182 *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989); *see also supra* text accompanying note 114.

183 *See* Elhauge, *supra* note 1, at 828–29.

184 *See* Licht, *supra* note 167, at 703 (noting that the statutes "have played a negligible part, if any, in litigation involving directors' decisions").

185 *See* Jesse Eisinger, *Hedge-Fund Activism Wins Plaudits, but the Focus Is Really on Firms' Cash*, WALL ST. J., Oct. 12, 2005, at C1 (discussing private equity's role in changes at Time Warner, McDonald's, Kmart, and Sears, among other firms).

specializing management and risk-bearing functions in publicly held firms.[186] The separation of management and risk-bearing, in turn, inevitably creates agency costs.[187] Although these circumstances in themselves do not dictate any particular level of accountability, devices for increasing accountability confront the logistics of shareholder voting and judicial supervision of management.

It is not clear, however, that owners need to be relegated to the ineffective protections of suing, selling, and voting. An alternative would be for publicly held firms to organize in the partnership form—for example, as limited partnerships or limited liability companies. Managers of publicly held partnerships, often called "master limited partnerships" (MLPs), might be expected to share the problems of publicly held corporations discussed in Part IV.A. But this section shows that the publicly held partnership form has several features that provide stronger accountability than the mechanisms discussed in Part IV.A. Rather than empowering managers to use corporate assets subject to oversight by courts and shareholders, partnership-type rules restrict managers' control of the firm's assets by imposing specific requirements to make distributions and by allowing dissatisfied members to cash out of the firm. Unlike limits on director discretion, including those on takeover defenses, these accountability devices do not require ongoing supervision by courts or collective action by shareholders.

These potential advantages of partnership suggest ways to fill gaps left by shareholders' conventional rights to vote, sell, and sue discussed above. Assuming firms can be provoked to adopt these mechanisms despite incumbent managers' likely opposition, perhaps by private equity funds,[188] this might significantly increase managers' accountability to shareholder interests. If these contracts are feasible, it would then be relevant to consider whether corporate social responsibility should constrain firms' legal ability to adopt them. In other words, an analysis of these mechanisms is an important aspect of determining how or whether corporate social responsibility relates to corporate governance.

1. Committing to Distributions

Given corporate shareholders' unsatisfactory options in dealing with managerial slack discussed in Part IV.A, there may be significant

186 *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

187 *See generally* Jensen & Meckling, *supra* note 142.

188 *See supra* text accompanying note 185.

benefits in reducing managers' discretion over retained earnings and requiring them to distribute cash periodically.[189] The problem with this alternative in corporations is that there are limits on the contractual commitment managers can make because of state statutes regulating or prohibiting usurping the directors' role.[190] Even if managers make general promises to pay dividends, courts may be no more willing to police such inroads on managers' broad discretion than they have been to police takeover defenses. Such promises also would conflict with the corporate norms of retaining earnings under managerial control and distributions that do not fluctuate with earnings.[191]

If managers are not bound to distribute dividends, they may tend to do so mainly when it is in their personal interests and not necessarily when it is in the shareholders' interests. For example, firms were more likely to increase dividends following the 2003 dividend tax cut[192] if their managers held stock than if they held stock options, in each case reflecting the effect of dividends on the value of their holdings.[193] Also, while firms generally increased dividends following the imposition of an undistributed profits tax in 1936, the increase was lowest for firms with the highest expected agency costs.[194]

Partnership law facilitates firms' commitments to distributions, thereby addressing the agency costs associated with retained earnings. A detailed study of MLP agreements shows how general partners of MLPs provide these assurances by promising to distribute "available cash" (net cash less reserves), giving general partners significant incentives to maintain high distribution rates, and restricting specific actions such as issuance of additional equity that might reduce distributions.[195] These provisions prod managers to serve the owners' interests, including by avoiding excessive compensation, more effectively than corporate shareholders' lower-powered rights dis-

189 *See* Frank H. Easterbrook, *Two Agency Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984) (proposing this idea with reference to corporate dividends).

190 *See* Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 197 (2004).

191 *See* Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1218–19, 1223–28 (2004).

192 *See infra* note 225 and accompanying text.

193 *See* Jeffrey R. Brown et al., *Executive Financial Incentives and Payout Policy* 4–5 (Nat'l Bureau of Econ. Research, Working Paper No. 11002, 2004), *available at* http://ssrn.com/abstract=631182.

194 *See* William G. Christie & Vikram Nanda, *Free Cash Flow, Shareholder Value, and the Undistributed Profits Tax of 1936 and 1937*, 49 J. FIN. 1727, 1749–50 (1994). Note that the effect of the Act was somewhat ambiguous because it also imposed double taxation. *See infra* text accompanying note 215.

195 John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471, 490–504 (2005).

cussed in Part IV.A, or easily manipulated earnings-based compensation. As one analyst noted, "'[i]t's hard to fake cash payments to shareowners.'"[196]

While distribution requirements effectively discipline managers, they do so without requiring interference by courts or owners in the firm's management. The managers are subject only to a constraint on output. In other words, they must produce a certain level of distributions or they are subject to penalties or a lower level of benefits. The firm can set this constraint ex ante in the agreement and revise it periodically. Neither the owners nor the courts need to decide what specific actions the managers should take in order to achieve the target output.

To be sure, distribution requirements may seem appropriate only for firms with passively managed assets such as natural resources or real property, which are the only publicly traded partnerships that are entitled to use single-level taxation.[197] Because a firm commitment to a high level of payouts requires stable and predictable earnings, many MLPs own gas pipelines, which essentially just charge rents for oil moving through and therefore are not subject to significant fluctuations in business.[198]

Firms that have more actively managed assets and less predictable earnings may want to make weaker commitments to distributions. But even such firms might gain from limiting managers' control over the firm's cash. Mandatory distributions do not block expansion or increased investment, but only restrict managers' access to retained earnings. Managers can still grow the firm or redeploy assets by raising new equity, borrowing, or getting owners' consent to waive the agreement's distribution or buyout provisions. Managers therefore must submit expansion decisions to continuous market scrutiny.[199]

2. Member Cash-Out Rights

A second partnership-type way to reduce managerial slack is to permit owners to cash out of the firm in situations other than the fundamental changes that trigger corporate appraisal rights. For ex-

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196 *Id.* at 479 (quoting Chuck Saletta, *Fool on the Hill: Growth in the Pipeline*, MOTLEY FOOL, Jan. 31, 2003, http://www.fool.com/news/foth/2003/foth030131.htm).

197 *See* I.R.C. § 7704(a) (West Supp. 2005) (defining publicly traded partnerships eligible for flow-through taxation); *see also id.* §§ 856–860 (providing for partial flow-through taxation of real estate investment trusts).

198 *See* Goodgame, *supra* note 195, at 480–82 (discussing tax and business considerations relating to nature of MLP assets).

199 *See* Easterbrook, *supra* note 189, at 654 (noting that "[n]ew investors are better than old ones at chiseling down agency costs"); Goodgame, *supra* note 195, at 501–04.

ample, general partnership statutes provide for a right to cash out at will.[200] Though many limited partnership statutes, including the 2001 version of the Uniform Limited Partnership Act,[201] do not provide for default cash-out rights, this can be linked to the fact that such a right affects valuation for estate and gift tax purposes in family limited partnerships.[202] In any event, cash-out rights clearly are consistent with the norms of partnership law. The question is whether they are appropriate for publicly held firms.

Like distribution provisions, cash-out provisions reduce managerial control over the firm's cash. Cash-out rights give owners more than they would get from being able to sell their interests on the market to the extent that the price is determined by the value of the underlying assets without any market discount for current managers' suboptimal use of the earnings. This owner right could also be more valuable than the owners' rights to sue and vote because it does not involve any free rider problems or the costs of coordinating with other owners. At the same time, like mandatory distributions, cash-out rights do not let courts or shareholders second-guess managers' discretion. Rather, they are a type of output-based control, where the output is determined ex post by the owners' individual judgments rather than specified ex ante through a duty to make distributions.

3. Interrelation with Corporate Shareholders' Rights

The rights to compel distributions and to cash out provide potentially more accountability than the traditional corporate rights to vote, sue, and sell. While managers might be able to manipulate assets over the short term to provide cash for distributions or cash-outs, this manipulation would have to involve real assets and money and therefore must be more transparent than mere accounting devices.

Because these devices involve stronger accountability, they also reduce the need for the conventional corporate forms of accountability. Thus, MLPs commonly take advantage of provisions in Delaware partnership law (the law selected by all exchange-listed MLPs) to broadly opt out of fiduciary duties.[203] Limited partners in MLPs have

200 *See* REVISED UNIF. LTD. P'SHIP ACT § 701 (amended 1985), 6A U.L.A. 446 (2003); UNIF. P'SHIP ACT § 31, 6 U.L.A. 370 (2001).

201 UNIF. LTD. P'SHIP ACT § 601(a), 6A U.L.A. 71–72 (2003).

202 I.R.C. § 2704(b) (2000) (providing that taxation of intra-family transfers of business organization interests depends on state statutory exit rights).

203 *See* DEL. CODE ANN. tit. 6, § 17-1101 (2005); Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004) (discussing judicial application of the Delaware opt-out provision). The use of these provisions in MLPs is discussed in Goodgame, *supra* note 195, at 485–90, 494–98.

only minimal voting rights[204] and hostile takeovers that involve replacing (rather than changing control of) the general partner are virtually impossible.[205] Because corporate accountability devices potentially let courts and shareholders intrude into corporate management, the partnership-type devices may be more consistent than the corporate devices with the goals underlying "director primacy."

The increased accountability under partnership-type rules leaves less slack for managers to engage not only in self-interested conduct, but also in socially-responsible conduct that does not produce more cash for owners. This result does not follow from managers' fiduciary duties, as in corporations,[206] since, as just noted, fiduciary duties, hostile takeovers, and even owner voting rights are minimal or nonexistent in MLPs. Thus, there is no doctrine of "partnership social responsibility" that mitigates partnership managers' duty to maximize profits on behalf of the owners. Rather, managers must maximize profits because they have less power to dispose of the firm's cash than do corporate managers.[207]

4. Analogous Corporate Devices

The partnership-type commitment to make distributions differs critically from a highly leveraged firm's functionally similar commitment to repay debt.[208] First, the partnership form does not involve significant agency costs between creditors and debtors. The partners entitled to the payments not only bear the risk of nonpayment but also, as residual claimants, capture at least some of the benefit of the firm's success. Second, if the firm does not meet its payout obligations, the partners are relegated to contract rights and cannot force the firm into costly bankruptcy proceedings.

Partnership commitments to pay distributions resemble, but also differ from, corporate preferred shares. Preferred shares' distribution and liquidation preferences over common stock are usually coupled

204 Goodgame, *supra* note 195, at 491–94.

205 *Id.* at 498–99.

206 *See supra* text accompanying notes 181–185.

207 Since the social responsibility issue does not arise in MLPs as a matter of fiduciary duty, it follows that it would not constrain any power the members have to transfer control. *Cf. In re* Marriott Hotel Props. II Ltd. P'ship, No. Civ.A. 14961, 2000 WL 128875, at *17 (Del. Ch. Jan. 24, 2000) (holding that, given the structure of the limited partnership, the general partner did not have a *Unocal* duty to protect the limited partners in connection with a tender offer by the general partner's parent).

208 *See supra* text accompanying note 140–142.

with inferior control rights.[209] Thus, corporate managers' primary accountability is usually to the voting common shares, though, as discussed in Part IV.A, this accountability is weak. Preferred shareholders normally are relegated to contract rights with only vague good faith duties that arise primarily from their contract.[210] To the extent that preferred and debt holders have control and fiduciary-like rights, these rights mainly protect them from the common shareholders and not from the managers, whose interests may be more closely aligned to those of fixed claimants than to those of the common shareholders.

By contrast, limited partners in publicly held limited partnerships typically hold all of the outside control rights, though these rights are typically minimal. The general partners are comparable to inside shareholder-managers owning high-vote stock. Accountability is enforced mainly through distributions and cash-outs rather than voting rights as in the corporation.

A corporation theoretically could have a single class of debt or preferred-like interests that resembles limited partnership interests. Because such a structure would be alien to the standard corporate form, it might present interpretation and enforcement problems. But it does not matter for present purposes whether the firm is called a "corporation" or a "partnership." What matters is that this form of governance is not common in modern publicly held corporations, and therefore presents the same issue as that presented by the above analysis of publicly held partnerships—that is, whether these devices

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209 For a discussion of the tradeoffs between preferred and common, particularly regarding liquidation preferences, see William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 916 (2002).

210 *See, e.g.*, Sanders v. Devine, No. Civ. A. 14679, 1997 WL 599539, at *5–6 (Del. Ch. Sept. 24, 1997) (preferred shareholders have no cause of action for breach of fiduciary duty in connection with cash-out merger if they received their contractual liquidation preference); Winston v. Mandor, 710 A.2d 835, 836 (Del. Ch. 1997) (no breach of fiduciary duty as to corporate actions permitted by certificate); Moore Bus. Forms, Inc. v. Cordant Holdings Corp., No. Civ.A. 13911, 1995 WL 662685, at *5–6 (Del. Ch. Nov. 2, 1995) (holding that fiduciary rights of preferred stockholders depend on whether the dispute arises from rights and obligations the preferred share with common shareholders); Bratton, *supra* note 209 (discussing duties owed to preferred shareholders in venture capital situation). Note, however, that in venture capital-backed startups preferred shareholders may exercise the dominant power, leaving the common shareholders vulnerable to opportunism. *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capital Control in Startups*, 81 N.Y.U. L. REV. (forthcoming 2006) (manuscript at 2–3), *available at* http://ssrn.com/abstract=784610. This would also differ from the partnership structure, where there is only one widely held class of equity-type shares.

should be permitted if they are feasible, or prohibited on social responsibility grounds.

C. *Tax Protection of the Corporate Form*

Part IV.B suggests that the value of at least some publicly held firms might be increased if the firms switched from standard corporate governance norms to stronger partnership-type forms of managerial accountability to shareholder interests. Even if such a switch did not increase social welfare, it would seem that firms would have a significant incentive to reduce their cost of capital. Nevertheless, there has been no major move in this direction. Does this indicate that such a move would not be in the interest of firms or society? Though these governance forms might trigger significant opposition of managers and involve costs of creating new business structures,[211] firms might adopt them if the increased value from organizing in or restructuring into these forms is evident.

One impediment to switching to the partnership-type accountability mechanisms discussed above may be the corporate income tax that applies to most publicly traded firms. Corporations are taxed on their income, and then their owners are taxed on the firm's earnings when they receive income distributions or realize a gain on selling their shares. The second-level tax in effect "traps" earnings in the firm by penalizing owners when they take cash out of the firm, particularly if the corporate rate is less than the individual rate. The second tax reduces owners' incentives to contract to press managers for cash distributions even if this might reduce agency costs by loosening managers' grip on corporate cash. The main exceptions to these rules in publicly held firms are MLPs that that engage in "passive" (asset-management) activities[212] and real estate investment trusts (REITs).[213]

Recognizing how the corporate tax affects owners' preference for distributions, corporate managers have not pressed Congress to eliminate double corporate taxation and open the earnings trap.[214] Indeed, there is persuasive evidence that corporate managers initially promoted double taxation as part of a political deal in 1936 to avoid an undistributed profits tax.[215] President Roosevelt had pushed for

211 *See* Ribstein, *supra* note 190.

212 *See* I.R.C. § 7704 (West Supp. 2005).

213 *See id.* §§ 856–860.

214 *See* Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 356–61 (1995).

215 *See* Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 183–98 (2002) [hereinafter Bank, *Agency Costs*]; Steven A. Bank, *The Story of Double Taxation: A Clash over the Control of Corporate Earnings*

such a tax, partly at the behest of Adolf Berle, one of his main advisors.[216] Berle, consistent with his views on the separation of ownership and control,[217] had argued that managers were using large corporate surpluses for personal gain.[218] Roosevelt's proposal would have eliminated both the corporate tax and the dividend exemption and imposed the double tax only on firms that had undistributed profits.[219] But managers opposed this increased pressure for distributions as a potential constraint on their power, arguing that they needed discretion to protect jobs.[220] Corporate managers headed off Roosevelt's proposal by agreeing to a compromise that traded a reduction in the undistributed profits tax for retention of the corporate tax and elimination of the dividend exemption—in other words, double taxation.[221]

There have been more recent proposals to eliminate the double corporate tax during both the George H.W. Bush[222] and George W. Bush administrations.[223] But managerial opposition also continues.[224] Thus, the proposal for elimination became a more modest scaling back in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA),[225] which merely reduces the tax on most dividends to fifteen percent.

[hereinafter Bank, *Story*], *in* BUSINESS TAX STORIES 153 (Steven A. Bank & Kirk J. Stark eds., 2005) (discussing the adoption of double taxation in 1936).

216 Bank, *Agency Costs*, *supra* note 215, at 184–85.

217 *See supra* text accompanying note 5.

218 *See* Bank, *Agency Costs*, *supra* note 215, at 184–85.

219 *Id.* at 198–99.

220 *Id.* at 200–03.

221 *Id.* at 222–23.

222 The proposal involved a Comprehensive Business Income Tax (CBIT). *See* U.S. DEP'T OF THE TREASURY, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 39–60 (1992) [hereinafter INTEGRATION REPORT], *available at* http://www.treasury.gov/offices/tax-policy/library/integration-paper/.

223 *See* PRESIDENT'S ADVISORY PANEL OF FEDERAL TAX REFORM, FINAL REPORT 162–63 (Nov. 2005), *available at* http://www.taxreformpanel.gov/final-report/TaxReform_Ch7.pdf (proposing flat tax on net positive cash flow of all businesses); Press Release, U.S. Dep't of the Treasury, Fact Sheet: The President's Proposal To End the Double Tax on Corporate Earnings (Jan. 14, 2003), *available at* http://www.ustreas.gov/press/releases/kd3762.htm.

224 *See* Bank, *Story*, *supra* note 215, at 178–80; Steven A. Bank, *A Capital Lock-in Theory of the Corporate Income Tax*, 96 GEO. L.J. (forthcoming 2006) (manuscript at 6 n.22) [hereinafter Bank, *Capital*], *available at* http://ssrn.com/abstract=861244.

225 Pub. L. No. 108-27, § 302(a), 117 Stat. 752, 760–61 (codified as amended at I.R.C. § 1(h))

Any reform that mitigates but preserves double taxation is unlikely to significantly change managerial behavior. Managers' strong incentives to retain earnings and shareholders' limited ability to restructure corporate governance create a bias for the status quo that only a significant change in tax incentives can overcome. Survey evidence shows that distribution policies are not sensitive to tax or agency cost considerations.[226] Under the JGTRRA, for example, given corporate, individual, and capital gains tax rates, there is still a tax benefit from deferring distributions.[227] While there is some evidence of post-JGTRRA increase in dividend payouts and in firms initiating dividends,[228] increases in dividends depended on whether managers were shareholders.[229] Even if managers are increasing payouts, they may do so through repurchases rather than dividends.[230]

Any inroads on the double tax are likely to trigger the same sort of arguments about the need to preserve managerial discretion to serve stakeholders as did takeovers, which led to the passage of state

226 Alon Brav et al., *Payout Policy in the 21st Century*, 77 J. FIN. ECON. 483 (2005).

227 *See* Bank, *Capital*, *supra* note 224 (manuscript at 49); William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L.J. 841, 846–47 (2004).

228 *See* Jeff D. Opdyke, *Tax Cut, Shareholder Pressure Stoke Surge in Stock Dividends*, WALL ST. J., Jan. 18, 2005, at A1 (noting that in 2004, following enactment of the JGTRRA, dividends were up twelve percent and 1288 companies increased their dividends, and that since the dividend-tax cut S&P 500 companies announced 421 dividend increases, twenty-four companies started paying dividends for the first time—the greatest increase ever in dividend initiations); Gene Amromin et al., *How Did the 2003 Dividend Tax Cut Affect Stock Prices and Corporate Payout Policy?* (Fin. & Econ. Discussion Series, Working Paper No. 2005-57, 2005), *available at* http://ssrn.com/abstract=873879 (showing some increase in dividends, but small effect on total payouts since firms reduced share repurchases); Nadarajan Chetty & Emmanuel Saez, *Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut* 21 (Nat'l Bureau of Econ. Research, Working Paper 10900, 2004), *available at* http://www.nber.org/papers/w10572 (showing that nearly 150 firms initiated dividend payments after the tax cut, that these were mostly regular rather than special dividends, that firms that had been paying dividends increased them, that these effects are significant relative to company size and occur across differences regarding profits and other firm characteristics, and that the effects are more marked than for the Tax Reform Act of 1986, which reduced the top individual tax rate on dividends significantly but led mainly to a temporary increase in special dividends). The experience after the JGTRRA indicates that managers may be more sensitive to tax considerations than Brav et al., *supra* note 226, at 22, predicted, since that survey reported that only one percent of managers questioned said their firms would definitely initiate dividends in response to the JGTRRA.

229 Brown et al., *supra* note 193, at 5.

230 *See* Bratton, *supra* note 227, at 855–58; *see also* Amromin et al., *supra* note 228 (showing some increase in dividends, but small effect on total payouts since firms also reduced share repurchases).

anti-takeover statutes in the 1980s[231] and the earlier Federal Williams Act.[232] Nevertheless, abolition of the double tax may be politically feasible, at least in the long run. First, the existence of publicly held partnerships that are not subject to the corporate tax encouraged the development of contracts designed to accommodate these firms. Increased familiarity with this form may spur broader recognition of the benefits of partnership-type accountability and single-level taxation beyond the passive asset partnerships current tax law encourages. These developments, in turn, may spur pressure for tax and other legal changes to facilitate broader use of these vehicles.

Second, the growing use of MLPs and REITs creates a clientele for a single-level tax. For example, a significant problem with MLPs is that tax-exempt vehicles such as mutual funds are deterred from investing that might subject them to "unrelated business tax on income."[233] This reduces the availability of institutional shareholder monitoring in such firms. However, the American Jobs Creation Act of 2004,[234] perhaps spurred in part by the growing MLP industry, enables mutual funds to invest in MLPs.[235] This increased potential for shareholder monitoring of MLP managers may invite increased voting power and decreased restrictions on hostile takeovers in such firms. To be sure, the inherent limits on dispersed owners' powers in publicly held firms also apply here. Increased shareholder monitoring might permit less reliance on, and therefore some loosening of, distribution constraints, and therefore make MLPs more feasible for managing variable cash flows. This could, in turn, create political demand for widening the application of single-level taxation beyond the passive asset category. Analogously, the popularity of REITs, which are now basically limited to publicly held firms, including corporations, in the real estate business,[236] may lead to expansion of the types of public corporations and other firms that may take advantage of single-level taxation.

231 *See* Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365 (discussing the politics of enacting these statutes).

232 *See* Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)–(e), 78n(d)–(f) (2000)); *see also supra* note 168 and accompanying text.

233 *See* I.R.C. § 511(a)(1) (2000); Goodgame, *supra* note 195, at 474 n.18; Ribstein, *supra* note 32, at 770.

234 Pub. L. No. 108-357, 118 Stat. 1418.

235 *See id.* § 331 (codified as amended in scattered sections of 26 U.S.C.); Goodgame, *supra* note 195, at 506.

236 *See* I.R.C. § 856(c) (West Supp. 2005).

Third, the demand for broader availability of single-level taxation is apparent from the fact that it has already broken through some regulatory and tax barriers. State law development of the limited partnership put pressure on the tax definition of the corporation, leading eventually to the "check-the-box" rule, which let closely held firms decide for themselves whether they wanted to be taxed as corporations or partnerships and thereby opened an escape hatch from the corporate tax.[237]

State limited partnership law also made single-level partnership taxation available to publicly traded partnerships. This initially created the possibility that firms might be able to broadly escape double corporate taxation.[238] Congress closed the loophole by extending the corporate tax to all but passive asset publicly traded partnerships.[239] But this history at least indicates the existence of political pressure for changes in the tax system. The demand persists despite Congress's and the IRS's efforts to reduce it by providing exceptions like Subchapter S corporations, check-the-box, and publicly traded partnerships.[240]

Fourth, a move toward broader availability of single-level taxation might be seen as a way to provide necessary additional managerial accountability in the post-Enron era. The corporate scandals at least may have reduced the persuasiveness of managers' arguments that they need discretion to help society by focusing on the costs of managerial discretion. As concerns about the costs and effectiveness of criminal liability and the Sarbanes-Oxley Act of 2002[241] increase, public demand may build for alternative accountability mechanisms.

Several economic arguments have been made for the corporate tax: it may deter over-investment in risky projects that would otherwise result from limited liability;[242] it arguably reduces agency costs by eliminating high-bracket owner-managers' incentives to time asset dispositions to minimize their own tax liabilities;[243] it assists the govern-

237 Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819 (2001) (discussing the evolution of check-the-box).

238 *See* Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and Its Implications for Corporate Law*, 16 J. CORP. L. 299 (1991).

239 *See* I.R.C. § 7704.

240 Arlen & Weiss, *supra* note 214, at 367–68 (explaining check-the-box along these lines).

241 Pub. L. No. 107-204, 116 Stat. 745.

242 *See* KOSE JOHN ET AL., CORPORATE LIMITED LIABILITY AND THE DESIGN OF CORPORATE TAXATION 2 (1991).

243 Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 255–56 (1991).

ment in regulating corporations by imposing tax penalties;[244] and it avoids the significant administrative complexities of single-level taxation.

I have previously criticized several of these arguments.[245] With respect to the regulatory argument, while tax penalties may be effective in controlling certain types of corporate conduct, they are not obviously more effective than fines or liability. Administrative complexities of single-level taxation are addressed in a U.S. Department of the Treasury report discussion of a "shareholder allocation" approach to tax integration that would retain the corporate tax, allocate corporate income (but not losses) to shareholders as earned, credit owners with corporate taxes paid, and not impose an additional tax on distributions.[246] The report noted, among other problems, the treatment of tax preferences and foreign source income, the need to amend governing instruments to provide for income allocations and maintain partnership-type capital accounts, and the difficulties for shareholders who sell stock during a year and for corporations that own stock.[247]

Although these arguments against eliminating the corporate-level tax may be persuasive, this Article will focus on what is probably the most important issue regarding elimination of the corporate tax, and the argument stressed by managers in opposition to eliminating the tax—the pressure this move would put on managers to distribute cash even when managers believe there are strong business reasons to retain cash. Just as both managers and shareholders may want to contract to preserve managers' discretion, as by providing for strong takeover defenses or weak shareholder voting rights, so they may not want to tax earnings retention. In other words, the corporate tax can be viewed as a result rather than a cause of capital lock-in.[248] This focuses the analysis on the reasons for capital lock-in, discussed in the next section.

Finally, the excessive costs of single-level tax might apply only to some publicly held firms. This suggests that it might be efficient to extend the application of the check-the-box tax rule[249] from closely held firms to publicly held firms. One response to this argument is that the benefits of the corporate tax, particularly including preserva-

244 *See* Avi-Yonah, *supra* note 10.

245 *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 467–73 (1992).

246 *See* INTEGRATION REPORT, *supra* note 222, at 27–37.

247 *Id.*

248 *See* Bank, *Capital*, *supra* note 224 (manuscript at 5).

249 *See* Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584 (1996) (to be codified at 26 C.F.R. pts. 1, 301, 602).

tion of managers' power over a firm's cash, accrue to society as a whole and not just to the owners who would decide which box to check. As discussed in the next section, this could be how corporate social responsibility becomes relevant to the corporate governance debate.

D. *The Role of Capital Lock-in*

Managers' power to control earnings has been said to be an important aspect of the modern corporation, which solved problems associated with the impermanence of partnership.[250] In this story, the strong corporate entity arose because spot markets did not accommodate the coordinated business practices large firms needed. In order to ensure that parts were ready for assembly and that manufactured units showed up for delivery, all in time to meet customer demand, firms internalized these functions and subjected them to the command and control of top executives and midlevel managers.[251] Partnership devices that force managers to distribute earnings or permit owners to cash out at will might compromise these objectives, destroy going concern value, and invite hold-up of owners who wanted to continue the firm.[252]

A problem with this story is that it is no longer clear that even large publicly held firms need this strong entity protection. Instead of owning large pools of assets whose value might be significantly reduced by breakup, many large businesses today are simply sets of contracts. Markets have solved some of the opportunism problems that once were thought to compel organization of traditional firms.[253] The value of these networked firms increasingly lies in their brand names rather than in the machines that produce the branded prod-

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250 Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003).

251 *See* CHANDLER, *supra* note 92, at 287–89; Blair, *supra* note 250, at 398–404; Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression* 1–11 (Nat'l Bureau of Econ. Research, Working Paper No. 10900, 2004), *available at* http://www.nber.org/papers/W10900 (observing that parties formed corporations during the late nineteenth and early twentieth century where they expected high profitability that might be jeopardized by untimely dissolution, despite the risk of controlling owner opportunism facilitated by corporate continuity).

252 Strong owner powers also may have the additional consequence of preventing the development of an entity "personality" through consistent decisionmaking over time. *See* Edward B. Rock, *The Corporate Form as a Solution to a Discursive Dilemma*, 15 J. INSTITUTIONAL & THEORETICAL ECON. (forthcoming (2006)) (manuscript at 11), *available at* http://ssrn.com/abstract=803866.

253 *See* Ribstein, *supra* note 190.

ucts.[254] The value of the brand, in turn, lies in intellectual property and human capital, and is not threatened by the risk that assets may need to be sold in order to meet distribution or cash-out obligations.

More generally, the tradeoffs between the higher agency and opportunism costs of strong corporate continuity and the liquidity benefits of partnership have been analyzed in the traditional partnership setting,[255] and in the choice between the corporate and partnership forms.[256] Kate Litvak presents evidence that many venture capital funds are structured to give owners essentially the power to put their investments back to the firm, subject to a wide variety of potential penalties.[257] Her data indicate that options and associated penalties in such firms depend mainly on the funds' access to other methods of controlling agency costs rather than on liquidity considerations.[258]

Publicly held firms might seem to be categorically different from small firms regarding the appropriateness of partnership-type liquidity. However, partnership-type rules are not necessarily inefficient for all publicly held firms. Though publicly held firms are likely to own larger pools of assets than are closely held firms, any firm stands to lose going concern value if it must distribute earnings, cash out members, or liquidate. Even venture capital funds, which do not have going operations, could incur costs from having to make distributions because they may miss significant opportunities if they lack funds to invest.[259] The existence of a public market for the firm's shares reduces both the benefits of letting owners cash out of the firm, by offering them a public market, and the costs, by enabling the firm to replace the cash through the securities markets.

Although cash-out rights and mandatory distributions may be appropriate for some publicly held firms, these rights are likely to differ from those in closely held firms. Firms' choices are not limited to the traditional unstable partnership and the traditional stable corporation. For example, publicly held firms might provide for cash-out at a price based on earnings or cash flow that does not require complex

254 *See supra* Part II.D.

255 *See generally* Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987).

256 *See* Lamoreaux & Rosenthal, *supra* note 251.

257 Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771 (2004).

258 *See id.* It may be that investors are constrained by reputational considerations from exercising their liquidity rights. *See* Victor Fleischer, *Fickle Investors, Reputation, and the Clientele Effect in Venture Capital Funds*, 40 WILLAMETTE L. REV. 813 (2004). But even if Fleischer's criticism is correct, this just suggests that liquidity rights are underutilized rather than impracticable.

259 *See* Litvak, *supra* note 257, at 790–97.

determination of "value," but that gives owners access to more of the underlying value of the firm's assets than is available in traditional corporations. These rights need not be available at will, but might be triggered by specific events, including the firm's failure to make distributions. The agreement can thereby trade cash-out rights for rights to distribution. Firms with less stable earnings than the typical MLP might nevertheless set distributions at a high level, with the penalty for failing to satisfy the obligation being a trigger of the cash-out right. The cash payment also might vary with the trigger, ranging from "fair value" appraisal to an artificial formula. Restrictions on members' ability to obtain the value of their interests involve tradeoffs between managerial accountability and the firm's need to retain earnings. But agreements can make fine-edged, firm-specific tradeoffs between liquidity and lock-in.

In general, neither reform of the corporate tax system nor any other reform designed to increase managerial accountability may be warranted because of the reforms' nongovernance-related costs. But that would only provide additional evidence of the irrelevance of corporate social responsibility to corporate governance. Just as rules regarding managers' fiduciary duties and takeover defenses can be largely explained by the inherent logistics of governing publicly held firms, so also the use of this accountability mechanism may turn on the mechanics of governance rather than larger concerns of social wealth.

The corporate social responsibility issue has bite if, and only if, any of these accountability devices are otherwise feasible. For example, as discussed above,[260] the law might mitigate logistical problems with the abolition of the separate corporate tax by letting publicly held firms elect between corporate-type and partnership-type tax treatment. Yet Congress nevertheless may reject this approach for publicly held firms solely to ensure that managers are left free to use corporate earnings to maximize social, rather than strictly corporate, wealth. Similarly, courts and legislatures may block corporations' use of partnership accountability devices such as the MLP that diminish managers' discretion to engage in socially-responsible management.

At this point the discussion in Parts II and III, above, becomes relevant. As discussed in Part II, the various markets in which corporations function provide significant assurance that managers who are accountable to shareholders are also serving society. Even if these market constraints are imperfect, Part III shows that managers who are not accountable to shareholders may nevertheless fail to maximize

260 *See supra* text accompanying note 249.

social wealth. Accordingly, even if corporate social responsibility is relevant, it may not justify restricting managers' accountability to shareholders.

CONCLUSION

This Article has established a framework for analyzing how corporate social responsibility bears on corporate governance. An important aspect of this framework is identifying the available legal options. A first option is radically changing the current system of corporate governance to reduce managers' accountability to shareholders or to empower nonshareholder stakeholders. However, this could have significant costs. The market constraints on profit-maximizing firms discussed in this Article make it doubtful that the social benefits of these radical moves will outweigh these costs.

An alternative is fine-tuning managers' accountability to shareholders to give them leeway to respond to social concerns. However, internal logistics and external constraints on the governance of public corporations ensure that managers will have significant discretion to deviate from shareholders' interests whether or not the deviation is rationalized on corporate social responsibility grounds.

This Article contributes to the corporate governance debate by identifying a third governance option: employing partnership-type governance mechanisms that reduce managers' control over corporate cash. These devices offer some promise of realistically holding managers accountable to shareholder interests. But this option is constrained both by the double corporate tax, which may or may not be politically entrenched, and by inherent governance needs to lock capital in the firm.

Assuming these partnership-type accountability mechanisms are feasible despite tax and capital lock-in considerations, it would then be appropriate to consider whether the risk of socially-irresponsible conduct justifies legal constraints on this type of contract. Profit-maximizing firms' incentives to act in society's interests are again relevant to this issue. Because firms are not free to maximize shareholder wealth at society's expense, there would be little danger in permitting firms to adopt these mechanisms, assuming they can survive in the marketplace even while sharply reducing managers' discretion over the firm's cash.

This Article's framework should be useful in future discussions of corporate social responsibility. Debates on what managers ought to do from a moral or ethical perspective should be separated from the specific legal issue of how or whether the law should restrict corporate contracts to ensure socially-responsible governance. This Article has shown that the relevant options for both reducing and increasing managers' accountability to shareholders are narrower than the prior literature assumes.