

# HEINONLINE

Citation: 28 Stetson L. Rev. 27 1998-1999

Content downloaded/printed from  
HeinOnline (<http://heinonline.org>)  
Tue May 22 13:47:40 2012

- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at <http://heinonline.org/HOL/License>
- The search text of this PDF is generated from uncorrected OCR text.
- To obtain permission to use this article beyond the scope of your HeinOnline license, please use:

[https://www.copyright.com/ccc/basicSearch.do?  
&operation=go&searchType=0  
&lastSearch=simple&all=on&titleOrStdNo=0739-9731](https://www.copyright.com/ccc/basicSearch.do?&operation=go&searchType=0&lastSearch=simple&all=on&titleOrStdNo=0739-9731)



Retrieved from DiscoverArchive,  
Vanderbilt University's Institutional Repository

This work was originally published in  
28 Stetson L. Rev. 27 1998-1999

# A CONTRACTARIAN DEFENSE OF CORPORATE PHILANTHROPY\*

Margaret M. Blair\*\*

## I. INTRODUCTION

Although a lively debate raged in the law from the mid-19th century to the mid-20th century about whether, and under what circumstances, corporations could give away funds to humanitarian, charitable, or philanthropic causes, this question appeared to be settled by the 1950s. Since then, both statutory and case law have made it clear that corporate officers and directors have very wide discretion to direct reasonable amounts of corporate resources toward artistic, educational, and humanitarian causes,<sup>1</sup> even those that have only a remote connection (or no obvious connection at all) to the business goals and profitability of the firm.

---

\* Paper prepared for presentation at Stetson University College of Law Corporate Philanthropy Symposium, November 7–8, 1997. Work on this paper has been supported by the Brookings project on Corporations and Human Capital, which is funded in part by the Alfred P. Sloan Foundation and the Pfizer Corporation. The opinions expressed in this article are the Author's, and should not be attributed to Brookings, its officers, directors, or financial supporters.

\*\* Senior Fellow, Brookings Institution, and Visiting Professor, Georgetown University Law Center.

1. In 1935, the tax code was changed to make it clear that charitable contributions by corporations were deductible. See Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1, 15–20 (1994) (recounting the history behind the adoption of § 170 of the Internal Revenue Code, which provides that charitable contributions by corporations are deductible); see also Linda Sugin, *Theories of the Corporation and the Tax Treatment of Corporate Philanthropy*, 41 N.Y.L. SCH. L. REV. 835 (1997) (critiquing the economic and philosophical rationale behind § 170). In the late 1940s and early 1950s, most states amended their corporation laws to make clear that corporations could donate reasonable amounts of funds to charitable, educational, or philanthropic causes. See, e.g., MODEL BUS. CORP. ACT ANN. § 4(m), ¶ 4 (1960) (citing 31 states that had amended their corporation statutes between 1945 and 1955 to allow charitable contributions, and listing 9 states that had done so between 1917 and 1945). In some cases, the statutes imposed some restrictions and procedural requirements on such expenditures. See, e.g., MD. CODE ANN., CORPS. & ASS'NS § 2-103 (1996) (allowing corporations to make contributions if authorized by the board of directors). Most of these statutes followed the corporate philanthropy provision codified as section 4(m) of the Model Business Corporation Act in 1950. A 1953 case, *A.P. Smith Manufacturing Co. v. Barlow*, 98 A.2d 581 (N.J. 1953), set the precedent that courts have since followed on the question. See also PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (1994) (stating that “a corporation . . . [m]ay devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes”).

This stance of the law has been defended primarily by reference to an entity theory of the firm. Under this theory, the corporation is itself a separate legal "person," with individual rights under the law, and it is therefore appropriate to expect, and even demand, that corporations be "good citizens," and that they behave in "socially responsible" ways, including contributing to "socially responsible" causes.<sup>2</sup> Corporate officers and directors, who act for this entity, must therefore be protected when they expend corporate resources on philanthropy.

But while the law appears to be settled, there is still an influential strand of legal thinking, particularly among scholars steeped in the jurisprudence of law and economics, that argues that corporate giving, if it is permitted at all, should be strictly limited to those situations where the benefit to the firm in the form of higher expected profits is clear and compelling. The argument against corporate philanthropy of a more general nature, as well as against other forms of gratuitous acts by corporations in the name of corporate "social responsibility," was made forcefully by Milton Friedman in 1962 in a famous and often-quoted essay.<sup>3</sup> Friedman's view was that a corporation is a special purpose institution for managing and governing private property — in particular, the private property of the shareholders. For corporate managers and directors to do anything with that property other than what the shareholders want them to do (which, presumably, is to increase profits) would be tantamount to expropriating resources that do not belong to them, and would violate the terms of their employment agreement.<sup>4</sup> Ar-

---

2. See, e.g., Daniel J. Morrissey, *Toward a New/Old Theory of Corporate Social Responsibility*, 40 SYRACUSE L. REV. 1005, 1013 (1989) (suggesting that "[l]ike each individual, the firm was a citizen in society with civic responsibilities"). See generally JAMES WILLARD HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970* (1970). For a critical discussion of the use of an entity theory of the firm as the basis for the tax treatment of corporate philanthropy, see Sugin, *supra* note 1, at 839-63.

3. See Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, (Magazine), at 32. Friedman's more scholarly treatment of his arguments was laid out in MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* (1962).

4. See Friedman, *supra* note 3, at 33. "In a free-enterprise, private property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires . . ." *Id.* Friedman was willing to concede, however, that there are two legitimate constraints on the basic charge of corporate officers and directors to "make as much money as possible." *Id.* These constraints are "the basic rules of the society, both those embodied in law and those embodied in ethical custom." *Id.*

guments to the same effect by subsequent contractarian legal scholars have generally been couched in terms of “principal-agent” theory (in which the central contractual relationship in a corporation is understood as an agency relationship between the shareholders, who are the real “owners” of the corporation’s property and act as “principals,” and the directors and managers who serve as their “agents”).<sup>5</sup>

This paper provides an alternative defense of managerial discretion with respect to corporate philanthropy that embraces the contractarian reasoning of Friedman and his proteges, but follows that reasoning to a different conclusion. I argue that Friedman’s conclusions apply only to a very narrow and special case, one in which the corporation in question is a mere holding device for assets that could, in principle at least, be held directly by the shareholders without serious costs in terms of operational efficiency.<sup>6</sup> In nearly all relevant cases, however, the publicly-traded corporate form is used in situations in which important assets of the firm — the things that make it valuable — include things that are intangible and inalienable. The property rights to assets such as certain kinds of intellectual capital, or organizational capital, for example, could not, even in principle, be assigned directly to shareholders because the assets are imbedded in the “human capital” of the em-

---

5. The literature analyzing corporate law in terms of a principal-agent model is enormous and too voluminous to cite, but begins with several articles by economists. See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Legal scholars have also viewed the corporation from this perspective. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). Articles specifically addressing corporate philanthropy from this perspective include Jayne W. Barnard, *Corporate Philanthropy, Executives’ Pet Charities and the Agency Problem*, 41 N.Y.L. SCH. L. REV. 1147 (1997); Faith Stevelman Kahn, *Legislatures, Courts and the SEC: Reflections on Silence and Power in Corporate and Securities Law*, 41 N.Y.L. SCH. L. REV. 1107 (1997); Faith Stevelman Kahn, *Pandora’s Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997) [hereinafter Kahn, *Pandora’s Box*]; Sugin, *supra* note 1.

6. Warren Buffett’s Berkshire Hathaway Corporation is an example. Other holding companies and investment companies might also be examples. But in almost any corporation with a significant number of employees, and actual operations, it would be impossible, or prohibitively costly in terms of transactions costs, for shareholders to directly own the assets used in production.

ployees.

If shareholders do not and cannot directly “own” the assets of the corporation, then a corporation cannot be merely the private property of shareholders, nor can it even be a mechanism for managing the private property of shareholders. And, if shareholders do not “own” either the corporation or its assets, the principal-agent model relied upon by so many legal scholars as a basis for understanding the relationships among shareholders, boards, and directors, is rendered inapplicable. Or, at the least, its application is limited to a narrow subset of governance problems. In the contemporary operating corporation, where human capital, intellectual capital, organizational capital, and other forms of intangible assets are likely to be quite important,<sup>7</sup> I argue Friedman’s logic does not necessarily imply that officers and directors should focus single-mindedly on increasing profits.

What is a corporation if it is not a bundle of assets “owned” by shareholders? I argue that a corporation is better understood as an institutional arrangement for governing a “team production” process.<sup>8</sup> As such, it is more than simply a “nexus of contracts.” It is a mechanism by which the terms of a complex set of interrelated relationships can be continuously written, revised, and enforced. These relationships are “contractual” in the sense that individuals enter into them voluntarily. But, the “contracts” are necessarily incomplete. When a firm is incorporated, participants in the enterprise (team members) implicitly agree, not to a set of outcomes, but

---

7. By some estimates, less than half of the market value of the equity in the publicly-traded corporate sector is accounted for by the book value of ownable assets such as property, plant, and equipment. See, e.g., Lowell L. Bryan, *Stocks Overvalued? Not in the New Economy*, WALL ST. J., Nov. 3, 1997, at A22.

8. This argument is developed in detail in Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. (forthcoming 1999) (manuscript on file with authors). Luigi Zingales notes that at least three definitions of a “firm” have appeared in the economic literature in recent years. See Luigi Zingales, *Corporate Governance*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (forthcoming 1998) (manuscript at 4–5, on file with author). Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779 (1972), define a firm as a nexus of contracts. Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 693 (1986), and Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1120 (1990), define a firm as a collection of physical assets that are jointly owned. And, Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387, 387–88 (1998), define a firm as a nexus of specific investments. The argument about the economic function of a “corporation” in Blair & Stout, *supra*, draws from each of these three ideas about “firms.”

to a decisionmaking process. The private governance structure and internal decisionmaking process established by the act of incorporation, then, serves as a substitute for the complex, multilateral contracts that would otherwise be required to govern those relationships.

An essential feature of that governance structure is that all of the participants in the firm agree to give up property rights over key inputs used in the joint enterprise, as well as any direct claims to the outputs. Inputs contributed by various stakeholders (especially those contributed by shareholders and employees) become *the property of the corporation itself*, and decisions about their use and allocation are governed by an internal hierarchy.<sup>9</sup> At the top of that hierarchy is the board of directors, which has extremely wide discretion under the law to make decisions about the use of the assets, and about the allocation of any economic surplus (rents) generated by the enterprise. This type of governance structure (a hierarchy headed by a board of directors) is virtually unique to the publicly-traded corporate form.<sup>10</sup> Careful contractarian scholars, then, understand that calling shareholders the “owners” of corporations, or referring to the assets of corporations as “shareholders’ property,” or the profits as “shareholders’ money,” is a rhetorical trick that, while powerful, is misleading, since it is neither an accurate description of the legal role that shareholders play in corporations nor a particularly informative statement about their economic role.<sup>11</sup>

---

9. Equity capital contributed by shareholders becomes corporate property immediately. Intellectual capital contributed by employees must first be converted to alienable property, in the form of patents, copyrights, engineering plans, operations manuals, etc., and these are then owned by the corporation. Although firm-specific skills developed by employees are technically not the property of the firm, they are, by definition, valueless to the employee outside the firm. So they, too, are stuck in the firm, where their use is subject to considerable control by management of the firm.

10. See Blair & Stout, *supra* note 8 (manuscript at 4 & nn.6–7) (noting: “An independent board of directors is one of the most important characteristics distinguishing public corporations from other forms of enterprise.”).

11. See, e.g., Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 904 n.22 (1997) (reviewing PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995)) (arguing that “[b]ecause shareholders are simply one of the inputs bound together by the web of voluntary agreements, ownership should not be a particularly meaningful concept in nexus-of-contracts theory. Someone owns each input, but no one owns the totality.”); see also Margaret M. Blair, *Corporate Ownership: A Misleading Word Muddies the Corporate Governance Debate*, BROOKINGS REV., Winter 1995, at 16. I agree with Bainbridge except to note that the individual team members may not necessarily own all of the inputs either.

Why do investors, employees, and other participants in the enterprise agree to relinquish property rights to a passive legal entity (the "corporation") controlled by a relatively unconstrained hierarchy? Since they do so freely when they enter into their relationship with the corporation, it seems reasonable to presume that they do so because they believe they will gain more than they will lose. In other words, they believe that the efficiency costs from the occasional misuse of power by executives and directors who are empowered to make decisions about the use of "corporate" assets will generally be far less than the costs of detailed and explicit contracting among the participants, or team members, would be. If the corporate form did not serve their needs in this particular way, presumably they would seek out an alternative arrangement to govern their relationships.<sup>12</sup>

Understanding that a corporation is a mechanism for governing a productive "team" directs attention to the fact that participating team members other than shareholders have often contributed inputs whose value is at risk in the corporation. The process of governing the relationships among all of those stakeholders inevitably involves trade-offs, judgment calls, and decisions that weigh the interests of one group against the interests of others. Vast discretion is required for corporate officers and directors to do this job. If the decisionmaking process within corporate hierarchies were captured and controlled by one set of stakeholders, other stakeholders might eventually cease to cooperate, to withhold inputs in the future, and try to withdraw inputs over which they have influence, at least to the extent that they could. It is, therefore, in the long-run best interests of shareholders *as a class* (although not necessarily of particular shareholders in particular firms) that managers and directors have discretion to make trade-offs among the corporation's many stakeholders and to allocate the economic rents as they deem necessary or desirable. In other words, I argue, the legislatures and the courts have been right to grant managers and directors broad discretion with respect to all kinds of decisions within corporations.

Hence, I differ from Friedman and most subsequent contractarian corporate law scholars in two major respects in the

---

12. Many alternative arrangements exist under the law, including direct contracting, limited partnerships, closely-held firms, and limited liability companies, and other forms might emerge if they were found to be valuable.

conclusions I draw from contractarian reasoning. First, I acknowledge the complex nature of modern corporations in which the “assets” at risk include many things that shareholders could never own directly, but that are nonetheless affected — sometimes dramatically — by the decisions of managers and directors. In light of this fact, I suggest that the principal-agent model is a misleading metaphor to use to analyze most problems in corporate law, including those surrounding corporate philanthropy. Following the joint work of Blair and Stout,<sup>13</sup> I propose instead that a more appropriate model for understanding corporate law is a “team production” model. Second, I show how this model provides a contractarian justification for why managers and directors must be given wide discretion in making decisions about the use of such assets, and the allocation of the returns from them. My argument applies to decisions to use corporate assets for philanthropic or charitable contributions as much as it applies to decisions about the transfer price for services provided by one subsidiary of a corporation to another, or about the division of a bonus pool among a group of employees.

In Section II, I review the argument that corporations should be understood as institutional solutions to the contracting problem inherent in team production.<sup>14</sup> In Section III, I show why the historical development of statutory and case law with respect to corporate philanthropy is consistent with the “team production” theory of the economic function of corporate law. And in Section IV, I draw a few conclusions about the implications of the “team production” theory for the broader debate about the so-called “social responsibilities” of corporations.

## II. THE TEAM PRODUCTION PROBLEM

### A. The Need for an Alternative to the Principal-Agent Model

Scholarly studies of corporation law and corporate governance in recent years have been dominated by an underlying view that a firm is, essentially, a bundle of assets that belongs to shareholders.<sup>15</sup> This conception of the firm is clearly different from, and not

---

13. See Blair & Stout, *supra* note 8.

14. Section II draws heavily on arguments made at length in Blair & Stout, *supra* note 8.

15. Friedman, *supra* note 3, at 33, is clearly based on this notion. Grossman & Hart, *supra* note 8, at 693, and Hart & Moore, *supra* note 8, at 1120, probably contribute to the general acceptance of this view by defining a firm as the assets under com-



necessary to, the contractarian notion of a firm as a “nexus of contracts.” The “bundle of assets” view, nonetheless, lurks in the background in a large part of the contractarian legal scholarship on corporate governance, providing a rationale for the recurring notion that the central contracting problem to be solved by governance arrangements in a corporation is a “principal-agent” problem: How can the “principals” (understood to be the shareholders) get their “agents” (understood to be managers and directors) to manage the firm in the best interests of the principals?<sup>16</sup>

But the idea that managers and directors are “agents” of “shareholders” has always been at odds with the way corporation law actually works.<sup>17</sup> Under American corporate law, directors and officers of a corporation are not agents of shareholders. Managers are agents of the corporation itself, and directors are *sui generis*. Directors are not subject to direct control by shareholders, and they owe no duty of obedience to shareholders. Confronted by these uncomfortable facts, contractarian legal scholars generally retreat to the “metaphor” argument: It doesn’t matter that there is no explicit legally enforceable agency contract between shareholders and directors. The “principal-agent” story is still a useful metaphor for the

---

mon ownership. Numerous other scholars and commentators implicitly accept this idea in casual references to “shareholders’ money.” See, e.g., Sugin, *supra* note 1, at 837 (arguing that “the [tax] Code has legitimized the power of management to spend the shareholders’ money for charitable purposes”).

16. See, e.g., Roberta Romano, *Corporate Law and Corporate Governance*, 5 *INDUS. & CORP. CHANGE* 277, 277 (1996) (“The fundamental task of corporate law is to provide a framework of governance institutions that mitigate the agency problem arising from the separation of ownership and control in the modern corporation — that the interests of the managers who control corporate decisionmaking may not coincide with the interests of their principals, the corporation’s owners.”). Other obligatory cites include *EASTERBROOK & FISCHER*, *supra* note 5; *Fama*, *supra* note 5; *Jensen & Meckling*, *supra* note 5.

An alternative strand of contractarian thinking about the nature of the firm has stressed the inevitable incompleteness of the contracts that make up the firm, and has focused on mechanisms for filling in the gaps in incomplete contracts. Leading works in this area are *Grossman & Hart*, *supra* note 8, at 693, and *Hart & Moore*, *supra* note 8, at 1120, who note that among the most important such mechanisms are property rights — which give the “owners” of an asset the residual right of control over that asset. These authors then appeal explicitly to the “bundle of assets” view of the firm by defining a firm as a collection of physical assets under common control.

17. See, e.g., Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 55, 56 (John W. Pratt & Richard J. Zeckhauser eds., 1987) (stating that “[t]o an experienced corporate lawyer who has studied primary legal materials, the assertion that corporate managers are agents of investors . . . will seem odd or loose”).

nature of the relationship between shareholders and directors.

I approach the problem differently. I do not develop an elaborate set of stories about how the rules of corporation law, and the internal rules governing specific corporations, function "as if they arose through the trading of rights and duties among the corporation's various constituencies and . . . represent a bargain."<sup>18</sup> Rather, I scrap the whole "bundle of assets" metaphor, and the "principal-agent" model based on it, and build a contractarian story about the nature of corporations that starts with a different central metaphor. The central contractual problem to be solved by the formation of a corporation, and by the structure of corporate law, is not a principal-agent problem (which could be solved through contract law). It is a "team production" problem.

### B. The Contracting Problems in Team Production

Team production problems are not well-studied in economics, although they are ubiquitous in the economy. They arise in situations in which a number of different parties contribute difficult-to-monitor inputs of varying types to a productive process, and in which the output of that process is "non-separable," meaning that it is impossible to determine which part of the output is attributable to which input. Alchian and Demsetz, who originated the notion that a firm is a nexus of contracts, developed that idea in the context of an article that was about team production problems.<sup>19</sup> If the output of a joint production process is non-separable, they noted, team members cannot simply be compensated for their contributions by paying them the "share" of the output that they produced, or for which they are responsible. There is no obvious, a priori rule to use to divide up the output, and if any sharing rule is established ex ante, team members will have an incentive to shirk, or "free-ride" on the efforts of other team members. This is because if team members contract in advance to share the output according to a particular rule, then all team members will share the costs of shirking, while only the individual team member who shirks will enjoy the benefits of shirking.<sup>20</sup>

Alchian and Demsetz argued that the solution to the team

---

18. Bainbridge, *supra* note 11, at 869.

19. See Alchian & Demsetz, *supra* note 8.

20. This argument was first made formally by Bengt Holmstrom, in *Moral Hazard in Teams*, 13 *BELL J. ECON.* 324, 325 (1982).

production problem is that one team member is assigned the task of monitoring all the other team members to be sure none of them shirk. Except for the monitor, all team members are paid according to their marginal opportunity cost, and the monitor receives any economic surplus or “rents” created by the activities of the team. The monitor, in their story, becomes the “owner” of the capitalist firm,<sup>21</sup> and they therefore argue that their story provides a rationale for capitalist firms.

Holmstrom, however, noted that the Alchian and Demsetz “solution” doesn’t really solve the most interesting team production problem: If it were possible to monitor effectively the inputs of the team members, it would be possible to contract directly for the inputs. The interesting and troubling case occurs in situations in which it is difficult or impossible to monitor and contract directly for the inputs, he said.<sup>22</sup>

Grossman and Hart<sup>23</sup> and Hart and Moore<sup>24</sup> consider another variation on the team production problem. Rather than thinking of the inputs of the team members as actions that are difficult to monitor, they think of the inputs as investments that must be made — for example, in firm-specific skills — that are difficult to specify and verify contractually. The team will be most productive if all of the team members invest, but the *ex ante* incentive that each team member has to invest depends on how much of the rents she thinks she can capture, which, in turn, depends on who has what bargaining power over the rents *ex post*.

### 1. Problematic Solutions

Several solutions to the intractable contracting problems involved in team production have been proposed, none of them wholly satisfactory. Holmstrom, for example, asks whether it would be possible to write a contract among the team members that allocates all of the output among them according to some *ex ante* sharing rule, and that would still provide the right incentives to keep each of them from shirking. He concludes that this is not possible, for the reasons stated above. Any *ex ante* sharing rule gives individual

---

21. This “solution” allowed the “bundle of assets” view of the firm to persist, and for many years after Alchian and Demsetz wrote their article, team production problems were treated as a subset of principal-agent problems.

22. See Holmstrom, *supra* note 20, at 327.

23. Grossman & Hart, *supra* note 8.

24. Hart & Moore, *supra* note 8.

team members an incentive to free ride.<sup>25</sup> The solution he proposes is a contract in which economic surpluses (rents) are distributed to team members only if they reach some minimum level. This solution creates a new problem, however: How to dispose of rents that fall short of the contractual minimum, without corrupting the original contract? If sub-contractual rents are to be paid out to team members, then team members once again have an incentive to free ride. But, if they are paid out to any outside party that has any influence over the behavior of team members, that outside party would have the perverse incentive to try to bribe one or more team members to shirk, in order to be sure that the rents fall short of the amount that would trigger payout to the team members.

Holmstrom suggests that outside shareholders in public corporations play the "budget balancing" role by being the recipients of the sub-contractual rents. Thus, he suggests, his model provides an explanation for the passive role played by outside shareholders in the publicly-traded corporation. Holmstrom's argument has not received much attention, probably because the role he ascribes to shareholders does not fit a common understanding about the role shareholders actually play.<sup>26</sup>

Grossman and Hart<sup>27</sup> and Hart and Moore<sup>28</sup> suggest an alternative solution. They assume that a complete contract cannot be written, so that, once production is underway, the rents generated by production will be up for grabs and will be allocated to the team members according to the bargaining power that each team member has. This leads them to focus on the role played by ownership rights in determining the outcome of the ex post bargaining. They note that if one of the team members is assigned a priori ownership rights (meaning that team member has the residual right to control decisions about the use of assets) over the output, that team member will have more bargaining power in negotiations over the rents, and will consequently be assured that she will be able to capture the value of any investment she makes in producing the assets. She

---

25. See Holmstrom, *supra* note 20, at 327. Gary Miller refers to this argument as "Holmstrom's impossibility result." See Gary Miller, *Tying the Owner's Hands: The Moral Hazard of Profit-Maximization* 12 (1996) (unpublished manuscript, on file with author).

26. Apart from the passivity question, Holmstrom's story differs from our common understanding because, in his model, higher than target levels of profits would be paid out to employees, while shareholders would only get paid when profits were below target.

27. Grossman & Hart, *supra* note 8.

28. Hart & Moore, *supra* note 8.

will therefore have a higher incentive to make the required investments (*i.e.*, to work hard and not shirk) in the first place. In other words, ownership rights discourage shirking. Hence, these authors suggest that a priori ownership rights to the output will have the highest value to the individual whose own investments (in, say, effort, or firm-specific human capital) are the most critical to the enterprise.

Of course, if one team member owns the output of the joint production process, the other team members will have much less incentive to invest under these circumstances. So the Grossman-Hart-Moore solution is not very helpful if there are numerous team members whose inputs are critical. Nonetheless, their story provides some insight into the economic function of ownership in an entrepreneurial firm, in which a single individual owns the critical assets and output of the firm, and contracts — albeit imperfectly — for inputs from the other members of the “team.”

## 2. Corporations as an Alternative Solution

Blair and Stout offer a third solution.<sup>29</sup> They argue that structuring the firm as a publicly-traded corporation helps to solve the team production problem in a way that incorporates and makes sense out of both Holmstrom's solution and the Grossman-Hart-Moore solution. When a public corporation is formed, property rights over critical inputs and over enterprise outputs are assigned *to the corporation itself*, a passive legal entity that is separate from any of the individual team members. Control rights over the firm's assets are thereby taken away from individual team members and assigned to managers, who are legally required to act as agents *of the corporation* rather than being permitted to act in their own interests. Managers, in turn, are subject to the control of directors, who act as *trustees for the firm itself*, rather than as agents for any specific participants or group of participants in the firm.

The problem identified by Holmstrom is solved because the corporation itself — a legal entity that is inherently passive — serves the function of “budget-breaker.” Output can simply be retained and not paid out to any team members if it is not large enough (whatever “large enough” means).<sup>30</sup> The Grossman-Hart-

---

29. See generally Blair & Stout, *supra* note 8.

30. Most economists and finance theorists think of retained earnings as being added to the equity value of the firm, and hence, going to shareholders. If financial

Moore problem is solved because none of the team members have ownership rights over the output of the firm, so none of them are in a position legally to expropriate all the rents from the other team members.<sup>31</sup> This helps to keep all of the team members on board and committed to the enterprise. The nature of the "contract" entered into by all the team members is a "pactum subjectionis,"<sup>32</sup> in which all agree to give up control rights to a supposedly neutral and independent board of directors.

Why would team members want to participate in an arrangement that required them to give up property rights over their output? They would if they believed that the total team output would be larger, and that therefore, the share of the total output they would receive in return for their contributions to the team would be larger than the output they could produce by themselves.

### C. Why Managers and Directors Need Wide Discretion

The Blair and Stout solution implies that directors and officers of the firm must have considerable discretion and protection from the influence of particular team members. They must be free, for example, to withhold bonus payments if production targets are not met, or to cut the dividend payments, or to redirect some resources to entice a new team member to join. And they must be protected from overweening influence or control by any particular team members as they decide the allocation of the rents. The Blair and Stout model, then, provides an economic rationale, consistent with contractarian legal thinking, for the enormous discretion over the

---

markets were perfect and there were no taxes, finance theory says retained earnings would be equivalent to dividends in terms of its impact on the value of equity securities. See generally Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411 (1961). But retained earnings do not belong to shareholders and might never be paid out to them at all. As long as they remain in the firm, they could be drawn down in future years to reward other stakeholders. This possibility is cause for great alarm among theorists such as Michael Jensen, who, relying on a "bundle of assets" view of the firm, regard retained earnings as the property of shareholders, and consequently fret about the "agency problems" that arise over the use of "free cash flow." See, e.g., Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

31. Rajan & Zingales, *supra* note 8, at 422-23, suggest that the solution to the Grossman-Hart-Moore problem is to assign ownership rights to a neutral third party.

32. The phrase is associated with Thomas Hobbes' idea that people might submit themselves to a coercive monarch in order to avoid a destructive war "of every one against every one." THOMAS HOBBS, *LEVIATHAN* 100 (Michael Oakeshott ed., Collier Books 1962) (1651).

use of corporate assets granted under corporate law to corporate officers and directors. Corporate directors and officers who are doing their job well will attempt to allocate resources and rents in such a way as to maximize the total rents being created. But, team members, having yielded control rights, may not be able to force them to do so. Moreover, since maximizing the total rents is not necessarily the same thing as maximizing the rents being captured by any one subset of participants in the firm, it does not necessarily lead to more efficient use of economic resources to give one subset of team members the power to force decisions that are in their interest.<sup>33</sup>

If corporate law doesn't provide direct mechanisms by which managers can be forced to make decisions that are aimed at maximizing the total rents being created by the team, what keeps the team generating rents? We argue that team members themselves are motivated to generate rents (as well as to maneuver to try to capture more of them), as long as they believe they will be able to capture enough of them so that they will make more by being part of the team than they would by operating alone.

For the most part, team members in a corporation will work out among themselves how to get this done: who zigs when, who zags when, who is responsible for what, and who gets what. The internal hierarchy of a corporation, of course, helps to set goals and coordinate that process by serving as a central node for processing information.<sup>34</sup> But, it also serves another important function not previously emphasized by economists. It provides a mechanism for resolving disputes over the distribution of the rents generated by the enterprise. Many of the terms by which the rents are distributed are not "contractual," in the sense that they are not enforceable by an outside party such as a court.<sup>35</sup> Instead, they can be resolved

---

33. The Blair and Stout model, then, provides a contractarian argument that justifies E. Merrick Dodd's view that managers and directors of corporations are fiduciaries who are supposed to act on behalf not just of shareholders, but of all those who have an interest in the business. See E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1161, 1162 (1932).

34. See, e.g., Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LITERATURE 1382, 1382 (1992) (surveying the economic literature on hierarchy as a system for gathering and processing information).

35. Courts routinely refuse to hear disputes between two divisions of the same company over transfer prices, quality, timely delivery, etc., as well as internal disputes such as those that might arise over the distribution of a bonus pool. See George Baker et al., *Implicit Contracts and the Theory of the Firm* 14 (Apr. 17, 1997) (unpublished manuscript, on file with author) (distinguishing transactions that take place within a

only by appealing to the internal hierarchy of the firm. When, on occasion, disputes rise to the level of the board of directors sitting at the top of that hierarchy, the board is given very wide discretion under the law to make the final call. Thus, the board of directors of Chrysler Corporation decided to increase greatly its dividend in response to pressure from its major shareholder, Kirk Kerkorian, and that matter was neither submitted to a vote of shareholders nor taken to the courts to resolve.<sup>36</sup> This fact is at odds with a view that a corporation is the property of shareholders, and directors are their “agents” of shareholders. But, it is consistent with a view that the corporation is a governance structure designed to govern the relationships among participants in a team production process, and directors are the “mediating hierarchs.”<sup>37</sup>

### III. THE LAW ON CORPORATE PHILANTHROPY

The Blair and Stout view of the social and economic function of corporation law provides a contractarian explanation for the broad discretion given corporate managers and directors under the business judgment rule, and for the fact that directors do not owe a duty of obedience to shareholders. It also explains the pattern of case law and statutory law on corporate philanthropy.

As other scholars have explored in far more detail than I will

---

firm (in particular, between a buyer of a worker's services and the worker acting as an “employee”) from those that occur across a market (between a buyer of a worker's services and the worker acting as a “contractor”) by whether or not the courts will hear disputes over the transaction). Being “in a firm,” then, means operating subject to the internal dispute resolution systems within that firm.

36. See Warren Brown, *Kerkorian's Bid to Buy Chrysler Called Doomed*, WASH. POST, Apr. 27, 1995, at B10. Had Kerkorian asked the Delaware court to compel Chrysler to pay out a larger dividend, he almost surely would have been rebuffed. As long as there are no allegations of director self-dealing, or other violations of directors' fiduciary duties, and as long as surpluses are sufficient that creditors and preferred shareholders are protected, matters of dividend policy are protected under the business judgment rule under Delaware law. See *Gabelli & Co. Profit Sharing Plan v. Liggett Group, Inc.*, 444 A.2d 261, 264–66 (Del. Ch. 1982) (holding that “[a] decision to declare a dividend is a matter ordinarily addressed to the discretion of the Board of Directors invoking, as it does, important business considerations. Prior Delaware cases have permitted directors wide latitude in making this decision and the declaring of a dividend is considered a routine matter which enjoys a presumption of sound business judgment” and that “it is settled in Delaware that the Court of Chancery will not compel payment of a dividend unless the corporation is in the proper business and financial posture to do so, and if the failure to declare the dividend is the result of an ‘oppressive or fraudulent abuse of discretion’” (citations omitted)), *aff'd*, 479 A.2d 276 (Del. 1984).

37. The phrase is from Blair & Stout, *supra* note 8 (manuscript at 31–43).



here, the earliest corporations were formed only upon the grant of a special charter by the crown, or in the early United States, by state charter, and these charters nearly always specified some sort of public purpose.<sup>38</sup> By late in the nineteenth century, however, most states had passed generalized incorporation laws.<sup>39</sup> Since these laws made it possible for anyone to incorporate, for any lawful purpose, the courts and the legislatures felt that it was important that incorporators state what their purpose was so that they could be held to that purpose. A compelling fact about the process of incorporation was that contributors of equity capital were giving up control over the use of their assets to corporate managers and directors. Since securities markets were thin or nonexistent at the time, and there were few reporting requirements imposed on the issuers of securities, investors lacked some of the assurances available today that the inputs they provided would not be expropriated. The courts, then, during the last half of the nineteenth century, and the first few decades of the twentieth century, tended to interpret and enforce the doctrine of ultra vires fairly strictly. In 1883, for example, a Delaware court ruled that contributions to charity were ultra vires, or outside the authority of the corporation.<sup>40</sup>

But, just thirteen years later, the courts were taking a more qualified view, particularly with respect to corporate expenditures on the provision of health, welfare, or community services that were likely to benefit employees. In *Steinway v. Steinway & Sons*,<sup>41</sup> the court observed that “[t]he field of corporate action in respect to the exercise of incidental powers is thus, I think, an expanding one. As industrial conditions change, business methods must change with them, and acts become permissible which at an earlier period would not have been considered to be within corporate power.”<sup>42</sup> Subsequent cases reiterated the view of the courts that corporate managers need discretion to use corporate resources in a variety of ways to provide noncash, noncontractual compensation and other benefits for employees.<sup>43</sup> In terms of the Blair and Stout model, corporate

---

38. See generally HURST, *supra* note 2.

39. See MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY* 73 (1992) (noting that “the movement for ‘free incorporation’ laws . . . triumphed between 1850 and 1870”).

40. See *Hutton v. West Cork Ry.*, 23 Del. Ch. 654, 668 (1883).

41. 40 N.Y.S. 718 (N.Y. Sup. Ct. 1896), cited in Shelby D. Green, *Corporate Philanthropy and the Business Benefit: The Need for Clarity*, 20 GOLDEN GATE U. L. REV. 239, 241 (1990).

42. 40 N.Y.S. at 720.

43. See, e.g., *People ex rel. Metropolitan Life Ins. Co. v. Hotchkiss*, 120 N.Y.S. 649

managers and directors needed discretion to be able to use as many tools as possible to recruit, motivate, energize, and compensate team members in order to maximize the rents created by the enterprise as a whole.<sup>44</sup>

By 1917, legislatures began to support this view when Texas broadened the statutory corporate purpose beyond pure profit-maximization, and other states followed along, so that by 1950, nearly half of the states had done so.<sup>45</sup> In 1934, the United States Supreme Court approved the tax-deductibility of charitable contributions as a legitimate business expense "when limited to charitable institutions, hospitals or educational institutions conducted for the benefit of its employees," and donations "which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its business."<sup>46</sup>

Of course, in the famous *Dodge v. Ford Motor Co.*<sup>47</sup> case in 1919, the Michigan Supreme Court reiterated the traditional view that "a business corporation is organized and carried on primarily for the profit of the stockholders."<sup>48</sup> But, even in that decision, the court in no way stripped corporate officers and directors of their wide discretion to pursue that goal in whatever way they thought appropriate.<sup>49</sup> In fact, some scholars have speculated that the court might not have second-guessed Henry Ford's judgment if he had justified his desire to retain his company's profits, cut prices of its products, and greatly expand its production as being in the long run interest of the corporation and its shareholders (as, indeed, it probably was).<sup>50</sup> Ford instead characterized these actions as an effort to "employ still more men; to spread the benefits of this in-

---

(N.Y. App. Div. 1909).

44. This comment is not meant to endorse any given tool over any other tool. The key issue here is need for discretion, not the merits of any particular use of that discretion.

45. See TEX. STAT. ANN. art. 1164 (Vernon 1918); Morrissey, *supra* note 2, at 1015 (noting that nearly half of all states had broadened corporate purpose by 1950).

46. *Old Mission Portland Cement Co. v. Helvering*, 293 U.S. 289, 293-94 (1934). The particular donation in this case, to a Community Chest fund, was disqualified, but that ruling was on the factual question of whether the donation was "a consideration for a benefit flowing directly to the corporation." *Id.* at 294.

47. 170 N.W. 668 (Mich. 1919).

48. *Id.* at 684.

49. See *id.* (holding that "[t]he discretion of the directors is to be exercised in the choice of the means to attain that end").

50. See, e.g., Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 601 (1992).

dustrial system to the greatest possible number, to help them build up their lives and their homes."<sup>51</sup>

In the post-World War II period, as large corporations became an increasingly dominant feature of the economy, the courts began to recognize more explicitly that the performance of a given corporation is connected to the performance of other social institutions, and to the performance of the economy as a whole. Sometimes these connections might be subtle. And sometimes managers might waste resources on projects and relationships that turn out not to benefit the corporation. But here again, the key issue is that, by their choice to enter into the corporate "contract," all of the participants in the firm agree to give up any direct claim on the inputs they provide and on the output of the firm, and to yield control over those assets to the discretion of managers and directors, who are bound by duties of care and duties of loyalty not to use the assets carelessly, nor expropriate them for their own benefit. Beyond those constraints, the courts decided, managers and directors should not be subjected to second guessing by the courts if they decide that it might be a good idea to expend corporate resources to support educational or community institutions.

In *A.P. Smith Manufacturing Co. v. Barlow*,<sup>52</sup> the courts upheld a \$1500 contribution made by the company to Princeton University.<sup>53</sup> The firm's president justified the donation on the grounds that the donations would evoke community goodwill and thereby help create a "favorable environment for their business operations,"<sup>54</sup> and that the donation would help to support an institution that would, in turn, help to train future employees.<sup>55</sup> The company also brought in prominent business leaders to testify that it was not good business for corporations to avoid the "normally accepted obligations of citizenship in the community,"<sup>56</sup> and that "corporations have a self-interest in the maintenance of liberal education as the bulwark of good government."<sup>57</sup> The court agreed:

More and more [corporations] have come to recognize that their

---

51. *Dodge*, 170 N.W. at 671.

52. 98 A.2d 581 (N.J. 1953).

53. *See id.* at 590.

54. *Id.* at 583.

55. *See id.*

56. *Id.* (quoting Frank W. Abrams, Chairman of Standard Oil Company of New Jersey).

57. *Id.* (quoting Irving S. Olds, Chairman of United States Steel Corporation).

salvation rests upon sound economic and social environment which in turn rests in no insignificant part upon free and vigorous non-governmental institutions of learning. It seems to us that just as the conditions prevailing when corporations were originally created required that they serve public as well as private interests, modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate.<sup>58</sup>

For the most part, corporate executives have not grossly abused the discretion given them under the law. There have been only two major cases brought to the courts since *A.P. Smith* in which the amounts given away by the firms were substantial enough, and the link to the business goals of the corporation tenuous enough, that shareholders thought it worth trying to fight.<sup>59</sup> These cases are *Theodora Holding Corp. v. Henderson*<sup>60</sup> and *Kahn v. Sullivan*.<sup>61</sup> In *Theodora*, Girard Henderson, the largest shareholder and son of the founder of Alexander Dawson, Inc. (which functioned mainly as a holding company, holding shares of Avon Products) used his influence on the board of Alexander Dawson to cause the company to make a series of donations to the Alexander Dawson Foundation, which he controlled. These donations ranged in value from \$27,923 to \$467,750, and occurred from 1960 through 1966. The foundation used the funds to support the activities of a camp for underprivileged boys which it operated in Colorado. Each of these donations was approved unanimously by the shareholders. In 1967, Henderson proposed that another gift, having a value of \$528,000, be made to the foundation, but that year, under pressure from Henderson's ex-wife (who held somewhat more than twenty-five percent of the voting shares of Alexander Dawson), several directors objected. Henderson then used his control over the board to cause the board to be reduced from eight members to three. The reduced board then approved the donation, and the ex-wife sued

---

58. *A.P. Smith*, 98 A.2d at 586.

59. One might argue that the barriers imposed by earlier court decisions are so high that gross abuses can occur and that shareholders, knowing they can't win, will not choose to fight them. But, if shareholders were deeply concerned about this issue, we might expect to see a rush by shareholder activists to propose changes in corporate charters or bylaws that would limit director discretion to make contributions to philanthropic causes. This has not happened.

60. 257 A.2d 398 (Del. Ch. 1969).

61. 594 A.2d 48 (Del. 1991).

derivatively for recovery of the donation (which amounted to 2.76% of Alexander Dawson's profits in that year).

In the second major case, the board of directors of Occidental Petroleum Corp. decided in the late 1980s to provide funding for building and operating an art museum to house the personal art collection of long-time Occidental chairman Dr. Armand Hammer. The commitment involved a number of pieces but the estimated total cost of the commitments made by the board was somewhat more than \$85 million. That represented almost 30% of Occidental's 1989 total net income of \$285 million (11.5% of pretax earnings).<sup>62</sup> A significant sum, to be sure, but, of course, the total commitment to the museum was to be paid out not in a single year, but over several years, and on an after tax basis, the impact on earnings would have been smaller.

These two cases are noteworthy because they are exceptional, in terms of both the size of the contributions relative to corporate earnings and the extent to which the contributions seemed to involve use of corporate resources for the special benefit of a single individual — the single largest shareholder in *Theodora*, and a powerful founder and long-time CEO in *Kahn*.<sup>63</sup> In the language of Blair & Stout, each donation could be understood as a special bonus or supplement to compensation paid to an especially powerful "team member."<sup>64</sup>

Contributions to pet projects of powerful team members probably happen on a small scale very frequently. But, it is rare that they are this large, relative to the size of the companies involved. Throughout the 1970s and 1980s, total contributions by large corporations averaged less than 1% of receipts less deductions, and in the 1990s, contributions by all corporations with taxable income

---

62. See Kahn, *Pandora's Box*, *supra* note 5, at 619 (citing \$85 million in contributions); OCCIDENTAL PETROLEUM CORP., 1989 ANNUAL REPORT 37 (reporting \$285 million net income).

63. Jayne Barnard cites several other examples of sizeable corporate contributions to philanthropic causes that have little or no connection to the financial goals of the corporation, but that seem motivated entirely by the preferences of the CEO. See Barnard, *supra* note 5, at 1160-64.

64. Sugin, *supra* note 1, at 875-76, argues that the tax treatment of such expenditures by corporations would be more correct if they were treated as compensation to the executive, and then deductible for the executive on his or her tax returns. Barnard, *supra* note 5, at 1170-73, and Kahn, *Pandora's Box*, *supra* note 5, at 611, 621, both argue that such expenditures should be treated as compensation to executives, or at the very least, corporations should be required to report such expenditures and directors should review them.

have continued at this level.<sup>65</sup>

Moreover, these contributions exhibit a pattern that strongly suggests that the donations are being made to institutions and causes that are linked to the business goals of the companies. For example, one commentator notes that banks, whose fortunes are often tied very closely to the health of the individual communities where they are located, tend to give nearly half of their total contributions to health and human services causes, and only about a quarter of their contributions to education.<sup>66</sup> Chemical companies, on the other hand, which have a higher need for technically-trained employees than banks, give more than 40% of their contributions to education.<sup>67</sup> Oil companies and cigarette companies, which have faced severe public relations problems in the past few decades, have focused their giving on culture and the arts, whereas industrial products companies, which have little need for high visibility among general consumers, typically give very little to culture and the arts.<sup>68</sup>

In a carefully structured statistical test, Peter Navarro found evidence that corporate contributions could be explained better by profit-maximization motives than they could by managerial discretion motives.<sup>69</sup> In particular, he found evidence that "corporate contributions represent a form of advertising," and that contributions to causes and institutions that enhance the attractiveness of the communities where firms operate "represent a quasi-fringe benefit to firm employees."<sup>70</sup> Meanwhile, he found no relation between contributions and either executive compensation or the degree of managerial control of the firms in his sample.<sup>71</sup>

Thus, while abuses do occur, the available evidence suggests that corporate managers and directors have not, in general, grossly abused the discretion given them by the legislatures and courts. Yet

---

65. See David R. Morgan, *Trends in Corporate Charitable Contributions*, 41 N.Y.L. SCH. L. REV. 771, 776 (1997); Michael Useem, *Corporate Philanthropy*, in *THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK* 340, 341 (Walter W. Powell ed., 1987). Companies are entitled to take tax deductions for charitable contributions up to 10% of pretax net income. See I.R.C. § 170 (1994).

66. See Useem, *supra* note 65, at 342.

67. See *id.*

68. See *id.*

69. See Peter Navarro, *Why Do Corporations Give to Charity?*, 61 J. BUS. 65 (1988).

70. *Id.* at 90.

71. See *id.*; see also Craig Smith, *The New Corporate Philanthropy*, HARV. BUS. REV., May-June 1994, at 105, 113 (arguing that "the new paradigm removes much of the CEO's control over giving decisions").

even in *Theodora* and *Kahn*, the courts ultimately upheld the board's authority to make the contributions in question, and dismissed the claims against directors for breach of their fiduciary obligations.<sup>72</sup> Under a theory of corporate law based on a "bundle of assets that belongs to shareholders" model, these decisions would be troubling. But under a theory of corporate law based on a model of corporations as solutions to team production problems, these decisions seem much more understandable.

#### IV. TEAM PRODUCTION PROBLEMS AND THE "SOCIAL RESPONSIBILITIES" OF CORPORATIONS

The argument that forms the basis of this paper is that the economic function of corporation law is to provide a solution to the contracting problems inherent in team production. In arguments first developed elsewhere, Professor Stout and I claim that this view of the nature and purpose of corporations goes a long way toward explaining aspects of corporation law that do not make sense when viewed from the perspective of principal-agent theory.<sup>73</sup> Our theory argues that the solution imposed by corporation law is to assign decision rights over the use of corporate assets to a set of individuals who have duties of loyalty and duties of care to the corporation itself.

The team production theory of corporation law rejects the anthropomorphic notion that corporations have social responsibilities because their status as separate legal entities implies that they must be "good citizens." But, it suggests that corporate executives and directors who are doing their job right are not only entitled to, but may at times be responsible for, directing that corporate assets be used in ways that are "socially responsible." Although the team production theory of corporate law was derived from economic reasoning, it suggests that corporations are fundamentally *political and social* institutions.<sup>74</sup> Since team members can be expected to

---

72. In *Kahn*, the issue at stake was a challenge to a settlement agreement between Occidental board members and another shareholder who had challenged the decision to support the museum. The Supreme Court of Delaware ruled that the Chancery Court had been correct in applying the business judgment rule to the settlement agreement, and in concluding that, "given the net worth of Occidental, its annual net income before taxes, and the tax benefits to Occidental, that the gift to the museum was within the range of reasonableness established in *Theodora Holding Corp. v. Henderson*." *Kahn v. Sullivan*, 594 A.2d 48, 61 (Del. 1991).

73. See generally Blair & Stout, *supra* note 8.

74. See, e.g., HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 287 (1996) (stress-

use the political tools available to them, in addition to economic and legal tools, to try to capture as much of the rents from the joint enterprise as they can, corporate managers and directors must also be allowed to use such tools. They must be free to encourage the participation and cooperation of employees, for example, with a variety of incentives, including moral suasion,<sup>75</sup> social pressures,<sup>76</sup> and gift exchanges,<sup>77</sup> in addition to contractual reward and punishment incentives. And, they may also find it necessary or useful from time to time to utilize those tools in their relationships with customers, or lenders, or suppliers, or even community leaders, voters, and members of the media.

If participants in the joint enterprise being undertaken by the firm are uncomfortable with giving corporate executives and directors such wide discretion, they could, presumably, structure their relationship differently. They could organize the firm as a limited partnership or a close corporation rather than a public corporation; or they could lend the firm money rather than investing in equity; or they could work as subcontractors rather than as employees. The fact that so much economic activity is organized within the private governance structures created under the law of public corporations suggests that participants in these enterprises find it in their interests to operate this way. This, in turn, suggests that the discretion granted to corporate managers and directors is serving an important economic purpose.

---

ing "the importance of viewing the firm as a political institution").

75. See generally MICHAEL TAYLOR, *THE POSSIBILITY OF COOPERATION* (1987) (discussing the prisoner's dilemma); *TRUST IN ORGANIZATIONS: FRONTIERS OF THEORY AND RESEARCH* (Roderick M. Kramer & Tom R. Tyler eds., 1996).

76. See generally David M. Kreps, *Corporate Culture and Economic Theory*, in *PERSPECTIVES ON POSITIVE POLITICAL ECONOMY* 90 (James E. Alt & Kenneth A. Shepsle eds., 1990).

77. See generally RICHARD M. TITMUS, *THE GIFT RELATIONSHIP* (1971); George Akerlof, *Labor Contracts as Partial Gift Exchange*, 97 Q.J. ECON. 543 (1982).



