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Responsible Profitability - Not on My Balance Sheet, 61 Cath. U. L. Rev. 651 (2012)

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RESPONSIBLE PROFITABILITY? NOT ON MY BALANCE SHEET!

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> "*A business that makes nothing but money is a poor business.*" -Henry Ford.[1]

"*'[P]rofit goes with liability,' meaning that only a person willing to bear a risk of loss is entitled to claim a profit.*"[2]

Many free-market capitalists believe in the syllogism that if a free market results in progress, and if progress is good, then by definition a free market

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1. *Message From Ford Motor Company Fund and Community Services President Jim Vella*, FORD MOTOR COMPANY FUND & COMMUNITY SERVICES, http://corporate.ford.com/our-company/community/ford-fund/presidents-message-401p?releaseId=1244754314736 (last visited Mar. 6, 2012).

2. Robert W. Hillman, *Limited Liability in Historical Perspective*, 54 WASH. & LEE L. REV. 615, 620 (1997).

must be good.[3] Two hundred years of economic development support this proposition.[4] The capitalist model, which is premised on free-market ideology,[5] is credited with producing many of the riches enjoyed by society as a whole.[6] Indeed, the pursuit of economic freedom ranks among the primary motivations for the founding of the United States.[7] The corporation has enabled that pursuit and can be credited with greatly contributing to the advancement of free-market capitalism.[8]

Proponents of the corporate enterprise argue that corporations have benefitted the American economy and, by extension, American society.[9] Undoubtedly, the corporation has created economic opportunity for shareholders,[10] and it is undeniable that "America owes much of its early development to these business enterprises."[11]

However, the use of the corporate device has exacted a heavy price on society, and observers have called its social utility into question.[12] Concerns about abusive practices have resulted in calls for additional regulation of

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3. *See, e.g.*, 5 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 2096.30 (2011) [hereinafter FLETCHER] (sharing the view that by striving to maximize profits, corporations are acting to benefit society).

4. *See, e.g.*, Robert Hessen, *Capitalism*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS 57, 57 (David R. Henderson ed., 2008) (tracing the history of capitalism).

5. Free-market ideology proposes that prices will adjust according to supply and demand, and that societal welfare will be maximized at the point where supply equals demand. ANDREW GILLESPIE, FOUNDATIONS OF ECONOMICS 86 (2007). Therefore, governmental intervention is not advantageous. *Id.* at 85–86.

6. Hessen, *supra* note 4, at 59 (noting the proliferation of luxury items as a result of capitalism).

7. *See* 1 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492–1900), at 29 (2002) ("[C]olonists were enticed to an America that was almost entirely owned and operated as a business.").

8. Hessen, *supra* note 4, at 57–61 (noting the parallel rise in capitalism and the growth of industry and the corporation).

9. *See, e.g.*, WILLIAM W. COOK, THE CORPORATION PROBLEM: THE PUBLIC PHASES OF CORPORATIONS, THEIR USES, ABUSES, BENEFITS, DANGERS, WEALTH, AND POWER, WITH A DISCUSSION OF THE SOCIAL, INDUSTRIAL, ECONOMIC, AND POLITICAL QUESTIONS TO WHICH THEY HAVE GIVEN RISE 4–5 (1891) (observing that corporations "have cheapened the necessaries of life, given quick and easy connection between distant points, developed agriculture, mining, manufacturing, and commerce; created employment for labor, marketed the products which before were not worth the cost of transportation, lowered the cost of living in Europe and America, transformed the uninhabited wildernesses into rich farms, towns, cities, and States; found land worth nothing and made it worth millions, and caused an interchange of the manufactures, luxuries, literature, arts, sciences, and ideas of the world").

10. Hessen, *supra* note 4, at 58.

11. THOMAS LEE HAZEN & JERRY W. MARKHAM, CORPORATIONS AND OTHER BUSINESS ENTERPRISES, CASES AND MATERIALS 3 (3d ed. 2009).

12. COOK, *supra* note 9, at 78 (calling the corporation "as perfect and heartless a money-making machine as the wit of man has ever devised").

corporations and increased corporate social responsibility (CSR).[13] Although corporations have yielded many great benefits to society, they also have imposed many substantial burdens.[14]

This Article contends that traditional legal theories have not adequately discouraged corporations from making socially undesirable choices and have not encouraged corporations to take socially responsible action. In response to the inadequacies of prior law, the CSR movement surfaced as an alternative and has become an important voice in the effort to call attention to corporations' irresponsible and unfettered actions.[15] The CSR movement has contributed to gains in labor,[16] environmental,[17] and safety policies.[18] However, the CSR voice lacks the power of legislation, and without legislation, its voice lacks legal authority.

Without legislation mandating responsible corporate behavior, corporations will continue to engage in behavior that is socially undesirable, albeit profitable, for its shareholders.[19] With the benefit of enabling legislation, the corporate entity can be both a profit-making device for its shareholders and a

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13. *See, e.g.*, Z. Jill Barclift, *Corporate Social Responsibility and Financial Institutions: Beyond Dodd-Frank*, 31 BANKING & FIN. SERVICES POL'Y REP. 13, 16 (2012) (arguing for mandatory corporate-responsibility requirements); *see also* GRANT THORNTON, CORPORATE SOCIAL RESPONSIBILITY: A NECESSITY NOT A CHOICE 2 (2008) (advocating the implementation of CSR).

14. *See In re* Union Carbide Corp. Gas Plant Disaster, 809 F.2d 195, 197 (2d Cir. 1987) (describing the Bhopal India leak as "the most devastating industrial disaster in history [that resulted in] the deaths of over 2,000 persons and injuries of over 200,000 caused by lethal gas known as methyl isocyanate which was released from a chemical plant operated by Union Carbide India Limited").

15. *See* Press Release, CSRWire, 2009 CSR Year in Review: Corporate Social Responsibility Solidifies into a Movement (Jan. 20, 2010), *available at* http://www.csrwire.com/press_releases/28632-2009-CSR-Year-in-Review-Corporate-Social-Responsibility-Solidifies-Into-a-Movement-.

16. *See Corporate Social Responsibility & Labor*, WORLD BANK, http://go.worldbank.org/99RH4AT0K0 (last visited Feb. 1, 2012).

17. *See World's Largest Firms "Acting on Climate Change" Analysis Shows*, GUARDIAN (Sept. 14, 2011, 7:16 PM), http://www.guardian.co.uk/environment/2011/sep/14/worlds-largest-firms-climate-change (describing the increasing number of large businesses that are taking steps to reduce emissions affecting climate change); *see also Products and the Environment*, HASBRO, http://csr.hasbro.com/sus07-products-and-the-environment.php#video-1 (last visited Feb. 1, 2012) (highlighting Hasbro's commitment to using environmentally sustainable products, materials, and packaging).

18. *See Basic Approach to Safety*, MAZDA, http://www.mazda.com/csr/safety/basic_position/ (last visited Feb. 1, 2011) (outlining Mazda's various safety initiatives in the context of vehicles, people, roads, and infrastructure).

19. *See* Barclift, *supra* note 13, at 43.

responsible corporate citizen.[20] This dual function may translate into customer loyalty, consumer preference, and ultimately corporate profits.[21]

Part I discusses the corporation's early role and the debate concerning its purpose. Part II explores the legal justifications for the pursuit of profit and discusses how modern financial theory contributed to profit-maximization efforts. Part III then discusses the failure of traditional legal theories to provide either adequate public protections or corporate incentives for responsible action. Finally, Part IV proposes encouraging responsible corporate action through the use of accounting rules and tax law.

I. BACKGROUND

The idea of CSR as an institutional mechanism to protect societal interests has been a topic of continuing debate in American legal jurisprudence for nearly a century.[22] In 1932, in the midst of the Great Depression, the *Harvard Law Review* presented a historic academic debate between Professor E. Merrick Dodd of Harvard Law School and Professor Adolf A. Berle of Columbia Law School regarding corporations' role in society.[23] During this time period, the American economy roiled in despair as stock values crashed and unemployment ranks swelled,[24] and misery became an uninvited guest in many homes throughout the country. In response, many blamed corporations for contributing to the financial uncertainty.[25]

In their debate, Professors Dodd and Berle diverged on the societal purpose of corporations. Professor Dodd claimed that the public saw the corporation as an "economic institution which has a social service as well as a profit-making

20. *See* THORNTON, *supra* note 13, at 2 (noting that responsible corporate action benefits businesses by improving their reputation while also enhancing ethical business practices).

21. Jackie Luan & Kusum L. Ailawadi, *Does Corporate Social Responsibility Build Customer Loyalty?*, ADAGE (May 24, 2011), http://adage.com/article/cmo-strategy/corporate-social-responsibility-build-customer-loyalty/227729/.

22. Am. Bar Ass'n Comm. on Corporate Law, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. L. 2253, 2254 (1990) (noting that the debate about corporate accountability commenced in the early 1930s).

23. *Id.*

24. Gene Smiley, *Great Depression*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS, *supra* note 4, at 320, 320 ("[I]n 1933, 25 percent of all workers and 37 percent of all nonfarm workers were completely out of work."); *see also* Ben S. Bernanke, Governor, Fed. Reserve, Remarks at the H. Parker Willis Lecture in Economic Policy, Washington and Lee University: Money, Gold, and the Great Depression (Mar. 2, 2004), *available at* http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm ("During the major contraction phase of the Depression, between 1929 and 1933, real output in the United States fell nearly 30 percent. . . . [T]he unemployment rate rose from about 3 percent to nearly 25 percent . . . .").

25. *See* Katharine V. Jackson, *Towards a Stakeholder Shareholder Theory of Corporate Governance: A Comparative Analysis*, 7 HASTINGS BUS. L.J. 309, 317 (2011) (stating that the New Deal policies enacted in the wake of the Great Depression were aimed at "temper[ing] corporations' influence in society").

function."[26] In contrast, Professor Berle maintained that "a social-economic absolutism of corporate administrators, even if benevolent, might be unsafe; and in any case it hardly affords the soundest base on which to construct the economic commonwealth which industrialism seems to require."[27] Professor Berle's position eventually triumphed as the prevailing model in American corporate jurisprudence.[28] Today, however, the question of the corporation's role still lingers.[29]

Throughout the twentieth century, corporations' management teams embraced the principle of maximizing shareholder profitability as the justification for their choices and decisions.[30] Although this approach may be economically beneficial and favorable in some respects, it also has led to undesirable results, including personal injury, death, and other socially destructive consequences.[31] In fact, corporations have been charged with and found guilty of criminal conduct,[32] polluting the environment,[33] and deceiving consumers.[34] As a result, society has had to absorb both the financial and the nonfinancial costs of corporate decisions.[35]

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26. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932).

27. A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1372 (1932).

28. Am. Bar Ass'n Comm. on Corporate Law, *supra* note 22, at 2255.

29. *See, e.g.*, C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century*, 51 U. KAN. L. REV. 77, 77–79 (2002) (noting that discussions as to corporations' societal role have persisted into the twenty-first century).

30. *See* Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L. & BUS. REV. 163, 164 (2008) (attributing the widely held tenet that the purpose of corporations is profit maximization to the Michigan Supreme Court's 1919 decision in *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919)).

31. *See, e.g.*, O'Gilvie v. Int'l Playtex, Inc., 821 F.2d 1438, 1440, 1446 (10th Cir. 1987) (noting that Playtex marketed high-absorbency tampons to increase profits despite its awareness that such products caused toxic shock syndrome, which led to the plaintiff's death); Gillham v. Admiral Corp., 523 F.2d 102, 105–07 (6th Cir. 1975) (indicating that a corporation continued to market and sell color televisions despite notice that its product posed a major fire hazard).

32. *See, e.g.*, United States v. Cattle King Packing Co., Inc., 793 F.2d 232, 239 (10th Cir. 1986); United States v. Carter, 311 F.2d 934, 942 (6th Cir. 1963); United States v. Griffin, 401 F. Supp. 1222, 1224–25 (S.D. Ind. 1975), *aff'd sub nom.* United States v. Metro Mgmt. Corp., 541 F.2d 284 (7th Cir. 1976).

33. *See* Sandy Smith, *Tyson Foods Pleads Guilty to 20 Felonies, Agrees to $7.5 Million Fine*, EHS TODAY (June 27, 2003), http://ehstoday.com/news/ehs_imp_36455/.

34. *See, e.g.*, SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1471 (2d Cir. 1996).

35. *See* Benedict Sheehy, *Corporations and Social Costs: The Wal-Mart Case Study*, 24 J.L. & COM. 1, 51–52 (2004) (contending that corporations that engage in undesirable behavior, such as "destroying the environment, poisoning employees, and undermining societies," in an effort to maximize their wealth lack incentives to internalize costs and are able to successfully pass on any costs to society).

The growth of corporate enterprise coincided with the Industrial Revolution, as the banking, oil, railroad, and steel industries grew.[36] Investors embraced the corporate form during the industrial era because it was an efficient way to accumulate capital while limiting personal liability.[37] However, this period also witnessed American corporations racing to the bottom of regulatory environments, meaning that entities sought to incorporate in business-friendly environments free from regulatory intrusion into internal corporate affairs.[38] A new race, on a global scale, developed during the late twentieth century as corporations fought to establish their economic presence in the world marketplace and began to seek out markets in which a lack of regualtions would allow the exploitation of labor and resources.[39]

Some criticize corporations for conduct that results in socially unacceptable consequences. For example, detractors point to corporations' fight against food-labeling requirements,[40] seat-belt requirements,[41] and warning labels.[42] CSR proponents argue that corporations must behave responsibly when choosing among various business alternatives.[43] They frequently cite the transference of costs by corporations onto unwilling participants when a corporation fails to act responsibly.[44] They also maintain that the corporate enterprise has a broader responsibility extending beyond the limited duty it

36. David Ronnegard, *The Legal Ontology of the Corporation as a Description of Its Goal, and Its Role in Society* 10 (INSEAD, Faculty & Research Working Paper 2011/16/ISIC, 2011), *available at* http://www.insead.edu/facultyresearch/research/doc.cfm?did=47140.

37. Marleen O'Connor-Felman, *American Corporate Governance and Children: Investing in Our Future Human Capital During Turbulent Times*, 77 S. CAL. L. REV. 1255, 1280 (2004).

38. *See* FRANKLIN A. GEVURTZ, CORPORATION LAW 41–42 (2000).

39. *See, e.g.*, John C. Knapp, Note, *The Boundaries of the ILO: A Labor Rights Argument for Institutional Cooperation*, 29 BROOK. J. INT'L L. 369, 384 (2003) (discussing the new race to the bottom in the context of regulating the global labor market).

40. *See, e.g.*, Jeffery Young, *Movie Theaters Fight to Keep Popcorn from Food-Labeling Rule*, SEATTLE TIMES (Mar. 15, 2011), http://seattletimes.nwsource.com /html/movies/2014505511_popcorn16.html (detailing the opposition of movie-theater chains to a regulation that would require theaters to list the calorie content of popcorn).

41. *See, e.g.*, Lindsey Ellerson, *To Buckle or Not to Buckle: Debate over Seat Belts on Buses Heats Up*, ABC NEWS (Mar. 5, 2010), http://abcnews.go.com/Politics/seatbelt-debate-states-mandate-school-bus-seatbelt-law/story?id=9999072 (noting that school-bus industry associations have raised arguments about cost and liability in opposition to the installation of seat belts in school buses).

42. *See* Ciba-Geigy Corp. v. EPA, 801 F.2d 430, 432–33 (D.C. Cir. 1986) (detailing a pesticide manufacturer's refusal to comply with labeling requirements).

43. *See* Barclift, *supra* note 13, at 15 (noting that effective CSR requires decision making that balances profit maximization against moral and ethical obligations).

44. *See* Sheehy, *supra* note 35, at 51–52; *see also* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 4–5 (2001) (describing the multitude of costs produced by irresponsible corporate actions).

owes to its shareholders and including duties to employees, suppliers, and the surrounding community.[45]

In contrast, CSR opponents argue that excessive regulation stifles creativity and competitiveness.[46] Additionally, opponents assert that regulatory solutions are burdensome and inefficient.[47] They maintain that market-based corrections result in efficient solutions that benefit all of society, not just corporations' shareholders.[48]

Both common law[49] and statutory[50] rules benefit corporate enterprises. It seems reasonable, then, that in exchange for the privilege of operating a business in corporate form, the free transferability of shares, and the perpetual existence of the corporate entity, corporations should be held accountable to the public and recognize that they owe the public a duty of good faith, fairness, and honesty in their decisions and actions. However, without legislation either mandating responsible conduct or incentivizing responsible conduct through economic means, corporations will not alter their modus operandi.[51] Although legal, acting solely in the name of profit maximization is irresponsible and counterproductive to society's best interests. Legislatures must give corporations legal incentives to act with due regard for society and to take immediate and affirmative steps to minimize externalities. Corporations often take corrective action only in response to governmental pressure, rather than in response to market pressure.[52]

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45. Afra Afsharipour, *Directors as Trustees of the Nation? India's Corporate Governance and Corporate Social Responsibility Reform Efforts*, 34 SEATTLE U. L. REV. 955, 1014 (2011).

46. *See* Olufunmilayo B. Arewa, *Risky Business: The Credit Crisis and Failure (Part II)*, 104 NW. U. L. REV. COLLOQUY 421, 423 (2010), http://www.law.northwestern.edu/lawreview/colloquy/2010/15/LRColl2010n15Arewa.pdf (contending that additional regulations on corporations should be avoided and suggesting that current regulations, such as the Sarbanes-Oxley Act of 2002, have reduced the competitiveness of U.S. companies).

47. *Id.*

48. IS THE GOOD CORPORATION DEAD? SOCIAL RESPONSIBILITY IN A GLOBAL ECONOMY, at ix (John W. Houck & Oliver F. Williams eds., 1996) (articulating economist Milton Friedman's view that ethical and social values are unrelated, and even harmful, to economic decisions).

49. The common law business judgment rule is "designed to protect the wide latitude conferred on a board of directors in handling the affairs of the corporate enterprise. The rule refers to the judicial policy of deferring to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions." 3A FLETCHER, *supra* note 3, § 1036.

50. *See* 17 C.F.R. § 120.14a-8 (2011) (providing the parameters for corporations' acceptance and rejection of shareholder proposals).

51. *See* MITCHELL, *supra* note 44, at 11 (stating that legislative reforms are necessary to "give corporations incentives to care about the rest of us").

52. *Cf.* John V. Jacobi, *Competition Law's Role in Health Care Quality*, 11 ANNALS HEALTH L. 45, 70–71 (2002) (contending that in the context of healthcare, market pressures alone are insufficient to enhance quality and that government regulation is needed).

II. THE RELENTLESS PURSUIT OF PROFIT

At the turn of the twentieth century, many began to embrace the concept of maximizing shareholder value as the justification for corporate actions and decisions.[53] In 1919, the Michigan Supreme Court decided the now-famous case of *Dodge v. Ford Motor Co.*,[54] a seminal decision in American jurisprudence which many often cite for the proposition that the increase of shareholder value is the overriding goal of a corporation.[55] This case centered on Ford's decision to forego paying a special dividend to its shareholders.[56] The plaintiffs, who owned 2000 shares of Ford stock, filed suit against Ford Motor Company and claimed that they were not adequately represented on Ford's board of directors, which was allegedly "dominated and controlled" by Henry Ford, Ford's president and majority shareholder.[57] The plaintiffs particularly took issue with Henry Ford's proclamation that "it [is] to be the settled policy of the company not to pay in the future any special dividends, but to put back into the business for the future all of the earnings of the company, other than the regular dividend of five per cent."[58] The plaintiffs challenged his unilateral alteration of future dividend policy and opposed his statement of public benevolence because they claimed that his decision adversely affected their interests as shareholders.[59]

Ford's declaration of a change in dividend policy came at a financially inexcusable moment for Ford Motor Company, which had just finished its most profitable year.[60] To illustrate, during this time, the company expected an annual profit of over $60 million.[61] It held over $132 million in assets, which included approximately $54 million of cash on hand, against total liabilities and capital stock of $20 million, resulting in a surplus of approximately $112 million.[62] By any reasonable measure, the company was in a comfortable position to pay the special dividend without injury to its declaration of social benevolence.[63]

53. *See supra* Part I; *see also* Smith, *supra* note 33, at 278, 308–09.

54. 170 N.W. 668 (Mich. 1919).

55. *See, e.g.*, D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 (1998) (noting that the idea of shareholder primacy—that "corporate directors have a fiduciary duty to make decisions that are in the best interests of its shareholders"—is most often attributed to *Dodge*). Professor D. Gordon Smith maintains that the correct interpretation of *Dodge* is one that addresses the rights of an oppressed minority shareholder. *Id.* at 279.

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

57. *Id.* at 670–71.

58. *Id.* at 671 (internal quotation marks omitted). Ford asserted that with the company's additional revenue, he intended "to employ . . . more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes." *Id.*

59. *Id.*

60. *Id.* at 683.

61. *Id.*

62. *Id.*

63. *Id.* at 685.

The court did not disregard the strength of Ford Motor Company's financial position, as it ultimately ordered the company to pay the dividend.[64] In oft-quoted language, the *Dodge* court reasoned,

> A business corporation is organized and carried on *primarily for the profit of the stockholders*. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in *the choice of means* to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[65]

This language gained currency, and courts and scholars still cite it as the justification for maximizing shareholder value.[66]

Although the Michigan Supreme Court rejected Ford's attempt at social responsibility in *Dodge*, it referenced several cases relied on by Ford that actually support the notion of CSR.[67] For example, in *Taunton v. Royal Insurance Co.*, a shareholder of Royal Insurance Company challenged the board of directors' decision to pay for losses resulting from a gunpowder explosion despite the fact that the insurance policies excluded such accidents from coverage.[68] The record establishes that the explosion damaged eighty-one insured houses, and that although the directors agreed to pay claims, the board denied having a legal obligation to make such payments.[69] At the time Royal Insurance Company made its payments, the practice of making payments not required by law or policy was accepted among insurance companies under the rationale that "it was for the advantage of a company to deal liberally with customers, even to the extent of paying losses not strictly within the of terms their policies."[70] The court stated that this was a "matter[] within the discretion of the board . . . to settl[e] claims; and even if the payments be called gratuities, it makes no difference if they are gratuities conducive to the successful conduct of the legitimate business of the

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64. *Id.*

65. *Id.* at 684 (emphasis added).

66. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423–25 (1993); Kenneth B. Davis, *Discretion of Corporate Management to Do Good at the Expense of Shareholder Gain—A Survey of, and Commentary on, the U.S. Corporate Law*, 13 CAN.-U.S. L.J. 7, 7–8 (1988); Robert Sprague & Aaron J. Lyttle, *Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy*, 16 STAN. J.L. BUS. & FIN. 1, 3 (2010).

67. *Dodge*, 170 N.W. at 684 (citing Hawes v. City of Oakland, 104 U.S. 450 (1881); People *ex rel.* Metro Life Ins. Co. v. Hotchkiss, 120 N.Y.S. 649 (N.Y. App. Div. 1909); Steinway v. Steinway & Sons, 40 N.Y.S. 718 (N.Y. App. Div. 1896); Taunton v. Royal Ins. Co., (1864) 71 Eng. Rep. 413 (Ch.); 2 Hem. & M. 135).

68. *Tauton*, 71 Eng. Rep. at 413.

69. *Id.*

70. *Id.*

company."[71] The court recognized that company funds must be used for only legitimate business purposes, but that boards of directors must be free to make decisions as to what actions are in the best interests of the company.[72] Therefore, the *Taunton* court held that a board of directors may legitimately make voluntary and non-contractually binding payments in the interests of the company because such payments contributed to the company's overall success.[73]

The *Dodge* court also referenced *Hawes v. Oakland*, another case in which a corporation acted for the public's benefit notwithstanding a shareholder's complaint.[74] In this case, the defendant water company supplied the City of Oakland with free water for nonessential purposes.[75] The plaintiff-shareholder filed a suit demanding that the company "limit the supply of [free] water . . . to cases of fire or other great necessity."[76] The plaintiff maintained that the practice of supplying water free of charge caused "great loss and injury of the company, to the diminution of the dividends . . . and to the decrease in the value of their stock."[77]

The Court dismissed the case because it found that the directors were acting within their authority and that the plaintiff lacked standing.[78] By dismissing the complaint, the Court recognized the directors' authority to make business decisions in the corporation's interest, even when such corporate action furthers a public interest and not just shareholder wealth.[79]

Although the concept of maximizing shareholder profitability is readily understood, it is questionable whether so broad a judicial application[80] of the shareholder-maximization theory subsequent to *Dodge v. Ford* is justified when considered against these cases.

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71. *Id.* at 415.

72. *Id.* at 414.

73. *Id.* at 415.

74. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

75. Hawes v. City of Oakland, 104 U.S. 450, 451 (1881).

76. *Id.* The Court noted that

> [t]he foundation of the complaint is that the city of Oakland claims at the hands of the company water, without compensation, for all municipal purposes whatever, including watering the streets, public squares and parks, flushing sewers, and the like, whereas it is only entitled to receive water free of charge in cases of fire or other great necessity.

Id.

77. *Id.*

78. *Id.* at 462. Discussing early derivative-lawsuit principles, the Court stated that a shareholder must show that the directors are exceeding the scope of their established authority, considering or engaging in a fraudulent transaction, acting in their individual interests as opposed to the corporation's interest, or engaging in an illegal course of action. *Id.* at 460.

79. *See id.* at 461–62.

80. *See generally, e.g.*, Miller v. Magline, Inc., 256 N.W.2d 761 (Mich. Ct. App. 1977) (illustrating the success of minority shareholders in compelling a dividend).

A. Profit: An Evolving and Expanding Definition

No other social device has garnered as much attention as the determination and the measurement of profit.[81] Governments measure profit to tax it, companies measure profit to gauge performance, and the average person measures profit to determine disposable income.[82] Profit is *the* fundamental tenet of capitalism.[83]

During the pre-industrial era, early conceptions of profit were relatively simple in format.[84] Corporations did not use profits as the basis for decision making or as a benchmark for evaluating performance.[85] One commentator noted that seventeenth- and eighteenth-century accountants lacked interest in profits and that "an examination of the ledgers of British businessmen has produced evidence of woeful ineptitude or lack of interest in profit measurement—probably both."[86] Rather, corporations used accounting purely for record keeping.[87] Historically, "the main demand for accounting data came from management concerned with internal resource allocation rather than absentee shareholders keen to assess the overall performance of the enterprise."[88] Unlike modern practices, there were no income-acceleration techniques or extraordinary charges associated with the calculation of profitability during this era.[89] Early conceptions of shareholder profitability

81. *See, e.g.*, C.J. Foreman, *A Division Among Theorists in Their Analysis of Profit*, 34 Q.J. ECON. 114, 114–17 (1919) (discussing the differences between the three major theories of profit and demonstrating the breadth of the debate).

82. *See, e.g.*, Richard Winchester, *Corporations that Weren't: The Taxation of Firm Profits in Historical Perspective*, 19 S. CAL. INTERDISC. L.J. 501, 501 (2010) (discussing corporate profits in the context of the U.S. tax scheme).

83. Lawrence E. Mitchell, *Financialism: A Lecture Delivered at Creighton University School of Law*, 43 CREIGHTON L. REV. 323, 325 (2010) ("[T]he fundamental purpose of capitalism [i]s a system for the production of goods and services and wealth creation and distribution.").

84. *See* J.R. EDWARDS, A HISTORY OF FINANCIAL ACCOUNTING 77 (1989).

85. *Id.*

86. *Id.* at 77, 79. Professor J.R. Edwards notes that even as industry began to develop, assets and liabilities were excluded from accounting records, profit calculations were haphazard, profit-and-loss accounts contained items that should not have been included, prepayments and accruals were ignored, and the general account contained items that should have been included in the capital account or the profit-and-loss account. *Id.* at 79–80.

87. *Id.* at 80; *see also* ELDON S. HENDERIKSEN, ACCOUNTING THEORY 39 (3d ed. 1977) ("In earlier periods, bookkeeping provided information mainly for managerial uses . . . .").

88. EDWARDS, *supra* note 84, at 80.

89. *See id.* at 89. Another commentator describes the simplicity of determining profitability at the beginning of the twentieth century:

> When, finally, the mine is producing, the revenue from it is spent (*a*) in paying for labour and other working costs at ordinary market rates; (*b*) in paying interest on the working capital at ordinary market rates, or something more; (*c*) in surplus profit, which goes to the prospector, the original subscribers to the syndicate, but chiefly to the financial controlling house."

R.A. Lehfeldt, *On Financiers' Profits*, 80 ECON. J. 551, 556 (1910).

were restricted to a consideration of dividend payment policy or to an analysis of a return of capital.[90]

The need for measuring profit evolved as business activity, business structures, and financial theory grew in sophistication.[91] Measuring profit allowed the "business manager to decide whether resources were gainfully employed."[92] Moreover, measuring profits enabled corporations "to identify the balance legally available for the payment of dividends . . . [and also served] as the basis for reporting to creditors and absentee owners."[93]

The determination of corporate profitability during the late nineteenth century and early twentieth century was a comparatively modest and unsophisticated process.[94] During this period, profitability was defined as the excess of revenues over expenses.[95] Unlike modern profit theory,[96] there were no sophisticated measurement conventions in use during this era.[97] Instead, the determination of profit was closer to a cash-basis reckoning than an accrual-basis determination.[98] The concept of profit among shareholders focused on a strong corporate dividend policy;[99] however, profits were to be distributed to shareholders only after due consideration of the company's

90. EDWARDS, *supra* note 84, at 111.

91. HENDERIKSEN, *supra* note 87, at 33, 39–40 (stating that "[a]ccounting developed historically as the needs arose, and changes occurred gradually in accounting techniques and concepts. But new accounting practices have been necessary to keep pace with changing economic institutions and relationships and the changing objectives of accounting").

92. EDWARDS, *supra* note 84, at 76.

93. *Id.*

94. *See* HENDERIKSEN, *supra* note 87, at 104 (noting that before 1930, accounting was based on rules, rather than on basic principles).

95. *See* EDWARDS, *supra* note 84, at 77 (noting that business managers gauged profitability based on the amount of cash on hand).

96. Modern profit theory consists of various concepts, including capital-asset pricing models, the Black-Scholes model, the efficient capital market hypothesis, and present value. *See* JAN R. WILLIAMS ET AL., FINANCIAL & MANAGERIAL ACCOUNTING: THE BASIS FOR BUSINESS DECISIONS 454–55 (15th ed. 2010) (defining present value); Joseph E. Bachelder, *Comments on* Pay Without Performance, 30 J. CORP. L. 777, 780 (2005) (describing the Black-Scholes model); Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475, 475 (1997) (commenting on the capital-asset pricing model and the efficient capital market hypothesis).

97. HENDERIKSEN, *supra* note 87, at 33, 104.

98. *See, e.g.*, EDWARDS, *supra* note 84, at 77. Accrual-method accounting realizes income when the taxpayer has earned the income or possesses a legal right to it. BLACK'S LAW DICTIONARY 22 (9th ed. 2009). Cash-basis accounting realizes income when the taxpayer has actually received the income. *Id.*; *see also* Comm'r v. N. Tex. Lumber Co., 281 U.S. 11, 12–14 (1930) (articulating the difference in tax liability generated by the use of either accrual or cash-basis accounting methods).

99. Mobile & Ohio R.R. v. Tennessee, 153 U.S. 486, 496 (1894) ("The term 'dividend,' in its technical as well as in its ordinary acceptation means that portion of its profits which the corporation, by its directory, sets apart for ratable division among its shareholders." (citing Lockhart v. Van Alstyne, 31 Mich. 76 (1875))); *see supra* note 93 and accompanying text.

financial needs.[100] Other financial products like credit markets, derivative transactions, and international markets were not in contemplation during this nascent era. The stock market crash of 1929 and the Great Depression led Congress to pass the Securities Exchange Act of 1933[101] and the Exchange Act of 1934,[102] and to create the Securities and Exchange Commission (SEC) in 1934.[103] During the nineteenth and early twentieth centuries, investors considered dividend policy and return of capital as primary factors when making an investment decision.[104] The *Dodge* court recognized that shareholders' desire to obtain dividends created tension between shareholders and management and remarked that "'[p]rofits earned by a corporation may be divided among its shareholders, but it is not a violation of the charter if they are allowed to accumulate and remain invested in the company's business.'"[105]

As one early measurement of profits, cash-basis accounting gained recognition from legislatures and courts because it helped protect the rights of creditors who dealt with corporations.[106] In response, courts and legislatures fashioned several devices to protect the rights of creditors. First, under certain circumstances, directors could be held personally liable for making distributions and draining the corporation of cash.[107] Second, in contrast to modern practices that significantly reduce par values, which have been recorded at one cent,[108] par values during the nineteenth century were

100. *Mobile*, 153 U.S. at 496–97.

101. Securities Exchange Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77 (2006)).

102. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78 (2006 & Supp. IV 2010)).

103. *Id.* § 4(a), 48 Stat. at 885; *see also The Investors Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 24, 2011), https://www.sec.gov/about/whatwedo.shtml.

104. *See, e.g.*, Hunter v. Roberts, Throp & Co., 47 N.W. 131, 131 (Mich. 1890) ("It is undoubtedly true that the ultimate object for which every corporation of the character of the one under consideration is formed, is the payment of dividends to its individual members.").

105. Dodge v. Ford Motor Co., 170 N.W. 668, 682 (Mich. 1919) (quoting VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 447 (2d ed. 1886), *available at* http://ia600400.us.archive.org/0/items/cu31924019224603/cu31924019224603.pdf).

106. EDWARDS, *supra* note 84, at 177; *see also* 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS § 8:16, at 8-79 to -80 (rev. 3d ed. 2011) (noting that many early statutory requirements were aimed to benefit creditors).

107. *Hunter*, 47 N.W. at 133–34 (discussing a Michigan state statute stating that "if the directors of any such corporation shall declare or pay a dividend when the corporation is insolvent, or any dividend the payment of which would render it insolvent, knowing such corporation to be insolvent, or that the payment of such dividend would render it so, the directors assenting thereto shall be jointly and severally liable, in an action founded on this statute, for all debts due from such corporation at the time of paying or declaring such dividend"); *see also* 29 AM. JUR. PROOF OF FACTS 3D *Liability of a Director to a Corporation for Mismanagement* § 6 (1995 & Supp. 2011) (discussing prohibitions on corporate waste).

108. 1 JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCURINGS AND REORGANIZATIONS § 4.4 (2d ed. 1995).

significantly higher in amount[109] and were viewed as a device to protect creditors' interests by assuring them that a minimum amount of capital was available.[110] Third, courts were ready to invoke the ultra vires doctrine[111] to protect creditors by finding that corporations acted outside the scope of authority, under the belief that corporations must abide by their narrowly approved objectives.[112]

Another practice in measuring profit was for contracting parties to define profit by mutual agreement to determine how much capital was available to the shareholders for an eventual distribution.[113] For example, in *Park v. Grant Locomotive Works*, the plaintiff-shareholders brought a suit to compel a larger dividend than the one the directors were prepared to issue.[114] At the time the lawsuit was filed, the defendant-corporation was insolvent.[115] The corporation's shareholders and creditors had entered into an agreement to recapitalize the insolvent corporation intending to restore the corporation to its business function.[116] The agreement provided for the cancellation of mortgages to strip the corporation of encumbrances and pay the corporation's debt to creditors in stock.[117] The terms of the agreement also provided that "all the net profits of the company, after the payment of taxes, insurance, and the necessary amount for the proper maintenance of the property of the company in its present condition and capacity, shall be divided annually among the stockholders."[118] The newly reconstituted group of shareholders then sued for a larger dividend than that which had been announced and claimed that approximately $205,000 remained to be distributed.[119]

As the court examined the shareholders' claim to make a determination of net profit, it identified two alternatives.[120] It recognized that when a contract controls the matter, the terms of the contract should operate as a limitation on the directors' discretion and thereby control the disposition of the matter.[121]

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109. *See* O'NEAL & THOMPSON, *supra* note 106, § 8.16, at 8-80.

110. *Id.*

111. 18B AM. JUR. 2D *Corporations* § 1733 (2004) ("Corporate acts . . . which are outside the scope of the general express and implied authority of the corporation are said to take ultra vires." (footnote omitted)).

112. Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (with Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1302 (2001) (noting the importance of the ultra vires doctrine in the nineteenth and early twentieth centuries).

113. Park v. Grant Locomotive Works, 3 A. 162, 164–65 (N.J. Ch. 1885).

114. *Id.* at 163.

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at 163, 166.

120. *Id.* at 165–66.

121. *Id.*

However, "[i]n cases where the power of the directors of the corporation is without limitation and free from restraint, they are at liberty to exercise a very liberal discretion as to what disposition shall be made of the gains of . . . the corporation."[122] The court's observation was significant because it confirmed that the determination of profit, if not fixed by contract, was within the reasonable discretion of the board of directors.[123]

The innovation of a standard measure of accounting, namely, generally accepted accounting principles (GAAP), did not exist when cases like *Park* and *Dodge* were decided.[124] Arguably, GAAP facilitates the measurement of profits, which thereby enables companies to report profitability results to its shareholders.[125] Before GAAP, no clear uniform standard of measuring income, expense, or profitability existed.[126] Although there was a sense as to what constituted profits, as these cases demonstrate, no clear consensus existed as to the various methods of accounting to be used when determining profit.[127]

The determination of profit has not been an easy task. An early tax treatise describes the challenges faced by individuals when determining profit because "profit" was not comprehensively defined.[128] For example, uncertainty existed when recording and reporting asset appreciation and asset depreciation—two financial events that affect the determination of profit.[129]

Even classical economists could not agree on the definition of profit. Adam Smith, for example, focused on the productivity of labor when he defined profit as payment for a combination of an entrepreneur's risks and services.[130] Others described profit as income in the form of return to the entrepreneur.[131] Surprisingly, the clearest articulation of profit comes not from within the disciplines of economics or accounting, but from the legal community. Judge Richard Posner states that "profits, are not facts, but rather are the conclusions

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122. *Id.* at 165.

123. *See id.*

124. *See* EDWARDS, *supra* note 84, at 239–40; *see also Facts About FASB*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/facts/index.shtml#mission (last visited Feb. 13, 2012) (stating that the Financial Accounting Standards Board was created in 1973 and tasked with setting standards of accounting in the private sector, including establishing the GAAP in the United States).

125. HENDERIKSEN, *supra* note 87, at 53–58, 81.

126. *See id.* at 33–73.

127. EDWARDS, *supra* note 84, at 239.

128. THOMAS GOLD FROST, A TREATISE ON THE FEDERAL INCOME TAX LAW OF 1913, at 14 (1913).

129. *Id.* at 14–15 ("[T]he word 'profit' ordinarily means the excess of returns over expenditures and may or may not, according to circumstances, include in the returns any increase in value of the capital and in the expenditures any depreciation of capital.").

130. Foreman, *supra* note 81, at 115; *see also* ADAM SMITH, THE WEALTH OF NATIONS 156 (Andrew Skinner ed., Penguin Books 1981).

131. *See* ALVIN SAUNDERS JOHNSON, INTRODUCTION TO ECONOMICS 238 (1909).

of a reasoning process that is based on the rationale for the rule and that as a result turns the rule into an implicit standard."[132]

B. Financial Theory Comes of Age

Modern financial theory progressed from a simple three-factor economic analysis of wages, profits, and rent[133] into a complex, multi-variable economic analysis that utilizes differential equations to determine profitability.[134] This shift ultimately affects how shareholders evaluate corporations and their directors.

The post-World War II environment prompted a robust period of economic growth.[135] As a result of the increased economic activity, corporations grew in number and economic strength.[136] An explosion of economic theories sought to explain the sudden development of the American economy.[137] During the last half of the twentieth century, "prodigious empirical and theoretical research and commentary has provided an economic perspective on the operation of capital markets."[138]

The new economic theories included highly evolved economic concepts describing, for example, how shareholders value stock prices,[139] how market participants behave,[140] and how costs are to be measured.[141] These new theories influenced corporate behavior.[142] They also influenced how courts analyzed corporate decisions. For example, in 1970, a paper by Professor Eugene Fama hypothesized that stock prices that incorporate publicly available information influence how market participants respond to public

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132. MindGames, Inc. v. W. Publ'g Co., 218 F.3d 652, 657 (7th Cir. 2000) (internal quotation marks omitted).

133. Arthur T. Hadley, *Interest and Profits*, 4 ANNALS AM. ACAD. POL. & SOC. SCI. 337, 337 (1893).

134. *See supra* note 96 and accompanying text.

135. *The Economy: "We Are All Keynesians Now,"* TIME, Dec. 31, 1965, at 64, 64.

136. Marty Harris & Ken Szeflinski, *Celebrating Ninety Years of SOI: Selected Corporate Data, 1916-2004*, STAT. INCOME BULL. 279, 284–85 (2007), *available at* http://www.irs.gov/pub/irs-soi/07cobulhis.pdf.

137. *See infra* notes 143–56 and accompanying text.

138. Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 373 (1984).

139. *See infra* note 153 and accompanying text; *see also* Jeffery S. Glasser, *Capital Asset Pricing Model: Risk Valuation, Judicial Interpretation, and Market Bias*, 50 BUS. L. 687, 689 (1995). ("Financial economic theory is extremely instructive in uncovering the various components of a security's valuation, one component of which is risk. The greater the risk, the less valuable the security; the lower the risk, the more valuable the security.").

140. *See infra* note 143 and accompanying text.

141. *See infra* note 148 and accompanying text.

142. *See* David I. Walker, *Financial Accounting and Corporate Behavior*, 54 WASH. & LEE L. REV. 927, 933 (2007) (observing the influence of accounting on corporate behavior and examining the underlying reasons).

information.[143] This theory came to be known as the efficient capital market hypothesis (ECMH).[144] The ECMH directly influenced the Supreme Court's decision eighteen years later when, in *Basic, Inc. v. Levinson*, it reasoned that "[r]ecent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information."[145] The ECMH quickly gained popularity as courts and markets accepted research indicating its accurate representation of the impact of public information in stock prices.[146]

Another influential financial device is the capital-asset pricing model (CAPM).[147] Financial experts use the CAPM to determine a company's cost of capital.[148] A higher cost of capital negatively affects profits.[149] The CAPM attempts to identify a risk-free rate for money and a risk premium that would be demanded for investment in the particular enterprise at issue.[150] Courts have acknowledged the validity and importance of the CAPM theory.[151] For example, the court in *Cede & Co.* noted that the CAPM approach is a "technique[] or method[] . . . generally considered acceptable . . . in the financial community."[152]

Additional financial innovations include the Black-Scholes model and present-value analysis. The Black-Scholes model is widely used to value stock

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143. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970).

144. *See* Carol R. Goforth, *The Efficient Capital Market Hypothesis—An Inadequate Justification for the Fraud-On-The-Market Presumption*, 27 WAKE FOREST L. REV. 895, 895 n.6 (1992) (describing the basis for ECMH theory).

145. 485 U.S. 224, 246 (1988). The Supreme Court recognized that "'[o]f all recent developments in financial economics, the efficient capital market hypothesis ('ECMH') has achieved the widest acceptance by the legal culture.'" *Id.* at 253 n.4 (quoting Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549 (1984)).

146. Dennis, *supra* note 138, at 374–75.

147. Glasser, *supra* note 139, at 690–92.

148. Douglas O. Edwards, *(Systemic) Risk and Taxation*, 31 VA. TAX. REV. 331, 354 (2011); *see also* Robert Ackerman & Elizabeth Chorvat, *Modern Financial Theory and Transfer Pricing*, 10 GEO. MASON L. REV. 637, 666–67 (2002).

149. *See* Pamela Peterson Drake, The Cost of Capital 1 (unpublished manuscript), *available at* http://educ.jmu.edu/~drakepp/principles/module7/coc.pdf (indicating that the lower the risk of producing income, the lower a corporation's cost of capital will be).

150. *See* Ackerman & Chorvat, *supra* note 148, at 666–68; *see also* Cede & Co. v. Technicolor, Inc., No. 7129, 1990 WL 161084, at *28 (Del. Ch. Oct. 19, 1990) ("[The CAPM] model estimates the cost of company debt (on an after tax basis for a company expected to be able to utilize the tax deductibility of interest payments) by estimating the expected future cost of borrowing; it estimates the future cost of equity through a multi-factor equation and then proportionately weighs and combines the cost of equity and cost of debt to determine a cost of capital.").

151. *See, e.g.*, *In re* Radiology Assocs., Inc. Litig., 611 A.2d 485, 492 (Del. Ch. 1991) (confirming the use of the CAPM method for determining the cost of capital).

152. *Cede & Co.*, 1990 WL 161084, at *28 (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983)); *see, e.g.*, N. Trust Co. v. Comm'r, 87 T.C. 349, 368 (1986).

options.[153] Present-value analysis measures "the time value of money"[154] and is used by corporate management to place a current value on a stream of future payments.[155] Present-value analysis figured prominently during the last half of the twentieth century as companies increasingly analyzed cash flows and liabilities on a present-value basis.[156]

These financial theories did not go unnoticed by the corporate community, lawyers, or regulators. Regulatory filings with the SEC routinely included reference to these financial theories.[157] Moreover, corporations repeatedly cite to these theories in their communications to shareholders and the public.[158]

At the same time that financial theory was growing in sophistication, accounting theory also began to evolve by moving away from historical cost accounting toward fair-value accounting.[159] Fair-value accounting is the

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153. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 38 n.8 (Del. 2006). In *In re Walt Disney Co.*, a compensation consultant applied the Black-Scholes model to assess the reasonableness of the executive stock option. *Id.*

154. WILLIAMS ET AL., *supra* note 96, at 454.

155. *See id.* at 454–55. One of the earliest judicial applications of the present-value concept is found in *In re Jamieson's Estate*, 15 Pa. D. 618 (Pa. Orphan's Ct. 1905). The court defined the present value of an annuity as "such a sum that, if invested and put at interest, it will, with a proportionate part taken from the fund yearly to make out the annuity, yield the required amount of it annually, the whole fund being exhausted during the expectancy of life of the annuitant." *Id.* at 618 (internal quotation marks omitted). A Texas state appellate court likened present value to "reverse interest" and explained that "[a] present value discount is, as it were, reverse-interest: it subtracts from the sum of payments to be received in the future the interest that would be earned on that sum if it were paid in full at present and held until each payment came due." Lau Family P'ship v. Nirtag U.S., Inc., No. 08-01-00022-cv, 2002 WL 997741, at *3 (Tex. App. May 16, 2002) (quoting PRC Kentron, Inc. v. First City Ctr. Assocs., II, 762 S.W.2d 279, 290 n.11 (Tex. App. 1988)). The court added that "if the interest rate and the present value discount rate are the same, the present value of a series of periodic payments—past payments with interest and future payments discounted—is the same at any point during the entire period." *Id.* (quoting *PRC Kentron, Inc.*, 762 S.W.2d at 290 n.11).

156. *See* Dan T. Coenen, *Priorities in Accounts: The Crazy Quilt of Current Law and a Proposal for Reform*, 45 VAND. L. REV. 1061, 1066 (1992).

157. *See, e.g.*, AT&T INC., FORM 10-K 72 (2010), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=113088&p=irol-SECText&TEXT=aHR0cDovL2lyLmludC53ZXN0bGF-3YnVzaW5lc3MuY29tL2RvY3VtZW50L3YxLzAwMDA3MzI3MTctMTEtMDAwMDE0L3htbA%3d%3d (referencing the Black-Scholes theory); COCA-COLA CO., UNITED STATES SECURITIES AND EXCHANGE COMMISSION FORM 10-K 48, 124 (2010), *available at* http://www.thecoca-colacompany.com/investors/pdfs/form_10K_2010.pdf (mentioning the present-value and Black-Scholes methodologies);.

158. FORD MOTOR CO., 2010 ANNUAL REPORT 88 (2010), *available at* http://corporate.ford.com/doc/ir_2010_annual_report.pdf. (mentioning Black-Scholes and present-value concepts); KELLOGG CO., 2010 ANNUAL REPORT 43 (2010), *available at* http://files.shareholder.com/downloads/K/1523434307x0x448599/a9b46c48-9b3b-41d4-9350-e9-02636df788/kelloggs_2010_ar.pdf (same).

159. *See* Stanley Siegel, *The Coming Revolution in Accounting, The Emergence of Fair Value as the Fundamental Principle of GAAP*, 42 WAYNE L. REV. 1839, 1840–41 (1996) (observing the shift from cost accounting to fair-value accounting in the twentieth century). Cost accounting refers to the method of accounting "[w]hen market prices are unavailable, [and] a

process of reporting the hypothetical fair market value of an asset or liability, as well as hypothetical gains and losses.[160] Proponents of fair-value accounting argue that this approach "provide[s] investors (and to a lesser extent business and policy makers) with accurate and clear information on a company's net assets and operating performance."[161] Critics, however, argue that fair-value accounting is subjective and provides management with an incentive to engage in gains trading activities.[162] Fair-value accounting also provides corporate management with the justification to use an array of value ranges that ultimately affect the profitability of a corporation.[163] For example, a management decision to categorize a security as a held-to-maturity security instead of a trading security affects whether the corporation records additional income or loss.[164] The choice of available accounting methods is not new. What is new, however, is the change in philosophy from the historical cost basis of accounting to the malleable fair-value basis of accounting.[165]

One must be mindful of the subtle, yet significant shift in determining profitability, a shift whereby the notion of profit expanded over time. In pre-industrial organizations, the owner was also the manager of the business and therefore knew with a high degree of certainty the financial welfare of the business enterprise.[166] However, the corporate form, which allowed for separation of ownership from management,[167] gained popularity, and the notion of profit expanded to include more variables, such as opportunity costs.[168] As the twentieth century drew to a close, the concept of profit continued to expand to include hypothetical gains and losses in the form of

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company values the investment and reports it at cost in periods subsequent to acquisition . . . . Companies recognize dividends when received. They value the portfolio and report it at acquisition cost. Companies only recognize gains or losses after selling the securities." DONALD E. KIESO ET AL., INTERMEDIATE ACCOUNTING 848 n.7 (12th ed. 2007).

160. FIN. ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS UPDATE: FAIR VALUE MEASUREMENT (TOPIC 820): AMENDMENTS TO ACHIEVE COMMON FAIR VALUE MEASUREMENT AND DISCLOSURE REQUIREMENTS IN U.S. GAAP AND IFRSS 10 (2011), *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822486936&blobheader=application%2Fpdf ("[F]air value measurement [attempts] . . . to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions . . . ."); *see also Summary of Statement No. 157*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/st/summary/stsum157.shtml (last visited Feb. 6, 2012).

161. PETER M. FASS ET AL., REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 3:87 (2011).

162. KIESO ET AL., *supra* note 159, at 860–61.

163. *Id.* at 839.

164. *Id.*

165. *See supra* note 159 and accompanying text.

166. EDWARDS, *supra* note 84, at 77.

167. *See* GEVURTZ, *supra* note 38, at 4.

168. WILLIAMS ET AL., *supra* note 96, at 931 (defining opportunity cost as "the benefit that could have been obtained by pursuing an alternative course of action").

fair-value accounting.[169] Every period of economic progress seems to bring with it an expansion in the notion of profit.[170] As the notion of profit has expanded, investors, seeking to exploit profit opportunities, have persuaded legislators to adopt hybrid entities such as limited-liability partnerships (LLPs),[171] limited-liability companies (LLCs),[172] and limited-liability limited partnerships (LLLPs),[173] which offer a narrow scope of liability and thereby widen the gap of responsibility.[174]

III. THE FAILURE OF TRADITIONAL LEGAL THEORIES IN PROVIDING ADEQUATE PUBLIC PROTECTIONS OR CORPORATE INCENTIVES

It is fair to ask why another structure regulating corporate behavior is necessary if there are already laws in place. Law, as a social institution for regulating behavior, is imperfect.[175] Because of the value society places on policies like freedom to contract,[176] freedom from undue restraint,[177] and free will,[178] imperfections in the social institution of the law are inevitable.

If the goal of the law is to provide justice, equity, and efficiency, then this goal is compromised in certain contexts when one considers that individual

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169. *See supra* note 159 and accompanying text. A gnawing question to consider: "If accounting theory, even after much academic and professional debate, boils down to management discretion among competing accounting principles, how much confidence can regulators or the public have in any financial reporting system?"

170. *See, e.g.*, Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1460 (1989).

171. An LLP is defined as a "partnership in which a partner is not liable for a negligent act committed by another partner or by an employee not under the partner's supervision." BLACK'S LAW DICTIONARY, *supra* note 98, at 1230.

172. An LLC is defined as "[a] company—statutorily authorized in certain states—that is characterized by limited liability, management by members or managers, and limitations on ownership transfer." *Id.* at 319.

173. *See* Carter G. Bishop & Daniel S. Kleinberger, *Registered Limited Liability Limited Partnerships*, *in* LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW CURRENT THROUGH 2011, ¶ 15.03[4][a] (2011) (describing the benefits of LLLP status).

174. *See* Franklin A. Gevurtz, *Using Comparative and Transnational Law to Teach Corporate Social Responsibility*, 24 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 39, 49–51 (2011) (examining LLCs and concerns about CSR in the context of multinational businesses).

175. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 93 (2007) ("[C]ontract law, like all social institutions, does not work perfectly . . . .").

176. 16A C.J.S. *Constitutional Law* § 720 (2011) (defining "freedom of contract" to mean the freedom "to make whatever contracts they please as long as the contracts are legal in all respects and not contrary to public policy, and as long as no fraud or deception is practiced").

177. *Id.*

178. *See* Charles Dougherty, Note, *Who Needs Contract Law?—A Critical Look at Contractual Indemnification (or Lack Thereof) in FHAA and ADA "Design and Construct" Cases*, 44 IND. L. REV. 545, 545 (2011) (observing the link between free will and the freedom of contract).

plaintiffs are subjected to enhanced procedural requirements.[179] These enhanced requirements have made it increasingly difficult for legitimate plaintiffs to proceed against corporate defendants.[180]

Corporations have successfully defended many cases in which serious injury or death occurred.[181] Several reasons account for this phenomenon. First, corporate defendants have structural devices in the forms of statutes and legal precedent that provide them with an initial legal barrier.[182] Second, corporate defendants have an enormous financial advantage over plaintiffs, which enables a corporate defendant to deploy considerable legal resources to stave off a plaintiff's legal threats.[183] Third, as times passes, individual plaintiffs become personally invested in the outcome of litigation from a psychological, emotional, and financial perspective, whereas corporate defendants can remain detached from the proceedings and dispassionately concern themselves solely with the financial implications of an adverse judgment.[184]

A. The Role of Tort Law in CSR

Torts cause harm to victims and society by diminishing the victim's quality of life and increasing suffering.[185] Correspondingly, tort law serves as a tool to fill the public-responsibility gap left by private ordering and government

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179. *See, e.g.*, Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.) (aiming to curb abusive litigation in securities class-action cases by increasing procedural requirements); *see also* Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1489 (2006) (surveying the ways in which the PSLRA attempts "to target the perceived abuse by plaintiffs' lawyers in class action securities litigation").

180. *See* Amy L. Craiger, Note, *From Conceivable to Impossible: The Hurdles Plaintiffs Must Overcome When Pleading Section 11 and Section 12(A) Securities Claims*, 5 BROOK. J. CORP. FIN. & COM. L. 549, 549–51 (2011) (emphasizing the difficulties faced by plaintiffs trying to bring legitimate claims in the face of strict procedural requirements).

181. *See, e.g.*, *In re* Union Carbide Corp. Gas Plant Disaster, 1984, 809 F.2d 195, 197 (2d Cir. 1987).

182. Charlestown Boot & Shoe Co. v. Dunsmore, 60 N.H. 85, 86 (1880) (discussing the broad authority held by corporate directors and noting that "[t]he only limitation upon the judgment or discretion of the directors is such as the corporation by its by-laws and votes shall impose").

183. *See* Richard B. Bernstein, *Mapping Legal History's "Middle Ground,"* 68 N.Y.U. L. REV. 675, 685–86 (1991) (reviewing EDWARD A. PURCELL, LITIGATION AND INEQUALITY: FEDERAL DIVERSITY JURISDICTION IN INDUSTRIAL AMERICA, 1870-1958 (1992)) (discussing a corporate defendant's significant resources as compared to an individual plaintiff's).

184. *See id.*; *cf.* Tamara Relis, *"It's Not About the Money": A Theory on Misconceptions of Plaintiffs' Litigation Aims*, 68 U. PITT. L. REV. 701, 721–22 (2007) (noting that plaintiffs' extra-legal objectives for litigation, such as "dignity and respect after the injury, [the] inability to be heard, refusal to listen, dismissal and victim blaming," did not decrease over time).

185. David G. Owen, *The Fault Pit*, 26 GA. L. REV. 703, 716 (1992).

regulation.[186] It addresses the conduct of actors engaging in public behavior by deterring unreasonable conduct and compensating injured parties.[187]

Tort law is designed to influence two distinct classes of behavior: impulsive conduct and deliberate conduct.[188] Impulsive conduct is sudden and unexpected, and the actor does not think before reacting,[189] whereas deliberate conduct is such that the actor contemplated the harm, although it was not necessarily intended.[190]

Government action can influence deliberate behavior. For example, government regulations requiring passenger air bags or seat belts ultimately forced the automobile industry to act.[191] Without clear regulations and enforcement, corporations are reluctant to implement safety measures voluntarily because of the added cost;[192] thus, manufacturers are faced with a Hobson's choice: does the manufacturer absorb the cost or should the manufacturer pass the cost onto the consumer? Manufacturers are sensitive to price increases because they generally translate into either lower profit margins for manufacturers, if manufacturers absorb the cost, or higher consumer prices if manufacturers pass on the cost.[193] In any event, manufacturers are acutely sensitive to costs because they directly affect a firm's profits and may create a competitive hindrance in price-sensitive markets.[194] The reality of this decision-making process must not be lost on policymakers.

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186. *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 6 (5th ed. 1984) (noting that tort law imposes liability on "socially unreasonable" conduct).

187. Daniel W. Shuman, *The Psychology of Deterrence in Tort Law*, 42 U. KAN. L. REV. 115, 118 (1993).

188. *Id.* at 127–28.

189. *Id.* at 128.

190. *Id.*

191. *See* Intermodal Surface Transportation Efficiency Act of 1991, Pub. L. No. 102-240, § 2508, 105 Stat. 1914, 2805 (codified in scattered sections of 23 and 49 U.S.C.); *Safety Belt Child Restraint Laws*, INS. INST. FOR HIGHWAY SAFETY (Apr. 2012), http://www.iihs.org/laws/safetybeltuse.aspx (noting that forty-nine states have laws requiring seat belts).

192. *See, e.g.*, Zygmunt J.B. Plater, *The Exxon Valdez Resurfaces in the Gulf of Mexico . . . And the Hazards of "Megasystem Centripetal Di-Polarity,"* 38 B.C. ENVTL. AFF. L. REV. 391, 400–01 (2011) (detailing the efforts of BP to "systematically cut back on critical safety measures" in order to cut costs before the Exxon Valdez oil spill).

193. *See, e.g.*, *Business and Commodity Prices: Everyday Higher Prices*, ECONOMIST, Feb. 26, 2011, at 68, 68 (describing manufacturers' decisions to pass on costs to consumers and the subsequent effects on business).

194. *See* CHARTERED INST. PERSONNEL & DEV., SUSTAINABLE ORGANISATION PERFORMANCE: WHAT REALLY MAKES THE DIFFERENCE? 19, 29 (2011), *available at* http://www.cipd.co.uk/NR/rdonlyres/69BF5AEA-7240-4F51-A437-BC165AA9B03E/0/Sustainable_organisation_performance_STF_interim_report.pdf (highlighting management's cognizance of the pressure to reduce costs while also maintaining quality and safety).

Plaintiffs seeking to impose tort liability must prove each element of the claim.[195] This is consistent with the American system of justice, which generally places the burden of proof on the plaintiff.[196] However, plaintiffs with both nominal and costly claims may find barriers to pursuing their cases. Litigation expenses can easily run into the hundreds of thousands of dollars, and attorney and expert-witness fees may make such a case cost-prohibitive for some plaintiffs.[197] Plaintiffs with nominal claims also face challenges because plaintiffs' lawyers tend not to take cases in which possible recovery is under \$50,000.[198] Such barriers to obtaining representation are akin to a de facto denial of protection for many potential plaintiffs who have suffered harm but are left with an unanswered injury.[199]

Moreover, pursuing a tort theory, even in the face of sympathetic facts, is not necessarily a fait accompli.[200] For example, in *Henningsen v. Bloomfield Motors, Inc.*, the plaintiff purchased a car for his wife as a gift.[201] Shortly thereafter, his wife was injured while driving when the car suddenly swerved into a wall.[202] The record indicates that the car had experienced no problem and she was driving the car at a moderate speed when she heard a loud noise and lost control of the car.[203] Testimony from a bus operator who witnessed the accident confirmed that the car suddenly "veered at 90 degrees . . . and

195. 86 C.J.S. *Torts* § 2 (2011).

196. *See* Lujan v. Defenders of Wildlife, 504 U.S. 555, 561 (1992).

197. David M. Scott, Note, *Non-Traditional Resolutions to Mass Tort Disputes Take a Hit as AIDS-Infected Hemophiliacs Bear the Cost of Judge Posner's "Economic Justice,"* 12 OHIO ST. J. DISP. RESOL. 159, 168–69 (1996). One study calculated that in 2007, tort costs in the United States were \$853 per capita and the total cost was \$252 billion. TOWERS PERRIN, 2008 UPDATE ON U.S. TORT COST TRENDS 3 (2008), *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=USA/2008/200811/2008_tort_costs_trends.pdf.

198. Shuman, *supra* note 187, at 120 (citing Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System—And Why Not?*, 140 U. PA. L. REV. 1147, 1190–91 (1992)). It is suggested that smaller claims in products liability and medical malpractice are usually not compensated by the legal system. *Id.* Usually, tort claims will be filed when the plaintiff has sustained serious injury as a result of a solvent defendant's unsafe behavior. *Id.*

199. *See* Robert R. Kuehn, *Denying Access in Legal Representation: The Attack on the Tulane Environmental Law Clinic*, 4 WASH. U. J.L. POL'Y 33, 35 (2000) (observing the inadequate amount of legal representation available to individuals in need of legal counsel); Shuman, *supra* note 189, at 119–20.

200. *See* Shuman, *supra* note 187, at 119–20 (stating that plaintiffs suffering minor tortious injuries may be "uncertain, *ex ante*, whether tortious behavior will result in a claim that triggers the deterrent function of tort law" given the perception that only conduct judged to require deterrence will permit eventual recovery).

201. 161 A.2d 69, 73 (N.J. 1960).

202. *Id.* at 75.

203. *Id.*

right into [a] wall."[204] The insurance adjuster opined that the accident "must have been due to mechanical defect or failure."[205]

The Henningsens sued Chrysler Corporation based on tort and contract claims.[206] Despite the evidence supporting their negligence claims, the trial court dismissed the negligence counts by reasoning that "the proof was not sufficient to make out a *prima facie* case as to the negligence of either the manufacturer or the dealer."[207] *Henningsen* illustrates the challenges faced by plaintiffs when pursuing tort actions.

Because courts seek to balance equity and efficiency when examining tort cases,[208] the question inevitably arises, how should courts strike this balance while evaluating the relative risks and hardships faced by tort litigants? Judge Learned Hand famously provided an answer in *United States v. Carroll Towing Co.*[209] The fundamental issue in this case centered on how far a defendant's duty to act and to prevent harm to others extends: is there an absolute duty to act always or is the duty relative and dependent on the circumstances?[210] Judge Hand reasoned that

> [s]ince there are occasions when every vessel will break from her moorings, and since, if she does, she becomes a menace to those about her; the owner's duty, as in other similar situations, to provide against resulting injuries is a function of three variables: (1) The probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions.[211]

Thus, Judge Hand adopted a relative duty of care by balancing the parties' interests and taking into account varying circumstances, risks, and costs.[212]

204. *Id.* (internal quotation marks omitted).

205. *Id.*

206. *Id.* at 73.

207. *Id.* at 75. The plaintiffs nonetheless prevailed at the trial-court level on their breach of warranty claims. *Id.* The New Jersey Supreme Court affirmed the decision on those grounds and thus declined to express an opinion on the negligence claim. *Id.* at 102.

208. CONG. BUDGET OFFICE, THE ECONOMICS OF U.S. TORT LIABILITY: A PRIMER 11 (2003), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/46xx/doc4641/10-22-tortreform-study.pdf.

209. 159 F.2d 169, 170–71 (2d Cir. 1947). In *Carroll*, when the defendant failed to take adequate precautions to safeguard and secure an unmanned barge, the barge broke free from its moorings and damaged other ships before sinking and losing its cargo. *Id.* at 171. The barge owner, as plaintiff, argued that the harbor master had the authority to determine the sufficiency of the strength of the lines attaching the barge to the pier. *Id.* The defendant countered by arguing that the barge owner was negligent because he failed to leave a person on board the barge. *Id.*

210. *See id.* at 173.

211. *Id.* Judge Hand famously articulated his theory as a formula, analyzing whether burden (*B*) was less than injury (*L*) multiplied by probability (*P*). *Id.*

212. *Id.*

Rationalizing costs and expenses was not a new phenomenon when the Second Circuit decided *Carroll* in 1947.[213] Indeed, a new theory of accounting called cost accounting—"used for measurement of cost, assignment of cost to cost accounting periods, or allocation of cost to cost objectives"[214]—was beginning to gain acceptance in commercial circles.[215] As manufacturing businesses expanded in size and complexity, simple accounting methods no longer sufficed to capture, measure, and account for direct and indirect costs adequately.[216] Cost accounting influenced the overall development of accounting theory, which led to improved measurement of profits.[217] Other cost accounting developments included the break-even analysis, which emerged in the 1950s, and the "cost-volume-profit" (CVP) analysis, which emerged in the mid-1960s.[218] CVP analyzes "how costs and profits behave in response to changes in the level of business activity"[219] and can help corporate management in determining the necessary amount of sales needed to reach a targeted income level, the margin of safety before an operating loss is incurred, and any anticipated income variation, among others.[220] Due to the benefits of these innovations, corporate managers and shareholders alike would never look at costs the same way again and embraced cost accounting as a tool to control costs and maximize profits.[221]

Despite the benefits of cost accounting, nowhere did the impact of cost accounting have such a garish application than in the Ford Pinto case.[222] The Ford Motor Company began developing the Ford Pinto in 1968 to compete in the emerging subcompact automobile market.[223] As a result of Ford's goal to produce a light car at a low cost, Ford sacrificed engineering for style.[224]

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213. Janet A. Hume-Schwarz, *Cost-Accounting: A Historical Perspective*, 12 PROC. ACAD. ACCT. & FIN. STUD. 53, 53–55 (2007), *available at* http://www.sbaer.uca.edu/research/allied/2007-reno/Accounting%20and%20Financial%20Studies/15.pdf.

214. Perry v. Martin Marietta Corp., 47 F.3d 1134, 1137 (Fed. Cir. 1995) (quoting 4. C.F.R. § 331.20(k) (1992)).

215. Hume-Schwarz, *supra* note 213, at 57.

216. *Id.* at 54–55.

217. HENDERIKSEN, *supra* note 87, at 42 (noting that improved accounting methods among growing industrial firms meant that "[i]nventory valuations became more firmly rooted in the cost principle, and a better matching of revenues and expenses resulted").

218. Hume-Schwarz, *supra* note 213, at 57.

219. WILLIAMS ET AL., *supra* note 96, at 890.

220. *See id.*

221. *See* Hume-Schwarz, *supra* note 213, at 54, 58.

222. *See* Grimshaw v. Ford Motor Co., 174 Cal. Rptr. 348 (Ct. App. 1981); *see also* Martin A. Kotler, *Motivation and Tort Law: Acting for Economic Gain as a Suspect Motive*, 41 VAND. L. REV. 63, 103 (1988).

223. *Grimshaw*, 174 Cal. Rptr. at 359–60.

224. *Id.* at 360.

During the testing phase of the Pinto, crash-test data indicated that rear-end damage threatened the fuel system's integrity.[225] Ford could have easily and inexpensively fixed the deficiency, but it chose not to do so.[226] Ford produced 326,867 Pintos in the first year of production alone.[227] Consumers reported numerous accidents involving exploding gas tanks in rear-end collisions.[228] Only after hundreds of people lost their lives or were seriously injured[229] did Ford act by spending "at least 20 million dollars to recall the 1971-1976 Pintos."[230]

Ford's macabre calculus in its decision to sell unsafe cars balanced the value of a human life against corporate profits.[231] Specifically, it balanced $137 million, the cost to correct the defect, against $49.5 million, the cost to defend lawsuits.[232] Even though Ford could have remedied the hazardous fuel-tank design at minimal cost, it "decided to defer correction of the shortcomings by engaging in a cost-benefit analysis balancing human lives and limbs against corporate profits. Ford's institutional mentality was shown to be one of callous indifference to public safety."[233]

Ford Motors Company is by no means the only car company with manufacturing problems. In 2009, reports alleged that the gas pedals on Toyota and Lexus models were sticking, which caused acceleration problems.[234] Toyota initially denied any problems with its pedals;[235] however, an internal document surfaced in which the company stated that it saved $100 million by delaying corrective action.[236] Toyota Motors faced allegations that these defects resulted in multiple injuries and deaths.[237] The National

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225. *Id.*

226. *Id.* at 360–61.

227. OFFICE OF DEFECTS INVESTIGATION, NAT'L HIGHWAY TRAFFIC SAFETY ADMIN., INVESTIGATION REPORT, PHASE I: ALLEGED FUEL TANK AND FILLER NECK DAMAGE IN REAR-END COLLISION OF SUBCOMPACT PASSENGER CARS (1978), *reprinted in* THE FORD PINTO CASE: A STUDY IN APPLIED ETHICS, BUSINESS, AND TECHNOLOGY 77, 83 (Douglas Birsch & John H. Fielder eds., 1994) [hereinafter THE FORD PINTO CASE]. By 1976, Ford had produced a total of 2,213,700 Pintos. *Id.*

228. *See* MARK DOWIE, PINTO MADNESS (1977), *reprinted in* THE FORD PINTO CASE, *supra* note 227, at 15, 16.

229. *See* Douglas Birsch, *Product Safety, Cost-Benefit Analysis, and the Ford Pinto Case, in* THE FORD PINTO CASE, *supra* note 227, at 147, 160.

230. DOWIE, *supra* note 228, at 16.

231. *Id.* at 35.

232. *Id.* at 28.

233. Grimshaw v. Ford Motor Co., 174 Cal. Rptr. 348, 384 (Ct. App. 1981).

234. *See* Ralph Vartabedian & Ken Bensinger, *Toyota's Woes May Not End at Floor Mats*, L.A. TIMES, Oct. 18, 2009, at A1.

235. Ken Bensinger & Ralph Vartabedian, *Toyota Is Publicly Rebuked on Defect*, L.A. TIMES, Nov. 5, 2009, at A1.

236. *See infra* Exhibit 2.

237. Ken Bensinger & Ralph Vartabedian, *Toyota to Fix 'Dangerous' Pedal Defect*, L.A. TIMES, Nov. 26, 2009, at A1 ("A review of consumer complaints to the National Highway Traffic

Highway Traffic Safety Administration (NHTSA) launched an investigation into the defective gas-pedal design,[238] which ruled out electrical malfunction and operator error, but found mechanical defects in the form of "pedal entrapment" and "sticky pedal."[239] As a penalty for failing to report the defective gas pedals to NHTSA in a timely manner, the agency ultimately imposed a $16.375 million civil penalty on Toyota.[240]

The Ford and Toyota cases illustrate why tort law is concerned with "socially unreasonable conduct."[241] By implication, tort law tolerates losses and will adjust for these losses through a system of damages awarded by law.[242] As a matter of policy, tort law tolerates, and even expects, that a certain degree of injury will be placed on the public.[243]

Like any actor, corporations attempt to balance costs against benefits before taking action.[244] Corrective action, too, has a cost, which must be weighed against any benefits as an integral part of any business decision.[245] Manufacturers of goods, in particular, constantly face the possibility of design flaws in their race to beat competitors to the marketplace.[246]

How, then, should corporations act in the absence of positive law? How should a corporation act when corporate-law principles require it to maximize profitability? Or, how should a corporation act when corporate-law principles

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Safety Administration shows at least 1,000 incidents of unintended acceleration in Toyota vehicles in the last eight years, along with scores of accidents and injuries as well as untold property damage."). Toyota ultimately recalled seven Toyota and Lexus models with the alleged defect. *Id.*

238. NAT'L HIGHWAY TRAFFIC SAFETY ADMIN., U.S. DEP'T OF TRANSP., TECHNICAL ASSESSMENT OF TOYOTA ELECTRONIC THROTTLE CONTROL (ETC) SYSTEMS, at vi (2011), *available at* http://www.nhtsa.gov/staticfiles/nvs/pdf/NHTSA_report_execsum.pdf.

239. *Id.* at vii, ix (internal quotation marks omitted).

240. *U.S. Department of Transportation Releases Results from NHTSA-NASA Study of Unintended Acceleration in Toyota Vehicles*, NHTSA (Feb. 8, 2011), http://www.nhtsa.gov/PR/DOT-16-11 (providing a complete timeline of events); *see also* Ken Thomas & Tomoko A. Hosaka, *Toyota Recall: Automaker Pays Record Fine over Acceleration Problems*, HUFFINGTON POST (Dec. 21, 2010, 7:10 AM), *available at* http://www.huffingtonpost.com/2010/12/21/toyota-recall-automaker-p_0_n_799549.html (stating that in addition to the fine levied by NHTSA, Toyota agreed to pay a $32.4 million fine to the U.S. government for its handling of safety recalls).

241. KEETON ET AL., *supra* note 186, at 6.

242. *Id.* (quoting Cecil A. Wright, *Introduction to the Law of Torts*, 8 CAMBRIDGE L.J. 238, 238 (1944)).

243. *Id.* at 24.

244. *See* Paul R. Portney, *Benefit-Cost Analysis*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS, *supra* note 4, at 38.

245. *See supra* notes 226, 231–34 and accompanying text.

246. *See, e.g.*, *Top 10 Product Recalls*, TIME, http://www.time.com/time/specials/packages/article/0,28804,1908719_1908717_1974910,00.html (last visited Feb. 26, 2011); *see supra* notes 222–26 and accompanying text.

insulate directors from ordinary breaches of due care?[247] In the absence of positive law, which establishes either a duty to act or an incentive to act, tort law encourages firms to weigh responsibility by balancing the probability and gravity of the injury against the burdens of action.[248] The state of our current jurisprudence provides corporations with a powerful incentive not to balance in favor of responsibility.[249]

Admittedly, it is unlikely that any corporate enterprise will ever again balance away corrective action against human life as Ford Motors did in the case of the Ford Pinto. However, no one can predict with reasonable certainty what temptations profit pressures will bring to bear on a corporation. What is certain is that the modern corporation can now affect an indeterminate number of individuals throughout the world within a relatively brief time frame.[250] The cry for responsible profitability will echo from all corners of the globe.

B. The Role of Contract Law in CSR

Contract law is ineffective as an instrument to encourage CSR because it is premised upon a consensual relationship between two or more parties who bargain for a specified performance.[251] In contrast, CSR initiatives seek to impose a duty on a corporate actor without the corporation's consent.[252] The

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247. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2011) (permitting corporations to include in their certificates of incorporation "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for breaches of fiduciary duty," but requiring that directors must remain liable for breaches of the duties of loyalty and good faith, and for any improperly derived personal benefits).

248. *See* Christopher M.F. Painter, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1057–58 (1984) (noting that firms "should avoid accidents only so long as the cost of avoiding accidents is less than the cost of allowing them to occur").

249. Gerald F. Tietz, *Strict Products Liability, Design Defects and Corporate Decision-Making: Greater Deterrence Through Stricter Process*, 38 VILL. L. REV. 1361, 1393–94 (1993).

250. For instance, Ford Motor Company sells its economy-priced Ford Focus in 122 countries. *Global Focus—Ford's New C-Segment Product Family Poised to Achieve Unprecedented Scale*, FORD.MEDIA.COM (Jan. 11, 2010), http://media.ford.com/article_display.cfm?article_id=31767. Coca-Cola Enterprises sells its product through a system of local bottlers in over 200 markets. *Our Company*, COCA-COLA COMPANY, http://www.thecoca-colacompany.com/ourcompany/index.html (last visited on Nov. 30, 2011). The online market for prescription drugs also allows firms to facilitate a sale to anyone with computer access, anywhere commercial deliveries are available. *See* Michael OReilly, *Get Ready for Online Sales of Prescription Drugs*, 161 CANADIAN MED. ASS'N J. PRESCRIPTION DRUGS 557, 557 (1999).

251. JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 1:1 (6th ed. 2009); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981) ("A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.").

252. *See* Kim Kercher, *Corporate Social Responsibility: Impact of Globalization and International Business*, CORP. GOVERNANCE E-J., at 5 (Apr. 2007),

objective of any CSR initiative is to broaden the corporate actor's scope of duty beyond the traditional norms of contract law.[253] Thus, the finding of a positive duty is paramount to any theory of CSR.[254]

At times, the line between contract-law duty and tort-law duty may blur, as both doctrines rely on a duty for a finding of responsibility and liability.[255] However, important doctrinal differences exist between the two.[256] Contract law is premised on the notion of private ordering between the parties.[257] Unlike tort liability, which stems from socially unacceptable conduct,[258] liability in contract is premised on the occurrence of a breach by one of the parties following a voluntary bargaining process.[259] In contrast, tort law seeks to regulate public conduct.[260] Liability in tort is premised upon the breach of a duty to act in a socially acceptable manner.[261]

At the root of contract law lies one of the most fundamental legal principles: the freedom to contract.[262] This doctrine holds that contracting parties are free to define the scope of their rights and duties governing their relationship, provided that the agreement is not otherwise illegal or contrary to public policy.[263] Courts zealously guard the principle of freedom of

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http://epublications.bond.edu.au/cgej/4 (discussing the debate on whether to impose CSR requirements on corporations).

253. *Id.* at 2–3.

254. *See id.* at 6 (noting the inability to hold corporations "accountable in the absence of prescriptive legislation").

255. *See* Jay M. Feinman, *The Jurisprudence of Classification*, 41 STAN. L. REV. 661, 669 (1989) (observing the overlap between contract- and tort-law doctrines).

256. *See* Michael I. Krauss, *Tort Law and Private Ordering*, 35 ST. LOUIS. U. L.J. 623, 626–27 (1991) (noting several important distinctions between contract and tort law).

257. *Id.*

258. *See supra* note 241 and accompanying text.

259. 23 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 63:8 (4th ed. 2002). When breach of a promise occurs, it is necessary to evaluate whether the breach is material because the breach would allow the plaintiff to cancel the contract and sue for damages. PERILLO, *supra* note 251, § 11:18. However, the plaintiff must additionally prove that he or she was "ready, willing and able to perform but for the breach." *Id.*

260. *See* John C.P. Goldberg, *Tort Law for Federalists (and the Rest of Us): Private Law in Disguise*, 28 HARV. J.L. & PUB. POL'Y 3, 3 (2004).

261. *See* Martin Petrin, *The Curious Case of Directors and Officers' Liability for Supervision and Management: Exploring the Intersection of Corporate and Tort Law*, 59 AM. U. L. REV. 1161, 1671 (2010); *see also* Palco Linings, Inc. v. Pavex, Inc., 775 F. Supp. 1269, 1271 (M.D. Pa. 1990) ("A policy consideration underlying tort law is the protection of persons and property from losses resulting from *injury* . . . ."); Lake v. Richardson-Merrell, Inc., 538 F. Supp. 262, 274 (N.D. Ohio 1982) ("The purpose of much of the law of torts . . . is to deter wrongful activity as well as to compensate victims thereof and to impose on proper party the cost of insuring against risks of certain activity."); Spring Motors Distrib., Inc. v. Ford Motor Co., 489 A.2d 660, 672 (N.J. 1985) ("[T]ort law protect[s] society's interest in freedom from harm.").

262. PERILLO, *supra* note 251, § 1:3.

263. *Id.*

contract,[264] and once a contract is established as enforceable, courts likewise protect the expectation interests of the bargaining parties.[265] Courts are also reluctant to bind parties to a contract when no legal relationship was intended.[266]

Contract liability is based on the notion of privity of contract.[267] Contract law mandates this relationship before liability will be imposed;[268] however, a widely recognized exception to this rule is the law of third-party beneficiaries.[269] The exception provides that "'one who is not privy to . . . [an] agreement may demonstrate . . . that the contract was actually made for his benefit . . . so that he becomes a third-party beneficiary and [is] eligible to bring an action on such agreement.'"[270] Courts have recognized the right of intended beneficiaries to enforce contracts since the middle of the nineteenth century when Judge Horace Gray stated in *Lawrence v. Fox* that "he for whose benefit [a promise] is made may bring an action for its breach."[271] However, the contract's term must expressly indicate an intent to benefit the third party, otherwise courts will presume that no third-party beneficiary was intended.[272] Another bedrock principle of contract law is that "only parties to a contract and any third-party beneficiaries of a contract have standing to enforce that contract."[273] CSR initiatives lack the direct privity of contract or the requisite intent to create a third-party beneficiary designee.[274] As a result, courts are

264. *See* HOWARD O. HUNTER, MODERN LAW OF CONTRACTS § 1.2 (2011).

265. *Id.*

266. PERILLO, *supra* note 251, § 2:1 ("Usually, an essential prerequisite to the formation of a contract is an agreement—a mutual manifestation of assent to the same terms." (citing Russell v. Union Oil Co., 86 Cal. Rptr. 424 (1970); Quality Sheet Metal Co. v. Woods, 627 P.2d 1128 (Haw. Ct. App. 1981); Brown v. Considine, 310 N.W.2d 441 (Mich. Ct. App. 1981); Christenson v. Billings Livestock Comm'n, 653 P.2d 492 (Mont. 1982))).

267. *Id.* § 17:1; First Nat'l Bank of Windsor v. Gilbert Marshall & Co., 780 P.2d 73, 74 (Colo. App. 1989) ("Privity is that connection or relationship which exists between two or more contracting parties." (citing Bonfils v. McDonald, 270 P. 650 (1929))).

268. *See* Peter Kiewit & Sons', Inc. v. ATSER, LP, 684 F. Supp. 2d 1126, 1137–38 (D. Neb. 2010). Contract liability may also be imposed despite the lack of a contract under the doctrine of promissory estoppel. *See, e.g.*, Feinberg v. Pfeiffer Co., 322 S.W.2d 163, 167–68 (Mo. App. 1959); Hoffman v. Red Owl Stores, Inc., 133 N.W.2d 267, 274–75 (Wis. 1965).

269. *Peter Kiewit & Sons', Inc.*, 684 F. Supp. 2d at 1137.

270. *Id.* (quoting Boy Scouts of Am. v. Responsive Terminal Sys., Inc., 790 S.W.2d 738, 747 (Tex. Ct. App. 1990)).

271. *See* 20 N.Y. 268, 274 (1859).

272. *Id.*

273. Verni v. Cleveland Chiropractic Coll., 212 S.W.3d 150, 153 (Mo. 2007) (en banc) (citing Andes v. Albano, 853 S.W.2d 936, 942 (Mo. 1993) (en banc); Gen. Motors Acceptance Corp. v. Windsor Grp., Inc., 2 S.W.3d 836, 839 (Mo. App. 1999)).

274. *Id.*

reluctant to find a duty to act for the benefit of some third-party beneficiary when it was not expressly intended.[275]

Contract law also is limited as a tool of social responsibility because it is based on freedom of contract and mutual agreement.[276] Corporations, keenly aware of these doctrines and mindful of courts' reluctance to interfere in the bargaining process, opportunistically exploit the contracting process. For example, arbitration clauses,[277] forum-selection clauses,[278] and home-office approval clauses[279] are thrust on unwary consumers in many consumer, sales, and financing contracts.[280]

Corporations exploit a procedural advantage in the contractual bargaining process. A corporation's dominant position allows it to exploit procedural advantages because the bargaining process is no longer conducive to a free and open negotiation process.[281] For example, corporate field offices employ corporate agents who have no authority to change the terms of a contract.[282] Contracts may be structured such that acceptance is subject to approval at the corporate home office, which thereby cleverly converts the customer into the offeror.[283] Similarly, structural limitations work counter to a policy of CSR. For example, mandatory arbitration and forum-selection provisions, limitations on the seller's warranties, and loss allocations are designed to maximize a corporation's contractual rights while simultaneously minimizing its contractual obligations.[284] Contracting parties in general, and corporate parties in particular, routinely use structural devices to limit their contractual responsibility.[285]

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275. *See* H.R. Moch Co. v. Rensselaer Water Co., 159 N.E. 896, 897 (N.Y. 1928) (declining to allow an individual to bring a third-party-beneficiary claim against a water company that breached its contract with a city to provide water for fire hydrants).

276. PERILLO, *supra* note 251, § 2:1.

277. An arbitration clause is "[a] contractual provision mandating arbitration—and thereby avoiding litigation—of disputes about the contracting parties' rights, duties, and liabilities." BLACK'S LAW DICTIONARY, *supra* note 98, at 120.

278. A forum-selection clause is a contractual provision designating the jurisdiction in which disputes will be litigated. 17A AM. JUR. 2D *Contracts* § 259 (2011).

279. *See* Raj Bhala, *Self-Regulation in Global Electronic Markets Through Reinvigorated Trade Usages*, 31 IDAHO L. REV. 863, 918 (1995).

280. Wayne Barnes, *The Objective Theory of Contracts*, 76 U. CIN. L. REV. 1119, 1153 (2008) (observing that merchants are aware of consumers' frequent failure to read the terms of contracts and noting that if they did, they would likely object to arbitration or forum-selection clauses contained therein).

281. *See* PERILLO, *supra* note 251, § 1.3 (noting the decreasing role of the bargaining process in consumer transactions).

282. Bhala, *supra* note 279, at 918.

283. *Id.*

284. *See* Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1203–04 (2003).

285. *See id.* (noting that the majority of commercial contracts employ such devices).

Corporations also exploit a substantive advantage in contract law through the use of adhesion contracts.[286] These contracts are the most common form of limiting responsibility and corresponding liability.[287] Although both parties are free to enter into these contracts, the reality is that the maker of such adhesion contracts almost always enjoys a superior bargaining position.[288]

Corporations have successfully used adhesion contracts to internalize benefits and externalize costs, often with drastic and inequitable results for society at large. For instance, courts have recognized the rights of parties to bargain for forum-selection clauses. As stated by the U.S. Supreme Court in *Bremen v. Zapata Off-Shore Co.*, "'(I)t is settled . . . that parties to a contract may agree in advance to submit to the jurisdiction of a given court, to permit notice to be served by the opposing party, or even to waive notice altogether.'"[289]

Industry practice is another impediment for CSR initiatives. Entire industries may have redrafted their contracts to minimize corporate liability.[290] For example, the oil-shipping industry outsourced certain business operations, such as the transportation of oil, to judgment-proof entities in order to limit liability.[291] Another example is the drafting of a contract clause to limit the insurance industry's exposure to certain types of policy risks.[292] Consumers, who are dispersed and unorganized, face a daunting task in overcoming the organized and well-funded efforts of corporations and their dependent trade organizations.

Parties have the freedom of contract to negotiate and include bargained terms in contracts,[293] as well as a duty to read their documents before signing.[294] However, the growing disparity in relative bargaining power,

286. Graham v. Scissor-Tail, Inc., 623 P.2d 165, 171 (Cal. 1981) ("'The term signifies a standardized contract, which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it.'" (quoting Neal v. State Farm Ins. Cos., 10 Cal. Rptr. 781, 784 (Dist. Ct. App. 1961))).

287. *See* Korobkin, *supra* note 284, at 1203–04; *see also* Richard C. Ausness, *Risky Business: Liability of Product Sellers Who Offer Safety Devices as Optional Equipment*, 39 HOFSTRA L. REV. 807, 814 (2011) (observing that the stronger one party's bargaining power, the more likely it is that that party will attempt to limit its liability with an adhesion contract).

288. *Graham*, 623 P.2d at 171.

289. 407 U.S. 1, 10 (1972) (quoting Nat'l Equip. Rental Ltd. v. Szukhent, 375 U.S. 311, 315–16 (1964)).

290. Richard R.W. Brooks, *Liability and Organization Choice*, 45 J.L. & ECON. 91, 93 (2002).

291. *See id.*

292. *See* Sharon M. Murphy, Note, *The "Sudden and Accidental" Exception to the Pollution Exclusion Clause in Comprehensive General Liability Insurance Policies: The Gordian Knot of Environmental Liability*, 45 VAND. L. REV. 161, 167 (1992) (illustrating a pollution exclusion clause that limits insurance coverage to damage caused by "sudden and accidental" events).

293. *See supra* notes 262–63 and accompanying text.

294. *See* PERILLO, *supra* note 251, § 9.41. For an example, see Apple's iTunes terms and conditions of use, which flash on the screen and must be accepted to download the program.

coordinated industry practices, and a body of contracts jurisprudence that affirms the validity of adhesion contracts makes the branch of contract law ill-equipped to embark on a CSR initiative.

C. The Role of Corporate Law in CSR

Shareholders seeking to require corporations to engage in socially responsible corporate behavior face a daunting task. There are structural impediments in corporate law that shareholders must overcome. The most important structural impediment is that many state statutes require a board of directors to oversee every corporation.[295] Such provisions clearly mandate that the decisions and judgments of the board of directors govern the "business and affairs" of the corporation,[296] despite the role of shareholders as the undisputed owners of the corporate entity.[297]

Still, shareholders have attempted in earnest to influence corporate policy. The most common method of influencing corporate policy is through the annual election of directors.[298] Corporate law enables the removal of a director by shareholders.[299] However, removing and replacing directors, while possible, is a cumbersome and difficult task.[300] Several reasons account for this. The board of directors, and not the shareholders, controls the nominating committee for directors.[301] The board of directors routinely communicates its recommendations for board positions to shareholders.[302] Additionally, the board of directors has access to and use of corporate funds to finance a communication strategy to shareholders and to defeat any potential

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Apple Updated iTunes Terms and Conditions, TECH. J. (Feb. 3, 2011), http://thetechjournal.com/electronics/iphone/apple-updated-itunes-terms-and-conditions.xhtml.

295. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (West 2011); MODEL BUS. CORP. ACT § 8.01(b) (2011).

296. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a).

297. Michael K. Molitor, *The Crucial Role of the Nominating Committee: Re-Inventing Nominating Committees in the Aftermath of Shareholder Access to the Proxy*, 11 U.C. DAVIS BUS. L.J. 97, 100–01 (2011).

298. Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668, 56,669 (Sept. 16, 2010) ("A principal way that shareholders can hold boards accountable and influence matters of corporate policy is through the nomination and election of directors.").

299. *See* 18B AM. JUR. 2D *Corporations* § 1250 (2004).

300. *See, e.g.*, *id.* ("The power of stockholders to remove a director for cause may only be exercised by stockholders controlling a sufficient number of votes required for action, which is at least a majority, but which, under particular certificates of incorporation, may be a number greater than a majority.").

301. *See* Marc R. Trevino, *Final SEC Proxy Access Rules*, 996 PRACTISING L. INST. TAX & EST. PLANNING COURSE HANDBOOK SERIES 681, 689 (2011).

302. *See* William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 466 (2007) (noting that proxy statements sent to shareholders will indicate the board's recommendations).

opponent.[303] Moreover, the board of directors functions as a unified group. In contrast, shareholders are fragmented, geographically dispersed, and place differing values on their investments in the corporation.[304] Many shareholders also lack the financial resources to mount a campaign against a corporate director, let alone the corporate entity.[305]

Another device available to shareholders is the use of the shareholder proposal.[306] SEC rules permit shareholders to submit proposals for inclusion in proxy materials that are distributed to shareholders.[307] However, shareholder proposals are subject to stringent procedural and substantive requirements.[308] SEC Rule 14a-8 sets forth the proposal procedure.[309]

The shareholder's right of inclusion is not absolute and is subject to several important limitations.[310] Rule 14a-8 limits a shareholder's proposal right by stating that, among other bases, management may exclude a proposal if it appears to promote a shareholder's personal interest[311] or if it is related to ordinary business operations within the board's purview.[312] Moreover, shareholders seeking to include shareholder proposals can expect formidable corporate opposition[313] and must be ready to mount an active and expensive campaign if their proposals are ever to be distributed.[314]

The challenges that shareholders face regarding shareholder proposals is exemplified in *Medical Committee for Human Rights v. SEC*, in which the U.S. Court of Appeals for the D.C. Circuit reviewed an SEC decision to exclude a

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303. RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 901 (9th ed. 2008).

304. Sjostrom & Kim, *supra* note 302, at 467 (noting that the dispersed nature of shareholders and that "shareholder apathy," among other things, contribute to shareholders' limited influence in the election process for directors).

305. *See id.*

306. *See* 17 C.F.R. § 240.14a-8 (2011) ("A shareholder proposal is your recommendation or requirement that the company and/or its board of directors take action, which you intend to present at a meeting of the company's shareholders. Your proposal should state as clearly as possible the course of action that you believe the company should follow.").

307. *Id.*

308. *See generally* DIR. OF CORPORATE FIN., SEC. & EXCH. COMM'N, STAFF LEGAL BULLETIN NO. 14 (CF), SHAREHOLDER PROPOSALS (2001), *available at* http://www.sec.gov/interps/legal/cfslb14.htm (outlining the procedural and substantive hurdles that shareholders have to overcome to have their proposal sent with the corporation's proxy information).

309. *See* 17 C.F.R. § 240.14a-8.

310. *See id.* § 240.14a-8(i). Arguably, this may very well be a situation in which the exception swallows the rule.

311. *Id.* § 240.14a-8(i)(4).

312. *Id.* § 240.14a-8(i)(7).

313. *See* David G. Yosifon, *The Consumer Interest in Corporate Law*, 43 U.C. DAVIS L. REV. 253, 294 (2009) (noting that this is especially true in the case of shareholder proposals on social issues).

314. *See id.*; *see also* BREALEY ET AL., *supra* note 303, at 901.

shareholder proposal.[315] The petitioner requested inclusion of a shareholder proposal to adopt a resolution "that napalm shall not be sold to any buyer unless that buyer gives reasonable assurance that the substance will not be used on or against human beings."[316] The SEC rejected the proposal request on the basis that it was untimely.[317] A year later, the petitioner renewed the shareholder proposal and requested inclusion of a separate proposal adopting a resolution to stop the company's production of napalm.[318] The Court of Appeals remanded the case to the Commission for review.[319] The Supreme Court granted certiorari; however, because the corporation ultimately decided to include the shareholder proposal the matter was dismissed at moot.[320] When the corporation submitted the proposal for a shareholder vote, not even three percent supported it.[321]

In *Roosevelt v. E.I. Du Pont de Nemours & Co.*, the shareholder, Amelia Roosevelt, appealed the district court's decision supporting the exclusion of her shareholder proposal from Du Pont's proxy materials.[322] The shareholder proposal requested that the board of directors undertake two actions: "1. [r]apidly accelerate plans to phase out CFC and halon production . . . [and] 2. [p]resent a report to shareholders within six months detailing (a) research and development . . . efforts to find CFC and halon substitutes . . . and (b) a marketing plan to sell those environmentally safe alternatives."[323]

The U.S. Court of Appeals for the D.C. Circuit affirmed the district court's decision permitting Du Pont to exclude the shareholder's proposal from the company's proxy materials.[324] The court noted that both aspects of the plaintiff's proposal implicated the "'ordinary business operations' exception."[325] The court observed that the exception includes "'certain matters which have significant policy, economic or other implications inherent in them.'"[326] The court further noted that Roosevelt's rapid phase-out proposal would "no doubt reflect 'significant policy' when large [timing] differences are

315. 432 F.2d 659, 661 (D.C. Cir. 1970).

316. *Id.* at 662. The letter also stated that their "objections to the sale of this product [are] primarily based on the concerns for human life inherent in our organization's credo." *Id.*

317. *Id.*

318. *Id.* at 663.

319. *Id.* at 682.

320. SEC v. Med. Com. for Human Rights, 404 U.S. 403, 407 (1972).

321. HAZEN & MARKHAM, *supra* note 11, at 689.

322. 958 F.2d 416, 417 (D.C. Cir. 1992).

323. *Id.* at 417 n.1.

324. *Id.* at 429.

325. *Id.* at 426.

326. *Id.* (quoting Adoption of Amendments Relating to Proposals by Security Holders Exchange Release Act No. 12,999, 41 Fed. Reg. 52,994, 52,998 (Dec. 3, 1976)).

at stake."[327] However, the court pointed out that the interval of time originally complained of by Roosevelt had been reduced significantly.[328]

In another case, *Lovenheim v. Iroquois, Ltd.*, the shareholder filed a lawsuit seeking inclusion of his proposed resolution.[329] The shareholder proposed to create a committee that would examine its French suppliers' method of producing paté de foie gras to ensure that it did not cause the geese involved in production to suffer.[330] At the time of the lawsuit, the corporation's annual revenues were $141 million with $6 million in profits and $78 million in assets.[331] In comparison, its sales of its paté de foie gras accounted for only $79,000 in sales, which amounted to a net loss on paté sales.[332]

The company sought to exclude the proposal under Rule 14a-8(c)(5), which provided that exclusion was appropriate

> if the proposal relates to operations which account for less than 5 percent of the issuer's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the issuer's business.[333]

Although the sales of paté de foie gras clearly met the exception, the court nonetheless granted a preliminary injunction "in light of the ethical and social significance" of the proposal."[334] The injunction barred the company from excluding the shareholder proposal, which requested formation of a committee to study the effects of the practice, from its proxy materials.[335] One is left to wonder: if courts are willing to entertain responsible behavior regarding the treatment of a goose, why not do the same regarding the treatment of a human?

The derivative lawsuit is another device that shareholders use to change corporate behavior.[336] One court described the derivative suit as "one of the most interesting and ingenious of accountability mechanisms for large formal organizations."[337] Shareholders have invoked the derivative device to

327. *Id.* at 427.

328. *Id.* (noting that the company changed its timeline to phase out CFC products from five years to one year).

329. 618 F. Supp. 554, 556 (D.D.C. 1985).

330. *Id.*

331. *Id.* at 558.

332. *Id.*

333. *Id.* at 557 (internal quotation marks omitted) (citing 17 C.F.R. § 240.14a-8(c)(5) (1984)).

334. *Id.* at 561–62.

335. *Id.* at 562.

336. *See* Bryant G. Garth et al., *Empirical Research and the Shareholder Derivative Suit*, 48 L. & CONTEMP. PROBS. 137, 137–39 (1985) (discussing the development and use of derivative suits).

337. Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 351 (Del. 1988).

challenge a board's decisions.[338] However, successfully invoking the shareholder derivative device is one of the most daunting tasks facing a shareholder.[339]

At common law, courts did not "permit stockholders to call corporate managers to account in actions at law."[340] This refusal is premised on the common function of state statutes: to empower directors to manage and direct the affairs of the corporation.[341] As a result, courts apply the business judgment rule by refusing to reexamine a corporation's decision by reasoning that it is a matter that falls within the province of directorial discretion.[342]

The derivative action is an equitable remedy.[343] It "provide[s] redress not only against faithless officers and directors but also against third parties who had damaged or threatened the corporate properties and whom the corporation through its managers refused to pursue."[344] A shareholder seeking to invoke the derivative device must satisfy prescribed requirements. Specifically, the subject matter of the dispute must be of a derivative nature, demand must be made upon the board of directors, and there must be a violation of a fiduciary duty.[345] To establish whether the subject matter is of a derivative nature, the Delaware Supreme Court stated in *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.* that the "issue must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[346] Next, the

338. *See, e.g.*, King v. VeriFone Holdings, Inc., 12 A.3d 1140, 1141 (Del. 2011) (derivative suit requiring a board to release records); *In re* S. Peru Copper Corp. S'holder Derivative Litig., 30 A.3d 60, 65 (Del. Ch. 2011) (derivative suit challenging the entire fairness of a proposed merger).

339. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 248 (Del. 2000) (dismissing a derivative complaint because plaintiff failed to establish facts sufficient to create a reasonable doubt that directors were disinterested); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969 (Del. Ch. 1996) (noting that a plaintiff-shareholder in a derivative suit alleging improper corporate information gathering and reporting systems must show a suspicion that the board or senior management violated the law).

340. Ross v. Bernhard, 396 U.S. 531, 534 (1970).

341. *See* 2 FLETCHER, *supra* note 3, § 505.

342. *See, e.g.*, Capital Bancshares, Inc. v. Fed. Deposit Ins. Co., 957 F.2d 203, 207 (5th Cir. 1992) ("Under this familiar rule of American jurisprudence, the courts refrain from second guessing business decisions made by corporate directors in the absence of a showing of fraud, unfairness or overreaching."). The business judgment rule creates a presumption that directors have acted in good faith unless the plaintiff can show fraud, bad faith, or abuse of discretion. *See* Cottle v. Storer Commc'n, Inc., 849 F.2d 570, 574 (11th Cir. 1988) (citing Mobil Corp. v. Marathon Oil Co., [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,375, 92,284 (S.D. Ohio 1981), *rev'd on other grounds*, 669 F.2d 366 (6th Cir. 1981)).

343. 19 AM. JUR. 2D *Corporations* § 1948 (2011).

344. *Ross*, 396 U.S. at 534.

345. *See* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW & PRACTICE § 1.1 (2011); *see also* FED. R. CIV. P. 23.1.

346. 845 A.2d 1031, 1033 (Del. 2004).

aggrieved shareholder must make a demand upon the directors to pursue the derivative claim,[347] and this requisite may only be excused in limited cases of futility.[348] Finally, a plaintiff-shareholder must allege that there is a breach of an existing fiduciary duty.[349] It is at this juncture where most, if not all, claims of social responsibility will fail.

For example, in *White v. Panic*, the shareholders filed a derivative action alleging that "the board of directors affirmatively refused to take any measures to stop or sanction sexual misconduct by a corporate officer that allegedly subjected the corporation to potential civil liability and expense."[350] The plaintiffs argued that the board used corporate funds to settle lawsuits against the officer quietly.[351] In affirming the Delaware Court of Chancery's dismissal, the Delaware Supreme Court found that the plaintiff's complaint did not show adequately that the board knew of the officer's harassment and refused to take proper steps to shield the corporation from liability.[352]

A plaintiff shareholder seeking to initiate a derivative action on the basis of a CSR initiative faces almost certain doom from both a procedural and a substantive basis. Derivative actions are problematic because a shareholder must assert that the directors have failed to discharge their duty to the corporation.[353] Directors have no duty of social responsibility,[354] and thus should handily overcome a derivative action involving claims of CSR.

The Committee on Corporate Laws considered whether constituency statutes, which allow directors to consider the interests of stakeholders other than shareholders, should be included in the Model Business Corporation Act.[355] The committee concluded that such statutes were an inappropriate mechanism for regulating corporate action, noting that they "would conflict with directors' responsibility to shareholders and could undermine the

347. 7C CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, FEDERAL PRACTICE & PROCEDURE § 1831 (3d ed. 2007).

348. *Id.* ("The question is whether, given the composition and structure of the board, it would be futile to expect it to respond to the shareholder's concerns.").

349. 12B FLETCHER, *supra* note 3, § 5923.30.

350. 783 A.2d 543, 546 (Del. 2001).

351. *Id.* at 548.

352. *Id.* at 553.

353. Gevurtz, *supra* note 38, at 386–87; *see supra* notes 345, 349 and accompanying text.

354. *See* David Rosenberg, *Delaware's "Expanding Duty of Loyalty" and Illegal Conduct: A Step Toward Corporate Social Responsibility*, 52 SANTA CLARA L. REV. 81, 82 (2012) (positing that expanding the fiduciary duty of loyalty may lead to a duty of CSR). However, thirty-one states have allowed a corporation's board of directors to consider the interests of constituents in addition to interests of the corporation when making decisions. 2 MODEL BUS. CORP. ACT § 8.31 ann. (2008) (statutory comparison).

355. Am. Bar Ass'n Comm. on Corporate Law, *supra* note 22, at 2253.

effectiveness of the system that has made the corporation an efficient device for the creation of jobs and wealth."[356]

Opponents of CSR can be expected to argue that directors may engage in less than optimal decision making when considering CSR initiatives.[357] As a result, directors will be exposing themselves to the increased possibility of litigation and arguably liability to any shareholders who oppose a CSR initiative.[358] Opponents of CSR may legitimately argue that CSR is really a governmental policy and as such, it should be subject to the political process of checks and balances.[359] Moreover, critics may contend that by engaging in CSR initiatives, corporate management is wasting valuable corporate resources.[360] Because CSR initiatives are vague and ambiguous, CSR opponents assert that they are not capable of satisfying the divergent range of interests.[361] Finally, CSR opponents argue that CSR initiatives will cloud management judgment with subjective preferences, which would make it difficult for shareholders to evaluate management's performance.[362] Critics of CSR initiatives opt for the perceived objective reality of profitability—"perceived" because profitability is merely a sophisticated game of financial assumptions under the auspices of GAAP.[363]

Doctrinal limitations hamper the use of corporate law as a tool for CSR initiatives. Statutes empower directors, not shareholders, to manage the company.[364] Shareholder rights are limited to dividends,[365] voting,[366] informational rights,[367] and rights of appraisal,[368] and do not include any rights

356. *Id.* at 2268–70; *see also* Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 J. CORP. L. 351, 355 (2001).

357. *See* Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 42 (2005) (suggesting that corporate managers could then pursue personal interests in the name of CSR).

358. *See* Tamara R. Piety, *Against Freedom of Commercial Expression*, 29 CARDOZO L. REV. 2583, 2631 (2008) ("[M]anagers could still expose themselves to shareholder liability if the alleged long term benefits [of CSR initiatives] are intangible enough and the sacrificed short term profits are very large.").

359. *See id.* at 2632 (reflecting on the benefits of leaving policy decisions to government).

360. *See* Gary van Stange, Note, *Corporate Social Responsibility Through Constituency Statutes: Legend or Lie?*, 11 HOFSTRA LAB. L.J. 461, 466 (1994) (noting that those who favor profit maximization as the goal of corporations regard expenditures on activities unrelated to profit maximization as wasteful).

361. *See* Lee, *supra* note 357, at 42 (describing CSR as an "amorphous goal"); Piety, *supra* note 358, at 2631.

362. *See* Tom Borelli, *Club CSR*, TOWNHALL.COM (Aug. 19, 2006), http://townhall.com/columnists/tomborelli/2006/08/19/club_csr/page/full/.

363. *See supra* Part II.A.

364. *See supra* notes 296–97 and accompanying text.

365. MODEL BUS. CORP. ACT § 6.40(a) (2011).

366. *Id.* § 7.21(a).

367. *Id.* § 16.02.

368. *Id.* § 13.02(a).

for CSR initiatives. Corporate law is singularly limited to protecting the economic rights of shareholders, safeguarding the institutional corporate powers of the directors, and maximizing the value of the corporation. It does not allow for consideration of affected third parties.

IV. PROPOSAL

Crafting any solution is a difficult task, but crafting a solution on matters affecting one's profitability is particularly daunting. The first step is to start a dialogue about the role of the corporate enterprise and the public's expectation of that role. This inquiry requires a deep and considered look at both the social benefits and social costs of the corporate enterprise. Any solution advanced by CSR proponents must give serious consideration to providing the legislature and the courts with enabling legislation. Anything short of this approach will be pointless.

To that end, this Article sets forth a two-prong proposal to encourage corporations to engage in socially responsible behavior. The first prong calls upon the Public Company Accounting Oversight Board (PCAOB)[369] to enact accounting legislation that will encourage corporations to act in a socially responsible manner. The second prong calls upon Congress to enact tax legislation that will encourage corporations to engage in socially responsible action. This two-part proposal encourages corporations to act responsibly while maintaining the twin goals of economic prosperity and social responsibility.

A. The Role of Accounting Pronouncements in Shaping CSR

First, the PCAOB should adopt an accounting rule that allows corporations engaging in socially responsible conduct to amortize the cost of socially responsible initiatives over a reasonable number of periods, as opposed to expensing the cost in one period. For example, capitalizing and amortizing the costs of corrective action over a period of ten years will help incentivize responsible corporate action.[370] Accounting rules are flexible and permissive; therefore, the PCAOB can draft such rules beyond the traditional profit-loss dichotomy to include socially responsible actions.

Profitability is no longer solely a function of a successful corporate sales operations; it is also a function of optimizing the choice of accounting policies.

369. The PCAOB "is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports." PUB. COMPANY ACCT. OVERSIGHT BOARD, http://pcaobus.org/Pages/default.aspx (last visited Feb. 11, 2012). The Sarbanes-Oxley Act authorized the creation of the PCAOB. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750 (codified as amended at 15 U.S.C. § 7211 (2006 & Supp. IV 2010)).

370. *Cf.* 2009 FEDERAL TAX COURSE ¶ 707, at 290 (2008) (explaining that amortization is used for intangible assets in the same manner depreciation is used for tangible assets).

It is no secret that the choice of a particular revenue-recognition policy, inventory method, or depreciation method affects a firm's profitability.[371] Corporate management chooses accounting policies in accordance with the accounting principles promulgated by GAAP or IFRS.

Consider pension-plan accounting. Like most other accounting policies, pension-plan accounting evolved from a simple cash-basis expense concept, which recognized the expense when paid, into a sophisticated and complex array of accrual-basis measurements, which recognize the expense when incurred.[372] Pension plans have been a part of the American economy since the late nineteenth century.[373]

The collapse of the Studebaker-Packard Corporation in 1963 brought pension plans to the nation's attention.[374] The Studebaker company's pension liabilities exceeded its available assets; therefore, it did not have the sufficient assets to liquidate its pension-plan obligations when the company's plant closed.[375] Although retirees received their full benefits, Studebaker was unable to honor its pension obligations to younger employees.[376] After the failure of the Studebaker-Packard Corporation, Congress became concerned that many American companies had either unfunded or underfunded pension liabilities.[377]

Until 1965, it had been a common practice for companies to leave the true cost of pension expense unrecorded and unreported.[378] In 1966, the Accounting Principles Board (APB) issued APB *Opinion No. 8*, which marked the first time that the accounting profession formally addressed pension-plan accounting.[379] APB *Opinion No. 8* sought to change the accounting treatment from a cash basis to an accrual basis.[380] The opinion provided companies with guidance in measuring and reporting a company's pension liabilities[381] and

371. *See* HENDERIKSEN, *supra* note 87, at 176–79, 288–89, 312.

372. KIESO ET AL., *supra* note 159, at 1026 & n.10.

373. S. REP. NO. 93-127, at 2–3 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4838, 4840.

374. James A. Wooten, *"The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683, 683–84 (2001).

375. *Id.* at 726, 730.

376. *Id.* at 684.

377. *Id.* at 726.

378. KIESO ET AL., *supra* note 159, at 1026 ("The problem was that the amount paid or funded in a fiscal period depended on financial management and was too often discretionary. For example, funding could depend on the availability of cash, the level of earnings, or other factors unrelated to the requirements of the plan."); *see also* William C. Norby, *Accounting for Financial Analysis*, FIN. ANALYSTS J., Sept.–Oct. 1979, at 18, 18.

379. ACCOUNTING PRINCIPLES BD., AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, ACCOUNTING FOR THE COST OF PENSION PLANS, OPINION NO. 8, at 67–68 (1966), *available at* http://clio.lib.olemiss.edu/cdm4/document.php?CISOROOT=/aicpa&CISOPTR=103&CISOSHOW=64.

380. *Id.* at 69.

381. *See* HENDERIKSEN, *supra* note 87, at 484 (recommending that the amount charged as normal pension cost and the actual amount contributed to the fund should be reported on the

justifications for choosing among alternatives for measuring and recording pension liabilities.[382]

Companies had to account for two major pension costs: past-service costs and current-year costs.[383] APB *Opinion No. 8* averred that an "unfunded prior service cost is not a liability which should be shown in the balance sheet."[384] Ten percent of the past service cost should be included in the annual provision for pension cost under the maximum-reporting method.[385] Opponents of this position argue that unfunded past-service costs can be quite substantial and, therefore, should be funded immediately.[386] Critics charged that it was still possible under APB *Opinion No. 8* to continue with unfunded pension liabilities.[387] APB *Opinion No. 8* provided the accounting justification for choosing among different expense methodologies.[388]

> Nine years elapsed before Congress finally addressed the brewing pension-funding crisis by enacting the Employee Retirement Income Security Act (ERISA).[389] ERISA established clear guidelines for participation, vesting, and funding requirements for private pension plans.[390] However, the question of pension liability funding was not completely resolved because ERISA permitted employers to amortize unfunded past-service liability over thirty or forty years, depending on the type

company's accounting sheets as an accrued pension liability). *Statement of Financial Accounting Standards No. 87* superseded APB *Opinion No. 8* in 1985 and provided that pension costs should be disclosed on the corporate balance sheet. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 87: EMPLOYERS ACCOUNTING FOR PENSIONS 5 (1985), *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820920574&blobheader=application%2Fpdf. *Statement of Financial Accounting Standard No. 158* is the latest accounting statement concerning pension-plan accounting and provides that companies with defined benefit plans must report the difference between pension-plan assets and pension-plan obligations as an asset or liability. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 158: EMPLOYERS' ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLAN 1 (2006), *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175817798717&blobheader=application%2Fpdf.

382. William C. Norby, *Accounting for Financial Analysis*, FIN. ANALYSTS J., July-Aug. 1981, at 22, 22.

383. *See* Patrick J. Regan, *Potential Corporate Liabilities Under ERISA*, FIN. ANALYSTS J., Mar.-Apr. 1970, at 26, 27.

384. *See* ACCOUNTING PRINCIPLES BD., *supra* note 379, at 76.

385. *Id.*

386. *See* HENDERIKSEN, *supra* note 87, at 481–82.

387. *See, e.g.*, *id.* at 482.

388. *See* ACCOUNTING PRINCIPLES BD., *supra* note 379, at 73.

389. Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001–1461 (2006)).

390. 70 C.J.S. *Pensions* § 10 (2011).

of employer and when the plan was created.[391] After the passage of ERISA, companies were still able to continue the practice of partially recording and partially funding pension liabilities, demonstrating the fluid nature of accounting pronouncements.

Similar to the flexible pension-accounting provisions, the PCAOB should adopt accounting conventions that recognize the cost of past corrections and report them in future periods. This will have the advantage of allowing the corporation to correct the defect immediately and amortize the cost of the defect into future periods. Adopting accounting rules that permit companies to invest in and to amortize the cost of socially responsible action benefits both the corporation and society. The corporation derives a benefit in the form of a cost that is spread over a reasonable period of time, and society derives a benefit in the form of corporate conduct designed to yield positive results. Amending accounting rules to allow amortization of the cost of CSR initiatives is reasonable and justifiable.

B. The Role of Tax Law in Shaping CSR

Congress should also use tax law to encourage corporations to engage in socially responsible behavior. Since the enactment of the Internal Revenue Code in 1913, Congress has passed a series of tax initiatives aimed at encouraging behavior that would yield positive benefits for American society.

Congress's most prominent use of tax law is providing for tax incentives aimed at stimulating economic activity. Business tax incentives aimed to encourage capital investment and economic development include the Investment Tax Credit,[392] the Targeted Jobs Tax Credit,[393] and the Orphan Drug Tax Credit.[394] Additional business tax incentives include granting businesses favorable tax deductions in the form of accelerated depreciation,[395] elections to expense certain costs,[396] and granting deductions for intangible costs that otherwise would be subject to capitalization.[397] Congress also has provided individual tax incentives aimed at stimulating behavior. For

391. ERISA § 303(b)(2)(B).

392. 26 U.S.C. § 46 (2006 & Supp. IV 2010).

393. 26 U.S.C. § 51 (2006 & Supp. IV 2010); *see* U.S. GEN. ACCOUNTING OFFICE, GAO/HRD-91-33, TARGETED JOBS TAX CREDIT, EMPLOYER ACTIONS TO RECRUIT, HIRE, AND RETAIN ELIGIBLE WORKERS VARY 2 (1991).

394. 26 U.S.C. § 45C (2006 & Supp. IV 2010). This law gives a fifty-percent tax credit for any expenditures on any medical clinical testing for creating drugs to treat orphan diseases. OFFICE OF INSPECTOR GEN., DEP'T OF HEALTH & HUMAN SERVS., THE ORPHAN DRUG ACT: IMPLEMENTATION AND IMPACT 4 (2001).

395. 26 U.S.C. § 168 (2006 & Supp. IV 2010).

396. *Id.* § 179.

397. *Id.* § 197.

example, Congress provided individuals with a homeowner tax credit[398] and the Hope Education Tax Credit.[399]

Most notably, tax law has also been invoked to combat repugnant behavior. In *Bob Jones University v. United States*, the Supreme Court's application of tax law shaped behavior repugnant to social values.[400] The Court heard challenges by Bob Jones University and Goldsboro Christian School, which challenged the Internal Revenue Service's (IRS) denial of their tax-exempt status.[401]

Bob Jones University, a religious and educational institution, barred African Americans from admission until 1971.[402] In 1971, the school began to accept applications from African Americans who had an African-American spouse.[403] The university's opposition to interracial dating and marriage motivated this policy.[404] In 1975, the university admitted unmarried African Americans, but still prohibited interracial dating.[405]

Goldsboro Christian Schools, Inc. was a religious and educational institution that offered instruction for all grades and gave particular emphasis to Christian teachings.[406] Goldsboro Christian Schools accepted only Caucasian students as a matter of course, but occasionally would admit a multiracial applicant if one parent was Caucasian.[407]

Earlier, in 1970, the IRS had reasoned that "it could 'no longer legally justify allowing tax-exempt status [under § 501(c)(3)] to private schools which practice racial discrimination.'"[408] The IRS thus had denied tax-exempt status to both schools to "discourage racial discrimination in education."[409] In reviewing the challenges by both schools, the Supreme Court affirmed the lower court's holding in favor of the government.[410] The Supreme Court declared that "[s]ection 501(c)(3) . . . must be analyzed and construed within the framework of the Internal Revenue Code and against the background of the Congressional purposes."[411] The Supreme Court was persuaded by the compelling social purpose that Congress pursued in the elimination of racial

398. *Id.* § 36.
399. *Id.* § 25A.
400. *See generally* 461 U.S. 574 (1983).
401. *Id.* at 577–85.
402. *Id.* at 580.
403. *Id.*
404. *Id.*
405. *Id.*
406. *Id.* at 583.
407. *Id.*
408. *Id.* at 574 (quoting *I.R.S. News Release*, 7 Stand. Fed. Tax. Rep. (CCH) ¶ 6790 (July 10, 1970)).
409. *Id.* at 579 (citation omitted).
410. *Id.* at 605.
411. *Id.* at 586.

discrimination.[412] The Supreme Court noted that "Congress sought to provide tax benefits to charitable organizations, to encourage the development of private institutions that serve a useful public purpose or supplement or take the place of public institutions of the same kind."[413]

In similar fashion, Congress should adopt tax-related legislation that discourages corporations from engaging in repugnant behavior that harms the public and that is reasonably avoidable. Specifically, Congress should adopt legislation requiring companies to demonstrate that (1) they took reasonable steps to safeguard products before such products are placed into the stream of commerce or (2) they took immediate action upon learning of a defect if such defect is discovered after the product enters the stream of commerce. Companies that fail to demonstrate that they took reasonable steps to safeguard products or immediate action upon learning of a defect must pay an excise tax on all product-line sales. Limited exemptions would be available for start-up companies, wholly service-oriented companies, and small-cap companies with limited distribution capabilities. The IRS, by regulation, can designate safe harbors that satisfy the "reasonable steps" standard. Additionally, if a company refuses to pay the excise tax, the IRS would have the authority to advance monies to the fund and charge the corporation or, alternatively, assess the amount of the unpaid tax against a "responsible person," such as an officer of the corporation.[414] Acquirers of stock or assets of the corporation known to have excise tax penalties shall become secondarily liable in the event that the corporation fails to satisfy its obligation. The IRS thus should impose the excise tax on a purchaser of stock or assets in the event the transferor fails to satisfy their liability. The IRS should use the excise tax to establish a litigation fund for plaintiffs alleging damages caused by unsafe products.[415] This approach is reasonable because the corporation is best able to demonstrate that it took reasonable steps to safeguard products placed into the stream of commerce.

IV. CONCLUSION

A common assumption of those who make public-policy decisions is that economic efficiency, the condition of obtaining the most benefit for the least cost,[416] is a good standard to justify policy choices. The idea of economic

412. *Id.* at 603–04.

413. *Id.* at 588.

414. *Cf. Employment Taxes and the Trust Fund Recovery Penalty (TFRP)*, INTERNAL REVENUE SERV., http://www.irs.gov/businesses/small/article/0,,id=108357,00.html (last updated Feb. 8, 2012).

415. *See, e.g.*, *The Oil Spill Liability Trust Fund*, BUREAU OCEAN ENERGY MGMT., REG. & ENFORCEMENT, http://www.gomr.boemre.gov/homepg/regulate/regs/laws/osltf.html (last updated Sept. 24, 2010).

416. *See* Paul Heyne, *Efficiency*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS, *supra* note 4, at 136, 137.

efficiency finds a natural home in a free-market economy that "allows each person to satisfy his or her preferences in such a way as to give that person the greatest freedom, personal autonomy of choice, and utility of outcome."[417] Efficiency is optimal when the parties have relatively equal bargaining power, and thus each party will seek to maximize his or her own advantage.

However, the idea of economic efficiency within the context of unrestrained free-market capitalism warrants reexamination. The economic-efficiency standard needs to be considered in light of the economic and structural barriers that now protect the corporate enterprise at the expense of the public. Efficiency becomes suboptimal when relative bargaining powers become increasingly disproportionate, when choices are limited, or when costs are externalized. As the gap between efficiency gains on one side and efficiency losses on the other widens, the transactions inevitably translate into an overall inefficiency gap negatively affecting society. As a result, inefficiency losses become counterproductive to society as a whole. In short, responsibility is traded for efficiency.

The current legal structure strongly discourages—if not unequivocally prohibits—corporations from considering their impact on a third party. To invoke the judicial protection, courts must first ascertain a statutory or common-law duty. Without a positive duty to act, corporations are left to their own devices as to what constitutes acceptable behavior. Directors will pursue the path of profitability to avoid shareholders' allegations of breach of fiduciary duty. Even with a majority of socially minded directors, absent a positive duty to act, directors will err on the side of caution and continue on the path of profit maximization. It is not for lack of desire that a director may fail to act; rather it is what the law requires and what shareholders expect: that directors aim to maximize firm profitability. As two distinguished commentators write,

> [M]anagers do not have an ethical duty to obey economic regulatory laws just because the laws exist. They must determine the importance of these laws. The penalties Congress names for disobedience are a measure of how much it wants firms to sacrifice in order to adhere to the rules; the idea of optimal sanctions is based on the supposition that managers not only may but also should violate the rules when it is profitable to do so.[418]

To reverse more than a century's worth of jurisprudence and commercial expectations will require legislative action; anything short is insufficient.

Every person, individual and corporation alike, has the right to earn a profit. This is an indisputable premise of American society. Corporations, as

417. *Introduction* to THE MORAL DIMENSIONS OF PUBLIC POLICY CHOICE: BEYOND THE MARKET PARADIGM 5, 5 (John Martin Gillroy & Maurice Wade eds., 1992).

418. Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1177 n.57 (1982).

possessors of capital, are particularly adept at exploiting the accumulation of capital. However, the ownership of capital does not give its possessor the unfettered right to take risks or engage in conduct that creates an uncompensated cost to society while creating a benefit for the corporation and its shareholders. Adding enforceable elements of social responsibility is the next chapter in the evolutionary process of the corporate enterprise.

EXHIBIT NO. 1

Table 2. Benefits and Costs Relating to Fuel Leakage Associated with the Static Rollover Test Portion of FMVSS 208

Benefits
Savings: 80 burn deaths, 180 serious burn injuries, 2,100 burned vehicles. *Unit cost:* $200,000 per death, $67,000 per injury, $700 per vehicle. *Total benefit:* 180 × ($200,000) + 180 × ($67,000) + 2,100 × ($700) = $49.5 million.
Costs
Sales: 11 million cars, 1.5 million light trucks. *Unit cost:* $11 per car, $11 per truck. *Total cost:* 11,000,000 × ($11) + 1,500,000 × ($11) = $137 million.

EXHIBIT NO. 2

Wins for Toyota – Safety Group

- <u>Rulemaking</u>
  - ➢ FMVSS 216 Roof Crush Rule - reduced PL and design burdens
  - ➢ FMVSS 305 Electric Shock Rule – delayed final rule
  - ➢ FMVSS 214 Side Impact Rule - Added lead time and phase in; Saved ~$124M/50,000 man hours
  - ➢ FMVSS 206 door locks – delayed rule; saved ~$11M for Sienna
- <u>Defects</u>
  - ➢ Sienna Rear Hatch w/ no "defect"; Closed Tacoma DP issue; Avoided Investigation on Tacoma Rust
  - ➢ FMVSS 110 NCIR labeling recall – No civil penalties, Saved $20M+ in buybacks
  - ➢ Negotiated "equipment" recall on Camry/ES re: SA, saved $100M+, w/ no defect found
- <u>Other</u>
  - ➢ Secured Tacoma, Scion XB, Corolla, '10 Prius 'Top Safety Picks' at IIHS
  - ➢ Delay of New NCAP program - 1000s of man hours in redesign for 2010 MY

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Toyota's Internal Memorandum available at: James R. Healy & Sharon Silke Carty, *Internal Toyota Memo Surfaces on Saving Safety,* USA TODAY, http://www.usatoday.com/money/autos/2010-02-21-toyota-recall-documents_N.htm (last visited Jan. 6, 2012).