Today’s readings begin our final week together. We spend the week looking at proposals for fundamental reform of the corporation. Today we’ll consider some ideas of how corporations should explicitly be reformulated — as new hybrid entities — to maximize both financial profits and social good. Tomorrow we’ll look at attempts to make management think “sustainably” by requiring disclosure of CSR matters and thus attention to such things as climate change. We finish by looking at an idea to change how we work in business — though more “integrated” living, something applicable to investors, consumers, suppliers … really everyone.

The first reading is from a set of materials that I assembled for a comparative law course in Venice. The reading begins with a description of “non-shareholder constituency” statutes that give directors leeway to consider non-shareholder effects of their decisions. Then you’ll find an article in which Professor Larry Mitchell argues that such statutes should be enforceable in court by employees, communities and other non-shareholder corporate constituencies. After this article, you’ll read a classic defense by Professor Jonathan Macey for the theory of shareholders wealth maximization in the corporation.

These readings — which suggest that the corporation might already provide a framework for sustainable management and business practices — are followed by some readings on new business forms that are meant to explicitly empower business managers to take into account non-shareholder interests. The first such business, called a “benefit corporation,” is described and critiqued in an article by Professor Dana Brakman Reiser. You’ll want to ask yourself why business managers and investors would migrate to a “benefit corporation,” given what we know about the dynamic flexibility of the regular for-profit business corporation.

Finally, you will read a recent study that looks at whether human subjects changed their “sharing” propensities when presented with a “stakeholder norm” (similar to the “other constituency” statutes described before) or were more moved by incentives. The study’s finding might surprise you, or maybe not.

Readings:
- Comparative Company Law - Mitchell and Macey articles (2010)
- Brakman-Reiser, Benefit Corporation (2011)
- Fischer, Goerg & Hamann, Cui Bono? (2012)
VI. Corporate Purposes

A. United States

[The chapter begins with a look at *Dodge v. Ford Motor Co.* and suggests that the Michigan court may have been engaged in “social engineering,” not necessarily application of corporate fiduciary duties to an intra-corporate dispute about corporate policy.]

In the past few decades, many state legislatures have passed so-called "other constituents” statutes, which seem to discredit the rhetoric of the *Ford Motor* case. The first such statute arose in Pennsylvania, modeled on a proposal by Ralph Nader, a progressive critic of corporate power in America. Curiously, corporate executives (not corporate law reformers) championed the statute as a means to promote management discretion in the face of hostile takeovers (that is, the purchase of a controlling interest by an uninvited corporate raider). Can you explain that corporate executives seeking to preserve their corporate power would want a statute that validates the power of the power to consider non-shareholder constituencies? Politics – in government and in the corporation – seems to make for strange bedfellows.

After you read the statute, you will find a law review article written by a progressive corporate law scholar – the antithesis of “law and economics” philosophy of Professors Easterbrook and Fischel. As you read the article by Professor Larry Mitchell, ask yourself whether it would be a good idea if employees and other non-shareholder constituents had the power to seek judicial protection under corporate law to the same extent as shareholders. Can a governance structure work where servants (the board) serve multiple masters (shareholders, creditors, employees, suppliers, customers, communities, Mother Earth? But don’t these other constituents deserve protection – how should corporate law view them?

The article following the one by Mitchell is by Jonathan Macey, who gives a contractarian answer to our question. Shareholders bought a corporate contract and with it the rights and privileges of being a shareholder; other constituents could have chosen to be shareholders, but mostly did not, so they get the protections of their contracts – and whatever else they can obtain from the political process. Mother Earth must look elsewhere for protection; corporate law does not consider her part of the contract.
§1715. Exercise of Powers Generally

(a) General rule. – In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate:

(1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.

(2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

(3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.

(b) Consideration of interests and factors. – The board of directors, committees of the board and individual directors shall not be required, in considering the best interests of the corporation or the effects of any action, to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor. The consideration of interests and factors in the manner described in this subsection and in subsection (a) shall not constitute a violation of 1712 (relating to standard of care and justifiable reliance).

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A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes
70 TEX. L. REV. 579 (Feb. 1992)
Lawrence E. Mitchell
(formerly Law Professor, George Washington; now Law Dean, Case Western University)

In 1989, at the urging of Governor Mario Cuomo, the New York legislature joined 28 other states to enact a “constituency statute,” which authorizes (but does not obligate) corporate boards of directors to consider the interests of constituencies other than stockholders in making corporate decisions. Commenting on the proposed New York legislation, then Commissioner Joseph Grundfest of the U.S. SEC remarked:

Sustainable Corporations (Spring 2014)  Week 04 / Day 10 – New Business Forms
The grant of authority without accountability raises the real and present danger that boards will use [§ 717(b)] as a fig leaf. Specifically, [§ 717(b)] may allow boards to rationalize decisions that they would not otherwise support in the name of constituencies who are powerless to monitor or challenge the actions that are purportedly taken in their interest.

Furthermore, in August 1990, despite the growing popularity of constituency statutes, the Committee on Corporate Laws of the American Bar Association's Business Law Section declined to include similar language in the Revised Model Business Corporation Act.

These reactions characterize the prevailing critical response to an increasing judicial and legislative trend toward detaching the corporation's board of directors from its traditional, bipolar relationship with the corporation's stockholders. The principal criticism of rejecting this traditional relationship is that authorizing the board to consider constituencies that have no monitoring or enforcement powers would leave the board accountable to nobody.

The critics are correct that, by acknowledging the interests of other corporate constituents, constituency statutes diminish the board's accountability to stockholders. What the critics often fail to appreciate, however, is that these statutes go further to question implicitly the underlying precept that directors ought to be accountable exclusively to stockholders.

I. A Theoretical Approach to Constituency Statutes

There is probably no more frequently articulated principle of corporate law than that directors are fiduciaries of the corporation and its stockholders. Rather, the basic approach has been to equate the interests of the stockholders and the interests of the corporation, which have been identified at the lowest common denominator as stockholder wealth maximization. The justification for this identification of interest has been the traditional assertion that the stockholders "own" the corporation and therefore are entitled to have it managed in their interest.

A. Constituency Statutes

The constituency statutes currently in force permit a corporation's board of directors to consider the interests of an enumerated list of constituents as well as the interests of the stockholders in deciding on proposed corporate action. * * * These statutes threaten to revolutionize "generations of corporation law in the states where they have been enacted" by changing the established principle that directors' fiduciary duties are owed primarily to (or at least for the benefit of) stockholders.

The specter is raised of a board of directors blindly groping to balance the conflicting interests of a variety of constituent groups without any means of measuring the interests required to be considered or of assessing the relative priorities of such interests. The ultimate consequence of this directorial chaos would be the elimination of any check on managerial discretion.
B. Vertical and Horizontal Conflicts of Interest and the Fiduciary Fallacy

Courts and scholars have traditionally focused their analyses of internal corporate conflicts on disputes between stockholders and management over management's use of corporate property or processes to gratify its own interest. These conflicts between virtually omnipotent managers and relatively powerless constituents of the corporation (or the corporation itself) can be described as "vertical conflicts of interest," since they exist between a powerful group and relatively powerless groups within the hierarchical corporate structure.

Vertical conflicts present the problem of restraining the board from acting in its own self-interest to the detriment of these less powerful groups. An illustration of a vertical conflict of interest is self-dealing by a director or officer.

The exception to this unitary approach is the conflicts among constituents, which has been sharpened by the dislocations caused by the takeover phenomenon. I term these conflicts, which exist among two or more relatively powerless groups that have interests in the corporation, "horizontal conflicts." Examples of these conflicts are the expropriation of wealth from bondholders by stockholders and the layoff of employees as a cost-cutting measure designed to assure the repayment of debt assumed to finance a leveraged takeover.

Vertical conflicts arise from the position of the board as manager of property in which it has no interest and from its charge to manage that property in the interests of others. On the other hand, horizontal conflicts result from competing claims to property in which each group has a legitimate interest.

Constituency statutes are a means of permitting the board to reallocate these costs without exposing itself to additional risks of litigation over vertical conflicts.

C. The Fiduciary Fallacy Examined

1. The Purpose of Rules Restraining Vertical Conflicts

Fiduciary duties are designed to redress the imbalance of power between the person who manages the economic or personal interests of another and the person who has delegated (or who has had delegated for her) that power to the fiduciary. Seen in this light, a variety of economic participants in the corporation might legitimately be owed a fiduciary duty by managers to refrain from self-dealing. Stockholders surely fit within this category. But I argue that some corporate constituent groups other than stockholders have sufficient interest in the corporation, and insufficient self-protective capabilities, that they ought to be given some legal protection against directorial self-dealing.

2. The Confusion of Vertical Restraints with Corporate Purpose
Charitable contribution cases, relatively few in number, reflect the analytical confusion between vertical and horizontal conflicts. Although originally grounded in the doctrine of ultra vires, they too present the risk that directors will use corporate property to further their own interests rather than those of the corporation. Because charitable contributions seem to go beyond the business functions of the corporation, the issue of charitable contributions became related to that of corporate purpose. But, as even a cursory examination of the cases demonstrates, preclusion of directorial self-dealing is at the heart of the issue.

For example, the famous case of *Dodge v. Ford Motor Co.*, established that the pursuit of stockholder profit is the primary purpose of the corporation. And, to this day, *Dodge v. Ford* remains the leading case on corporate purpose. But, although the opinion gives no hint of any other question, the historical context of that case strongly suggests self-dealing overtones.

The Dodge brothers, ten-percent stockholders of Ford Motor Company, sued in part to compel payment by the corporation of larger dividends than they had been receiving, given the corporation’s enormous profits and retained earnings. Henry Ford, the defendant's controlling stockholder, had recently articulated a policy of retaining all but a relatively small portion of these profits to permit the company’s expansion and to reduce the price of its cars.

Although the court accepted Ford’s altruistic motives at face value it is of more than passing interest that the Dodge brothers, whose own business was a significant parts supplier to Ford, had started a competing automobile manufacturing company. Obviously, large dividends from Ford would have been useful in financing their venture. It seems likely that Ford’s motives in withholding dividends may have gone beyond simple altruism.

### 3. Rules Restraining Vertical Conflicts Intensify Horizontal Conflicts: The Role of Constituency Statutes

All of the corporation's constituents benefit from legal restraints on vertical conflicts of interest. To the extent that directorial self-dealing deprives the corporation of usurped corporate assets, surely the interests of all who look to the corporation for wealth and security will be served by prohibiting such conduct. However, the consequence of placing enforcement mechanisms exclusively in the hands of stockholders, along with the right to vote for those directors and effect wholesale changes in control by selling their stock, just as surely focuses directors' attention solely on the stockholders and imposes costs on other constituents.

This, then, is the cost of rules restraining vertical conflicts. Seen in this light the role of constituency statutes becomes clear: constituency statutes permit the board to reallocate the cost of restraining managerial self-dealing among the corporation's various constituents, while protecting the board from incurring additional risks of litigation by stockholders who are unhappy with that reallocation. This is so because constituency statutes shield directors from stockholder
litigation when they consider the interests of other constituents, even though the result might be that the stockholders obtain less wealth than they otherwise would.

The creation and allocation of these costs under the existing legal structure can be illustrated by the paradigmatic horizontal conflict case: a leveraged takeover. [The author then describes a takeover battle in which the board of Greenacres Corporation chooses between two competing bids for the company: one at a lower price that would leave management intact and protect existing noteholders and employees, and another bid at a higher price, but without any protections for non-shareholder constituents.]

The board has no choice but to accept the higher offer under Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. [506 A.2d 173 (Del. 1986)] which requires the board to act as auctioneers of the corporation to obtain the highest price for the stockholders once the sale of the corporation has become inevitable. Any other action would be a breach by the board of its fiduciary duty under the Revlon rule.

If a constituency statute permitting the board to take account of the interests of creditors and employees were in force in Greenacres's state of incorporation, the result might well have been different. It would have been clear to the board that an extra $1 in value obtained for each stockholder would result in a $6 loss for each noteholder. Given the substantial premium the stockholders would have received in any event, the board reasonably might have decided that the interests of the corporation as a whole were better served by accepting the lower priced offer. The diminished gain to the stockholders would represent a portion of the cost of rules restraining the board from acting in its own interest, and would have been borne by the stockholders roughly in proportion to the benefit they received from those rules.

As to the employees and their communities, the same $1 of foregone stock price might have sufficiently limited the increase in the corporation's debt burden such that the acquiror would not have had to close plants in order to pay debt service. The outgoing board might even have been able to contract with the acquiror to provide some protection for employees against at least immediate layoffs, and some assistance for employees who might have been laid off in the near term for legitimate business reasons. The price of these protections would be the same diminution in stockholder gain, but would reflect a fairer allocation of the cost of the self-dealing rules that permitted the employee losses in the first place.

Under existing law, the Revlon rule prohibits the board from accepting the lower priced offer to protect creditors, employees, communities, or other constituents. Meanwhile, constituency statutes permit the board to internalize these costs and apportion them among those groups benefitted by the general proscription of managerial self-dealing. ***

III. A Practical Model for Enforcing Constituency Statutes
It is obvious that the corporation is far more complex an undertaking, consisting of intertwined human and economic relationships, than the traditional stockholder-owner model permits. But the centerpiece of constituent recognition, the constituency statute, stops short of fulfilling its ultimate goal. Most of the statutes are permissive, imposing no requirement that the board consider constituent interests.

My suggested approach is relatively simple. The basic presumption underlying the test would continue to be that directors are to act in the interests of maximizing stockholder wealth. However, boards would further be required to take into account the extent to which such actions harm a range of statutorily identified constituents. Members of each such constituent group would have standing under the relevant constituency statute to challenge corporate actions that they claim have injured them.

Plaintiffs would have the burden of proving that such actions were in fact injurious. The injury must have been to a legitimate interest, and in this respect plaintiffs would need to resort to express or implied contracts with the corporation, legitimate expectations, and the like. After the plaintiff will have demonstrated injury, the burden would be placed on the board to prove that its actions were undertaken in pursuit of a legitimate corporate purpose rather than in the interests of the board itself. For example, the board would have to show that it was acting to promote the interests of stockholders, of another statutorily identified constituent group, or of the corporation as a whole. Finally, the plaintiffs would be permitted to prove that the board’s stated purpose could have been accomplished in a manner less injurious to their interests. If the plaintiffs were to meet that burden, the appropriate remedy would be to enjoin the challenged transaction or, if necessary and possible, to undo it.

To see how this test might work, consider the hypothetical Greenacres takeover I discussed earlier. If the directors permit the higher priced offer to succeed despite its concomitant harm to noteholders, the noteholders can bring an action alleging a violation of the board’s duty not to harm. The board will then demonstrate, as it can, that the transaction is in pursuit of a legitimate corporate objective, the maximization of the corporation’s value. However, all of that maximized value is going to benefit the stockholders to the damage of the noteholders in the significant decrease in the market value of their notes. The noteholders may then demonstrate that, had the board permitted the lower priced offer to succeed, the basic business goal would still have been attained but with less harm to the noteholders and at only slight cost to the stockholders.

The Greenacres employees have a similar cause of action, analyzed in a similar manner. In considering the employees’ rights, relevant evidence includes express or implicit promises of job security, length of time that facilities had been operating, the average length of service of employees of such facilities, compensation levels relative to those of comparable jobs (to help evaluate, if possible, the trade-off between compensation and job security), severance benefits, and other forms of vested, contingent compensation generally available to employees.
Ultimately, constituency statutes suggest a new role for the board [in which it] serves as an independent mediator of a variety of legitimate economic and personal interests in the corporation. This role acknowledges that the modern large corporation has become a pluralistic entity. It also acknowledges the interdependence of corporate constituent groups and the importance of each in attaining corporate success. Finally, it focuses on the board’s responsibility to resolve the tensions arising from conflicting interests within corporate groups in a manner most beneficial to the entire enterprise.

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An Economic Analysis of the Various Rationales for Making
Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties
21 Stetson L. Rev. 23 (1991)
Jonathan R. Macey
[formerly Professor, Cornell Law School; now Law Professor, Yale Law School]

I. INTRODUCTION

Under traditional state and corporate law doctrine, officers and directors of both public and closely held firms owe fiduciary duties to shareholders and to shareholders alone. Directors and officers are legally required to manage a corporation for the exclusive benefit of its shareholders, and protection for other sorts of claimants exists only to the extent provided by contract. This legal norm, however, has been subjected to considerable stress as a result of recent legislative action in a majority of states that authorizes (or, in the case of one state, requires) directors to take into account the interests of other "constituencies" such as employees, suppliers, customers, and the local community in making business decisions.

II. THREE CRITICISMS OF NONSHAREHOLDER CONSTITUENCY STATUTES

A. The Residual Claimant Argument

The most well-known argument supporting the proposition that fiduciary duties should be owed exclusively to shareholders is derived from the insight of modern financial theory that shareholders retain the ultimate authority to control the corporation because they have the greatest stake in the outcome of corporate decisionmaking. The idea here is that, despite the fact that corporations are merely complex webs of contractual relations—and despite the fact that shareholders do not "own" the modern, publicly held firm in any meaningful sense—the ultimate right to guide the firm (or, more precisely, to have it guided on their behalf) is retained by the shareholders because they are the group that values it most highly.

The implication is clear. Since shareholders value fiduciary duties most highly, they will pay other corporate constituencies for the right to have these duties inure to their benefit. If, for example, the shareholders place an aggregate value of $10 million on the legal protection provided by a corporate governance system that allocates fiduciary duties exclusively to shareholders, while
other constituents value it at $2 million, then both parties will be better off if the shareholders are permitted to compensate these other constituencies—in the form of higher interest on bonds, higher wages to workers and managers, and better prices for suppliers and customers—for the right to have fiduciary duties flow exclusively to them.

Thus, all constituencies will be better off by allocating fiduciary duties within the firm exclusively to shareholders if the latter place the highest value on such duties. But why would shareholders, as residual claimants, place the highest value on fiduciary duties? After all, once we accept the view that the firm is not an entity at all, but a set of contracts or series of bargains, the organization decomposes into a group of identifiable participants—e.g., investors, managers, creditors, employees, and suppliers—who negotiate an equilibrium position among themselves. An implication of this perspective is to deny that any one class of participants (i.e., the shareholders) have a natural right to view themselves as the owners of the firm. Rather, shareholders are seen not as the firm’s owners, but as suppliers of equity capital; they are the “residual claimants,” who bring to the firm their special ability at risk-bearing, which creditors, managers, and employees tend to lack.

Of course, we view the shareholders as simply the residual claimants who have agreed to accept a more uncertain future return because of their superior risk-bearing capacity, it is far from self-evident that shareholders are necessarily entitled to control the firm,” i.e., to have managers' and directors' fiduciary duties flow exclusively to them. The rationale for why shareholders place the highest value on such rights is said to be that:

Uniquely, the residual claimants ... are interested in the firm's overall profitability, whereas creditors and managers presumably other constituents as well] are essentially fixed claimants who wish only to see their claims repaid and who will logically tend to resist risky activities. Having less interest in the overall performance of the firm, creditors can bargain through contract and do not need representation on the board to monitor all aspects of the firm's performance.

Thus, fiduciary duties exist because the decisions that face officers and directors of corporations are sufficiently complex and difficult to predict that it would not be feasible to specify in advance how to respond to a wide range of future contingencies. Fiduciary duties are the mechanism invented by the legal system for filling in the unspecified terms of shareholders' contingent contracts. These duties run solely to shareholders because, as residual claimants, gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line.”

B. The "Too Many Masters" Argument

The second and perhaps the most common argument made against nonshareholder constituency statutes is that such statutes, to the extent they effect any change whatsoever in existing law, simply confuse the legal landscape by forcing directors to attempt an impossible
The confusion of directors in trying to comply with such statutes, if interpreted to require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling. Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.

Take, for example, the issue of whether a firm should relocate its headquarters from the large metropolis that has served as its base for many years to a small town with better schools, lower labor costs, and lower taxes. While shareholders might profit from this move, the community in which the firm is presently located would clearly suffer. Some employees might benefit, others might suffer. The firm could justify virtually any decision as serving the interests of some constituency. Imagine now that the proposal to relocate the company comes not from incumbent management, but from an outside bidder who is launching a hostile tender offer for the company at a substantial premium over the current market price of the firm’s shares. Here the nonshareholder constituency statute can be used to justify resisting a lucrative offer that may be in the best interests of the shareholders.

Thus, the problem with nonshareholder constituency statutes is not that they require managers and directors to serve too many masters. The problem is that they have the potential to permit managers and directors to serve no one but themselves.

C. The Real Concern: Shareholders as the Group with the Most Acute Need for Fiduciary Duties

The real drawback of nonshareholder constituency statutes is that they fail to recognize that shareholders face more daunting contracting problems than other constituencies. These acute contracting problems vindicate the traditional common law rule that managers and directors owe their primary fiduciary responsibilities to shareholders. Nonshareholder constituencies can protect themselves against virtually any kind of managerial opportunism by retaining negative control over the firm’s operations. Workers, bondholders, and even local communities can protect their interests by contracting for the right to veto future proposed actions by management. By contrast, the shareholders must retain positive control over the actions of the firm in order to realize the full potential value of their shares. ***
Workers are perhaps the group with whom one sympathizes the most when thinking about the possible benefits associated with nonshareholder constituency statutes. Unlike shareholders, who are concerned with the overall profitability of the firm in which they have invested, workers are concerned with wages, pensions, hours, and working conditions. From a contracting perspective, wages and hours pose few, if any, contracting problems. Workers could potentially protect their wage expectations with pension guarantees, golden parachutes, successor clauses, stipulated cost of living adjustments, and other straightforward provisions.

It might be argued that rank-and-file employees lack bargaining power, and that at-will employment contracts are likely to reflect this lack of bargaining power. Consequently, it has been argued that the gap-filling that is done in the context of at-will employment contracts is likely to be unhelpful to employees.

This argument is flawed and without merit. If workers lack bargaining power in their employment relationship, changing the law to add a fiduciary duty to this relationship will harm workers, not help them. This is because extending the reach of fiduciary duties to rank-and-file employees will not change any fundamental imbalance in the allocation of bargaining power between workers and their employers that already exists. Any legal regime that "protects" workers by making them the "beneficiaries" of fiduciary duties will, by definition, make those same workers less valuable (in monetary terms) to their employers. The employers will, in turn, utilize any bargaining power they possess to make the employees pay the full costs of these new legal obligations.

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NOTES

1. The Pennsylvania “other constituency” statute gives the board of directors great leeway in making corporate decisions.

   a. What do you imagine was the political genesis of this statute? Were these statutes the brainchild of Ralph Nader (a consumer advocate) or corporate executives?
   b. What situations did the Pennsylvania legislature have in mind that corporate boards would use the statute’s assurances?

2. Professor Macey asserts that nonshareholder constituents can protect their interests by contract. This depends on how well these contract rights are protected. A recent study of creditor protection in different legal systems shows that legal institutions that effectively protect lenders (good accounting standards and judicial systems) are a good substitute for collateral, making long-term debt available to firms even in volatile industries. In countries where the law does not guarantee creditor rights, lenders prefer short-term debt and the firms must liquidate projects when there are temporary difficulties. See Mariassunta Giannetti, Do Better Institutions Mitigate Agency Problems? SSRN paper 203768 (2000).
3. Compare the articles by Professors Mitchell and Macey.

   a. What is Mitchell’s thesis? What is Macey’s?
   b. In the world imagined by Mitchell, what rights should nonshareholders have if they disagree with board action? Could employees sue if they thought layoffs were unfair?
   c. In the world imagined by Macey, what rights should nonshareholders have if they disagree with board action? Could community leaders force a company not to relocate a plant?
   d. Who do you agree with? Why?

3. Is “shareholder wealth maximization” really mandated by corporate law? What would stop a corporation from pursuing a more balanced “socially conscious” business agenda? If the answer is that corporate management merely responds to shareholder pressures (reflected in market mechanisms), then what is to prevent investors from pressuring management to adopt policies of greater social responsibility, exclusive of shareholder profit maximization? Some have advocated that share holders have greater ability to make proposals urging corporate social responsibility and that corporate management be required to disclose ethical analysis of corporate conduct. Ian Lee, Corporate Law, Profit Maximization and the Responsible Shareholder, __ Stan. J. L. Bus & Fin __ SSRN Paper 692862 (Mar. 2005). Is “ethical investing” rational, simple-minded, or pernicious?

5. Despite the rhetoric that directors of US corporations owe duties to maximize shareholder wealth, the law actually imposes duties on directors to monitor the activities of the corporation to ensure compliance with non-corporate legal norms even when non-compliance (that is, violating the law) might maximize shareholder wealth. For example, directors must establish and monitor the corporation’s compliance with government rules on Medicare billing, environmental laws, and antitrust compliance. See In re Caremark Int’l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996) (approving settlement of derivative litigation challenging directors’ failure to prevent corporate liability for violating federal law applicable to health care providers).

The effect is that directors have become “watchdogs” for non-corporate regimes. For example, the MBCA creates liability for directors whose “conduct consisted of...a sustained failure ... to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefor.” MBCA § 8.31(a)(2)(iv).

Whether directors face a real threat of personal liability in conducting their “monitoring” duties has been the subject of recent attention, both in the United States and abroad. Consider the liability of outside directors, under company law systems with varying philosophies of shareholder primacy. According to a recent study comparing four common
law countries (Australia, Canada, Britain and the US) and three civil law countries (France, Germany and Japan), the risk of “nominal liability” – that is, a court finding of liability or settlement by directors – differs greatly from jurisdiction to jurisdiction. But actual “out-of-pocket” liability – as that is, payments by directors personally of damages or legal fees – is uniformly low. Even when directors are subject to “nominal liability,” actual payment is made by the company or directors’ and officers’ (D&O) insurance. That is, despite differing philosophies and standards of director accountability, actual results show a functional convergence across jurisdictions. Black, Cheffins & Klausner, Liability Risk for Outside Directors: A Cross-Border Analysis, 11 Euro. Fin. Mgmt. J. 153, SSRN paper 688647 (2005).
BENEFIT CORPORATIONS—A SUSTAINABLE FORM OF ORGANIZATION?

Dana Brakman Reiser *

46 Wake Forest L. Rev 592 (2011)

Founders of social enterprises believe profits and social good can be produced in tandem and wish to form organizations that will pursue these dual missions. They will, however, encounter obstacles to articulating and enforcing such dual missions if they adopt either a traditional nonprofit or for-profit form of organization. Nonprofit forms bar profit distribution and for-profit forms will create practical, if not legal, pressure to favor profit maximization over social good when the two come into conflict.

Social entrepreneurs believe social good can be produced along with profits and desire hybrid forms of organization to smooth a single enterprise’s path to realizing both goals. A mounting number of jurisdictions have attempted to meet this demand by enabling new hybrid organizational forms: low-profit limited liability company ("L3C") available in nine U.S. states and the "B Corp," a private certification for U.S. for-profits that demonstrate their commitment to a dual mission of making profits and promoting social good.

This Article examines another recent entrant into the hybrid form category: the benefit corporation and evaluates whether the innovations in the benefit corporation form can meet the goals social entrepreneurs have for hybrid organizational forms, ultimately concluding it will fall short.

I. THE BENEFIT CORPORATION

Before delving into the details of the new benefit corporation form, it is useful to describe the dynamic scene onto which it enters. When social entrepreneurs’ frustration with traditional nonprofit and for-profit forms became apparent, jurisdictions began to respond with new hybrid forms. An early mover here was the United Kingdom, which established the community interest company (CIC) in 2004. The CIC is a company formed for community benefit purposes, which may offer investors limited dividends, but must lock its assets and earnings beyond these limited disbursements into the community benefit stream.

Innovation began stateside with the L3C, first adopted by statute in Vermont in 2008. The L3C is a limited liability company formed to “significantly further the accomplishment of one or more charitable or educational purposes” and for whom neither income production nor property appreciation may be a significant purpose. An L3C may have investor members who can receive unlimited disbursements during the L3C’s existence or upon dissolution, and if the L3C ceases to pursue its educational and charitable purposes it transforms into an ordinary LLC.

In addition, companies have been able to obtain private certification as a "B Corps" since 2006. B Corps must provide in their formative documents that fiduciaries must consider the impact of their
decisions on various nonshareholder constituencies, including the environment and the local, state, and national economy. A private nonprofit organization, B Lab, vets aspiring B Corps to confirm that these governance structures have been established and conducts an extensive survey to determine how well an applicant uses “the power of business to solve social and environmental problems.” Those applicants meeting B Lab’s standards may license the B Corp mark and are subject to audit by B Lab on an ongoing basis.

In 2010, Maryland became the first state to establish a "benefit corporation" -- a form of organization distinct from the standard corporate form. Although it exists under a separate statutory framework, “benefit corporation” status is available both to newly forming corporations that may use the form from their inception and to existing for-profit corporations that adopt benefit corporation form by amending their charters, only after special notice and a supermajority two-thirds vote of shareholders.

Public Benefit

The main thrust of benefit corporation statutes is to require these entities to pursue purposes beyond profit-making. A benefit corporation must be formed for a “general public benefit,” meaning a "material, positive impact on society and the environment.” All statutes permit the benefit corporation to pursue more “specific public benefits,” including:

- Providing [low income or underserved] individuals or communities with beneficial products or services;
- Promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;
- Preserving [or improving] the environment;
  Improving human health;
  Promoting the arts, sciences, or advancement of knowledge;
  Increasing the flow of capital to entities with a public benefit;
- Accomplishing any other particular [identifiable] benefit for society or the environment.

The statutes all declare that the general or specific public benefits that benefit corporations pursue “are in the best interests of the corporation,” seemingly conclusively. In addition, the benefit corporation statutes define how directors ought to make decisions and provide additional liability shields.

Directorial Obligations and Protections

Each statute explains the obligations of benefit corporation directors. They are required to consider the impact of their decisions on shareholders, employees of the corporation, subsidiaries and suppliers, “customers [to the extent they are] beneficiaries of the general or specific public benefit purposes of the benefit corporation,” the community, society, and the local and global environment.
Unless the benefit corporation’s charter specifies otherwise, directors may base their decisions on any one or combination of these groups or interests.

The statutes also specifically provide directors of benefit corporations with immunity from liability for performance of their duties within the broad discretion given to them by statute and provide that no duty of such a director runs to the corporations’ beneficiaries.

This broad discretion — modeled on nonshareholder constituency statutes for business corporations -- can be faulted for giving directors unbridled discretion, with which they might pursue social good or might pursue foolish or self-serving practices. Some later-enacted statutes suggest specific concerns about protecting benefit directors in the takeover context, requiring directors to consider “the short-term and long-term interests of the benefit corporation, including benefits that may accrue to the benefit corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the benefit corporation.” Thus, directors of benefit corporations appear protected from personal liability on claims that they have insufficiently produced public benefits or inadequately pursued profits for shareholders, whether in the context of ordinary business decisions or control transactions.

Third-Party Standard-Setters

To distinguish corporate purposes and directorial obligations in business corporations and benefit corporations, only corporations pursuing a general (and perhaps also specific) public benefit can qualify as benefit corporations. To make these initial determinations, the benefit corporation statutes delegate this responsibility to third-party standard-setters. All of the statutes anticipate that such third parties will make available standards “for defining, reporting, and assessing” the social and environmental performance of aspiring benefit corporations – though without specifying minimum content for such standards. Instead, the statutes simply mandate that standard-setters be independent and transparent.

B Lab – an independent non-profit -- has been deeply committed to and involved with the passage of benefit corporation statutes. Its survey and audit processes are described online to fit the transparency requirements. B Lab evaluates potential B corporations using the B Impact Assessment, which looks at issues of corporate accountability, employee policy, products’ benefit to consumers, the company’s relationship with its community, and its impact on the environment. The assessment contains a total of two-hundred points, and companies must score eighty points to be certified and granted access to the B Corp mark. B Lab also audits twenty percent of those companies who qualify for B Corp certification every two years.

Enforcement

Whether or not B Lab is joined by other standard-setters, the benefit corporation is also subject to self-enforcement. The statutes impose disclosure obligations upon benefit corporations, requiring them to provide annual benefit reports to their shareholders and to post them on their public
websites – and sometimes to file them with a state office. The statutes describe the contents of this report differently, but all require timely benefit reports including elements of description and assessment. Assessment requires each benefit corporation to consider and report how well it performed in accordance with its third-party standard as compared with prior performance.

In addition, benefit corporation statutes create a special right of action often called a “benefit enforcement proceeding” to enforce the special duties of benefit corporation directors and officers and the public benefit purposes of the corporation. The statutes limit potential plaintiffs in benefit enforcement proceedings to shareholders entitled to bring derivative actions and, in some cases other groups, if specified in a corporation’s charter.

As yet, there is no case law addressing the obligations of benefit corporation fiduciaries, and the statutes do not speak to how courts should analyze such claims. One commentator argues that “the core duty of the benefit corporation can be defined as the duty to secure profits for the shareholders while considering the socially beneficial purposes of the corporation.” But without greater legislative explanation or judicial interpretation, it remains difficult to provide guidance to fiduciaries in situations where profit and social benefit goals conflict.

Conclusion

The benefit corporation is thus significantly different from both traditional nonprofit and for-profit business forms and from other hybrid forms. By retaining traditional business purposes and adding the requirement of pursuing general public benefit, the benefit corporation allows entities to pursue a dual mission of both profit and social good.

The benefit corporation also differs in substantial ways from other hybrids currently available. Unlike the United Kingdom’s CIC, the benefit corporation may offer investors unlimited midstream and residual returns and is subject to no government regulation of its purposes or activities. These attributes are shared by L3Cs, but the benefit corporation has more rigid governance structures than the almost fully flexible governance by contract in an L3C. The benefit corporation also requires greater disclosure than the L3C. These disclosure and fiduciary authorization mandates also represent a divergence from the B Corp structure, though B Corps and benefit corporations share the fundamental idea of third-party review of public benefit purposes – and an idea not found in either the CIC or L3C.

II. ASSESSING THE BENEFIT CORPORATION

Fundamentally, founders and operators of social enterprises unsatisfied with traditional nonprofit or for-profit forms seek a type of organization that will legally establish their sense of a dual profit-making and social mission and enforce it over time. They would also like a hybrid form to expand the range of funding streams they can effectively access. Further, they seek to use the hybrid form as part of their effort to brand their social enterprises to enable them to market their products and services to consumers, business partners, and others as special and different from those offered by
typical nonprofit charities and for-profit businesses. Will benefit corporations accomplish these goals?

_Articulating and Enforcing a Dual Mission_

**The Limitations of Traditional Forms.** One might think social entrepreneurs could use traditional nonprofit or for-profit forms to house their dual mission enterprises. After all, nonprofit forms do not bar profit-making. These forms do, however, dramatically cabin profit distribution under the nondistribution constraint, which is imposed by state law (and tax-exemption rules) and prevents distributing net profits to shareholders, other investors, directors, and officers. Therefore, if a social entrepreneur wishes to distribute profits to investors, a nonprofit form is a nonstarter.

The problems with adopting a traditional for-profit form for social enterprise are more complex and arise from both legal and nonlegal sources. At inception, it appears permissible to include charitable or social goals as part of a corporation's purposes. Yet, anecdotal reports suggest that in some states, inclusion of such goals as a major component of corporate purposes may stall or block acceptance of articles by the secretary of state. Typically, LLC law will be flexible enough to allow adoption of both profit and social purposes, though partnership statutes requiring a "business purpose" may create barriers to social enterprises in that form.

Still, there are concerns that in a social enterprise formed as a traditional for-profit, fiduciaries will be hemmed in by their responsibilities to pursue profits for owners. There is considerable debate about the degree to which for-profit fiduciaries may properly pursue other purposes without breaching their duties. Even those who argue that for-profits possess substantial leeway to pursue social goals seem to be arguing about the edges of for-profit activity, not its core.

If a for-profit social enterprise wants to draw market-rate investors, its dual mission will be squarely put at risk. Consensus favoring a dual mission can easily break down and market-rate investors may refuse to invest or quickly or detrimentally sell off their ownership stakes. Rather than fearing litigation, the founder of a for-profit social enterprise may instead worry about locking in a dual mission legacy, about sufficient access to capital, or both. Dual mission is not easily embedded in traditional for-profit forms.

Ideally, a hybrid organization would offer a solution to this dual mission dilemma. To solve it, a hybrid form of organization should provide guidance on which goal, profit maximization or social good production, has priority and in what situations this priority must be given. This does not necessarily mean that either profit maximization or social good production must be prioritized every time the two come into conflict. Instead, the structure must work predictably and relatively transparently, and there must be some method for enforcing it.

**The Benefit Corporation and Dual Mission Articulation.** When one thinks more deeply about how a dual mission will be articulated in a benefit corporation doubts emerge. The requirement of general public benefit is vague and undefined. The determination of whether a particular organization's
goals pursue a general public benefit is left to an unregulated third-party standard-setter. Moreover, the statutes provide no baseline or guidance for the standards these third parties should use to make this determination; they require only transparency and independence. If a standard-setter clearly and transparently sets low standards, it may qualify unrelated entities to form as benefit corporations just as would a standard-setter with higher standards, leaving the door open to greenwashing or even fraud. At the moment, benefit corporations require only formal articulation of a dual mission, and oversight over the genuineness of these statements is lacking.

*The Benefit Corporation and Dual Mission Enforcement.* Third-party standard-setters, fiduciaries, and shareholders all play enforcement roles in the benefit corporation. Although standard-setters are initial gatekeepers, their role in ongoing enforcement is less clear. For example, while the statutes envision public benefit assessments in annual benefit reports made with reference to the third-party standard, none specifies whether or how standard-setters should be involved in vetting public-benefit provision after incorporation.

As for shareholders, outside the context of transformation to fully for-profit status, the statutes offer little guidance to shareholders or fiduciaries on the thorny issue of how profit and social good should be balanced. They allow directors to forego profit maximization in favor of social good production or vice versa, but they do not instruct directors on how to exercise this broad discretion. Thus, the statutes impose no clear framework for directorial decision making. Without one, it is difficult to identify a metric by which shareholders might enforce fiduciaries’ compliance with dual mission.

Shareholders of all benefit corporations retain the informational, voting, and litigation rights of ordinary shareholders. Any of these rights could, theoretically, be used to enforce dual mission. Benefit corporation shareholders may demand to inspect corporate books and records beyond the benefit report to determine how a particular mission conflict was resolved. They may vote out directors who fail to sufficiently pursue their favored balance of profits and mission. They may even sue directors for a failure to meet their special fiduciary obligations under the statute, and the later-enacted statutes also provide for the benefit enforcement proceeding.

Still, shareholders are unlikely to be assiduous and consistent enforcers. Their ability to obtain damages to redress faulty directorial decisions is significantly limited by ordinary fiduciary liability concepts like the business judgment rule and will be further frustrated by benefit directors’ broad and unguided discretion and immunity. Moreover, benefit corporation shareholders have an additional reason not to engage in enforcement of dual mission—or at least a serious potential bias toward one-half of it. If a benefit corporation begins veering away from its dual mission to achieve greater profits, shareholders stand to gain financially from this decision.

The statutes uniformly exclude other potential parties from engaging in enforcement through litigation. Beneficiaries and the public will not have standing to challenge actions by benefit corporation directors. This position resonates with the traditionally extremely limited standing to challenge actions by nonprofit corporate directors. This policy is justified as necessary in order to
recruit directors, which are most often uncompensated, to serve on nonprofit boards. However, the nonprofit context provides for government enforcement by state attorneys general and, for exempt nonprofits, the IRS. There is no regulatory role for any public official in the benefit corporation.

The Benefit Corporation’s Disclosure Model. The benefit corporation form relies significantly on disclosure, both to amplify dual mission articulation and to lubricate enforcement. The benefit report gives shareholders and the public an opportunity to view how the entity reacts to situations in which profit and social mission conflict. Whether these recipients of disclosure will actively enforce is not yet known.

In terms of disclosure, benefit corporations occupy a sort of middle ground between the situations of traditional nonprofit and for-profit entities. On the one hand, benefit corporations must issue self-styled disclosures about public benefit provision to shareholders and allow for public review, a different kind of transparency than would be required of a nonprofit. Nonprofits must provide standardized annual reports on their charitable activities to state attorneys general and, if they are tax-exempt, they must submit annual informational tax returns to the IRS and make them public. The level and contents of required disclosures for benefit corporations should provide greater transparency on how a dual mission is being managed than would be available from a standard for-profit corporation, partnership, or LLC. Benefit corporation disclosures are thus fairly robust and are certainly more closely tailored to address dual mission performance than either nonprofit or for-profit disclosures.

Conclusion. In sum, the benefit corporation form is effective in allowing social enterprises formally to articulate a dual mission. In terms of enforcement, the benefit corporation usefully limits movement in and out of dual mission status by its shareholder vote requirements but gives little guidance on enforcing dual mission outside of the ultimate exit question. Third-party standard-setters could take a more active role here, but they need not do so under the statutes. Benefit corporation statutes expressly permit, but do not require, the pursuit of social goals over profit, and bend over backwards to protect fiduciaries from liability for their decisions. In this context, shareholder enforcement will be challenging and shareholders themselves may become biased toward profit goals or be bought out by others seeking financial over social gains.

Expanding Funding Streams

Founders or operators of social enterprises can opt to form their entities as traditional nonprofit corporations or as one of various for-profit organizational forms. Yet, any of these choices will limit the funding streams available to their enterprises.

Due to the nondistribution constraint, equity capital will not be available to social enterprises formed as nonprofits, but they can obtain capital through donations, income earned on investments, or sales of goods and services, and borrowing. Further, although nonprofits may borrow, banks and other lenders may be less willing to lend to nonprofits or require more onerous
terms from them due to an accurate or mistaken impression of the organization's financial risk or its lack of an equity cushion.

Organizing as a traditional for-profit entity will give social entrepreneurs access to equity and debt, but a social entrepreneur using a for-profit form may find it difficult to convince arms-length investors to take equity positions, and it may be hard to obtain loans without offering personal guarantees or collateral. Using traditional business forms may avoid some concerns among investors or lenders about the incentives of the entity and its leaders to succeed financially and to repay its debts.

A for-profit form also limits access to donated funds. Adopting a traditional business form bars tax-exemption and eligibility for deductible contributions. This is so regardless of whether an entity pursues social purposes or charitable activity. Of course, forming as a for-profit will not necessarily preclude all socially-motivated sources of revenue. Cause-related marketing campaigns -- like the RED campaign to combat AIDS in Africa -- have raised millions of dollars through sales by purely for-profit corporations. If hybrid forms can ease access to donations and other socially-motivated funding sources, social entrepreneurs will prefer them to traditional for-profit forms.

The benefit corporation statutes do not speak expressly to the question of financing, but adopters of this form would certainly be ineligible to receive deductible contributions. Rather, benefit corporations can pursue the funding sources available to traditional for-profits. In this pursuit, the dual mission embedded in the form may or may not prove advantageous. The benefit corporation form seems likely to draw potential investors and lenders' attention to the dual mission of the organization. On the one hand, this may make those motivated purely by profit even more hesitant to invest or lend to a benefit corporation than to a for-profit social enterprise. On the other hand, it may attract potential investors or lenders who are interested in combining their financial contributions with a purchase of social good.

The indeterminate ability of the benefit corporation form to expand funding streams is not unusual in the hybrid space. None of the other current hybrid forms can offer tax deductions to donors. Likewise, none of the hybrids appear much more likely to attract market-rate investors. CICs offer only capped dividends and lock remaining assets into the community benefit stream; thus, its investments are simply not on par with market-rate products. The L3C is amenable to tranched investment, which some believe will enable it to draw investors seeking market-rate returns. But without providing governance or other guarantees to market-rate investors, I am skeptical that they will view L3C investment as a substitute for market-rate products. Thus, to my mind, the L3C, like the CIC, the B Corp, and the benefit corporation, is likely to draw in new investment capital only from the socially-motivated category of investors.

Sustainability

Finally, social entrepreneurs may also see a hybrid form as providing their enterprises with greater sustainability than traditional nonprofit or for-profit forms can offer. Of course, sustainability can
mean many different things. When thinking about sustainable development, the UN Brundtland commission defined it as "meeting the needs of the present without compromising the ability of future generations to meet their own needs." When researching sustainable corporations, one quickly runs across ideas like the triple bottom line (economic, social, and environmental outcomes) or the 3-P model (People, Profit, Planet). These ideas clearly resonate with the fundamental ideas of a social enterprise, melding pursuit of profits with social good, often including environmental goals. But, the benefit corporation form is not there yet. This new hybrid form must allow social enterprises to articulate and enforce dual missions, to obtain greater access to capital, and to brand themselves to consumers and partners as distinct and special entities offering distinct and special products, in order to truly embody the sustainable corporation.

CONCLUSION

The benefit corporation will not yet achieve all of the goals social enterprises desire from a hybrid form. Benefit corporation statutes have opened up a place for social enterprises to legally articulate their dual mission, and have guarded the ultimate exit from the hybrid form with significant shareholder voting requirements. Leaving all content to unregulated standard-setters and providing little guidance or enforcement apparatus for midstream decision making, however, does not do enough to ensure benefit corporations can enforce a dual mission over time. Thoughtful founders and leaders of social enterprises considering the benefit corporation form will consider whether investors, consumers, partners, and employees will find this balance and brand appealing. Until a hybrid form is created that clearly and powerfully enforces dual mission, though, I believe access to expanded capital and sustainability will remain elusive.
CUI BONO, BENEFIT CORPORATION?
AN EXPERIMENT INSPIRED BY SOCIAL ENTERPRISE LEGISLATION IN GERMANY AND THE US

Sven Fischer, Sebastian J. Goerg, and Hanjo Hamann


Abstract: How do barely incentivized norms impact incentive-rich environments? We look at social enterprise legislation that establishes rules on behalf of constituencies that have no institutionalized means of enforcing them. By relying primarily on managers’ other-regarding concerns whilst leaving corporate incentive structures unaltered, how effective can such legislation be? This question is vital for the ongoing debate about social enterprise forms, as recently introduced in several US states and in British Columbia, Canada.

We ran a laboratory experiment with a framing likened to German corporate law, which traditionally includes social standards. Our results show that a stakeholder provision, as found in both Germany and the US, cannot overcome material incentives. However, even absent incentives the stakeholder norm does not foster other-regarding behavior, but slightly inhibits it instead. Our experiment thus illustrates the paramount importance of taking into account both incentives and framing effects when designing institutions.

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Don’t tell me where your priorities are. Show me where you spend your money and I’ll tell you what they are.

James W. Frick (University of Notre Dame)

1 Introduction

The Social Purpose, and New Types, of Business Corporations

If many years from now historians analyze the turn of the first to the second decade of the current century, they might identify corporate greed as one of the more persistent and defining buzzwords of this era. Corporate greed is said to have caused economic crises world-wide, and in one of the more unlikely motion picture sequels ever to be made, we see Gordon Gekko suggesting: "I once said "Greed is good". Now it seems it's legal."

This alleged greed for profit has thrust to a movement known by CSR, corporate social responsibility. More than ever, firms care about their reputation and discover the social purpose of doing commercial business. The "Rise of the Social Enterprise" is seen as the "Future of the Law" and special legal entities emerge all over the world. Most notable among these may be the Low-
Since stakeholder value has long been the predominant conception of German corporate law, German experiences can surely inform the social enterprise legislation currently arising in North America. The remaining two sections of this introduction elaborate on how exactly the German corporate framework is comparable to that of the new brand of US corporations, and how a study inspired by this framework can cast a light on the determinants of its efficacy.

**German Stakeholder Legislation and US Benefit Corporations**

Articulating a concept that had been part of German stock company law since 1937, Section 4.1.1 of the German Corporate Governance Code (GCGC) was amended in 2009 to read:

"The Management Board is responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value."

According to a semi-authoritative commentary, "stakeholders" consist of at least "employees, managers, customers, suppliers and the general public."

In the US, traditional business corporations had to comply only with shareholder interests. But very recently an alternative type of corporation, without a pure shareholder orientation, was introduced. In April 2010, Maryland was the first state to introduce so called benefit corporations and by now more than a dozen states have followed suit. The model legislation on benefit corporations requires directors to

"consider the effects of any action or inaction upon: (i) the shareholders of the benefit corporation, (ii) the employees and workforce of the benefit corporation, its subsidiaries and its suppliers, (iii) the interests of customers as beneficiaries of the general public benefit or specific public benefit purposes of the benefit corporation, (iv) community and societal factors, including those of each community in which offices or facilities of the benefit corporation, its subsidiaries and its suppliers are located, (v) the local and global environment...

Compared with the German provision quoted above, its American equivalent may be more verbose, but its wording is strikingly similar. In addition, shareholders "are listed first, and remain the only stakeholder entitled to bring a legal action against the corporation or its directors [... such as] a benefit enforcement proceeding for failure to consider other stakeholder interests."
Behavioral Study Inspired by Stakeholder Legislation

Both Sec. 4.1.1 GCGC and the model US legislation regarding benefit corporations seem rather odd. What good is a duty to consider a host of stakeholders, when only one of those can litigate? Doesn't this asymmetry quite naturally force managers to look no further than to the shareholders' will? Then a benefit corporation really wouldn't be much different from an ordinary corporation, whose degree of other-regarding "preference" is merely a function of the generosity of its shareholders. Whether or not such stakeholder statutes can increase the other-regarding focus of corporate decision-making is ultimately an empirical question.

Because "much could turn on a more sophisticated understanding of the role played by other-regarding preferences within corporations and corporate law" we shall turn to the behavioral literature for a first intuition of what to expect. Since managers of both classical and benefit corporations are answerable only to the shareholders, the traditional principal agent relation holds in either case. Recent behavioral studies have observed that delegating decisions to an agent markedly reduces other-regarding behavior.

At the same time, neither the dictator who delegated her decision to an agent, nor her agent feel responsible for the reduction in the amount given to recipients. It may be arguable whether the ability to commission unethical behavior while maintaining a positive self-image is really "an additional rationale" for principals to hire agents or merely one of agency's behavioral effects. Either way, the finding is backed by other experiments showing that third parties indeed hold principals less responsible for harm inflicted through agents even if the principals have full foreknowledge of their agent's actions.

This literature clearly suggests that agents have a behavioral tendency to disregard interests other than their own and that of their principal. Then how consequential can stakeholder legislation be?

Corporate boards are not an ideal target of behavioral research. They are rich institutional arrangements with intransparent decision-making procedures, which makes identification of causation difficult, if not impossible. On top of that, board members are typically high-profile decision makers concerned with confidential high-stake decision tasks, which makes it difficult to engage them for behavioral research in the field. Thus, the most suitable research design in the present context, appears to be a controlled laboratory experiment that introduces the corporate decision-making context by imitating its incentives and framing.

2 Experiment

Procedure

The experiment was conducted at the BonnEconLab of the University of Bonn. In total 149 subjects participated in the study. They were randomly invited from a pool of 6,000 registered subjects. Out
of the 149 participants in our sample, 93 were female (62.4%). Participants ranged in age from 19 to 32 years, with an average age of 22.9 years. With the exception of two, all were either university students or already had a university degree. In total, 36.7% had a background in natural sciences, psychology or medicine, 34.7% in law, politics or economics, and 28.6% in other subjects, including the humanities. 89.9% of the subjects were native speakers of German, the experiment’s language of instruction.

Upon arrival subjects were seated in separate cabins and received instructions. These instructions were read aloud, with a control questionnaire distributed afterwards. The experiment started only after all subjects had correctly answered all questions. Subsequent interactions were entirely computer-mediated. To avoid confounding the general willingness to donate to a charity with the willingness to donate to a specific one, we revealed the charity only after all decisions were made. However, subjects were told at the beginning of the experiment that the charity had the seal of approval by the German Central Institute for Social Issues (DZI), ensuring that the charity was tested and well-reputed.

After the experiment, subjects answered a questionnaire about socio-demographic details and motives for their decisions. In addition, all subjects completed the Justice Sensitivity Questionnaire with scales for justice sensitivity from the perspectives of victims, observers, and perpetrators.

Finally, subjects were paid individually and the amounts assigned to charity were put into a transparent glass jar. The last subject supervised the counting of the total donation and the online transfer to the charity. All subjects were informed about this procedure in the instructions. Including instructions, control questions, 10 decision periods, post-questionnaire and payments, each session lasted between one and two hours with average payments per subject of 10.22 Euro (i.e., about US$ 13.50).

3 Hypotheses

The baseline of our experiment was provided by the Control treatment. The rich experimental literature on dictator games shows that most proposers (on average 64%) transfer some non-trivial positive amount (on average 28.3%) to the receivers. Our recipient was a charity, which has been shown to increase average redistribution rates by as much as threefold and reduce the number of purely selfish subjects. On the other hand, we applied a business framing which has been shown to move behavior closer to rational predictions. But even business-framed decision experiments do suggest some role for such other-regarding preferences, albeit only a weak one. We therefore expected our baseline to dampen, but not completely eliminate the prevalence of positive transfers.

Introducing managers in the experiment puts agents in charge of financial decisions without restraining them to the principals’ interests since managers were free to donate to the charity whatever amount they pleased. In such cases, the managers can expropriate funds as they see fit. Given this liberty over corporate funds, managers will likely engage in a sort of competition, assessing their income relative to that of other corporate stakeholders. In our treatments without
competition, this lateral comparison figured prominently in that agents faced a secure, fixed wage of 3,000 Taler (10*300) while principals were paid out of a budget of 10,000 Taler from one random round. If agents transferred to the charity as much as senders usually do in the dictator game (20 to 30% of their endowment), their principals would still be twice as well off as they themselves. However, subjects are often inequality averse and promote a distribution of payoffs that is more equal. Thus, an inequality averse manager would transfer more than senders in a standard dictator game commonly do. Thus the first hypothesis tested in this paper is

**Hypothesis 1: In treatments with entrenched managers and without a manager market, transfers are higher than in Control**

Moving on from the simple entrenched manager case to one with three competing managers, we turn to Hamman et al. for an intuition of what to expect. In their treatments with agency, transfers initially equaled those in the condition without competing agents, but very quickly declined to half of those in the baseline condition. Facing a market, managers needed to please the shareholders to be hired again and thus managers suppressed their own generosity. This could be seen especially in the last round, where transfers exceeded previous ones by far, driven largely by several agents [...] choosing to give away all $10 in the final round, when there are no future possible repercussions from principals. Compared to Hamman et al., treatments differ primarily in terms of framing and the charity recipient. We assumed that this difference would not change the general pattern, but would merely affect its level.

**Hypothesis 2: The manager market aligns the managers' behavior with the shareholders' interests and thus reduces transfers**

Introducing the stakeholder frame into the treatments with and without the manager market, we adopted the naive hypothesis underlying Sec. 4.1.1 GCGC (and the model legislation on benefit corporations): Stakeholder legislation serves to increase the consideration given to stakeholders. We should therefore expect higher transfers in both of these treatments if the legal framing does work at all.

**Hypothesis 3: The introduction of the stakeholder norm increases the awareness for the stakeholders' concerns and thus increases transfers**

4 Results

First, as expected, we observe positive transfers in all five treatments. Our first hypothesis stated that transfers would be higher if decided upon by an agent rather than the principal. Across all periods, transfers in treatments were significantly higher than in treatment Control. Obviously, subjects in the role of managers prefer higher donations than shareholders themselves do.
We therefore conclude our first result.

**Result 1: In treatments with entrenched managers and without a manager market, transfers are higher than in Control.**

Our second hypothesis stated that manager competition would lower transfers. Both treatments with competition had significantly lower mean transfers than their counterparts without competition. This indicates that managers perceive a market-induced pressure to comply with shareholders’ interests. However, they initially seem to underestimate this pressure, so that transfers decrease even further after period 1.

Is a manager more or less likely to be chosen again if he donated a lot? The experiment showed that the more a manager donates, the less likely he will be selected again. Therefore, a manager who donates 100 more, decreases the likelihood of being chosen again by 21%, a rather strong effect. However, the estimation only explains little of overall variance.
Since shareholders conditioned their hiring decisions on previous allocations, managers had an incentive to please them. The effectiveness of this incentive can be gleaned from the behavior of managers who had continuously not been hired: Stated transfers of managers that had not been selected for at least four periods in a row were significantly higher than the transfers of those who had been selected at least once in the last four periods. But even regularly selected managers increased their transfers as soon as the pressure to comply with the shareholders' interest vanished. We conclude:

**Result 2:** The manager market aligns the managers' behavior with the shareholders' interests. When market incentives vanish, managers significantly increase their transfers.

We now turn to the effectiveness of the stakeholder provision. We hypothesized—in line with the innocent assumption of Sec. 4.1.1 GCGC—that the stakeholder provisions would have the desired effect, i.e. increase consideration given to the general public, as proxied by the charity in our experiment.

![Graph showing donation trends](image)

**Figure 2:** Amount (out of 10,000) donated to Charity over time

However there is no significant difference between the two treatments with manager markets, which suggests that the stakeholder norm does not play itself out in the presence of an incentive to be hired.

More surprisingly, we also observe no positive effect of the stakeholder norm in the treatments without manager market: Transfers to the charity are not higher in any of the treatments. We thus conclude:
Result 3: We do not observe that the stakeholder norm increases transfers. On the contrary, descriptively there seems to be an effect in the opposite direction.

In a final step, we tested the robustness of our previous results with parametric analyses and try to obtain some additional insight into the transfer decisions.

We found that competition decreases transfers significantly, while the introduction of the stakeholder norm does not increase transfers. The panel regression allows us to investigate some

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<th>Table 6: Random effects GLS estimation of transfers to charity</th>
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Clusters on group level; Robust Standard errors in parentheses; *** p < 0.01, ** p < 0.05, * p < 0.10; Only actually implemented transfers are used. An estimation with all data from the the strategy method obtains qualitatively similar results. See Table 8 in the Appendix.
developments over time. We observe a general increase of transfers over time and a huge and highly significant increase in the last period. With competition, managers face the risk of not being hired and this leads to additional adverse effects. After being unemployed for more than four periods, managers tend to transfer significantly higher amounts to the charity. We can only speculate whether this is caused by frustration, desire for revenge, image awareness or genuinely stronger concern for charity.

Models 3 and 4 also include a measure for personal sensitivity towards unjust behavior, as elicited using the Justice Sensitivity Questionnaire. As might be expected, being sensitive to injustice is positively correlated with managers' transfers. Parametric analyses therefore confirm our pervious results, and additionally we suggest:

**Result 4: Transfers increase significantly if managers have higher justice sensitivity and if they had been unemployed for at least four periods.**

As a very last step we turn to elicited beliefs and post-questionnaire items. Additional insight into managers' decisions is provided by the beliefs which we elicited with every allocation decision, asking what shareholders would do if left to their own devices. We found that across all treatments, managers’ beliefs were statistically indistinguishable from each other and from the true shareholder behavior in the Control, meaning that managers were well-calibrated with respect to their shareholders' preferences.

Our post-questionnaire items cast more light on this finding. One of the five-level Likert items ("strongly disagree" to "strongly agree") that our subjects had to answer read "Managers felt bound to the expectations of their shareholders". Note that managers answering in the affirmative admitted noncompliance with their framed duties, according to which "a manager is not bound by the expectations and demands of the shareholder". In the two treatments with manager competition, 70% and 62.5% of subjects selected one of the two agreement levels of this item, but even in the treatments without manager competition, this percentage was still 20.83% and 29.16%, respectively. The incentivized competition frame thus seems to have lowered managers' regard for the non-incentivized duties frame and given them a justification to submit to the competitive pressure.

**Result 5: Managers were well aware of shareholders' preferences and chose to abandon their stated duties based on their perceived incentives to conform to the shareholders' expectations.**

5 **Summary and Discussion**

We have conducted an experiment to shed light on some determinants of the efficacy of stakeholder legislation. In a dictator game variant with business framing, subjects were prompted to transfer any part of an exogenous endowment to the general public (represented by a charity) on behalf of their enterprise. In one condition, subjects were framed to be owner-managers, in four others they
were shareholders or managers required to take complementary steps towards this decision. In all treatments, the business framing strongly depressed transferred amounts, with less than half of the usually observed allotment going to charity.

In treatments with a manager, these managers transferred significantly higher amounts to the charity than shareholders had done themselves. This may be read as a case of agency costs, which in turn were reduced to almost zero if managers had to compete for their position. Such competition induced behavior virtually indistinguishable from shareholder behavior in the absence of managers. On the one hand, shareholders hired managers that were less other-regarding, on the other hand managers conformed consciously to what they (rightly) thought shareholders would expect.

When additionally prompting managers to pay due consideration to stakeholders such as the general public—as in Sec. 4.1.1 of the German Corporate Governance Code—this did not happen. Managers behaved no different in the presence of this norm. This even held if the institutionalized incentive of competition was lacking; if managers responded to the legal provision at all, they did so by lowering their transfers to charity.

One potential explanation might be that increasing the salience of stakeholder interests also increased the salience of shareholder interests. In our experiment managers were prompted to act in the "interest of the stakeholders [e.g. shareholders, employees, customers, general public]" where subjects might have read the order in which the different constituencies appeared as a ranking of priority. Thus the apparent "stakeholder frame" of Sec. 4.1.1 GC is may also be a "shareholder frame", in that it also mentions shareholder interests. This points to the fact that in any given context, it may not be apparent which reference group a normative framing favors.

Our study tentatively suggests policy implications for the design of social enterprises such as low-profit limited liability companies and benefit corporations. Lawmakers must be careful to consider incentives, and should think carefully about how to phrase the stakeholder norm. Because of the managers’ incentive to please shareholders, it might be ill-advised for benefit corporations to empower only shareholders. Unless shareholders in a benefit corporation are assumed to be very other-regarding, managers will first and foremost maximize shareholder value, just as in a classical corporation without any stakeholder norm. Anticipating that, investors in a benefit corporation need not be interested in social endeavors, so the label "benefit corporation" can not even be trusted to effectively select the "right" shareholders.

Regarding the stakeholder norm itself, our results shed some doubt on whether such an appeal will be helpful at all. Maybe stakeholders are better off if directors are not faced with a list of constituencies in which shareholders are mentioned at the very top. Perhaps managers should be formally granted full discretion by some catch-all phrase like "any other pertinent factors or the interests of any other group that [the directors] deem appropriate." On the other hand, lawmakers may just want to remind management that shareholders, too, are stakeholders to be considered.
Given the results of this paper, however, such reminders are barely necessary as long as management acts under the threat of being sanctioned by shareholders, and by shareholders only.