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CORPORATE PHILANTHROPY AS SIGNALING AND CO-OPTATION

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This Article provides a new perspective on corporate philanthropy by examining a previously unnoticed mechanism through which corporate pro-sociality enhances firm value: signaling. In particular, cash donations can signal financial strength. A substantial and unexpected increase in the level of cash donations can signal that a firm's insiders perceive the company's future to be good enough to spend ultra-discretionary funds on unrelated third parties. The first contribution of this Article is in shifting focus from the traditional "buying goodwill" explanation for corporate philanthropy (i.e., companies engage in pro-social sacrifices because stakeholders are willing to pay more for corporate goodness) to a signaling explanation (i.e., pro-social sacrifices mitigate asymmetric information about a firm's fundamentals). But corporate philanthropy is not unequivocally good for the company. This is where the Article's second contribution comes in: examining the conditions under which corporate philanthropy decreases firm value. Under certain circumstances, managers can use their discretion over pro-social expenditures to co-opt corporate governance mechanisms, thereby increasing the level of agency costs. This occurs, for example, when managers cause companies to donate to charitable causes affiliated with independent directors. The Article next evaluates the legal implications of corporate philanthropy. In particular, the theoretical arguments presented here on how philanthropy can be good (signaling) or bad (co-optation) for the company strengthen the case for introducing some form of mandatory disclosure.

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INTRODUCTION

Corporate pro-sociality is an important and growing phenomenon. Corporate behaviors that do not directly benefit the company or meet legal requirements—such as moving to greener production, being employee-friendly, or donating to charitable causes—affect not only social and environmental causes, but also financial allocations. Indeed, over three trillion dollars are currently invested in part on the basis of corporate social performance.[1]

Yet despite its growing importance, corporate pro-sociality remains an elusive phenomenon. This is especially true in the corporate and securities law literature where, instead of understanding the causes and consequences of pro-social profit sacrificing, commentators traditionally focus their attention on the endless normative debate over whether corporations should

1. *See Report on Socially Responsible Investing Trends in the United States*, SOC. INV. FORUM 8 (2010), http://ussif.org/resources/research/documents/2010TrendsES.pdf.

engage in non-maximizing activities.[2] Even when the focus is shifted to understanding why companies behave pro-socially, the discussion anachronistically alludes to the market forces driving corporate pro-sociality, without attempting to understand what affects those market forces. In particular, one needs to consider how the current legal regime impacts market incentives to engage in pro-sociality. This Article aims to bridge these gaps by advancing our understanding of why companies engage in pro-sociality and how the law should regulate it.

Before we begin our analysis, it is useful to resist the traditional tendency to treat various behaviors grouped under the umbrella term Corporate Social Responsibility (CSR) as if they present the same descriptive and normative issues. In reality, different pro-social expenditures serve different purposes and target different audiences. This Article focuses on the subset of CSR that is called corporate philanthropy (CP), which involves explicit pro-social spending. CP is defined as corporate donations to qualified (i.e., tax-exempt) charitable organizations. My focus, then, will be behaviors that are more explicitly non-maximizing. More precisely, I will not focus on behaviors like treating employees nicely, where the expenditures are on the immediate corporate realm (operational profit sacrificing), or on behaviors like cause-related marketing or corporate sponsorships of sports events, which are more akin to traditional advertising. By contrast, CP lacks expectations for an immediate, direct quid pro quo. Such a narrow definition has several advantages. First, it will allow us to resist "fighting the hypothetical," that is, evading issues arising from profit sacrificing by assuming that the behavior is really profit maximizing in disguise. Second, focusing on this extreme example of pro-sociality also allows us to extrapolate to other, less extreme behaviors along the non-maximizing spectrum. Finally, in the debate over the proper purpose of the corporation, CP is the example traditionally used in the legal literature. It is therefore fitting to revisit it by freshly examining the assumptions that commentators made in that normative debate.[3]

Current accounts of CP fall under two main categories: the profit-enhancing approach, which construes CP as buying goodwill for the company, and the agency costs approach, which views CP as a managerial perk. Both accounts suffer from under-articulation. They do not clearly identify the mechanisms linking CP with enhanced profits or managerial agency costs. This inadequacy of current explanations may be responsible for CP laws' evolution into a regulatory vacuum. Since the mid-twentieth century, decision makers have been afforded wide discretion to sacrifice profits in the public interest, while no protective mechanism—notably, no

2. *See generally* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

3. On the need to study individual components of CSR separately and the advantages of focusing on the CP component, see, for example, Baruch Lev et al., *Is Doing Good Good for You? How Corporate Charitable Contributions Enhance Revenue Growth*, 31 STRATEGIC MGMT. J. 182 (2010). For the terminology I adopt here, see Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005).

disclosure requirement—applies. This legal treatment may be a consequence of viewing the buying goodwill mechanism as extremely simple: companies donate because stakeholders like the fact that companies donate. Companies can increase profits by acting philanthropically, and if CP increases profits, then there is no need to intervene. Nonexistent legal regulation may also be a consequence of a simplified view of the critical accounts of CP as agency costs. The agency approach assumes that managers will always have some discretionary resources to spend as they wish, as totally eliminating agency costs is simply too costly (monitoring managers is imperfect). Given this level of discretionary resources at the managers' disposal, it should be of no consequence to shareholder value whether managers choose to spend on their preferred charity or on traveling in luxurious company jets. Moreover, the understanding goes, these expenditures are insignificant in dollar terms and thus do not merit intervention.

The main contribution of this Article is to change the perspective of current value-enhancing accounts of CP. We cannot simply assume that companies, by acting nicely, can increase consumers' or employees' willingness to pay. The necessary conditions underlying this theory are simply too unrealistic. For one, consumers have to be aware of companies' CP policies and be willing to pay to delegate their philanthropy (that is, pay for someone else's charitable preferences). We should focus less on charitable preferences and warm-glow concepts (cognitive and emotional aspects), and more on image considerations: what information do observing outsiders get when companies significantly increase their pro-social expenditures?

Explicit sacrifices of profits can serve as costly signals. They reliably convey messages about attributes that are important to shareholders, consumers, and employees, who are evaluating whether to invest in, buy products from, or work for those companies. To illustrate, I elaborate on the option of CP as a type of a costly signal to investors. An increase in the level of donations could convey messages about financial strength to potential investors, who could infer that future free cash flows are perceived by insiders to be relatively high, that the company is now less financially constrained, or that the riskiness of future cash flows has decreased.

My CP-as-signaling-to-investors account is the first elaborate treatment of such a signaling story. Other signaling stories are also plausible. For example, pro-sociality could bridge asymmetric information between insiders and non-financial stakeholders, such as employees and consumers. In those contexts, CP could reliably convey messages about the styles and characteristics of top management, such as their personal preferences, the extent to which they are subject to "short-termism," and their commitment to a certain corporate culture. Acknowledging the possibility that benefits arise from signaling also has legal implications: laws affect the flow and quality of information, as well as the choice of signals.

This Article next offers a more modest contribution to the agency costs literature on CP. Even if we assume that CP decisions are driven by managerial utility, it is unclear whether they are detrimental to shareholder value or merely a value-neutral diversion (i.e., a substitute for other managerial perks within a fixed level of appropriation). The interesting question, then, is not whether managerial utility drives some CP decisions; it probably does. Rather, the question is whether giving managers wide discretion over pro-social expenditures affects the level of overall appropriation. I endeavor to show that insiders have both the will and the means to strategically select the levels and targets of corporate charity in order to covertly bypass mechanisms that are supposed to cap managerial agency costs. Donations to directors' pet charities can co-opt board independence. Donations to certain educational charities can influence politicians and policies, resulting in a sub-optimal level of shareholder protection. Spending on certain environmental or social agendas can help managers create coalitions with activist groups, thereby entrenching themselves and sub-optimally reducing CEO turnover. The upshot is that some sort of legal intervention may be needed. Leaving agency problems totally unregulated in the CP context could create negative spillovers in other contexts.

With these theoretical contributions in mind, I move to policy implications: rethinking the laws of corporate pro-social profit sacrificing.[4] My primary contribution here is in strengthening the case for disclosure. Stressing the importance of informational benefits to those donations driven by value enhancement focuses our attention on how the current regulatory vacuum leads to an uninformative environment full of cheap talk. Regulating some standardized, comparable, subject-to-liability form of disclosure could be good for the market by increasing awareness and mitigating asymmetric information. This form of disclosure could also be good for the non-profit sector by allowing companies to focus on real impact, rather than marketing.

At the same time, exploiting the potential to use undisclosed CP to co-opt governance mechanisms stresses the importance of not leaving CP in the dark. In this respect, legal intervention should focus not only on the levels of pro-sociality, but also on its targets. I then tie the discussion to the related, timely topic of corporate political donations laws, which are currently in flux.[5] I argue that, unlike in the political donations context, there is no need to introduce more intrusive protective mechanisms, such as a shareholder vote, for "regular" donations.

Why is it so important to understand CP behavior? After all, CP is "merely" one percent of corporate pretax profits, and five percent of overall

4. I do not offer a fully detailed blueprint for reform. Rather, I sketch the initial implications of my analysis.

5. A 2010 U.S. Supreme Court decision relaxed existing restrictions on political spending. *See* Citizens United v. FEC, 130 S. Ct. 876 (2010); *see also* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83, 97 n.38 (2010) (referring to proposed legislation before Congress).

giving in the U.S.[6] My answer is that CP is a practically important, timely, and theoretically interesting issue. Donations from corporations amount to around sixteen billion dollars per year.[7] That is hardly pocket change for investors, not to mention the impact it has on social institutions (by supporting, for example, the arts and the healthcare sector). More important, understanding what drives this unusual corporate behavior can serve as a starting point for understanding much larger phenomena, lumped under the term CSR, which impact trillions of dollars.[8] CP is also a timely topic, if only because the regulatory overhaul of corporate political donations needs to take into account the subtle ways in which CP can be used to influence policies. If you regulate explicit channels only, leaving implicit ones untouched, then the goals of regulation may be frustrated. Finally, a better understanding of CP can be of theoretical interest. The exception could tell us something about the rule. If the rule is that corporations are single-minded profit maximizers, then delineating the exceptions to this rule—such as how and when its limits are crossed—can tell us a lot about corporations and their functions in society.

Some notes on scope and terminology are in order. First, I will deal mostly with "direct" corporate giving, as opposed to giving through corporate foundations.[9] Second, unless otherwise stated, my analysis will deal with large public companies. Finally, I use terms such as "philanthropy" without purporting to make statements about the noble inner motives of the giver. Rather, I will focus on inputs and outputs; that is, the fact that the company gives its money in a way that promotes others' wealth.

Part I of this Article is a survey of the CP literature. Part II introduces my signaling theory of CP. Part III clarifies whether and how CP could be a corporate governance problem. Part IV deals with policy implications, surveying current laws and evaluating proposals to introduce mechanisms that will protect shareholders' interests from managerial abuse of CP.

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6. *See* GIVING USA FOUND. & CTR. ON PHILANTHROPY AT IND. UNIV., GIVING USA 2011: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2010, at 104, 106 (2011) [hereinafter GIVING USA 2011].

7. *See id.* at 4.

8. *See supra* note 1 and accompanying text.

9. Giving through foundations raises substantially different questions than direct giving. Direct giving is a bigger phenomenon (foundation giving comprises 25 to 30 percent of overall CP), so it makes sense to focus on it. *See infra* note 10 and accompanying text. A corporate foundation is an entity established by the company that qualifies under I.R.C. § 501(c)(3) as a charitable organization for tax-exemption purposes. Companies can transfer CP money to their foundations, and the latter decide on when, how much, and to whom to donate. *See generally* Natalie J. Webb, *Corporate Profits and Social Responsibility: "Subsidization" of Corporate Income Under Charitable Giving Tax Laws*, 48 J. ECON. & BUS. 401 (1996).

I. CURRENT TAKES ON CORPORATE PHILANTHROPY: DATA AND THEORY

A. Existing Data

This section situates the CP phenomenon by addressing the following questions: How much do companies give? To whom? What do they give, cash or products? Is CP good on average for the financial bottom line? Under what firm-specific conditions are CP levels high, and under what conditions is CP value enhancing? Specifically, do firms with strong governance mechanisms give more or less?

1. Putting Corporate Philanthropy in Perspective: The "On Aggregate" Data

American companies spend approximately fifteen to sixteen billion dollars annually on philanthropy.[10] In relative terms, CP amounts to one percent of corporate pre-tax profits.[11] While the absolute amounts increase over time, donations as a percentage of profits remain somewhat stable, around one percent. At the industry level, pharmaceutical companies give the most. At the firm level, the biggest product donors (Pfizer, Oracle) evaluate their contributions in billions,[12] while the biggest cash donors (Wal-Mart, Bank of America) each donates around 300 million dollars annually.[13] Among the *Fortune* 100 companies, the median giving is around fifty million dollars annually.

Corporations also must decide what to give and to whom. Cash donations have traditionally been the dominant form of giving, but in recent years, there has been a movement toward in-kind donations (for example, products or employees' time), especially among pharmaceutical and technology companies.[14] The beneficiaries of CP vary, most notably by industry. The healthcare sector gets the biggest share of CP, which relies primarily on the big pharmaceutical donors; followed by educational organizations, which rely primarily on the big technology donors.[15] Another interesting pattern is that corporations give very little to religious organizations—all the more notable when compared with individual giving patterns, where the largest share goes to religious causes.[16]

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10. *See* GIVING USA 2011, *supra* note 7, at 4. Throughout this section, I rely on the notable private aggregator of CP crude numbers: *Giving USA*, researched and written by the Center of Philanthropy at Indiana University (which also surveys other sources). Data in this section come from the *Giving USA* 2008, 2009, 2010, and 2011 annual reviews.

11. *See id.*

12. *See, e.g.*, *id.* at 117.

13. *See id.* at 118.

14. *See, e.g.*, *id.* at 117.

15. *Cf. id.* at 108.

16. *See id.* at 76.

Who decides CP policy? It seems that despite a recent trend to put CP policy in the hands of specialized departments and professionals, CEOs still exert a lot of influence over these discretionary expenditures.[17]

2. Does Social Performance Lead to Better Financial Performance? The "On Average" Data

These facts can help us understand the basic contours of the phenomenon, but we need to know more about CP in order to properly evaluate it. Specifically, is CP economically grounded? That is, does giving affect the financial bottom line, and if so, how?

There is voluminous literature studying the link between corporate social performance and corporate financial performance. A recent meta-analysis summarized the overarching patterns: there is a small but positive association between social and financial performance; this association is stronger for CP than for other social performance proxies (such as corporate policies and transparency); and the link from financial to social performance is at least as strong as the reverse (i.e., doing well enables doing good; companies that generate more profits can afford to sacrifice more profits in the public interest).[18] The main lesson from this meta-analysis is that, while we cannot conclude that companies do well *by* doing good, we can conclude that companies can both do well *and* do good. In other words, there is no evident financial punishment for pro-sociality.[19]

3. When Does Social Performance Lead to Better Financial Performance? The Cross-Sectional Data

We need to go beyond studies on the link between giving and having to thoroughly evaluate corporate pro-sociality. Specifically, instead of fruitlessly trying to prove that a strategy (in our case, pro-sociality) is generically good for the bottom line, one should try to identify the conditions under which CP increases or decreases the value of the company.[20]

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17. This is notable when considering the relatively small size of such expenditures. CEOs of large companies do not exert such influence on equivalent expenditures. *See* Jayne W. Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem*, 41 N.Y.L. SCH. L. REV. 1147, 1157–60 (1997); Jaepil Choi & Heli Wang, *The Promise of a Managerial Values Approach to Corporate Philanthropy*, 75 J. BUS. ETHICS 345, 349, 351 (2007).

18. *See generally* Joshua D. Margolis et al., Does It Pay to Be Good? A Meta-Analysis and Redirection of Research on the Relationship Between Corporate Social and Financial Performance 59 tbl.3 (2007) (unpublished manuscript), *available at* http://stakeholder.bu.edu/docs/walsh,%20jim%20does%20it%20pay%20to%20be%20good.pdf.

19. This is true only to a certain point. Companies cannot heavily sacrifice profits and still do well, as pro-sociality's impact on financial performance will follow some inverse-U shaped form. *See* Amir Barnea & Amir Rubin, *Corporate Social Responsibility as a Conflict Between Shareholders*, 97 J. BUS. ETHICS 71, 72 (2010); Heli Wang et al., *Too Little or Too Much? Untangling the Relationship Between Corporate Philanthropy and Firm Financial Performance*, 19 ORG. SCI. 143, 146–47 (2008).

20. *See* DAVID VOGEL, THE MARKET FOR VIRTUE 33 (2005); Ray Fisman et al., Corporate Social Responsibility: Doing Well by Doing Good? 8 (2005) (unpublished

For purposes of this Article, studies linking the quality of corporate governance mechanisms and CP behavior are the most interesting. In theory, if there is a positive correlation between strong governance and CP, then the profit-enhancing approach is supported, and the need for legal intervention decreases. If there is a positive correlation between weak governance and CP, then the agency costs approach is supported, and the need for intervention increases. Yet so far, empirical studies linking governance to CP remain largely inconclusive and open to interpretation. CP levels positively correlate with some proxies for weak monitoring (for example, firms with low debt ratios donate more),[21] while negatively correlating with others (firms with more independent boards donate more).[22] To make things more complicated, other conditions that are unrelated to governance or agency costs were also found to predict CP levels. Some of those predictors—like advertising intensity, research and development expenditures, and labor intensity—lend support to the profit-enhancing approach.[23] But other predictors—notably, the fact that firms with fewer financial constraints donate more[24]—introduce causation issues that further complicate the analysis.

A better theoretical understanding and better data could one day lead to more conclusive findings. But there is a possibility that mixed evidence portrays the reality: CP is a bag of mixed motivations. "Bad" motivations may bring positive spillover effects (such that managerial utility-driven decisions can still buy some goodwill with consumers), and good

manuscript), *available at* http://apps.olin.wustl.edu/jfi/pdf/corporate.social.responsibility.pdf.

21. *See generally* Barbara R. Bartkus et al., *Governance and Corporate Philanthropy: Restraining Robin Hood?*, 41 BUS. & SOC'Y 319 (2002) (large blockholders and institutional investors curtail high levels of CP); William O. Brown et al., *Corporate Philanthropic Practices*, 12 J. CORP. FIN. 855, 857–58 (2006).

22. *See* Brown et al., *supra* note 21, at 857–58 (noting that board independence is positively correlated with CP); Jordi Surroca & Josep A. Tribó, *Managerial Entrenchment and Corporate Social Performance*, 35 J. BUS. FIN. & ACCT. 748 (2008) (noting that board independence is positively correlated with corporate social performance in general); Maretno A. Harjoto & Hoje Jo, Why Do Firms Engage in Corporate Social Responsibility? (2009) (unpublished manuscript), *available at* http://www.eben.gr/site/Papers/Maretno%20Harjoto%20WHY%20DO%20FIRMS%20ENGAGE%20IN%20CORPORATE%20SOCIAL%20RESPONSIBILITY.pdf (same). Another study found no support for the hypothesis that the duality of CEOs (when sitting as chairpersons of boards) is positively correlated with CP, or for the hypothesis that CEO ownership levels are negatively correlated with CP. *See* Bartkus et al., *supra* note 21, at 332.

23. *See generally* Brown et al., *supra* note 21, at 868–75; Peter Navarro, *Why Do Corporations Give to Charity?*, 61 J. BUS. 65, 90 (1988). Firm size is another common variable that is often discussed. For example, a recent study identified a cubic relationship: the largest and smallest firms donate a larger share of their taxable income. *See* Louis H. Amato & Christie H. Amato, *The Effects of Firm Size and Industry on Corporate Giving*, 72 J. BUS. ETHICS 229, 229–30 (2007).

24. *See generally* Harrison G. Hong et al., Financial Constraints on Corporate Goodness 31 tbl.3 (Jan. 3, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1734164.

motivations may bring negative spillover effects.[25] This Article attempts to resolve these seemingly conflicting patterns.

4. Problems and Gaps in Existing Data

I approach the data cited in this part with much caution and skepticism. Data are often second-hand, self-reported, distorted, and incomplete, and the corresponding methods are unable to overcome these deficiencies.[26]

Sources of data are especially problematic. American firms are not required to make information on their CP policies available to the public, and although firms must detail their tax-exempt donations, the IRS only releases aggregate data to the public because of privacy considerations. Most empirical studies thus rely either on voluntary CSR reports published by the firms, annual surveys by directories and magazines, or "social rating" agencies. Voluntary CSR reports are not subject to any comparable standard form or to any threat of liability. Accordingly, insiders have incentives to exaggerate positive elements and to hide negative ones. These reports usually encompass dozens of pages of anecdotes replete with pictures of smiling faces, making it difficult to generate hard, quantifiable, meaningful information.[27] Relying on surveys is also problematic, as they suffer from social-desirability bias and high non-response rates. Companies can stop reporting or responding to surveys at will, or alter the form and scope of their disclosure when they think that complete disclosure could hurt them. This undoubtedly limits the applicability of empirical findings.[28]

Finally, aggregations of data by information intermediaries (for example, social rating agencies) also suffer from basic flaws. First, the market for corporate social performance information is characterized by a cacophony of indices, each measuring a different aspect, but also measuring similar aspects differently.[29] Second, these intermediaries rely mostly on voluntary information reported by the firms, without superior access to relevant information. Third, the reliability and comparability of this information is hampered by under-theorizing problems, such as conflating distinct social performance dimensions.[30] Indeed, recent systematic empirical studies of

25. *See* M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 580 (2009).

26. *See* Donna J. Wood, *Measuring Corporate Social Performance: A Review*, 12 INT'L J. MGMT. REVS. 50, 62 (2010).

27. *See, e.g.*, VOGEL, *supra* note 20, at 67–68 (noting that reports are overwhelming and distorted); *id.* at 39 (the threat of legal liability for misinformation is non-existent); Li-Wen Lin, *Corporate Social and Environmental Disclosure in Emerging Securities Markets*, 35 N.C. J. INT'L L. & COM. REG. 1, 14 & n.55 (2009).

28. *See, e.g.*, James R. Boatsman & Sanjay Gupta, *Taxes and Corporate Charity: Empirical Evidence from Micro-level Panel Data*, 49 NAT'L TAX J. 193, 202 (1996).

29. *See* Aaron Chatterji & David Levine, *Breaking Down the Wall of Codes: Evaluating Non-financial Performance Measurement*, 48 CAL. MGMT. REV. 29, 30 (2006); Michael E. Porter & Mark R. Kramer, *Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, HARV. BUS. REV., Dec. 2006, at 81 ("[T]he existing cacophony of self-appointed scorekeepers does little more than add to the confusion.").

30. *See* Jean-Pascal Gond & Andrew Crane, *Corporate Social Performance Disoriented: Saving the Lost Paradigm?*, 49 BUS. & SOC'Y 677, 684–85 (2010); *see also supra* note 3 and

social ratings question the ability of such sources to provide real transparency.[31]

Aside from data limitations, the empirical literature also suffers in methodology and theory.[32] Because CSR has always been difficult to specify and operationally define, studies vary widely in their use of measures, and many stay at a high level of aggregation. Lumping together different dimensions makes it difficult to generate applicable insights, as CSR activities are in all likelihood audience specific, and cater to different demands. This is especially true for CP, which is an extremely distinct dimension.[33] There is also a related lack of articulation of causal mechanisms; studies are plagued by endogeneity problems and fail to control for important variables and spuriousness.[34]

In summary, our knowledge of CP practices consists of a high level of generality. We know that CP is neither a huge nor an insignificant corporate expenditure, that top managers exert a lot of influence over these ultra-discretionary expenditures, that there is no evidence that pro-sociality is being punished financially, and that conditions leading to more giving or more profit-minded giving are hard to identify. Mainly, we know that we do not know much. Clearly, we need a better understanding of the mechanisms that might link CP to outcomes that are good or bad for the company, as well as better access to reliable and comparable information.

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accompanying text. To illustrate: the most widely used database is that of KLD's Socrates, which categorizes corporate social performance into seven subgroups. CP studies use the subgroup of "community," which lumps together and gives equal weight to several different aspects: not only levels of CP, but also highly subjective and less relevant measurements such as whether the giving is "innovative" and whether the company supports housing projects. Thus, if company X donates 5 percent of its profits to charity, it might still end up with a lower/equal score compared to company Y, which donates 0.5 percent of profits but targets housing solutions. Aside from lumping, the measures themselves are inevitably crude; to score "1" and not "0," companies need to give above 1.5 percent of pretax income for the preceding three years. Thus, company X that donates around 1 percent regularly (which amounts to tens of millions of dollars annually) would get the same score as company Y which does not engage in CP at all.

31. *See generally* Aaron K. Chatterji et al., *How Well Do Social Ratings Actually Measure Corporate Social Responsibility?*, 18 J. ECON. & MGMT. STRATEGY 125 (2009).

32. *See* Margolis et al., *supra* note 18, at 27–28; Brandon Vaidyanathan, *Corporate Giving: A Literature Review*, SCI. GENEROSITY 31–34 (2008), http://generosityresearch.nd.edu/assets/17636/corporate_giving_final.pdf.

33. On the misguided tendency to lump together all CSR expenditures, see Gerwin Van der Laan et al., *Corporate Social and Financial Performance: An Extended Stakeholder Theory, and Empirical Test with Accounting Measures*, 79 J. BUS. ETHICS 299, 299 (2007); *see also* Jennifer C. Chen et al., *Corporate Charitable Contributions: A Corporate Social Performance or Legitimacy Strategy?*, 82 J. BUS. ETHICS 131 (2008) (showing weak correlations between CP and other CSR expenditures); Fisman et al., *supra* note 20 (same).

34. *See, e.g.*, Choi & Wang, *supra* note 17 (managerial values can drive both variables); Margolis et al., *supra* note 18, at 27.

B. Existing Theory

Milton Friedman's credo continues to be the benchmark for accounts of CP: "The social responsibility of business is to increase its profits."[35] Managers engaging in profit sacrificing are seen in this view as taking money away from shareholders and imposing a tax on them. If managers cannot put this money to good business use, the argument goes, they should pay out to shareholders who could then decide how to satisfy their own individual charitable preferences.

From this starting point, theoretical accounts of CP can be divided into three categories. First, CP is profit-enhancing (however indirectly or intertemporally), rather than profit-sacrificing. This approach attacks assumptions, implicit in Friedman's analysis, that social and economic performances are unrelated and that corporations cannot satisfy charitable preferences better than individuals.[36] Second, CP is managerial utility-driven. This approach develops Friedman's conjectures that CP cannot really be characterized as an irrational sacrifice, because expenditures on charity are rather extra-rational. They are chosen not so much for the benefits they bring to the company, as for the benefits they bring to the agent, the manager. Third, CP is a moral duty. This approach talks past Friedman's critique; yes, CP may be profit-sacrificing, but that is fine. Companies should do more than just maximize their profits; they should also do good for society.[37] Critiques of those different theories are countless. For brevity's sake, I focus on the most prevalent profit-enhancing and agency costs versions.[38]

1. Corporate Philanthropy as Profit Enhancing

This "win-win" or "dual agenda" approach to corporate pro-sociality suggests that sacrificing profits in the public interest is actually efficiency enhancing: doing well by doing good. Various nonexclusive mechanisms are typically offered to link pro-sociality and the financial bottom line. Two notable categories are, first, delegated philanthropy, which sacrifices profits to meet the charitable preferences of stakeholders, thus increasing demand or reducing operating costs; and second, long-term benefits, which refers to sacrificing profits in the short term to increase value over the long

35. Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32; *see also* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133–34 (2d ed. 1982).

36. *See* Michael E. Porter & Mark R. Kramer, *The Competitive Advantage of Corporate Philanthropy*, HARV. BUS. REV., Dec. 2002, at 58–59.

37. *See generally* Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 65, 81–85 (1995); Bill Shaw & Fredrick R. Post, *A Moral Basis for Corporate Philanthropy*, 12 J. BUS. ETHICS 745, 747–50 (1993).

38. We will not deal with the "moral duty" approach, as it is normative more than descriptive. To the extent that it aims to describe the phenomenon, it collapses into agency explanations. It is the decision maker, after all, who decides what the morally right thing to do is. In making this choice, I follow the excellent overview of Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1 (2010).

term.[39] The latter approach treats profit sacrificing as a way to run the company; it is a distinctive resource with actual effects (for example, treating employees nicely). The delegated philanthropy approach, by contrast, focuses on appearance regardless of the actual effects of doing good.[40]

To understand the delegated philanthropy approach, the key is to assume that stakeholders have some charitable preferences. Stakeholders prefer "nice" companies—that is, companies that sacrifice profits in the public interest. For example, consumers are assumed to perceive pro-social corporate behavior as adding a favorable attribute to the products of the donating company.[41] Corporations that spend on pro-sociality simply cater to consumer demand. These corporations offer a bundle of direct utility from consuming, and "warm glow" from buying, products that were manufactured by nice companies.[42]

Those key assumptions may be too unrealistic to predict actual behavior accurately, however. First, while some survey and experimental evidence shows increased willingness to pay for nicer companies' products, evidence of actual buying decisions is rather tenuous.[43] Second, even if you believe that declarations in surveys do translate into actions, you cannot conclude that CP is especially effective at buying goodwill. Consumers profess much stronger preferences for other pro-social expenditures, such as labor and environmental issues, than for cash donations.[44] Third, it cannot be assumed that consumers are aware of different levels of CP. This assumption could hold for certain cause-related marketing programs, such as when a product's package advertises the percentage of revenues that will go to charity from each sale, but not for "classical" donations.[45] Finally,

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39. *See id.* at 9–11.

40. *See* Margolis et al., *supra* note 18, at 7–8.

41. Similar stories are told about other stakeholders, including financial ones (firms offer a bundle of warm glow and financial returns on investment). *See, e.g.*, Joshua Graff Zivin & Arthur Small, *A Modigliani-Miller Theory of Altruistic Corporate Social Responsibility*, 5 TOPICS ECON. ANAL. & POL'Y, no. 1, 2005, at 1.

42. *See* Ray Fisman et al., *A Model of Corporate Philanthropy* 2 (2006) (unpublished manuscript), *available at* http://knowledge.wharton.upenn.edu/papers/1331.pdf (providing a concise description followed by a critique). The concept of warm glow denotes the boost to direct private utility people experience from acts of giving (regardless of the actual effects on recipients or the total supply of charity). *See* James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 ECON. J. 464, 466–68 (1990).

43. *See* VOGEL, *supra* note 20, at 46–47; Porter & Kramer, *supra* note 29, at 83. *But see* Daniel W. Elfenbein & Brian McManus, *A Greater Price for a Greater Good? Evidence that Consumers Pay More for Charity-Linked Products*, 2 AM. ECON. J.: ECON. POL'Y 28 (2010) (study indicating that an eBay charity auction will yield higher prices than an equivalent non-charity auction).

44. *See, e.g.*, Amato & Amato, *supra* note 23, at 229; Bénabou & Tirole, *supra* note 38, at 14; Linda Sugin, *Encouraging Corporate Charity*, 26 VA. TAX REV. 125, 127 n.5, 141 n.43 (2006).

45. *See, e.g.*, VOGEL, *supra* note 20, at 52; Sankar Sen et al., *The Role of Corporate Social Responsibility in Strengthening Multiple Stakeholder Relationships: A Field Experiment*, 34 J. ACAD. MARKETING SCI. 158, 163–64 (2006) (noting that consumer awareness of CP is low).

even if consumers have meaningful charitable preferences, and even if they are willing and able (i.e., aware of CP levels) to act upon them, one still needs to explain why consumers would want to delegate charity. Instead of paying more for a nice company's product, consumers can pay for a value-adjusted cheaper product of a non-sacrificing firm. Consumers can then use the cash saved to satisfy their own charitable preferences, which, in all likelihood, differ somewhat from those of the donating company's managers. A possible rebuttal is that, in some circumstances, companies are better positioned to bundle direct utility with warm glow. This rebuttal could perhaps hold for operational profit sacrificing, where the production process or distribution channels generate complementarities with the good deeds that are important for stakeholders, but it is less likely to hold for explicit profit sacrificing, because CP is easily decoupled from production.[46]

The second strand in win-win approaches to CP—the long-term benefits version—assumes that limits of governance and managers' time horizons cause firms to suffer from short-termism. Those intertemporal problems affect not only third parties (externalities), but also firms' value (if, for example, employees are unwilling to make firm-specific investments in those firms that are plagued by short-termism). Adopting an approach that allows for profit sacrificing in the public interest could balance this detrimental short-termism. It could push insiders toward developing skills and a willingness to satisfy the implicit demands of stakeholders whose cooperation is needed (labor, regulators, community), thus maximizing intertemporal profits.[47]

The general flaws of the long-term benefits version are reviewed elsewhere.[48] For purposes of this Article, the limited applicability of the long-term benefits version to CP is especially relevant. If its basic premise is to promote firm-specific investments by key stakeholders, then it is hard to explain sacrificing profits to benefit unrelated third parties who do not make firm-specific investments (i.e., charitable organizations).[49] Consider a notable attempt in the corporate law literature to apply such an approach: Margaret Blair's application of the "team production" model. Blair

46. *Compare* Bénabou & Tirole, *supra* note 38, at 10–11, *with* Fisman et al., *supra* note 42, at 2. Even within the context of operational profit sacrificing, there are reasons to doubt the argument: complementarities of good deeds and production do not always exist, and are not always readily observable to outsiders. *See id.* at 2.

47. *See* Fisman et al., *supra* note 42, at 2. A key assumption in such an argument is that contracts are incomplete.

48. *See, e.g.*, Porter & Kramer, *supra* note 29, at 82.

49. A related version sees profit sacrificing as a defensive strategy, meant to reduce the volatility of future cash flows by limiting the uncertain future claims and decreasing the likelihood of future regulatory intervention. *See* Sadok El Ghoul et al., *Does Corporate Social Responsibility Affect the Cost of Capital?*, 35 J. BANKING & FIN. 2388, 2390 (2011). The argument of inapplicability to CP that appears in the body of the text applies also to such a "defensive" version. CP, unlike other CSR activities, is not about being nice to potential claimants; it is about being nice to unrelated parties, non-claimants. Thus, CP has to rest on some image considerations: parties you care about observe how nice you behaved to unrelated parties, and then they update their beliefs and act accordingly.

describes CP as a specific example of how directors ought to—and do in fact—use their discretion to steer a clear path between different stakeholders within the organization.[50] What Blair sidesteps is that the ultimate beneficiaries of directors' discretion to engage in CP—tax-exempt organizations—cannot be thought of as part of the "team" that engages in "production."[51] The example Blair uses to bypass this problem is telling. She claims that the infamous case of an oil company, Occidental Petroleum Co. (Oxy) paying eighty-five million dollars to build a museum in the name of its soon-to-retire CEO is justified because an especially powerful member of the team (the CEO) enjoyed this expenditure.[52] This example illustrates how "stakeholder" explanations to CP collapse into other explanations (for example, justifying CP as a substitute for explicit CEO compensation)[53] and fail to specify independently how to make and measure necessary tradeoffs.[54]

2. Corporate Philanthropy as Agency Costs

The win-win approach stresses the adaptive features of CP as benefiting the company. The agency costs approach, by contrast, suggests that the seemingly irrational profit-sacrificing phenomenon survives because it

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50. *See* Margaret M. Blair, *A Contractarian Defense of Corporate Philanthropy*, 28 STETSON L. REV. 27, 49–50 (1998).

51. Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195, 1220 (1999).

52. *See* Blair, *supra* note 50, at 46–47. For further discussion of the Oxy example, see *infra* notes 112–07 and accompanying text.

53. *See* Symposium, *Corporate Social Responsibility: Paradigm or Paradox?*, 84 CORNELL L. REV. 1282, 1321 (1998). Alternatively, Blair could argue that this donation is necessary to establish the role of directors as mediating hierarchs, signaling to the other team members (not just the benefited CEO) the directors' ability to function well in such a role and eliciting a cooperative response. But then the team production argument collapses into an explanation about image concerns as a sort of signaling: we need to make clear why and how exactly CP generates value through image considerations. *See infra* Part II.

54. Can the CEO be paid back for his contribution with $200 million of CP? At whose expense? Why not use these $85 million to benefit other team members, such as employees in match-giving programs? *See generally* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 447–49 (2001); Michael Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPL. CORP. FIN. 8 (2001). As applied to the CP context, see James P. Shannon, *Foreword* to CORPORATE PHILANTHROPY AT THE CROSSROADS (Dwight F. Burlingame & Dennis R. Young eds., 1996). Also, if we see donations as benefiting dominant team members (executives), then arguably donations should be subjected to similar rules that apply to perks and executive compensation (i.e., much more stringent disclosure and tax rules). *Cf.* Blair, *supra* note 50, at 46 n.64. I will return to this point in Parts III and IV.

In my opinion, there are stronger versions of the long-term approach, such as suggesting that CP enhances the company's value by buying moral wiggle room with the public and politicians. *See* Paul C. Godfrey, *The Relationship Between Corporate Philanthropy and Shareholder Wealth: A Risk Management Perspective*, 30 ACAD. MGMT. REV. 777 (2005) (CP generates moral capital among stakeholders and communities; this moral capital is used as insurance to protect firms' relational assets); *see also* Ailian Gan, *The Impact of Public Scrutiny on Corporate Philanthropy*, 69 J. BUS. ETHICS 217 (2006) (companies subject to public scrutiny are more likely to donate).

makes corporate decision makers better off. The impetus driving CP behavior is private benefits to those insiders; they donate with shareholders' money and enjoy disproportionate benefits from the expenditure. Among the benefits CP can confer to managers are social currency in elite circles, access to tangible benefits (board seats or tickets to gala events), satisfaction of their individual other-regarding preferences, and warm glow.[55]

But the managerial utility explanations do not provide well-developed accounts of the mechanisms that make managers choose CP as a channel to reap private benefits. To illustrate, it makes no sense for managers to engage in CP in order to enhance their personal reputations, if the correlation between levels of engagement in CP and managerial personal traits is questionable (i.e., if industry and firm characteristics dictate much of the ability to engage in CP).[56] Alternatively, if the reason managers engage in CP is to signal their power over their company's resources, there are other, arguably more effective means to achieve such a goal, such as negotiating for better traditional perks (for example, a private jet or a luxurious corner office). And if the manager engages in CP to get warm glow and satisfy her own charitable preferences, she could arguably get more warm glow from negotiating higher pay and then donating the extra dollars in her own name. A fuller managerial utility explanation should thus point out unique attributes of pro-social profit sacrificing that make it effective at generating private benefits.[57] Indeed, existing data casts doubt on mechanisms that were traditionally offered to link CP to managerial utility. For example, it was found that firms that pay their CEOs more are not the firms that donate more.[58]

Another related flaw of managerial utility accounts is that they do not clearly answer the "so what?" question: assuming CP is indeed driven by managerial utility, is it necessarily bad for the company, the shareholders, or overall welfare? In Part III, I will try to narrow these flaws by explaining how pro-social expenditures are effective at generating private benefits, and under what conditions pro-sociality is bad for shareholders and society.

While both profit-enhancing and agency costs approaches hold some sway, each approach suffers from flaws. Deciding which model captures

55. *See, e.g.*, Barnard, *supra* note 17, at 1160–64; Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 609–25 (1997).

56. For example, financial constraints dictate much of CP levels. *See* Hong et al., *supra* note 24; *cf.* John F. Padgett, *Corporate Potlatch*, 15 CONTEMP. SOC. 818, 820–21 (1986).

57. For example, one should come up with a story on how gaining discretion over CP money does not come at the expense of more pay, but rather increases the potential pay package—perhaps because it stretches the "outrage constraint." *Cf.* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 64–70 (2004). Pro-sociality, the argument would go, is by nature less susceptible to trigger backlash by outsiders than explicit pay/perks.

58. *See* Navarro, *supra* note 23; Steven C. Trost, An Examination of Corporate Charitable Contributions: Evidence from Firm, Managerial, and Community Factors 90–93 (May 2006) (unpublished Ph.D. dissertation, University of Virginia), *available at* http://www.stevenctrost.com/diss.pdf (replacement of CEO does not change the firm's giving policy).

reality more accurately is an empirical question, but the evidence is currently inconclusive. The dearth of firm-specific data and the lack of means to address causality do not help. The few notable firm-specific studies generate contrasting results.[59] Even findings presumed to favor one approach can be interpreted to cut both ways, at least until the mechanisms that link CP to company-level and managerial level benefits are better articulated.[60] This Article next sets forth an attempt at a better explanation of these mechanisms.

II. CORPORATE PHILANTHROPY AS A COSTLY SIGNALING MECHANISM

We saw that profit-enhancing explanations are missing something, but what exactly is missing? To illustrate, consider a puzzling pattern identified by an oft-cited study, which tested whether and how pro-sociality reduces labor costs.[61] The hypotheses generated by the traditional buying goodwill argument are, first, that companies that are more pro-social will do better at attracting potential job applicants. Second, that the effect will be mediated by the applicants' "social" preferences, that is, applicants who feel strongly about social or environmental issues will be more attracted to pro-social companies. The study's findings were consistent with the first hypothesis: in line with the value-enhancing theme, applicants did consider pro-social companies as more attractive places to work. But the study did not support the second hypothesis: inconsistent with the buying goodwill mechanism, the effect was not mediated by the applicants' social or environmental preferences. Potential job applicants considered pro-social companies as more attractive to work for, regardless of whether applicants cared about social issues.[62]

This implies that preferences and delegated philanthropy arguments are not giving us the full account of the benefits arising from pro-sociality. We should switch focus to image considerations. Apparently, the fact that a company engages in high levels of pro-sociality was indicative of something that convinced applicants that the company has other favorable attributes. Even strictly profit-minded stakeholders prefer companies that are nice; not because of the niceness per se, but rather because niceness is an indication of something else. The interesting questions are thus: what is pro-sociality indicative of, and how exactly can pro-sociality be credibly indicative of other traits? The following is my attempt to answer these questions and better understand an unnoticed mechanism that ties pro-

59. For notable early studies, see generally Boatsman & Gupta, *supra* note 28 (the association between CP and tax rates suggests giving beyond profit maximization considerations); Navarro, *supra* note 23 (firm characteristics drive CP more than managerial characteristics). For a more recent study, see generally Brown et al., *supra* note 21 (mixed results).

60. *See* Bartkus et al., *supra* note 21, at 337; Choi & Wang, *supra* note 17, at 346.

61. *See* Daniel W. Greening & Daniel B. Turban, *Corporate Social Performance as a Competitive Advantage in Attracting a Quality Workforce*, 39 BUS. & SOC'Y 254 (2000).

62. *Id.*

sociality to value enhancement—namely, the mitigation of asymmetric information between outsiders and insiders.

A. The Basic Story: Signaling Financial Strength

It is plausible to assume that there is asymmetric information about companies' underlying attributes. Insiders know more than outsiders. Both have incentives to mitigate the asymmetry. One method for insiders to mitigate asymmetries is to communicate information to target audiences about unobservable qualities through observable, costly activities (for example, handicapping yourself to signal that you can afford it). This is the basic background of a costly signaling story. As applied here, profit sacrificing in general and CP in particular can serve as costly and observable attributes, conveying messages about unobservable attributes. Out of many possible versions, I will focus on one specific example: CP as signaling future free cash flows to outside investors.

The signaler in our informal model is the company, or, more precisely, its insiders (i.e., decision makers, such as top management or dominant shareholders). Receivers of the signal—the target audience—are outside investors. Insiders want to convey messages to outsiders about an underlying but not readily observable attribute, so that outsiders increase their valuation of the company. One important attribute for valuation is future free cash flows. Because future free cash flows are not readily observable by outsiders, they make a plausible subject for costly signaling.[63] What could constitute an observable costly attribute that credibly conveys messages about future cash flows? In the current context, big changes in cash donations could fit the bill. Cash donations are costly in an intuitive manner: insiders decide to take a dollar that they could have used to meet the demands of contractual claimants, and instead give it to unrelated third parties. Outsiders that observe a company substantially increasing its expenditures on pro-social profit sacrificing will infer that the company's insiders perceive their ability to procure future resources as better than was previously evaluated. Outsiders then update their forecasts about the company's prospects accordingly.

But for such a signal to work, it needs to be more than just costly. It has to be costlier for low-quality companies in order to avoid mimicry (the costs have to be differentiating and quality-dependent). In the current context, cash donations need to be costlier for firms with low future free cash flows than for those with high cash flows.

One could argue that companies with low future cash flows can finance a high level of donations out of retained earnings or external finance. If insiders can simply borrow money to raise their CP levels even when times are bad, then outsiders will not change their valuations based on observing CP. Yet a recent empirical study showing that corporate goodness is

63. Accounting concepts like depreciation and capital investment bridge a gap between net profits and uncommitted cash flows. Asymmetric information only increases when the attribute in question is a perceived future ability.

costlier for financially constrained firms refutes this argument.[64] There are several possible reasons behind such a link between corporate goodness and financial constraints. For one, borrowing to finance the donations is costlier for companies with relatively bad future prospects because it requires them to expose themselves to unfavorable covenants or disclosure requirements.[65] Furthermore, there is evidence that managers care deeply about meeting earnings benchmarks and smoothing earnings, to the extent that they will even sacrifice projects with positive net present value to set aside buffer cash.[66] Thus, it is plausible to assume that insiders in low quality firms will find it more costly to spend ultra-discretionary dollars on CP, since they need all the cash buffers they can get. Outsiders observing a large increase in CP levels could therefore infer that insiders know they are not going to be financially constrained.[67]

Put differently, the conditions for costly signaling are *in nuce* as follows.[68] First, companies vary in their ability to generate future free cash flows. Second, outside investors cannot readily observe future free cash flows, and stand to gain from knowing more about them. Third, at the same time, outsiders cannot simply believe all direct messages from insiders about future free cash flows; insiders stand to gain from sending false, exaggerated signals. So, outsiders resort to making inferences based on some observable, costly behaviors of companies, and the fact that the behavior is costly assures the credibility of the signal; low-quality signalers cannot incur the same amount of costs as high-quality signalers. Fourth, one such observable behavior is explicit profit sacrificing. Big cash donations will carry information about the prospects of the company as long as the costs of donating are negatively correlated with an ability to generate future free cash flows.

If these propositions are plausible, then we can assume that communication through profit sacrificing will be informative. Yet a fully conscious, meditated decision to sacrifice profits with a clear intent to signal financial strength is not needed. When the above propositions apply, we can assume that some "design force"—conscious decision-making,

64. *See* Hong et al., *supra* note 24. Another recent study that could be interpreted as suggestive evidence in favor of signaling establishes that CP is a good predictor ("Granger-cause") of future financial health (revenue growth). *See generally* Lev et al., *supra* note 3.

65. For a discussion of external finance as cost-differentiating, see generally Sudipto Bhattacharya, *Imperfect Information, Dividend Policy, and "The Bird in the Hand" Fallacy*, 10 BELL J. ECON. 259 (1979) (a dividend-signaling model).

66. *Cf.* John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 33 tbl.6 (2005).

67. Alternatively, outsiders can infer that insiders do not care so much about meeting the earnings per share benchmarks and are not subject to short-term market pressures.

68. My informal model builds on formal models of signaling developed in economics and sociobiology. *See, e.g.*, Herbert Gintis et al., *Costly Signaling and Cooperation*, 213 J. THEORETICAL BIOLOGY 103 (2001); Alan Grafen, *Biological Signals as Handicaps*, 144 J. THEORETICAL BIOLOGY 517 (1990); Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973). *See generally* AMOTZ ZAHAVI & AVISHAG ZAHAVI, THE HANDICAP PRINCIPLE: A MISSING PIECE OF DARWIN'S PUZZLE (1997) (elaborating on signaling explanations in sociobiology).

market forces selection, or imitation of successful companies—will instill in CP the tenets of a costly, informative signal of financial strength. But are all these propositions really possible? The next section elaborates on their potential limitations to arrive at a definition of signaling by conspicuous goodness.

B. Refining the Basic Story: Limitations

Before concluding that pro-social profit sacrifices bring benefits through signaling, several conditions and limitations need to be addressed. A classical criticism against signaling explanations applies in our context as well: why one particular signal and not another? If throwing cash away serves as a signal for an ability to procure resources, why should companies throw it away on charitable organizations? All it takes is for a firm to sacrifice profits, so why make the sacrifice in the public interest? Why not signal, for example, with dividend policy?[69] The key to answering this question is acknowledging that signaling through pro-social sacrifices does not preclude the use of other signals. In real life, unlike in models, multiple messages are conveyed by multiple means (both costly and non-costly).[70] The real question, then, is not choosing CP over dividends, but what the mix of signals chosen in the given circumstances will be. While a complete answer to the mix-of-signals question is beyond the scope of this Article, I sketch a few guidelines below.

First, some potential signaling channels are often blocked or are too costly for some firms. For example, most firms do not pay dividends.[71] If those firms need to signal an ability to procure resources, they have to resort to other channels, perhaps pro-sociality.

Second, even when different signaling channels are all open, insiders will not necessarily choose only one channel. For example, signal choice is affected by the probability that signal receivers will make errors when evaluating them. When receivers are error-prone, signalers may try to increase the accuracy by using a "backup," that is, conveying the same message through multiple signaling channels rather than exaggerating signals through the same channel.[72] Indeed, the corporate environment

69. For a discussion of the classical dividend-signaling models, see generally Bhattacharya, *supra* note 65; Kose John & Joseph Williams, *Dividends, Dilution, and Taxes: A Signalling Equilibrium*, 40 J. FIN. 1053 (1985); Merton H. Miller & Kevin Rock, *Dividend Policy Under Asymmetric Information*, 40 J. FIN. 1031 (1985).

70. In finance, see Harry DeAngelo et al., *Reversal of Fortune: Dividend Signaling and the Disappearance of Sustained Earnings Growth*, 40 J. FIN. ECON. 341, 365 (1996). In sociobiology, see generally Eileen A. Hebets & Daniel R. Papaj, *Complex Signal Function: Developing a Framework of Testable Hypotheses*, 57 BEHAV. ECOLOGY & SOCIOBIOLOGY 197 (2005).

71. *See* Alon Brav et al., *Payout Policy in the 21st Century*, 77 J. FIN. ECON. 483, 516 (2005).

72. Rufus A. Johnstone, *Multiple Displays in Animal Communication: 'Backup Signals' and 'Multiple Messages,'* 351 PHIL. TRANSACTIONS BIOLOGICAL SCI. 329 (1996) [hereinafter Johnstone, *Multiple Displays*]. The reason we borrow insights from models developed in the sociobiology literature is that the information economics literature focuses more on the strategic aspects of signaling (the why), while sociobiology focuses more on the efficacy of

creates a greater need for backup signaling in the face of obstacles such as noisy communications, strong incentives to cheat, widely varying perceptions and preferences of receivers, and accelerating signaling costs.[73] Accordingly, when insiders want to signal good prospects, they may supplement the increase in dividends with an increase in CP levels, thus increasing the chances that outsiders get the right message (for example, that outsiders are not attributing an increase in dividends to managers bowing to pressures from shareholders eager for payouts). While this CP-as-backup-signal speculation is ultimately a matter for future empirical research, existing evidence indicates that it is not farfetched. Firms that pay out more also donate more.[74]

Third, aside from factoring in the possibility that multiple signals convey the same message, we also need to acknowledge that, in reality, each signal conveys multiple distinct messages. It is true that if insiders want to signal financial strength, they can do so through various types of sacrifices: burning money in the street, building luxurious headquarters, or purchasing lavish perks. Conspicuous consumption—not just conspicuous generosity—can signal an ability to procure resources.[75] But each type of sacrifice also conveys messages apart from information about changes in resources. For example, the type of sacrifice could say something about management's commitment to business strategies. A pro-social handicap suggests that managers do not hoard cash for themselves and are not subject to pressure by shareholders to pay out each free dollar.[76] By contrast, managerial perks do not convey messages about the pro-social tendencies of corporate decision makers. And dividends do not convey messages about

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signaling (the how). Efficacy considerations cannot be ignored when analyzing corporate communications in a noisy environment filled with strong incentives to cheat. Telephone Interview with Rufus Johnstone, Dep't of Zoology, Univ. of Cambridge (Mar. 15, 2011).

73. For discussions on conditions for backup signaling, see generally Hebets & Papaj, *supra* note 70 (existence of several different groups of receivers and variability of preferences within groups of receivers induces backups); Johnstone, *Multiple Displays*, *supra* note 72 (accelerating costs of the main signal); Sarah R. Partan & Peter Marler, *Issues in the Classification of Multimodal Communication Signals*, 166 AM. NATURALIST 231 (2005) (non-cooperative, competitive contexts favor the evolution of conspicuous, redundant signals).

74. *See* Navarro, *supra* note 23, at 87–88. Although the positive correlation does not prove that CP is used as a backup signal to dividends (there are other ways to explain the positive correlation), it nevertheless indicates a direction worth pursuing and a pattern for which we must account.

75. *Cf.* Vladas Griskevicius et al., *Blatant Benevolence and Conspicuous Consumption: When Romantic Motives Elicit Strategic Costly Signals*, 93 J. PERSONALITY & SOC. PSYCHOL. 85, 86–87 (2007) (conspicuous generosity—for example, public acts of philanthropy—can signal both an ability to procure resources and a pro-social personality/tendency. By contrast, acts of conspicuous consumption can be an alternative signal to the former, but not to the latter). *See generally* THORSTEIN VEBLEN, THE THEORY OF THE LEISURE CLASS (Penguin ed. 1994) (1899) (recognized as the first elaborate treatment of conspicuous consumption as signaling).

76. In that respect, a better understanding of pro-social behavior could serve as a window to an area in need of future research: managerial styles and their economic consequences. *See generally* Marianne Bertrand & Antoinette Schoar, *Managing with Style: The Effect of Managers on Firm Policies*, 118 Q.J. ECON. 1169, 1170–72 (2003).

how managers are insulated from the pressure of shareholders with short-term interests. This does not suggest that pro-social profit sacrificing is a better signal. After all, too much pro-sociality or too much insulation from shareholder demands could be interpreted negatively by investors. In general, because the effectiveness of signals depends on their ability to be interpreted favorably by receivers,[77] the mix of signals is expected to vary across companies and times. For example, the mix will depend on how outsiders evaluate the company's investment opportunities. The point is that the existence of other potential ways to signal does not categorically eliminate the potential for signaling benefits from conspicuous goodness.

Another major criticism of the costly signaling theory is that CP is not really costly. To be sure, CP does cost something, but is it truly a handicap to big firms? After all, CP levels in many companies represent only a "modest incremental cash drain on resources available to managers,"[78] and modest costs cannot differentiate between high- and low-quality signalers. The key to accommodating this limitation is to refine our predictions regarding benefits arising from signaling. Pro-sociality will convey credible messages about future financial prospects only when conducted on a large scale relative to a company's size and resources. Day-to-day marginal contributions are not likely to generate signaling benefits; big changes in CP policy are.[79] For example, in March 2008, when Goldman Sachs announced a new $100 million CP program meant to further business education of women in the developing world, outsiders took notice.[80] Outsiders were free to infer that Goldman's top managers simply cared about the cause of women's business education, or that they were hoping to buy goodwill by appearing nice. But outsiders may also have inferred that Goldman's managers thought that the company could afford to sacrifice profits much more than it had previously because future prospects were looking brighter. An event study checking the impact of announcements of big donations (or, conversely, announcements of omissions from social rankings or surveys) is another matter for future empirical research.[81]

77. An effective signal is less prone to a "mixed-motivations" problem: outsiders perceive the expenditure not as an arbitrary cost (that is, a handicap signaling something), but rather as a cost incurred in order to generate intrinsic benefits to the signaler. When behavior is perceived to be intrinsically beneficial to the actor, it cannot be an effective costly signal. *Cf.* ERIC A. POSNER, LAW AND SOCIAL NORMS 11–35 (2000).

78. *See* DeAngelo et al., *supra* note 70, at 343–44; *id.* at 368 (noting that corporate signals must be considerable handicaps).

79. The emphasis is not only on "big" but also on "changes." CP policy of pursuing rigidly a rule of thumb like donating 1 percent of profits year after year will tell us less than unexpected changes.

80. *See 10,000 Women Brochure*, GOLDMAN SACHS, http://www2.goldmansachs.com/citizenship/10000women/10000-women-immersive/10000-women-brochure.pdf (last visited Mar. 23, 2012).

81. Of course, a positive stock price impact could be interpreted in many ways. The key in such a future study would thus be to identify the contrasting predictions. To simplify: a signaling-benefits hypothesis would predict a bigger impact in companies and industries that are more equity-dependent and where future prospects are more uncertain, while under the buying goodwill hypothesis, the benefits of being nice are unrelated to financial strength or to asymmetric information.

What is more, the perceived costs of explicit profit sacrifices are arguably greater relative to their absolute costs and to expenditures such as operational profit sacrifices. Managers of companies that fail to meet expectations will arguably be pressed to explain why they were so conspicuously generous with the company's dwindling resources, rather than to explain equivalent expenditures on greener modes of production or employees' conditions. In other words, ultra-discretionary expenditures on unrelated third parties, especially when the resources could have been easily deployed within the company, are likely to be perceived as meaningful handicaps even when their absolute size is small relative to other expenditures.

A related potential criticism would suggest that CP is not a reliable signal precisely because it is too discretionary. If insiders suffer no punishment when reducing the level of CP, then the value of the signal is eroded. To accommodate this limitation, we first need to understand that the stickiness of signals is not a binary matter. Indeed, signals need to have some level of stickiness[82] to be reliable because something removable at will is not a true handicap. But once this minimal threshold of stickiness is reached, the optimal level of stickiness varies according to many considerations. Do pro-social expenditures meet this stickiness threshold? While CP might be less sticky than other pro-social expenditures (such as reversing expenditures on employees' working conditions), anecdotal evidence indicates that there is a degree of asymmetric stickiness to CP. Managers enjoy much flexibility when deciding to initiate or raise CP levels, but there are perceived costs to omitting or dropping existing levels. For example, managers fear reputational sanctions and personal pressures from NGOs if the company drops its support. Social ratings by information intermediaries provide another commitment mechanism, because the stock market apparently punishes companies when their social ratings decrease.[83]

A fourth potential limitation of the signaling theory is that pro-sociality is not observable to outsiders in a timely and useful manner. Although this limitation applies more strongly to operational profit sacrificing than to CP—cash donations in particular are readily communicated and quantified—this is still a strong limitation. As mentioned, disclosure of CP is unregulated, and this creates an environment in which it is difficult for companies to reliably convey the relative level of their explicit pro-sociality.[84] Though lack of regulation is likely to reduce the benefits from signaling, it will not totally eliminate them. We should think of it as

82. "Stickiness" here denotes the tendency of decision makers to leave the level of an expenditure unchanged. The various considerations dictating the optimal level of stickiness from a signaling-efficacy point of view include, among other things, what message is conveyed (is it a transitory fixed change in underlying attributes?), and what other means are available to convey this message (increasing the dividend level?).

83. *See* Bénabou & Tirole, *supra* note 38, at 12 n.18; Interview with Bill Valentino, Vice President for CSR in China, Bayer, in Cambridge, Mass. (Oct. 6, 2010). To be sure, such an argument about the level of stickiness is speculative, and future event studies are still needed to establish it.

84. *See infra* Part IV.

creating conditions for some coarse signaling story: companies wishing to distinguish themselves can voluntarily disclose their conspicuous goodness in a wide and timely manner, but outsiders will be able to distinguish between companies based on their CP levels only when the differences across companies and time are great. Again, the conclusion is that the profit sacrifices most likely to generate signaling benefits are big changes, which are easily communicated to outsiders.

Having accommodated all those considerations,[85] we are now left with a limited, refined story of corporate pro-sociality as a signal to outside investors. Only sacrifices that are relatively significant in size, readily observable, and not easily reversed can be expected to serve as an effective signal.[86] Granted, these limitations confine the applicability of the signaling story to only a small number of actual CP decisions. Yet it is precisely those few large donations that are practically important; a small number of donations comprise the bulk of overall corporate giving expenditures and raise the most concerns.[87] The signaling-to-investors story is therefore relevant to the more significant and/or controversial cases of CP, and thus merits attention.

Furthermore, even when circumstances make the signaling-to-investors story unlikely, it is important to consider the asymmetric information perspective on pro-social expenditures. It could be that pro-sociality conveys other messages to other audiences. For example, product or employee release-time donations[88] might be ineffective signals to investors looking for information on future financial conditions, but they could serve as effective signals to employees looking for information on management's commitment to a certain corporate culture. It is these other sorts of signaling stories—signaling to non-financial stakeholders—to which this Article now turns.

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85. There is another, generic objection that was not addressed here. Corporate signaling models rely on twin assumptions: not only asymmetric information, but also short-termism. That is, managers are assumed to care about current stock prices and not just about finite value. If they cared only about finite value, then they would have no reason to incur the costs of signaling to convey information that will be eventually reflected in stock prices anyhow. Against these twin assumptions, the argument goes, why can shareholders not contract with managers to reduce incentives to engage in costly signaling? *See generally* Philip H. Dybvig & Jaime F. Zender, *Capital Structure and Dividend Irrelevance with Asymmetric Information*, 4 REV. FIN. STUD. 201, 204–15 (1991). The answers to this generic objection are well developed in the finance literature, and I defer to them. *See, e.g.*, Lucian Arye Bebchuk & Lars A. Stole, *Do Short-Term Objectives Lead to Under- or Overinvestment in Long-Term Projects?*, 48 J. FIN. 719, 722 n.6 (1993).

86. Additionally, alternative non-pro-social signals should be somewhat cost-accelerating or noisy.

87. *See* REPORT OF THE STAFF OF THE DIVISION OF CORPORATE FINANCE OF THE U.S. SECURITIES AND EXCHANGE COMMISSION ON H.R. 887 REGARDING DISCLOSURE OF CHARITABLE CONTRIBUTIONS 32 (May 2009), *reprinted in Increasing Disclosure to Benefit Investors: Hearing on H.R. 887 and H.R. 1089 Before the Subcomm. on Fin. & Hazardous Materials of the H. Comm. on Commerce*, 106th Cong. 90 (1999) [hereinafter *Increasing Disclosure to Benefit Investors*].

88. *See supra* note 14 and accompanying text.

C. Other Possible Stories: Signaling Product Quality or Workplace Attractiveness

In order to flesh out the plausibility of benefits arising from signaling in corporate pro-sociality, I used a specific example of conveying messages to investors about financial strength.[89] To my knowledge, this is the first attempt to describe value-enhancing aspects of CP in this way. But pro-sociality in general, and CP in particular, can also have other informational contents and target audiences. This section addresses those different signaling stories. First, I discuss the few previous accounts of signaling that are found in the management and finance literature, in which CP is studied as conveying messages to customers or employees. Then, I sketch another possibility of signaling to investors, which conveys the riskiness of future cash flows.

According to a signaling-to-customers story, high levels of CP convey information about the quality of the firm's product.[90] The model assumes two types of entrepreneurs. One type has other-regarding preferences, and thus cares about externalities, and the other type lacks those preferences and cares only about profits. For the other-regarding types, sacrificing profits is less costly, as they gain warm glow by refraining from externalities. By contrast, for the purely profit-motivated entrepreneurs, CP is a total sacrifice. Accordingly, the model assumes that when customers observe a company engaging in higher CP levels than its competitors, they infer that insiders in this company will be more averse to sacrifice unobservable qualities of products than their competitors are (because sacrificing product quality will generate externalities, which will in turn decrease the other-regarding entrepreneur's utility). This theory addresses some of the flaws in the delegated philanthropy accounts. It argues that CP is value-enhancing not because it satisfies customers' preferences for nice companies, but rather because it mitigates informational gaps about attributes relevant to the company's line of business.

While this general direction of inquiry is worthy, in my opinion, the specifics of this signaling-to-customers theory rests on some shaky assumptions. First, just like delegated philanthropy explanations, the signaling-to-customers theory assumes that charitable preferences drive corporate behavior—only here, the preferences are those of entrepreneurs rather than consumers. Such an assumption might be plausible in manager-owned, small companies where the entrepreneur is tantamount to the company, but it is less plausible for large impersonal corporations.[91] Second, the theory assumes that information on CP levels can be easily observed and compared by customers who make purchases accordingly, but

89. *See supra* Part II.A.

90. *See* Fisman et al., *supra* note 42 (setting out a model); *see also* Donald S. Siegel & Donald F. Vitaliano, *An Empirical Analysis of the Strategic Use of Corporate Social Responsibility*, 16 J. ECON. & MGMT. STRATEGY 773 (2007) (empirical testing of the model).

91. Moreover, firms could simply select managers with charitable preferences, thus gaining a competitive advantage.

recent empirical studies suggest that consumers' awareness of CP policies is actually low.[92]

Another possibility for pro-sociality to generate signaling benefits is through attracting high-quality employees. Proponents of the profit-enhancing approach frequently argue that one of CP's benefits is decreased costs of labor, but they do not adequately articulate the mechanisms that supposedly cause this. A "delegated philanthropy" mechanism—suggesting that employees' morale gets a boost from working for nice companies—is problematic for the reasons mentioned above, and a "better-image" mechanism—suggesting that a company's "niceness" gives it a better image as a workplace—is merely a starting point for analysis. Instead, the question is: how exactly is CP associated with working conditions?

This relates to the puzzling empirical pattern discussed above: job applicants preferred pro-social companies regardless of how they felt about pro-sociality itself.[93] So what did the level of pro-sociality teach applicants about the company? For one, pro-sociality could have sent a message about a "cooperative" corporate culture. High pro-sociality suggests that the top management is committed to being not only profit-hungry, but also other-regarding. Donating managers will thus be seen as more likely to continue to engage in "gift-exchange" relationships with employees in the future. More generally, explicit profit sacrificing can serve as a credible and visible commitment to a certain corporate culture, thus helping to generate efficient assortative matching (that is, attracting job applicants who will fit the company).[94] One implication of these hypotheses is that benefits arising from signaling to employees will be more relevant in high-quality labor industries, and so in those industries we should expect more CP, all else being equal. Perhaps it is yet another factor explaining the dominance of pharmaceutical and technology companies among the largest corporate donors.

To return to investor signaling, big increases in CP can convey fundamental information not only about the level of future free cash flows, but also about systematic decreases in riskiness of future cash flows, thus updating the denominator rather than the numerator in the discounted cash flow formula. When projections of cash flows become less risky, insiders can make better assessments of their future opportunities and opportunity

92. *See, e.g.*, Sen et al., *supra* note 45, at 164.

93. *See generally* Greening & Turban, *supra* note 61.

94. The emphases are on credibility and visibility. Existing signaling-to-employees stories do not account adequately for issues such as mimicry; if management can reduce labor costs at will simply by denoting certain organizational values, why do we not observe every company doing so? Regarding visibility, for a corporate culture to attract outsiders, it needs to be visible to those not experiencing it; hence, there must be some observable symbols associated with certain cultures. *See* George A. Akerlof, *Labor Contracts as Partial Gift Exchange*, 97 Q.J. ECON. 543 (1982) (discussing the gift-exchange aspect of corporate culture); Colin F. Camerer & Ulrike Malmendier, *Behavioral Economics of Organizations*, *in* BEHAVIORAL ECONOMICS AND ITS APPLICATIONS 235, 255 (Peter Diamond & Hannu Vartiainen eds., 2007) (noting that corporate culture plays a role in assortative matching).

costs, and can thus better maximize the level of pro-social sacrifices—they need less cash buffers. In this respect, pro-sociality could mitigate asymmetric information about changes along the life cycles of organizations and managerial reactions to those changes.[95]

D. Adding Complexity

After sketching the contours of a basic signaling explanation to corporate pro-sociality, I can introduce additional layers of complexity, such as the choice between pro-social and wasteful signals, the possibility for errors in signaling, and costs from attracting the wrong reaction.

A necessary condition for costly signaling is that the behavior will be costly to the signaler. But nothing in the model requires the behavior to actually benefit others. The handicap can be pro-social, but it can just as well be wasteful (as in conspicuous consumption). A fuller analysis should thus account for conditions under which pro-social signals are more effective than wasteful ones. For example, if receivers have preferences for pro-social displays and if such displays receive greater attention (known as "broadcast efficiency"), then the signaler should prefer them to wasteful handicaps.[96] The choice of signals also has policy implications. Society might be better off when corporate signaling is done via pro-social handicaps, rather than wasteful ones—think donations versus gold-embroidered shower curtains.[97]

It is also important to take fuller account of errors in signaling communication. We have already mentioned that receivers are error-prone when perceiving signals in noisy environments. Signalers can be error-prone, too. For example, corporate managers might be overly optimistic. When deciding CP levels based on their upwardly biased perception of future prospects, managers might "advertise" too much, that is, engage in too much CP.[98] A bias in forecasting future cash flows erodes the value of the signal and at some point the signaling stops being informative. Therefore, the corporate context, with its noisy environments and over-

95. *Cf.* Gustavo Grullon et al., *Are Dividend Changes a Sign of Firm Maturity?*, 75 J. BUS. 387 (2002) (payout policy as signaling risk); Marc Orlitzky & John D. Benjamin, *Corporate Social Performance and Firm Risk: A Meta-analytic Review*, 40 BUS. & SOC'Y 369, 376 (2001); Van Der Laan et al., *supra* note 33, at 308 (noting that we need to explore the effects of organizational life cycles on CP).

96. *See* Gintis et al., *supra* note 68, at 112–15. As applied here, the choice between different signals is perhaps where the "delegated philanthropy" consideration kicks in, as (only) a second-order influence. Companies sacrifice profits to signal their ability to procure resources, and they do so by being nice, rather than being wasteful, because their audiences prefer interacting with nicer companies.

97. *Cf.* Ernst Fehr & Urs Fischbacher, *The Nature of Human Altruism*, 425 NATURE 785, 789 (2003); Geoffrey F. Miller, *The Handicap Principle: A Missing Piece of Darwin's Puzzle*, 19 EVOLUTION & HUM. BEHAV. 343, 347 (1998) (reviewing ZAHAVI & ZAHAVI, *supra* note 68).

98. On managerial over-optimism in general, see J.B. Heaton, *Managerial Optimism and Corporate Finance*, 31 FIN. MGMT. 33, 39–40 (2002). For an analogy from the dividend-signaling literature, see generally DeAngelo et al., *supra* note 70.

optimistic signalers, necessitates a thorough understanding of the extent of errors in signaling.

Finally, future research could also consider the possibility of another type of cost to the signaler—namely, attracting an unintended observer or provoking an unintended reaction from target audiences. Explicit profit sacrificing is conspicuous, and conspicuousness can attract predators who think that the signaler has too much waste.[99] Consider activist hedge funds. When such predators observe a company increasing its profit sacrificing, they may decide to target the company because of the slack it obviously possesses. Regardless of whether activist hedge funds are beneficial to overall welfare, incumbent managers usually want to avoid attracting them. Indeed, insiders worried about attracting hedge funds could be pushed to choose suboptimal signaling levels ex ante. Future empirical research could try to shed light on this speculation by examining, for example, whether changes in CP policies attract certain investors.

E. Fit with Evidence

The story thus far has been hypotheses-generating rather than hypotheses-testing. Future empirical research could further refine and/or discredit the logic suggested here. In particular, as signaling is being judged based on eliciting behavioral responses from receivers, we should study stock market reactions to unexpected announcements of big changes in CP policy. Until such systematic data are available, though, we could look at the congruence between our theory and patterns already identified, to assess the plausibility of benefits arising from signaling. The signaling-cash-flows version, for example, predicts a higher level of CP in companies and industries where future free cash flows are less readily observable by outsiders, free cash is perceived to be good for the company,[100] and other channels for signaling cash flows are blocked or too costly. Do these predictions fit with the patterns observed?

As firm-specific data are scarce, we resort to indications at the industry level. The fact that pharmaceuticals and technology companies are among the largest donors is consistent with these predictions.[101] Those companies rely relatively heavily on external finance, which is costly for various reasons. Their future cash flows depend on technological and medical innovations not easily observable by outsiders, their tangible assets contribute little to firm value, and their earnings are more opaque. Other factors necessitate maintaining a relatively large cash buffer: long gestation periods of products (for example, pushing a new drug through the FDA

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99. *See generally* Hebets & Papaj, *supra* note 70.

100. Excess cash could be evaluated positively or negatively by investors. It depends on firm- and industry-related factors, like the relative importance of mitigating risk, preserving financial flexibility, or avoiding underinvestment. It also depends on how investors expect this cash to be used by insiders. Free cash is prone to be turned into private benefits. *See* Stewart C. Myers & Raghuram G. Rajan, *The Paradox of Liquidity*, 113 Q.J. ECON. 733 (1998).

101. *See supra* notes 12–14 and accompanying text.

approval stages) and volatility of earnings generate a great need for finance before the company's own cash flows become more verifiable.[102] Uncommitted, internal sources of finance like free cash could thus be especially valuable.

These observations are indicative at best.[103] What else have we to show for the signaling story predictions? One especially notable empirical pattern arising from meta-analyses is that CP—the most discretionary, explicit form of profit sacrificing—has a stronger association with financial performance than other corporate social performance expenditures. It is difficult to reconcile this pattern with existing theories. For example, under the delegated philanthropy story, corporations are better positioned to cater to charitable preferences only when good deeds are intertwined with production, and so operational profit sacrificing should be associated with profits more strongly than CP.[104] Similarly, under the managerial utility explanation, the most discretionary expenditure is supposed to be the most susceptible to managerial abuse, and so CP is expected to be less strongly associated with good financial performance.[105]

The signaling story, by contrast, fits this empirical pattern. A signal has to be clearly communicated, quantifiable, and perceived to be handicapping with few intrinsic benefits. Cash donations are more effective signals than operational profit-sacrifices; they are more easily communicated and quantifiable to outsiders. Moreover, the fact that they benefit unrelated third parties (i.e., are more explicit sacrifices) means that they are perceived as greater handicaps than operational sacrifices.

Another puzzling empirical pattern is the dominance of cash over in-kind donations. Traditional profit-enhancing theories predict that in-kind donations would yield better results than cash donations in terms of tax advantages, better bundling of warm glow with intrinsic utility, and stronger consumer preferences.[106] Yet the opposite is observed: cash donations generate better reputational payoffs.[107] Why? This Article proposes that some of the value enhancement comes from signaling: cash donations are more effective signals because they are easily observable and less open to interpretation.[108]

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102. Indeed, Brown et al., *supra* note 21, at 867, mention volatility of earnings as one of the predictors of industry variance in CP. On the relatively greater dependency on external capital in those industries, compare Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559, 566 tbl.1 (1998).

103. The facts can also be explained through non-signaling stories. For example, tax laws favor product donations by the technology and pharmaceutical industries. *See* Sugin, *supra* note 44, at 157.

104. *See supra* Part I.A.2.

105. *Cf.* Myers & Rajan, *supra* note 100 (noting that free cash is more susceptible to managerial abuse).

106. *See* Sugin, *supra* note 44, at 156–57 (noting tax advantages); *supra* note 44 and accompanying text (noting consumer preferences).

107. *See, e.g.*, Stephen Brammer & Andrew Millington, *Corporate Reputation and Philanthropy: An Empirical Analysis*, 61 J. BUS. ETHICS 29 (2005) (a UK study).

108. One could claim that managers choose cash over product donations because it allows them to reap private benefits more effectively, compare Bartkus et al., *supra* note 21, at 329,

Importantly, these patterns do not provide conclusive evidence in favor of the signaling story. Causation between CP and corporate financial performance is more complex, and alternative explanations also fit these empirical patterns. Yet those patterns are indications that existing theories do not fully capture the drivers and consequences of CP, and that pursuing the signaling angle could lead to a more comprehensive account.[109] Furthermore, I do not suggest that by simply raising their pro-sociality, firms can compel outsiders to immediately upgrade their evaluations of the firm. As with dividends and other corporate signaling mechanisms, pro-sociality is probably only a "'punctuation mark' at the end of the sentence"[110]: if companies are doing well financially and communicating well by other means (for example, managerial forecasts), then an increase in pro-sociality can add an extra punch to the message delivered. My argument is thus modest: among other benefits stemming from pro-sociality, big changes in donations might also increase the probability that outsiders will perceive a firm's fundamentals to be better than they previously thought.

III. CORPORATE PHILANTHROPY AS A CO-OPTATION MECHANISM

The previous part sought a better understanding of the positive side of CP: how CP is good for the company. This part seeks a better understanding of the negative side: how CP can also be bad for the company. It is generally accepted that pro-social profit sacrificing is driven to some extent by managerial utility considerations. The debate is over the extent to which those considerations drive it and the implications. Yet, both sides of the debate often downplay an important distinction that this part emphasizes: the distinction between profit-sacrificing expenditures that merely reflect agency costs, and those that actually generate more agency costs.

The basic logic here is intuitive. If managers enjoy wide discretion to sacrifice profits and can use this discretion to further their own interests, then they can also use it to entrench themselves and weaken the mechanisms that monitor them, generating more agency costs.[111] The

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but such an argument does not explain why cash donations yield better reputational payoffs for the company.

109. A general clarification: the signaling explanation is not meant to be exhaustive. CP behavior cannot be explained under a single theory. These are context-sensitive decisions, influenced also by individuals' values. CP policies can simultaneously contain agency problems, buying goodwill, and costly signaling aspects. Theories of CP should thus be conditional, not general. Moreover, given the dynamic character of corporate signaling, any signaling explanation might become anachronistic, fit only to describe the historical evolution. For example, the recent trend of managers voluntarily issuing cash flow forecasts could reduce the need to use costly signals to convey cash flow information. *See generally* Charles E. Wasley & Joanna Shuang Wu, *Why Do Managers Voluntarily Issue Cash Flow Forecasts?*, 44 J. ACCT. RES. 389 (2006). We thus need to consistently reevaluate the fit of evidence with the signaling theory predictions.

110. *Cf.* Brav et al., *supra* note 71, at 512.

111. An implicit assumption here is that markets are somewhat limited in constraining managers.

question, then, is not whether managers can abuse CP in such ways, but rather whether managers want to do so. Is profit sacrificing really an effective means to the supposed end of weakening corporate governance? Logic, anecdotal observations, and recent empirical studies suggest several reasons to answer this question in the affirmative. CP money can be used by managers as mechanisms to co-opt independent directors, influence politicians, and entrench themselves by allying with activist stakeholders.

Before I begin to explore those mechanisms in detail, let me illustrate the distinction between problem-reflecting and problem-generating CP with two infamous cases, Occidental Petroleum Co. (Oxy) and Enron. Oxy donated more than $85 million (a third of its annual profits) to a museum named after Armand Hammer, its soon-to-retire CEO. Enron was much more modest; the company donated between $1 and $2 million to a medical center headed by a member of the board audit committee, and several hundred thousand to a think tank that employed another independent director.[112] Usually, agency explanations of CP lump both instances together. In both cases, decision makers used discretion over corporate profit-sacrificing money to satisfy the preferences of top management. Seen from this angle, the Oxy case is much more detrimental to company and shareholder interests simply because the sacrifice is larger.

But is it really more problematic? In Oxy's case, the donation was disclosed, as the amount was material enough to mandate disclosure under the securities laws.[113] No adverse impact on stock prices was observed when the sacrifice was announced,[114] perhaps because the market already anticipated that Armand Hammer controlled the board and could pass decisions on whatever other types of profit sacrificing that he pleased. Arguably, no agency costs were created because of this donation; it only reflected existing agency costs.

By contrast, Enron consistently pursued a CP policy that undermined the checks and balances on corporate governance. Perhaps not surprisingly, its donations were not disclosed. The direct hit to the financial bottom line from those donations was insignificant, but what mattered more than the levels of the donations were the targets of the donations. The choice of targets made it somewhat less likely that the CEO would be asked tough questions later. In my view, these latter types of donations represent a corporate governance problem justifying legal intervention even more than the former type of pure self-aggrandizement.

To understand why this distinction is not trivial, it is important to understand the generic "fixed appropriation" objection to critical agency

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112. *See generally* Kahn v. Sullivan, 594 A.2d 48 (Del. 1991) (containing an analysis of the Oxy CP decision); Stuart L. Gillan & John D. Martin, *Financial Engineering, Corporate Governance, and the Collapse of Enron* 49 tbl.6 (Univ. of Del. Coll. of Bus. & Econ., Working Paper No. 2002-001, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354040 (listing examples of Enron's CP policy).

113. Disclosure of the donation likely would have occurred in any event, as building a museum in your name is not something you could or would want to hide.

114. *See* R. Franklin Balotti & James J. Hanks, Jr., *Giving at the Office: A Reappraisal of Charitable Contributions by Corporations*, 54 BUS. LAW. 965, 990 n.161 (1999).

costs accounts of CP. One could argue that managerial discretion to engage in CP, even when translated into value diversion (for example, pet charities), does not really hurt shareholders. The key assumption in such an argument is that managerial discretion is capped by market and/or contractual mechanisms, such that increased use of discretion to sacrifice profits pro-socially will come at the expense of other managerial expenditures, such as executive pay and perks. Any benefits that managers achieve through CP will offset other forms of managerial appropriation.[115] The fixed appropriation argument is assailable: compensating managers with discretion over CP is ineffective; value diversion is not really neutral because it generates perverse effects on managerial efforts (incentives); and allowing additional channels for value diversion increases managerial agency costs, because more channels for appropriation increase the difficulty of tracking and capping managerial abuse.[116]

This Article emphasizes a different rebuttal: managerial discretion in an unregulated channel like CP can be used to co-opt those in charge of monitoring. Like the previous rebuttals, my argument challenges the assumption that agency costs are capped regardless of the value diversion method. Unlike the previous rebuttals, my argument stresses that monitors will find it more difficult subjectively (not only objectively) to cap managerial agency costs when also having to track the unregulated CP channel, because monitors will be reluctant to constrain managers when the latter donate to the monitors' preferred charities.

There are three channels through which CP can generate agency costs. First, there is a possibility that CP money will be used to co-opt board independence. This possibility was mentioned in the legal literature when alluding to Enron's paradigmatic case,[117] but this pattern is not limited to Enron. Look to other post-mortem analyses of failed governance mechanisms and you are likely to find that one of the tactics top management used to co-opt the board is donations to independent directors' pet charities. Ross Johnson did it at RJR Nabisco,[118] Conrad Black at Hollinger,[119] and Dennis Kozlowski at Tyco,[120] to name but a few. To be

115. *See, e.g.*, Elhauge, *supra* note 3, at 835–39.

116. *See* Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J.L. ECON. & ORG. 487 (1999); David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587 (2005); Symposium, *supra* note 53, at 1321. It was also pointed out that the view of CP as merely another form of executive compensation does not fit with current laws. CP is not subject to the same tax and disclosure laws as executive compensation. *See id.* at 1327 (discussing disclosure obligations). I can add anecdotally that such a concept is also inconsistent with practice; a leading executive compensation attorney noted that his clients do not consider the level of discretion over pro-social expenditures when negotiating their pay. Interview with Joseph Bachelder, Founder and Senior Partner, Bachelder Law Firm, in Cambridge, Mass. (Nov. 2008).

117. *See, e.g.*, Mark J. Roe, *On Sacrificing Profits in the Public Interest*, *in* ENVIRONMENTAL PROTECTION AND THE SOCIAL RESPONSIBILITY OF FIRMS 88, 96–97 (Bruce L. Hay et al. eds., 2005).

118. *See* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE 82, 97 (1990).

119. *See* REPORT OF INVESTIGATION BY THE SPECIAL COMMITTEE OF THE BOARD OF DIRECTORS OF HOLLINGER INTERNATIONAL INC. 409–25 (Aug. 30, 2004), *available at* http://www.sec.gov/Archives/edgar/data/868512/000095012304010413/y01437exv99w2.

sure, abuse of CP was not the main cause of corporate governance failures in those companies. But even a minor contribution to such colossal governance failures may be important enough to justify consideration by policy makers.

Critics could suggest that these are only anecdotes, and that there is no systematic evidence showing that such misuses of CP are meaningful enough to merit attention. Still, we cannot expect to find systematic evidence of abuses when no mandatory disclosure is required. Insiders will not voluntarily disclose such details, and so the dirty laundry will be aired in public only when post-mortem investigations generate access to the company's books.[121] As board independence increasingly becomes a governance panacea, the attractiveness of CP as an implicit channel to influence directors without losing their "independent" tag will probably only increase.[122]

A second mechanism that makes CP a corporate governance issue is the use of money designated as CP to influence politics. The ability and willingness of corporations to use CP in politics is especially relevant today. In the aftermath of the *Citizens United v. FEC*[123] decision, there has been a lively discussion in Congress, the SEC, and legal academia on the need to introduce protective mechanisms for explicit political spending. Not enough attention, however, has been directed to the possibility of bypassing protective mechanisms through corporate donations to tax-exempt "charitable" organizations that serve as conduits for political influence; that is, implicit political spending. CP is relatively unregulated, so managers have incentives to couch political spending as CP in order to evade restrictions on explicit political donations. The means exist to effectuate this managerial will. While I.R.C. § 501(c)(3) non-profit organizations may not legally engage in political activity, there is ample room to characterize political activity as "educational," thus maintaining an organization's tax-exempt status. Two notable ways to engage in politicized CP are: first, funding think-tanks that qualify as educational organizations while de facto supporting very specific policies or politicians; and second, supporting classic advocacy organizations (also known as § 501(c)(4) organizations) with CP money, through the "c3/c4 split" (i.e., lobbying organizations establishing a complementary tax-exempt entity that is heavily funded by corporations).[124]

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htm. The report accuses Black of two categories of misuse of CP: as self-aggrandizement, for example, by attributing company donations to himself, thus usurping public credit, *see id.* at 415 tbl.14; and as a co-optation device, for example, by donating to independent directors' pet charities, *see id.* at 419 tbl.15.

120. Michael J. Bohnen & David M. Phillips, *Corporate Gifts Should Be Disclosed*, CHRON. PHILANTHROPY, Mar. 21, 2002, at 39.

121. *Compare* Blair, *supra* note 50, at 45–47 (reports of managerial abuse are isolated anecdotes), *with* Barnard, *supra* note 17, at 1163–64 (reports are "illustrative of [a] dark side").

122. *See* BEBCHUK & FRIED, *supra* note 57, at 29.

123. 130 S. Ct. 876 (2010).

124. For a detailed analysis of the distinction between explicit and implicit political influence, see Frances R. Hill, *Corporate Philanthropy and Campaign Finance: Exempt*

Such uses of CP money are obviously an issue for campaign finance laws, but they might also be a corporate governance problem. To be sure, political donations are not necessarily bad for shareholders. If insiders use their clout over politicians to further favorable policies, then shareholders may actually value the purchase of political clout with CP money.[125] The point here is that political donations can also be used to further narrow, managerial interests, such as lowering investor protection.[126]

Consider the case of managerial lobbying for corporate laws that are not necessarily in shareholders' interests: anti-takeover legislation. The legal literature took note of the influence managers had in pushing for those laws, but it ignored *how* managers influenced politics, particularly the role CP played as part of the "influence technology" of managers. For example, when Dayton Hudson, a Minnesota corporation, became a target for takeover in 1987, the managers convinced the state to hold a special legislative session where the company's charitable record was used as consideration for enacting a new anti-takeover bill.[127] More generally, funding certain think tanks and indirectly funding lobbying organizations translate into promoting management-friendly laws, such as hurdles on shareholder litigation and lobbying against increased transparency requirements and shareholder involvement. Indeed, a recent empirical study found that explicit political spending affects shareholder value negatively.[128] Perhaps implicit political spending, via CP that is done without public scrutiny, is at least as detrimental to shareholders.

A third, less intuitive use of CP to generate further agency costs is as a subtle anti-takeover mechanism. This argument was recently made

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Organizations as Corporate-Candidate Conduits, 41 N.Y.L. SCH. L. REV. 881, 908–11, 922 n.197, 928 (1997). For detailed examples of politicized CP, see Kahn, *supra* note 55, at 636–62. For a theoretical account, see generally STEVEN R. NEIHEISEL, CORPORATE STRATEGY AND THE POLITICS OF GOODWILL (1994). For examples of lobbying organizations that are heavily funded by corporate donations, see Bebchuk & Jackson, *supra* note 5, at 93–95.

125. Indeed, one could cite evidence that firms in regulated industries give more to support claims that politicized CP is profit-driven. *See* Brown et al., *supra* note 21, at 872. From the point of view of diversified shareholders, however, corporate rent-seeking is not necessarily good; it might simply redistribute wealth from one company to another with deadweight losses. *Cf.* Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1117 (2002).

126. There is no evidence suggesting that such misuses take place on a meaningful level, as is perhaps expected given the lack of a disclosure requirement, but anecdotal evidence suggests that this is a real possibility worthy of further research.

127. On managerial-driven anti-takeover legislation, including the Dayton Hudson example, see MARK J. ROE, STRONG MANAGERS, WEAK OWNERS ch. 10 (1994). For an elaborate discussion on the role that Dayton Hudson's CP policy played in influencing the legislation, see HARVARD BUS. SCH. CASE STUDY NO. 9-391-403, DAYTON HUDSON CORPORATION: CONSCIENCE AND CONTROL (A, B, C) (1990). See other examples at Faith Stevelman Kahn, *Legislatures, Courts and the SEC: Reflections on Silence and Power in Corporate and Securities Law*, 41 N.Y.L. SCH. L. REV. 1107, 1140 n.126 (1997) [hereinafter Kahn, *Reflections*]; Kahn, *supra* note 55, at 633–34.

128. John C. Coates, IV, *Corporate Governance and Corporate Political Activity: What Effect Will* Citizens United *Have on Shareholder Wealth?* (Harvard Law and Econ. Discussion Paper No. 684, 2010), *available at* http://ssrn.com/abstract=1680861.

regarding corporate social responsibility in general. Managers invest strategically in profit sacrificing in order to gain support from activists, such as consumer groups or public pension funds. Those activists are then expected to return the favor by reducing the probability of CEO turnover. Even if a potential raider can increase a company's value, activist stakeholders will have incentives to keep incumbent managers in place, as long as incumbents credibly commit to continue investing in specific social or environmental issues. Activists can use non-conventional "voice" mechanisms—mounting a media campaign, threatening boycotts, or using their political clout—to support incumbents and fend off takeovers. Initial empirical evidence lends support to the pro-sociality as entrenchment hypothesis.[129]

For purposes of this Article, the question is whether sacrificing profits to gain personal favor with activists applies not only to operational profit sacrificing but also to CP. Anecdotal evidence suggests that it does. In the Minnesota anti-takeover bill, for example, Dayton Hudson's CP policy was not merely touted as valuable; the incumbents also called upon the company's grantees—apparently key players in the state—to help promote managerial lobbying efforts.[130] More generally, the question is: can incumbents commit to a specific CP policy that is favored by activists better than insurgents can?[131] If the answer is yes, then CP can reduce CEO turnover to a suboptimal level, and the case for legal intervention in CP is thereby strengthened.[132] Possible mechanisms to credibly commit to specific CP policies include sitting on boards of specific NGOs, or getting highly involved in the social circles of NGO leaders.[133]

Viewed as a co-optation mechanism and not merely a managerial perk, CP can explain why firms with independent boards donate more.[134] If profit sacrificing is a managerial perk, then arguably managers who are monitored by independent boards should engage in it less. But if CP is not only self-aggrandizing but also entrenching, then managerial-driven CP should only increase when internal governance is stronger (for example, when boards are more independent). Under a greater internal threat to their

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129. *See generally* Giovanni Cespa & Giacinta Cestone, *Corporate Social Responsibility and Managerial Entrenchment*, 16 J. ECON. & MGMT. STRATEGY 741 (2007) (setting a model); Surroca & Tribó, *supra* note 22 (empirical testing of the model). *But cf.* Annita Florou, *Discussion of Managerial Entrenchment and Corporate Social Performance*, 35 J. BUS. FIN. & ACCT. 790, 791–92 (2008) (noting that limitations and directions future research will need to explore in order to increase the applicability of said empirical tests).

130. *See* JEROME L. HIMMELSTEIN, LOOKING GOOD AND DOING GOOD: CORPORATE PHILANTHROPY AND CORPORATE POWER 129 (1997).

131. While it might be intuitive to think that incumbents can make manager-specific investments in operational pro-sociality that make them valuable for stakeholders (for example, specializing in a particular green mode of production), it is less clear how managers can commit to being "better" at CP than those who want to replace them.

132. *See infra* Part IV.

133. As was indeed the case in the Twin Cities. *Cf.* Joseph Galaskiewicz, *An Urban Grants Economy Revisited: Corporate Charitable Contributions in the Twin Cities, 1979-81, 1987-89*, 42 ADMIN. SCI. Q. 445 (1997).

134. *See supra* Part I.A.3.

authority, managers need to invest more in maintaining influence (a demand-side explanation). Unregulated managerial discretion over pro-social expenditures is therefore more likely to be used in such contexts as another tool to influence key players, whose support managers need more when threatened from within.

Indeed, a recent study found that managerial entrenchment is positively correlated with corporate social performance levels and that this effect is more strongly pronounced when the internal governance mechanisms (such as board monitoring) are strong.[135] This pattern suggests that managers who need to use explicit anti-takeover measures to fend off external governance threats also use pro-sociality as implicit anti-takeover measures to fend off internal governance threats.[136] While more robust evidence is needed on the potential channels for managers to use profit sacrificing to relax constraints, it seems that there is already enough to raise concerns and necessitate a rethinking of the legal implications.

IV. THE CASE FOR DISCLOSURE

A. *The Current Legal Landscape*

The current legal control of CP has been reviewed extensively elsewhere.[137] This section summarizes legal regulation of CP, with subsequent sections more fully evaluating current and proposed laws.

Every state has a statute explicitly granting corporations the power to engage in CP.[138] But such statutes provide little guidance. How do we determine whether this power is exercised properly? The common law answer evolved in a way that allows wide discretion for managers in making CP decisions.[139] The courts suppose that donations are done with some long-term benefit for the company in mind.[140] As no direct benefit is required, managers can practically always justify profit sacrifices by alluding to some indirect benefit. The only constraint on CP in Delaware law is that the donation should be reasonable. "Reasonable" is interpreted extremely broadly; as long as the donation meets the criteria for tax deduction, it will not be questioned.[141]

This brings us to tax law's treatment of CP. I.R.C. § 170 allows a tax deduction for CP, effectively reducing its costs at the rate of the top marginal income tax of the company. Donations qualify for deduction under § 170 as long as they meet three criteria: they must be no bigger than

135. *See* Surroca & Tribó, *supra* note 22, at 748–49.

136. *See generally* Maretno A. Harjoto & Hoje Jo, *Corporate Governance and CSR Nexus*, 100 J. BUS. ETHICS 45 (2011) (analyzing the association between entrenchment indices and corporate social performance); Surroca & Tribó, *supra* note 22.

137. *See, e.g.*, Elhauge, *supra* note 3; Kahn, *supra* note 55.

138. *See* Elhauge, *supra* note 3, at 867–68.

139. *See, e.g.*, Kahn v. Sullivan, 594 A.2d 48 (Del. 1991); Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969); A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J. 1953); Union Pac. R.R. v. Trustees, Inc., 329 P.2d 398 (Utah 1958).

140. *See, e.g.*, *A.P. Smith Mfg.*, 98 A.2d at 590.

141. *See Theodora Holding Corp.*, 257 A.2d at 405.

10 percent of taxable income, made to a recognized 501(c)(3) organization, and intended as a "gift," defined as being made without expectation of quid pro quo.[142] Essentially, the current legal approach is a hybrid: corporate law authorities allow donations by invoking a long-term benefits explanation, while tax authorities allow donations by invoking an altruistic explanation.

Aside from tax laws, CP is not subject to significant federal regulation. In particular, CP is not subject to a specific disclosure requirement. It is not captured by the general disclosure criteria either; because donations are almost never significant in terms of their size relative to the company's resources, they are not captured by the materiality requirements of the securities laws or accounting standards (while expenditures will be reflected in the overall balance, they will not be itemized separately in financial reports).[143] Furthermore, shareholders cannot use their rights of access to information to learn about CP.[144] Still, there is some limited treatment of "interested" donations: the New York Stock Exchange listing rules demand that a listed company that donates over one million dollars to a tax-exempt organization affiliated with an independent director must disclose this contribution.[145] Delaware courts have indirectly addressed this issue as well. When analyzing the independence of special litigation committee members, the Delaware Chancery has considered philanthropic ties between the company and the CP recipient institution employing the directors.[146]

A summary of CP laws would not be complete without alluding to the related, timely issue of corporate political donation laws. *Citizens United*

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142. Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, The Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1, 35–45 (1994).

143. *See* Balotti & Hanks, *supra* note 114, at 989; Kahn, *supra* note 55, at 582–83 nn.7–8. There are exceptions where CP is counted as part of executive compensation, as in "director[s'] legacies" contributions. *See id.* at 610–11, 624.

144. Narrow interpretation of such statutory rights deems them inapplicable for attaining CP information. *See* Kahn, *Reflections*, *supra* note 127, at 1132–33; Benjamin E. Ladd, Note, *A Devil Disguised as a Corporate Angel?: Questioning Corporate Charitable Contributions to "Independent" Directors' Organizations*, 46 WM. & MARY L. REV. 2153, 2187 n.196 (2005).

145. *See* NYSE, INC., LISTED COMPANY MANUAL § 303A.02(b), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F. Note that this is a watered-down version, an exception to the criterion for "independence": if a company engages with the director's business organization in a transaction of the magnitude of one million dollars (or 2 percent of the organization's revenues), then the director is no longer considered "independent." But if similar amounts are being transferred by the company to the director's charitable organization, the director is still considered independent. The NASDAQ listing rules are more stringent in this respect. *See* Ladd, *supra* note 144, at 2169–70 (also analyzing the main limitations of such regulations, including ineffective enforcement and the possibility of side-stepping the rules). For more on the unwillingness of stock exchanges to enforce such issues, see Lin, *supra* note 27, at 29 n.115 and accompanying text. I have researched NYSE filings and have not located a single case of disclosure of such an interested donation. Several companies regularly report explicitly that no such donation was made.

146. *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 932–33 (Del. Ch. 2003). While this case signals that courts see CP ties as an issue, without mandatory disclosure the possibility to deter interested CP ex ante is limited. *See infra* Part IV.B.

relaxed the historical ban on political donations.[147] In the wake of this decision, proposals are now before Congress to significantly regulate political donations. The logic is that once historic bans are removed, managers cannot be left with unfettered discretion as if political donations were ordinary business expenditures; rather, mechanisms need to be put in place that will protect shareholders' interests.[148] Thus, the discussion of "regular" donations can inform the discussion of explicit corporate political spending, and vice versa.

B. Evaluating Current and Proposed Laws

As noted, CP practices exist in a regulatory vacuum. The laws evolved to grant wide discretion to sacrifice profits pro-socially, without affording investors the means to control this discretion, such as by mandatory disclosure.[149] In this section, I build on my analysis in previous parts to assess the fit between the observed and the theoretically optimal modes of regulating CP.

What can we learn from the previous discussion? Part I analyzed the complexities of CP and the incomplete empirical picture of corporate giving. Despite these mixed results, there are still some relevant general implications. We can conclude that there is no financial penalty for CP. A blanket legal ban on all CP expenditures cannot be justified on economic grounds. If CP is indeed value-enhancing, then there is little reason to intervene in the name of corporate governance. Yet, we also know that CP is not just value-driven. The logic of incentives and the evidence (once purely anecdotal, but now more systematic) suggest that managerial discretion can be used, under certain circumstances, to benefit managers at shareholders' expense. Such indications suggest that while a total ban is unwarranted, we also cannot afford to ignore CP completely. Those opposing legal intervention frequently respond that, while some donations are indeed about managerial self-aggrandizement at the expense of shareholders, those are only isolated cases of relatively small magnitude that do not merit intervention.

My analysis in Part III sheds light on the problems that arise from continuing to ignore CP. First, we should not be quick to dismiss anecdotal evidence of abuse as merely anecdotes; CP is currently not subject to disclosure, so the scope of the phenomenon might be more alarming than we are allowed to observe. Second, even relatively small amounts of managerial-driven CP, which are not troubling by themselves, can serve as early warnings of suboptimal diversion of corporate resources by managers for their own interests.[150] The result is that disclosure of CP might have spillover benefits that go beyond direct effects of the donations on the bottom line. Third, in the subset of cases in which managerial-driven CP

147. *See* 130 S. Ct. 876 (2010).
148. *See supra* note 5 and accompanying text.
149. *See* Kahn, *Reflections*, *supra* note 127, at 1146.
150. *See* Barnard, *supra* note 17, at 1174–77.

not only reflects existing agency costs but also generates additional agency costs, the case for legal intervention is much stronger. Failure to address agency problems in CP decisions might make it more difficult to address agency problems in other corporate decisions.[151]

But saying that something must be done just begins the analysis. The question is what exactly to do. We need to make a preliminary choice between two basic options: either we try to target and ban those CP decisions that are bad for the company and allow all others, or else we refrain from direct interference with CP decisions and rather supply protective mechanisms that will facilitate market control. This is where the discussion on the value-enhancing aspects of CP in Part II can help. It highlights the futility of trying to distinguish bad from good—that is, profit-enhancing from profit-reducing donations. Shareholders and courts are unable to eliminate bad CP decisions based on the existence of clear signs of quid pro quo, or professed insiders' motivations. The asymmetric information angle suggests that profit sacrificing may still be value-enhancing.[152] It thus strengthens the argument that targeted bans are impractical and unwarranted—another reason for us to leave profit-sacrificing discretion to managers, and to focus instead on less intrusive protective mechanisms. The following sections evaluate two such options, requiring disclosure and mandating shareholder involvement.

1. Requiring Disclosure?

The lack of any substantive disclosure requirement has not gone unnoticed or unquestioned. Proposals for legislation have been brought up frequently in Congress and the corporate and securities law literature over the past fifteen years.[153] A fairly common denominator in those proposals is the call for two types of disclosure: targeted disclosure of "interested" donations to NGOs affiliated with directors, and general disclosure both of total amounts given yearly and of beneficiaries receiving sums over a certain threshold. Yet those proposals, even the modest ones, never made it into law. For example, the House of Representatives version of the Sarbanes-Oxley Act contained a CP-disclosure requirement, but it was omitted from the final Act.[154] Below we try to assess whether this is justified.

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151. *Cf.* Bebchuk & Jackson, *supra* note 5, at 91 (in the context of political donations).

152. The benefits from signaling will outweigh agency costs from managerial utility-driven donations only when the weight placed on the short-run improvement—generated by the elicited response of outsiders updating their valuation—outweighs any extra surplus captured by the manager.

153. See the representative proposal in H.R. 3745, 107th Cong. (2d Sess. 2002), which was later duplicated in subsequent Congresses. *See also* Barnard, *supra* note 17, at 1169–70; Melvin Aron Eisenberg, *Corporate Conduct that Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure*, 28 STETSON L. REV. 1, 22–25 (1998); Kahn, *supra* note 55; Richard W. Painter, *Commentary on Brudney and Ferrell*, 69 U. CHI. L. REV. 1219, 1228 (2002).

154. *See* H.R. 3763, 107th Cong. § 7 (2d Sess. 2002).

The pros of requiring CP disclosure are intuitive. Firms cannot be expected to voluntarily provide sufficient and comparable information on their pro-social activities, due to agency and coordination problems.[155] First, when left on their own, insiders will have incentives to provide biased disclosure, whether by exaggerating the positive aspects of donations or by camouflaging the negative aspects. Mandatory disclosure could serve as an early warning by flushing out cases of self-aggrandizement, as well as reducing the ability of managers to use CP as a co-optation device to bypass existing restrictions on board independence, political spending, or anti-takeover measures.[156] Second, mandatory disclosure would standardize both the form and the substance of the information, thereby allowing comparability and increasing the value of information to outsiders.

Commentators direct less attention to the cons of mandatory CP disclosure. The legislative history of proposed bills reveals a basic set of three recurring arguments against disclosure: (1) the costs of implementing disclosure; (2) the negative impact of an expected chilling effect on overall CP; and (3) the marginal benefits of regulated disclosure—the relevant information is already public and/or no one is interested in it.[157]

The first argument invokes several types of disclosure costs: actual costs, like compiling and disseminating data, and indirect costs, like overwhelming investors (that is, additional information dilutes the value of existing information). Those arguments may hold on paper, but in practice, introducing a new disclosure requirement will not add significantly to the mix of costs already incurred. Firms are required to report the levels and targets of certain donations to the IRS, so no compiling costs would be added.[158] Since large firms disseminate information about their pro-social behavior to the public via company websites and separate, lengthy corporate social responsibility reports (CSR reports),[159] no disseminating costs will be added either. Finally, acknowledging this steady flow of social responsibility information discredits the "overwhelming investors with information" argument as well. On the contrary, because the mass of public information is presented in a distorted, non-standardized, and non-

155. *Cf.* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 278–79 (2d ed. 2009).

156. Such an argument stresses the role of mandatory disclosure in reducing agency costs (not just the accurate pricing-enhancement role). *See generally* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

157. *See, e.g.*, *Increasing Disclosure to Benefit Investors*, *supra* note 87.

158. *See* Kahn, *supra* note 55, at 586 n.20. A stronger version of this argument would object to the targeted disclosure proposed, claiming that companies are not able to continuously keep an eye on which NGO boards the officers are currently sitting. But officers already provide extensive disclosure of various affiliations, so this could hardly be counted as a significant added cost of disclosure. Moreover, such an objection does not hold against the proposed general disclosure requirement (disclosing overall amount and large individual donations).

159. On the prevalence of CSR reports among large companies, see, for example, KPMG, *International Survey of Corporate Responsibility Reporting* 13–20 (2008), http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/International-corporate-responsibility-survey-2008.pdf; *see also* Kahn, *Reflections*, *supra* note 127, at 1143 (for a similar argument on the low costs of disseminating online).

transparent manner (anecdotes instead of comparable numbers, forcing readers to wind through the maze of long CSR reports),[160] any requirement that companies publicize a standardized and concise form, such as a single number of overall donations, will not muddy the waters but rather crystallize them.

It is more difficult to dismiss the second "chilling effect" argument because of its abstract nature. Without previous experience with mandatory CP disclosure, we have no evidence of the consequences of disclosure. Those concerned about a potential chilling effect rest their criticism on two assumptions. First, that disclosure will decrease overall CP, and second, that benefits to shareholders from deterrence of bad CP decisions will be dwarfed by the negative impact on the non-profit sector. These assumptions are supported by neither logic nor evidence.

To understand why, consider the different categories and motivations of CP. Donations motivated by buying goodwill or signaling are not likely to be deterred by disclosure. Currently, information about corporate pro-sociality exists in an environment where virtually all companies profess to be nice and disseminate long and anecdotal CSR reports. In this environment, companies can easily exaggerate their goodness because a threat of legal liability for exaggeration is extremely remote. A threat of market sanction is also very limited since information on pro-sociality is not readily verifiable.[161] Companies that actually invest heavily in pro-sociality find it hard to distinguish themselves from those who merely pretend to be generous. This cheap talk environment leads outsiders to discount information about corporate pro-sociality, and leads insiders to invest in marketing rather than actual philanthropic impact. In other words, pro-social activities are picked for their window-dressing value.

Regulated disclosure could lead to less cacophony, and less cacophony could lead to more incentives to engage in meaningful pro-social profit sacrificing. Disclosure would thus not decrease CP. To the contrary, it would likely increase both doing good, because incentives to exaggerate goodness will decrease, and doing well, because outsiders are likely to be better informed about corporate goodness.

The next step in evaluating the chilling effect argument is to consider the effect on bad, managerial utility-driven CP. Here, it is more intuitive to speculate that disclosure would indeed decrease donations, and the question is whether this is a good thing for society. Proponents of the chilling argument could claim that the loss to the non-profit sector from decreased funds outweighs shareholder gains from decreased perk-like donations

160. *See supra* note 27 and accompanying text. Considerations of overwhelming investors do not eliminate the need for standardized disclosure. At most, they point to directions for designing the disclosure requirement.

161. On the lack of implicit assurance via litigation threats for non-financial reporting (as opposed to financial reporting), see Dan S. Dhaliwal et al., Voluntary Non-financial Disclosure and the Cost of Equity Capital: The Case of Corporate Social Responsibility Reporting 9–10 (Feb. 15, 2009) (unpublished manuscript), http://ssrn.com/abstract=1343453.

because shareholder gains are supposed to be nominal. Managers will simply substitute this discretionary expenditure for another (for example, move from CP to ineffective operational profit sacrificing or traditional perks). As Part III clarifies, however, this neutral-value-diversion argument ignores the possibility that CP is not only self-aggrandizing, but also potentially co-opting. Co-opting donations have the effect of bypassing existing restrictions and are thus ones that society (and probably also shareholders as a group) wants to deter.[162] The only category in which the chilling argument's assumptions might hold is that of CP decisions driven by managerial self-aggrandizement.

But even with self-aggrandizing donations, both assumptions on which the chilling effect argument rests are shaky. It is not clear that disclosure would decrease self-aggrandizing donations. If the point behind them is to bolster managers' images or intrinsic benefits, then perhaps disclosure would trigger a race among managers to be perceived as the biggest donor, a "ratcheting-up" effect where no CEO wants to be seen as below-average in pro-social engagement. After all, this was the result of introducing new disclosure requirements in related areas such as managerial perks.[163] Furthermore, even if disclosure would somewhat decrease self-aggrandizing donations, it is not clear that the losses to the non-profit sector outweigh all the other benefits.[164]

Across all different categories of CP, the chilling argument's two assumptions do not hold: disclosure is unlikely to decrease donations that do good, and it enables doing well; the only donations it is likely to decrease are those that do bad. In any case, even if the effects of disclosure

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162. There is a general argument in favor of CP disclosure, which goes beyond corporate and securities law considerations. We have already discussed election law justifications for CP disclosure. Another notable example is the perverse effects pharmaceutical CP can have on medical care, recently addressed by the Sunshine Act. *See* Rick Cohen, *Shenanigans of Corporate Grantmaking*, NONPROFIT Q. (Jan. 31, 2008), http://www.nonprofitquarterly.org/index.php?option=com_content&view=article&id=288:shenanigans-of-corporate-grantmaking&catid=149:rick-cohen&Itemid=991. The upshot is that instead of putting a finger in the dike whenever perverse effects of CP abuse are being detected ex post in one context or another, we should increase transparency of profit-sacrificing activities altogether.

163. *See* Yaniv Grinstein et al., *The Economic Consequences of Perk Disclosure* 17–18 (Johnson Sch. Research Paper Series No. 06-2011, Apr. 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108707. To be sure, one can claim that a ratcheting-up competition for more profit sacrificing would be a bad thing for shareholders and perhaps even for overall welfare. But I raise my argument as a rebuttal against the assumption of disclosure opponents, according to which disclosure of discretionary resources necessarily leads to fewer expenditures. One could argue that in CP, unlike in executive pay or perks, it is less likely that disclosure would lead to ratcheting up because there are fewer incentives for insiders to keep engaging in the disclosed activity when facing increased market or social control. The level of private benefits for every dollar spent on CP is probably lower than the private benefits from every dollar spent on perks, not to mention on direct salary. Whether we subscribe to this prediction or not depends on our understanding of what causes ratcheting-up effects.

164. For one, there is an argument in favor of submitting perk-like donations to the same disclosure requirements that are applied to traditional perks.

on overall levels of CP are uncertain, it is still likely to better align corporate pro-sociality with shareholder value.

The third and final objection to requiring disclosure of CP posits that the benefits from introducing disclosure are insignificant and are unlikely to outweigh the costs. Proponents of this objection maintain that investors are not interested in information about CP, and those investors who are interested can assemble the relevant pieces of public information without needing costly regulatory intervention. In support of this claim, opponents of disclosure invoke the relative dearth of shareholder litigation and proposals on the matter.[165] But all we can really conclude from such evidence is that shareholders are not interested in the information currently available. Naturally, the abuse of profit-sacrificing expenditures will not be disclosed voluntarily, so shareholders and regulators cannot act upon them ex ante. A more relevant question is whether the managers of Enron and RJR Nabisco could have freely used CP as a co-optation device if there had been a disclosure requirement in place at the time.[166]

The argument that outsiders can already get CP information through existing sources is also flawed, if only because it unrealistically assumes a competitive market for corporate social responsibility information. The conditions for an "unraveling" effect—where firms voluntarily disclose all private information on their pro-sociality for fear that outsiders will assume the worst if information is not fully disclosed—do not hold in our context.[167] For example, misrepresentation is not costly, because information is unverifiable and subject to very little legal scrutiny.[168]

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165. *See generally* Kahn, *Reflections*, *supra* note 127.

166. *See id.* at 1143; *see also supra* notes 118, 151 and accompanying text. In general, invoking the low number of litigations or shareholder proposals to suggest that disclosure is unnecessary ignores how the current legal regime affects the revealed preferences of shareholders. For example, courts have made it clear that challenges to CP decisions are bound to be rejected even when the donations are clearly self-aggrandizing and comprise one-third of the annual profits; and it was traditionally unclear whether the SEC allows shareholders to use the proxy mechanism to bring forth decisions related to the subject. *See* Kahn, *Reflections*, *supra* note 127, at 1123–24. All this makes it costly for shareholders to challenge CP practices.

167. On the conditions for the "unraveling" effect, see Anne Beyer et al., *The Financial Reporting Environment: Review of the Recent Literature*, 50 J. ACCT. & ECON. 296, 300–15 (2010); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 682–85 (1984) (discussing the "unraveling" effect in securities law).

168. Note that the transparency needed also might regard future profit-sacrificing behavior, so it would be very difficult to assess the integrity of a manager's disclosure. *Cf.* Jason Scott Johnston, *Signaling Social Responsibility: On the Law and Economics of Market Incentives for Corporate Environmental Performance* 35, 74 (John F. Kennedy Sch. of Gov't, Harvard Univ., Corp. Soc. Responsibility Initiative Working Paper No. 14, 2005), *available at* http://www.hks.harvard.edu/m-rcbg/CSRI/publications/workingpaper_14_johnston.pdf.

A similar argument against regulated disclosure could invoke my own signaling analysis. *See generally* Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177 (Franklin R. Edwards ed., 1979). If indeed CP brings with it benefits of mitigating asymmetric information, then disclosure need not be mandated. Companies wanting to distinguish themselves as high quality will disclose credibly and sufficiently. But

Indeed, while most large companies generate detailed CSR reports, these reports achieve no real transparency.[169] Social responsibility information intermediaries also fail to generate sufficient, credible information, if only because they do not enjoy superior access to relevant information.[170] In any case, sending outsiders to piece together bits of information is unrealistic and ineffective; companies are better positioned to supply this information in a complete, comparable, and timely manner.[171]

The lack of reliable information also answers the generic critique against regulatory intervention that shareholders are free to sort their investments based on their approval or disapproval of pro-social policies. It is not only that shareholders have many other factors according to which they sort companies. Even if shareholders do want to sort based on CP, they cannot do it effectively without mandatory disclosure. In an uninformative "cheap talk" environment, practically all companies profess to be nice, and no manager professes to abuse CP money to entrench herself, so outsiders cannot distinguish between nice guys and pretenders.

A common theme in these arguments against disclosure is that they do not account enough for how laws affect the baseline. While corporate pro-sociality is very much controlled by market forces, the presence of market control does not mean that legal control is meaningless, because the existing legal regime influences market forces. Specifically, market control relies on information flow, and the law affects how information flows.[172] Against the background of the lack of legal standards governing pro-social disclosure, voluntary reports by firms fail to generate transparency. Similarly, corporate social responsibility information intermediaries cannot be assumed to produce satisfying results on their own without standardization of metrics, credible third-party liability threat, or access to comparable information.[173] Legal control of the flow of information—that is, requiring standardized reporting form and substance, and establishing a liability threat for falsely communicating or failing to report—could thus be beneficial for both shareholders and stakeholders by reducing managerial

even if we assume that meaningful signaling "pressures" are at work (remember that our refinements suggested that signaling is rather coarse), then signal selection can be expected to operate mostly on the level of donations, and less on the targets. In our example, outsiders pay more attention to how much cash companies dispose of when donating, and less to where exactly this cash is being disposed.

169. *Cf*. Porter & Kramer, *supra* note 29, at 81.

170. *See* Kahn, *Reflections*, *supra* note 127, at 1142–43 n.131; *supra* Part I.A.4. Moreover, without legal intervention it is less likely that those private intermediaries could deter abuse of CP money sufficiently, since their ratings focus more on levels of CP, rather than on targets (and it is the choice of targets that generates the ability to use CP as a co-optation mechanism).

171. *Cf.* Bebchuk & Jackson, *supra* note 5, at 106.

172. *See* Johnston, *supra* note 168; *see also* Lin, *supra* note 27, at 27.

173. After all, the same factors that created a need to regulate the market for financial information intermediaries (for example, possible collusion with monitored companies) are also likely to operate in the social information intermediaries market. For example, considerations of competition for clients and pressures from interest groups could dictate adopting overly wide metrics. *See* Johnston, *supra* note 168.

agency costs and allowing firms to credibly commit to pro-sociality with real impact.

To be sure, we cannot expect disclosure to be a panacea for all negative aspects of CP. For disclosure to be justified, it must have a real potential to induce readers to act on the disclosed information and change the behavior of the disclosing entity for the better.[174] In our case, for example, it could be claimed that the amounts spent are not significant enough to elicit a response.[175] Another concern is that subjecting this voluntary "charitable" practice to a new disclosure requirement would crowd out motivation, and tame the practice in the eyes of outsiders and insiders.[176]

Yet, we should not overstate these concerns. For one, disclosure can play a role in greasing the wheels of corporate governance even when the amounts involved in suspicious transactions are not material by themselves.[177] Perhaps the best answer to these concerns is to proceed cautiously: first mandate some form of limited disclosure, then gather information on the regulations' effects and CP practices, and finally reassess the consequences of regulation and alter it if necessary.[178]

A distinct question is why proposals that would require disclosure of CP continue to be rejected. Indeed, we saw that the commonly raised objections do not have enough merit to justify the current regulatory vacuum. A full answer to this question would require a separate article, so I will only briefly sketch some conjectures based on congressional hearings and personal interviews. Lack of regulation can be attributed to a mixture of three main causes. First, some policymakers still hold the outdated belief that pro-social sacrifices are not big enough to merit costly intervention.[179] Second, policymakers are reluctant to be perceived as thwarting philanthropy, which is "as American as apple pie," and so turn a blind eye

174. *See generally* Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005) (noting that disclosing conflicts of interest can have perverse effects, such as making the disclosing agent feel morally licensed); Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003) (noting that more information is not necessarily better; it depends on whether users can process that information effectively).

175. *Cf.* Sugin, *supra* note 44, at 140 (noting that shareholders "would be unlikely to make ownership decisions based on the corporation's decision to give away a very small percentage of the company's profits").

176. *See generally* Sandeep Gopalan, *Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation*, 35 PEPP. L. REV. 207 (2008) (requiring enhanced disclosure of executive pay will send a message that pay without performance should invite disapproval (i.e., laws affecting social norms)).

177. *See* KRAAKMAN ET AL., *supra* note 155, at 280–81. Indeed, evidence suggests that disclosure of other expenditures thought to be reflecting or generating agency problems leads to a negative stock price impact far larger than the expenditure itself. *See, e.g.*, Grinstein et al., *supra* note 163. Anecdotally, when it was discovered that Tyco donated a large amount to an independent director's preferred charity, the firm's stock price fell. Bohnen & Phillips, *supra* note 120, at 39.

178. *Cf.* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 309–12 (2005).

179. *See Increasing Disclosure to Benefit Investors*, *supra* note 87.

to the supposedly insignificant dangers it brings.[180] Third, unsurprisingly, there are private interests at play.

One usual suspect for killing disclosure proposals is the strong managerial lobby, whose interest is to protect managers' unfettered discretion. After all, while both shareholders and stakeholders may fare better under mandatory disclosure, managers might fare worse—one covert channel for managerial influence on key players will be hampered.[181] A closer look reveals additional, less intuitive suspects possibly pushing against disclosure. Incumbent politicians who are currently enjoying this subtle channel for corporate money have incentives to keep CP in the dark in order to evade restrictions on explicit corporate funding.[182] More interestingly, charitable organizations themselves oppose disclosure proposals. There is a strange divide in the non-profit sector over the matter: while some organizations publicly support disclosure, leaders of the mainstream foundations and associations are vocal in their resistance.[183] Publicly, they profess their concern that disclosure would yield a chilling effect, but perhaps there is a cynical flavor to their opposition; what those players care about might not be the level of overall CP, but rather the share of CP directed at their own specific non-profits. They might fear that disclosure would hinder their advantage in influencing corporate insiders behind closed doors.

2. Additional Protective Mechanisms

In the political donations context, recent calls to mandate protective mechanisms other than disclosure focused specifically on mandatory shareholder involvement.[184] Should this be the case with all donations, not just the explicitly political ones? In the past, legislatures and academics

180. See the comments made in that spirit by a former SEC chairman, academics, and practitioners in Balotti & Hanks, *supra* note 114, at 991, 996; Richard C. Breeden, *Giving It Away: Observations on the Role of the SEC in Corporate Governance and Corporate Charity*, 41 N.Y.L. SCH. L. REV. 1179, 1180 (1997); Symposium, *supra* note 53, at 1324–25.

181. This is similar to arguments made in the CP-as-antitakeover-mechanism articles: when requirements of accountability become stronger and more explicit, firms can credibly commit to pro-sociality and the importance of a specific incumbent manager's commitment is reduced. *See* Cespa & Cestone, *supra* note 129.

182. *See* Jill E. Fisch, *Teaching Corporate Governance Through Shareholder Litigation*, 34 GA. L. REV. 745, 769 & n.118 (2000).

183. *See* E-mail from Pablo Eisenberg, Senior Fellow, Ctr. for Pub. & Nonprofit Leadership, Georgetown Univ., to Author (Apr. 25, 2011, 4:30 PM) (on file with author); Telephone Interview with Marion Fremont-Smith, Senior Research Fellow, Hauser Ctr. for Nonprofit Orgs., Harvard Univ. (Apr. 11, 2011); Rick Cohen, *Enron's Philanthropic Misdeeds*, DMIBLOG (Aug. 1, 2006, 12:48 PM), http://www.dmiblog.com/archives/2006/08/enrons_philanthropic_misdeeds.html ("The lobbyists against increased disclosure . . . weren't corporations, it was the leadership of the nation's mainstream foundation and nonprofit trade associations, somehow thinking that the portion of legitimate corporate philanthropy foundations hand out might be sacrificed if the nation cracked down on the shadier elements of corporate giving.").

184. *See supra* note 5 and accompanying text.

proposed mandatory shareholder votes on CP.[185] These proposals rested on the CP model of Warren Buffett's company, Berkshire Hathaway, where management set the levels of CP and shareholders designated the targets. But those proposals drew elaborate criticism, and in retrospect Berkshire Hathaway's experiment provides an argument against shareholder involvement. Berkshire Hathaway terminated its CP program when subsidiaries of the company were boycotted because shareholders designated controversial organizations as beneficiaries.[186]

There are additional arguments to explain why a shareholder vote, even if justified in the specific context of political donations, is not justified in the broader context of CP. First, consider the impact it would have on the bottom line. Logic and evidence suggest that the choice of targets impacts possible benefits accruing to the company from CP. It is likely that managers will be better positioned than dispersed shareholders to identify such benefits and act accordingly.[187] By contrast, with political donations, the benefits are the type that can secure a seat at the table, make sure the company is being heard, or promote the politician or policy that is most likely to further the corporate interests. Shareholders are thus more likely to be able to designate or approve targets for effective political spending. To oversimplify: in non-political donations, the daunting task is to identify which stakeholders prefer what causes, which stakeholders are more important to the company at the moment, and which policy will draw attention and get attributed to the right motives; in political donations, the (less daunting) task is to identify who is in power or who promotes policies that favor the company.[188]

Second, some claim that in the political donations context, shareholder involvement could also mitigate "expressive harms," that is, reduce the costs of being associated with donations to causes opposed to shareholder preferences and beliefs.[189] While this argument could hold for political donations, it is less plausible for CP in general. Political purposes are bound to be polarized and of a zero-sum character, regardless of who is making the decision (spending on right-wing causes hurts the expressive

185. *See, e.g.*, H.R. 945, 105th Cong. (1st Sess. 1997); Victor Brudney & Allen Ferrell, *Corporate Charitable Giving*, 69 U. CHI. L. REV. 1191 (2002).

186. *See* Letter from Warren E. Buffett, Chairman of the Board, Berkshire Hathaway, to Shareholders of Berkshire Hathaway Inc. (Feb. 27, 2004), *in 2003 Annual Report*, BERKSHIRE HATHAWAY 21–22 (2003), http://www.berkshirehathaway.com/2003ar/2003ar.pdf.

187. *See* Painter, *supra* note 153, at 1219.

188. In general, to justify invoking the costly mechanism of a shareholder vote one needs to rely on some underlying theory of corporate voting. If the supposed expected benefits of shareholder involvement come from information-aggregating and error-correcting aspects, then CP is not a good context to require a shareholder vote. *See generally* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 144–52 (2009). In such a scenario, information-aggregating is unlikely advantageous, as the condition of consensus among aggregators on the right policy (of targets) does not hold (Berkshire Hathaway's shareholders designated 3,500 different charities. *See* Sugin, *supra* note 44, at 166.). Effective monitoring through being attentive to stock prices is also unlikely here because the stock price impact of CP is small.

189. *See* Bebchuk & Jackson, *supra* note 5, at 95–97.

interests of those supporting leftist causes).[190] In the non-political donations context, however, giving shareholders power to designate targets can actually be expected to generate more expressive harms. Evidence suggests that manager-designated donations usually steer clear of extreme, expressive-ideological, polarized, or religious targets, while those targets are exactly the ones favored by shareholders.[191] Taking into account expressive harms, advocates for this proposal should not push toward a shareholder vote.[192]

I have focused on the impact on shareholders, both financially and expressively. But it could be claimed that one should also consider the impact on non-shareholders, such as the non-profit sector. Shareholder vote proponents argue that deferring to shareholder preferences will channel CP money toward more diverse social goals and generate more utility from the virtuous feelings of donors.[193] Yet such arguments are problematic, as has been shown elsewhere.[194] Notably, they ignore the possibility that giving shareholders a say on targets will decrease the overall level of CP: a shareholder vote is likely to decrease the level of profit-enhancing-motivated donations because managers would not want to risk outraging stakeholders with a choice of controversial targets, such as occurred with the abrupt termination of CP at Berkshire Hathaway. A shareholder vote is also likely to decrease the level of managerial utility-motivated CP—managers gain fewer private benefits when they cannot designate targets, and are thus likely to drop the percentage of discretionary resources they allocate to CP.[195]

Overall, the corporate governance concerns raised by CP should not be overstated. There are other agency problems more urgent than misuse of pro-social discretion. The legal system does not need to interfere too much with existing practices. At the same time, misuses of CP could be indicative of agency problems and, when used in tandem with other co-optation devices, could generate agency problems. Introducing a limited form of the less restrictive protective mechanism—mandatory disclosure—may therefore be the best option. Whatever form of regulation is introduced, careful attention has to be paid to its expressive aspects. Intervention should be couched as not interfering with voluntary sacrifices

190. Some types of political spending can be in the economic interests of all shareholders, as they might be directed at gaining more favorable industry or firm-specific regulation. But since Bebchuk and Jackson target different types of political spending, my argument also tackles those different types.

191. Again, the Berkshire Hathaway experience is a case in point. *See supra* note 186 and accompanying text.

192. If anything, taking into account expressive harms lends more support to requiring disclosure as a way of preventing the risk that, when kept in the dark, CP can turn into subtle political spending and favor the ideologies of the managers.

193. *See* Brudney & Ferrell, *supra* note 185, at 1207.

194. *See, e.g.*, Painter, *supra* note 153; Craig M. Sasse & Ryan T. Trahan, *Rethinking the New Corporate Philanthropy*, 50 BUS. HORIZONS 29, 34–35 (2007).

195. Managers who decrease those CP expenditures will probably substitute it with other expenditures. Whether this substitution is worse in overall welfare terms is another question. *Cf.* Elhauge, *supra* note 3, at 796–814.

and not taming corporate pro-sociality, so as not to crowd out motivations and erode benefits arising from signaling.[196]

CONCLUSION

This Article aims at advancing our understanding of corporate pro-sociality and sketching initial policy implications. We should focus more on informational benefits stemming from corporate profit sacrificing in order to understand what outsiders learn when they observe companies behaving pro-socially. We should also keep an eye on how unfettered discretion over pro-social expenditures could generate governance problems. Acknowledging both of those oft-unnoticed elements then strengthens the case for introducing some form of standardized mandatory disclosure.

This Article makes three contributions to the existing literature. The first and primary contribution is shifting the focus of value-enhancing explanations of CP from a buying-goodwill approach to a signaling approach. Companies engage in pro-sociality not only because stakeholders like that companies are nice, but also because pro-sociality sends a favorable message about the company's fundamentals. The second theoretical contribution is the shift of focus from a "managerial perk approach" to a "co-optation approach" to agency costs explanations of CP. Managerial self-aggrandizing donations might be problematic, but co-opting donations are even more detrimental and necessitate legal intervention. The third contribution is to emphasize a shift of focus from a traditional "hands-off" approach to the legal implications of CP in order to strengthen the case for disclosure.

These three contributions are based on straightforward intuitions. First, the notion that corporate pro-sociality is signaling is based on the intuition that to understand why corporations engage in pro-sociality, one needs to understand why *anyone* behaves pro-socially.[197] Signaling plays an increasingly important role in explaining individual pro-sociality, and there is all the more reason to apply it to the corporate context: this is a relatively competitive, impersonal context, filled with asymmetric information and high-powered incentives to cheat in communication. It is time, therefore, that we switch from emotional and cognitive explanations for corporate cooperative behavior and focus more on signaling aspects.[198] Note that I am not suggesting that signaling is the sole or even the main driver of CP behavior, or that insiders carefully contemplate signaling with CP levels. My narrower, and thus more intuitive, point is rather that signaling is one unexplored mechanism through which pro-sociality could advance the

196. *Cf.* POSNER, *supra* note 77, at 176 (noting that external intervention can cause unintended consequences, such as pushing signalers to signal in a worse way, or to stop signaling and therefore lose some of the ability to mitigate asymmetric information).

197. *See* Henderson & Malani, *supra* note 25, at 572.

198. *See* Fehr & Fischbacher, *supra* note 97, at 789 (showing how, in competitive, *n*-person contexts, non-signaling explanations are less likely). *See generally* Elinor Ostrom, *Collective Action and the Evolution of Social Norms*, 14 J. ECON. PERSP. 137 (2000).

bottom line. This intuitive signaling point runs the risk of turning into a "just so story," future research is still needed. In particular, we should try to examine the impact of announcements of major changes in CP policies on stock prices.

Second, the notion that corporate pro-sociality is a co-optation mechanism is also based on a simple intuition: if managers can use discretion over pro-social expenditures to generate managerial perks, they can also use it to entrench themselves and co-opt the governance mechanisms that constrain them. It is difficult to determine the true scope of this corporate governance problem due to the lack of public disclosure: it could be minor relative to other agency problems. Nevertheless, the introduction of some form of disclosure could be a reasonable step toward deterring such misconduct while bolstering signaling and other benefits arising from CP, at relatively little cost.

Finally, the need to rethink the current hands-off approach to legal regulation is also intuitive. The current approach is based on the anachronistic premise that corporate pro-sociality is of little relevance to the market. Nowadays, strong market incentives shape corporate social responsibility practices. The legal system needs to acknowledge the impact it has on those market forces and act accordingly.[199]

CP and corporate pro-sociality in general are complex phenomena, thus I omitted several aspects from this Article for the sake of brevity and clarity. For example, I did not consider the roles charitable organizations or corporate foundations play in altering CP behavior. Examining the beneficiaries of CP, their connections with corporate decision makers, and their use of CP money could help us better understand both potential agency problems and benefits from signaling.[200] Similarly, elaborating on donations channeled through corporate foundations could affect analysis; giving through foundations tends to be more stable, is reported to the IRS in forms accessible to the public, and is ostensibly less susceptible to CEOs' influence. Those differences matter for all sorts of CP implications—buying goodwill, signaling information, and generating private benefits.[201]

199. *Cf.* Kahn, *Reflections*, *supra* note 127, at 1142; Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1206, 1284–89 (1999).

200. For example, a situation where the beneficiaries of the signal (NGOs in our case) are not the same as the receivers (investors) yields a prediction that beneficiaries will try to elicit excessive altruistic signaling. *Cf.* Jonathan Wright, *Altruism as a Signal: Zahavi's Alternative to Kin Selection and Reciprocity*, 30 J. AVIAN BIOLOGY 108, 109 (1999).

201. For example, more stability in levels of giving could strengthen profit-enhancing aspects, because of tax considerations or delegated philanthropy benefits (continuing to look nice in the eyes of consumers). Indeed, evidence shows that industries subject to more earnings fluctuations have a greater tendency to establish foundations. *See* Brown et al., *supra* note 21, at 865–67. It could also be advantageous for the non-profit beneficiaries by isolating them from ebbs and flows. We should not overstate, however, the benefits from giving through foundations. First, agency problems at the foundation level might mean that the cash is hoarded, rather than utilized in the non-profit sector. Second, although reports to the IRS are open to the public, in reality they are severely delayed. Finally, evidence shows that CEOs still exert significant influence even when the giving is done via foundations. *See* Rick Cohen, *Corporate Giving: De-cloaking Stealth Philanthropy*, NONPROFIT Q., Sept. 20,

I also did not address all the normative angles. Suggesting that corporate pro-sociality might serve as a signal is not the same as saying that CP is beneficial to overall welfare. Signaling could evolve into a pooling, uninformative equilibrium. A signaling rat-race could lead managers to focus on the perceived, instead of the real, impact of their pro-social expenditures, or to focus more on how to be perceived as nice instead of on the firm's fundamentals. Overemphasis on perceived pro-sociality could also be used as window-dressing, disguising bigger problems. For example, Enron was a CSR poster child, winning numerous accolades.[202] On the other hand, signaling with pro-sociality might have a longer-lasting impact on society than corporate signaling with other, wasteful means. Similarly, when discussing the expected consequences of disclosure—whether it will chill, ratchet up, or not affect CP levels—I did not intend to make a statement on the overall desirability of CP, but rather to show that the assumptions of the opponents of disclosure are tenuous. Whatever the overall normative implications are,[203] this Article aims to increase awareness of the informational aspects of pro-sociality, and the impact a given legal regime has on the market for information.

The new perspective on corporate pro-sociality provided in this Article could also be built upon to develop new understandings in seemingly distinct areas of corporate governance literature, in ways that were not developed here: how companies build a reputation toward outsiders, how managers instill a corporate culture that facilitates cooperation inside the corporation, and how insiders mobilize resources to act in the political sphere. These directions for future research share an underlying theme, which is also the basis for this Article: the corporate governance literature has much to gain from a fresh look at corporate pro-sociality.

2002, at 47; *see also* James D. Werbel & Suzanne M. Carter, *The CEO's Influence on Corporate Foundation Giving*, 40 J. BUS. ETHICS 47 (2002).

202. *See* Robert L. Bradley, Jr., *Corporate Social Responsibility and Energy*, *in* 1 CULTURE AND CIVILIZATION 181, 181–82 (Irving Louis Horowitz ed., 2009); Robert Murphy, *Enron, the CSR Poster Child*, TOWNHALL (Apr. 26, 2008), http://townhall.com/columnists/RobertMurphy/2008/04/26/enron,_the_csr_poster_child. For the argument that pro-sociality serves as disguising corporate misdeeds, see generally Daryl Koehn & Joe Ueng, *Is Philanthropy Being Used by Corporate Wrongdoers to Buy Good Will?*, 14 J. MGMT. & GOVERNANCE 1 (2010).

203. Basically, the normative question deals with whether companies enjoy a comparative advantage over other supporters of societal causes such as non-profits and the government. *See generally* Henderson & Malani, *supra* note 25.