Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure

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I. INTRODUCTION: THE MAXIMIZATION PRINCIPLE

This paper is part of a symposium on the problem of corporate philanthropy. That problem, in turn, is part of a larger issue raised by any corporate conduct that is not designed to maximize shareholder gain. Indeed, it is often difficult to know whether a reference to corporate philanthropy concerns only true philanthropy or is a shorthand term for all nonmaximizing conduct.

In this paper, I consider the general question of nonmaximizing corporate conduct, not simply the specific question of corporate philanthropy. The objective of this paper is to clarify the analysis, partly by showing that there are a number of different types of corporate conduct that appear to be or are nonmaximizing, but are nevertheless consistent with the maximization principle. In the interest of brevity, I will not canvass the case law, the statutes, or the secondary literature,¹ and I will not discuss the concepts of

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¹ See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS
corporate social responsibility, enlightened corporate self-interest, and stakeholder theory, which conceal at least as much as they reveal.

I will use section 2.01 of the American Law Institute's Principles of Corporate Governance as the narrative, although not the analytical, spine of this paper, and as a basis for my illustrations. Section 2.01 is divided into two parts. Subsection (a) concerns the objective of the corporation. It provides that, subject to the provisions of subsection (b), a corporation "should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain." Subsection (b) provides that "[e]ven if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:"

(1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
(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.

For purposes of this paper I assert, but do not try to establish, that the principle stated in section 2.01(a) is correct — that, subject to certain limitations, the maximization of shareholder gain and corporate profit (I will use those terms interchangeably) is the proper objective of the corporation. I call this the maximization principle. I do not claim that this principle is self-evident, or that it holds or should hold universally at all times and in all countries. I do claim that, for reasons I have discussed elsewhere, the maximiza-

§ 2.01 (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE]. I was the Chief Reporter for the Principles of Corporate Governance. Much of the analysis in this paper goes beyond (although it is consistent with) § 2.01.


3. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 1, § 2.01(a).
4. Id. § 2.01(b).
5. See generally Melvin Aron Eisenberg, Corporate Legitimacy, Conduct, and Gover-
Nonmaximizing corporate conduct is desirable at this time in this country.

Nevertheless, the maximization principle, like most principles, is subject to certain limitations. Although nonmaximizing corporate conduct is often treated as a single entity, I show in this paper that corporate conduct that is or appears to be nonmaximizing needs to be unpacked into component parts, many of which can be justified by one or more special principles that can comfortably coexist with the maximization principle. I call these the legal-conduct, ethical-conduct, penumbra, reciprocity, prisoner’s dilemma, and sheep’s clothing principles. After developing these special principles, I consider the residual class of nonmaximizing corporate conduct that does not fall within these principles, and therefore is justified, if at all, only under the general principle, stated in section 2.01(b)(3), that the corporation may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes. Finally, I discuss the role of disclosure in this area.

II. THE LEGAL-CONDUCT PRINCIPLE

Under the Principles of Corporate Governance, the maximization principle embodied in section 2.01(a) is made subject to the limitations stated in section 2.01(b). The first of these limitations, embodied in section 2.01(b)(1), is that the corporation, in the conduct of its business, is obliged to the same extent as a natural person to act within the boundaries set by law, even if shareholder gain is not thereby enhanced. I will call this the legal-conduct principle. The reason for this principle is straightforward. Ours is a society of law. We don’t want a society in which major players—that is, corporations—are lawless. So, for example, the economist Milton Friedman, in a well-known essay in The New York Times Magazine, argued that the “one and only . . . social responsibility of business” is to increase profits, but only “while conforming to the basic rules of society,” including the rules embodied in law.6

Here is an illustration of the legal-conduct principle:

1. Corporation A is a publicly held corporation with annual earnings in the range of $3–5 million. A hopes to be awarded a supply contract by X, a large publicly held corpo-

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ration. The anticipated profits on the contract are $5 million over a two-year period. A vice-president of X has approached Brown, the relevant corporate decisionmaker of A, with the suggestion that if A pays the vice-president $20,000, A will be awarded the contract. Brown knows such a payment would be illegal, but correctly regards the risk of detection as extremely small. After carefully weighing that risk and the consequences of detection, Brown causes A to pay the $20,000. A's action is improper.\footnote{The Illustrations in this paper are modified versions of the Illustrations to § 2.01 of PRINCIPLES OF CORPORATE GOVERNANCE, supra note 1. Illustration 1 in the text is based on Illustration 7 to § 2.01.}

It can be assumed that the amount of the payment demanded by the vice-president of X, plus the present value of a fine, discounted by the likelihood of detection, is less than the value of the contract. On a maximization or economic cost-benefit analysis, therefore, A should pay the bribe. Under the legal-conduct principle, however, the bribe should not be paid. Instead, A should obey the legal rule that prohibits bribery. Cost-benefit analysis may very well factor into a decision by a legislature or court as to what the law should be. Once that decision is made, however, private actors, including corporations, should not make a decision whether the benefits of disobeying the law would exceed the costs, except in the relatively rare case in which the sanction under the relevant legal rule is properly regarded as a price.

The legal-conduct principle is not inconsistent with the maximization principle. The maximization principle states what the objective of the corporation should be. The legal-conduct principle does not state a corporate objective, or modify the maximization objective, but merely lays down the channels within which that objective may properly be realized.

An analogy may be drawn to the rules of a game. The objective of playing a game is to win, or to excel, or to have a good time, or the like. Suppose we say that the objective of a game is to win. Following the rules of the game is not inconsistent with that objective, even when breaking the rules would make winning more likely. If a player asserted that she was justified in breaking the rules because doing so maximized her chances of winning, we would say that she simply doesn't understand what it means to play a game.
Essentially the same is true of any other objective of a game.

As with the rules of a game, so with the rules of law. A corporate actor who says that maximization justifies breaking the law doesn't understand what law means and doesn't understand what maximization means.

III. THE ETHICAL-CONDUCT PRINCIPLE

A second limitation of the maximization principle, embodied in section 2.01(b)(2), is that the corporation, in the conduct of its business, may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, even if shareholder gain is not thereby enhanced. I will call this the ethical-conduct principle. The reasons for this principle are comparable to the reasons for the legal-conduct principle. We don't want a society in which people are encouraged to become amoral when they become corporate executives. We don't want a society in which managers check their ethics at the door. Thus when Milton Friedman qualified his advocacy of profit-maximization by stating that this goal should be pursued only "while conforming to the basic rules of society," he added that those rules included not only the rules embodied in law, but also "those embodied in ethical custom."

Here is an illustration of the ethical-conduct principle:

2. Corporation B is a publicly held corporation with annual earnings in the range of $6–8 million. White, a longtime middle-manager of B, is forced to retire because of serious injuries sustained in an automobile accident. B has a pension plan covering White, but the plan was installed only recently, and White's benefits are only 80 percent vested. B's assets net of liabilities are $30 million. White is the only employee whom the liquidation will leave without retirement security. The relevant decisionmaker causes B to purchase an annuity, at a cost of $50,000, to bring White's retirement income up to a reasonable amount, partly because ethical considerations that B's officials reasonably regards as appropriate to the responsible conduct of business suggest that a business should make reasonable provision for a

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8. Friedman, supra note 6, at 33.
faithful long-term employee who has made a contribution to the business, and is forced by ill health to retire while in the corporation's employ. B's action is proper.9

Like the legal-conduct principle, and for the same reasons, the ethical-conduct principle is not inconsistent with the maximization principle. The maximization principle states what the objective of the corporation should be. The ethical-conduct principle does not state a corporate objective, or modify the maximization objective, but merely lays down rules within which the maximization objective may properly be realized.

Section 2.01(b) partly unpacks nonmaximizing corporate conduct, by breaking out for special treatment the legal-conduct principle and the ethical-conduct principle. In the next four parts of this paper I will further unpack conduct that is either nonmaximizing or appears to be so, by showing that important categories of such conduct can be justified by special principles that are either within or consistent with the maximization principle. I will then turn to the residual class of nonmaximizing conduct that is not justified by one of these special principles, and is therefore justified, if at all, only by a more general principle.

IV. THE PENUMBRA PRINCIPLE

Many forms of corporate conduct that are not squarely justified under the legal-conduct and ethical-conduct principles are nevertheless justified because they fall within the penumbras of those principles. I will call this justification the penumbra principle.

For example, the line between the humanitarian conduct of business and the ethical conduct of business can be very thin. As a result, the conduct of business in a humanitarian manner can often be justified on the ground that it falls within the penumbra of the ethical-conduct principle, even though the reason for the conduct is closer to a moral aspiration than to a moral obligation. Thus the purchase of the annuity in Illustration 2, supra, can be characterized, and justified, as humanitarian conduct as easily as it can be characterized and justified as ethical conduct. (Indeed, it is charac-

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9. Illustration 2 is a modified version of Illustrations 2 and 13 to Principles of Corporate Governance, supra note 1, § 2.01.
terized and justified on both bases in the *Principles of Corporate Governance*. This point is further exemplified by the following illustration:

3. *C*, a publicly held corporation, has assets of $100 million and annual earnings in the range of $13–15 million. *C* owns three aluminum plants, which are profitable, and one plastics plant, which is losing $4 million a year. The plastics plant shows no sign of ever becoming profitable, because of its very high operating costs, and there is no evidence that the plant and the underlying real estate will increase in value. *C* decides to sell the plastics plant.

The only person who bids on the plant is a real-estate developer who plans to close the plant and hold the land for investment. The developer is agreeable to leasing the plant back to *C* at a moderate rent for up to 12 months. *C* enters into a three-month lease, and continues to operate the plant during that period, at a loss of $500,000, so as to provide a period of adjustment to the employees at the plant prior to its closing. This action is taken partly out of humanitarian considerations, and partly because ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business suggest that an enterprise should make reasonable provision to cushion the transition of long-term employees who are about to be discharged. *C*'s action is proper.

Just as the conduct of business in a humanitarian manner may fall within the penumbra of the ethical-conduct principle, so the use of corporate resources to further social welfare may fall within the penumbra of the legal-conduct principle. This is most likely to be the case where the corporation acts in the spirit of a clearly defined public policy. Here is an illustration:

4. Corporation *D* is a large publicly held corporation engaged in the manufacture of powerful computers, with annual earnings of $60–70 million. *D* has been negotiating with a North African country for the sale of three computers.
Negotiations were essentially complete, and a contract ready to sign, when the State Department announced that within the next few days the President would adopt an executive order prohibiting the shipment of certain high-technology products to that country, because its conduct was highly inimical to the United States and threatened the stability of the entire area. The State Department also announced that the prohibition would not be applied to contracts made before the order became effective, but urged voluntary compliance as of the date of the announcement. It was clear that when the executive order became effective it would apply to D's computers. D estimates that the sale would generate earnings of $6 million, and that short- and long-term costs entailed by completing the sale would not be significant. D nevertheless decides not to sign the contract, because its officials believe that sale of the computers would contravene a strong and clearly announced national policy. D's action is proper.  

To take another example, a corporation that conducts its business in such a way as to further the purpose of, or to aid in, a social policy that is clearly embodied in a statute that prohibits discrimination would be justified as within the penumbra of the legal-conduct principle, even if the conduct is not required by the statute.

V. THE RECIPROCITY PRINCIPLE

Still another principle that justifies certain corporate conduct that appears to be nonmaximizing is the reciprocity principle. Under this principle, a corporation may properly make compensation for a benefit it has received, even though it is not legally obliged to pay for the benefit. The reciprocity principle is not inconsistent with the maximization principle, because it does not involve pure benevolence — any more than, say, a tip to a waiter, or a reward paid to a person who has found and returned lost property.

A recent Delaware case, *Zupnick v. Goizueta*, brings out the relationship between maximization and reciprocity in a particularly clear manner. For fourteen years, Roberto Goizueta was the CEO of

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12. Illustration 4 is a modified version of Illustration 22 to PRINCIPLES OF CORPORATE GOVERNANCE, supra note 1, § 2.01.
Coca-Cola.\textsuperscript{14} During those years, Coca-Cola had made exceptionally high profits and the market value of the company had increased by nearly $69 billion.\textsuperscript{15} In 1995, Coca-Cola's board granted to Goizueta extremely valuable options to purchase one million Coca-Cola shares.\textsuperscript{16} The options were exercisable on retirement.\textsuperscript{17} Since Goizueta was then eligible for retirement, he could have exercised the options on the day they were granted.\textsuperscript{18}

Coca-Cola's proxy statement said that the option grant was a form of retroactive compensation — a bonus for extraordinary services that had substantially benefitted Coca-Cola, but that Goizueta had been contractually obliged to perform.\textsuperscript{19} A shareholder attacked the option award on the ground that the board could not lawfully award retroactive compensation.\textsuperscript{20} Defendants moved to dismiss.\textsuperscript{21} In ruling on the motion, Vice-Chancellor Jacobs began by quoting from \textit{Blish v. ThompsonAutomatic Arms Corp.},\textsuperscript{22} in which the Delaware Supreme Court addressed the issue whether retroactive compensation could be proper:

The appellant's argument [that the retroactive salary increase was improper] is based upon the general rule that once an officer's salary has been fixed for a given period the Directors cannot at a subsequent meeting raise the [executive's] salary and make their action retroactive. This is so, says the appellant, for the reason that the retroactive feature of the salary . . . must be regarded as being without consideration, since the amount of salary to [the executive] had been fixed by previous agreement and the services had been performed.

Conceding the general rule to be as stated, nevertheless, we find its application subject to two well recognized exceptions: (1) Where an implied contract is shown; (2) Where the amount awarded is not unreasonable in view of the services rendered.

We conclude from the evidence that the services rendered by [the executive] were unusual in character and extraordinary, from which [the corporation] received great gains and profits; therefore,

\begin{itemize}
  \item \textsuperscript{14} See \textit{id.} at 385.
  \item \textsuperscript{15} See \textit{id.}
  \item \textsuperscript{16} See \textit{id.}
  \item \textsuperscript{17} See \textit{id.}
  \item \textsuperscript{18} See \textit{id.}
  \item \textsuperscript{19} See \textit{Zupnick}, 698 A.2d at 386.
  \item \textsuperscript{20} See \textit{id.}
  \item \textsuperscript{21} See \textit{id.} at 385.
  \item \textsuperscript{22} 64 A.2d 581 (Del. 1949).
\end{itemize}
the retroactive feature of [the executive’s] increases in salary... were proper under the second exception as noted above.23

On this basis, Vice-Chancellor Jacobs dismissed the complaint in \textit{Zupnick v. Goizueta}:

In this case, the pleaded facts establish (for present purposes) that reasonable, disinterested directors could have concluded — and in this instance did conclude — that Goizueta’s past services were of that [extraordinary] character and that the resulting benefit to the corporation was of that [great] magnitude.24

Just as Coca-Cola could properly make a payment to Goizueta for the past benefits it had received from his leadership, under the reciprocity principle, a corporation could, for example, properly make payments to local nonprofits, like Community Chest or Red Cross, in the community in which the corporation is operating, to compensate for the benefits that the corporation has received from operating in a community that has those programs, such as helping the corporation attract and retain desirable employees.

The reciprocity principle is normally self-limiting: It applies only to cases where the corporation is making compensation for a benefit, and it justifies only compensation that is reasonably proportionate to the benefit.

\textbf{VI. THE PRISONER’S DILEMMA PRINCIPLE}

The prisoner’s dilemma is a generic name for the dilemma that actors face when (1) they can maximize their joint and individual utility by taking a given action, but (2) they cannot secure binding commitments from each other to take that action, and (3) in the absence of such a commitment, the best course for each actor is to chose a second- or third-best alternative. Here is a full statement of the prisoner’s dilemma, by Robert Cooter and Tom Ulen:

Two people, \textit{Suspect 1} and \textit{Suspect 2}, conspire to commit a crime. They are apprehended by the police outside the place where the crime was committed, taken to the police station, and placed in separate rooms so that they cannot communicate. The authori-

\begin{itemize}
  \item [23.] \textit{Zupnick}, 698 A.2d at 388 (alterations in original) (quoting \textit{Blish}, 64 A.2d at 606–07).
  \item [24.] Id.
\end{itemize}
ties question them individually and try to play one suspect against the other. The evidence against them is circumstantial — they were simply in the wrong place at the wrong time. If the prosecutor must go to trial with only this evidence, then the suspects will have to be charged with a minor offense and given a relatively light punishment — say, one year in prison. The prosecutor would very much prefer that one or both of the suspects confesses to the more serious crime that they are thought to have committed. Specifically, if either suspect confesses (and thereby implicates the other) and the other does not, the non-confessor will receive 7 years in prison, and as a reward for assisting the state, the confessor will only receive one-half of a year in prison. If both suspects can be induced to confess, each will spend 5 years in jail. What should each suspect do — confess or keep quiet?

... Each suspect has two strategies: confess or keep quiet.

... If Suspect 1 confesses and Suspect 2 also confesses, each will receive 5 years in prison. ... If Suspect 1 confesses and Suspect 2 keeps quiet, Suspect 1 will spend half a year in prison, and Suspect 2 will spend 7 years in prison. If Suspect 1 keeps quiet and Suspect 2 confesses, then Suspect 2 will spend half a year in prison, and Suspect 1 will spend 7 years in prison. ... Finally, if both suspects keep quiet, each will spend 1 year in prison.

We now wish to explore what the optimal strategy — confess or keep quiet — is for each player. ... Let's consider how Suspect 1 will select her optimal strategy. Remember that [Suspect 1 and Suspect 2] are being kept in separate rooms and cannot communicate with one another.

First, what should Suspect 1 do if Suspect 2 confesses? If she keeps quiet when Suspect 2 confesses, she will spend 7 years in prison. If she confesses when Suspect 2 confesses, she will spend 5 years. So, if Suspect 2 confesses, clearly the best thing for Suspect 1 to do is to confess.

But what if Suspect 2 adopts the alternative strategy of keeping quiet? What is the best thing for Suspect 1 to do then? If Suspect 2 keeps quiet and Suspect 1 confesses, she will spend only half a year in prison. If she keeps quiet when Suspect 2 keeps quiet, she will spend 1 year in prison. Again, the best thing for Suspect 1 to do if the other suspect keeps quiet is to confess.

Thus, Suspect 1 will always confess. Regardless of what the other [suspect] does, confessing will always mean less time in prison for her. ...

Because the other suspect will go through precisely the same calculations, he will also confess. Confessing is the dominant strategy for each [suspect]. The result is that the suspects are both
going to confess, and, therefore, each will spend 5 years in pris-
on.\textsuperscript{25}

The bite of the prisoner’s dilemma is that the best strategy for
each of the suspects — confession — is not the strategy that will
maximize their welfare. The prisoners’ best strategy, if they could
secure binding commitments from each other, would be to keep
quiet, rather than to confess. As Cooter and Ulen point out:

\[\text{[Confessing] is not a Pareto-efficient solution to the game.} \]
\[\text{When both suspects confess, they will each spend 5 years in pris-} \]
\[\text{on. It is possible for both players to be better off. That would hap-} \]
\[\text{pen if they would both keep quiet.}\textsuperscript{26}\]

Corporate conduct often appears to be nonmaximizing only
because of the prisoner’s dilemma. To take a dramatic example,
suppose America is at war. \textit{C} Corporation devotes corporate re-
sources for the purpose of furthering the war effort, rather than for
maximizing the profits on the commodities it produces and sells —
for example, by holding down prices to prevent inflation.

It may appear that \textit{C}’s action is not consistent with maximiza-
tion. However, that isn’t necessarily the case. Assume that it is in
the economic interest of all American corporations that America
should win the war, and as soon as possible. It would therefore be
profit-maximizing for all corporations to devote resources to the war
effort. But \textit{C} and other corporations may seem to face a prisoner’s
dilemma. If they all devoted resources to the war effort, they would
all be better off. In the absence of a mutually binding commitment,
however, each corporation may believe that if it contributes, other
corporations won’t and will free-ride on its contributions or, alterna-
tively, that it need not contribute because it can free-ride on the
contributions of others. As a result, no corporation may contribute
to the war effort even though, by hypothesis, the maximizing solu-
tion would be for all corporations to contribute to the war effort.

Here is another, less dramatic but more salient case. Suppose
that \textit{D} Corporation makes contributions to education. Again, such a
use of corporate resources may not appear to be maximizing. But
suppose that all American corporations believe that they will maxi-
mize profits if Americans are better educated, because better educa-

\textsuperscript{25} \textit{ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS} 33–35 (2d ed. 1997).
\textsuperscript{26} \textit{Id.} at 35.
tion provides a better pool of potential employees and tends to improve the economy as a whole. More particularly, suppose that certain classes of American corporations believe they will maximize profits if a certain type of education — for example, computer-science education — is improved. It would therefore be profit-maximizing for these corporations to devote resources to computer-science education, if they could secure mutually binding commitments from each other to make such contributions. (Of course, it might turn out ex post that some of the corporations would gain more than others, but the important thing is that ex ante there is a probability that all the corporations will gain.)

The dilemma, therefore, is that activity which, by assumption, would be profit-maximizing if engaged in as a result of mutual binding commitments, might not be undertaken in the absence of such commitments, even though a failure to engage in such activity is a second-best choice in terms of maximizing profits.

There is, however, a way out. The prisoner's dilemma may not bite where the interactions between the relevant actors do not have a finite limit. As stated by Cooter and Ulen:

> Things may be different if the game is to be repeated an indefinite number of times. In those circumstances there may be an inducement to cooperation. Robert Axelrod has shown that in a game like the prisoner’s dilemma repeated an indefinite number of times the optimal strategy is *tit-for-tat* — if the other player cooperated on the last play, you cooperate on this play; if she didn’t cooperate on the last play, you don’t on this play.\(^{27}\)

With this background, it can be seen that certain kinds of conduct that do not appear to be maximizing can be justified under the maximization principle on the ground that the conduct *is* maximizing if engaged in by all or a sufficient number of corporations.

For example, suppose \(E\) is in some sector of the computer business. \(E\) may observe that all other relevant corporations, although not committed to engage in computer-science education, engage in such conduct in fact. If \(E\) reasonably believes that this pattern will persist, \(E\)'s use of resources for such education will be profit-maximizing, at least while \(E\) continues to observe corresponding behavior by other corporations.

Furthermore, even if *all* corporations don’t do their share, \(E\)
might believe that contributions to computer-science education are profit-maximizing as long as the level of corporate resources devoted to that activity is sufficiently high that \( E \) will benefit even though some corporations free-ride. For example, each of IBM, Compaq, Sun, Microsoft, Intel, and Oracle may believe it is profit-maximizing to devote resources to computer-science education if the others do, even if Apple, Sybase, and other smaller players do not.

I will call the principle that a corporation may properly devote resources to a purpose that would be profit-maximizing if all similarly situated corporations devoted their fair share of resources to that purpose the \textit{prisoner's dilemma principle}. This principle is, of course, not limited to wars and education. It may apply as well, for example, to contributions by local corporations to local nonprofit organizations that provide important services to local employees and thereby assist local corporations in attracting and retaining good employees.

The prisoner's dilemma principle is to a large extent self-limiting. The principle only justifies activities that would be profit-maximizing if all or a sufficient percentage of corporations (or corporations of a certain class) engaged in the activity. Furthermore, it only justifies a corporation in shouldering its fair share of the relevant activity.

\textbf{VII. THE SHEEP'S CLOTHING PRINCIPLE}

Often, the use of corporate resources for conduct that appears to be nonmaximizing can be justified on a straight maximizing basis, because it is simply a special form of ordinary business expense. For example, General Motors subsidizes Ken Burns in making his documentaries for public television.\textsuperscript{28} GM gets the same kind of economic benefit from these subsidies that it would get from a conventional corporate commercial: it gets its name associated with a classy product and it gets to put a fifteen-second commercial before and after the documentary.

Similarly, the \textit{Wall Street Journal} recently reported that United Air Lines is dramatically increasing its market share of traffic at Los Angeles International Airport.\textsuperscript{29} The story noted that

\begin{itemize}
  \item \textsuperscript{28} See Marc Gunther, \textit{The New Adventures of Lewis & Clark}, \textit{FORTUNE}, Nov. 10, 1997, at 60.
\end{itemize}
"because [the City of] Los Angeles is a strategic priority [for United, Los Angeles] also is getting the lion’s share of United’s advertising, charitable giving and training dollars." In other words, United is using charitable giving as a tool to maximize revenues and, thereby, profits.

It seems fairly safe to assume that GM publicly presents its subsidies to Ken Burns as public-spirited, and that United publicly presents its gifts to Los Angeles charities as charitable giving. But if these donations are in fact ordinary business expenses, why not publicly present them as business expenses? The answer is that

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30. Id.
31. This type of giving has been perfected to a fine art in cause-related marketing (CRM) and corporate special-events sponsorships (CSE). CRM and CSE are described as follows by Faith Kahn:

   The distinguishing feature of a CRM program is that the firm’s commitment to transfer a percentage of the revenues earned from the promotion to the specified charitable organizations is used as the basis of an appeal to consumers. The popularity of CRM from the corporate perspective has been based on its consumer appeal and on the ability of corporations to adapt CRM promotions to their precise commercial needs. . . . In addition, CRM promotions have often garnered attention from the news media, so the participating corporations (and charities) have frequently received favorable publicity independent of their own advertising.

   While CRM promotions have generally proved beneficial for the participating charitable organizations, they are fundamentally regarded both by the business community and by nonprofit leaders as part of corporate marketing efforts. The essential marketing thrust of CRM promotions is illustrated, for instance, by the fact that contributions arising from CRM promotions are typically funded from advertising and marketing budgets, as opposed to corporate philanthropy budgets. . . .

   Like CRM programs, CSE sponsorships represent strategic partnerships from which both the corporation and the nonprofit organization anticipate financial benefits. Corporate executives have described CSE sponsorships as even more efficient than traditional advertising in terms of the cost of publicity in comparison to the resultant media exposure. The typical arrangement in CSE sponsorship is that the charity’s special event will prominently display the corporation’s name, logo, or products in exchange for the receipt of a substantial sponsorship payment. . . . Thus, CSE sponsorships are essentially exchange transactions in which the corporation receives substantial media exposure and favorable acknowledgements (if not “advertising”) in exchange for the contributions it makes to the nonprofit organization hosting the event. Highly flexible arrangements, CSE promotions can be coordinated with CRM programs as well as traditional advertising campaigns in order to produce the maximum favorable publicity for the corporation. The most common event sponsorships, for obvious reasons, have been arts performances and amateur athletic events — the regular and Special Olympics and college bowl football games being the most salient examples of the latter.

Kahn, supra note 2, at 686–69 (footnotes omitted).
part of the economic value GM and United derive from those activities is the manner in which the activities are publicly presented. When GM contributes to the cost of documentaries to be aired on public television, it looks like a good corporate citizen, and that aura presumably rubs off in various maximizing ways on GM’s business. If, on the other hand, GM publicly stated, “We really don’t care about improving people’s lives by contributing to these documentaries; instead, we do it to get a dollar-for-dollar benefit,” then GM would get less economic benefit, because it would not get the aura. The same is true for United. In other words, frequently a corporation can earn greater profits by appearing to be philanthropic than by appearing to maximize.

We shouldn’t be too cynical here. Ken Burns has been reported to say that GM is his Medici family, that is, that GM is a public benefactor who has taken Ken Burns on as a protege. And Ken Burns may be partly right. It’s hard to believe that GM isn’t aware of the business benefits of subsidizing Ken Burns. It’s not hard, however, to believe that GM has mixed motives here; that it subsidizes Ken Burns partly because it believes that the subsidies not only maximize profits but are also a public-spirited use of its pocket change. And something similar probably holds true of United’s charitable giving in Los Angeles.

Why should we put GM, United, or other corporations to the fire in such matters? Requiring corporations to publicly present a purely profit-maximizing justification for such activities would actually reduce profits. Furthermore, we don’t want to force executives who are doing something partly because they think it’s the right thing to do to falsely and opaquely justify their conduct as if their only motivation was to maximize. Accordingly, corporate conduct that appears to be within the social-conduct norm should be regarded as proper when it is essentially an ordinary business expense, regardless of how the conduct is publicly presented. I call this the sheep’s clothing principle.

It’s important to emphasize the narrow ambit of this principle. Often, conduct that appears to be nonmaximizing is publicly justified on the ground that it will maximize profits “in the long run.” Sometimes this is the real motivation for the conduct. For example, conduct that benefits employees in a manner not required by a con-

tract of employment may be justified on the ground that it improves morale and therefore productivity and loyalty. Conduct that benefits trading partners in a manner not required by contract, such as forgoing some contractual right, may be justified on the ground that it improves the likelihood of continued profitable relations with the trading partner.

Often, such justifications can be taken at face value. Sometimes, however, they are only fig leaves for directors and executives who either don't want to admit that they are being benevolent or don't want to be hassled for being benevolent. The sheep's clothing principle does not apply to conduct that looks as if it is nonmaximizing but is publicly presented as maximizing. Rather, the principle applies only to maximizing conduct that is publicly presented as nonmaximizing.

What about conduct that looks as if it is nonmaximizing but is publicly presented as maximizing? If that's the real motivation, and the conduct is rationally designed to be maximizing, then the conduct falls within the maximization principle. Even if the activity is not really motivated by the maximizing objective, it may be justifiable, despite the fact that it doesn't fall within one of the special principles considered so far, under the principle stated in the Principles of Corporate Governance section 2.01(b)(3), which will be considered in Part VIII. But the sheep's clothing principle will not justify such conduct.

VIII. THE SOCIAL-CONDUCT PRINCIPLE

Not all kinds of corporate conduct that appears to be or is nonmaximizing will be justified by the special principles considered so far. The question then becomes, what should be the treatment of these residual cases?

Recall that section 2.01(b)(3) of the Principles of Corporate Governance provides that the corporation, in the conduct of its business, may devote a reasonable amount of resources to public-welfare, humanitarian, educational, and philanthropic purposes, even if shareholder gain is not thereby enhanced. I will call this the social-conduct principle.

The residual kinds of conduct that fall within this principle are more difficult to deal with than the kinds of conduct that fall within the special principles developed above.

For example, the legal-conduct, ethical-conduct, and penumbra principles are by and large channels through which the stream of
business operations should flow, and conduct that falls within the reciprocity, prisoner's dilemma, or sheep's clothing principles involves at least a rough quid pro quo. In contrast, the use of corporate resources for public-welfare, humanitarian, educational, and philanthropic purposes that is not justified by those special principles may seem to divert the stream of corporate funds without a demonstrable quid pro quo.

A related problem is that a decision made on the basis of legality or ethics is likely to involve only a forgone profit, while the use of resources for public-welfare, humanitarian, education, or philanthropic purposes is likely to involve a diminution of the corporation's assets. From a strictly economic perspective, there may be no difference between a forgone profit and a diminution of assets. From a psychological perspective, however, there is a considerable difference.3

Furthermore, the social-conduct principle is not as strong as many of the special principles. For example, the legal-conduct and ethical-conduct principles concern kinds of conduct that are generally regarded as duties in our society. In contrast, conduct that falls within the social-conduct principle and is not justified by one of the special principles is normally regarded as an aspiration rather than as a duty. For example, a person who breaks the law or lies is viewed as a wrongdoer, but a person who fails to devote resources to educational purposes is not.

Moreover, the special principles are generally self-limiting, while the social-conduct principle is not. For example, a duty to act legally or ethically is only a limit on how to conduct business. It is not an open-ended tap into corporate resources. In contrast, a power to use corporate resources for the purposes specified in section 2.01(b)(3) may often have no inherent limit.

Finally, at least some of the types of conduct specified in section 2.01(b)(3) may involve conflicts of interest on the part of corporate officers or directors. In contrast, application of the special principles will rarely involve such conflicts.

It is important to keep this problem in perspective. The average level of corporate giving in America is around one percent of

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Much nonmaximizing corporate conduct is probably justified by one or more of the special principles. Accordingly, the residual cases that are justified (if at all) under the social-conduct principle almost certainly involve less than one percent of pretax income.

Putting the question in perspective still leaves the question. Certainly the prohibition of such residual conduct would be plausible. However, it would not be preferable. The corporation is a social actor. It benefits from the social climate. It is now widely accepted that the corporation should at least consider the social impact of its activities, so as to be aware of the social costs those activities entail. By implication, the corporation should be permitted to take such costs into account, within reason. Accordingly, the corporation should be permitted to take into account, within reason, public-welfare concerns relevant to groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of the communities within which the corporation operates. Social policy also favors humane behavior by major social institutions. Finally, social policy favors the maintenance of diversity in education and philanthropic activity, and this objective is facilitated by allowing corporations to devote resources, within reason, to those ends.

Accordingly, a corporation, in the conduct of its business, should be permitted to devote a reasonable amount of its resources for public welfare, humanitarian, educational, and philanthropic purposes, even if the conduct is not justified by one of the special principles developed above. Whether a corporation's use of resources in this way is reasonable depends on all the circumstances of the case. The principal factors to be considered are the customary level at which resources are devoted to such purposes among comparable corporations, in proportion to earnings and assets, and the strength of the nexus between the use of corporate resources and the corporation's business.

Here are two illustrations of the reasonableness principle in cases where there is no meaningful nexus between the corporate conduct in question and the corporation's business:

34. See American Association of Fund-Raising Counsel, Giving Reaches $150.7 Billion (visited Apr. 15, 1998) <http://www.aafrc.org/NEWS.htm> (describing 1996 corporate contributions as "about 1.3% of pretax income, approximately the same rate of giving as the past three years").
5. F Cement Company is a publicly held corporation with assets of approximately $125 million and annual earnings in the range of $15 million. All of F's facilities are located in the western United States, and the nature of the cement business is such that F cannot practicably make sales outside the region. On the basis solely of philanthropic considerations, F makes an anonymous donation of $3 million to a local-history museum in New York city. F's action is improper. A contribution equal to approximately 20 percent of F’s annual earnings for a use that lacks any meaningful nexus to F’s business is not reasonable. The contribution cannot be justified under the maximization principle, because it is not motivated by profit considerations and, given the nature of F's business, there would be no basis for concluding that the contribution would increase either short- or long-term profitability.

6. The facts being otherwise as stated in Illustration 5, F donates only $1,000 to the museum. F’s action is proper. Based on present corporate practice, contributions of relatively small amounts for public-welfare, humanitarian, educational, or philanthropic purposes are normally reasonable even though a clear nexus to the corporation’s business is lacking.\(^5\)

I now consider an illustration of the reasonableness principle in which there is a nexus between the corporation’s conduct and the corporation’s business, but the amount involved is disproportionate to the strength of the nexus. Recall the facts of Illustration 3: C, a publicly held corporation, has assets of $100 million and annual earnings in the range of $13–15 million. C owns three aluminum plants, which are profitable, and one plastics plant, which is losing $4 million a year. The plastics plant shows no sign of ever becoming profitable, because of its very high operating costs, and there is no evidence that the plant and the underlying real estate will increase in value. C decides to sell the plastics plant but leases the plant back for three months to provide the employees at the plant a period of adjustment prior to its closing. The conclusion was that

\(^{35}\) Illustrations 5 and 6 are based on Illustrations 15 and 16 to PRINCIPLES OF CORPORATE GOVERNANCE, supra note 1, § 2.01.
this conduct was proper. The facts in the following illustration are the same, except that:

7. The only bidder for the plant is Gold, who intends to use the plant for a new purpose, introduce automation, and replace all existing employees. C turns down Gold's bid and keeps the plastics plant operating indefinitely for the purpose of preserving the employees' jobs. C's action is improper. The action is for a humanitarian purpose, but the expenditures involved are unreasonable in amount in relation to earnings. C's action cannot be justified under the ethical-conduct principle, because a corporation is not ethically obliged to continue indefinitely the operation of a business that is losing large amounts of money, equal to more than one fourth of the corporation's earnings, for the purpose of keeping workers employed. The action cannot be justified under the maximization principle, because the action is not motivated by profit considerations, and on the facts it would not be within the realm of business judgment to conclude that the action will result in short- or long-term profits exceeding the costs involved.\(^{36}\)

The results of Illustrations 3 and 7 strikingly parallel the manner in which Warren Buffett conducts the business of Berkshire Hathaway, the publicly owned corporation he owns in significant part. As discussed by Henry Hu:

[C]orporate managers often resort to a fig leaf when they take actions or adopt a policy that is "socially responsible" but costly to shareholders. Although such actions or policies hurt shareholders in the short run, they are said to be conducive to maximization of shareholder wealth in the long run.

Buffett does not take this easy route. He says explicitly that he is willing to sacrifice the financial interests of shareholders in favor of "social" considerations. He states that he and [his associate Charles] Munger share one attitude that hurts Berkshire's financial performance: "[w]e are . . . very reluctant to sell sub-par businesses as long as we expect them to generate at least some cash and as long as we feel good about their managers and labor

\(^{36}\) Illustration 7 is based on Illustration 20 to PRINCIPLES OF CORPORATE GOVERNANCE, supra note 1, § 2.01.
relations.” He further notes:

We hope not to repeat the capital-allocation mistakes that led us into such sub-par businesses. And we react with great caution to suggestions that our poor businesses can be restored to satisfactory profitability by major capital expenditures. . . . Nevertheless, gin rummy managerial behavior (discard your least promising business at each turn) is not our style. We would rather have our overall results penalized a bit than engage in that kind of behavior.

In 1985, Buffett finally closed down Berkshire’s struggling textile business, perhaps about ten years after it should have been closed down. In explaining his decision to close Berkshire’s textile business despite the impact of its closing on the local economy, Buffett wrote:

I won’t close down businesses of sub-normal profitability merely to add a fraction of a point to our corporate rate of return. However, I also feel it inappropriate for even an exceptionally profitable company to fund an operation once it appears to have unending losses in prospect. Adam Smith would disagree with my first proposition, and Karl Marx would disagree with my second; the middle ground is the only position that leaves me comfortable.37

IX. CONFLICTS OF INTEREST AND DISCLOSURE

Maximizing conduct raises a problem when it involves a conflict of interest. So does nonmaximizing conduct. The most obvious type of conflict is that in which Corporation C makes a contribution to Nonprofit N, and an officer, director, or controlling person of C is also an officer or trustee of N. Such contributions may be made to further the interest of the insider, rather than either the corporate interest or the social interest. I will call contributions of this sort conflict-of-interest contributions.

A notorious case of this kind involved Occidental Petroleum Corporation and its then-CEO, Armand Hammer. Armand Hammer was a famous art collector. He had long planned to give his art

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Nonmaximizing Corporate Conduct

collection to the Los Angeles County Museum. However, when that museum balked at naming galleries after Hammer, he decided to have Occidental build a museum to house his collection. The museum would be named Armand Hammer Museum of Art and Cultural Center. It would be built next to Occidental Headquarters. Occidental would construct the new Museum building, renovate portions of four floors of its adjacent headquarters for use by the Museum, construct a parking garage beneath the Museum, and lease the new building and the renovated headquarters floors to the Museum rent-free for 30 years. The cost of the new building was originally estimated at $50 million, but later ballooned to $86 million. In addition to paying for the cost of the new building and the renovations, Occidental would pay the property taxes and would purchase a 3-year annuity at a cost of $35.6 million to provide funding for the Museum’s initial operations. Occidental would be allowed to name the Museum’s courtyard, library, or auditorium, would have the right to use the Museum for functions, and would be entitled to corporate sponsor rights.

Occidental shareholders filed a suit objecting to the transaction. The suit was settled under an agreement that, among other things, limited Occidental’s contributions for the building to $50 million plus up to $10 million for cost overruns. The Delaware Chancery Court approved the settlement with great reluctance: “If the Court was a stockholder of Occidental it might vote for new directors, if it was on the Board it might vote for new management and if it was a member of the Special committee it might vote against the Museum project. But its options are limited in reviewing a proposed settlement . . . .”


It's not easy to figure out how to deal with the problem raised by conflict-of-interest contributions. Certainly, the mere possibility that philanthropic contributions may involve conflicts of interest should not be a reason for prohibiting corporate conduct that falls within the social-conduct norm, any more than the mere possibility of conventional conflicts of interest is a reason for prohibiting corporations from engaging in conventional business transactions.

One possibility would be to prohibit conflict-of-interest contributions. That's not quite as draconian as it might sound. The world of nonprofits might be thought of as a sort of market. If Corporation C is prohibited from contributing to Nonprofit N, C will often be able to find a comparable nonprofit that does not raise a conflict-of-interest problem. However, nonprofits are often not fungible, especially in the case of local charities. Furthermore, local nonprofits often want officers or directors of local corporations on their boards, not only to attract contributions from the corporations, but also because of the abilities and contacts of such officers and directors and the cachet they carry.

Instead of a prohibition, therefore, a three-part design should be adopted to deal with the conflict-of-interest problem.

First, the existence of a conflict-of-interest should be a factor in determining whether a philanthropic contribution satisfies the reasonableness test.40

Second, if it is shown that a director, officer, or controlling person derived a substantial individual benefit from a contribution — as in the Occidental case, where the new Museum would both house Armand Hammer's collection and be named after him — the burden should be on the director or officer to establish the reasonableness or fairness of the contribution.

Third, the SEC Proxy Rules should be amended to require appropriate disclosure of conflict-of-interest contributions. One approach would simply be to extend the existing Proxy Rules to require disclosure of a conflict-of-interest contribution that would have to be disclosed if it was a conflict-of-interest payment for a commodity. The problem with this approach is that the reporting threshold would be set too high. When a payment is made for a commodity, the corporation gets something material in return, so

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40. See Davis, supra note 2, at 73.
that even if the payment is inflated by a premium due to self-interest, the premium will only be a fraction of the entire payment. In contrast, a corporation that makes a conflict-of-interest contribution may receive nothing material in return, so that the entire amount of the contribution might be unreasonable. Accordingly, a better approach would be to set a threshold of, say, $10,000 or $20,000, at which conflict-of-interest contributions must be disclosed.

It would also be desirable to require annual disclosure of the total amount of a publicly held corporation's philanthropic giving, together with a list of the beneficiaries who have received more than a designated amount and the amount those beneficiaries received. A requirement of such disclosure would be based on the concern that even when philanthropic contributions involve no conflict of interest and can be justified under one of the principles considered in this paper, they are sufficiently different from normal maximizing conduct that their extent and nature should be made open for evaluation. However, because the reasons for such disclosure differ from the reasons for conflict-of-interest disclosure, the nature of such disclosure may also differ. For example, such disclosure might be made in media other than the proxy statement, and the minimum amounts at which disclosure of particular contributions must be made could differ from the minimum amounts at which disclosure of conflict-of-interest contributions must be made.41

X. CONCLUSION

Corporate philanthropy, or more generally nonmaximizing corporate conduct, has posed a continuing puzzle in corporation law. On the one hand, nonmaximizing conduct seems hard to square with the maximization principle, which is widely, although not universally, accepted by the legal profession. On the other hand, corporations routinely engage in such conduct. On the surface, therefore, there seems to be a radical tension between corporate theory and corporate practice.

The tension, however, is more apparent than real. To begin with, following legal or ethical rules does not raise an issue of nonmaximization. Rather, as Milton Friedman points out, maximization has to be understood as a process that occurs within a legal

41. For a discussion of disclosure, see generally Kahn, supra note 2, at 624–25, 674–75.
and ethical framework.

Next, much corporate conduct that appears to be nonmaximizing, and is not legally or ethically required, is consistent with the maximization principle, because the conduct is within the penumbra of legal or ethical duties; is based on reciprocity for past benefits; would be maximizing if engaged in (and is actually engaged in) by other, similarly situated corporations; or is maximizing conduct that is simply presented as nonmaximizing. Finally, the use of corporate resources for public-welfare, educational, scientific, and philanthropic purposes should be permitted, even though neither maximizing nor consistent with maximization if, but only if, the conduct satisfies a reasonableness test based on the nexus between the conduct and the corporation's business and the amounts involved, and any conflicts-of-interest are properly disclosed and controlled.