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THE GOALS OF THE CORPORATION UNDER SHAREHOLDER PRIMACY: JUST PROFIT— OR SOCIAL RESPONSIBILITY AND RELIGIOUS EXERCISE TOO?

Abstract:

Under the doctrine of shareholder primacy, the duty of a corporate director is to act for the benefit of the shareholders. This is not the same as profit maximization. It is only the same if shareholders care about profit and nothing else. The current *Hobby Lobby* case regarding a corporation's religious exemption from the Obamacare emergency contraception mandate is an example: the shareholders have made it clear they wish the directors to spend more on litigation than could possibly be saved by avoidance of the mandate. Goals other than pure profit should be permitted both for public and for closely held corporations. Even for public corporations in financial "efficient markets", maximization of market value may demand that the corporation sacrifice longterm profit for other goals. In some cases this will be to the detriment of minority shareholders who value profit alone, but the problem is no difference in essence from shareholder disagreement because of their differing time horizons or tax positions.

While corporate directors should and do have a fiduciary duty to act only for the benefit of shareholders, not for customers, employees, or community, this is not precisely equivalent to profit maximization, nor does it require (or even allow) directors to ignore religious beliefs. In practice the business judgment rule gives directors enough slack to accommodate other goals besides profit maximization, but it is worth detailing the interplay between the beliefs and desires of shareholders and directors to aid conscientious directors in their duty.

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I would like to thank Steven Bainbridge, William J. Carney, J. Mark Ramseyer, Thomas E. Rutledge, and participants in Indiana's Kelley School of Business's BEPP Brown Bag Lunch for useful comments, without implying lack of vigorous disagreement with what I say. This draft is rougher than I would ordinarily circulate, but since the *Hobby Lobby* case is currently before the Supreme Court, I wish to put it in circulation while interest is focussed on the question of corporate religious exercise. Note that I have included hyperlinks for convenient reference here and there.

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1. INTRODUCTION

A corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.¹

It is the obligation for directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders.²

These two statements about the objective of the corporation both frame the objective in terms of shareholder welfare. Corporate profit is indeed a key element of shareholder welfare, and for most large public corporations the only reason shareholders hold shares is for monetary reward. In their daily lives, however, people care about more than money. This is true even in the economic sphere. People do not always choose the job with the highest salary, and they do not always drive the hardest deal they can when they are bargaining. Thus, some shareholders do care about more than corporate profit. Consider, too, that not every corporation is public, or large, or widely held, but all fall under the same corporate law, if not the same securities law. Thus, it is useful to think about what “shareholder gain” and “long-run interests of the corporation’s stockholders” mean besides money.

Much is now being written on whether for-profit corporations are entitled to the same protections as individual people receive from the Religious Freedom Restoration Act (RFRA). Regulations based on the Patient Protection and Affordable Care Act (Obamacare) require any employer who offers health insurance to his employees to cover contraceptives, including emergency contraceptives such as “Plan B” which some believe causes abortions.³ The Administration argues that when RFRA exempts

¹ The American Law Institute, *Principles of Corporate Governance* §2.0.

² *Katz v. Oak Industries*, 508 A.2d 873, 879 (Del. Ch. 1989).

³ See Mark L. Rienzi, [God and the Profits: Is There Religious Liberty for Money-Makers?](#) 21 GEO. MASON L. REV. (2013); Frederick Mark Gedicks and Rebecca G. Van Tassell, [RFRA Exemptions from the Contraception Mandate: An Unconstitutional Accommodation of Religion](#); Jeremy M. Christiansen, *The Word ‘Person’... Includes Corporations: Why the Religious Freedom Restoration Act Protects Both For-And Nonprofit Corporations*, S.J. Quinney College of Law research paper No.39. Thomas E. Rutledge, [A Corporation Has No Soul-- The Business Entity Law Response to Challenges to the Contraceptive Mandate of the PPACA](#) (January 6, 2014).

“Obamacare” is the everyday term for the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), amended by the Health Care and Education Reconciliation Act of 2010. Pub. L. No. 111-152, 124 Stat. 1029. I will use “Obamacare” instead of the official name or the common abbreviation ACA because “Affordable Care Act” is tendentious, un-descriptive, bland, and contrary to popular usage, and is no more official than “Obamacare” (the official name is as stated at the start of this sentence). I have heard

“persons” from laws that infringe upon their exercise of religion, that includes nonprofit but not for-profit corporations. Depending on one’s jurisprudence, the answer depends on what dictionaries say, how the courts have defined “person” in other contexts, what various Congressmen intended, and so forth. I will not discuss those issues, but one part of them is the question of normative public policy and positive corporate law of what goals are proper for corporate directors to pursue. Corporate law’s vision of corporate goals is helpful in thinking about whether it is even legally possible for a corporation to exercise religion.

Hobby Lobby is typical of the mandate cases.⁴ *Hobby Lobby*, which is a corporation, and its shareholders wish to offer employee health insurance that excludes coverage of certain birth control pills which they oppose for religious reasons as possible abortifacients. They seek a preliminary injunction to stop the government from imposing fines for noncompliance until the case is decided on the merits. The circuits have split. The 10th Circuit has held for the corporation in *Hobby Lobby*; the 3rd Circuit has held for the government in *Conestoga*. The Supreme Court has granted cert on the question in *Hobby Lobby* of whether RFRA entitles corporations to exemption from the mandate for religious reasons.⁵

people say that “Obamacare” is derogatory, but I do not see it as such: close identification of a law with its promoters is derogatory only to the extent that the law itself is bad. RFRA is also a bad name, but that statute lacks a common name, so I will use “RFRA” for 42 U.S.C. §§2000bb: “Government shall not substantially burden a person’s exercise of religion even if the burden results from a rule of general applicability...”.

Until 2015 (at latest report), employers are not required to provide any insurance at all, but if they do offer it, it must include contraceptives. Even after 2015, employers with under 50 employees will not be required to offer insurance, but if they do so voluntarily, they will have to provide contraceptives.

⁴ *Hobby Lobby v. Sebelius*, 870 F.Supp.2d 1278 (W.D. Oklahoma 2012). See also *Conestoga Wood Specialties Corp. v. Sec’y of U.S. Dep’t of Health & Human Servs.*, 724 F.3d 377 (3d Cir. 2013); *Hobby Lobby Stores, Inc. v. Sebelius*, 723 F.3d 1114 (10th Cir. 2013) (en banc). *Gilardi v. U.S. Dep’t of Health & Human Servs.*, D.C Circuit No. 13-5069 (November 1, 2013); *Korte v. Sebelius* (November 2013) 7th Cir., No. 13-1077.

⁵ A distinct legal question is whether direct corporation religious rights are irrelevant because the owners of the corporation can sue as individuals—“reverse veil piercing.” See Stephen M. Bainbridge, *Using Reverse Veil Piercing to Vindicate the Free Exercise Rights of Incorporated Employers*, 16 THE GREEN BAG (2013). This doctrine applies if the corporation is closely held, which is true in *Hobby Lobby*, but it avoids the issue of whether a widely held public corporation has religious rights, unless we allow their shareholders some kind of class action reverse veil piercing. An alternative is “associational standing” of the corporation as an organization representing its members. Ordinarily, though, associational standing is used when a law hurts individuals as individuals but does not affect the organization. Here, the individuals are hurt only through government action against the organization. Associational standing would have the corporation suing on behalf its shareholders’ right not to be required to provide contraceptives via a corporation--- the same one--- that they own. See the discussion and cases cited in Brandon L. Garrett, *The Constitutional Standing of Corporations*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2330972 at 40 (September

With certain exceptions, corporate persons, whether nonprofit or for-profit, have the same constitutional protections as natural persons.⁶ The Obamacare mandate cases are not based on the 1st Amendment but on RFRA because the Supreme Court ruled in 1990 that even natural persons' 1st Amendment rights are not violated by limitations on religious exercise incidental to the aims of a statute.⁷ Congress responded by passing RFRA, to grant statutory protection instead. The Obamacare cases arose because the Administration promulgated regulations that interpreted a statute as requiring employer health plans to include various contraceptive pills. The Administration has granted RFRA exemptions on various grounds, but has fought granting them to for-profit corporations claiming religious scruples. Various corporations filed suit in response.⁸

Is the exercise of religion even a legitimate corporate activity? If it is contrary to the directors' fiduciary duty, then surely that kind of unlawful (though not criminal) behavior would not be protected by RFRA. I have not seen this argument made formally in the context of Obamacare, but I think it is in the back of the minds of some of the courts that have ruled on it.⁹

2013). Since the corporation is itself a legal person, it seems simpler just to let it sue in its own name when someone injures it, whether that someone be a private tortfeasor or a government regulator. The question, of course, then comes down to what consists of "injury" to the corporation--- is it just the damage to its monetary objective or the violation of its property rights, or can a corporation be injured by damage to other objectives its directors may be pursuing on behalf of the shareholders?

⁶From *Korte v. Sebelius* 7th Cir., No. 13-1077 (November 2013): "For example, long before *Citizens United* reinvigorated the political-speech rights of corporations, see *Citizens United v. FEC*, 558 U.S. 310 (2010), the Court confirmed that corporations have free-speech rights, see, e.g., *Bd. of Trs. of the State Univ. of N.Y. v. Fox*, 492 U.S. 469 (1989); *Pac. Gas & Elec. Co. v. Pub. Utils. Comm'n of Cal.*, 475 U.S. 1, 8 (1986) (plurality opinion); *Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of N.Y.*, 447 U.S. 557 (1980); *First Nat'l Bank of Bos. v. Bellotti*, 435 U.S. 765, 776 (1978); *N.Y. Times Co. v. Sullivan*, 376 U.S. 254 (1964). Prior to *Smith* the Court held that the Fourth Amendment protected corporations from unreasonable searches and seizures. See *Silverthorne Lumber Co. v. United States*, 251 U.S. 385, 392 (1920); *Hale v. Henkel*, 201 U.S. 43, 76 (1906), overruled on other grounds by *Murphy v. Waterfront Comm'n of N.Y. Harbor*, 378 U.S. 52 (1964)." The right against self-incrimination is an exception (see *Korte* for cites), but of course the corporation itself cannot testify or write documents, and its directors and employees may assert the privilege individually.

⁷ *Emp'l Div., Dep't. of Human Res. of Oregon v. Smith*, 494 U.S. 872 (1990).

⁸ I do not know of any corporation which has filed suit on 1st Amendment grounds. To win such a suit, it would have to show that the executive constraint on its religious belief was not incidental, but rather was a major purpose of the regulation or its stringent enforcement. Give the Administration's strong litigation positions and the many non-religious exemptions it has granted, such an argument might have some basis.

⁹ E.g., "We do not see how a for-profit 'artificial being, invisible, intangible, and existing only in contemplation of law,' *Consol. Edison Co.*, 292 F.3d at 346 (quoting *Dartmouth Coll.*, 17 U.S. at 636 (Marshall, C.J.)), that was created to make money could exercise such an inherently 'human' right." *Conestoga v. Sec'y*, 724 F.3d 377 (3d Cir. 2013). Non-profit corporations such as churches are of course exactly as artificial, invisible, intangible, and

To address the question of religious goals for corporations, we must address the general question of whether a corporation can have any goal but profit. Here constitutional law meets corporate law. The proper goal of a corporation is an old question in corporate law, most commonly discussed in connection of “social responsibility”.¹⁰ American law has taken the view that a corporation’s directors must act solely for the goal of benefiting the shareholders, subject to minor caveats such as not engaging in criminal acts. This is known as “shareholder primacy”.¹¹ The opposing view is that the directors also should sometimes act to hurt shareholders if that would benefit “stakeholders”: other parties interested in the acts of the corporation, such as customers, employees, suppliers, and local governments.¹²

existent only in the contemplation of law, so the real objection must pertain to the organization’s objectives.

¹⁰ Leo Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Charge of Control Transactions: Is There Any There There*, 75 CAL. L. REV. 1169-1188 (2001-2002) (contrasting two views of whether the board has a duty to sell the company at the highest price bid).

¹¹ On shareholder primacy, see Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439-468 (2000-2001) (convergence of different country’s law to shareholder primacy); John Armour, Simon Deakin, and Suzanne J. Konzelmann, *Shareholder Primacy and the Trajectory of UK Corporate Governance* (application to U.K. law); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization* 149 U. PA. L. REV. 2027-2062 (2000) (divergence between shareholder and society wealth maximization due to monopoly power). Professor Bainbridge, while accepting that directors should act for shareholder benefit, warns of the danger of confusing that kind of “shareholder primacy” with the idea that shareholders, not directors, are the legal decisionmakers for the corporation. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2002) and Stephen M. Bainbridge *Director v. Shareholder Primacy in the Convergence Debate* 16 TRANSNT’L LAW. 45-62 (2002-2003). “Shareholder primacy” does not by itself say what to do when different shareholders have different interests, the subject of many of corporate law’s most interesting problems.

¹² For criticisms of shareholder primacy, see Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy* 31 J. CORP. L. 637-674 (2005-2006); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory Of Corporate Law*, 85 VA. L. REV. 247 (1999); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979).

An orthogonal line of thought disputes whether the directors have any fiduciary duty towards creditors, especially when the firm is near bankruptcy but has not yet filed. (Once it files, a trustee makes decisions in accordance with bankruptcy law; a classic case is *In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987, Easterbrook, J.).) Chancellor Allen of Delaware said, “At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.” *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, Court of Chancery of Delaware, New Castle County, WL 277613, 34 (1991.) (Calling the board an “agent” is an inadvertent technical error here, see below at xxx.) On the pro-creditor side are Douglas G. Baird and M. Todd Henderson, [*Other People's Money*](#), 60 STANFORD LAW REVIEW (2008); for the shareholders are Henry T.C. Hu and Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 108 COLUM. L. REV. (2008).

For this paper, we will be taking shareholder primacy as a given. Instead, we will focus on a different concept which is often confused with shareholder primacy: profit maximization. Of course, a corporation which maximizes profits, the benefits of which flow to shareholders and only incidentally to other parties, is disregarding stakeholders.¹³ But that does not mean it is acting in accordance with shareholder primacy. If the shareholders do not want the corporation to maximize profits, a corporation which does so is not acting in accordance with shareholder primacy. It is operating under “profit primacy” instead, and contrary to the owner’s interests.

Consider, for example, a corporation owned by one shareholder who wishes it to donate 20% of its profits to fund a program to help needy children without any prospect of that good deed increasing profits. Profit maximization would require the directors (if there is more than one) to vote against the donation. Shareholder primacy require them to vote in favor--- unless they can have a good reason to suppose that the shareholders true interest would not thereby be served.¹⁴ Under a stakeholder theory, on the other hand, the director might be allowed or required to make the donation whether or not the shareholder wanted it.¹⁵

One cannot look to a corporation’s charter to discover whether it is intended to maximize profits. The main specification in a charter is the corporation’s “purpose”— the activities in which it can engage— rather than its “goal”— the term I use for its objective.¹⁶ Nowadays, charters are less important than in the 1800’s and they are usually written to specify the purpose as broadly as possible.¹⁷ The Model Business Corporation Act

¹³ This is well put in a much-cited magazine article on why shareholder primacy is desirable: Milton Friedman, [*The Social Responsibility of Business Is To Increase Its Profits*](#), N.Y. TIMES MAG. 32 (Sept. 13, 1970). Professor Friedman, like most of the academic literature, focusses on the question of shareholders vs. stakeholders rather than delving into the various objectives shareholders might have.

¹⁴ For example, the directors might know of a business opportunity that if pursued using the donation money would allow twice as big a donation to be made the following year. We will go into such exceptions later in the paper.

¹⁵ Stakeholder theories have not addressed all the puzzles multiple interests generate. For example, if the directors follow the shareholders’ desire and make the 20% donation, should employees be able to go to court to block the donation because it leaves less revenue for wages?

¹⁶ It is easy to get tripped up by the word “purpose”, and readers will see that even corporate law scholars sometimes use “purpose” and “goal” interchangeably (but that the model codes do not). There is no standard term for the objective shareholders desire the corporation to attain via its purpose. The *ultra vires* doctrine, now largely obsolete, restricts the activities in which the corporation can engage, but if a corporation stays within those activities, the directors may, as far as that doctrine is concerned, act for any reason they like, even self-dealing. Different doctrines deal with problems such as self-dealing.

¹⁷ See William J. Carney, [*Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*](#), 5 AMERICAN BAR FOUNDATION RESEARCH JOURNAL 69-132 (1980). But see

says, “Every corporation incorporated under this Act has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation.”¹⁸ The State of Delaware provides a template, for example, which says “The purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware,” with no blanks for limiting the purpose further.¹⁹ That template says nothing whatsoever as to the goal of the corporation.

A company has owners, and if we follow the usual principle that theft is wrong, Robin Hoods should not be allowed to sit on the boards of directors and distribute corporate assets to the poor.²⁰ But shareholders are people, and people do not own things just so they can sell them. People want money so they can accomplish things: buy houses, rent cars, make political donations, support their church, and so forth. Thus, under the standard doctrine of “shareholder primacy”²¹, profit should not necessarily be the only goal. On the other hand, some corporations are nonprofit. We think of nonprofit corporations as if their goal is to further the public good, but that is not quite right. The public good is the legal goal of charitable nonprofit corporations— a subset of nonprofit corporations generally— but it is not always the intent of their founders, who in many cases are thinking of advancing their own careers. Thus, the roles and goals of both profit and nonprofit corporations require careful thought.

In *Hobby Lobby* case, the Green family, who control the corporation, have a religious objection to the use of Plan B contraceptives. Avoiding the mandate would also save them the price of the contraceptives, but that

also Jonathan Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. LAW 85 (1999).

¹⁸ *Model Business Corporation Act* §3.01 “Purpose” is a term of art in corporate law, meaning not the objective (e.g. profit) but the kinds of activities in which the corporation can engage. As the quote suggests, most corporations do not wish to limit their purpose. “A recent survey has demonstrated conclusively that the overwhelming majority of corporations in most states, particularly medium and large-sized corporations, has adopted broad, boilerplate purpose clauses or, where available, an “any lawful purpose” clause.” Michael A. Schaeftler, *The Purpose Clause in the Certificate of Incorporation: A Clause in Search of a Purpose* 58 ST. JOHN’S LAW REVIEW 476, 482 (1984).

¹⁹ Delaware Dept. of State, *Stock Certificate of Incorporation*, <http://corp.delaware.gov/incstk09.pdf> (December 7, 2013).

²⁰ Whether a corporation is technically property I do not know, though its shares certainly are property. I use the term in the same sense as we talk about the “owners” of a corporation, even though perhaps shareholders are not technically owners.

²¹ Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001) (“The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured, even if it was problematic as recently as twenty-five years ago.”).

saving would be trivial.²² In terms of cash flows, the money Hobby Lobby has spent on the case's litigation cannot be justified by the saving on insurance cost. If some shareholder member of the Green family were to sue to enjoin the corporation from continuing the litigation, and if the directors were to admit that they made their decision based on the religious principles of other shareholders rather than to maximize profit, should the plaintiff win?²³

The *Hobby Lobby* case itself is relatively simple. We don't need to worry about the separation of ownership and control. The company is closely held by members of one family, so the directors are closely aligned with the shareholders, and there seems to be no problem of minority disagreement. In terms of corporate law, the issue comes down to whether if someone incorporates his business he must thereafter maximize profits at the expense of all other objectives. This seems absurd. Why should the directors be required to follow a policy that benefits no one—neither shareholders, stakeholders, nor themselves? Regarding RFRA, cases like *Hobby Lobby* present the question of whether by incorporating, the owner has forfeited the religious exercise rights he would retain if the business were a sole proprietorship, partnership,²⁴ or a nonprofit with unrelated business activity. If he does forfeit them, we would expect such a policy to distort governance forms away from what is optimal for productive efficiency as some businesses decide to avoid the corporate form.

In this paper I wish to look at more difficult questions as well. What if Hobby Lobby were a public corporation with thousands of owners? What if it were privately held, but a minority of shareholders were irreligious? What if the religious beliefs of the shareholders of a corporation change, whether because of a changes in the original shareholder's belief or changes in ownership? What if the shareholders are not religious, but

²² Teva makes the Plan B pill. Teva's sale of "Women's products" was \$448 million in 2012. Divide that by the perhaps 200 million American adults (I don't know whether foreign sales are included) and we get about \$2/pill per employee. If Hobby Lobby has 5,000 employees, that comes to \$10,000/year. Teva Pharmaceutical Industries Ltd., *Historical Sales by Branded Products*, <http://ir.tevapharm.com/phoenix.zhtml?c=73925&p=irol-reportsAnnual>

²³ The admission by the directors is important because the business judgment rule, discussed later in this article, would otherwise shield the directors, since a rational argument can be made that the litigation spending created good publicity for Hobby Lobby that will increase sales.

²⁴ A separate issue is whether even individuals should be granted exemption by RFRA from the Obamacare mandate. RFRA does not require an exemption if the effect on religious exercise is not "a substantial burden" or the government has "a compelling interest" which this is the "least restrictive means" to achieve. I will discuss none of that here. For a good discussion, see the blog post series (including the comments) that ends with Eugene Volokh, 6. *Beyond RFRA: What Should We Think of Mutual Duties of Accommodation?* THE VOLOKH CONSPIRACY, <http://www.volokh.com/2013/12/07/6-beyond-rfra-think-mutual-duties-accommodation/> (December 7, 2013) (last viewed December 7, 2013).

stakeholders are? What if an individual director is religious but the shareholders are not?

In addressing these questions, and in trying to clear up general confusion about governance, purpose, goals, and roles, this paper will make four points.

First, the economic goal of a corporation is to advance the goals of natural persons, and so cannot be restricted to profit maximization. A corporation is just a way of organizing individual effort. Starting a religious bookstore or a hospital, someone might choose to be a partnership, a nonprofit corporation, or a for-profit corporation. You cannot pin down his life goals by his choice of organizational form.

Second, the individual goals advanced by corporations motivated solely by profit include religious goals instrumentally, because the well-being of even the most selfish shareholder depends on the beliefs of his company's stakeholders—its customers, workers, executives, and directors. This is well-known. An implication, however, is that the stakeholders are something like contract law's third party beneficiaries; they have a keen interest in the corporation's right to exercise religion, keener perhaps even than the shareholders'. Shareholders earn a normal rate of return in ordinary markets, but customers obtain not only value for money, but consumer surplus. In addition, the corporate director is not an agent, but a fiduciary, who not only may, but must, exercise his own discretion in trying to serve the interests of the owners. The law should not *require* a director to listen to stakeholders, but it should *permit* him to listen, and to act in their interests when they coincide with the shareholders'. Moreover, the director must act in what he believes to be the true interests of the shareholders, even if they have not made all their interests explicit, and in some cases even when they disagree with the director. This is a straightforward application of the business judgment rule. The exercise of religion may be motivated by profit as well as piety, for businesses as it is for individuals.

Third, current corporate law, though somewhat confused in its dicta, in practice endorses the idea that a director should be free to pursue goals of principle as well as profit— if he can argue that this is for the benefit of shareholders. The business judgment rule allows directors ample wiggle room in pursuing nonmonetary goals. Moreover, the most consistent explanation of existing law is that a director is free to leave the safe harbor of the business judgment rule and admit that his goals hurt profits— so long as he is acting to benefit the shareholders.

Fourth, the law should carefully tell a director how he is to act in the interests of shareholders, even though its ability to compel him to do so is limited by the difficulty of enforcement. The business judgment rule is a response to the enforcement problem, and in practice it allows directors

considerable slack for putting their own interests ahead of shareholders, something that is unfortunate but is better for shareholders than letting courts decide how the business should be conducted. But directors do not always take advantage of their slack, any more than taxpayers do not always take advantage of the IRS's infrequency of auditing to underpay taxes. Well-meaning directors need guidance on ethics, so it useful to tell them what they should be doing even if the courts do not have the information and ability to force them to do what is right.

2. WHAT IS A CORPORATION?

The dissent in the 7th Circuit's Obamacare case *Korte v. Sebelius* says:

[I]t strikes me as potentially demeaning to religious faith to say that a corporation should be said to possess the same right to free exercise of religion that a human being enjoys in this country. ...To say, as the court does today, that the right to exercise one's religious faith may be asserted on the same terms by a legal construct—an incorporated currency exchange, accounting firm, or automobile repair shop, for example—as by a human being, is, to my mind at least, irreconcilable with the very essence of religious faith and, for that matter, humankind.²⁵

Our first task is to address whether the corporate form is compatible with religious objectives.

2A. ORGANIZATIONAL FORM IS A TOOL OF PRODUCTION, NOT THE BUSINESS ITSELF

2A1. MOTIVES FOR ORGANIZING A BUSINESS--- THE STORY OF JOHN AND RON

Suppose brothers John and Ron have just split a large inheritance. John is a pious boy who wanted to be a missionary till he realized he couldn't give a sermon without putting the congregation to sleep. Ron is selfish but intelligent. He wants a good income without much work.

John has decided to start a Christian radio station. He sees that his city lacks such a radio station and many people are never reached by the Gospel of Christ. A local easy listening station is failing, and he knows he has the talent to convert it to a religious format that will attract many listeners and enough ad revenue to make it self-sustaining.

John can choose from a number of organizational forms— for-profit

²⁵ *Korte v. Sebelius*, 7th Circuit, No. 13-1077 (November 8, 2013). See also James Boyd White, *How Should We Talk about Corporations? The Languages of Economics and of Citizenship*, 94 YALE L. J. 1416-1425 (1985).

corporation, the nonprofit, the partnership, and so forth. They do not differ in having to obey general business rules and regulations such as tax withholding, OSHA safety rules, and so forth. These often depend on the size of the organization—staying small can permit exemption—but not on organization form.²⁶ Organizational forms do differ in who provides capital, who makes decisions, and what taxes are paid. If John wanted, he could perhaps escape some of these regulations by conforming to the requirements for a “religious organization”, which like a small business is exempt from some regulations, but he doesn’t want the constraints this would put upon him.²⁷

When John begins his planning, he is a **sole proprietorship**. He has complete control of the radio station’s assets—his inheritance, initially. If nothing changes, he will pay tax on the station’s income as part of his personal income, but that’s fine with him. He thinks to himself, “This is not just a business, this is a mission. It’s how the 1st century Church was organized—people gave generously to the apostles, who spent it as they thought fit. It’s just like in *Acts*.”²⁸ But John has a problem. It costs a lot to start a radio station. His inheritance is too small. It isn’t enough to serve as collateral for a sufficiently big bank loan, and even if it were, he is nervous about staking his entire inheritance on one business.²⁹

²⁶ See [Mirit Eyal-Cohen](#), *Down-Sizing the Little Guy Myth in Legal Definitions*, 98 IOWA L. REV. 1041 (2013).

²⁷ See Zoë Robinson, *What Is a Religious Institution?* 55 BOSTON COLL. L. REV. ____ (forthcoming, 2014); Richard Schragger and Micah Schwartzman, *Against Religious Institutionalism*, 99 VA. L. REV. (2013).

²⁸ Acts 4:34-35: “Neither was there any among them that lacked: for as many as were possessors of lands or houses sold them, and brought the prices of the things that were sold, And laid them down at the apostles’ feet: and distribution was made unto every man according as he had need.” John is not quite right. The early church was an **unincorporated association**, the nonprofit equivalent of a partnership, a body without legal personality in which all property is held in the name of individuals in trust for the association. To the extent that John accepts donations, his sole proprietorship too will be a constructive trustee.

²⁹ Since the sole proprietorship is a for-profit form of organization, notice that being for-profit does not prevent an organization from exercising religion, if you grant that a church can exercise religion and that it can be completely controlled by the founder and hold all property in his name. This also shows that a for-profit organization need not have profit as its goal at all—not even as one of several goals. The founders of many churches found them as sole proprietorships because that is simple and easy, even though they intend to use any excess of revenue over cost for charitable purposes. Or—though this is just a different way to classify the same behavior—an economist might say that the church makes a profit which the owner, the founding pastor, donates back for charitable purposes. A storefront church whose low-income congregation that does not itemize might well continue as a sole proprietorship for quite some time.

To be sure, deductions to such a church are not tax deductible. For that, it must become at least an **unincorporated association**, no members of its governing body (which could still be one person) being residual claimants, even without applying for formal 501 (c)(3) status

Where can he get capital? Donations, perhaps. John asks some of his father's wealthy friends, but they are reluctant, because they aren't sure whether it's John or Ron who is the selfish brother and they don't want to put a donation directly into John's bank account. Thus, they suggest that John organize as a **nonprofit corporation**. They even will let him select a majority of the board of directors, since they know the law will not allow him to pay himself a giant salary, buy supplies from a front company he owns, dollars apiece, or otherwise "tunnel" the corporation.³⁰ John will donate capital too, and the station will take out of a loan, but he can keep some of his inheritance safely as personal property. Better yet, he can create a **501(c)(3) charitable nonprofit corporation** so the donations will be tax-deductible and the income tax-exempt.³¹ John won't get dividends on his contribution, but he'll in effect set his own salary and have perfect job security so long as he doesn't run in the red too long.³²

(though that status serves as a safe harbor and without it the IRS may question whether the organization is truly religious). The law of unincorporated associations is an uncomfortable combination of partnership law and trust law. Like a partnership, the association does not have to have any by-laws or any particular governance structure, and property must be held in the name of individuals. See Internal Revenue Service, *Tax Guide for Churches and Religious Organizations*, Pub. 1828, <http://www.irs.gov/pub/irs-pdf/p1828.pdf>; Nolo, *What is An Unincorporated Nonprofit Association?* <http://www.nolo.com/legal-encyclopedia/what-an-unincorporated-nonprofit-association.html> (August 2013) (viewed December 8, 2013); Roger Sapp, *Four Ways to Legally Organize Your American Church or Ministry*, http://www.allnationsmin.org/Download/documents/4_Ways_to_Organize_a_Ministry.pdf (viewed December 8, 2013). The unincorporated religious association has received surprisingly little scholarly attention, despite including some relatively large organizations. In 1989, the Reorganized Latter Day Saints, a lesser-known branch Mormon denomination, was still an unassociated association— see *Gene M. Hummel, Trustee for the Reorganized Church of Jesus Christ of Latter Day Saints v. Wesley Townsend*, [883 F.2d 367](#) (5th Cir. 1989). It is now the 250,000-member Community of Christ, which by 2011 was suing in its own name; *Community of Christ Copyright Corporation; Community of Christ Church v. Devon Park Restoration Branch of Jesus Christ's Church; David McLean*, [634 F.3d 1005](#) (8th Cir. 2011).

³⁰ On various ways in which insiders can loot a corporation (some of them applicable only to for-profit corporations), see Vladimir Atanasov, Bernard Black and Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1 (2011); Naomi Lamoreaux and Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States before the Great Depression*, CORRUPTION AND REFORM: LESSONS FROM AMERICA'S ECONOMIC HISTORY 125 (Edward L. Glaeser and Claudia Goldin eds., 2006).

³¹ For a discussion of current U.S. tax rules and governance, see David S. Miller, *Reforming the Taxation of Exempt Organizations and Their Patrons*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2343376 (October 21, 2013).

³² Becoming a 501(c)(3) is purely a tax decision, not an organizational one, except that certain organizations can't possibly qualify. Be careful in thinking about cases like the Obamacare ones of not confusing the two dimensions of tax status and governance. The question there is whether for-profit corporations are covered by RFRA; nobody is asking whether a 501(c)(3) nonprofit would be covered but a taxable nonprofit would not be covered. Indeed, a further wrinkle is that a nonprofit can be tax exempt (but is not necessarily so) even if has not been

Alas, John finds he still can't persuade enough wealthy donors. One of them, however, suggests that they form a **partnership**. He's willing to put a lot of his wealth in if he can earn a return on it, as well as doing good. That suits John until he finds out that the rich man is thinking of a **limited partnership** in which John alone bears personal liability for all the partnership's debts. So John starts thinking about the manifold variety of "uncorporations": **the limited-liability partnership, the limited-liability limited partnership, the master limited partnership, the limited liability company, the trust, the charitable trust, the cooperative, the benefit corporation, the low profit limited liability corporation, California's "flexible purpose corporation",**³³ and even the archaic common law "**corporation sole**"³⁴ used by the Roman Catholic church.³⁵

In the end, his head whirling, John settles on forming a simple, garden-variety **corporation**. He can get devout people in town to buy shares, so his starting capital will be ample. He can retain control by retaining a majority of the voting shares, but his liability is limited to the capital he puts into the company. It won't be tax-exempt, but money isn't his main objective and tax exemption is no use if you don't have enough capital to get started. Plus, he can always convert to a charitable corporation later if the venture is successful and he can buy out the other shareholders.³⁶ Or,

granted 501(c)(3) status. [Cite to rules about pending applications, and to some cite that talks about 501(c)(3) just being a safe harbor.]

³³ See Emily Cohen, *Benefit Expenses: How the Benefit Corporation's Social Purpose Changes the Ordinary and Necessary*, 4 WM. & MARY BUS. L. REV. 269 (2013); Ashley Schoenjahn, *New Faces of Corporate Responsibility: Will New Entity Forms Allow Businesses To Do Good?* 37 J. CORP. L. 453-474 (2011); Eric L. Talley, *Corporate Form and Social Entrepreneurship: A Status Report from California (and Beyond)* (2013); Brian Galle, *Social Enterprise: Who Needs It?* Forthcoming, 54 BOSTON COLLEGE LAW REVIEW — (2013); Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879 (2010); J. William Callison and Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VERMONT L. REV. 273 (2010); James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179.

³⁴ See F. W. Maitland, *Corporation Sole*, 16 L. Q. REV. 335-354 (1900) and http://www.allnationsmin.org/Download/documents/4_Ways_to_Organize_a_Ministry.pdf.

The corporation sole is rarely an option now. It is regulated by state law, which has long restricted it to religious organizations in some states and often prohibits the establishment of new corporations sole, while grandfathering the old ones. Master limited partnerships are currently restricted to energy businesses in the United States.

³⁵ If we allow John to create more than one entity, the possibilities grow exponentially. For one combination strategy, see Seong J. Kim, *Note: Hiding Behind the Corporate Veil: A Guide to Non-Profit Corporations with For-Profit Subsidiaries*, 5 HASTINGS BUS. L. J. 189 (2009).

³⁶ For converting to non-profit status, John must buy out the other shareholders and donate enough capital to the new nonprofit corporation to make it viable. Getting tax-exempt status would be more problematic if he remained in the new nonprofit's governance, even though he

he dreams, perhaps he will expand into other cities. He would need more capital for that, but he could become a **publicly held corporation** and be listed on the New York Stock Exchange if he gives up some more control and adheres to Securities and Exchange Commission regulations.

The point of this story is that throughout all these organizational changes, John's business remains unchanged. He wants to get hold of some capital to run a radio station so he can earn a living and spread the gospel. He doesn't really care about the name of the legal entity— that's lawyer stuff, and won't affect what he does with the business. Different forms of organization are convenient for different enterprises, but it is wrong to think that some are inherently religious and some are inherently profit-oriented.³⁷ Just as a human being can choose as his objective wealth, the spread of Christianity, or a mixture of the two (e.g. making money to donate to missionaries), so his organization can maintain diverse objectives (selling advertisements for profit plus broadcasting sermons for

would be entitled to 501(c)(3) status, because the IRS would be suspicious that the conversion was an attempt by John to evade taxes and he would have to satisfy them that it was not.

Conversion from non-profit corporation to for-profit is also possible. From 1994 to 2003, 14 states' Blue Cross Blue Shield insurance companies converted from nonprofit to for-profit corporations (after the nonprofits had lost their tax-exempt status in the 1986 tax reform bill). They cited the increased ease of obtaining new capital and the usefulness of being able to base executive pay on stock performance. They remain affiliates of the national Blue Cross Blue Shield, which still contains the nonprofits which did not convert. See Leemore Dafny and Subramaniam Ramanarayanan, *Does It Matter if Your Health Insurer Is For-Profit? Effects of Ownership on Premiums, Insurance Coverage, and Medical Spending*, NBER Working Paper 18286, <http://www.nber.org/papers/w18286> (July 2012); Nancy Beaulieu, *An Economic Analysis of Health Plan Conversions: Are They in the Public Interest?* 7 FORUM FOR HEALTH ECONOMICS & POLICY:Article 6 (2004); Christopher Conover, Mark Hall, and Jan Ostermann, *The Impact of Blue Cross Conversions on Health Spending and the Uninsured*, 24 HEALTH AFFAIRS 473-482 (2005). Hospitals and HMO's also convert from non-profit to for-profit status; see David Cutler and Jill Horwitz, *Converting Hospitals from Not-for-Profit to For-Profit Status: Why and What Effects?* THE CHANGING HOSPITAL INDUSTRY: COMPARING NOT-FOR-PROFIT AND FOR-PROFIT INSTITUTIONS. D. Cutler, Ed., 45-79 (2000); Robert Town, Roger Feldman, and Douglas Wholey, *The Impact of Ownership Conversions on HMO Performance*, 4 INTERNATIONAL JOURNAL OF HEALTH CARE FINANCE AND ECONOMICS, 327-342 (2004). To convert, a tax-exempt non-profit must transfer its equity value to a charitable entity and obtain state government approval for its plan; see James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701 (1997-1998).

³⁷ See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980); Anup Malani and Eric A. Posner, *The Case for For-Profit Charities*, Univ. of Chicago Law Sch., John M. Olin Law & Economics Working Paper No. 304, <http://www.law.uchicago.edu/files/files/304.pdf> (2006); Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL UNIV. L. REV. 819 (2012). David Easley and Maureen O'Hara, *The Economic Role of the Nonprofit Firm*, 14 BELL J. ECON. 531 (1983). Edward L. Glaeser & Andrei Shleifer, *Not-for-Profit Entrepreneurs*, 81 J. PUB. ECON. 99 (2001); Dana Brakman Reiser, *For Profit Philanthropy*, 77 FORDHAM L. REV. 2437 (2009).

evangelism). Being able to choose from different forms of legal organization helps him coordinate his activities with those of other people, allocating powers and duties in various ways. The form of legal organizations is a means to an end, rather than a thing in itself. A church can be organized as a partnership, a nonprofit corporation, or a for-profit corporation, depending on such things as simplicity, liability rules, and the details of tax law, just as the church vehicle could be either a sedan or a pickup truck, depending on its particular circumstances. Just as we should not make a person's religious rights depend on whether he drives a sedan or a pickup, so we should not make them depend on whether he uses a nonprofit corporation or a for-profit corporation. A pastor's right to preach the Word should not be forfeited just because he has chosen to incorporate his preaching as a Chapter-S corporation.

Let us resume the story. We have forgotten Ron, the hedonist brother. He, too, wants to earn a living, though he cares no more for God than for gophers. Ron is in an excellent position to steal John's idea for a Christian radio station. Ron, too, has to think about how to organize his business—and quickly, so he can buy the easy listening station before John does. Ron's thinking is much the same as John's, but it does differ at a few points. At first, he doesn't like the idea of the nonprofit corporation, because he won't get any dividends on his contribution and won't be able to use the other donations for personal consumption without undue risk of prison. Plus, he will have to file reports with the government if he makes it a 501(c)(3) corporation. But after a little thought he realizes that the nonprofit form has a lot of benefits. By getting donations instead of selling shares, he will escape the ongoing scrutiny that shareholders would bother him with. (Partners would be even worse.) He can't get dividends, but he can take perks like company cars and a painting collection for the lobby based not just on his own capital, but other people's— and this return on capital is tax exempt! Plus, he can take his dividends in the form of an inflated salary, since the authorities are very generous in their definition of "reasonable compensation" for himself, his wife, and his numerous in-laws. A closely held corporation would make all this more difficult, with its requirements for director elections, annual reports, and so forth. He shudders at the thought of working for a publicly held corporation— way too much transparency, plus the risk of a hostile takeover.³⁸ In the end, Ron decides to work harder than John did at finding some wealthy donors

³⁸ In fact, he might prefer to organize his business as a church, a better organizational category for unscrupulous self-enrichment because churches do not need to file Form 990's, which publicly list the salaries of top employees. Our perverse public protection of dishonest clergy is discussed in John Montague, *The Law and Financial Transparency in Churches: Reconsidering the Form 990 Exemption*, 35 CARDOZO L. REV. 203 (2013).

to start off the company. Being unscrupulous, he's unrestrained in his ability to tell lies, and so it's easier for him to hoodwink old ladies and start a charity. And so he moves quickly and emerges as the winner, effective owner of a nonprofit radio corporation.

Is this a sad ending? No, not really. Pious John goes off and does something else. Perhaps he starts a car repair business, intending to serve the public by offering them honest service with no kickbacks, overdiagnosing, or goldplating, and free repairs for the deserving poor for whom a broken transmission is financial disaster. Such honesty may cost him some profits, but he is serving God, not Mammon. Indeed, it is standard Christian doctrine, emphasized in particular by Protestants, that secular vocations serve God just as well as religious ones. Martin Luther said

It is pure invention that pope, bishop, priests, and monks are called the spiritual estate while princes, lords, artisans, and farmers are called the temporal estate. This is indeed a piece of deceit and hypocrisy....All Christians are truly of the spiritual estate, and there is no difference among them except that of office.³⁹

Christian doctrine of the traditional variety that is likely to be motivating requests for religious exemptions says that men are born sinful and cannot be redeemed by their own efforts. God must choose to redeem them, and does not choose based on how someone behaves. He redeems them by the death of Jesus Christ on the cross rather than their own degree of sinfulness. The Christian, however, should be grateful for his salvation and for that reason should seek to please God, which means trying to obey His commands.⁴⁰ Those not saved will suffer in Hell for their sins, but will suffer less if they sin less. God is pleased with secular callings as well as pastoral ones, because in both the Christian can do God's will, and the secular calling is merely a different way of serving God, with no fewer obligations. One ought not to be a "Sunday Christian". In addition, God may or may not choose to inflict punishment in the earthly life of someone who commits a sinful act (even one of the redeemed—though then the punishment is in the spirit of paternal discipline).⁴¹ This will also be relevant to our discussion later of the Christian director's duty.

How about the Christian radio station, with its hypocritical CEO Ron? That turns out happily too. Ron is selfish, but not stupid. He is careful not

³⁹Martin Luther, *Appeal to the German Nobility* (1520).

⁴⁰ Roman Catholicism would add that even most of the redeemed will spend time in Purgatory after death, a time proportional to their sinning, but a few ("saints") will go directly to Heaven.

⁴¹ [Figure out what footnotes to use for this.] John Stott, *BASIC CHRISTIANITY* (1958); [*The 39 Articles*](#) (1571); [*The Westminster Confession of Faith*](#) (1656); [*CATECHISM OF THE CATHOLIC CHURCH*](#) (1993).

to flaunt his impiety, and he knows how to run a tight ship so as to save on costs and earn extra revenue for his own perks and vacations. Those perks do cost something, to be sure, but what in life is free? Ron still gives good value for his money, and though his efforts may not lead to his own salvation, that does not mean they will not advance God's will. Think, moreover, of the evil that would have resulted if John had been a little quicker and started the radio station first. John would run the station exactly the same as Ron, just at a lower salary. But if Ron had chosen the car repair business, think of how the cost of repairs would rise! Piety is helpful for more than just preaching.

2A2. IS THE CORPORATION A LEGAL FICTION?

Jensen and Meckling said in their celebrated 1976 article initiating the “nexus of contracts” view of the firm that “[M]ost organizations are simply *legal fictions which serve as a nexus for a set of contracting relationships among individuals*.”⁴² Similarly, in one of the Obamacare cases, Judge Rovner said, in dissent,

A corporation is a legal construct which does not have the sentience and conscience to entertain such ultimate questions. “In the words of Chief Justice Marshall, a corporation is ‘an artificial being, invisible, intangible, and existing only in contemplation of law.’” *Browning-Ferris Indus. of Vt. v. Kelco Disposal, Inc.*, *supra*, 492 U.S. at 284, 109 S. Ct. at 2925 (quoting *Trustees of Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1819)). It is a creature of man, not of God. It “believes,” if it can be said to believe anything, only what the people who found, own, and/or manage the corporation believe.⁴³

Is a corporation really just a legal fiction? John's business in our previous section is real. It has radio equipment that you can touch, and in everyday language it is certainly real. How about John's organizational form? If he organizes as a corporation, does the corporation have a real existence *qua* corporation? After all, the corporation is defined by the laws of the state, which authorizes the creation of corporations under strict

⁴² Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS, 305–360, 310–311 (1976). That theory of the firm is better described as a “reciprocal arrangement” theory of the firm, to use Prof. Eisenberg's term in Melvin A. Eisenberg, [*The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*](#), 24 J. Corp. L. 819, 822 (1998). The theory was developed in opposition to Coase's idea of the firm as a set of resources whose use was controlled by authority rather than by markets, an idea based on property rather than contract. Ronald H. Coase, [*The Nature of the Firm*](#), 4 ECONOMICA, NEW SERIES 386–405 (1937). The nexus of contracts theory, though not the term also be attributed to Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

⁴³ *Korte v. Sebelius*, 7th Circuit, No. 13-1077 (November 8, 2013).

requirements starting with registration and regulating it all the way to its dissolution.

To answer this, it is useful to go back to Jensen and Meckling's broader statement about organizations in general and ask whether if John organized as a partnership, that organization would be a legal fiction. It, too is defined by the laws of the state, which specifies what course of events creates a partnership, and how a partnership is to be terminated. The law is perhaps case law more than statute, but if a corporation is a legal fiction, so is a partnership. Or what if John organizes as a sole proprietorship, so that he owns all the business's assets himself? What it means to "own" something is equally defined by the law--- and in the case of real property is certainly as strictly specified as what it means to be a corporation.

To be sure, the U.S. legal system does restrict a corporation's governance rules more than a natural person's or a partnership's, but garden-variety natural persons are similarly constrained in our governance arrangements. An hour before birth, a baby is not a legal person; an hour afterwards, he is. Even then, he is not an individual, legally speaking. The government's mandatory governance structure gives his parents authority to make decisions for him, so our newborn baby is really a legal structure made up of three human beings (two more people than a California one-shareholder corporation⁴⁴). It takes a village to sue a child. If a corporation has no existence independent of the legal system, then neither does a baby.

The idea that corporations are legal fictions gives too much credit to the importance of having a legal system. Suppose the state eliminated its court system. Would all the corporations disappear? As businesses, of course, they would not. But what about as corporations? They would still have the same governance structure, just without the aid of law. The situation of the corporation would be just a more complicated version of the situation of the contract. Using our standard definition of a "contract" as "an agreement enforceable in court", contracts would no longer exist. People would still make business agreements, though, which might use the exact same language as the old contracts. The agreements would be more brittle, since the courts would not enforce them, but reputation, shame, and morality would still make many agreements viable. Indeed, even at the present time many, perhaps most, contracts are unenforceable in practice because going to court is too slow and expensive, yet people still fulfill their obligations. Similarly, one might say a "corporation" is a business chartered according to a state's incorporation laws, in which case

⁴⁴ By California state law, a one-shareholder corporation need have only one director; a two shareholder corporation, two; a corporation of three or more shareholders, three. CALIFORNIA CORPORATIONS CODE SECTION 212.

corporations would disappear with the laws. Consider the implications, though. Under the incorporation law definition, not a single business corporation exists in England. You will look in vain in England's *Model Articles for Private Companies Limited by Shares* for the term "corporation".⁴⁵ There do exist limited-liability businesses with many owners of differing shares--- but those are "limited companies", even though they happen to have all the characteristics of corporations. If Indiana were to change the word "corporation" to "limited company" in its code, would all the corporations in Indiana vanish? In one sense they would indeed. But it is their disappearance that would be the legal fiction, not their previous existence. When the law labels something, it does not create it.

Returning to the quotation from Judge Rovner, it is perhaps true that the corporation is the creation of Man, not God.⁴⁶ That is beside the point, though. A church is equally the creation of a group of people organizing for an activity. Judge Rovner comes closer to the truth when she says of the corporation, "It 'believes,' if it can be said to believe anything, only what the people who found, own, and/or manage the corporation believe." That is quite true, and takes us the true problem of corporate belief: what does the corporation believe when its owners believe different things? Corporate belief per se is not a problem. Both for-profit and nonprofit corporations assert beliefs all the time. General Motors believes its cars are safe. The Democratic Party says it supports President Obama. Where difficulty arises, as we will discuss later, is when the owners or members of the corporation disagree, something that can happen as much in a church as in a for-profit corporation.

2B. CORPORATE ROLES AND GOALS

Now suppose we take a different point of view of our story of Ron and John. It is not John or Ron who sees the need for a religious radio station, but a group of church pastors. One thing they could do is take turns going on leave from their church to run a new radio station. But that would cause a huge amount of disruption, and, in any, case they know that pastors have no special skill in running businesses. They want to choose a way to get a quality radio station at the lowest cost. But that was, in effect, the objective of John (who had the same ultimate objectives as the pastors)

⁴⁵ *Model Articles for Private Companies Limited by Shares*,
<http://www.legislation.gov.uk/ukxi/2008/3229/schedule/1/made>

⁴⁶ Though we must again think about *reductio ad absurdum*. Is a human being a creature of Man or God? The Supreme Court has ruled that immediately before birth, the creature is a fetus and immediately after it is a human, for purposes of the law.

and Ron (who wanted to make the station as successful as possible so he could maximize his personal gain). So the pastors should help organize the same kind of entities John and Ron would choose.

If John and Ron would choose a for-profit corporation (let us suppose Ron couldn't find his rich old lady donors), so should the pastors. The for-profit corporation is the cheapest way of organizing and running the provision of Christian radio. The shareholders will earn profits, but "the labourer is worthy of his hire," and "Thou shalt not muzzle the ox when he treadeth out the corn,"⁴⁷ is as true for the provider of capital as the provider of labor. And so we would have the customers organizing a corporation and telling the directors to concentrate on maximizing profit, because that will result in the lowest prices and best product. They don't care directly about the individual goal of the corporation; they care about its social role.

Going further, the pastors will indeed care about the corporation's goal, because that is crucial to its role. For the corporation to achieve its role of providing the best religious broadcasting, its goal should be to maximize profits.⁴⁸ It will then produce a good product at a good price. If the corporation were set up with the direct goal of providing the best religious broadcasting, it would be an immediate failure, because without the profit incentive it could not attract capital. Or, if state law permits the directors and managers to consider other goals besides profit, the pastors have reason to be nervous. Instead of focusing on cost and quality, the managers could satisfy their own charitable or political whims, giving free radio ads to opera houses (while raising the price for everyone else), hiring, out of pity, stutterers who couldn't get jobs at other stations, and devoting air time to saving the whales. The pastors will do much better under a purely selfish corporate regime, one which runs the corporation to the benefit of the shareholders.

This is how we should think about all indirect benefits to stakeholders. I take my terminology from Martin Wolf, who distinguishes between the *goal* of the firm— the objective the owners of the firm are pursuing— from the *role* of the firm— its usefulness to society:

First, one has to distinguish the goal of a firm from its role. The role of companies is to provide valuable goods and services— that is to say, outputs worth more than their inputs. The great insight of market economics is that they will do this job best if they are subject to competition. Profit maximization (or shareholder value

⁴⁷ Luke 10:7 and Dt 25:4.

maximization, its more sophisticated modern equivalent) is *not* the role of the firm. It is its goal. The goal of profit maximization drives the firm to fulfill its role.⁴⁹

The stakeholders do not need and should not have a legal right to demand that the directors act for their benefit. They should have some kind of legal recourse, however, to prevent outside parties from preventing director actions for stakeholder benefit. If the government passes a law prohibiting corporations from selling religious books, the main loss is not to the corporation but to the customers. One could say that the corporation has no religious rights because its aim ought to be simple profit maximizing, or perhaps if it can be proved that its directors aim to maximize profit. Removing the First Amendment's protection from the religious book company, however, is in practice a far more harmful infringement upon religious freedom than prohibiting natural persons from selling (or giving away) religious books. The corporation is not run for the direct benefit of its stakeholders, but it is run to their indirect benefit. In the words of Professors Hansmann and Kraakman:

[A]ll thoughtful people believe that corporate enterprise should be organized and operated to serve the interests of society as a whole, and that the interests of shareholders deserve no greater weight in this social calculus than do the interests of any other members of society," the shareholder primacy norm is the best means to achieving aggregate social welfare. Indeed, a "common response to the question of whether directors should have a duty to serve the interests of nonshareholders has been to argue, as Friedman did, that all stakeholders are automatically protected, as though by an invisible hand, if we allow corporations to do what they do best: maximize profits.⁵⁰

The most common application of this idea is to the price of goods. Shareholder primacy leads to the lowest costs of production, and the cost savings are passed along to consumers. Here, we apply it to working conditions and consumer preferences. If the corporation takes appropriate actions that comply with the religious beliefs of its employees and customers, the corporation can pay lower wages and charge higher prices, but the employees and customers end up net winners as a result of the entire new package.

2C. LEGAL STANDING

⁴⁹ Martin Wolf, *Ten Points about Profit*, CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFET, AND OTHER ECONOMIC LEADERS 84-87 (Michael Kinsley & Conor Clarke eds., 2008).

⁵⁰ Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439 (2001). They are referring to Milton Friedman's New York Times magazine article cited earlier.

The role of the firm as a source of jobs to its employees, customer to its suppliers, and products to consumers has implications for legal standing. A corporation whose supplier breaches its contract by hiking up the price of materials has standing to sue for damages because its profits are hurt. Economic analysis tells us that actually the biggest loss from that breach can be to the customers, because the corporation passes along part of the increase in its costs in the form of higher prices. Nonetheless, the corporation has incentive to enforce the contract, and this is actually much better for the customers than if they had to sue individually or via class action.⁵¹ Similarly, since the corporation can sue people in tort for negligent harm, people are careful around corporate property and costs are kept low, to the benefit of the customers. This applies to other causes of action too. In one recent Supreme Court case, a corporation sued the Internal Revenue Service on behalf of its employees to obtain refunds of overpaid taxes:

Although Quality Stores collected and paid the FICA tax, it did not agree with the Internal Revenue Service (IRS) that the severance payments constituted wages for FICA purposes. Quality Stores took the position that the payments made to its employees pursuant to the plans were not wages but instead constituted SUB payments that were not taxable under FICA.

Quality Stores asked 3,100 former employees to allow the company to file FICA tax refund claims on their behalf. See Treas. Reg. §31.6402(a)-2. Of those contacted, 1,850 former employees allowed Quality Stores to pursue FICA tax refunds for them.(*U.S. v. Quality Stores, Inc.*, CA-6, No. 10-1563, 9/7/12)

All this is really a corollary to Adam Smith's Invisible Hand. The greedy capitalist is led by his greed to act to the benefit of everyone with whom he deals:

...By directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.⁵²

It is natural to extend this idea to a hypothetical government decision to ban ideological broadcasting— a ban which would incidentally ban religious broadcasting. The Obama Administration's position is that the

⁵¹ Alternative theories of standing are associational standing (*Tony & Susan Alamo Foundation v. Secretary of Labor*, 471 U.S. 290 (1985)) and prudential standing (*Bennett v. Spear*, 520 U.S. 154, 163 (1997)).

⁵² Adam Smith, *THE WEALTH OF NATIONS* (1776).

Religious Freedom Act does not apply to the corporation.⁵³ If John is sole owner of the corporation, we have a case like *Hobby Lobby*. Let us assume, *arguendo*, that John would win his suit, because the decisions of the corporation are directly motivated by the religion of its owner.

What if Ron owns the corporation? His ultimate motive for opposing the ban is profit, not religion. At trial, he would have to testify that he doesn't really care whether he's selling religion or toothpaste. Yet the reason behind his profit motive for opposing the ban is that his customers have religious motives. Should his case be dismissed because he is himself irreligious?⁵⁴

I would say no for several reasons. First, his motive is based on religious beliefs--- just not his own beliefs. In the absence of religious considerations, Ron would be unaffected by the ban. It is just that "motive" can refer either to surface objectives or to deeper objectives. Ron's narrow objective is to provide religious broadcasting even though his deeper motive is to make money. This is no different from when we say that a steel mill's objective is to make lots of steel at low cost, when on a deeper level it is to make money, not steel. And this fits with how we treat religious organizations. Presumably a church would not lose its status as a religious organization just because it was discovered that its pastor had lost his faith. He and the organization are still exercising religion, even if with some hypocrisy. Christian theology has recognized this from early in its history. The question arose in the 4th century of whether the sacraments were valid if they were administered by someone who had sinned by recanting during a Roman persecution. The orthodox answer was that the sin of the priest, however heinous, did not make his priestly actions any less valid.⁵⁵

Second, investigations into subjective states of mind increases the cost of legal decisions markedly. Past behavior is easy evidence of religious sincerity. Trials become problematic when we require attorneys to probe into whether someone has lived as an Orthodox Jew for fifty years because he is a sincere believer or because he likes living with Orthodox Jews; whether an Episcopalian priest really believes in God or just wants a socially prestigious job; whether someone attends church because he believes in God or because it is good for his realty business. The temptation to perjury when questioned would be high.

⁵³ In this particular hypothetical, the corporation could perhaps find other causes of action directly in the 1st Amendment with regard to freedom of speech, regard to freedom of religion and the establishment clause, but let us focus just on the RFRA claim.

⁵⁴ See *Bob Jones Univ. v. United States*, 461 U.S. 574, 603 (1983) ("[T]he Free Exercise Clause provides substantial protection for lawful conduct grounded in religious belief")

⁵⁵ The view that an unbelieving priest's exercise of religion was invalid became known as the Donatist heresy. See Peter I. Kaufman, [*Augustine, Evil, and Donatism: Sin and Sanctity Before the Pelagian Controversy*](#), 51 THEOLOGICAL STUDIES 115-126 (1990).

Third, allowing Ron standing reduces transaction costs. Just as in contract and tort, Ron is representing not just himself but his customers. Judge Rovner puts it well in her dissent in *Korte v. Sebelius*, even though she comes down against the for-profit corporation:⁵⁶

Permitting a religious organization, incorporated or not, to invoke the Free Exercise Clause makes sense as a matter of pragmatism if not legal theory. A religious association is often as well if not better situated as the individuals who make up the association to assert the relevant religious interests: the association can speak on behalf of all of its members; it likely has resources to pursue legal relief that individual members do not...

This does raise the question of what directors are to do. In our hypothetical here, the pastors just wanted a good radio station, they set up a profit-maximizing company to do it, and they are happy with the result. If, however, the organizers of an enterprise have different objectives, they will want to plan carefully. A corporation may still be the best organizational form, but governance becomes more complicated.

3. CAN A RELIGIOUS CORPORATION SURVIVE IN A COMPETITIVE MARKETPLACE?

Suppose we have a corporation some or all of whose shareholders wish for the business to sacrifice profit for some religious goal such as closing on Sunday. We will consider this in three parts. First, we will think about a corporation whose shareholders are unanimous in wanting it to sacrifice profit for principle. It may seem obvious that the directors of this corporation ought to follow the desires of the shareholders, but in some interpretations of the law, doing so makes them scoundrels who should have to pay damages to the shareholders for doing what the shareholders want. Second, we will ask whether such a corporation can survive if it is publicly traded, or whether market pressures will force it to maximize profit alone or be acquired by profit maximizers. Finally, we will examine the case of heterogeneous shareholders who disagree on the tradeoff between principle and profit.

3A. UNANIMOUS SHAREHOLDERS

The first case is that of unanimous shareholder preferences— as in *Hobby Lobby* and the other Obamacare cases. Note that what matters for us is the homogeneity of shareholder interests, not the number of shareholders. A one-man corporation will automatically have unanimous

⁵⁶ *Korte v. Sebelius* 7th Cir., No. 13-1077 (November 2013).

preferences.⁵⁷ A two-man corporation will not, and will raise troubling governance issues. Those issues get no worse with a million shareholders, and, indeed, the governance problem is less severe since there isn't likely to be a 50-50 split of opinion in a widely held corporation.

It would seem unfair to sue the directors personally to recover the lost profits, especially since directors' liability insurance doesn't cover intentional acts.⁵⁸ But it is not unknown for people to use litigation to bite the hand that feeds them.⁵⁹ We will here not dwell on this case, since it seems clear, except to those who see religious motivations as illegitimate for any purpose and feel constrained by the 1st Amendment from denying them to natural persons but feel that the courts should not support them any more than it supports contracts against public policy.⁶⁰

3B. THE PUBLIC CORPORATION: THE PARADOXICAL EFFECT OF MARKET PRESSURE TO MAXIMIZE VALUE

For a public corporation, maximizing market value is not the same as maximizing profit, and a rejection of profit for principle can benefit even unprincipled minority shareholders.⁶¹ This paradox is due to efficient markets that adjust stock prices as a result of change in supply and demand.

If the directors sacrifice profits for principle, you might think that the stock price will fall and some outsider who cares only about profits will find it worthwhile to acquire enough shares of the corporation to replace those directors.⁶² The new directors will change company policy to increase

⁵⁷ "Automatically" is hyperbole. Should the directors aim to benefit the current shareholder, or his future self, or the person who will buy the corporation some time in the future? We will defer these questions to where we discuss heterogeneous shareholders.

⁵⁸ David Wood (Anderson Kill) [*Risking It All: Getting Insurance Coverage For Intentional Acts*](#), MONDAQ (April 20, 2009).

⁵⁹ See Lauren Weber, *Condé Nast Ends Internship Program: Decision Follows Pay Lawsuit by Former Magazine Interns*, WALL STREET J. (Oct. 23, 2013). (Students lucky enough to get internships with a fashion magazine sue on the grounds that their stipend came to less per hour than the minimum wage, after which the magazine ends its internship program.)

⁶⁰ In that view, it would be good policy, and constitutional, to require people who wish to organize activities by means of corporations to relinquish any religious rights their actions might have as those of sole proprietorships or partnerships, even though it would be unconstitutional to strip them of the rights otherwise. See numerous comments to the Eugene Volokh web posts cited earlier.

⁶¹ People often use "profit" and "market value" as synonymous goals, but they are not, even if markets are efficient, as will be explained below. They are synonymous if all investors care only about profits, but not otherwise.

⁶² See Ronald J. Gilson, *Can a Corporation Do Good without Fear of Carl Icahn?* CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFET, AND OTHER ECONOMIC LEADERS 80-83 (Michael Kinsley & Conor Clarke eds., 2008).

profits, thus rewarding the acquirer, and so the corporation's religious mania will be a minor blip in its history. This reasoning is fatally flawed.

Consider Acme, a restaurant corporation that currently has annual profit of \$100, the maximum possible, and a market capitalization of \$1,000: \$1 per share for 1,000 shares. A group of 1,500 religious investors, each with \$1 to invest, are looking around for a place to invest their money. They want to own a restaurant corporation, but only if it stays closed on Sundays. Acme would have annual profit of \$80 if it stays closed on Sundays. The religious shareholders think that \$1 per share is a great price for which to buy a return of \$.08/share annually if Acme were to close on Sundays. The board of directors therefore decides to close on Sundays. The non-religious shareholders immediately sell, because the price of \$1/share was only justified if the profits were \$.10/share annually; now they would pay no more than \$.80/share.

With all 1,500 religious investors trying to buy Acme stock, though, the price will rise above even its original \$1 price. It must rise to a level so high that religious investors become indifferent between buying Acme stock and keeping their funds as cash. Suppose that is at a price of \$1.20/share. At that price, religious investors are investing \$1,200 of their funds in Acme, and 300 of the religious investors give up and just hold cash. In the end, the religious investors are no better off than to begin with— since Acme stock is so expensive— but the original, non-religious investors have benefitted greatly from the directors' Sunday-closing decision, because they were able to sell out for \$1.20/share and move into other investments just as attractive to them.

What of a greedy corporate predator, who is look for companies he can buy, get rid of inefficiencies, and resell at a profit? He won't find Acme an attractive target in the slightest. Acme's move to sacrifice profits hasn't hurt its stock price; the stock price has risen. If the predator takes over and starts opening on Sunday, investors will no longer want to hold Acme and the stock price will fall. There is simply no way for the predator to increase the value of the firm.

The argument that a firm which sacrifices profits will have a lower stock price falls apart if shareholders like sacrificing profits that way. If they do, their valuation of the profit-sacrificing stock doesn't fall: it rises. The firm finds it cheaper to acquire capital than rival firms, and its sacrifice of revenue has been more than repaid by the reduction in costs. The shareholders, to be sure, are not as rich as they would be if they cared about profits alone. But that is fine with them; profits are only valuable to the extent that they buy things, and the shareholders care more about Sunday closing than about higher dividends and fancier cars.

In the long run, this isn't an equilibrium either. Since there is such demand for investment in restaurants that close on Sundays, other

restaurant corporations will follow Acme's lead, until the price of Sunday-closing stocks is \$1/share, the same as ordinary stocks. At that point, the market will be in equilibrium, even though the percentage profit yield of Sunday-closing restaurants will be much lower than for ordinary restaurants. Also, in that long-run equilibrium, the religious investors *will* be better off than when they started, since they will only have to pay \$1 for \$.08/share annual profits.

Consider another possibility. Suppose there are only 600 religious investors, that they band together and buy 600 shares of Acme, and that with their 60% control they close the restaurant on Sundays. The price will fall to \$.80/share, since the remaining 400 non-religious investors would not be willing to hold onto their shares unless it fell that far.⁶³ It isn't clear whether the outcome is good or bad. The 600 religious shareholders are delighted; the 600 nonreligious who sold out are indifferent, and the 400 remaining non-religious shareholders are unhappy.⁶⁴

This is an old problem in corporate law. Often a single policy not only cannot please everybody: there is no policy is that is best for every shareholder. What should the directors do? One answer is that the directors should simply act to maximize the market price of the stock, which means that if there at least 1,000 religious shareholders in the world, so demand for religious stock is high enough, then closing on Sundays is the director's duty

But for a director to act for the benefit of the owners is inevitably ambiguous when there are many owners. This is a problem even when owners care only about money. Some want share price to be high now,

⁶³ This is the case argued for in Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005). He fails to note that the first case, in which the stock price rises, is also possible, since he does not think about the possibility that investment demand by religious shareholders exceeds the available shares, and he thinks of the objective of religious shareholders as being to change company policy (which can be done with just 51% religious ownership) rather than to only hold stock in ethical companies. That objective might be realistic if we are thinking of very large religious investors who individually can affect control, but not if we are thinking of ordinary-size investors, who invest based on the current price and policy rather than thinking they will sway the company's decisions.

⁶⁴ This version does get us into the deep waters of game theory, however. First: if the plans of the 600 religious shareholders are leaked early, the non-religious investors will stampede to escape, and the price will immediately fall to \$.80/share, making it even easier for the religious shareholders to take over. On the other hand, once they have taken over, if the price falls to \$.80/share, some nonreligious hedge fund could buy all 1,000 shares, open up on Sundays again, and sell out at a \$200 profit. Going Martian-like to a third hand, however, if investors foresee a hedge fund doing this, they will bid up the price to \$1/share even before the hedge fund appears—in which case the hedge fund may not find it worthwhile to appear. There are ways out of this paradox, but they are not relevant to the point here, which is that in some circumstances a religious policy will help some shareholders and hurt others. See Sanford J Grossman and Oliver D Hart "Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation," 11 BELL J. ECON. 42-64 (1980).

some later, depending on when they plan to sell their stock. Tax and liquidity situations differ, so some want dividends, while others prefer capital gains.⁶⁵ The directors must make a decision one way or the other, and they will have to choose which group of shareholders to please.

3C. THE INTERMEDIATE CASE: MINORITY DISSENT IN AN ILLIQUID CORPORATION

The most difficult problem is with corporations that are closely held yet have minority shareholders who do not share the goals of the majority. As with public corporations, the closely held corporation is problematic even with regard to purely financial decisions if the shareholders have different goals. Indeed, the problem is worse, since neither faction of shareholders can sell their shares without far greater loss than with publicly traded stock. Nor are shareholders diversified in their securities holding. If they were, then they would at least all share the same goal of getting the best profit/risk combination possible. Since so much of their wealth is tied up in one company, though, they may disagree seriously about how much to trade possible returns against risk or how big a dividend to pay. This disagreement will not just be a difference of opinion; even with exactly the same opinion as to the objective effects of a decision, the different shareholders will disagree as to whether the outcome is good or bad.

Not only will decisions made in good faith fail to please all shareholders, but in addition there will temptation for opportunism when it comes to trading off profit against religious or other principles. The majority might not want to sacrifice profits if they were 100% owners of the firm, but be willing to as 51% owners by following a religious policy. After all, 49% of the burden is being borne by the minority shareholders. Or, there might simply be a problem of unjust transfer of wealth, which besides its injustice would discourage people from becoming minority shareholders in the future and hence would discourage economic growth. Making a donation to a church would be 100% to the benefit of the majority shareholder, but they would be bearing only 51% of the cost. Or, put

⁶⁵ This last was the problem in *Dodge. v. Ford*. Shareholders may also disagree as to which company policies will achieve their goals, but in this case the director's duty is clear: he is to use his own best judgement, and whether all the shareholders agree with him or none does not matter. He is like Burke's Member of Parliament: "To deliver an opinion, is the right of all men; that of constituents is a weighty and respectable opinion, which a representative ought always to rejoice to hear; and which he ought always most seriously to consider. But *authoritative* instructions; *mandates* issued, which the member is bound blindly and implicitly to obey, to vote, and to argue for, though contrary to the clearest conviction of his judgment and conscience— these are things utterly unknown to the laws of this land, and which arise from a fundamental mistake of the whole order and tenor of our constitution." Edmund Burke, *Speech to the Electors of Bristol* (3 Nov. 1774).

differently, it would be like issuing a dividend to just the majority shareholders, one of the bedrock forbidden acts of corporate law.

Worse yet, since the shares are closely held, they are illiquid. There is no market price, so the majority shareholders are not hurt in their ability to sell shares, and the minority shareholder has no way to escape his miserable situation unless he sells at a price below even the reduced dollar value of his holding. And the minority shareholders may find it difficult to find investments that suit them equally well: they are shareholders in this business precisely because they have some special connection to it, sentimental (e.g., the family firm) or informational (e.g., they know it is a great business opportunity, but outsiders cannot see that).

This problem occurs in other contexts, and has given rise to the idea of “shareholder fiduciary duties”.⁶⁶ The classic case is *Wilkes v. Springside Nursing Home*.⁶⁷ Four investors started a corporation with equal shares. They were all employees, but the corporation paid no dividends. Wilkes and the other three shareholders had a disagreement, and they fired him from his job. He sued, and the court ruled that the others had a fiduciary duty to Wilkes. A general New York rule covers this kind of situation too. Professor Ragazzo tells us that

[T]he majority breaches its fiduciary duty to the minority whenever it engages in conduct that frustrates the reasonable investment expectations of the minority. According to this view, the legitimacy of the majority's purposes is irrelevant if the minority is denied something for which it bargained, either explicitly or implicitly, at the time of investment.⁶⁸

Spending on religious or social responsibility goals would be dealt with in much the same way. Courts would not intervene except in clear cases—see our discussion of the business judgment rule below—and existing director fiduciary duty would work as well as the ill-fitting idea of shareholder fiduciary duty, but outrageous cases could be dealt with by courts' equitable powers.⁶⁹

⁶⁶ See Deborah A. DeMott, *Agency Principles and Large Block Shareholders*, 19 CARDOZO L. REV. 321 (1997-1998).

⁶⁷ *Wilkes v. Springside Nursing Home, Inc.*, 53 N.E. 2nd 657 (Mass. 1976).

⁶⁸ Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U.L.Q. 1099, 1105 (1999). Interestingly enough, Delaware, famous for its law of publicly held corporations, stands out as a state which does *not* recognize such causes of action.

⁶⁹ Professor Greenwalt notes the similar problem that arises when courts are asked to decide disputes about goals that arise within nonprofit organizations. One of his hypotheticals presents the same problem as that of the minority shareholder who finds the goals of the corporation have shifted: “Courts have rarely, if ever, dealt with splits in secular organizations over purpose, when the purposes involved promulgating ideas. Suppose that a

4. THE RELIGIOUS CORPORATION WITH 100% IRRELIGIOUS OWNERS

What of the corporation *none* of whose shareholders care about principle? I will argue that even then, under the theory of shareholder primacy the director may have not just the option, but the obligation, to follow principle. We will use a hypothetical to illustrate. Whether there is one shareholder or a million will not matter here: we will assume that they are unanimously atheistic, but the director making the decision is not an owner but a pure fiduciary.

First, note that the corporate director is not the agent of his shareholders, if we use “agent” in its legal (not economic) meaning.⁷⁰ The director is a fiduciary, but he is more like a trustee than an agent. An agent acts subject to the direction of a principal. He can be told what to do and he can be fired, though he might be able to collect damages for breach of contract. A trustee acts for the benefit of his beneficiaries, but they cannot tell him what to do and they cannot fire him, though they can file for a court to replace him with a new trustee. The agent’s duty is to obey; the trustee’s is to do what is good for the beneficiaries, subject to the limitations of the trust agreement. A corporate director has no duty to obey the shareholders, and they cannot fire him without considerable effort. He has, in fact, a duty to disobey the shareholders if he thinks their desire is contrary to their interests.

Both the beneficiaries of a trust and the shareholders of a corporation can go to court when they disagree with a decision. Both will ordinarily lose. In particular, courts look with disfavor on “derivative actions” in which a shareholder sues a director on behalf of the corporation, alleging that the director has failed in his fiduciary duty. I will go into that in more detail later. In brief, unless the director has made self-dealing decisions to his own monetary benefit, the court will allow him any degree of sincere stupidity under the “business judgment rule”.

We will return to the details of the business judgment rule in the next section. In the meantime, let us assume away enforcement problems of

national organization set up to protect “freedom of speech” shifts its position across a substantial spectrum. In contrast to earlier stands, it now supports stringent restrictions on sexually explicit speech and hate speech... A ‘local’ faithful to the old views withdraws from the national and claims that it should keep property donated to it.” Courts generally reject such claims, which suggests they should do the same with regard to ordinary corporations that change policy in a way displeasing to minority shareholders— particularly since in a nonprofit, the new policy may even be opposite to the desires of a majority of those who donated capital. Kent Greenawalt, *Hands off! Civil Court Involvement in Conflicts over Religious Property*, 98 COLUMBIA L. REV. 1843-1907, 1873 (1998).

⁷⁰ See Deborah DeMott [*Shareholders as Principals*](#). KEY DEVELOPMENTS IN CORPORATE LAW AND EQUITY: ESSAYS IN HONOUR OF PROFESSOR HAROLD FORD, Ian Ramsay ed., Sydney, Butterworths, 2001. <http://ssrn.com/abstract=275049>.

how to make a director comply with his fiduciary duty, ignore the actual American law of 2013, and think about what directors *ought* to do.

I find it useful to think about this in terms of Justice Holmes's Good Man and Bad Man.⁷¹ The Bad Man is the more famous of the two. He does not care what the law says, only cares what it *does*. He feels no guilt over breaking the law, but he does fear penalties, so he thinks about how courts actually behave. A law difficult to enforce is hardly a law at all for the Bad Man. And to know what the law is, one must observe practice and not trust what people claim the law to be based on what is written down in the casebook or the statute book. "You may write the laws, so long as I get to enforce them," the Bad Man says.

The Good Man, on the other hand, is usually forgotten. The Good Man sincerely tries to obey the law, whether or not anybody enforces it. From his point of view, the law is indeed what legislatures and courts say it is. The only problem is how to interpret what they say, but somewhere there is a legitimate law to be followed.

In this section we will assume away the enforcement problem of how to make the director comply with his duty. We will deal with Holmes's Good Man, not his Bad Man. Everyone is sometimes a Good Man, even if nobody is never a Bad Man. In one's Good-Man moments, one still has the problem of knowing what one ought to do, and that is what this section will address.⁷² A way to think about this is what rulebook the shareholders would like to give the director if they know he will follow the rulebook—but where he can reject the job in the first place if the rulebook is too onerous. Later, in the next section, we will be more practical and ask what coercive legal rules should be used when directors are a realistic mix of Good and Bad Men.

Hypothetical 1: *The Government legalizes production of dangerous household cleaning chemicals which everyone knows will kill a large number of children if they are used in homes.⁷³ Are the directors legally obliged to order the CEO to sell the chemical? In each case, suppose all the shareholders want to maximize profits and think this chemical would be profitable.*

⁷¹ Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457 (1897).

⁷² See Jonathan C. Lipson, *The Expressive Function of Directors' Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224 (2007).

⁷³ We will put aside the question of what directors should do about acts that are unlawful but increase corporate profits or other corporate goals. Difficult issues arise that are tangential to the topic of corporate goals generally, e.g. if President Obama says he will not enforce statutes requiring corporations to provide certain types of insurance, but the statute is not repealed, what is the corporation's legal duty?

There are a numbers of arguments for why a director should act contrary to the wishes of the shareholders.

4A. FIDUCIARIES ARE NOT-AGENTS: THEY MUST USE THEIR OWN JUDGEMENT

Suppose the director thinks the shareholders are wrong in their belief that the new line will be profitable, perhaps because they underestimate the product-liability danger from accidental ingestion. The director's duty is to act for the benefit of the shareholders, not to act at their direction. Thus, he must refuse to sell the chemical, even though he will be voted out.

4B. PLEASING STAKEHOLDERS CAN INCREASE PROFIT

Suppose the CEO doesn't want to sell chemical, for whatever reason, and will quit if he has to, or demand higher pay. If the director thinks keeping the CEO happy will add more to profits than the loss from not selling chemical, his duty is to not sell chemical. This also applies to workers, suppliers, and customers. The directors are sacrificing direct profits from the chemical to enhance other profits.⁷⁴

4C. CORPORATE POLICY REDUCING PROFIT VIA DIVINE PROVIDENCE

Let us now come to two arguments that sound odd. Suppose the director, unlike the shareholders, is religious. He thinks that although the new chemical would otherwise be profitable, God will impose retribution on the company, which will incur massive losses in one of its other lines of business. Thus, he believes that from the point of view of overall profitability the company should not sell the chemical. He is duty-bound to vote against selling poison. This is exactly like his belief that demand for product X has permanently declined and so the firm should wind down that business—it is a belief about the profitability of a particular policy, which only future events will prove correct or false. In fact, such a director does not even have to be devout, though he must believe. He could believe in God, but hate God. Satan as director might regretfully forecast that selling chemical would result in divine retribution in the form of future financial losses.

⁷⁴ See Gates's claims in his speech in Michael Kinsley and Conor Clarke eds., *CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFET, AND OTHER ECONOMIC LEADERS* (2008). See also Lindsay Gellmand and Rachel Feintzeig, [*Social Seal of Approval Lures Talent: Employers Tout Their B Corp Label as a Credential to Compete for Young Hires*](#), WALL STREET J. (Nov. 12, 2013).

This discussion may seem fanciful, but only to someone who does not have serious religious beliefs. Whether God will punish the corporation with financial losses is a question of fact. It is either true or false, even if it is hard to determine which. Convinced atheists will confidently say “No”; believers may or may not say “Yes,” depending on their theology. Ex post, financial analysis economists will no more be able to pin down the answer than it can determine whether profits are increased by promoting from inside the company instead of externally. A director need not— and must not, if he is to be a good fiduciary— ignore his religious beliefs about the consequences of corporate policy any more than he can ignore his beliefs about what will happen to demand next year. If what he call a religious belief is really a belief, then he cannot ignore its implications for his company’s future. If shareholders disagree with his religion and think it will cause him to make bad decisions, they should not choose him as a director any more than they would choose someone whom they believed had the wrong beliefs about what talents a good CEO needs.

4D. CORPORATE POLICY HURTING SHAREHOLDERS DIRECTLY VIA DIVINE AGENCY

The board can decide not to sell chemical because it thinks that is bad for the shareholders, implicating them in heinous though legal acts. The shareholders have ill intent, but the board should frustrate it, because the shareholders will earn heavier punishment on earth or in the afterlife, e.g. Hell (Christianity) or bad karma (Hinduism). As with the divine agency hurting profits, whether the director’s belief is true or false is a matter of fact, not opinion. It is only because people disagree so widely about that fact that religion belief is so often called opinion. It is no more opinion than whether the number of the uninsured will rise under the new government policies of 2014— simply a fact that is widely disputed.

4E. CORPORATE DECENCY IS REQUIRED TO RETAIN DECENT DIRECTORS

In certain situations, an agent or fiduciary should resign rather than carry out his legal duty. Such is the case if his legal duty is to carry out an action that is legal but unethical, where legality is determined by society and ethicality is determined by the individual. Ordinarily, directors can assume that shareholders share roughly the same ethical beliefs as the directors. Hypothetical 1 is perhaps unrealistic because most people who own shares in America would rather not kill children. But differences in ethical beliefs will arise, and that is what Hypothetical 1 confronts us with:

What if the shareholders do not mind killing children, but the director does?

In an extreme case like this, we might counsel the director not to resign even if he concludes that resigning would be better for the shareholders than to have the board decide against the deadly chemical. This, however, would be to counsel breaking the law and violating the principle of private property. If we are willing to give this counsel to the director, we should also be willing to counsel him to sabotage the chemical's production facility with explosives if he is overruled by the other directors. Indeed, we should counsel him to sabotage the facilities of other companies that produce the chemical. At this point, we have left the subject of fiduciary duty and entered into civil disobedience. The court should still condemn the director if he is caught hurting shareholder interests, sabotaging his company, or sabotaging other companies, but executive clemency would be appropriate.

Let us put aside the possibility of civil disobedience. The director should consider resigning. But he can and should think a step further. His resignation would, apart from the extra profits from killing children, hurt the shareholders. He was elected director for a reason, and replacing him would create some cost, as an equally talented director would have to be found and would start with zero experience. If a majority of the directors resign, or an inside director— either the CEO or some secondary employee— the disruption would be considerable. Indeed, the loss to the shareholders from the resignations might be greater than the loss from not producing the chemical. In such a situation, even a director who did not find killing children objectionable would vote against selling the chemical, in order to keep his objecting colleagues on the board. Indeed, voting against the chemical would be his duty. This being the case, the objecting director should be free to do so also. Director Smith must vote for the policy Smith wants solely in order to keep Smith on the board, even if the policy has no other value. On the other hand, if the loss of Smith would hurt the shareholders less than the loss of the chemical profits, Smith and the other directors should favor his resignation.

5. A WARNING: DIRECTORS SHOULD NOT SELFISHLY INDULGE NOBLE WISHES TO BE "SOCIALY RESPONSIBLE"

It is easy to misunderstand what I have been saying. Mushroom guides always have some sort of warning of the kind that "although poisonous amanitas don't really look like delicious meadow mushrooms, if you run out and pick some white mushrooms after skimming the book, you'll probably die in agony."⁷⁵ Thus, before you eat my mushrooms, let me

⁷⁵ See [I Ate Amanita Muscaria Mushrooms with David Arora!](#), YOUTUBE; Richard Eshelman, [I Survived the "Destroying Angel"](#), CORNELL MUSHROOM BLOG (November 22,

underline a crucial point: a director should not indulge his own views on religion, charity, or politics at the expense of the shareholders. He may act against their desires, but not against their benefit. If he thinks that the shareholders are rich enough already and should give some of their money to the employees as a gift, he is no more entitled to pay high wages on that account than he is to embezzle funds and donate it to some other company's workers, or to use armed guards to lift the wallets of everyone attending the shareholders' annual meeting. It is not his property to give away. The corporation has no social responsibility; only the shareholders do. My point is just that the good of the shareholders, especially in a small corporation, is not purely monetary.

I am not proposing a change in corporation law. Rather, I am saying that if scholars and judges pause to think about it, they will realize that the current dominant view of director primacy is compatible with motives other than profit. We do not need to change it. Prof. Berle said in 1932, that

'the great industrial managers, their bankers and still more the men composing their silent "control," ' function today more as princes and ministers than as promoters or merchants. Exclusive profit-making purpose necessarily yields to this analysis.

but he also said

I submit that you can not abandon emphasis on "the view that business corporations exist for the sole purpose of making profits for their stockholders" until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else....Otherwise the economic power now mobilized and massed under the corporate form, in the hands of a few thousand directors, and the few hundred individuals holding "control" ' is simply handed over, weakly, to the present administrators with a pious wish that something nice will come out of it all. The only thing that can come out of it, in any long view, is the massing of group after group to assert their private claims by force or threat -to take what each can get,...⁷⁶

Moreover, even if the directors can be trusted not to pursue their own charitable ends, the corporation is an organizational tool best suited for running a business, not philanthropy. Shareholders have nonmonetary goals, but they will not want to use the corporation for attaining most of those goals. Shareholders want to give Christmas gifts to their children,

2006). I add these references in order to underline my fear that what I am saying here will be misinterpreted.

⁷⁶ Adolph A. Berle, Jr., *For Whom Corporate Managers are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

but that doesn't mean they want the corporation to give Christmas gifts to the children of shareholders. They can do it themselves, and do it better. Similarly, in general the shareholders can give donations to charities better directly than by means of the corporation. Or, if they want to use a corporation, they will want to use a corporation specialized in making donations—the United Way, for example—rather than a corporation that sells insurance or makes circuit boards. For a director to be justified in voting for the corporation to make donations, he must believe that the shareholders benefit more from the corporation making the donation than from doing it directly. Such is the case if the corporation will benefit more from public recognition, or if the corporation can make a donation in kind that is cheaper and better than the cash gift a shareholder could make. In every case, the director should ask himself, "Would the shareholders prefer higher dividends so they can make the gift themselves, or would they prefer that the corporation do it?" This will rule out most nonmonetary objectives of the shareholders, from the gifts to children to donations to their churches to gifts to environmental groups. What is left are gifts that promise a substantial reciprocal benefit to the corporation, even if that benefit doesn't exceed the cost. A shareholder might, for example, prefer that the corporation give a gift to the local children's museum, because the corporation will get a reputation benefit back equal to 90% of the money value of the gift, whereas the shareholder would only get back 20% in reputation benefit. Ordinarily, though, the shareholder would prefer to give the gift and get the credit himself.

It is specious to say, for example, that the shareholders should give up 10% of their wealth to stop global warming because they will have to live on Earth. The shareholders bear the entire cost of the donation, but they share the benefit with billions of other people. They would not give the money as individuals. The question must always be: would the shareholders donate the money as individuals, and, if so, why would they prefer to have the corporation give it for them?

We can, however, expect directors, managers, and majority shareholders to talk about the duty of the corporation and the need for social responsibility. Not only is this good for the public image of the company, it also gives them an excuse to give away other people's money. The excuse is particularly enticing because they can feel noble even while robbing shareholders who are poorer than themselves. Thus, the Business Roundtable said:

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.⁷⁷

Mike Kowalski, CEO of Tiffany's, gives a typical managerial view:

Public companies can and should contribute to the solution of the world's problems. Every company requires an implicit social license to operate, and that license must ultimately depend upon the ability to contribute to the well being of the world's peoples. A public company does not exist as a matter of right, it exists to serve—its customers, shareholders, employees and civil society at large.⁷⁸

This is also a common view among legal academics, though rarer among professors of finance. In 1932 Professor Dodd of Harvard said:

Business— which is the economic organization of society— is private property only in a qualified sense, and society may properly demand that it be carried on in such a way as to safeguard the interests of those who deal with it either as employees or consumers even if the proprietary rights of its owners are thereby curtailed.⁷⁹

By 2013, though, one unhappy professor would say:

Fifty years ago, if had you asked a director or executive what the purpose of the corporation was, he was likely to answer that the firm had many purposes: to produce satisfactory returns for investors, but also to provide good jobs to employees, make reliable products for consumers, and to be a good corporate citizen...By the close of the millennium, most scholars, regulators and businesspeople had come to accept without question that shareholders "owned" public corporations and that the proper purpose of the corporation was to maximize its shareholders' wealth. ...If we want our corporations to perform better for investors and the rest of us as well, we need to re-visit the wisdom of shareholder value thinking.⁸⁰

⁷⁷ The Business Roundtable, "*Statement on Corporate Responsibility*" (1981).

⁷⁸ Tara Weiss, Matthew Kirdahy and Klaus Kneale, *CEOs on CSR*, FORBES (10/16/2008). The authors say, "To try and get at some answers we asked some prominent CEOs for their thoughts on CSR. We also solicited input from academics and money managers. Perhaps unsurprisingly, the CEOs were the most bullish on CSR, while investors were the least enthusiastic."

⁷⁹ Dodd, *For Whom Are Corporate Managers Trustees?* 45 HARV. L. REV. 1145 1931-1932. It is to this article that Berle is replying in the passage quoted earlier.

⁸⁰ Lynn A. Stout, *The Problem of Corporate Purpose*, 48 ISSUES IN GOVERNANCE STUD. 1 (Brookings: June 2012). See also her *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC* (2012). I am dubious of the historical claims of most of Professor Stout's article. I do believe the statement of hers quoted in above in the text, but must qualify it. Corporate managers fifty years ago and today would very likely say this, but only for publicity value. They wouldn't mean it. It doesn't go over well if a business says it is run only for profit, or only for the benefit of its owners, even if that is what it is legally obliged to do. One must pretend to altruism— or, at least, one's profits will go up if one does so.

The people who think that corporate law ought to recognize the “social responsibility” of corporations seem to confuse “corporations” with “big companies”, a conflation which, indeed, is the common view of ordinary people. Such a view falls to pieces, however, when confronted with a huge sole proprietorship or a tiny corporation. This is no small conceptual problem. Are the advocates of corporate social responsibility really saying that if a public corporation switched to being a master limited partnership or a trust then the owners should be able to expect more loyalty and less stakeholder advocacy? Are they saying that when a small gas station incorporates, its manager should be free to donate the month’s net receipts to the Metropolitan Opera or the home for stray dogs? Recall that the vast majority of corporations are small and closely held, and those are where most governance legal disputes occur.⁸¹ I think, rather, that they are aiming to create a new body of law applicable to large companies of any organizational form, a sort of tax on large businesses, or perhaps a freedom for CEO’s to advocate liberal political positions (since I do not think that they would approve, for example, of a CEO who sacrificed company profits by firing homosexual but competent employees in an attempt to advance society’s moral tone).

I agree with the dominant view that shareholder value should be the objective of the corporation; indeed, I am arguing for a more extreme version of the shareholder value theory than is usually stated. I am arguing that shareholder value is not purely monetary. Rather, as in the standard paradigm of economics, shareholders value many different things. If shareholders wish to use the corporation solely to earn money, fine. But if, as is not only often but usually the case in a closely held corporation, the shareholders have other goals, those are legitimate too. That principle holds just as true for the widely held public corporation; it is just that shareholders of public corporations only rarely see them as an efficient way to indulge their charitable or religious desires.

It is worth discussing why that is so. A first reason is that the goal of going public is to attract new capital from numerous new shareholders. This being the case, there is likely to be disagreement among them about any goal other than profit maximization. Berkshire Hathaway at one time had a “shareholder designation plan” in which shareholders could ask the corporation to give to specific charities. This was ended because there was too much objection to particular donations. Warren Buffett said of an abortion foe, “One guy wrote me and said I don’t care if you give a billion dollars to pro-life organizations and one dollar to a pro-choice organization,

⁸¹ [Find evidence for these two points and put it here.]

he says, I'm still boycotting you.”⁸² The easiest resolution to the problem is to restrict the company to profit maximization and use other means—private charity, for example—to advance non-monetary objectives.⁸³

A second reason why a widely held corporation is ordinarily a poor tool for doing good is that the principal-agent problem is more severe in a public corporation—something that happens precisely because the company is so widely held. The directors have more freedom to abuse their position by making decisions that benefit themselves at the expense of shareholders. Shareholders cannot hope to use the corporation for such finely tuned objectives as charity. Profits are a simpler objective. Much of the monitoring of public company directors comes from the spotlights of stock analysts, who are good at analyzing dollars but not at analyzing the proper objects of charity. Thus, shareholders of publicly held corporations do not want to allow their directors the liberty to pursue diverse goals. It is simpler to tell them to maximize profits, because if directors are allowed to do other things they won't do them properly. There may well be exceptions to this—the basic principle that directors should act for the good of the shareholders even if that is not monetary still holds—but they are exceptions, not the rule. It is no accident that no challenges to the Obamacare contraceptive mandate are coming from large, publicly held, corporations.

Thus, we must test every apparent sacrifice of profit by a corporate directors against the shareholder-benefit justifications given above. Nonreligious charity that does not indirectly raise profit by generating financial concessions from stakeholders will generally fail the test. The religious director can argue that God has told him profits will increase because of the good deed, or that the shareholders will avoid Hell, or that he would have to resign as director if he had to do a bad deed, but only if he really believes these things. Someone of less traditional religious views, or someone acting out of general benevolence cannot make those arguments to themselves. In fact, even with religious arguments, the director's theological belief must be that an involuntary gift somehow

⁸² Warren Buffett and Bill Gates, *Bill Gates and Warren Buffett Discuss "Creative Capitalism,"* in CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFET, AND OTHER ECONOMIC LEADERS 20-39 (Michael Kinsley & Conor Clarke eds., 2008).

⁸³ The charter can impose some restrictions on the new corporation, but the charter is too inflexible a tool to allow for changes over time. The charter could require a corporation to close its stores on Sunday, but its writers could not foresee that there might be a government mandate to buy employee insurance that included certain types of birth control pills. Less binding statements of policy, such as by-laws or board resolutions, may be useful to put potential shareholders on notice of the non-profit objectives of the corporation. See the *Statement of Purpose, Hobby Lobby*, http://www.hobbylobby.com/our_company/purpose.cfm (last visited Feb. 26, 2013).

benefits the giver— that it’s not “the thought that counts”, and that the giver ends up in a better position even if he bitterly curses the gift under his breath and wishes he had the money to spend on something else.

6. THE CORPORATION’S GOAL: THE LEGAL POINT OF VIEW

American law is confused about the goal of a corporation. The *Model Business Corporation Act* says:

§3.01 Purposes

(a) Every corporation incorporated under this Act **has the purpose of engaging in any lawful business** unless a more limited purpose is set forth in the articles of incorporation.

The American Law Institute’s *Principles of Corporate Governance* says:

§2.01 The Objective and Conduct of the Corporation

(a) ... a corporation [§1.12] **should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.**

(b) Even if corporate profit and shareholder gain **are not thereby enhanced**, the corporation, in the conduct of its business:

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

(2) **May take into account ethical considerations** that are reasonably regarded as appropriate to the responsible conduct of business; and

(3) **May devote a reasonable amount of resources to public welfare,** humanitarian, educational, and philanthropic purposes.

§3.02 General Powers

Unless its articles of incorporation provide otherwise, every corporation has perpetual duration and succession in its corporate name and **has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs**, including without limitation power:...

(13) **to make donations for the public welfare** or for charitable, scientific, or educational purposes;

(14) to transact any lawful business that will **aid governmental policy;**

(15) **to make payments or donations, or do any other act, not inconsistent with law, that furthers the business and affairs of the corporation.**

These two model statutes say that the goal of the corporation is to benefit its owners, the people who organized it.⁸⁴ The current shareholders might not be the original organizers themselves, but those organizers transferred their rights to the current shareholders, and to the extent that the law makes directors act for the good of the shareholders it increases

⁸⁴ We must acknowledge, however, that more than thirty states have “constituency statutes” which permit directors to do things that hurt the shareholders. See Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85 (1999).

the price that organizers of corporations are paid when they sell their shares.

“Because the obligations in § 2.01 run to the shareholders, rather than to third parties or the state, there is little doubt that such limitations would normally be permissible if agreed to by all the shareholders. Such an agreement might be embodied in the certificate of incorporation, or not. In either case, the agreement should bind not only the parties but also any subsequent shareholders who acquire their shares by gift, inheritance, or operation of law. Even subsequent shareholders who acquire their shares for value should be bound if they know or should know of the corporation's special character. Cf. *Matter of Reading Co.*, 711 F.2d 509 (3d Cir.1983). Whether a subsequent shareholder should know of that special character depends on the circumstances of each case. If the corporation is publicly held, the mere fact that it has a restriction of this nature in its certificate of incorporation may not be sufficient to make a restriction on the profit motive effective if few shareholders are actually aware of the provision. However, where the special character of the corporation is publicly known through the manner in which the corporation openly conducts its business, or through adequate and ongoing mechanisms of disclosure, persons who acquire shares may be deemed to be on notice of its special character.”

This is reasonable; we generally think it not only economically desirable but fair that whoever creates something by his own efforts and resources deserves to keep what he creates. Some people do think that the director of a corporation, unlike the owner of a sole proprietorship, should have a legal duty to act partly for the benefit of other stakeholders— for customers, creditors, employees, and neighbors— but this is not the view that American law has taken.⁸⁵

In its comments, however, the American Law Institute shows confusion in what it says about the goals of a corporation. The *Principles* are not so bad in themselves, but the comments shows a desire to have it both ways. On the one hand, the corporation should take profit as its sole objective:

These Principles take as a basic proposition that a business corporation should have as its objective the conduct of such activities with a view to enhancing corporate profit and shareholder gain. This objective, which will hereafter be referred to as “the economic objective,”

On the other hand, the directors should follow “social needs”:

⁸⁵ There are, of course, many legal duties that both a corporation and a sole proprietorship (and every other kind of entity, including the customer) owe towards stakeholders. An entity must not defraud, steal from, or default against third parties, at least not without paying the appropriate legal penalties. This is not special to corporations. For example, Baird and Henderson argue that the director owes a fiduciary duty towards creditors in deciding whether to declare bankruptcy, but their arguments apply just as well to the consumer. In both cases the idea is that the debtor is no longer the true owner of its assets, so it has a fiduciary duty towards its creditors as trustee of a constructive trust. [CHECK on THIS]

The provisions of Subsection (b) reflect a recognition that the corporation is a social as well as an economic institution, and accordingly that its pursuit of the economic objective must be constrained by social imperatives and may be qualified by social needs.

and should take into account “ethical considerations” and sacrifice some profit to “social welfare”:

Subsection (a) may be thought of as a broad injunction to enhance economic returns, while Subsection (b) makes clear that certain kinds of conduct must or may be pursued whether or not they enhance such returns (that is, even if the conduct either yields no economic return or entails a net economic loss). ...

For comparable reasons, the economic objective does not imply that the corporation must extract the last penny of profit out of every transaction in which it is involved. Similarly, under normal circumstances the economic objective is met by focusing on the business in which the corporation is actually engaged.

This is the work of a committee, not an individual. The American Law Institute does seem to recognize that “ethical considerations” are problematic. The Institute does not want to allow ethical principles that are “idiosyncratic”, but they want to allow for “emerging ethical principles... that have significant support”:

This does not mean that corporate officials can properly take into account any ethical consideration, no matter how idiosyncratic. Because such officials are dealing with other people's money, they will act properly in taking ethical principles into account only where those considerations are reasonably regarded as appropriate to the responsible conduct of business. In this connection, however, it should be recognized that new principles may emerge over time. A corporate official therefore should be permitted to take into account emerging ethical principles, reasonably regarded as appropriate to the responsible conduct of business, that have significant support although less-than-universal acceptance.

There is no mention of whether any of the owners must agree with these principles. The message seems to be, however, that ethics can trump profits if the principles are universal or stylish, even if the shareholders disagree with them. The comment to §4.01 *Duty of Care of Directors and Officers; The Business Judgment Rule* is in the same vein:

In general, the principles stated in §2.01 and the “best interests of the corporation” (as stated in §4.01(a)) will be in harmony. There are, of course, instances when §2.01 would permit the corporation to voluntarily forgo economic benefit— or accept economic detriment— in furtherance of stipulated public policies. This could happen, for example, when the corporation takes account of ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business (see §2.01(b)(2) and Comment h to §2.01) or devotes resources to public welfare, humanitarian, educational, or philanthropic

purposes (see §2.01(b)(3) and Comment i to §2.01). Such actions, even though they may be inconsistent with profit enhancement, should be considered in the best interests of the corporation and wholly consistent with the obligations set forth in §4.01.

The *Reporter's Note* goes further in the direction of Professors Dodd and Stout:

[U]tilization of corporate resources for such purposes has been recognized as a legitimate end in itself, either on the ground that there is an independent social policy to maintain diversified centers of such activity, and full effectuation of that policy depends upon and therefore justifies corporate support, or on the ground that activity that maintains a healthy social system necessarily serves a long-run corporate purpose. See, e.g., *Theodora Holding Corp. v. Henderson*, 257 A.2d 398 (Del.Ch.1969); *State ex rel. ; A.P. Smith Mfg. Co. v. Barlow*, 13 N.J. 145, 98 A.2d 581 (1953); *Sorensen v. Chicago, B. & Q. Ry.*, 112 Neb. 248, 199 N.W. 534 (1924)

In the preceding section, I showed that a church could be organized in any of a number of ways. So could the activities of a person who cares only about profit, and so could the activities of a person—the most realistic of all, and the one economic theory is designed to explain—who has multiple objectives. I think that the common law recognizes this, in theory and practice. The theory, however, is made cloudy by the language used in statutes, model laws, and judicial decisions, even if the outcome is clear when we look at how the law actually operates. Here, we have an interesting reversal of Holmes's *Path of the Law*. Holmes's Good Man wishes to do good things regardless of reward and punishment, and so looks at what the law says rather than its practical implications. Holmes's Bad Man doesn't care what the law says: he only cares what will happen to him, if anything, if he breaks the law. Corporation law seems designed to serve only the Bad Man, who cares only about profit, not principle, and threatens the Good Man with dire consequences for his lack of attention to profit. But the Good Man need not fear. The law in practice allows him to do good and disobey only those parts of the conflicted letter of the law which make sense. If he is a Bad Man in the sense of looking only to what is true de facto (that is, the penalties the law actually imposes), but a Good Man in the sense of wanting to do what is morally right regardless of what the letter of the law says, he will do good.⁸⁶ In brief: legal language is contradictory, in some places allowing the corporate director to sacrifice profits for virtue, in other places saying that he must pursue profits alone. Regardless of that, however, in practice courts apply the business

⁸⁶ If he is a Good Man in the sense of obeying the law de jure, he is more likely to end up doing bad instead of good. And if he is a Bad Man in the sense of obeying only the de facto law and scorning to do good, then he will definitely do bad. But that is okay. The Bad Man will do some harm regardless of the law, and the law's task should be to minimize the harm he does while not restricting the benevolence of the Good Man.

judgement rule so that the director has all the necessary freedom to do good when that is in the interests of the shareholders, even though it restricts him from doing good when he thinks it hurts the shareholders but helps others. The key to resolving the law's confusion is that when we say a director must act for the benefit of the shareholders, that is not to say he must act for the monetary benefit of the shareholders. Shareholders have other aims than money, and the dutiful director should take those other aims into account. He is acting for the shareholders, but if the shareholders wish to sacrifice profits for principle, he not only can but should take into account their wishes.

6A. THE BUSINESS JUDGMENT RULE

As we have already mentioned, the business judgment rule means that in practice, directors can get away with a considerable amount of reducing profit for the sake of principle. *The Model Business Corporation Act* says:

§8.30 Standards of Conduct for Directors

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) **in a manner the director reasonably believes to be in the best interests of the corporation.**

The American Law Institute's *Principles of Corporate Governance* say:

§4.01 Duty of Care of Directors and Officers; The Business Judgment Rule

(a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be **in the best interests of the corporation**, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. This Subsection (a) is subject to the provisions of Subsection (c) (the business judgment rule) where applicable....

(c) A director or officer **who makes a business judgment in good faith** fulfills the duty under this Section if the director or officer:

- (1) is not interested [§1.23] in the subject of the business judgment;
- (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
- (3) **rationaly believes that the business judgment is in the best interests of the corporation.**

(d) **A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care**, including the inapplicability of the provisions as to the fulfillment of duty under Subsection (b) **or (c)**, and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.

The business judgment rule protects the director even from unreasonable decisions, so long as they do not benefit the director

personally and he has made them in good faith.⁸⁷ The *Principles* says:

It is recognized that the word “rational,” which is widely used by courts, has a close etymological tie to the word “reasonable” and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase “rationally believes” is intended to permit a significantly wider range of discretion than the term “reasonable,” and to give a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term “reasonable” but are not so removed from the realm of reason when made that liability should be incurred.

Thus, the director who does wish to act for the benefit of the shareholders in practice need not fear that he will be penalized by a court that thinks benefit consists only of monetary benefit.

6B. PROTECTING SHAREHOLDERS FROM DIRECTOR PSEUDO-ALTRUISM

Having goals besides profit maximization does not change the fundamental problem of corporate governance. When directors are told to pursue profit, the big problem is that they may pursue their own profit, not the shareholders'. When directors are told to pursue the Good, the big problem is that they might pursue their own notions of the Good, not the shareholders'. What is new is that in pursuing the Good, the directors must decide not just how to pursue it, but what the Good is.

If the corporation is closely held, it will not be hard for a director and courts to identify the desires of the shareholders. If it is publicly held, things are much harder. The problem of minority shareholders is as difficult when it comes to the Good as it is with shareholder time horizons and tax situations. Share value only helps to an extent. We have already seen that maximizing share price may be a better description of the goal of a corporation that pursues profits and the Good than of a corporation which just pursues profits. The pure profit-seeking corporation will have a higher cost of capital, and so a lower share price. But all the director sees is current share price, and while that tells him the market's aggregate view of the aggregation of all the decisions he makes, it is hard to untangle the impact of each decision, and in any case the director has much better information than the market.

In the previous section, I chose Hypothetical 1 to be extreme in the direction of making it plausible that the director would believe that his actions would “benefit the shareholders” despite their disagreement. Here,

⁸⁷ On good faith, see Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti, and Jeffrey M. Gorris, [*Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*](#), GEORGETOWN L. J. (2009).

let us look at a few more hypotheticals to help us think about how it should work out in practice if courts permit non-financial goals, but only if they are in the interest of the shareholders.

Hypothetical 2: *The directors of a publicly held fast-food chain vote to require each of their restaurants to choose 100 poor people and serve them all the free meals they can personally consume. Analysts predict this will cut corporate profits in half. Have the directors violated their fiduciary duty?*

We often talk as if the business judgment rule is so broad that a director can get away with anything, no matter how outrageous, except self-dealing, unconsidered decisionmaking, and turning down dominating offers (e.g., accepting a merger offer of \$50 million in cash and \$50 million in debt in preference to an offer of \$60 million in cash and \$60 million in debt). Courts should and would not be much more constraining of director actions purported to be for non-monetary goals. Unless the directors can provide additional special facts in Hypothetical 2, they should lose on summary judgment, because no reasonable jury could find that they have complied with the business judgment rule:

1. The fiduciary-not-agent defense is weak: it is hard to argue that the analysts are so far off the mark and the directors are just using their business judgment, at least if the stock price falls on the news and the profits do turn out to be low.
2. Even if the CEO will quit unless the new policy is adopted, it is not worth effectively paying him half the profits of the corporation to keep him. That level of compensation violates the directors' fiduciary duty.
3. The directors will not be able to provide evidence that they sincerely believe basic decency requires serving free meals and they would refuse to serve on the board of any company that does not thus act. Such evidence is conceivable, of course, as a special case, e. g. if they had publicly announced before election to the board that if shareholders elected them that would serve as an indication that shareholders wanted them for their other talents even if it meant accepting the food-for-the-poor policy.
4. The directors will likely not be able to provide evidence that they sincerely believe God will reward the business for this sacrifice. It is possible to imagine cases in which they can indeed provide such evidence, and then they should be protected by the business judgment rule. That

evidence could be, for example, that they all attend the same church, which has its own special set of beliefs that God rewards giving to the poor even if the givers (shareholders in this case) do it against their own will, and the sincerity of this church is demonstrated by the requirement that its leadership board all donate 50% of their income to the poor. I would believe that such directors were sincere, and, moreover, that the shareholders had assumed the risk of heavy donations when they chose to elect directors given such evidence of the directors' financial strategies.

***Hypothetical 3:** The directors of a fast-food chain vote to exclude abortion coverage from employee insurance. They are on record as having said that aborting a baby is evil. Have they violated their fiduciary duty?*

This case could go either way. Eliminating abortion coverage saves money, but economic theory tells us the corporation will have to raise wages to compensate if they are to pay employees the market wage. The business judgment rule would protect the directors, but let us suppose that the directors admit that they think wages will have to rise more than the cost of insurance falls.

They may still have recourse to the business judgment rule if they argue that many of the employees want abortion coverage, they think that such employees make worse workers, or that suppliers will be more willing to deal with them, or the CEO will turn down an outside job offer if they concede him his desire on this policy. But let us suppose they are unwilling to make this argument.⁸⁸

The two religious arguments could be seriously argued in this case. It is a central doctrine of many religions (though less so of Christianity—especially, when as here the good deeds are involuntary) that Divine Providence provides an earthly reward for good deeds, so the directors would only have to show some evidence that they share this belief. Demonstration that the director believes that bad deeds led to punishment in the afterlife would be even easier, since it is standard Christian belief that a person is punished less if he sins less, even if he only sins less because someone else stops him.

⁸⁸ A peculiar aspect of arguing the business judgment rule in court is that the judge knows he must make some argument for the corporation, because business reasons block the corporation from doing so. The corporation often cannot argue that it gives to charity only because that makes its profits higher in the end. That would offend public opinion, nullifying any good the donation does— so fiduciary duty requires the corporation to prevaricate. It would also put into doubt the tax deductibility of the donation, though this is a complex issue since the former charitable deduction could be recategorized as a marketing expense. For these reasons, the judge must *sua sponte* search for the corporation's motivation, based not on its announced motive but on whether a plausible business motive does exist.

The defense that the directors would not serve as directors if they were required to authorize abortions is also viable. This has a small enough effect on employee morale that it is quite plausible that the shareholders, though dissatisfied with the decision, might still be willing to accept it as one of the costs of having talented directors. If that is wrong, they can unseat the directors, and the mistake will not have caused much harm. Simultaneous resignation of a majority of the board, on the other hand, could well be more costly to the firm.

Evidence is required to back up these defenses, but in this hypothetical it should not be hard to provide, for the simple reason that it is hard to think of situations where the directors would exclude abortion coverage for illegitimate reasons. If the directors don't think dropping coverage would raise profits, and they don't have sincere religious reasons for dropping it, why would they drop it? To be sure, the directors may have insincere religious reasons. They may be hypocrites who wish to give evidence of a religious belief while not holding it sincerely. This would be difficult to prove in court, but we can imagine special cases— if a majority of the directors have paid for abortions for their own daughters, for example, and so are treating the corporation differently than their own households. Or, it might be provable that they are directors of other, private, corporations where they have voted the opposite way and here they are just trying to keep their public reputation to retain their good standing in their churches. This hypothetical, however, is a good one for illustrating how the directors might choose to act against the announced policy preferences of the shareholders, but for the good of the shareholders.

***Hypothetical 4:** The directors of a fast-food chain vote to close on Sundays, conceding that revenue will fall by 10%. Have they violated their fiduciary duty?*

Hypothetical 4 is harder. Self-dealing is a worry here, and relevant to determining motive. Directors are not entitled to sacrifice the corporation to a public or personal need, unless they can argue that doing so benefits the shareholders.

A situations similar to this actually has arisen. In his history of the Cravath law firm, Robert T. Swaine says of a New York public transportation corporation:⁸⁹

The Transportation Company was not an immediate success, and required additional funds. Dissension developed between the directors and Elliot F. Shepard, who bought up more than a third of the outstanding stock. To augment revenues the directors in early 1888 began to run stages on Sundays. Shepard brought suit for an injunction on the ground that this

⁸⁹ Robert T. Swaine (1946) *THE CRAVATH FIRM AND ITS PREDECESSORS, 1819-1906, Volume 1.*

was 'an act of Sabbath breaking.' Seward defeated Shepard's suit but the continued controversies between the directors and the principal stockholder became intolerable. Shepard offered to provide funds for 'permanent stable accommodations' and to meet other 'present wants' if he were given control and allowed to discontinue the Sunday buses. Accordingly a number of the directors, including Morawetz, resigned and permitted Shepard to take control. This terminated the Steward counselship.⁹⁰

It seems that the corporation was not financially viable unless it discontinued Sunday buses, because only under that policy would shareholder Shepard subsidize its operations.⁹¹

Although the firm appeared to be prosperous, for many years Shepard had augmented the firm's meager proceeds using his own funds (the wealthy attorney and newspaper publisher— *NY Mail and Express*— was married to the eldest daughter of William H. Vanderbilt) and after his death on March 24, 1893 his family lost interest in propping up the money-losing enterprise. His brother was allegedly placed in charge of the enterprise and proceeded to run it into the ground... Before long the inevitable bankruptcy took place and the firm was placed in the hands of a receiver on February 7, 1895.

The late Col. Elliott F. Shepard was largely identified with this stage line. It was regularly earning a deficit, and the stockholders favored increasing its gross receipts by running the stages on Sundays, but Col. Shepard opposed this, and to gain his end obtained proxies which enabled him to oust President E. Ely Goddard and get control of the road. Then Col. Shepard levied an assessment of 95 per cent on the stock and froze out enough stockholders to obtain complete but unprofitable sway.⁹²

Since the company could not continue operations unless the directors agreed to please Colonel Shepard by adopting a policy pleasing to his religious beliefs, this is an easy case: their duty was to adopt the revenue-losing policy so as to reduce the company's cost of capital.

7. CONCLUDING REMARKS

Corporations are the property of their shareholders, and the directors are like trustees of that property. They owe a fiduciary duty to the shareholders, and not to anyone else. This fiduciary duty, however, is not a duty to maximize profits or to maximize share value, but to maximize the

⁹⁰ http://www.coachbuilt.com/bui/f/fifth_avenue/fifth_avenue.htm.

⁹¹ http://www.coachbuilt.com/bui/f/fifth_avenue/fifth_avenue.htm.

⁹² NEW YORK TIMES, December 22, 1898 "*Fifth Avenue Line Sold*" via http://www.coachbuilt.com/bui/f/fifth_avenue/fifth_avenue.htm.

benefit to the shareholders. Since shareholders care about things other than money, it may be the duty of the directors *not* to maximize profit. This is less true of public companies than of closely held companies for practical reasons such as increased shareholder heterogeneity and the need to reduce the directors' discretion, but the theoretical principle is the same for both. In practice, directors can justify a considerable degree of service to non-profit objectives for the benefit of shareholders, and they should act accordingly.

8. **Cases** (Incomplete. these are not formatted carefully, and are often cut-and-pastes from other sources, since this will probably appear in a law review, which will strip out the cases and references sections)

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