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DEFINING THE CORPORATE OBJECTIVE AND IMPLICATIONS FOR PHILANTHROPY

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Defining the Corporate Objective and Implications for Philanthropy

My purpose today is to address the question of defining the corporate objective, as a matter of sound policy, and then to consider the implications of that definition for corporate responsibility and corporate philanthropy.

What Should The Corporate Objective Be?

Debate over the proper purpose of the business corporation in America has been lively and continuous throughout the Twentieth Century. The traditional view was that the corporation existed to attract capital for the production and sale of goods and services at a profit, all for the benefit of its shareholders. Some have called this theory profit maximization. It was rooted in notions of free market competition. Directors and officers, acting with reasonable care and in good faith to carry out this mandate, were protected against errors of judgment by the so-called "business judgment rule." Even while profit-maximizing, the corporation was expected to comply with the law. And it was through the substantive laws at the local, state and federal level that the profit seeking efforts of the corporation were to be modulated in response to recognized needs of customers, employees, communities, suppliers and society at large.

This traditional view, in fact, has weathered many a storm. Over the years, repeated efforts by business theorists and reformers have sought to broaden the responsibilities of corporations -- particularly the largest ones -- to embrace social as well as economic goals. The problem for these reformers, however, was always the same -- to define the broader system so as to preserve accountability. Beyond its role in fostering competition, the profit-maximizing theory made it possible to judge management's performance and to limit the growing power of corporations. Adolf Berle wrote in 1932 "that you cannot abandon 'emphasis on the view that business corporations exist for the sole purpose of making profits for their shareholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else."

Thirty years later, Professor Milton Friedman echoed the theme:

The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners, or the staff.

> "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible.... [I]f businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can self-elected private individuals decide what the social interest is?"

And, from the legal side, in his important study of Corporate Responsibility in a Changing Society, Professor Phillip Blumberg concluded flatly that as of 1970 "[s]ingle-minded pursuit of shareholder interest remains the legal standard for corporate conduct."

Despite these conclusions, efforts to broaden the corporate mission have continued. Ralph Nader and his colleagues have argued that the large corporations are responsible not just to shareholders, but to many other constituencies, including workers, consumers, local communities, taxpayers, small business and future generations. Yet, the argument goes, corporations remain accountable to none, save the shareholders. The Nader solution would be to put on the corporate boards representatives of these different constituencies.

During the decade of the 70's the chorus of those critical of the social role of our corporations grew louder and more strident, assisted no doubt by the disclosures of illegal and questionable payments made by many of our large corporations, both domestically and abroad. Corporate management became increasingly concerned that Congress might redefine both the objective of the business corporation and how that objective was to be achieved. In short, a federal corporation law. One response to this threat has been for some business leaders to adopt a rhetorical redefinition of the corporate purpose along lines parallel to those espoused by Nader and other corporate reformers. It is this response and its implications that I wish to talk about today. I foresee an interesting paradox in the making if corporate management continues to accept the perception of the corporate mission espoused by the reformers. In an effort to deflect legislative initiatives, they may be assuring that legislation eventually materializes in order to make management accountable to the broader constituencies newly embraced by corporate management.

Let's look at some recent expressions of what the corporate objective ought to be.

The Business Roundtable Statement

In 1981 The Business Roundtable published a Statement on Corporate Responsibility, which reached the following conclusions:

> "Their [the corporation's] importance to the well-being and quality of life of the average person has created perceptions and expectations that go far beyond what many considered their historic purpose, which was the creation of goods and services at a profit."
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> * * *
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> "Corporations operate within a web of complex, often competing relationships which demand the attention of corporate managers. The decision-making process requires an understanding of the corporation's many constituencies and their various expectations."

The constituencies are then described in the Statement as including customers, employees, communities, society at large, suppliers and shareholders.

> "Balancing the shareholder's expectations of maximum return against other priorities is one of the fundamental problems confronting corporate management. The shareholder must receive a good return but the legitimate concerns of other constituencies also must have the appropriate attention."
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> * * *
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> "[E]conomic responsibility is by no means incompatible with other corporate responsibilities in society. In contemporary society all corporate responsibilities are so interrelated that they should not and cannot be separated."

Now this Statement, in its emphasis on management's need to serve many constituencies, including shareholders, and to balance their often competing interests, comes rather close to the position of Ralph Nader and his colleagues Mark Green and Joel Seligman, authors of Taming the Giant Corporation and promoters of the Corporate Democracy Act of 1980 -- legislation introduced as H.R. 7010 before the 96th Congress.

Consider Mark Green's argument for federal standards to broaden the duties of directors:

> "The goal of the standards ... is that there are constituencies and stakeholders other than shareholders and we should struggle to figure out how to give them either some voice in or access to the corporation itself and the managers who make the decisions. They should be somehow built into the process they are now excluded from, yet affected by."

Of course, the Business Roundtable Statement does not seek, as the Nader group did, to actually place on the Board individuals particularly responsible for these many constituencies. But they share the same new vision of a management accountable to many claimants beyond the shareholder group. Another important difference is their views on the need for legislation. The Nader group wants federal law to redefine the corporate objective and management's duties. The Business Roundtable appears to have moved away from the traditional view precisely to eliminate the need for new laws. As I hope to show, however, the large business corporations are perched on a slippery slope. Only the tether of the traditional view restrains their descent into unknown regions. By encouraging them to cast off that tether, the Business Roundtable may well invite the legislation it sought to avoid.

<u>The National Association of Manufacturers Statement</u>

In contrast to the Business Roundtable and the Nader group, the position of the NAM is decidedly traditional:

> "The National Association of Manufacturers reaffirms that corporations are instruments of their shareholders. Accordingly, directors and managers of corporations have a continuing legal responsibility to protect the property and investment of shareholders by competing within our system of free enterprise."

* * *

> "The National Association of Manufacturers recognizes the legal accountability of management to the board of directors and shareholders as essential to the effective governance and operation of corporations."

* * *

> "Corporate accountability should be restricted to relationships with shareholders where the economic interests and fiduciary responsibilities are clear."

The American Law Institute Proposal

Some three years ago the American Law Institute embarked on a study of the governance and structure of the business corporation. We now have Tentative Draft No. 1, a Restatement and Recommendations on Principles of Corporate Governance and Structure. In it, the objective and conduct of the business corporation are defined as follows:

> "Corporate law should provide that the objective of the business corporation is to conduct business activities with a view to corporate profit and shareholder gain, except that, even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business
>
> (a) is obliged, to the same extent as a natural person, to act within the boundaries set by law,
>
> (b) may properly take into account ethical principles that are generally recognized as relevant to the conduct of business, and
>
> (c) may devote resources, within reasonable limits, to public welfare, humanitarian, educational and philanthropic purposes.

While stated in somewhat novel fashion, the American Law Institute principles conform to the traditional view of the corporate role and are generally in line with current law and practice. Thus the ALI, too, stands in contrast to the positions of the Business Roundtable and the Nader group.

Problems with the Business Roundtable and the Nader Group Approaches

The differences between the Business Roundtable and the Nader group, on the one hand, and the NAM and ALI, on the

other, I submit, are not just blemishes to be overlooked. They provide us with a fascinating peek into the minds of some of our outstanding leaders in business and law. They offer a distinct choice -- one which, I believe, could have a profound impact on the governance of corporations in the future. Although I am deeply sympathetic with the aspirations expressed so well in the Business Roundtable Statement, I think they are ill-conceived. I see major problems with the Business Roundtable approach and the Nader group approach as well. Let me summarize them for you.

1. Measurement of performance becomes exceedingly difficult. Accountability becomes so diffuse as to be practically meaningless. The "business judgment rule," as applied to their definitions of the corporate objective, would permit any action justifiable in terms of one of the many diverse constituencies. The traditional concept of corporate waste would seem to become all but abandoned. Liability of directors and officers to shareholders or to the corporation for acts of mismanagement or breach of fiduciary duty would become a remote possibility. The fiduciary obligations of directors and officers to shareholders would become attenuated at best. The classic duty of care -- owed to shareholders -- would be diluted by similar duties to many other constituents, and the classic duty of loyalty would be virtually eliminated.

2. The progression noted by Berle & Means would be extended to the next and final step. First, as observed by Berle & Means, control of the corporation (resting in the hands of management) was separated from ownership (resting in the hands of shareholders). Under this scheme, at least the directors remained strictly accountable to the shareholders, and only the shareholders, for decision-making in their best interest. Now, with this new definition, the shareholders would be relegated to the status of but one constituency among many to whom the corporation is responsible --including such constituencies as customers, employees, communities, suppliers and society at large. This ideology seems to abandon any notion of a shareholder as owner of the corporation, to whom the directors and officers are accountable as fiduciaries. Once the responsibilities of management are defined to include many different constituents with often competing claims, the notion of a fiduciary becomes difficult to apply. One emerges from a reading of the Business Roundtable Statement, in particular, with the idea that <u>management</u> owns the corporation, with diverse and often conflicting responsibilities to many different constituencies. This, in my judgment, is a formula for achieving accountability to none.

3. The corporation would assume quasi-governmental powers and responsibilities, but without the Madisonian checks and balances which have been the keystone to our democratic

system of government, at federal, state and local levels. This country does not easily accept aggregations of property and power unchecked by any form of accountability. If corporations are successful in describing their objectives as quasi-governmental, in the manner suggested by the Business Roundtable and the Nader group, they will invite governmental interference in the management of their affairs. I view this trend, whether espoused by so preeminent a business organization as the Business Roundtable or by so well known a "public citizen" as Ralph Nader as dangerous to our free enterprise system.

4. These approaches would also be inconsistent with notions of competition and entrepreneurship.

The NAM and ALI Approaches Are Sound

The approaches taken by the NAM and ALI are sound. I will elaborate briefly on the ALI Statement, because it is more specific and also because it addresses the philanthropic issue.

Under the ALI approach, the goal is corporate profit and shareholder gain, within the constraints of law. This is the economic purpose, and is consistent with present corporate law. The ALI Statement goes on to permit, but not compel, generally recognized ethical principles relevant to the conduct of business and the application of a reasonable amount of corporate resources to various social purposes, even though corporate profit and shareholder gain are not thereby enhanced. In the comment to the ALI Statement, the observation is made that, in most cases, these kinds of conduct could be pursued under the economic purpose test, because such conduct would usually be consistent with self-interest.

The purpose of these exceptions to a strict approach to profit maximization, I believe, is to enable the corporate managers, without serious threat of lawsuit for corporate waste, to do what seems right to them, and in the best interest of the enterprise, even though it cannot be clearly demonstrated to foster or achieve profit maximization.

The critical difference between the ALI approach and that suggested by the Business Roundtable Statement is in maintaining the economic purpose -- profitmaking -- as the sole purpose, for which management is held strictly accountable to shareholders.

I believe that the nation will best be served by a corporate policy that

(i) preserves the notion that corporations exist to make profits for their shareholders through the sale of goods and services in vigorous competition with others and in strict compliance with law, and

(ii) holds management strictly accountable to shareholders for breach of their fiduciary duties of loyalty and of care, which are owed not to society at large but solely to shareholders.

I also believe that this corporate policy, if vigorously espoused and explained to the nation, will assist our business leaders in dealing with the public perception that corporations wield excessive power in our society. In a poll of public attitudes commissioned by the New York Stock Exchange shortly <u>after</u> President Reagan's election, 42% of the respondents said they wanted the new President to try to decrease corporate power. My concern is that the redefinition of corporate purpose suggested by the Business Roundtable expands, rather than contracts, corporate power and does so without offering any satisfactory system of accountability. The public will not long tolerate this arrangement.

The stakes for private enterprise as we now know it are high. Pressure from "the new left" for radical change may be building again, abetted by the prolonged recession and increasing unemployment. Robert Lekachman's new book entitled "Greed Is Not Enough" sketches out the alternative.

> "Liberal revival will accordingly be founded on initiatives radical in appearance for Americans, if not for Europeans. The place to begin is with recognition of the dominant position of the large corporation as employer, guarantor of community and regional prosperity, shaper of national investment policy, and manipulator of public opinion and electoral processes.
>
> Credible pursuit of full employment, reconstruction of urban communities, stable prices, and increased equity in the distribution of income and wealth requires effective political control of corporate policy and, in particular, regulation of investment."

How private enterprise chooses to define its role will be of major importance in determining the future course of this national debate.

Implications for Philanthropy

Under the Business Roundtable approach, and also that of the Nader group, philanthropy could, and perhaps would, occupy an important place in the priorities of management. Certainly management could, consistent with its broadly defined duties, give substantial support to social projects of its choice.

Under the ALI and NAM approaches, there would be flexibility, but not as much as the Business Roundtable would tolerate.

In my own view, one can reasonably question the desirability of having corporations distribute significant amounts of their earnings to philanthropic causes which are not sufficiently linked to their economic self-interest to be justified under the economic purpose test.

I share Professor Blumberg's view that "Corporate activity in the social sphere is not, in fact, altruistic. ... It reflects a tactical judgment as to the most advantageous manner for the corporation to conduct its business in the light of the climate of opinion in which it must function." It is for this reason that I am inclined to question the wisdom of that part of the ALI definition, previously quoted, which would permit corporations to devote reasonable resources to social purposes without _any_ regard to corporate profit and shareholder gain. Virtually all states now have in place statutory provisions empowering corporations to make contributions for the public welfare and for charitable, educational and scientific purposes. These powers have been widely interpreted to permit their use only in the interests of the corporation. Yet, I am unaware of any evidence suggesting that these powers have proved inadequate to support the philanthropic impulses of our business leaders. So why make this change?

I realize that corporate giving has long been recognized as appropriate, even laudatory, behavior. Indeed, the Internal Revenue Code has long afforded a corporate tax deduction for gifts to charity up to 5% of the corporation's taxable income. And last summer, Senator Edward Kennedy introduced an amendment to increase that ceiling to 10%. The amendment passed the Congress and was signed into law by President Reagan.

However, only 23.4% of the nation's 2.5 million corporations make _any_ contribution. Of those that do, the average is around 1% of taxable income. Only a handful, mainly from the Minneapolis area, reached the 5% maximum.

Out of $53.6 billion given to charitable organizations in 1981, only $3 billion, or 5.6%, came from corporations. Charitable giving is apparently concentrated in the ranks of the corporate giants.

I am not offended by these figures. Were they to increase dramatically, I would worry about the costs being incurred by society, through lower wages, higher prices for products or lesser quality. Are we better served by charitable giving at the corporate level than we would be were those gifts dividended out to shareholders? Last year individuals made contributions of $44.5 billion. On the other hand, if government wants to encourage corporate philanthropy, would not it be better to accord dollar for dollar tax credits, so that shareholders would not be penalized? Would it be reasonable for management to seek shareholder approval of a charitable giving program or at least make its contours well known so that investors can become aware of corporate policy in this area before becoming shareholders? In this regard, recent initiatives by Warren Buffet, Chairman of Berkshire-Hathaway Corporation, and legislation (H.R. 4979) introduced by Congressman Barber Conable and Senator Patrick Moynihan, deserve widespread attention. Under the Buffet plan, shareholders of Berkshire-Hathaway were permitted to nominate three charitable organizations to receive contributions up to a total of $2 per share owned. A tax ruling protected the shareholders from adverse personal tax consequences. In his letter to shareholders describing the plan Mr. Buffet said: "What bothers me about ordinary corporate practice is the way gifts tend to be made based more on who does the asking and how corporate peers are responding than on an objective evaluation of the donee's activities."

H. R. 4979 would allow shareholders to divert dividends to charities of their choice without the amounts payable being treated as income to the shareholders.

Mr. Buffet's concern leads to other questions. Is it likely that, in their philanthropic endeavors, corporations will be supporting the innovative, the risky or the controversial endeavor? I think not, nor should they be. Corporate giving programs ought not to stir up controversy within the communities in which the corporations are active, because that would be hurtful to the business of the corporation. Nor, in fact, have they provoked much controversy over the years. Philanthropy, as practiced by business, has traditionally been limited to the extension of financial assistance to not-for-profit community organizations providing health and welfare services, and to colleges and universities.

Moreover, support for projects at the cutting edge of social innovation requires substantial time and effort by the grantor, both to develop the case for giving and then to follow through as the grant is implemented. This point leads me to another -- and my last -- observation.

The professionally run private foundations should be, and many are, the source of funding for the new and untried among social enterprises. They should be, and many are, the venture capitalists for research and development into better ways to meet society's needs. They should be, and many are, the risk takers. If they do their jobs well, they deserve the public's support. I mean the public's monetary support.

It has always struck me as peculiar that the great foundations of our country have not sought public support for their endeavors. I recall, years ago, hearing of the small contribution attempted to be made to The Ford Foundation by a well-meaning lady who wanted to express her support for Ford's philanthropic achievements. The Foundation had no system for digesting this small bit of nourishment. The check was returned with a statement that the Foundation did not accept gifts. With individuals accounting for more than 80% of all charitable contributions annually, this policy may be shortsighted. It may also be changing. At least I was told just a few weeks ago that The Ford Foundation had recently accepted its first small bequest. I would urge the foundations carefully to consider the notion of seeking public support for their work.

The Scylla of inflation and Charybdis of the payout requirement have made it difficult, if not impossible, for foundations to serve the present without sharply diminishing their capacity to serve the future. Their endowments need replenishment. As experienced professionals in the field of creative philanthropy, foundations provide a talent pool ready to earn a sound philanthropic return on dollars contributed to them. Why not trade on these talents? Why not give fund raising a try? There could also be a side benefit from this kind of effort. With public support would come public scrutiny and, perhaps, a means of achieving that ephemeral goal of foundation accountability.