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Corporate Philanthropy and the Handicap Principle*

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Contents

Preface

The most notorious case of Corporate Philanthropy is arguably *Kahn v. Sullivan*.[1] Occidental Petroleum Corporation (OXY) decided to give approximately fifty million dollars for building a museum in the name of its CEO and chairmen of the board, Armand Hammer.[2] OXY minority shareholders were furious. They submitted legal actions, claiming, inter alia, that the expenditure is highly excessive and designed primarily to enhance the personal reputation of Hammer; resulting in damage to the company itself. The legal battle ended in a settlement, which practically left the excessive donation untouched. Since then, students of corporate law read *Kahn v. Sullivan* as an (bad?) example of settling derivative actions and the board-centric approach of Delaware courts (giving wide latitude to managers and board committees). Corporate law scholars harshly criticize the decision, using the case as a vivid example of the dark side of corporate philanthropy, benefiting managers with shareholders' money.[3]

But there is one aspect left a bit unnoticed. How did the market react to this excess donation, a blunt efficiency-reducing expenditure? Quite well, actually.[4] The market did not punish OXY for giving a not-insignificant amount of the company's money away. The market did not punish OXY for allegedly sending the signal that Hammer's reputation comes before shareholders' profit considerations. Why? How come the market does not punish even the most

[1] 594 A.2d 48 (S. Ct. Del. 1991) (hereinafter: *Kahn v. Sullivan*).
[2] As it turned out, the costs were almost twice as big as was originally estimated in the company's proxy statement! See Cathleen McGuigan, *Whose art is it, anyway?*, 116 Newsweek, 7/30/90, Issue 5.
[3] See for example *Transcript of Proceedings – Corporate Charity: Societal Boon or Shareholder Bust?,* 28 Stetson L. Rev. 52, 62-65, 84 (1998) (hereinafter: Stetson's transcript); Robert A.G. Monks & Nell Minow, *Corporate Governance* 488-491 (4th ed., 2008); Melvin A. Eisenberg, 28 Stetson, infra note 10, at pp. 22-23.
[4] The idea to build such a museum in the name of Hammer was made public in January 21st, 1988. Oxy share price was $24.87 then. The decision to allocate approximately $50 million was made public in a proxy statement released in 25 April, 1989. Oxy share price was then $27.12. It did not plunge at all in the following days, rather stayed still. After a month, in 25 May 1989, it was already $28.62. (This reflects a 5.5% increase, where the S&P 500 index, for example, was up by "only" 4% at that time. To be sure, I do not imply that this is a proper event-study with conclusive results; only that this represents an anecdotal indication that perhaps even high level of efficiency-reducing donations can go unpunished.) See also Balotti & Hanks, infra note 81, at p. 990, footnote 161.

notorious cases of corporate philanthropy? Could it be that the market sees some sort of a function for giving money away? If so, what is this function?

The most famous academic debate in corporate philanthropy is the Berle-Dodd debate. Berle claimed that managers should care only about stockholders, so corporate philanthropy is illegitimate; Dodd claimed that managers should care also about stakeholders, so corporate philanthropy is not only legitimate, but wanted. The debate is especially noted for its "ending", i.e., Berle's chivalry admittance of defeat.[5] However, here as well perhaps the most interesting aspect is left a bit unnoticed. Berle was clearly *not* convinced that his argument was *theoretically* flawed. He just noted the sustainability and continued growth of the phenomenon of corporate philanthropy. In a traditional Darwinian logic maneuver, this seemed to lead him to think that something must be working in favor of corporate philanthropy – an irrational phenomenon could not have survived the natural selection of the market forces.[6] What exactly is this elusive "something" that worked in favor of corporate philanthropy, lending it Darwinian sense? What is this something that caused the market to value OXY even more when it engaged in ("bad") philanthropy[7]? There is obviously a need for an explanation to corporate philanthropy. Many such explanations were given in the past. Following is my attempt to provide a fitter one.

[5] Adolf A. Berle, *Corporate Decision-Making and Social Control*, 24 Bus. Law. 149, 150 (1968).

[6] Note Berle's own words (*Id.*): "*Practically*, Prof. Dodd won the debate. *I was not convinced as a matter of doctrine* that social responsibility should not be left to governance but there was no doubt that the event conformed rather to his prediction than to mine" [emphasis added]. This aspect was noted in Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 Del J. Corp. L., 649, 697, footnote 186 (2004).

[7] Similarly, the most famous case in the never-ending debate about the purpose of corporations and legitimacy of corporate philanthropy in particular, is *Dodge v. Ford* (204 Mich. 459, 170 N.W. 668 (1919)). It was (still is) analyzed and cited by numerous legal articles. Yet, perhaps the most important aspect of the case has gone virtually unnoticed. Every corporation student knows that the Michigan Supreme Court banned Henry Ford's philanthropic ambitions, stating that one cannot aspire to do good with stockholders money. What is less emphasized is the actual outcome of this struggle between the Dodge brothers and Ford. In a classic Coasian maneuver, the legal outcome did not alter the final allocation: after losing in court Ford bought out the Dodge brothers. He then proceeded to engage in the same "philanthropic" activity that was challenged in court. The company only became more profitable in the following months and years (see Roger Burlingame, *Henry Ford* 91-101 (1954); Henry G. Manne, *The Limits and Rationale of Corporate Altruism: An Individualistic Model*, 59 Va. L. Rev. 708 (1973) (hereinafter: Manne)). Could it be that engaging in philanthropic activity donated to this success? If so, how?

Introduction

Corporate philanthropy (CP) is indeed a sustainable, global, growing phenomenon. However, some may claim that its importance is grossly overstated. This point should not be easily discarded: in the U.S, CP takes a small portion of total charitable giving (5%), and a smaller portion of total corporate expenses (1% of corporate income). Still, I believe that hundreds of academics from various fields are not wrong (at least not in this instance…) when investing so much in studying this subject.

First, CP *cannot be said to be practically unimportant*: Nearly all of the public companies in the U.S. donate to a certain extent[8]; this extent – sixteen billion dollars per year, is still considerable; and its importance to basic institutions in society is unquestionable: 28% of the giving to society-benefit organizations and 18% of the giving to the health sector comes directly from CP.[9] *Second*, and perhaps more importantly, CP certainly *cannot be said to be uninteresting*.[10] On the contrary: counterintuitive phenomena are the most interesting ones. Understanding exceptions to the rule provides us with a better understanding of the rule itself.[11] By looking at a non-profit-maximizing phenomenon, we could understand better the contours of the profit-maximizing rule in the corporate purpose debate.[12] Furthermore, understanding CP might provide us with better understanding of corporations, their function in society, and

[8] Hayden W. Smith, *If not corporate philanthropy*, *then what?*, 41 N.Y.L. Sch. L. Rev. 757 (1997) (hereinafter: Smith, 41 NYL), at footnote 29 and the accompanying text.
[9] Besides, CP has been said to serve as bellwether to other sources of giving, thus making it even more important than its numbers tell. Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. Rev. 579 (1996) (hereinafter: Kahn, 44 UCLA), at p. 588, footnote 23.
[10] To borrow Eisenberg's words: "putting the question in perspective still leaves the question". Melvin A. 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 (1998) (hereinafter: Eisenberg, 28 Stetson), at p. 19.
[11] Slavoj Zizek, *The Fright of Real Tears* 13-31 (2001) (in the film studies theory context); Steven Pinker, *Words and Rules* (1999) (in linguistics theory context). *See also* Giorgio Agamben, *State of Exception* (Kevin Attell trans., 2005) (in the political thought context, analysis of the notion of "state of exception").
[12] Consider Zizek's words, and think of the analogy to the proper purpose of the corporation debate: "… if all individual cases of the species are just so many failed attempts to actualise the universal notion, where do we locate this notion 'as such'? *In the exception*" [emphasis in original]. Slavoj Zizek, *The Fright of Real Tears* 27 (2001).

corporate law in general. *Finally*, CP is a sub-set of a much larger phenomenon of prima facia non-maximizing expenditures by corporations.[13] Understanding better the extreme test-case within that larger phenomenon, might provide insights on other not-so-obviously-non-maximizing expenditures.

Currently, there is a gap in understanding this important and interesting phenomenon. CP is still considered counterintuitive, or at least as presenting some puzzles. This is true also in economics, business management and sociology[14]; but especially in the legal literature.[15] I offer an alternative explanation for CP. One that I hope would solve most of the puzzles and could lead to a better legal regulation.

I propose to see CP as costly signaling. It is a perfectly rational phenomenon, because it allows companies to effectively signal their quality to their target-audiences.

My general framework starts from the assumption of asymmetric information in the market. Insiders have private information regarding the quality of their firms. They wish to communicate it effectively to the target-audiences. But the market is also very competitive. The interests of the companies and their target-audiences collide. This means that companies have strong incentives to cheat in this communication – to present themselves as better than they truly are. So target-audiences would respond only to a reliable communication. But how could insiders attach reliability to their messages about company's quality? They invest in the signals. They use

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[13] For this notion see especially the writings of Eisenberg: Eisenberg, 28 Stetson; Stetson's transcript, p. 81 (1998).

[14] See the forward to *Corporate Philanthropy at the Crossroads* (Dwight F. Burlingame & Dennis R. Young Eds., 1996) (hereinafter: CP at the crossroads) (While the fact of substantial level of CP is documented; what is not clear are the reasons for such a level).

[15] Rikki Abzug & Natalie J. Webb, *Rational and Extra-Rational Motivations For Corporate Giving: Complementing Economic Theory With Organization Science*, 41 N.Y.L. Sch. L. Rev. 1035 (1997) (hereinafter: Abzug & Webb), at p. 1037 ("Although economists, corporate executives, and nonprofit readers have discussed the growth and propriety of, as well as the reasons for, corporate living for over fifty years, many questions remain unanswered"); 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 (1999) (hereinafter: Butler & McChesney) ("'…there remains considerable controversy… one reads more and more about the 'problem of corporate philanthropy'").

handicaps. These handicaps are quality-dependent – they cost less for a high-quality company to produce them. Target-audiences could thus invest in paying attention to costly signals, because they are reliable – companies that can handicap themselves more are fitter.

Applying this to our context, I suggest one possibility for how CP serves as a costly signal: *companies are the <u>signalers</u>; potential investors – shareholders – are the signal-<u>receivers</u>; ability to generate future cash flow is the underlying, not readily-observable <u>quality</u> that is being conveyed;* and *cash donations is the <u>signal</u>'s form*. It is plausible that future cash flows would be the subject of signaling: think of the centrality of cash flows in evaluation methods; and the fact that outsiders cannot assess directly the merits of the company's future projects. It is also plausible that donations could convey effectively messages about cash flows, because of CP's discretionary, slack-resources-related nature, and the predominance of cash donations in CP.

If this explanation is accepted to be fitter than its predecessors, it will have some important legal implications. First and foremost, we should not regulate CP anymore than we regulate expenditures on "regular" advertising (namely, under a Business Judgment Review). The current U.S. law – allowing CP as long as it is determined ex post by the courts that a donation was made in order to create long-term, indirect value to the corporation – is problematic. It creates uncertainties and is difficult to implement; sends a wrong message to society (negative expressive value); and may push companies to costly signaling by ways of *waste*, other than by way of altruism, which would be less beneficial for society as a whole. Still, there are some aspects of CP which may call for more regulation than other business/marketing expenditures. An example is the decision about the identity of the donnees. The signal selection forces that constrain agency costs in other aspects of CP, might not work effectively here. The task would be to come up with a mechanism that constrains these costs, while avoiding the above mentioned problems of over-regulating the decisions to make donations in given amounts.

Some terminology: I alternate between the terms "donations", "contributions", "philanthropy", "gifts", etc – when relating (unless stated differently) to corporate expenditures for qualified charitable organizations. By "qualified" I mean organizations that are tax-exempted under IRC § 501(c)(3). Without getting into in-depth analysis at that part of the paper, it will suffice to note that the terms "philanthropy" or "altruism" were denoted as "misnomers" when used in the corporate context, CP being called an oxymoron.[16] The way I see it, these semantic remarks are part of the problem in understanding CP. It is better to refer to corporate donations as representing "cooperative" behavior, in the sense that it "contributes to the attainment of goals by others in that system", regardless of what exactly attitudinal and intentional states it reflects.[17] It would be better then to stick to the "philanthropy" terminology.

Such definition also focuses the paper on a narrow sub-set of corporate non-maximizing activities: I will not focus on all corporate social responsibility activities; only on those behaviors that are obviously (prima facia) non-maximizing.[18] I will also not focus on corporate foundations activities; only on "direct" donations made by the corporation to the ultimate beneficiaries.[19]

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[16] See for example Hildy J. Simmons, *Symposium: Corporate Philanthropy: Law, Culture, Education, and Politics: Luncheon Address*, 41 N.Y.L. Sch. L. Rev. 1013 (1997); Smith, 41 NYL, p. 762; Dennis R. Young & Dwight f. Burlingame, *Paradigm Lost: research toward a New Understanding of Corporate Philanthropy,* in: CP at the crossroads, pp. 159-160.
[17] Yochai Benkler, *Law, Policy and Cooperation,* (draft, 2008).
[18] For example, cause-related marketing and corporate sponsorship programs are not included in such definition for CP. Needless to say: even less obvious non-maximizing activities, like being employee-friendly or environmental-friendly, will also not be covered in this paper. See Nancy J Knauer, *The Paradox of Corporate Giving: Tax Expenditures, The Nature of the Corporation, and the Social Construction of Charity*, 44 DePaul L. Rev. 1 (1994) (hereinafter: Knauer), at footnote 360 and the accompanying text; Kahn, 44 UCLA, pp. 668-669.
[19] To clarify: CP can be done not only directly by the corporation, but also through a "corporate foundation". Corporate foundations are entities established by the corporations, which qualify under § 501(c)(3) as charitable organizations for purpose of tax-exemptions. Corporations sometimes transfer money to their foundations, which in turn are the ones making the actual donation decision: how much, to whom and when. Most of the CP is still being done directly, though. For elaboration see Natalie J. Webb, *Corporate Profits and Social Responsibility:*

Part I of this paper would present the current take on the CP phenomenon: empirical data on its manifestations, theoretical explanations for its manifestations, and doctrinal aspects of legal regulation of its manifestations. *Part II* would present my proposed alternative explanation. First, by introducing the costly signaling model I would build on; then by applying this general model to the corporate context; and finally refining this application by trying to answer and accommodate potential alternatives and objections to it. In this part I would try to implement the conventional economic approach to corporate law with the sociobiology literature. *Part III* would sketch some legal implications deriving from my suggested explanation of CP. *Part IV* would try to identify what future research is implied and would be needed if accepting my explanation of the phenomenon. I would then conclude.

Chapter I – the current take on corporate philanthropy

I.1 – current data

In order to explain the phenomenon, we need first to understand the scope and characteristics of its manifestations. We will begin by reviewing the *recent numbers* – relying on the most updated yearly-base data, which represents the 2007 CP activities.[20] Then, we will move to look at *longitudinal analysis* – see how exactly CP numbers have changed during the years.[21] Finally, we will look at the many studies conducted when trying to find explanations to the phenomenon that account for its considerable inter-company variability. These studies focus on *correlative results* – to what characteristic of the corporation does CP correlate and how.

'Subsidization' of Corporate Income Under Charitable Giving Tax Laws, 48 J. Econ. & Bus. 401 (1996). *See also* Kahn, 44 UCLA, footnotes 10 and 26 and the accompanying texts, and pp. 592-593.

[20] I will be relying mainly on 2008 *Giving USA* (hereinafter: Giving USA). A caveat is in order here: current data on CP is gathered mainly on company-blind basis, not giving us enough company-specific data.

[21] There is available non-anecdotal information only from 1936 (following the amendment to the IRC in 1935, which brought reporting of CP for tax-exemption purposes). See Smith, 41 NYL, p. 758. For some of the anecdotal pre-1935 evidence on CP, see Knauer, at pp. 15-18.

I.1.a – the current situation in numbers:

Let us start with the basics: *how much* do corporations donate? In absolute terms, CP amounted to *15.69 billion* dollars in 2007 (to put things in perspective: this reflects a 1.9% nominal increase compared to 2006, or a 0.9% decrease when adjusted to inflation).[22] Note that the 15.69 billion does not reflect an additional 4.37 billion dollars in corporate foundation giving.[23] In relative terms, as a percentage out of total annual charitable contributions CP amounted to *5.1% of overall giving in 2007*.[24] As a percentage of corporate overall income, CP amounts generally to approximately *1% of corporate pre-tax profits*.[25]

The next question is *what form* does CP take? (What do companies donate – cash/in-kind donations[26]?) *Cash donations are the most popular form of CP*.[27] In the 1990's cash donations were estimated to represent 80% of total CP. [28] In recent years it has been reported that in-kind products donations gradually take a greater share of overall CP. This was attributed to the pharmaceutical and technology companies, which donate a lot of their (outdated) inventory.[29]

[22] Giving USA, pp. 13, 77.
[23] Giving USA, pp. 77, 84.
[24] Giving USA, pp. 9. Individual giving represented 74.8% of total giving; foundation grant-making represent 12.6%; charitable bequests represent 7.6%. See *Id*, p. 13.
[25] Giving USA, p. 30 (in 2007 the exact share was 0.8% of corporate pretax profits); Ronald S. Burt, *Corporate Philanthropy as a Cooptive Relation*, 62 Social Forces 419, 421 (1983) (hereinafter: Burt).
[26] In-kind donations might come at various forms: products, expertise, services, employee release time, use of facilities, etc. Bruce Seifert et al., *Having, Giving and Getting: Slack Resources, corporate Philanthropy, and Firm Financial Performance*, 43 Business & Society 135 (2004) (hereinafter: Seifert et al.), at p. 139; See also the Council on Foundations elaborative definitions on their website: http://www.cof.org/members/content.cfm?itemnumber=1247&navItemNumber=2417. (all websites cited in this paper were last visited on 4/20/09.)
[27] I shall only note at this time, without taming too much this dry data with my interpretations, that the predominance of cash to in-kind donations is a puzzle. I will discuss why exactly this is a puzzle and what explanation could solve this puzzle, in Chapter II.2.
[28] See Kahn, 44 UCLA, p. 588, fn 26-27 and the accompanying text.
[29] Giving USA, pp. 77, 83.

Accordingly, it was reported that in 2007 in-kind donations might have comprised already more than a third of total CP.[30]

After establishing how much and what, we should check *to whom* do corporations donate? Who are the beneficiaries of CP? Obviously, there can be no conclusive answers for this question, other than "it varies". Still, some patterns are worth noting. The sector that gets the biggest share of CP is the health sector, followed by contributions to education.[31] This is attributed in large part to those large products donations made by the pharmaceutical companies we mentioned earlier. When comparing CP to overall giving, it is notable that corporations generally do not give to religious organizations, which are by far the largest beneficiaries of overall giving.[32] This means that while in overall giving CP can be said to play only a minor part (5%), in many sectors it comprises a not-insignificant share: 28% of contributions to society-benefit organizations, 22% of contributions to international affairs organizations, 18% to the health sector, etc.[33] Finally, an increase at the level of giving internationally (i.e., to beneficiaries located in countries other than where the corporation's seat is) was reported.[34]

There were many attempts to identify patterns of the "to whom" question, which will have more predictive power and less generalization than the abovementioned categorization. It was suggested that geographical proximity matters: corporations would give more to "local" charities.[35] Some stressed "industry proximity", maintaining that what matters is the linkage between the nature of the business and that of the charity (i.e., hi-tech companies give more to

[30] Giving USA, p. 81. It is important to note that this figure is only estimation. There are several problems with accurately measuring in-kind donations. For one, they are reported to the public in their "regular" market value, but in fact the amount allowed for tax-deduction is much less. See *Id*., pp. 81-82.
[31] Giving USA, pp. 83-84, especially figure 2.
[32] Giving USA, pp. 33 (overall giving to religious organizations amounted to more than 102 billion dollar in 2007). *See also* Victor Brudney & Allen Ferrell, *Corporate Charitable Giving*, 69 U. Chi. L. Rev. 1191 (2002) (hereinafter: Brudney & Ferrell), at p. 1197.
[33] Giving USA, pp. 149, 178, 140 (accordingly).
[34] Giving USA, p. 81.
[35] Smith, 41 NYL, p. 765. "Local" here means geographical proximity to the giving company's facilities/personnel.

research institutions and engineering schools, pharmaceutical companies give more to hospitals and medical schools).[36] Others focused on what seems as a "dark side" of CP – giving to "pet charities". It was suggested that corporations decide the identity of beneficiaries by matching the individual philanthropic preferences of their insiders (for example, matching the gifts given personally by directors).[37]

This ties us to findings on the last question addressed here – *who decides* on CP? Who inside the corporation makes these "how much", "what form" and "to whom" decisions? Generally, CEOs exert extraordinarily influence and discretion over CP decision-making. This is especially notable when compared to CEOs influence over other equivalent expenditures (remember that CP takes only a marginal part of corporate expenditures).[38]

I.1.b. Longitudinal analysis:

Overall, CP has been a very stable phenomenon – consistently, slowly, gradually growing.[39] In real, absolute terms, the inflation-adjusted growth of CP is evident. If considering the last forty years and measuring in five-years spans (to compensate for local abnormalities), CP has made a 209% growth.[40] When measuring as a share of pre-tax corporate earnings, we observe small

[36] Smith, 41 NYL, p. 765.
[37] Lawrence A. Cunningham, *The Essays of Warren Buffet: Lessons for Corporate America,* 19 Cardozo L. Rev. 5, 52 (1997).
[38] Usha C.V. Haley, *Corporate Contributions as Managerial Masques: Reaffirming Corporate Contributions as Strategies to Influence Society*, 28 Journal of Management Studies 485 (1991) (hereinafter: Haley), p. 493; Michael Useem, *Market and Institutional Factors in Corporate Contributions,* 30 California Management Review 77, 82 (1988) (hereinafter: Useem, Institutional Factors); Kahn,.44 UCLA, p. 591, footnote 48 and the references there; Jayne W. Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem,* 41 N.Y.L. Sch. L. Rev. 1147, 1157-1160 (hereinafter: Barnard).

Anecdotally, when I got the chance to ask Ben Heineman, GE's former general council for many years, how does CP decisions were made in a giant corporation; he remarked that the "direct" donations (i.e., those not made by the corporate foundation) are almost completely a product of the CEO's discretion and initiation (personal conversation in HLS, 11/11/08).
[39] "Over the past 40 years, the real rate of growth for corporate giving has changed little". Giving USA, p. 27.
[40] Giving USA, p. 22.

movements around a fairly stable 1% share.[41] Still, we can identify several sub-areas worth noticing, in which CP either decreased or increased significantly, as demonstrated below.

External shocks that affect substantially overall giving in general, usually affect corporate giving as well. Thus, we have seen CP reach a local pick at the advanced stages of WWII, where corporations took part in the national effort; while in the following years there was a balancing decline.[42] Similar pattern was observed in response to natural disasters in a global scale: in 2005 CP reached an abnormal high, due to contributions to the Katrina hurricane (New Orleans) and the Tsunami (East Asia) victims; in 2006, CP level returned to trend, decreasing by 10.1%.[43]

Perhaps more interesting are those sub-areas for which no external readymade explanation exist to account for abnormal CP levels. Consider the last forty years, in which overall giving, adjusted for inflation, "…typically increases in nonrecessionary years and stays level or falls slightly when the national economy is in recession".[44] In this light, it is interesting to note that in 1982-1986, corporate giving increased even though corporate profits decreased, until CP reached a pick of 2% of corporate pre-tax earnings. Similar phenomenon – decreasing profits and increasing giving – occurred in 2000-2001.[45]

<u>I.1.c. Correlative results</u>:

Vast amount of studies was conducted in order to pinpoint the causes and correlates of CP, trying to explain the considerable inter-company variability. Many of them contradict each other. I tried to gather the most conclusive or notable ones, so that we could nevertheless sketch roughly some limited conclusions worth taken into account.

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[41] Giving USA, p. 30.
[42] Smith, 41 NYL, p. 759, footnotes 9-10 and the accompanying text.
[43] Giving USA, pp. 17, 27 (Similar disaster relief explanations were provided for 2001 and 2002.).
[44] Giving USA, p. 20.
[45] Giving USA, p. 30. See also Useem, Institutional Factors, at p. 78. While my alternative explanation for CP suggested in part II infra might shed light on those phenomena, I left the attempt to provide detailed explanation of the historical evolution of CP in the U.S for future work (my intended SJD dissertation).

Firm size: many studies found that large firms donate more.[46] Other studies indicated that while big firms might give a larger amount, small firms give a higher proportion of their pretax earnings.[47] Overall, there is an acceptation of firm size as a dominant predictor of CP.[48]

CEO's attributes: the discretionary nature and the fact that CEOs exert a lot of influence in CP decision-making, suggest that CEOs perceptions and motives would affect CP. Accordingly, it was suggested that CEO's ownership has a negative impact on CP, while CEO's social network ties to local philanthropic leaders have a positive impact on CP.[49]

Industry effects: Several studies suggested, in line with a CP-as-a-form-of-marketing explanation, that industries with higher degree of public contact (think insurance) donate more than those with little public contact (think mining).[50] Other market considerations, it was claimed, are manifested in the "to whom" decisions: for example, commercial banks give more to health and human services, while electrical machinery companies give more to education.[51] In contrast, other studies found no statistically significant industry effects.[52]

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[46] Ferdinand K. Levy & Gloria M. Shatto, *Social Responsibility in Large Electric Utility Firms: The Case for Philanthropy*, in: Research in Corporate Social Performance and Policy, vol. 2 (L. E. Preston, Ed.) 237-249 (1980); Mike Adams & Philip Hardwick, *An Analysis of Corporate Donations: United Kingdom Evidence*, 35 Journal of Management Studies 641 (1998) (hereinafter: Adams & Hardwick) (level of CP positively related to company size in the UK); and generally, the studies mentioned in Seifert et al., p. 150.

[47] Banwari L. Kedia & Edwin C. Kuntz, *The Context of Social Performance: An Empirical Study of Texas Banks*, in: Research in Corporate Social Performance and Policy, vol. 3 (L. E. Preston, Ed.) 133-154 (1981); *See also* the references in Peter A. Stanwick & Sarah D. Stanwick, *The Determinants of Corporate Social Performance: An Empirical Examination*, 16 American Business Review 86, 87 (1998).

[48] Dwight F. Burlingame & Patricia A. Frishkoff, *How does Firm Size Affect Corporate Philanthropy?*, in: CP at the Crossroads, at p. 87; Seifert et al, at p. 136; Useem, Institutional Factors, at p. 81.

[49] Lisa Atkinson & Joseph Galaskiewicz, *Stock Ownership and Company Contributions to Charity*, 33 Administrative Science Quarterly 82 (1988); Joseph Galaskiewicz, *An Urban Grants Economy Revisited: Corporate Charitable Contributions in the Twin Cities, 1979-81, 1987-89*, 42 Administrative Science Quarterly 445 (1997). I would like to add a caveat here: these studies use data collected from a very specific, narrow, exceptional case of companies headquartered in Minneapolis-St. Paul. I think it consciously tells the story of the exception (a close-knit community known for its high level of CP), rather than the rule. For this caveat, see also Barnard, p. 1166, at footnote 96 and the accompanying text.

For other CEOs' attributes findings, see Ann K. Buchholtz et al., *Beyond Resources: The Mediating Effects of Top Management Discretion and values on corporate philanthropy*, 38 Business & Society 167 (1999).

[50] Useem, Institutional Factors, at p. 79.

[51] Useem, Id, p. 80.

[52] Adams & Hardwick, at p. 642 (remember: theirs is a UK-companies study).

Corporate governance and ownership structure: while a research that was conducted in the U.K. found no statistically significant link between ownership structure and CP; other studies found that existence of large block-holders constrain CP.[53] As for corporate governance, board structure was found to affect CP (female members, number of outside directors, etc).[54]

Marketing expenses: There are contradictory views on the relationship between advertising and donations expenditures.[55] While several studies found correlation between consumer dependencies and advertising expenses and CP[56]; others did not.[57]

Financial correlates – The relationship between having and giving: based on the assumption that corporate profitability would generate slack resources, which could in turn be directed towards "non-business" expenditures in general and CP in particular, researches studied the relationship between corporate having and giving. It is now widely accepted in the business management and finance literature that *CP depends on the availability of slack resources*.[58]

A basic question in such studies was what measure to use as a predictor of CP. Earlier studies focused on accounting returns or other publically available data. Studies found that income over sales or over total assets predicted the level of CP.[59] Another study, focused on increases in dividends and debt-to-equity ratio (both negatively correlated with amounts of

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[53] See, accordingly: Adams & Hardwick; Barbara R. Bartkus et al., *Governance and Corporate Philanthropy*, 41 Business & Society 319 (2002); Banwari L. Kedia & Edwin C. Kuntz, *The Context of Social Performance: An Empirical Study of Texas Banks*, in: Research in Corporate Social Performance and Policy, vol. 3 (L. E. Preston, Ed.) 133-154 (1981).
[54] Jia Wang & Betty S. Coffey, *Board Composition and Corporate Philanthropy*, 11 Journal of Business Ethics 771 (1992).
[55] Haley, p. 488.
[56] Burt, pp. 426-427; Louis w. Fry et al., *Corporate Contributions: altruistic or for-profit?*, 25 Academy of Management Journal 94 (1982); *See also* the references in Abzug & Webb, pp. 1045-1048.
[57] Levy & Shatto, supra note 46.
[58] Seifert et al, p. 136 (where the target sample was the Fortune 1000 companies). Organizational slack was defined either as "spare or uncommitted resources, a cushion of resources beyond the minimum necessary to maintain the organizational coalition", or "excess resources beyond those needed to produce a given level of output". See Seifert et al., p. 139 and the sources there.
[59] See Galaskiewicz, Revisited, *supra* note 49. *See also* Adams & Hardwick.

financial slack[60]), found that (1) higher debt/equity ratio decreases CP – consistent with the slack-leads-to-giving assumption; and (2) increasing dividends are linked to more philanthropic giving – in contrast with the expectation.[61] In part II.2.b infra we will revisit this alleged puzzle.

Recent studies replaced the accounting returns measures with others, more appropriate in my mind. Accounting returns do not necessarily reflect the amount of discretionary resources, since high returns can be already committed.[62] Instead, cash flow[63] was identified as the most appropriate measure of slack resources and thus predictor of CP. This is because excess cash is the most discretionary of slack resources. It represents uncommitted money that can be directed, inter alia, towards philanthropy.[64] Profits, in contrast, do not necessarily translate into free cash flow, and thus many times are committed to satisfy claims, and cannot satisfy those without any claim towards the company (i.e., donees). It was found that *cash flow has a significant impact on corporate cash donations*. These findings supported the view of CP as a discretionary expenditure, and the notion that doing well enables doing good.[65]

<u>Financial correlates – the relationship between giving and having</u>: ever since the rise of the “corporate social responsibility” (CSR) notion, scholars were trying to find a connection between giving and having. Alas, as more and more studies accumulated, it became clearer that such a connection cannot be empirically proven conclusively.[66] In fact, it was found that “Financial performance was more positively related to subsequent social performance than to

[60] See Seifert et al., p. 140 (referring to G. E. Greenley & M. Oktemgil, *A Comparison of Slack Resources in High and Law Performing British Companies*, 35 Journal of Management Studies 377 (1998).).
[61] Peter Navarro, *Why Do Corporations Give to Charity?*, 61 Journal of Business 65 (1988) (hereinafter: Navarro).
[62] Buchholtz et al., supra note 49, at p. 171.
[63] Defining cash flow as “… a firm’s operating income before depreciation minus the expenses considered to be nondiscretionary – interest on debt, taxes and dividends” (Seifert et al., p. 141 (citing K. Lehn & A. Poulsen, *Free Cash Flow and Stockholder Gains in Going Private Transactions*, 44 Journal of Finance 771 (1989).).
[64] M. P. Sharfman et al., *Antecedents of Organizational Slack*, 13 Academy of Management Review 601, 602 (1988); Seifert et al., pp. 136-139.
[65] Seifert et al, 2004. See also the studies mentioned in Adams & Hardwick, pp. 645-646.
[66] Seifert et al., p. 143; Kahn, 44 UCLA, pp. 664-665, footnote 371 and the sources mentioned there.

prior social performance".[67] On the other hand, when studies focused on the specific subset within CSR of CP, it was found that cash donations generate significant positive reputational payoffs for the donating firm.[68] We will reinterpret these findings in part II.2.a infra.

I.2 – current theoretical explanations

Neoclassical economists and some economically inclined legal scholars used to view CP as irrational. In the famous Milton Friedman's version: the social responsibility of business is to increase its profits.[69] Spending money on philanthropy was therefore considered a waste. Managers, it was claimed, should not be generous with shareholders money. If anything, this money should be distributed as dividends, and then shareholders would be free to fulfill their own individual philanthropic preferences.[70] But this approach suffered from a basic flaw: if CP indeed runs against rational economic considerations, how can we explain its sustainability, not to mention its consistent growth over the years? A re-examination was needed – one that would point to the adaptive characteristics of the phenomenon.

The explanations that follow were either rational economic explanations – CP brings direct/indirect benefits to the company; or extra-rational organizational explanations – CP brings psychological/tangible benefits to insiders who donate other people's money. However, No particular explanation has prevailed as the fittest.

Given this indecisiveness in the academia, it might have been constructive to check what the insiders' take on the phenomenon is. Corporate executives often explain CP in according

[67] Seifert et al., p. 140, and the studies mentioned there.
[68] Stephen Brammer & Andrew Millington, *Corporate Reputation and Philanthropy: An Empirical Analysis*, 61 Journal of Business Ethics 29 (2005) (but note: the sample for this study was U.K based).
[69] Milton Friedman, *Capitalism and Freedom* 133-134 (1962); Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times, Sept. 13, 1970, p. 32.
[70] Compare: Milton Friedman, *Capitalism and Freedom* 135 (1962).

with the stage on which their explanations are made.[71] They refer to CP interchangeably as an altruist act (when trying to get tax-deduction), as discharging their social responsibility (when addressing stakeholders or trying to avoid public/regulatory backlash), or as enlightened self-interest (when explaining it to stockholders, or when challenged in court). So here as well, we cannot locate a single explanation that prevailed as the most accepted.

The purpose of this sub-chapter would be to organize the competing explanations in an as-concise-as-possible manner. After surveying the core assumptions and ideas behind every explanation, I will shortly point some notable problematic aspects in each explanation – aspects that prevented it from achieving dominancy. This would hopefully prove helpful in part II of this paper, when evaluating my alternative explanation against existing ones.

<u>I.2.a. "direct benefit" explanations:</u>

<u>The neo-classical approach – CP is about financial bottom line</u>: if pure corporate philanthropy is a waste, the neo-classical economists posit, CP that is sustainable must be in effect about enhancing the financial bottom line. Otherwise it would not have survived the natural selection of the market-forces. What is left to do under this model, is to find out how exactly this connection between CP and profit maximization works. Several non-mutually-exclusive versions were suggested as answers. Below I would present and criticize three of the most notable: the *marketing* argument, the *R&D* argument, and the *tax-deductibility* argument.

According to the marketing argument, CP is about helping the company to develop and preserve its consumers' base:[72] enhancing name recognition,[73] commodifying charitable good

[71] Compare: Abzug & Webb, pp. 1037-1038.
[72] Phillip L. Blumberg, *Social Responsibility and the Social Crisis*, 50 B.U. L. Rev. 157 (1970) (hereinafter: Blumberg), at p. 161; Kahn, 44 UCLA, pp. 671-672.
[73] Craig Smith, *The New Corporate Philanthropy*, 72 Harvard Business Review 105 (1994).

will,[74] and the likes. The R&D argument posits that corporations can use philanthropy money to lower their R&D costs, funding relevant innovations at research institutes, effectively out-sourcing the company's R&D efforts.[75] The tax argument emphasizes the role of favorable tax treatment afforded to corporations under IRC §170 (see part I.3.b.2 infra) in facilitating CP sustainability. Tax deduction reduces the costs of CP to the corporation, by the complement of the marginal corporation tax rate.[76] Thus, it was argued that CP is about "corporations maximize some function composed of corporate profits, individual and corporate tax rates, and altruism".[77]

The direct benefit explanations are flawed, if only for the following three reasons. *First*, logically – they do not explain convincingly how investing in CP boosts a company's competitive advantage. If CP is a business strategy that enhances financial bottom line, how come we observe such high inter-company variability (with companies that donate little or not at all)?[78] *Second*, it does not account for a large portion of CP manifestations. What about the many donations companies make to organizations that do not possess such recognizable public image or technological innovation potential? It seems that those making these arguments usually have in mind only a small portion of corporate expenditures that may qualify as CP; like corporate sponsorship or cause-related marketing.[79] These sorts of expenditures are less interesting for our purposes, since they are more like advertising in a narrow sense; and many times do not qualify

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[74] I.e., taking advantage of the privileged status afforded to the charitable organization; hoping that some of the beneficiary's positive image would rub on the donating company. This creates what is termed in marketing a "halo effect". When the corporate donate to a respectable charity, the former's name becomes associated with the latter's. Knauer, pp. 53-81; Richard Steckel & Robin Simons, *Doing Best by Doing Good* (1992); Haley, pp. 487-488.
[75] Katherine E. Maddox & John J. Siegfried, *The Effect of Economic Structure on Corporate Philanthropy*, in: The Economics of Firm Size, Market Structure and Social Performance (Siegfried Ed., 1980); Smith, The New CP, supra note 73, p. 105; Haley, pp. 487-488, 500.
[76] See Abzug & Webb, p. 1046; Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving*, in: Philanthropic Giving (Richard Magat Ed., 1989), at pp. 198-200.
[77] Haley, p. 489. See also Joseph Galaskiewicz, *Corporate Contributions to Charity: Nothing More Than a Marketing Strategy?*, in: Philanthropic Giving (Richard Magat Ed., 1989), in pp. 250-252.
[78] Abzug & Webb, pp. 1035, 1045.
[79] On cause-related marketing and the American Express example, see Patricia Caesar, *Cause-Related Marketing: The New Face of Corporate Philanthropy*, 59 Bus. Soc. Rev. 15 (1986).

as CP the way we defined it.[80] *Finally,* there are specific flaws in each specific direct-benefit mechanisms suggested. The marketing argument does not account enough for non-profits over-selling their image or elasticity of demand and consumers' preferences.[81] Empirical evidence contradicts the tax argument, showing no correlation between tax rates and CP.[82]

I.2.b "indirect benefit" explanations:

As it was extremely difficult to find a direct-benefit theory which will be both logically sound and widely applicable, the focus has started to move towards attributing CP to some much more elusive, long-term, indirect benefit. Below we focus on two notable sub-genres in this approach: the political model and stakeholder theory applications.

I.2.b.1 The political approach:

CP is not about profits or about social good per se; it is about companies playing in the public sphere – preserving corporate power and autonomy, bolstering corporate position, positing an alternative to and limiting governmental interference.[83] Such political explanation has several versions, suggesting different mechanisms by which CP influences politics. Some claim that CP

[80] I.e., not tax-deductible under IRC §170.
[81] See Knauer, p. 65. Compare: R. Franklin Balotti & James J. Hanks, *Giving at the Office: A reappraisal of Charitable Contributions by Corporations*, 54 Bus. Law. 965 (1999) (hereinafter: Balotti & Hanks), at p. 967.
[82] See Navarro (no relationship between tax rates and CP rates); Haley, p. 489 (further references).

There are additional flaws to the tax argument. *First,* CP was a sustainable phenomenon before the first tax-deduction provision was enacted; so tax deduction can not be the sole cause of it. Knauer, 44 DePaul, p. 50. *Second*, Even if we assume that the argument's logic holds it is important to not that the argument is *not sufficient***.** Tax deduction merely reduces the costs of CP. It does not eliminate them altogether. The corporation still pays 0.65$ for every dollar donated. Knauer, 44 DePaul, p. 49. *Third*, it is not clear why the level of CP does not even come close to the deduction ceiling imposed in §170(b)(2) of the IRC, and is not affected by changes in the ceiling. Burt, at p. 421. Raising the ceiling of tax-deduction from 5% to 10% in 1981 did not have a significant effect on CP. Galaskiewicz, Corporate contributions, supra note 77, at p. 251. *Finally*, insiders reported that tax considerations are at best an ancillary factor in their CP decision-making. Galaskiewicz, Corporate Contributions, *Id*. (I must note, however, that I believe that we should not attach too much value to statements of insiders. Insiders – either from the side of the donators or the donees – are too often too much interested and tainted with "reverse hypocrisy" (i.e., managers trying to convince others that when they are donating they are actually thinking about the financial bottom line, in order to insulate themselves from scrutiny). So we should not adhere to their rhetoric. See Manne, at p. 712; Knauer, p. 81; Kahn, 44 UCLA, pp. 662-663, fn 362.)
[83] Jerome L. Himmelstein, *Corporate Philanthropy and Business Power,* in: CP at the Crossroads, pp. 160-161. In many ways, this explanation is compatible with advancement of direct benefit. See Manne, pp. 714-715.

helps preserving the "free enterprise system"[84]; others emphasize preserving relationship with certain political actors in the American context[85]; and others promote a more defensive approach, of CP as a way to mitigate fear of government intrusion – by behaving as a "good citizen", the corporation allegedly reduces the probability that regulators would go after it.[86] This is in line with the corporate governance literature that emphasizes "legitimacy concerns".[87]

These explanations are susceptible to free-riding. Preservation of capitalism and the likes are classic public goods.[88] How can they enhance a given company's competitive advantage? Where will such donations derive their internal legitimacy (i.e., why should "shareholders' money" be used to achieve questionable public goods, without even giving shareholders a say on it)? Moreover, while other CSR activities might indeed be about legitimacy concerns (think spending money on employee-friendly initiatives); outright donations are in my mind a relatively weak use of discretionary funds to achieve legitimacy.[89]

<u>I.2.b.2. the stakeholder theory approach</u>:

Represented in the legal literature by the Dodd side of the Berle-Dodd debate, this approach claims that we should not measure CP by the difference it makes (or does not make) to shareholders alone. Rather, we should check how CP affects other constituencies: workers, consumers, the local community, etc. This way of looking, it is suggested, would lead us to understand that CP is about managers trying to steer a clear path, reconciling different groups'

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[84] Neil J. Mitchell, *The Generous Corporation* (1989); Richard Eells, *Corporation Giving in a Free Society* (1956) (CP as one response to cold-war fear of encroaching communism); Knauer, pp. 85-88; Manne, p. 710, footnote 8 and the accompanying text (citing Wallich) (CP as a way to preserve capitalism in the fight against socialism).
[85] Jerome L. Himmelstein, *Looking Good and Doing Good: Corporate Philanthropy and Corporate Power* (1997).
[86] See for example Blumberg, p. 164, footnote 37; Smith, 41 NYL, p. 761-762.
[87] On the need for corporations to achieve and sustain legitimacy, see Mark J. Roe, *The Institutions of Corporate Governance*, in: The Handbook of New Institutional Economics (Menard & Shirley eds., 2005), pp.375-376. On the claim that CSR helps in this legitimacy preservation efforts, see Haley, p. 490.
[88] Manne, p. 710; Brudney & Ferrell, p. 1200.
[89] Perhaps a comparison between the U.S and Western Europe would be constructive here: legitimacy problems are said to be more central to corporate governance in Western Europe than in the U.S (see Roe, institutions, *supra* note 87, p. 372). At the same time, American companies invest much more in CP than their European counterparts. What does that tell us? I hope to pursue such cross-cultural examinations in my SJD dissertation.

interests when conducting the corporation business. Put differently: CP is about managers using discretionary funds to satisfy not just the explicit contractual rights (like those of lenders), but rather the more implicit claims of other constituencies.[90] Here as well, various mechanisms were suggested to explain how this model works in practice: from resource dependency[91]; to a direct-benefit-like approach of CP as increasing workers' productivity[92]; and the relatively recent support from the application of the "*team production* theory" to CP.[93]

All these explanations suffer from common basic flaws: being highly amorphous, with a little explanatory and predictive power[94]; not adding much to the corporate law debate, since they either do not really question the criterion of profit maximization, or do not specify how to make necessary tradeoffs and to measure them[95]; and failing the empirical tests whenever attempts are being made to concretize the amorphous approach.[96] The specific mechanisms

[90] Donna J. Wood & Raymond E. Jones, *Research in Corporate Social Performance: What Have We Learned?,* in: CP at the crossroads; Dennis R. Young & Dwight f. Burlingame, *Paradigm Lost: research toward a New Understanding of Corporate Philanthropy,* Id., at pp. 161-162; Margaret M Blair, *A Contractarian Defense of Corporate Philanthropy,* 28 Stetson L. Rev. 27 (1998) (Hereinafter: Blair, 28 Stetson L. Rev.).

[91] The argument runs as follows: corporations may be dependent on certain stakeholders for access to critical resources. In order to mitigate this dependency, the corporations might invest in contributing some of the resources that it *does* have (cash, for example) to these stakeholders. See Abzug & Webb, p. 1054-1055. See also Joseph Galaskiewicz, *Social Organization of an Urban Grants Economy* (1985); Seifert et al., p. 142.

[92] The argument: CP that is based on employee matching grant programs – assuring employees get psychic benefits – would affect employees' morale and productivity, also by making the community they live in better. See Alice Korngold & Elizabeth Hosler Voudouris, *Corporate Volunteerism: Strategic community Involvement,* in: CP at the Crossroads, especially at pp. 26-27; David Lewin & J.M. Sabater, *Corporate Philanthropy and Business Performance,* Id; Kahn, 44 UCLA, pp. 672-673.

[93] The team production model asserts that directors must retain vast discretion to mediate between all the different team-members that are involved in production within the firm. Its application to CP: as part of such needed vast discretion, it is essential to generally not challenge management's philanthropic endeavors with corporate money. Blair, 28 Stetson L. Rev. See also Stetson's transcript, pp. 71-72.

[94] The model "does not make clear exactly how the various stakeholders interact to determine corporate policy or how the various economic and social objectives are reconciled with one another". Young & Burlingame, p. 162.

[95] The model just recognizes that stakeholders' responsibility is an essential element for corporate success (and it does so without providing tools to assess the benefit ex post/ante….). Archie B. Carroll, *The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders*, 34 Business Horizons 39, 42-43 (1991). For the critiques see Michael Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function,* 14 J. Applied Corporate Finance 8 (2001); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law,* 89 Geo. L.J. 439, 447-449 (2001); Knauer, pp. 31-32.

[96] For example, there were indications that decisions on CP are influenced less by employees' perception, more by "outside" factors, such as the level of CP in competing corporations; as well as indications that CP is not correlated with any of the measures of a firm's market dependency on consumers. See, accordingly: John J. Siegfried et al.,

mentioned above suffer from specific flaws as well. For example, the team production argument ignores the fact that allowing "socially responsible" donations do not have anything to do with neither "team" nor "production".[97] Blair calls for a "contractarian" defense of CP, but at the same time advocates benefiting those who do not have any contractual claim against the firm.[98]

(Without jumping ahead to legal arguments, note that it was claimed that the stakeholder explanation triumphed because it was supposedly codified in the “other constituencies” statutes.[99] I do not think that this is convincing – such interpretation of the Other Constituencies statutes is seriously contested.[100] Furthermore, such argument does not explain why the statutes have no significant effect on CP, and why we observe the same (if not bigger) level of CP by companies that are subjected to state corporate law which does not include an Other Constituencies statue – most notably, all the Delaware companies.[101])

I.2.c. – managerial utility (agency theory) explanations:

According to this approach, the attempt to explain the sustainability of CP by trying to find how it benefits the company (either directly or indirectly), is futile. Decisions of corporate

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The Management of Corporate Contributions, in: Research in Corporate Social Performance and Policy, vol. 5 (Preston ed., 1983), 87; Joseph Galaskiewicz, *Social Organization of an Urban Grants Economy* (1985).

[97] Butler & McChesney, pp. 1219-1225.

[98] Blair’s argument might hold for other CSR actions, such as being employee-friendly or “going green”. But in the extreme sub-set of CP, its applicability is very limited. You cannot include the entire society in your "team" for purposes of the team-production model. Consider two illustrations from the way her argument is structured. First, she maintains that the wide discretion rationale applies to CP decisions exactly like it applies to decisions on transfer prices or employees’ bonuses (p. 33). But there is a much relevant difference between those expenditures – their beneficiaries: the former are not team members, the latter *are*…. Second, she uses the examples of problematic donations to pet charities (including the *Kahn v. Sullivan* case), to prove her point. But this is exactly the problem: the team production argument must assume some kind of substantial interestedness, some perk that the CEO gets from using corporate money to pet charities-donations, in order to justify CP (because only then will a team member “enjoy” the donation). This line of argument has limited applicability and is normatively problematic.

[99] For the view that Other Constituencies statutes codify the view of local communities as stakeholders deserving “organizational attention and resources”, See Abzug & Webb, pp. 1053-1054. *See also* Balotti & Hanks, pp. 966, 979-980; Stetson’s transcript, p. 77.

[100] An alternative explanation is that these statues are the result of incumbent managers’ lobbying for another entrenchment mechanism. See Mark J. Roe, *Strong Managers, Weak* Owners 161 (1994); Stetson’s transcript, p. 91 (Henry Manne’s view).

[101] But see Einer R. Elhauge, *Corporate Managers’ Operational Discretion to Sacrifice Corporate Profits in the Public Interest,* in: Environmental Protection and the Social Responsibility of Firms (Bruce L. Hay et al. Eds., 2005), at p. 25 (claiming that Delaware case law implemented the spirit of those statutes).

expenditures are taken by individuals; these individuals are agents, deciding about other people's money; so expenditures are made to promote the interests of the agents, sometimes at the expense of the principals.[102] This agency problem, it was suggested, explains such efficiency-reducing phenomenon as CP: it might be efficiency-reducing for the company or the shareholders, but it is efficiency-enhancing for the managers, and that is what matters for the expenditure to be made. The question, according to this explanation's proponents, is how exactly CP enhances managers' utility. Several mechanisms were suggested, including: the social currency approach (managers using CP money in exchange relationships with non-profit leaders, to gain personal prestige and status), with peer pressure and managers' fear of "losing face" within the business elite as the driving forces behind CP's sustainability[103]; tangible perks[104]; and satisfaction of individual philanthropic preferences.[105]

Managerial utility explanations are certainly logically plausible. I also believe that in not insignificant subset of cases they actually play a meaningful part in CP decisions. But we should not overstate their importance. For one, it is not at all clear that CP activities are being

[102] For a short overview, see Abzug & Webb, p. 1041.

[103] See Galaskiewicz, *Social Organization of an Urban Grants Economy* (1985); Michael Useem, *Corporate Philanthropy*, in: The Nonprofit Sector (Powell ed., 1987), 340. See also Haley, pp. 491-492 (1991); Kahn, 44 UCLA, pp. 616-618. This approach sees CP as similar to the gift-exchange models in anthropology, associated with Marcel Mauss (*The Gift* (W.D. Halls trans., 2002) (1925)).

A related approach is Haley's, who stresses the symbolic aspect, claiming that CP is about managers symbolically transmitting messages. This happens, supposedly, in three steps: CP attracts attention to what the managers have to say; mimes messages, transmitting interests to other stakeholders; and thus institutionalizes values in society. By doing this, CP helps managers secure power and influence in society.

[104] For example, CP can be about managers getting seats on boards of non-profits, invitations to gala events and opening nights, etc. See for example Atkinson & Galaskiewicz, supra note 49; Kahn, 44 UCLA, pp. 618-619.

[105] This can be done either by politicized philanthropy, which furthers the managers' own political and ideological preferences (think of contributions to pro-life charities); or by donating to a non-political pet charity. Legal writers stressed the agency costs in such mechanisms: politicized CP was said to undermine shareholders' free speech and associational ties; while donations to non-political pet charities was said to create a possibility of tax avoidance – subsidizing the managers' own preferences. Kahn, 44 UCLA, pp. 609-625, 636-637. In my view, the corporate speech argument is questionable. It is not clear if in large public corporations someone could reasonably attach such consent to the diffused shareholders. Identifying company X with individual Y is not plausible in real-world situations, where individuals are investing through intermediaries, and in most times do not even know in which company they invest.

effectively transformed into reputation of the manager as a "generous"/"strong" person.[106] There is no logical or empirical correlation between the signal (CP) and the message it supposedly conveys. Remember, for example, the studies we surveyed in part I.1.C, which found that CP is mainly correlated to the level of a company's slack resources. This means that a generous manager in a "lean company" would donate less, while a less generous manager in a high-in-slack company would donate more. No quality-dependency here (see elaboration in part II infra). The same holds to the argument according to which CP elevate the manager's reputation as someone who "can make things happen" with the company's money:[107] there are more effective and credible ways to generate such reputational impact. Think for example on negotiation for higher pay and/or fringe benefits.[108] Finally, it is important to note that when put to an empirical test, the managerial utility explanations fare badly in relation to others, such as CP as advertising and generally profit-maximization explanations. No relation was found between CP and executive compensation or managerial control of the firm.[109] This is not surprising: most of managerial utility explanations rest on an assumption of some exchange aspect in CP; but in real-life situations, exchange aspects are significant only in a small subset of CP.[110]

Furthermore, when dealing with managerial utility explanations, we need to ask ourselves the "so what" question. Even if CP is about managers benefiting themselves, does it necessarily entail that CP should be limited by regulation? Think for example on the classic agency-theory-

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[106] John F. Padgett, *Corporate Potlatch,* 15 Contemporary Sociology 818, 820-821 (1986) ("While no one would argue an absence of correlation, there is no clear production function transforming 'good deeds' into reputation as a 'generous person', because other's construction of motives intervenes").
[107] Barnard, p. 1149, at footnote 6.
[108] On the salary-fringe benefit mix see James A. Brickley et al., *Managerial Economics and Organizational Architecture* 399-401 (4th ed., 2007). However, as will be mentioned shortly in the body of text, this specific counter-argument is limited. Public outrage constrains certain level of executive pay and fringe benefits; and thus might make them bad candidates for signaling in some circumstances (too costly a signal – socially unacceptable).
[109] See Navarro. A caveat: as mentioned in part I.1.C supra, there are many empirical studies and contradictory results. Nothing is particularly holy about Navarro's study refuting the managerial utility explanations.
[110] A lot of the expenditures on CP are made to an unknown beneficiary, with no direct reciprocity and no repeat interactions with the corporation's managers. It is thus no wonder that the exchange-approach is based on a field-study of a specific small-knit community in Minneapolis-St. Paul area (see footnote 49 supra for the caveat).

centered explanation of Manne. He viewed CP as part of a discretionary pool of resources available for managers, equivalent to the transaction costs of removing them from office.[111] There would always be discretionary funds that cannot be captured by the shareholders, the argument goes. Managers may use those funds for "selfish forms", like shirking or company jets; but they also can and do use some of it for "social purposes". There is a normative conclusion implicit in this argument: we should not restrict CP, because this will only channel managers to use the same level of discretionary funds to more wasteful (in social welfare terms) activities.[112] And if CP is not only about managerial utility, but also about benefits to the corporation itself (see part II infra), then the shareholders are not necessarily worse off. We will address these points more thoroughly in part III infra, when discussing legal implications.

A final argument worth noting in that context is that CP should be considered as part of the executive compensation package.[113] (Note that his mean that we could have also categorized it under a benefit-to-the-corporation explanation.). The counter-argument is that the manager would prefer to receive the extra given amount in salary/personal benefits, and then be free to fulfill his own individual philanthropic preferences as he wishes.[114] But I think that we could refute the counter-argument, as long as we could show that CP is a way for companies and managers to avoid cultural constraints.[115] Executive pay is plausibly constrained by public outrage, which in turn may lead to camouflaged pay.[116] This is where CP presumably kicks in (as a camouflage mechanism): both players (company, manager) are afraid that pay beyond a

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[111] Manne, pp. 718-719.
[112] For a modern version of such argument in the CSR context see Elhauge, supra note 101, p. 33.
[113] See Haley, p. 491 (1991); Stetson's transcript, pp. 70-71 (Blair's speech).

Some may point in that context to the practice of forming of a fund in the name of a specific insider, for a charity of his Choice. Kahn, 44 UCLA, pp. 621-622. However, such practices are not the interest of this paper, as they clearly pass as executive compensation and regulated accordingly. They pose none of the main puzzles that CP poses. See Kahn, 44 UCLA, fn 176 and the accompanying text.
[114] Butler & McChesney, p. 1206, at footnote 37.
[115] Mark J. Roe, *Can Culture Constrain the Economic Model of Corporate Law*, 69 U. Chi. L. Rev. 1251 (2002).
[116] Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance* 64-70 (2004).

certain level would result in public opinion/regulatory backlash. So they structure the compensation in a way that allows managers wider latitude over discretional funds, with which he could pursue, inter alia, his individual philanthropic preferences.[117] While logically possible, I believe that this argument suffers from limited applicability in real-life. First, in most cases the CEO's pay is way below the outrage limit. Second, anecdotal evidence suggest that practitioners do not consider such factors when negotiating pay.[118]

<u>I.2.d – the *Ethical*/Altruistic explanations</u>:

According to this approach, CP is not about benefit to the principal or to the agent, but rather about doing what is right. Ethical and moral precepts and creating social value dictate CP practices.[119] This approach is manifested through many buzzwords. According to the common "corporate citizenship" notion, corporations are seen as citizens who generate financial surplus; this surplus is in turn used to do what is right for society; CP is one obvious result of such process.[120] Corporations are integral part of the community from which they derive their "existence and sustenance". Therefore, they have moral obligation to support the community.[121]

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[117] Manne, p. 720.
[118] In a personal conversation with Joe Bachelder, leading executive pay attorney, he maintained that practically no top executive is taking into consideration discretion over CP when negotiating his pay; they rather focus on more obvious, easily-observable perks (think corporate jets…) (personal conversation in HLS, 12/12/08).
[119] See generally Lance C. Buhl, *The Ethical Frame of Corporate Philanthropy,* in: CP at the crossroads; Id, p. 160.
[120] An elaboration can be found in Buhl, *Id*. To summarize his main points: even the normal conduct of a company's business is filled inherently with ethical requirements, as part of the social contract between "society and the engines of economic production it sanctions" (p. 128); let alone the company's giving. "… [A] company can hardly establish full ethical credentials without also demonstrating its support for community problem solving *beyond* the normal course of operations". [emphasis in original.] According to the "doing good for the community by doing well for the company" approach, there is no justification for maintaining CP if it cannot be demonstrated that there is a positive connection between CP and the bottom line. Therefore, we should move to a "doing well for the company by doing good for the community" approach.
[121] Smith, 41 NYL, p. 764: Blumberg, p. 164.

It was noted that the ethical model, like its competitors, reflected a contemporary view in society when developed. It grew out in the 1960s, with the era's emphasis on helping with social problems. the Neoclassical model grew in the 50s, an era of business domination of the economy. The Political model grew in the 70s and 80s, with emphasis on societal participation and minimizing government encroachment. And the Stakeholder theory has been growing since the 60s, out of the notion of "empowerment" and the felt need to recognize the influence other groups (workers, etc) gained in the environment. See Dennis R. Young & Dwight f. Burlingame, *Paradigm Lost: research toward a New Understanding of Corporate Philanthropy,* in: CP at the crossroads, at p. 162.

Related and especially predominant is the notion of *corporate social responsibility* (CSR). CP is seen as a part of the pyramid of CSR, meaning that among other responsibilities, the corporation also has a responsibility to donate like a good citizen (this specific responsibility, though, comes last in the hierarchy).[122] [123]

The CSR explanation is problematic, if only for being highly-amorphous in the same manner that stakeholder theory is, and thus susceptible to the same criticism mentioned in part I.b.2.b supra. Once attempts are made to concretize the CSR approach, they collapse into an indirect/direct benefit approaches.[124] To illustrate, consider the meeting-public-expectations argument: since the public expects corporations to behave responsibly as good citizens, it is argued, corporations that do so and discharge philanthropic responsibility would derive increased public relations, maybe even increased stock-market returns.[125] But arguments of that sort suffer from the same flaws of the "benefit" approaches. *First*, they can not account for inter-company

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[122] Carroll, supra note 95. Such responsibility arises, as mentioned in the body of text, out of (1) necessity – the needs for private philanthropy exceed the capacity of other sources for it; (2) capacity – corporations play a crucial part in society, so they obviously can and should bring social change; or (3) morality – like flesh and blood citizens, the corporation should behave morally and ethically towards the community in which it is a member. See Kahn, 44 UCLA, pp. 628-630; Keith Davis, *The Case For and Against Business Assumption of Social Responsibility,* 16 Academy of Management Journal 312 (1973).

[123] I did not deal in the body of text with the more "altruistic" explanations (as opposed to the more ethical-centered). There are also (less dominant) explanations that focus on the way that CP gives rise to "pure" altruism – by providing ways to better satisfy the shareholders' individual philanthropic preferences. Under some conditions, the argument goes, it might be better for shareholders to pursue their preferences through CP. Reasons include: tax considerations – since dividends are double-taxed while CP is deducted, corporate donations come at a reduced cost; economies of scale – corporation might be able to make larger gifts that would be more meaningful for the donee (think of utility thresholds on part of the charitable organizations, for instance); avoiding free-riders – donating at the company level assures that charities would receive money that would otherwise have not been donated (if distributed to the stockholders, there might be a free-rider problem). See generally Abzug & Webb, p. 1038.

Note that these "pure altruistic" explanations refer to advancement of shareholders preferences, not to the level of the corporation. This is because CP, unlike individual philanthropy, can not be explained in terms of emotional satisfaction that accrues to the philanthropist. The corporation has no emotions. Similarly, it might be difficult to explain CP as promoting moral values that the philanthropist holds dear. Corporations are "inert constructs", legal fictions. They cannot act "charitably". See Brudney & Ferrell, p. 1194 (see there also the opposite view, according to which corporations are capable and perhaps even obliged to act morally).

[124] See Sasse & Trahan, infra note 296, p. 34 ("In fact, CSR advocates, as well as stakeholder theory proponents, may align more closely in practice to [Milton] Freidman than they might wish").

[125] …Based on the assumptions that consumers choose between competing products and investors choose between competing investments based on the degree of social responsibility. See generally Abzug & Webb, pp. 1039-1041.

variability.[126] *Second*, they are inconsistent with the empirical findings. As mentioned, no positive correlation between CSR and performance was shown.[127]

Furthermore, we have reasons to doubt the assumption that the company's target-audiences look at CP as a good signal that the company is responsible. Other things matter more for them when passing judgments over corporate citizenships. For example, it was found that stakeholders perceive donations to be unrelated to the company's environmental performance, or that customers pay more attention to the way companies treat employees than their level of donations.[128] Cross-cultural study could shed light on the subject. For example, it was found that Germans and French value more the social responsibility of companies, while Americans value more economic "responsibilities".[129] If CP was indeed tied to CSR, we would expect companies in Germany and France to donate more, all other things equal. They do not. They donate much less than their American counterparts. So perhaps CP is tied to economic rather than social responsibilities. We will elaborate on this in parts II and IV infra.

<u>I.2.e. Miscellaneous explanations and the legal literature</u>:

Naturally, many other explanations that do not fit easily into my categorization were offered. One that might be of relevance for latter parts in this paper is based on an application of the contractual approach to corporate law. The argument is that shareholders would want the firm to engage in those sorts of CP that would increase the firm's goodwill more then it will increase the

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[126] If companies could increase employee's morale or attract more investors whenever they donate, why do we observe high inter-company variability? Cf., Burt, p. 422. It was noted that if all companies would have acted responsibly, there would be no competitive advantage for being socially responsible; and the CP-as-CSR-which-benefits-the-corporation argument would loose ground. See Marry Hunter-Morris, *Book Review: What Businessmen Talk about When They Talk About Ethics*, available at http://works.bepress.com/mary_hunter_morris/2/.
[127] See generally Abzug & Webb, p. 1040; sub-part I.1.C supra.
[128] Brammer & Millington, supra note 68, at pp. 40-41; Suzanne Perry, *Giving By Companies Rose 14% Last Year, Study Finds*, 18 Chronicle of Philanthropy 10, 6/15/2006.
[129] Isabelle Maignan, Consumers' Perceptions of Corporate Social Responsibilities: A Cross-Cultural Comparison, 30 Journal of Business Ethics 57 (2001).

individuals' good will, had the individuals donated the same money.[130] But that does not mean, the argument goes, that SH would want courts to ban other, managerial-utility driven donations. If shareholders adopt the plausible assumption that judges would have a hard time distinguishing good from bad donations (and once market forces constrain to some extent managerial discretion), then they would opt for giving managers wide latitude regarding CP.[131] The legal implication is that we should not bother ourselves with finding specific solutions for CP – it is a subset of agent's non-maximizing behaviors, like office sizes or company cars; and as such can be dealt with contractually by the shareholders.[132]

This contractual approach explanation is problematic, if only for the reason that it collapses eventually into a “direct” benefit approach, suffering from the same fallacy. It assumes that *if* CP is not profit-motivated but rather socially responsible motivated, then we should not allow it, because the firm does not gain over the shareholders in deciding what is good for society.[133] But this distinction ruins the practical wisdom of the argument: we cannot and ought not to distinguish between donations based on “motivation” of the decision-maker (see part III infra). Moreover, this explanation also downplays the social welfare perspective, when ignoring the difference between spending on luxurious headquarters or company jets and spending on altruism (see part II.2 infra). *Finally*, even if you agree with the final outcome of this model (i.e., do not regulate CP more than you regulate other expenditures), as I do, one cannot help but noting the “just-so story” element in explaining the behavior. This explanation simply assumes some logic behind existing patterns, without trying to explain how the mechanism works. Why

[130] Butler & McChesney, p. 1203.
[131] *Id*, pp. 1206-1210 (preferring type II errors over type I errors).
[132] *Id*, p. 1211.
[133] *Id*, pp. 1223-1224.

should donations create goodwill? Which donations are good and which are bad? How do you explain the huge inter-company variability? In short, this explanation has little predictive power.

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Some factors contributed to the fact that the legal literature lagged behind the business and sociology literature in understanding CP. *First*, the legal discussion of CP was perceived as a sub-genre of the corporate purpose debate.[134] This emphasis has done disservice to the understanding of CP: instead of trying to understand what the phenomenon is about, it was assumed that CP is the paradigmatic case of a non-shareholders-profit-maximization act.

Second, there was an emphasis on a futile distinction between "pure" donations and donations that come with a quid pro quo expectation – a distinction imposed by the tax-deduction provision enacted in 1935. When combining together the tax law aspect of looking at the motivation for the donation (assuming that this is possible and relevant), with the corporate law aspect of looking at the legitimacy of throwing away shareholders' money (assuming that this is the case), the result was reference to CP as a paradox, a "problem".[135]

One way presumably out of this dilemma, was the adoption of the "enlightened self-interest" approach to CP in the legal literature. According to it, there is no need for a tension

[134] For this perception see Stetson's transcript, p. 80 (Melvin Eisenberg's words); for an elaborate account of that debate see Clark, *Corporate Law* (1986), chapter 16. Shaped from its early stages by the contours of the Berle-Dodd debate, the question of legal regulation of CP was treated as a sub-part in the bigger question of the legitimate objective purpose of the corporation. For those – like Berle – who stated that the purpose of the corporation is to maximize shareholders profit, giving away corporate assets simply for charity purpose was illegitimate. By contrast, for those – like Dodd – who claim that the corporation is and ought to be socially responsible (i.e., consider not only shareholders but also other constituencies), giving away corporate assets to charity is a mean to discharge such responsibility, and thus permissible per se. For a recap see Licht, supra note 6, at pp. 690-698. Note that there are alternative views of the debate. For example, a recent article posits the debate in its historic context, arguing that we cannot anachronistically ascribe the modern "shareholder primacy" notion to Berle, nor can we ascribe the modern "CSR" notion to Dodd. Instead, it is argued, we should read the debate against the background of the shift in policy brought by the New Deal. See William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34 Journal of Corporation Law 99 (2008). But for our purposes there is no need to delve into alternative interpretations: our focus is on the common explanation for the debate that dominated corporate law – and the question being asked here is how we can reconcile the dominant explanation with real-life manifestations of the phenomenon.
[135] The titles of Eisenberg, 28 Stetson and Knauer speak for themselves.

between the two notions in the corporate theory debate: CP advocates social responsibility while at the same time articulates the goal of profit maximization.[136] However, this solution does not really advance the understanding of the phenomenon. It still rests on an assumption of corporate benefit in CP[137] – without suggesting a coherent explanation of how does this benefit accrue. At the end, it falls into assuming a more amorphous, elusive, "long-term" benefit to the corporation.

Without a coherent explanation for the phenomenon afforded by the legal academia, the legislatures and courts had to rely on their practical, Darwinian wisdom in order to regulate CP. We turn now to see how they fared.

<u>**I.3 – current doctrine**</u>:

It seems that corporate philanthropy laws in the U.S. have evolved into a stable equilibrium: courts allow managers wide latitude in making CP decisions, both in the "how much" and the "to whom" questions[138]; they do so by invoking the "long-term" benefit to the company reasoning. At the same time, tax courts and authorities allow the same donations to pass as tax-deductible; by doing so they conclude, at least implicitly, that the donation was made *without* any contemplation of a benefit. For our purposes, it is important not only to understand how this hybrid approach works, but also to understand how exactly it evolved throughout the years. Accordingly, this part will be divided into three: I.3.a will survey the historical phases of the evolution of CP laws. I.3.b will survey the current situation, divided into state corporation laws – statutory and case law, and federal laws – tax and securities. I.3.c will survey the secondary literature on the subject, focusing on the most notable criticism of existing CP laws.

<u>I.3.a. Historical background: the phases of evolution of CP laws</u>:

[136] Knauer, pp. 6-7. See also Jensen, supra note 95; Richard Eells, *Corporation Giving in a Free Society* (1956).
[137] As is especially evident in Smith, 41 NYL, p. 763. Compare: Blumberg, p. 204-208.
[138] Butler & McChesney, p. 1205, referring to the *Theodora* case (see below).

The "charter" theory phase and the Intra Vires requirement:[139] Up until the 1930's, corporate law was concerned mainly with the question of "if" to donate – do corporations have the power for it. Under the dominant legal doctrine of the time – the "charter" theory – corporations were not allowed to make donations because states' incorporation's statues did not include CP as one of the enumerated corporate powers.[140]

The "incidental powers" theory phase and the direct benefit requirement:[141] in spite of the abovementioned legal complete ban, CP continued to exist and grow. The common law, puzzled, began to look for doctrinal ways out of this direct clash with a clearly sustainable phenomenon. The first such doctrinal hook was the notion of incidental corporate powers. CP was explained as another way to achieve benefit to the corporation. Importantly, the "benefit" that would make CP legitimate according to this theory, was a *direct, foreseeable benefit* to the corporation; not just appeals to "the benefit of the community". Thus, although there was no more a complete ban[142]; there still was a partial one, stronger in some states, less in others. For instance, the famous case "against" CP – *Dodge v. Ford*, relied on the direct benefit requirement as its doctrinal hook.[143]

The first wave of philanthropic provisions – restrictive, explicit regulation:[144] in response to the big uncertainty created by the courts' efforts to soften the complete ban on CP, some state legislatures enacted philanthropic provisions. This disarmed completely the Intra Vires requirement – the complete ban approach was officially gone. However, the first provisions were still *very restrictive*. They regulated the question *who decides* and *if* to donate – by requiring express board approval for every donation. They regulated the question *how much* by limiting

[139] For an overview, see: Blumberg, pp. 168-173; Kahn, 44 UCLA, at footnotes 58-61 and the accompanying text.
[140] See, for example, *Davis v. Old Colony Railroad Co.*, 131 Mass 258 (1881).
[141] For an overview, see Kahn, at footnotes 61-64 and the accompanying text.
[142] For several examples see Blumberg, at p. 169, the references in footnotes 64-70.
[143] The English company law landmark case was *Hutton v. West Cork Railway Company* 23 Ch. D. 654 [C.A. 1883] (this case was important for its reasoning, although its circumstances were arguably distinguishable – a corporation in liquidation, etc. For an overview see Bloomberg, p. 172).
[144] For an overview, see Kahn, at footnotes 66-76 and the accompanying text.

the permissible amount (bigger donations could have been made only if the shareholders approved them). And the question *to whom* was also regulated, by requiring that donations were made only to charities in geographical proximity to the business' operations.

The second wave of philanthropic provisions – a much more liberal approach:[145] the sustainability and continuing growth of the phenomenon of CP, has continued to exert "evolutionary" pressures on CP laws to keep evolving towards more liberalized approach. By mid-century, after CP played an important role during the two world wars; and after congress enacted the corporate charitable deduction[146]; the American Bar Association reacted by advocating a liberalizing reform of philanthropic statues. The immediate result was section 4(m) of the MBCA (published in 1950), with broad-based state-legislation reform following suit.[147] A similar development occurred at the same time in case law with the famous *Smith v. Barlow* case. At this time, the stage was set for what seems now as a stable equilibrium – the "end of history" for CP laws, as currently existing. This is the subject of the next part.

I.3.b The current situation:

I.3.b.1. State corporation law:

It is state law that deals with the main issues of CP, such as do corporations have the power to make donations. Generally, it can be said that in corporate law an "extraordinarily laissez-faire approach" to CP has evolved.[148] Later, in chapter II.2, we would see the logic behind this evolution of the law – how the "fit" might also be "just". But first, let us understand how exactly such wide latitude is allowed. We will start with statutory law and move to case law.

[145] For an overview, see Blumberg, pp. 192-202; Kahn, 44 UCLA, at footnotes 77-90 and the accompanying text.
[146] The Revenue Act of 1935, Pub. L. No. 74-407, 49 Stat. 1014. For elaboration on the circumstances surrounding the 1935 federal recognition of CP, see sub-chapter I.3.b.2 infra.
[147] See *Model Business Corporations Act*, 6 Bus. Law. 1 (1950).
[148] See for example Kahn, 44 UCLA, pp. 583-584.

Statutory law: as mentioned, statutory CP law has evolved from a complete ban to enablement.[149] The basic question turned from an inner to outer limits perspective: "Although corporate power may exist, it may still not be used in the interests of the corporation".[150] The states all adopted the concept of not limiting CP, as advocated by the ABA (the exact way in which the states adopted the approach varies[151]). The statutes, however, provided little if any guidance as for the standards that should be applied to a manager's decision to donate.[152] So eyes turned to the case law to provide such guidance.

Case law: CP case law is easily traceable. Only four important cases addressing CP came out since the 1950's:[153] *Barlow*,[154] *Union Pac*,[155] *Theodora Holdings*[156] and *Kahn*.[157] (Two of those – *Barlow* and *Union Pac* – were "friendly" ones, i.e., the CP act was not challenged (the management brought the issue to court to gain a pre-ruling/ establish precedent).[158].) These cases are summarized for our purposes in the table below.

[149] See Model Business Corporation Act § 3.02(13), § 3.02(15).
[150] Blumberg, p. 202; see also Stetson's transcript, p. 76.
[151] …According roughly to three distinct formulations: (1) in approximately half of the states, and, most importantly, Delaware, there is a *simple, single provision*, enabling corporations to "make donations for the public welfare or for charitable, scientific or educational purposes". (2) Other states have two provisions: one authorizing contributions with direct benefit and the other authorizes (like the single provision mentioned above) charitable contributions. (3) Finally, in some states, including New York and California, the language of the provision expressly dismiss the "benefit" requirement – either direct or indirect, allowing CP irrespectively. Similarly, the American Law Institute's Principles of Corporate Governance provided that corporation may "devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes" (§2.01(3)). For an overview see Balotti & Hanks, pp. 970-973; Kahn, 44 UCLA, footnotes 91-94 and the accompanying text.
[152] See generally Balotti & Hanks, p. 970.
[153] The fact that there were only four series legal challenges to CP practice is emphasized in the academic literature. The reasons suggested for such a small amount of challenges are, among others: lack of available information; permissive broad language of the statutes; and the fact that contributions are generally not large enough to justify litigation (as opposed to takeovers issues, for example). See, for example, Smith, 41 NYL, p. 768-769; Kahn, 44 UCLA, footnote 101.
[154] *Smith v. Barlow*, 98 A. 2d 581 (N.J. 1953).
[155] *Union Pacific Railroad Co. v. Trustees, Inc.,* 8 Utah 2d 101, 329 P. 2d 398 (1958).
[156] *Theodora Holding Corp. v. Henderson*, 257 A. 2d. 398 (Del. Ch., 1969).
[157] *Supra* note 1.
[158] See Knauer, footnote 142 and the reference there. Furthermore, the precedential value of *Kahn* is indirect, as it is about judicial review of a settlement. See Balotti & Hanks, p. 977, footnote 81.

The case: name, instance, year	The donation: How much? To whom?	Ruling
Dodge v. Ford; Michigan S.C.; 1919	Suspending of a payment of special dividend; In order to increase wages and reduce product prices	Rule: *Direct benefit approach*:[159] Holding: The company should give the shareholders those assets (=pay the special dividend). Policy: the purpose of the corporation is to maximize shareholder profit; directors are to act for that end.
Smith v. Barlow; New Jersey S.C.; 1953	1,500$; To Princeton University	Rule: *Indirect benefit requirement*:[160] Policy: aside from the need to act as a "good citizen" now that more wealth is accumulated in corporations; CP generates benefit to the corporation, albeit in an abstract manner. Such benefit is, for example, the preservation of the "free enterprise system".
Union Pac; Utah; 1958	5,000$; to a non-profit foundation of the plaintiff	Rule: "Not unreasonable conviction" of a benefit requirement.[161] Policy: there is a need for corporate giving to supplement individual giving.
Theodora holding; Del. Ch. C; 1969	528,000$ value donation (when net earnings were ~19M$); to the controlling shareholder's foundation	Rule: the standard = *reasonableness* of amount and purpose[162]; the guiding lines for determining reasonableness = the IRC tax-exemption provisions: less than 10% of pre-tax profits is permissible amount; qualified § 501(c)(3) organization is a permissible beneficiary. Reasoning: long-term benefit approach.

159 See p. 684.
160 See p. 586.
161 See pp. 401-402. For further analysis and other similar cases, see Blumberg, pp. 175-176.
162 See p. 405.

Kahn v. Sullivan; Del. S.C; 1991	~50M$[163]; To a museum named after the company's CEO.	Same as in *Theodora*: tax-based reasonableness standard.[164]

So, where does this line of cases leaves us nowadays? It seems that the Delaware courts holdings in *Theodora* and *Kahn* are positing the current standard by which to judge a CP decision. But what exactly does that standard mean – do corporations still need to show benefit of some sort?[165] The *Theodora* standard and the Delaware courts' reasoning, it seems, *do not get rid of the benefit requirement* altogether.[166] At the same time, one can argue that such requirement is a fiction. From *Barlow* on, it would be extremely difficult to challenge CP – managers could always adhere to some amorphous indirect benefit; any arguable long benefit would do. Only those insiders that would insist for some reason on making altruistic motives painfully explicit and exclusive (like Henry Ford) could loose in such lawsuits.[167]

What do the reasoning and policy considerations invoked in those cases tell us about the prevalence of any of the competing theoretical explanations of CP? The common wisdom in the legal literature was that *Dodge v. Ford* and *Smith v. Barlow* each represents a competing theory of the corporate purpose. *Ford* is supposed to be a manifestation of the shareholders' profit maximization theory; while the later *Barlow* decision is supposed to signal the prevalence of

[163] The costs turned out to be much higher than anticipated at the time of the claim. See footnote 2 supra.
[164] See p. 61.
[165] It could be argued that this question is now "only" relevant to the states in which there is a single-provision formula (see above); but Delaware is among those states, so we should not discard this question in any case.
[166] See the analysis in Balotti & Hanks, pp. 977-978.
[167] In Stout's hard-core version: "In the rare event that such a decision is challenged on the grounds that the directors failed to look after shareholder interests, courts shield directors from liability under the business judgment rule so long as any plausible connection can be made between the directors' decision and some possible future benefits, however intangible and unlikely, to shareholders. If the directors lack the imagination to offer such a 'long-term' rationalization for their decision, courts will invent one". Lynn Stout, *Why We Should Stop Teaching Dodge v. Ford*, in: The Iconic Cases in Corporate Law (Macey ed., 2008). See also David L. Engel, *An Approach to Corporate Social Responsibility*, 32 Stan. L. Rev. 1, 16-17, at footnote 51 (1979).

Dodd's social responsibility theory.[168] However, other commentators argued (and I agree) that we cannot view the "liberalization" of CP law as a wholesale adoption of the CSR notion.[169] The case law only relaxed the benefit requirement, expanding legitimate corporate expenditures to those that entail also amorphous indirect benefit. It is still about profit maximization; it is only that more ways to achieve this goal are deemed legitimate now.[170]

I.3.b.2 – federal law:

Securities law: in line with the laissez-faire approach to CP in state corporation law, public corporations' philanthropy is not subject to significant federal intervention. No special disclosure requirements per se are required (that is, as long as the donation does not amount for an interested "transaction", etc).[171] Also, traditionally the SEC allowed companies to withhold from their proxy materials shareholder's proposal challenging the management's CP policy (although proposals regarding other CSR activities were allowed).[172]

Some regulations could count as "indirect" exceptions to the laissez-faire approach. Item 402 of the S-K regulations deals with thorough disclosure of all forms of executive compensation. This item indirectly regulate the "to whom" and "what form" questions, since CP that confer substantial benefits on executives (like insurance plans pay-out in the name of

[168] See for example Knauer, pp. 23-24 and the references there. For a different angle, see Stout, *Id* (*Ford* is a limiting source on those matters: statements on the topic were dicta, and the legal ground for the ruling was a breach of the controlling shareholder's fiduciary duties towards minority shareholders).
[169] Knauer, pp. 27-28.
[170] Chancellor Allen claimed that this adoption of the indirect benefit approach allowed the courts to hold on to the shareholders' profit maximization norm, while in practice allowing decisions consistent with stakeholder theory. See William T. Allen, *Our Schizophrenic Conception of the Business Corporation,* 14 Cardozo L. Rev. 261, p. 273, footnote 37 and the accompanied text (1992).
[171] See for example Balotti & Hanks, p. 989 (describing the application of item 404 of regulation S-K to CP in certain "interested" situations). See generally Kahn, 44 UCLA (the laissez-faire approach to CP in securities law).
[172] See Barnard, p. 1167, footnote 101 and the references there; Elhauge, supra note 101, p. 27.

specific directors) could be subject to disclosure requirements.[173] Similarly, item 404, which deals with interested "transactions", might include also substantial CP to pet charities.[174]

Stock exchange rules present another thin layer of CP regulation. In the wake of the Enron debacle, the NYSE corporate governance rules tackled the issue of use of CP to compromise the independence of the board: when a public company donates substantial amount to a charitable organization to which its director is affiliated, that director no longer counts as "independent".[175]

Tax law: the Internal Revenue Code allows, under §170, a tax-deduction for CP. The tax-deduction reduces the costs of giving in the rate of the top marginal income tax rate of the corporation. To illustrate: a dollar given to charity can cost the corporation 0.65$, while benefiting the recipient (a qualified organization) by a whole 1$. The residual 0.35$ is the tax expenditure, the subsidy that the federal government offers to CP.[176] In order to qualify for deduction, the donation must meet three requirements, regarding its *beneficiary*, *purpose* and *amount*.

First, the donation must be made to a beneficiary who qualifies as a charitable organization under §501(c)(3). The qualification provision is interpreted very broadly, thus making this restriction almost meaningless.[177] *Second*, the donation must be a "contribution or gift"; a phrase that was interpreted by the treasury regulations as a transfer *made without a*

[173] See Kahn, 44 UCLA, pp. 621-622.
[174] See Barnard, p. 1170.
[175] See NYSE, Inc., Listed Company Manual §302A.02; Robert C. Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers too*, 22 Georgia State University Law Review 251, footnote 49 and the accompanying text (2005).
[176] See I.R.C. §11(b)(1) (West Supp.2006). See also Knauer, pp. 32-33.
[177] Since the language of § 501(c)(3) was interpreted in a very broad way, it allowed for politicized charitable organizations to qualify. Thus, it was claimed that this indirect regulation of the "to whom" question, does not really constrain "bad" decisions. Furthermore, it was claimed that because of strict regulation of corporate campaign-financing and political lobbying activities, corporations resolve to use of the less regulated channel of CP, to pursue political interests. See Kahn, 44 UCLA, pp. 637-644.

reasonable expectation of a direct quid pro quo.[178] It is important to note that even if a donation is deemed to be made *with* a "reasonable expectation of financial return commensurate with the amount of the transfer", this donation may still enjoy deductibility: it might loose its status as CP under IRC §170; but it could still be deducted as a business expenses, under IRC §162.[179] *Finally*, the donation must be under ten percent of the corporation taxable income (IRC §170(b)(2)).[180] In practice this is not much of a restriction: CP on average circles around 1%. Accordingly, it was suggested that the function of this ceiling is not to constrain CP, but rather to induce it: setting it high to serve as a "hortatory appeal"[181] or religious symbolism (a tithe). The effects of such an appeal, however, are questionable. Setting the ceiling higher did not change the trend, perhaps not surprisingly: we can infer from the literature and evidence on the "crowding effect" that such appeals might be problematic in such contexts.[182]

It is interesting to look at the historical evolution of tax aspects of CP as well.[183] As mentioned, the phenomenon of CP was alive and kicking ever since there were large public corporations. The mere fact that CP was illegal, ultra vires, did not stop it from occurring (although maybe slowed its growth). Congress resisted pressures to recognize this growing phenomenon for many years. Behind this reluctance were several factors: the notion that donations should not be made with other people's money; reluctance to act before state

[178] See Treas. Reg. 1.170A-1, available also at http://www.taxalmanac.org/index.php/Reg._1.170A-1. For a concise survey of the application and interpretation of the nature of the donation requirement (by the courts and the IRS), see Knauer, pp. 35-41.
[179] See Knauer, pp. 41-43. There are, however, some distinctions that might make deduction under §170 preferable (such as differences between commercial and charitable "purchase" of goodwill – when it must be capitalized and when it is not immediately deductible). See Knauer, pp. 43-45
[180] The corporation may carryover excess donations for up to the five succeeding taxable years (§170(d)(2)). §162(b) prevents the use of §162 mentioned in the previous paragraph to circumvent the ceiling requirement in §170. As mentioned, up until 1981 this ceiling was lower – five percent. The ceiling was raised by the Economic Recovery Tax Act of 1981. For commentary and legislative history, see Knauer, pp. 28-29; Kahn, 44 UCLA, pp. 632-633.
[181] Kahn, 44 UCLA, footnote 109.
[182] Compare and use as an illustration the Titmus-Arrow debate, in the context of inducing blood donations (for a recap, see Yochai Benkler, *The Wealth of Networks* 92-94 (2006)).
[183] See generally Knauer, pp. 15-20; Blumberg, pp. 178-181.

legislatures did[184]; and populist fear of concentrated power – as evident in President Roosevelt's firm standpoint against CP, based on the notion that corporations should not be allowed to "purchase goodwill".[185] But the pressures to recognize CP got stronger: growing evidence of the sustainability of the phenomenon; lobbying efforts by fundraisers; and a background of economic instability where the federal government needed all the private help it could get. Finally, in 1935 congress enacted the tax-deduction provision, actively soliciting assistance from the corporate sector.

The historical account can shed light on some paradox in the legal regulation of CP. Fueled by the populist sentiment (so dominant in the corporate law context) the CP deduction was enacted as an act of compromise: corporations could deduct donations as long as they would not go on to purchase good will with a quid pro quo expectations. This restriction doomed the corporate philanthropy to be referred to in the legal literature as a "paradox" – while corporate law seems to require CP to be made with a benefit to the company in mind, tax law requires that CP would be made without such expectations. The alternative model to CP that I will suggest below could contribute to mitigate this paradoxical approach.

<u>I.3.c. Legal commentary</u>:

Above we saw how CP law appeared to be settled. But in the legal literature, CP issues were far from settled. Led by traditional law and economics thinking, many continue to question the merits and legitimacy of CP; or in a more modest version – to suggest specific changes to current laws. Below is a survey of some of the notable critiques.

<u>Statues too vague</u>: commentators have criticized the modernized CP laws, not so much for what they say but rather for what they do not say. Recall that the current enabling statutes

[184] See Blumberg, p. 178.
[185] Clotfelter, supra note 76, at p. 171. On the populist sentiment see Mark J. Roe, *Strong Managers, Weak Owners* (1994).

regulate the question *if* to donate. By contrast, they do not regulate the questions *how much* to donate ("fail to define any quantitative parameters"); or *who decides* on the donations ("…absolutely silent on the matter of who shall have decision-making authority"). In short: they validate the authority, but do not regulate the practice.[186] Guidelines, it was suggested, are needed, if only to stop CP from being exploited by strong managers, on weak owners' expenses.

Case law under-inclusive: similarly, the case law – with *Theodora's* reasonableness standard – was criticized by being much too lax. In particular, the adoption of the IRC provisions as guidance seemed controversial. Such standard renders the regulation of the *how much* and *to whom* questions meaningless: it allows donations in the huge size of ten percent of pre-tax profits; and leaves an extraordinary broad spectrum of organizations to donate to, including controversial/pet charities.[187] Aside from being a bad heuristic, this tax-based guidance was said to be basically flawed: first, when congress decides who should be the beneficiaries, it does so from a broader, society point of view; when a corporation decides to whom, it should do it from a narrower, shareholders' interests point of view. Second, why tie the company decision on the level of donation to the congress decision on the level of subsidy? If the donation is good for the firm – why limit it? And if the donation is bad for the firm – why not ban it altogether?[188]

Similarly, it was argued that applying the lax standard of business judgment review (BJR) to CP is problematic. This is because BJR should be applied only to actions and donations that are expected to be profit-maximizing, while the whole problem in CP cases would be to evaluate

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[186] See Balotti & Hanks, p. 965: "These statutes, however, give little if any guidance on how corporations… and, in particular, individual managers – should determine whether to make charitable applications and, if so, to what charities and in what amounts. What few standards the courts have been able to develop to guide corporations and managers are often vague and inconsistent". *See also* Kahn, 44 UCLA, p. 603.

[187] …Because of the extremely liberal interpretation given to the qualification requirement in § 501(c)(3), as discussed above. Kahn, 44 UCLA, p. 607.

[188] Kahn, 44 UCLA, p. 608.

whether the donation in hand is about profit-maximizing.[189] It was also argued that this approach to CP is inconsistent with traditional corporate law paradigms, such as the shareholders-wealth-maximization norm, the waste doctrine and the directorial oversight doctrine.[190]

Courts reasoning and rhetoric problematic: the criticism was directed not only to the holdings. It was argued that by positing the "indirect" benefit requirement, courts' reasoning created an unnecessary fiction; and that this approach leads to companies camouflaging their altruism. It would be better, it was claimed, to upheld CP on other theoretical bases – such as invoking a modified duty of corporations to donate, under the CSR approach.[191]

Securities law – duty to disclose called for: perhaps the most common criticism to date is the lack of accountability. Accordingly, commentators have called mostly for some version of a duty to disclose details regarding CP. The rationale was that disclosure would constrain the inherent potential for abuse, especially that arising from managerial broad discretion over CP.[192]

Tax law – distinction between donations based on expectation for benefit is futile: Knauer criticized the attempt of the tax code to distinguish between donations with and without an expectation "quid pro quo". Based on a marketing explanation for CP, it was claimed that if being altruistic gives the corporation's public-image a boost, then a donation can never be without a reasonable expectation of a quid pro quo.[193]

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To sum up, the way the legal world have dealt with the "problem" of CP is to adopt some hybrid solution: the "indirect benefit" that CP produces would not be count as a "return" on the expenditure for purposes of tax law (and thus would be deductible); but it would count as a

[189] Kahn, 44 UCLA, p. 665, footnote 374.
[190] See Balotti & Hanks, pp. 978-980, 986-988.
[191] See Blumberg, p. 176.
[192] Kahn, 44 UCLA, p. 609; Blumberg, p. 177; Balotti & Hanks, pp. 980-982.
[193] Knauer, p. 43.

"return" for purposes of deciding whether such an expenditure is permissible.[194] After offering a new explanation for the phenomenon in part II, we will revisit this hybrid solution in part III, to see if we can improve on it.

Chapter II – an alternative explanation for corporate philanthropy:

Trying to explain altruism has been one of the most daunting, fascinating tasks faced by various fields of studies.[195] So when trying to grasp the small subset of the phenomenon – altruistic behavior in the corporate context – we might want to resort to the vast literature developed on the subject. Perhaps the richest literature can be found in evolutionary theory. This is because altruism seems to be at odds with Darwinian logic. How can a behavior that reduces the fitness of one individual while at the same time increasing the fitness of his competitor, survive the forces of natural selection? A specific mechanism has to be in work; the question is "just" which mechanism, and how exactly it works. Several solutions were suggested. One or more of them might apply nicely to the corporate context. Since we are dealing here with human beings and legal entities, it is important to note at the outset that the explanations for altruism we will build upon do not limit themselves to genetic reproduction. Reproduction can be cultural as well, and these mechanisms are being applied constantly to explain institutions. In short, I believe that the sociobiology literature is a good place to start when borrowing ideas to better understand CP.

Out of the many competing (though not mutually-exclusive – at least not in my view) models for explaining altruism in general, I think that the fittest one to be applied in the specific

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[194] Brudney & Ferrell, p. 1195.

[195] The 125th anniversary edition of *Science* magazine included the evolution of altruism within one of the twenty-five critical questions facing science today. See Elizabeth Pennisi, *How Did Cooperative Behavior Evolve?*, 125 Science 93 (2005) (I found out about this interesting fact from Ayelet Shavit, *One for All?* 5 (2008) [in Hebrew]). But forget about respectable surveys; the evidence for the importance of that question lies just beneath our noses: in the "Hollis" online catalog, the example given in the main page for searching the catalog was "'evolution' and 'altruism'" together. Now that is a scientific proof for the importance of the subject!

corporate context is the costly signaling model. This model, known in the sociobiology literature also as the "Handicap Principle", might be intuitive even to those not remotely familiar with sociobiology literature. This is because costly signaling theory is used frequently by economists as well. While it is not an unfamiliar concept, I believe that its application to our context, based on some oft-unnoticed points that are emphasized in the less-familiar sociobiology literature, would prove fruitful for our understanding. Part II.1 would present the model. Part II.2 would present the model's application to the corporate context. Then, part II.3 would go back to the sociobiology literature, trying to explain why the costly signaling explanation is indeed the fittest one to be applied in the corporate context.

II.1 – presenting the model:

Let us start with terminology. If we want to borrow insights from explanations of altruism in other fields, we should understand how the concept is being defined there. In sociobiology, a behavior is altruistic if it benefits the donator less than it benefits the donnee.[196] Similarly, in economics altruism is defined as giving more weight to others' outcomes than to your own when deciding your strategy. These definitions share an emphasis on the costs to the altruist, and a disregard of his motives.[197] This characteristic makes them better served for our purposes. As would become clear later, in the corporate context it is better to focus on "evolutionary altruism", rather than on "vernacular altruism": The former emphasizes consequences, while the latter emphasizes motives.[198]

[196] Edward O. Wilson, *Sociobiology* 117 (1975).
[197] Jane Allyn Piliavin & Hong-Wen Charng, *Altruism: A Review of Recent Theory and Research*, 16 Annual Review of Sociology 27, 29 (1990).
[198] For the distinction see Elliot Sober, *What Is Evolutionary Altruism?*, 14 Can. J. Philos. 75 (1988). For the preference see Robert Wright, *The Moral Animal* 186 (1994) ("… behavior, not thought or emotion, is what natural selection passes judgment on; acts, not the feeling themselves, directly guide the transportation of genes").

Defining altruism that way, it is easy to see why it presented (still presents) a puzzle, both for socio-biologists and economics. How could an efficient-reducing behavior be sustainable? If one would go on and benefit others on his expense, he would, theoretically, lower its reproductive success (which is a "local", relative concept). This is more puzzling than trying to explain cooperative behavior in general. Cooperation is merely about contribution "to the attainment of goals by others in that system"; while we are dealing with a behavior that more closely resembles the more puzzling subset of cooperative behavior: *unconditional* altruism.[199]

One possible solution to altruistic behavior came when zoologist Amotz Zahavi developed The "Handicap Principle" (HP) in the 1970s. The HP was not meant exclusively to explain altruism, but rather to explain more generally certain phenomena of waste as adaptations, evolving to facilitate reliable communication.[200] But because the HP regarded waste in general as possibly adaptive, it could also be applied to a subset of wasteful behavior: altruism (especially unconditional altruism). After being fiercely criticized by the academic world, a mathematical, game-theoretic proof of the HP has brought to its gradual acceptance since the 1990s.[201] Since then, it was accepted as mainstream approach in explaining communication in nature, as well as in various fields of human behavior.[202] In recent years, the application of HP to altruistic behavior is starting to gain ground in economics[203] and anthropology.[204] In the legal

[199] Kobe Millet & Siegfried Dewitte, *Altruistic Behavior as a Costly Signal of General Intelligence,* 41 Journal of Research in Personality 316, pp. 316-317 (2007). See elaboration in part II.3 infra.
[200] Amotz Zahavi, *Mate Selection: A Selection for Handicap,* 53 Journal of Theoretical Biology 205 (1975); Amotz Zahavi & Avishag Zahavi, *The Handicap Principle* (1997) (hereinafter: Zahavi).
[201] Alan Grafen, *Biological Signals as Handicaps*, 144 J. Theor. Biol. 517, 524 (1990) (hereinafter: Grafen).
[202] See Arnon Lotem et al., *From Reciprocity to Unconditional Altruism through Signaling Benefits,* 270 Proc. Roy. Soc. Lond. B. 199, 199 (2003) for references; Richard Sosis & Candace Alcorta, *Signaling, Solidarity and the Sacred: The Evolution of Religious Behavior,* 12 Evolutionary Anthropology 264, 266-268 (2003), and Richard Sosis, *Why Aren't We All Hutterites? Costly Signaling Theory and Religious Behavior,* 14 Human Nature 91 (2003) (costly signaling explanations of religious rituals); Fraser D. Neiman, *Conspicuous Consumption as Wasteful Advertising: A Darwinian Perspective on Spatial Patterns in Classic Maya Terminal Monument Dates,* in: Rediscovering Darwin (Burton et al., eds., 1997) (costly signaling explanations in architecture).
[203] Herbert Gintis et al., *Costly Signaling and cooperation*, 213 J. Theor. Biol. 103 (2001).

world costly signaling theory is being increasingly applied in other contexts, as well as our own – the corporate world.[205] I think it is time to benefit from its application to altruism in the corporate context as well. We will start with the basics.

Signals must evolve: the background for the development of the HP or costly signaling theory is quite intuitive: individuals *compete with others* over finite resources. They *differ in their phenotypic quality* – each may possess different qualities and attributes. Knowledge and assessment of these qualities and their variability might be valuable. But many of those qualities are *not readily observable*, so it is difficult to assess them. The individual possessing high quality would have *incentives to convey messages to others about his non-observable traits*, in order to bridge this asymmetric information (to use an economic term). This is because upon receiving this information, there are more chances that receivers would choose him as a mate or avoid getting into a costly conflict with him. A need for communication arises, but how will it occur? The answer is *through signals*.

Signals must evolve to be reliable: signals are defined, under the HP, as "traits whose value to the signaler is that they convey information to those who receive them".[206] Communication, in that sense, is defined as a sort of collaboration between the signaler and the receiver. It takes place only when both of them benefit from it. There are two necessary conditions for communication to evolve: *first*, the signaler and the receivers must have a common interest; *second*, the *signals used for communication must be reliable*, ones that cannot

[204] See for example Millet & Dewitte, supra note 199 (Altruistic behavior of individual human beings as costly signaling of general intelligence); Rebecca B. Bird & Eric A. Smith, *Signaling theory, strategic interaction, and symbolic capital*, 46 Current Anthropology 221 (2005) (hereinafter: Bird & Smith) (an overview).

[205] See Edward M. Iacobucci, *Toward a Signaling Explanation of the Private Choice of Corporate Law*,6 Am. L. & Econ. Rev. 319 (2004). For a non-corporate law application to the legal world see Eric A. Posner, *Law and Social Norms* (2000). For a relevant, though different, application, see the literature on signaling at the IPO context (for references, see Assaf Hamdani, *Gatekeeper Liability*, 77 S. Cal. L. Rev. 53, 95, at footnote 101 (2003)).

[206] Zahavi, p.59.

be faked.[207] The reliability requirement stems from the assumptions of finite resources and competition (plausible assumptions in the corporate context). Competitive environment creates incentives for mimicry – individuals that do not possess the quality will have incentives to signal that they do possess it, to pass themselves off as better than they truly are. This would mean that receivers of the signals would stop investing (=paying attention) in them, and the signal would loose its meaning (and thus would not have evolved in the first place). Some mechanism must evolve to assure reliability of signals.

<u>Signals' reliability is assured by their costs</u>: against this background, it is easy to understand the underlying propositions for the HP[208]: (1) signals are effective only if they are reliable; (2) in order to gain reliability, signals have to be costly; (3) signals are logically and closely related to the message they convey. In order to check whether to pay attention to a given signal, we first need to check how costly it is for the signaler. *These costs, the "handicaps", allow the signaler to effectively demonstrate his quality*. Handicaps reveal, by their very burdensomeness, that those who carry them would make strong competitors and desirable mates.

<u>The costs of the signal are quality-dependent</u>: as mentioned, the signaling mechanism should deal with the problem of low-quality individuals that would invest in costly signaling in order to cheat, to pass off as high-quality individuals. This means that in order for signals to be adaptive, the costs of the signal must by higher than the expected benefit of sending a false, cheating signal. *The costs of sending a signal should relatively be smaller for a high-quality individual than for a low-quality one*.[209]

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[207] Zahavi, p. 12.
[208] For a concise overview, see Zahavi, p. XIV.
[209] See the zoological illustration in Zahavi, pp. 33-34. This assumption was naturally also the base for the development of economic signaling theory. Michael Spence, *Job Market Signaling*, 87 Quarterly Journal of Economics 355 (1973). (Spence won later the Nobel Prize for his costly signaling work.)

An immediate implication of what we learned so far is that sometimes what seems to be a waste, a behavior that lowers the individual's chances to succeed, is actually a behavior which lends the handicapped individual a relative competitive advantage (hence its sustainability). To illustrate, consider the paradigmatic application of the HP – the peacock's tail.[210] What can explain the fact that the peacock is dragging such massive, encumbering tail? Why should the peacock be so handicapped when trying to find food and avoid predators? The answer is in advertisement: it is exactly this massive handicap that allows the peacock to effectively advertise his quality. Strong and agile peacocks would be able to find food and avoid predators despite carrying such tail; well-developed and nurtured peacocks would be able invest the energy needed to develop the tail's extravagant bright-colored features and growth. In nature, the criterion for quality is reproductive success – the peahen will choose the peacock whose future chicks have the highest probability to survive and reproduce. Strong and agile peacocks are more fit for this purpose. Therefore, peahens will pay attention to peacocks tails, knowing that it would convey reliably messages about the peacocks' chances of reproductive success.

What Zahavi offered was a change in the famous selection dichotomy: unlike what Darwin claimed, selection is not demarcated between natural and sexual selection; but rather between natural and signal selection. Although this proposed distinction is not consensual in sociobiology, for our purposes we need not adopt it exclusively. Suffice to note that we can distinct between two possible ways for evolution of traits, based primarily on the function of the costs of a given trait/act: in a "regular", natural selection, costs are a necessary evil; the lower they are, the better the individual is. In a signal selection, *costs are a necessary pre-condition; if they become too low, they could loose their value* (think of it as "inflation").[211]

[210] This is the paradigmatic example that gave birth to the HP. See Zahavi, p. XIV.
[211] See Zahavi (1997), pp. 58-60. Compare: Lotem et al., supra note 202, at p. 203.

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So far we have been going over the fairly well-known insights of costly signaling theory. Before we move to apply them to the corporate context, there are some less noticed insights that can be developed against this theoretical background, and might prove important for our purposes. Perhaps most important is the distinction between *two optional categories of handicaps: altruism and "sheer" waste*. Remember: under the HP, from the viewpoint of the signaler what is necessary is just that the behavior would be "wasteful". It does not need to be that the waste for the signaler actually benefits others.[212] But from the viewpoint of the group, there is a difference: an altruistic handicap is better for the group than mere wasteful handicap. To illustrate: the peacock's tail does not improve others' reproductive success[213] - it is a waste not only from the signaler's but also from the group's point of view. By contrast, when a babbler is standing guard while the other members of his group eat,[214] he engages in a costly, wasteful act for himself, while at the same time the others in his group benefit (i.e., it is not a waste from their viewpoint). This distinction has special importance in our context. When two potential effective handicaps are available, society would be better of if the altruistic behavior option prevail over the sheer wasteful one (see part III infra).

Another notion worth noting is *assessments errors*. In real life it is likely that the players would be prone to errors. Signalers might advertise too much because they overestimate their ability; receivers might not perceive perfectly the signal and the message it conveys.[215] To be

This is like individual gift giving: when the giver emphasizes the value of the gift, or his expectation of a return, the gift looses its value, turning into something that resembles barter. An increase in efficiency thus reduces overall fitness, by reducing the value of communication. See Judith Donath, Signals, Truth and Design (forthcoming; synopsis available at http://smg.media.mit.edu/people/Judith/).

212 Zahavi, pp. 149-150.

213 …Aside from its signaling value. And no, mere aesthetics do not count here…

214 For a sample overview of altruistic acts, see Zahavi, pp. XV, XVI; Geoffrey F. Miller, *Review: The Handicap Principle*, 19 Evolution and Human Behavior 343, 346 (1998).

215 See Grafen, pp. 528-529.

sure, costly signaling of quality can still be stable even under imperfect assessment.[216] But a better understanding of the communication will demand accommodation of a more realistic signaling explanation that accounts for assessments errors.

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A final note on the relationship between the sociobiology and economic literatures is due. As mentioned, costly signaling has been developing almost hand in hand, sometimes in parallel lines, in both literatures.[217] Once the HP model was game-theoretically proven and accepted as a generally applicable principle, it became possible to use the sociobiology concepts even when dealing with a business context.[218] I have chosen to adhere here also (mainly) to the socio-biological concepts and terminology for two reasons. *First*, borrowing from it would help us posit the costly signaling explanation of altruism against competing explanations, to shed light on our understanding of corporate behavior. *Second*, the socio-biological framework can give us better tools to explain and predict the specific *content* of the utility that is supposedly maximized, in some sense, in the activity we are studying. (These points will be made clearer, I hope, in part II.3 infra.)

II.2 – applying the model

The application of the HP to the corporate context is simple to assert: corporations can communicate to their target-audiences the company's non-observable qualities through observable activities that seemingly reduce fitness. However, it is more difficult to explain how exactly this happens in the context of CP. We should first define what we mean by the "target-

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[216] Rufus A. Johnstone & Alan Grafen, 248 *Error-Prone Signaling*, Proc. R. Soc. Lond. B. 229 (1992).

[217] Spence and Zahavi developed the concepts almost simultaneously. For the economic literatures paradigmatic examples see: Spence, supra note 209; Sanford Grossman, *The Role of Warranties and Private Disclosure About Product Quality*, 24 Journal of Law and Economics 461 (1981).

[218] Consider also Grafen's words on the sufficiency of stated-in-simple-logic explanations: "These verbal arguments are really just as convincing as the mathematics… The handicap principle is a strategic principle, properly elucidated by game theory, but actually simple enough that no formal elucidation is really required". Grafen, p. 541.

audiences" of CP and by the "fitness" that is seemingly being reduced by it. Generally, we will have to explain how this signaling mechanism works – how all the conditions necessary for evolutionary/game-theoretical stability of costly signaling are being met.

I suggest here one possibility for how the corporate signaling story is being played out in CP activities: **(1)** ***companies are the <u>signalers</u>;*** **(2)** ***potential investors – shareholders – are the signal-<u>receivers</u>;*** **(3)** ***ability to generate future cash flow is the underlying, not readily-observable <u>quality</u> that is being conveyed;*** **and (4)** ***cash donations is the <u>signal</u>'s form***. In the next sub-part I will try to explain why all these propositions are plausible.

<u>II.2.a. how does CP effectively signals quality</u>?

We will start with the definitions: for the "fitness" seemingly being reduced by CP, we could use several financial acceptable measures for determining companies' success. For the sake of parsimony, let us then *define profit maximization as the "fitness" element*. It is the equivalent for reproductive success in nature – under traditional economic thinking firms that will not maximize profits will not survive.[219] We could also think of it from the point of view of the decision-makers: they will need to satisfy the demands of those with contractual claimants against the company (return on investment; principal and interest to debt-holders; etc). Their fitness will be determined by their ability to satisfy these demands in the best way.

Next, a much tougher task: how should we define the target-audience of CP? In nature, this could mean either the female mates of the signaler, his predators, or others who comprise his surroundings and affect his reproductive success. In the corporate context, target-audiences for CP can be one or more of the many stakeholder groups who affect the corporation's profits: shareholders, customers, employees, creditors, regulators, etc. Each of these has different

[219] See Abzug & Webb, p. 1050, footnote 60 and the accompanying text (citing Stieglitz).

preferences over corporate behavior, and will pay attention to different signals.[220] For our purposes, we will *focus on the example of investors – stockholders – as the potential target-audience* of the company's signaling. This would be helpful in terms of clarity and parsimony (not having to deal with many different contexts in a single paper). Moreover, this is not just an arbitrary choice; it is also a natural one, the most intuitive. *First*, as we have seen in part I.3 supra, the effects of CP on stockholders are the most important element when the law deals with the CP phenomenon (it determines CP's legitimacy). *Second*, the way that CP is defined in the literature we rely upon (i.e., expenditures qualified for tax-deduction under IRC §170), makes the other natural candidates to be CP's target-audience – the consumers – less plausible. This is because expenditures directed towards consumers like cause-related-marketing and corporate sponsorship are not included as CP and do not represent CP's "problems" and puzzles. Again, this is not to say that CP does not have a function in communicating with other stakeholders; only that those other functions would have to be left for future work.[221]

Having done with the definitions (for now), we move to the set of questions one need to clarify when trying to explain why and how a certain behavior is about costly signaling. First, how exactly does the donation reduce the company's fitness (remember the general form: how does the trait burden the individual who carries it)? Here, the answer is intuitive. The *donation reduces profit maximization by taking away a dollar from the company and giving it to someone else*. Every dollar given to charity is a dollar that will not be invested in purchasing machines, increasing wages, paying back loans, re-investing, etc. Instead of paying to one of the contractual claimants, the company is paying to a non-contractual, unrelated third party.

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[220] Charles Fombrun & Mark Shanley, *What's in a Name? Reputation Building and Corporate Strategy*, 33 Academy of Management Journal 233 (1990).

[221] I intend to pursue these directions of inquiry during my SJD dissertation. One example include investigating the impact that different forms of CP have on different target-audiences (cash donation as targeting potential investors?; products donations as targeting consumers?; employee release time donations as targeting employees' morale?; etc).

Next, we should ask ourselves how does this burden is more costly to a low-quality firm than to a high-quality firm. Here we tackle our perhaps most important dilemma – what is the criterion that establishes the quality of firms, and to which CP logically relates? Looking at investment theory and methods of evaluation (remember: our target-audience is potential investors), it seems intuitive that *ability to generate future cash flows is a main criterion in establishing quality* of companies.[222]

Ability to generate future cash flow is not only an underlying attribute for the target-audience. It is also one that is not readily-observable for them; making it a plausible candidate for being conveyed by signaling. Remember: receivers will rely (invest) in signals when direct evaluation of a certain quality is relatively difficult. *Free* cash flow in itself is less observable than other financial available data: when looking at the income statement, the stockholders would have difficulties in assessing the actual amount of free cash flow that will be available to stockholders in a relevant year. This is because accounting concepts like "depreciation" and "capital investment" bridge a gap between net profits and uncommitted cash flow.[223] More importantly, even if assuming away such problems, keep in mind that the underlying attribute is *future* cash flows. There is clearly asymmetric information regarding future abilities of the company. The insiders have better perceptions about it.[224] They could try to communicate their perceptions to investors; but investors should know better than to take every insider's optimistic forecast at its face value. Something is needed to lend credibility to the message. That something, as we shall further see, is CP, which is more readily observable (either through financial reports – level of CP; or through popular media reports – to whom and what form the CP has taken).

[222] See for example Jeffrey J. Haas, *Corporate finance* 109 (2004) (Discounted Cash Flow method and its variants are the most common valuation method employed by the financial community today).
[223] William T. Allen et al., *Commentaries and Cases on the Laws of Business Organizations* 135 (2nd ed., 2007).
[224] On perceptual measures of slack resources, see Seifert et al., p. 140.

Managers would spend more on donations if they assess their future projects as successful, ones that would yield above-expectations cash flows. They would feel like "we can afford it" – afford to spend cash on non-contractual claimants and still be able to meet in the future the demands of contractual obligations.

Now we can go back to the question – how is CP quality-dependent for cash flow? Why should a firm with better ability to generate future cash flows find it less costly to donate than a firm with lower ability to generate future cash flows? The answer is engrained in the practices of corporate philanthropy and corporate finance. CP, as we saw in part I.1 supra, is mostly about cash donations. Firms would need to generate cash in order to donate. Theoretically, they could do it externally: get the cash they need to donate by selling debt (borrowing cash from the bank) or equity (issuing stock to the public). However, *lending money or going public in order to donate when you have low ability to generate cash flow is costly*: the firm and its insiders would expose themselves in a fragile situation to unfavorable covenants or disclosure requirements. Therefore, it is less costly to engage in CP when you know you have a good ability to generate cash flows. This is the logical connection between the signal (=donation) and the message that the firm wishes to convey (=ability to generate cash flows).

To emphasize: the dominance of cash donations is not trivial at all. Researchers have long observed that in-kind corporate donations should gain, in terms of benefit to the company, on corporate cash donations.[225] Among others, in-kind corporate gifts would attract more public attention[226]; build up better a "built-in" goodwill for the product, expanding better its market

[225] "It makes your giving look larger than what it costs you to give", as Himmelstein was quoted on Lisa Guernsey, *Corporate Largesse: Philanthropy or Self-Interest?* The Chronicle of Higher Education (1998), available at http://chronicle.com/data/articles.dir/art-44.dir/issue-33.dir/33a02801.htm.
[226] Knauer, footnotes 400-401 and the accompanying text.

base[227]; and could result in a favorable tax-treatment (better to donate excess inventory than to liquidate or dump it).[228] That CP continues to be mostly in cash, in spite of these considerations, suggests something about the function of CP (i.e., signaling cash flow).[229]

Indeed, when a recent empirical study paid attention to the differences in reputational impact between cash and in-kind donations, it was found that *cash giving generates more significant reputational payoffs than in-kind giving*.[230] This is inconsistent with existing explanations for CP (see part I.2), but consistent with the alternative signaling explanation. To be sure, things are more complicated: this finding is relevant when we look at “outsiders” as the target-audience; it might be that in-kind giving like employee release time will generate better reputational impact for the company among its employees, functioning as motivation tool. These aspects are subjects for future research.[231] For our purposes here, it suffices to note that the costly signaling model explains better the actual practices of CP.

[227] John A. Yankey, *Corporate Support of Nonprofit Organizations: Partnerships across the Sectors*, in: CP at the crossroads, at pp. 7, 14.
[228] To elaborate: a firm can dispose of its excess inventory either by selling to a liquidator or by dumping it. Several considerations (mainly tax) make it better in many times to dump than to sell. In contrast, disposing excess inventory by donating has substantial advantages: *first*, favorable tax treatment allows the company to recoup some of the costs of production (the firm is entitled to the deduction even if the products transferred are not suitable, obsolete); *second*, by reducing inventory levels and carrying costs, the firm allows for further costs savings; *third*, dumping useful products can create public relations backlash if the dumping is being published somehow – donating “turn a potential public relations liability into a useful public image asset”. See John A. Yankey, *Corporate Support of Nonprofit Organizations: Partnerships across the Sectors* in: CP at the crossroads, pp. 7, 14; IRC §170(e); Knauer, footnotes 430-434 and the accompanying text.
[229] This counterintuitive form of cooperative behavior also contrasts with what was observed in the individual context of gift-giving, where it was maintained that in-kind giving is a better signal. The argument is as follows: gift-exchanges between individuals present a puzzle: vast amount of resources (time, money, stress) is wasted on gifts that many times do not benefit their receivers in the way that they burden their giver. It was suggested that costly signaling explain this “wasteful”-cooperative activity: the receiver gets reliable information about how much the giver cares and/or knows about him, for example. See Eric A. Posner, *Law and Social Norms* 49-67 (2000).
[230] Brammer & Millington, supra note 68, at p. 40.
[231] See part IV infra.

II.2.b. Why CP and not other signals?[232]

A general criticism against costly signaling explanations is that even if a specific trait can be explained under the HP, it is not clear why this specific handicap evolved and not others. In our context, it could be argued that there are other available signals to convey a message regarding ability to generate future cash flows. Building company headquarters with gold shower-curtains, buying company jets, distributing bigger dividends – all can allegedly substitute CP in that matter. To generalize, all sorts of expenditures that involve throwing cash away could qualify as a costly signal for ability to generate cash flows. Generalizations aside, we have a ready-made illustration of a possible alternative signal: dividends. Indeed, the fact that dividends are double-taxed while sale of shares is taxed at a lower rate (as capital gains), presented a puzzle to the finance literature: why do firms distribute dividends? Several solutions were offered,[233] and one of the most accepted relied on signaling theory. It was suggested that dividends convey information about current and future earnings, and specifically about expected cash flow.[234] So why donate instead of increasing dividends?

[232] This part is the product of research and discussions I conducted when preparing my SJD dissertation proposal – as I intent to develop this specific subject much further in my SJD work. The upcoming paragraphs reflect the main initial directions I have came up with so far.

[233] An overview of the main non-signaling explanations for the dividend puzzle: *first*, the agency costs explanation, according to which distributing dividends reduce costs of external equity, such as monitoring the managers and risk-aversion on the part of managers. See Frank Easterbrook, *Two Agency-Cost Explanations of Dividends,* 74 American Economic Review 650 (1984). *Second*, the transaction/issue costs explanations, according to which firms restrict dividends to funds not required for investment purposes. See Robert C. Higgins, *The Corporate Dividends-savings Decision,* 7 Journal of Financial and Quantitative Analysis 1527 (1972). *Third*, the pecking order theory, according to which firms restrict dividends as the need for slack arises, and that need increases when asymmetric information increases. See Sanjay Deshmukh, *The Effect of Asymmetric Information on Dividend Policy,* 44 Quarterly Journal of Business & Economics 108 (2005). And *finally*, to a lesser extent, the tax explanation – see Fischer Black & Myron Scholes, *The Effects of Dividend Yield and dividend Policy on Common Stock Prices and Returns,* 1 Journal of Financial Economics 1 (1974).

[234] Sudipto Battacharya, *Imperfect Information, Dividend Policy and 'The Bird in the Hand' Fallacy,* 10 The Bell Journal of Economics 259 (1979). *See also* Merton H Miller & Kevin Rock, *Dividend Policy under Asymmetric Information,* 40 Journal of finance 1031 (1985). For empirical support, see David J. Denis et al., *The Information Content of Dividend Changes: Cash Flow Signaling, Overinvestment, and Dividend Clienteles,* 29 The Journal of Financial and Quantitative Analysis 567 (1994).

This is a valid point. I personally think it is the most interesting point in our inquiry. It involves core concepts in signaling, corporate law and sociology. Accordingly, I will divide my response to that very valid and important point to three: *first*, I am *not* saying that CP is the *only* signal for cash flow; *second*, I *am* saying that CP *can* be under some circumstances the best signal for cash flow; *finally*, I am saying that this is complicated – and that this point is a matter for future cross-cultural study that will shed light on much broader questions, such as what do different cultures look for in public corporations.

First, the clarification: My explanation of CP as a costly signal *does not entail that this is the only sustainable signal that evolved*. It is not mutually-exclusive of other potential signals, but rather a substitute/supplement for them.[235] I speculate that every company picks its own blend of signaling, and that this choice is affected by many factors: the pre-existing interest in the target-audiences (see below), the level of asymmetric information existing, the nature of the private information that the company holds and legitimacy concerns.[236] Indeed, the empirical literature supports the notion of CP and dividends as complementing. Remember the study mentioned in part I.1,[237] according to which increasing dividends are associated with increasing CP. This finding was inconsistent with the hypothesis: it was assumed that increasing dividends would diminish the amount of slack resources, thus making it harder for companies to donate. The opposite happened. This suggests that companies signal according to their perceptual future abilities, and that they can use several different signals to convey the same, or similar, messages.

[235] An area for future research could therefore be the compatibility between good predicators of both dividend yield and CP level. For example, firm size is positively correlated with both (see Clifford W. Smith & Ross L. Watts, *The Investment Opportunity Set and Corporate financing, Dividend and Compensation Policies*, 32 Journal of Financial Economics 263 (1992)).
[236] Compare: Roe, institutions, supra note 87, p. 376.
[237] See Navarro.

The real question, then, should be how we can predict the mix of signals that would be chosen in a given set of circumstances.

The sociobiology literature can help us answer the specific mix of signals question. Specifically, it introduces two concepts we should take into consideration: backup signaling and multiple messages.[238] In backup signaling contexts, signalers use multiple signals about a single aspect of the signaler's quality, in order to allow for more accurate assessment. This would be use when, inter alia, receivers are more prone to perception errors. In multiple messages contexts, signalers use multiple signals about different aspects of the signaler's quality. These concepts can be applied to corporate signaling. To illustrate with the empirical study we just mentioned: perhaps the reason that high level of dividends is related to higher levels of CP is backup signaling: where the level of asymmetric information is high and investors are prone to assessment errors, one form of signals is not enough; companies would use several forms in order to be sure that the investors get the point. Further directions are sketched in part IV infra.

Second, I suggest distinctions between CP and other potential signals, which would make CP under some circumstances a better signal for our purposes. CP can be less prone to certain assessments errors than dividends. This is because *CP is more discretionary than dividends*. The more discretion in expenditure, the more it tells us about the insiders' perceptions of the future ability to generate free cash flow. The more constraints on managers' discretion, the more the decision to spend cash would be subjected to other factors, distorting its signaling aspect. Philanthropy could be a better signal, precisely because you totally do not have to take a given level of it upon yourself. Assessment errors would go up when the receivers' perceive the expenditure to be more of a product of mixed motivations – not only signaling but also

[238] See Rufus A. Johnstone, *Multiple Displays in Animal Communication: 'Backup signals' and 'Multiple Messages'"*, 351 Phil. Trans. R. Soc. Lond. B. 329 (1996).

"functional" benefits. To understand why dividends could be perceived as more involving mixed motivations, think of the beneficiaries of the corporate expenditures. While shareholders, the beneficiaries of dividends, can exert pressures on the top management; the beneficiaries of CP lack the power and urgency necessary (at least in the majority of cases). They are "discretionary stakeholders".[239] Once the company wastes its money by buying jets for its managers, this would become the standard for future negotiations with its top employees.[240] Once the company distributes huge amount of dividends – its shareholders would be disappointed and act accordingly if the company would distribute less (not to mention omitting) in the future.[241] And the donnees? They have no claim at the company. So who cares about them?[242]

One potential counter-argument is that it is exactly the stickiness of dividends that make them better signals than the non-sticky donations.[243] If managers know that they could increase CP in high-slack times and easily decrease it when things go bad, the counter-argument goes, than increasing it would be less of a commitment and thus less of a credible signal. To answer this counter-argument, we first need to remind ourselves of a basic premise of costly signaling: the signaling can only be costly up to a certain level; the level in which they start to outweigh the benefits to the signaler from advertising. So in some circumstances more costly or stickier signals would be preferred, and in other circumstances they would not. When combining this with the literature of backup signaling, we could also predict that as dividends would get stickier

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[239] Ronald K Mitchell et al., *Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of who and what really counts*, 22 Academy of Management Review 853 (1997); Seifert et al., p. 157, end-note 3 ("Although one could argue that dividends should be considered discretionary, CEOs have found it difficult to wean shareholders off of the dividends they have become accustomed to receiving".).

[240] On the centrality of benchmarking in executive pay and perks negotiations, see for example Bengt R. Holmstrom, '*Pay Without Performance' and the Managerial Power Hypothesis: A Comment,* (working paper, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=899096.

[241] The origin of this "sticky dividends" argument can be found in John Lintner, *Distribution of Incomes of Corporation among Dividends, Retained Earnings, and Taxes,* 46 American Economic Review 97 (1956).

[242] A similar argument can be made with regards to expenditures on CSR in general – CP gain as a signal on CSR because it is the most voluntary, least obligatory of all company's presumed responsibilities (last in the pyramid). See Carroll, supra note 95; Seifert et al., pp. 137-139.

[243] This critique, along with many substantial others, was offered to me by Prof. Roe.

and more costly, companies would need to use backup signals – and will probably increase their CP level. This is somewhat intuitive: if a potential investor cannot assess if a company maintains a high level of dividends because it is signaling correctly or because it is pressured by the stockholders, then the high-quality company would need to send a backup signal by way of donation (then the investor would tell himself: "OK, no one can pressure them to distribute more dividends *and* donate at the same time; they do it simply because they think they can afford it. They must know something about future cash flows/profitability").

CP can also gain on wasteful signals in some circumstance, because of being less prone to other set of assessment errors: not "mixed motivations" errors but "measurement" errors. In sociobiology, one reason for evolution of altruistic handicaps was their ability to solve assessment problems. If the receiver is the beneficiary of the altruistic act, then he can assess it more accurately (knows exactly the size of the handicap – it is the benefit bestowed upon him).[244] In the corporate context, however, we cannot translate it directly to altruistic acts. In most cases the target-audiences of the company are not the beneficiaries. In fact, this insight suggests that dividends would be less prone to this type of assessment errors than CP (because the receivers = the beneficiaries = the shareholders). Still, CP can be less prone to assessment errors than wasteful signals, like building luxurious company headquarters. This is because fringe benefits are less accurately assessed than cash donations (difficult to put hard numbers behind them), and are less readily observable in publicly-available data.

Finally, the answer to the "why signal by X and not by Y" question requires us to expand the framework of analysis. The costly signaling framework cannot solve the question by itself; but, along with current literature in evolutionary psychology, it can provide us with initial

[244] Jonathan Wright, *Altruism as a Signal: Zahavi's Alternative to Kin Selection and Reciprocity,* 30 Journal of Avian Biology 108, 109 (1999); Gilbert Roberts, *Competitive Altruism: From Reciprocity to the Handicap Principle,* 265 Proc. R. Soc. Lond. B 427, 430 (1998).

directions. In order to find out what makes a certain costly signal more effective than others we need to pay attention to the pre-condition for evolution of signals. There must be a pre-existing interest on the part of the target-audience. In nature, a "mutation"-signal in the form of a handicap would survive only if it would immediately catch the attention of the target-audience, thus lending competitive advantage to its bearer. Because the form of the signal is logically related to the message conveyed, the explanatory power cuts both ways: from the form of the signal to its meaning and vice versa.[245] Applied here: signals in the corporate context would evolve (to reiterate: culturally evolve) only if the company's target-audience would see them as a good proxy for something that interests them. This something could vary – between cultures, political systems, periods of times, industries, etc. It is a matter for future cross-cultural research.

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To recap our application of the model, let us now reframe it in game-theoretic stability terms. The conditions to be met in order to get a costly-signaling stable equilibrium are:[246] (1) inter-company variance in some underlying attribute, that is not readily observable; (2) target-audience would gain from accurate information about this underlying attribute; (3) signalers would gain from sending false signals, passing themselves of as better in that underlying attribute than they truly are; (4) the marginal cost of sending a signal is negatively correlated with the quality of that underlying attribute. Once we establish this, then we can assume that some "design agent" – be it cultural evolution, conscious decision making, or other – would make sure that communication in the corporate context would adhere to costly signaling.

[245] Grafen, p. 541. To illustrate, think again of the paradigmatic zoological example: the evolution of the peacock's massive tail was predated by a pre-existing interest from the peahens. The peahens were interested in the tail because it is a good proxy for body-weight. Since peahens generally lack access to weighting scales, they paid attention to a good proxy for weight – size of the tail. That, in turn, enabled the evolution of the tail as a costly signal.

[246] Based on Grafen. See also Bird & Smith, p. 224.

There is an *inter-company variance in ability to generate future cash flow*; this is an underlying attribute of companies – think of the centrality of cash flow in evaluation of companies; this attribute is not readily observable, if only because of its perceptual character. So condition (1) is met. *Shareholders stand to gain from receiving accurate information* regarding the company's ability to generate future cash flow – they would be able to better evaluate the company, and make better investments decisions. So condition (2) is met. *Companies with low-quality in generating cash flow could gain if they could signal that they have better quality* – for one, they would lower their costs of raising capital. So condition (3) is met. *The marginal cost of sending a signal conveying message on ability to generate cash flow – donating money in our case – is negatively correlated to ability to generate cash flow internally,* because companies would find it hard to sell debt or equity in order to get money to donate. So condition (4) is met as well. Therefore, we can assume that costly signaling selection would govern the communication between companies and shareholders regarding the company's ability to generate cash flow (although for fuller understanding, we still need to clarify to ourselves who/what is the design agent that assures this). The result would be separating equilibrium in which good-quality companies donate more than bad-quality companies.[247]

II.3 – potential critiques and limitations of the model:

My thesis borrows from costly signaling theory, implementing those insights to the corporate context. Therefore, it is subject to attacks on two grounds (at least…): *first,* it could be claimed that the theory I am relying on – costly signaling – does not entail the explanatory and predictive powers I attach to it; and that my thesis might be better serviced with other models for explaining altruism. Indeed, many evolutionary scholars would opt for a different mechanism as their first

[247] See Lee A. Dugatkin & Hudson Kern Reeve, *Game Theory and Animal Behavior* 98 (1998).

choice for explaining a given altruistic behavior. *Second*, even if assuming that costly signaling is a good background to draw upon, my application of these sound insights into the corporate context could be misguided. Accordingly, this part will try to deal with potential alternatives and criticism, in order to assess (hopefully somewhat objectively…) how sound my thesis is.

II.3.a – applying alternative socio-biological explanations of cooperative behavior:

My model assumes that CP is an adaptation at the corporate level. But altruistic behavior can be an adaptation at other levels (a group-level?); or it can be mal-adaptive altogether (a sort of cultural parasite?). The point is the one made in the beginning of this chapter: there are many competing explanations for altruism in sociobiology. The HP explanation of CP can seem intuitive (at least to me it does). But in order to establish more firmly that it is the fittest, we should try to distinguish it from competing models, which might also be relevant for our context.

Reciprocity models: perhaps the most common explanations for cooperation between non-kin,[248] unrelated individuals are based on the notion of future reciprocity. To start with the basic model – *reciprocal altruism* (RA) evolves when altruists are more likely to benefit each other than to benefit randomly others.[249] Applied to our context, we can find this concept being echoed in the words of those that explain CP as a need of corporations to reciprocate the benefit that society conferred upon them – an adaptation at the level of the corporation.[250] RA is also

[248] Altruism among genetically related individuals can be explained by kin selection (KS). William D. Hamilton, *The Genetical Evolution of Social Behavior*, 7 Journal of Theoretical Biology 1 (1964). The key in KS is moving to the concept of "inclusive fitness"; focusing on the gene rather than on the organism. The "indirect legacy" of genes, realized via relatives, is taken into account. While the altruistic act might reduce the fitness of the individual, it could increase inclusive fitness – and thus be adaptive. This will happen when the costs from helping are smaller than the benefits for the needed kin multiplied by the degree of relatedness ($r > b/c$). Applying the KS framework to our context is problematic, because of the genetically-centered character of it. The relevant insights offered by this model can be applied to our context via analogies to group selection models (see below).
[249] Robert L. Trivers, *The Evolution of Reciprocal Altruism*, 46 *Quarterly Review of Biology* 35 (1971) (presenting the model); Robert Axelrod & William D. Hamilton, *The Evolution of Cooperation*, 211 *Science* 1390 (1981) (showing how the "tit-for-tat" strategy prevails in computer simulation experiments).
[250] Smith, 41 NYL, p. 764; Stetson's transcript, p. 86 (Melvin Eisenberg's view).

echoed in the argument that CP is about for-profits and non-profits leaders exchange donations and status – an adaptation at the level of the agent-insider.[251]

What is wrong with an explanation of CP as RA? For start, RA's possible flaw – susceptibility to free-riding – is especially eminent in out context. Why should companies, or elite leaders, reciprocate? Detecting and punishing non-reciprocators are themselves costly, positing a second-order public goods problem. Remember: our context is a very competitive, business-oriented one. In an environment with relatively high degree of anonymity and strong economic incentives the free-rider problem becomes more realistic.[252] As an anecdote, note that even the studies that came out against a strong version of the free riding problem, found support for the hard-core version of the problem when economists were used as subjects….[253] This can indicate, at least to some extent, that the strictly business atmosphere of the corporate world would make the free riding problem harder to solve.[254]

But this is not the most important flaw in applying RA to CP.[255] Even if we assume that we can get pass the free riding problem, one cannot describe CP as being about delayed repayment of the favor of an "altruistic" act. In the corporate context, the recipients of the company's donation are not the ones who can be expected to give back. They are rather mostly distant and/or poor individuals or institutions. So, the cooperative behavior we are trying to

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[251] See for example Abzug & Webb, pp. 1040-1041, and the references there.
[252] Cf., Oliver Kim & Mark Walker, *The Free Rider Problem: Experimental Evidence*, 43 Public Choice 3 (1984).
[253] Gerald Marwell & Ruth Ames, *Economists Free Ride, Does Anyone Else?* 15 J. Public Econ 295 (1981).
[254] I do not mean to imply that there is something wrong with corporate guys. In fact, some of my best friends are corporate guys! Honestly!
[255] There are other flaws aside from those detailed at the body of the text. For example, the fact that we do not deal here with genetic evolution but rather with a cultural one, eliminates important features of the RA explanation. For one, it is hard to explain under RA how did a reciprocal mutation established itself in the first place – in an environment of non-reciprocators, a reciprocator would loose. We cannot apply the RA-as-pleiotropism solution to CP. The pleiotropism solution to this problem assumes that RA is an inherited genetic left-over, where a genetic system that was coded for kin altruism produced a side effect of non-kin altruism (see Eugene Burnstein, *Altruism and Genetic Relatedness*, in: The Handbook of Evolutionary Psychology (David M. Buss Ed., 2005), p. 545; Robert Wright, *The Moral Animal* 200-201, 206 (1994)). Here, with no genes to do that job, the "dove among hawks" problem is harder to solve. (See also Piliavin & Charng, supra note 197, p. 46, at footnote 22.)

model here is more like *unconditional* altruism. It has been shown that unconditional altruism can be the evolutionary stable strategy, regardless of future reciprocation – only when signaling benefits of altruism are introduced. This will happen when the cost of altruism is higher than the signaling benefits to *some* individuals (so that high-quality individuals would behave altruistically).[256] To move from conditional to unconditional altruism we need signaling benefits. Reciprocity alone will not do.[257]

To be sure: there are some forms of CP in which the RA model *can* logically be applied to provide a plausible explanation. For an adaptation at the level of the agent, think of the cases reported in small-knit communities where for-profits and non-profits interact closely. For an adaptation at the level of the corporation, think of donations to a specific laboratory in an R&D-related manner. In these cases the beneficiaries could very plausibly "respond" eventually to the donations in a way that will favor the donor (providing the corporation with better work-force/better technology; or rewarding/punishing the manager with social currency). So, CP is not *always* about unconditional altruism. But overall, the RA cannot account for the overwhelming amount of cases in which CP does look like unconditional altruism.[258] Therefore, HP has a widest applicability, and gains on RA in an Ockham Razor's sense for explaining CP.

Before moving on to other explanations, things get somewhat more complicated. The flaws and constraints in simple RA models[259] have led to refinements of the theory. So, before chalking a gain to costly signaling theory in the battle for explaining CP, we should test it against

[256] Lotem et al, supra note 202; Gilbert Roberts, supra note 244, at p. 428.
[257] To better understand why, consider the formal condition for RA: $w > c/b$, when w = the probability of future encounter between the altruist and the beneficiary. See Martin A. Nowak, *Five Rules for the Evolution of Cooperation*, 314 Science 1560, 1561 (2006) (hereinafter: Nowak).
[258] Eisenberg, who invoked the reciprocity explanation, acknowledged that it is "…self-limiting: It applies only to cases where the corporation is making compensation for a benefit, and it justifies only compensation that is reasonably proportionate to the benefit". Eisenberg, 28 Stetson, at p. 10.
[259] For elaboration, see Jeffrey L. Harrison, *Strategy and Biology: The Continuing Interest in Self-Interest*, 86 Colum. L. Rev. 213, 215 (1986); Kevin C. Clements & David W. Stephens, *Testing Models of Non-Kin Cooperation: Mutualism and the Prisoner's Dilemma*, 50 Anim. Behav. 527 (1995).

those refined models as well.[260] Representative of such refinements is the "*indirect reciprocity*" model (IR). IR is based on the notions of image and reputation. Even if the beneficiary of the donation will not reciprocate, the donation will not be left unreciprocated – someone else will reciprocate after observing the fact that the helping individual is a "cooperator".[261] This is getting more towards a fit explanation of CP – but it is still not fitter than HP-costly signaling.

First, it is less clear what meaningful contribution the IR model could bring that HP did not already bring in a more concise manner and with more predictive power. Yes, altruism confers status/prestige/advertising gains on the altruist; this is exactly the point of costly signaling….[262] *Second*, IR models assume a uniform population without individual variation in quality. So, the information conveyed by the altruism is about past behavior, not about the altruist's quality.[263] In the public corporation context this makes the model less fit. The assumption is unrealistic. Moreover, it is hard to see why potential investors should pay attention to past behavior of the company. These behaviors should already be reflected to some extent in

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[260] Note that we do not deal explicitly in the body of text with the "strong reciprocity" notion, according to which there are individuals that would reciprocate regardless of the costs they will incur. For the example of third-party sanctioning, see Ernst Fehr & Urs Fischbacher, *Third-Party Punishment and Social Norms,* 25 Evol. Hum. Behav. 980 (2004). The reason for not elaborating on altruistic punishment in the body of text can be found in Nowak's words: "Punishment is an important factor that can promote cooperative behavior in some situations, but it is not a mechanism for the evolution of cooperation. All evolutionary models of punishment so far are based on underlying mechanisms such as indirect reciprocity, group selection, or network reciprocity. Punishment can enhance the level of cooperation that is achieved in such models". Nowak, p. 1563. In the body of text we will deal with the applicability of some of those underlying mechanisms (such as group selection). Those that we will not deal with, are less relevant for the corporate context (think of the individual-level advantages strong reciprocity is said to bring – emotional, neural aspects, which are less suited for explaining corporate behavior (see Dominique J.F. de Quervain et al., *The Neural Basis of Altruistic Punishment,* 305 Science 1254 (2004))).

[261] See Martin A. Nowak & Karl Sigmund, *Evolution of Indirect Reciprocity by Image Scoring,* 393 Nature 573 (1998). Note that in the corporate context it might be that a different refined model is more relevant: "network reciprocity" (NR). NR is based on the premise that in real-world situations some individuals interact more often than others (see Nowak, p. 1561). However, for the purpose of comparing between the models and costly signaling, sticking with the basic IR model will do.

[262] Zahavi, p. 149.

Similarly, when the models are relying on the "symbolic capital" notion, they are in fact governed by costly signaling selection, at least in those circumstances that apply in our context: (1) generosity is towards "multiple other regardless of their exchange relationship to the 'giver'"; (2) generosity is being acted in "a social arena in which knowledge of the distribution is transmitted to multiple others"; (3) generosity is dependent upon non-observable trait of the giver, which is valuable to the target-audience of the giver (whether they are the beneficiary of his gifts or not). These are, as mentioned, typical of the CP context. See Bird & Smith, p. 226.

[263] See Lotem et al., supra note 202, at p. 199.

its stock prices. In contrast, the HP predicts that since the level of help would depend on the quality of the helper, and since individuals vary in quality, then helping conveys information about the altruist's quality, which will be used by observers who will in turn cooperate with the altruist in other contexts.[264] This is a much more accurate account of CP: companies vary to a great extent in their capacity to donate, and the companies' target-audience would not rely solely (if at all) on past public information on certain behaviors.

<u>Conventional signaling models</u>:[265] signaling theory in general is about explaining how signals evolve to be reliable. The HP – *costly* signaling theory – emphasizes the quality-dependent handicap as the mechanism that prevents cheating. Conventional signaling offers other mechanisms to prevent deception, available for human beings: either the reliability can be attached without costs; or the costs might come from "outside", meaning that the signal itself need not be inherently costly, because the cheating signaler would still incur heavier costs through institutions such as reputation, social norms and conventions. Applied here, we could claim for example that companies donate in order to attract social conscious investing funds.[266] CP, it would be argued, is just about companies saying "hey, we are nice, thoughtful, and care about the needs of the greater society". And because people appreciate this kind of quality (so it must be assumed), they will value more the donating company. Companies that would act as nice and caring, while not really being nice and caring, would be punished for going against the convention.

Conventional signaling in general can be stable only in a limited set of circumstances.[267] In our context, it is highly implausible, in all its forms. The "cheap talk" explanations (i.e.,

[264] See Gilbert Roberts, supra note 244; Lotem et al., supra note 202.
[265] See John Maynard Smith, *Must Reliable Signals Always be Costly?*, 47 Animal Behavior 1115 (1991).
[266] Kahn, 44 UCLA, p. 674.
[267] See Michael Lachman et al., *Cost and Conflict in Animal Signals and Human Language*, 98 Proceedings of the National Academy of Sciences USA 13189, 13191 (2001). See also Grafen, p. 529.

signals would be reliable because the players would not have motivation to cheat) *does not account convincingly for inter-company variability*. If companies can benefit from sending a costless signal by donating, why do we see companies that donate little or not at all? Most importantly, remember that in our context *there is not a high degree of coinciding interests*; on the contrary.[268] The "social punishment" explanations (i.e., signals are costly, but the costs are not inherent but rather imposed by social conventions) are weaker in our context, where there are *strong economic incentives to cheat and free-ride*, high level of anonymity and competitiveness. Punishing those who go against convention is costly and unlikely to occur at a sufficient level; and there is *not* a high degree of verifiable aspects of conflicting interest.

Still, there are important lessons from introducing conventional signaling framework. Ours is a context of human conduct and cultural evolution, filled with cheap talk and non-handicaps signals. Human signaling is much more dynamic, changing fast. In many cases the signal's reliability would be secured by a mix of more than one mechanism (structured inherent costs *and* social conventions). We cannot simply assume that CP was, is and will be a product of "clean" separating equilibrium of handicap signaling. Communication would depend on nuances, subtleties and ever-changing social influences; and will be highly cultural-dependent. All these messy aspects of corporate communication should be constantly examined in future research. A special emphasis should be given to the possibility that the costly signaling explanation is already becoming or will shortly become anachronistic. For example, lower information costs might reduce the need for signaling; or the growing CSR movement might make CP less efficiency-reducing.

[268] Our context fits Cronk's description: "Specifically, costly-signaling theory is relevant where there are confluences of interest between individual signalers and individual receivers in contexts where the broad categories to which signalers and receivers belong have conflicting interests". Lee Cronk, *Comment,* 46 Current Anthropology 239 (2005).

Group selection models (GS): After decades in which it was rendered theoretically possible but too weak a force to be taken into consideration,[269] a new, stronger version of GS emerged. Evolution, it is now argued, is not just about mutational change; it also takes place through major transitions: a group that reaches a certain size and then split into two (or turns into a higher-level organism). Each transition implies group selection: some groups would grow faster and split more often. A possible application is that groups of altruists would out-compete groups of selfish individuals.[270] Still, even proponents of this much more accepted version of GS seem to agree about its limitations in gaining over individual selection. For example, certain rates of migration and splits must be met.[271] Applied to our context, group-level advantages in CP are frequently mentioned: preserving the free enterprise system, disarming general hostility towards corporations, building a healthier, more educated society, etc.[272]

These applications are limited. As mentioned, GS can become a force to be reckoned with only under certain non-trivial conditions. GS works better in small groups; and in conditions of small intra-group variance and high inter-group variance.[273] In the CP context all of these pre-conditions are far from being met. *First*, the size of the group here is a big hurdle: in the CP context the trait-group would be in most instances huge. This is because the way to define the trait-group is according to the trait in question[274]; and in CP that means that the group would have to include both the donating corporation and the beneficiaries of CP (the donees). So, aside

[269] John Maynard-Smith, *Group Selection and Kin Selection*, 201 Nature 1145 (1964); George C. Williams, *Adaptation and Natural Selection* (1966); Robert Wright, *The Moral Animal* 186-188 (1994) (concise overview).
[270] See David S. Wilson & Eliot Sober, *Reintroducing Group Selection to the Human Behavioral Sciences*, 17 Behavioral and Brian Sciences 585 (1994).
[271] Robert Wright, *The Moral Animal* 187 (1994).
[272] Recall for example the *Barlow* case dicta (p. 586); Smith, 41 NYL, p. 764.
[273] To understand why, it would be helpful to consider the formal pre-condition for GS: $b/c > 1 + (n/m)$, where "n" is the maximum group size and "m" is the number of groups. See Nowak, p. 1562; David S. Wilson, *Darwin's Cathedral* 35 (2002).
[274] David S. Wilson, *Darwin's Cathedral* 14-17 (2002). After identifying the trait-group, we would have to compare fitness within groups, compare fitness among group, and then combine those effects.

from those instances in which most of a company's donations are to the same targeted small group of beneficiaries (say, a non-profit in a close-knit community where the donating corporation is located and where everybody is employed by that corporation), the trait-groups of CP would have to be country-size. CP would have to make the whole economy better than others. *Second*, the within group (=within countries) variance in CP is huge. Similarly, profitability of companies is in the majority of cases more affected by national rather than international product markets' competition; and the frequency of dissolutions of groups is still low.[275] All these characteristics render GS selection forces less significant for our purposes.

To be sure: there are some circumstances in which selection for CP could possibly occur at the group level. CP at war times comes to mind.[276] Indeed, as noted in part I.1.b, CP sky-rocketed in both World Wars, only to go back to its regular trajectory post-war. This could be attributed to the group-level advantage, which is stronger in such times. Another example is those corporations whose activities are concentrated in a small town, and whose donations go to local non-profits, whose activities are, in turn, benefiting local potential employees of the corporation.[277] But this is only a small subset of CP. So group-level explanations too have limited applicability and fail the Ockham's razor test when compared with costly signaling.

Still, the introduction of group-level thinking can offer some insights. For example, remember that costly signaling can come at both categories of costs: either altruism or waste. Now think of two competing groups in which signaling is needed to bridge informational gaps. If in one group signaling would take the form of altruistic handicaps while in another wasteful

[275] …Though it is arguably possible that globalization of product markets and cross-listing in securities markets might eventually turn inter-groups selection forces to stronger than intra-group selection forces.
[276] This example was used in a similar manner in Eisenberg, 28 Stetson, at p. 12. See also Engel, supra note 167, p. 4.
[277] Again, see Eisenberg, 28 Stetson, at p. 14.

handicaps would be used, the former group would fare better, all other things equal.[278] This is important for policy-makers: we should aim at directing (or not crowding out) costly signaling by corporations towards altruism rather than waste (see part III infra).

Cultural evolution models: when applying evolutionary theories to human behavior we need to account not only for biological but also for cultural evolution (i.e., gene-culture co-evolution). In our context, recognizing cultural evolution forces is a must. When discussing the adaptability of CP, we are assuming a certain level of cultural learning-transmission mechanism.[279] Conscious as well as unconscious mechanisms, like imitation, trial and error, rational thought, and the likes – transfer adaptive corporate practices. However, recognizing that cultural evolution is in force here does not necessarily entail that CP is adaptive; it certainly does not necessarily entail that CP is about costly signaling. This is because "cultural variation does not always result in cultural evolution".[280] Culture can be mal-adaptive, too. Indeed, there is a polemic in the cultural evolution literature on the correct emphasis that should be given to cultural mal-adaptiveness. Applied to our context, could CP be just a cultural parasite?

Consider the theory of memetics. The *meme selection*[281] concept was introduced to stress that genes are not the only replicators; cultural ideas themselves can be seen as replicators as well ("memes", á la genes).[282] Cultural ideas are transmitted from one mind to another, through various mechanisms such as imitation, speech and rituals. The important notion is that memes

[278] In Miller's words: The HP "…offer[s] the only group-selection argument for altruism I have ever read that stands up to game-theoretic scrutiny… Groups that evolve 'altruistic' signals that confer benefits on others while advertising one's own quality will do better than groups that evolve purely wasteful signals that confer no benefits except to increase one's own prestige". Miller, supra note 214, p. 347. *See also* John Leslie Mackie, *The Law of the Jungle: Moral Alternatives and Principals of Evolution*, in: Persons and Values (1985).
[279] *Cf.*, Michael Alvard, *Comment*, 46 Current Anthropology 238 (2005) ("Signaling theory is a theory of communication, and in the context of humans it is fundamentally a theory of culture").
[280] David S. Wilson, *Darwin's Cathedral* 79 (2002).
[281] See generally Susan Blackmore, *The Meme Machine* (1999); Richard Brodie, *Virus of the Mind: The New Science of the Meme* (1996). "Memetic theory has yet to be applied to any significant extent in the business disciplines" (Gad Saad, *The Evolutionary Bases of Consumption* 167 (2007)).
[282] Richard Dawkins, *The Selfish Gene* 189-201 (2nd ed., 1999).

replicate and respond to selective pressures *independently* of their hosts (=us human beings). In that sense, they are like cultural germs, spreading from head to head horizontally. Applied here, we can think of the sustainability of CP not as suggesting benefits for the organism (company/decision-makers), but rather as suggesting benefits for the idea of corporate philanthropy, which perpetuated itself better than competing ideas.

Another, similar version of CP as cultural maladaptation could derive from the approach that applies the *Runaway Process* model to cultural evolution.[283] According to the runaway model, we need not assume that sustainable phenomena of waste are adaptive in the traditional sort. Their sustainability is rather a product of an arbitrary process, based on the notion of "success breeds success". In nature, a female that will follow the majority preference for attractiveness, would have attractive sons as well. To illustrate with the peacock's cumbersome tail: arbitrary observer preferences of peahens preferring mates with showy tail, is correlated to the excess trait itself (showy tails) via genetic inheritance. So the offspring of the showy-tail-preferring-peahen and the showy-tail-peacock would inherit both the arbitrary preference and the excess trait. Success in that sense is frequency-dependent and self-reinforcing. Applied here, it could be claimed that in an arbitrary process, it became profitable for companies to donate. This is because shareholders that invest in donating companies get better returns – the result of majority preferences in the shareholder community for companies that are "nice" (once a company is perceived as nice, everybody buys its shares). Managers that observe how companies that do good actually do well, will imitate this strategy, and do good themselves.

[283] For the model see Ronald A. Fisher, *The Genetical Theory of Natural Selection* (1930). For concise overviews see Helena Cronin, *The Ant and the Peacock* 201-204 (1991); Bird & Smith, pp. 223-224. On the application of the model to cultural evolution see Peter J. Richerson & Robert Boyd, *Not by Genes Alone* 163-164 (2005).

These explanations, though plausible to some extent, are less fit than the costly signaling explanation.[284] *First*, we have to remember that the relevant group here is huge in evolutionary terms. In huge, country-size groups the possibility for an arbitrary majority preference to arise is insignificant. *Second*, it is also less plausible that CP can be a good replicator in the meme sense. It is hard to fit it into some gene-like catchy cultural idea. This is because there are many mixed notions and perceptions in the idea of the company as "nice". Some might think that what counts for good citizenship is better treatment of employees; others that the meme is "be green" (environmental friendly). If anything in our context resembles something like a meme selection, the candidate for meme would be CSR. This makes the replication of the CP idea much less plausible: some managers might recognize that companies that do good do well; but than when trying to imitate doing good in their own companies, they will invest in better protection of the environment (for example) instead of outright donations. Potential replicators are therefore weak.

Still, introducing the rich literature on cultural evolution could yield some meaningful insights for our purposes. For example, it might tell us something about the pre-existing interest in the target-audience of corporations – the pre-condition that led to signaling in given forms (see part II.2.b supra).[285] Here as well, further research is warranted.

<u>II.3.b – limitations, open and controversial issues</u>:

Putting aside the challenges from competing explanations for altruism, there are potential critiques of my application of costly signaling theory to CP.[286] Below I will try to accommodate and refute some critiques, while admitting my explanation's limitations.

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[284] Another critique of such theories is that they are too much of just so stories – not being able to account for how exactly a practice first developed (only account for the fact that it has developed) without resorting to other theories.

[285] On the pre-existing interest: "the cultural evolution of epidemiology of signals is an undeveloped area of empirical research and promises to be a complex and fruitful topic". Bird & Smith, p. 233.

[286] These valid critiques are yet another example for use of materials I have prepared for my SJD proposal in this paper (they represent initial directions for expanding the research of cooperative corporate behavior in general).

(I have already dealt extensively with two potential critiques: "So what? There is no real issue with CP" (see the introduction. Suffice to mention again that a main motivation in providing an alternative explanation, is to use a better understanding of this extreme exception of non prima facia profit-maximizing corporate activity, to gain eventually better understanding of much larger realms of corporate non-maximizing behavior in general[287]); and "Why CP and not other handicaps that can signal cash flow"? (See part II.2 supra).)

"How could letting the world know that there is a lot of slack be beneficial for the company"? One dominant view in corporate finance literature – associated with Jensen – stresses the dark side of high level of slack resources.[288] Based on that approach it could be claimed that there is no reason to assume that CP evolved as a way for companies to signal high-quality. This is because when the signaler let the world know that there is going to be a lot of slack accumulated, his message is prone to be perceived by the receivers as a rather negative message – implicating larger managerial agency costs. So there will be no incentives to send such message in the first place.[289] I do not think that negative perceptions are more plausible than positive ones: what CP signals is ability to generate better results than what is expected; it does not necessarily signal inefficient use of the slack created. But even if we assume that CP is perceived as signaling high-slack, there is one simple fact that undermines this critique: slack resources are not always bad. In many circumstances high slack can be perceived as beneficial for the company. So it would only make sense to communicate it. The real question is what those circumstances are.

[287] This is indeed the subject of my SJD dissertation proposal.
[288] See for example Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers,* 76 American Economic Review 323 (1986).
[289] See also the classic Stephen R. Ross, *The Determination of Financial Structure: The Incentive-Signaling Approach,* 8 Bell Journal of Economics 23 (1977).

Slack resources have many positive functions.[290] Consider the following two examples. *First*, slack can *facilitate innovation*. A company that can create an efficient internal capital market reduces the transaction costs associated with outside financing. These transaction costs are especially high when it is difficult to explain to outside financiers the complex technological (or other) innovations in future projects. A company that creates its own free cash would have a competitive advantage. This is also related to better ability to go through strategic changes and to break "routinization" problems in large corporations.[291] *Second* and highly relevant nowadays, slack resources can also serve as *a safety cushion in times of crises*; a buffer against exogenous dramatic changes. This is because slack allows companies to seek alternative markets/products when its previous environment is in crisis; they can respond to shifting demand without having to rely on dried-up external sources of financing. Recent empirical study backs this argument.[292]

So, in companies and in circumstances where slack can play such positive roles, a message conveying information on creating high amounts of slack would be perceived as a signal for high-quality. This leads to hypothesize that technologically/innovation driven firms as well as pro-cyclical firms would benefit more from such signals. This argument seems to be consistent with the data: the firms that donate the most are pharmaceuticals and technological companies (see part I.1 supra), where high level of free cash flow is advantageous. Systematical data and "series" testable hypotheses are needed before we could reach conclusive conclusions.

<u>"What about the role of the beneficiaries of CP"</u>? This is indeed a limitation of my proposed explanation. For the sake of brevity I have assumed away the strategy of the

[290] For a recent survey see Scott F. Latham & Michael R. Braun, *The Performance Implications of financial Slack During Economic Recession and Recovery*, 20 Journal of Management Issues 30 (2008).
[291] On that function of slack resources see Nitin Nohria & Ranjay Gulati, *Is Slack Good or Bad for Innovation?*, 39 Academy of Management Journal 1245 (1996); on the routinization problem, see Rebecca M. Henderson & Kim B. Clark, *Architectural Innovation*, 35 Administrative Science Quarterly 9 (1990). For a basic explanation of the innovation-facilitating function, see Sharon M. Oster, *Modern Competitive Analysis* 390 (3rd ed., 1999).
[292] Latham & Braun's study (supra note 290) suggests that in times of recessions, high-in-slack firms are performing worse in earlier stages of the recession, but are coming out much better from the crisis in the long run.

beneficiaries of CP. But in real life fund-raisers might play a not insignificant part. In cases where the beneficiaries of the altruistic handicap are not the receivers, these third-parties can theoretically elicit "excessive altruistic signaling, which would be of limited selective benefit to the signaler".[293] To be sure, the effect of such strategic activity by the beneficiaries is limited. But in further research it might be useful to take also this modest factor into account.

General critiques on drawing analogies from sociobiology: *First*, "selection forces are too slow to be relied on when explaining such a relatively young phenomenon". The answer to that critique is straight-forward: even if we assume that genetic evolution is that slow, this is not relevant for our purposes. We are dealing with rather *cultural* evolution here, which is recognized as a much faster process.[294] *Second,* "corporations are being driven by intentional, conscious mechanisms – your explanation is downplaying these mechanisms". The key in answering this critique is to distinguish between proximate and ultimate explanations for CP. CP could have evolved in several ways, such as selection mechanisms (corporations that donated outcompeted those who did not) or imitation (corporations consciously recognized the success of a donating corporation, and imitated it). For our purposes, it matters less how CP spread. These mechanisms *create* function, not *offer* function. The function of CP is to bridge the information gap regarding companies' abilities to generate free cash flows. This functionality can be achieved also by unconscious processes, either at the individual (decision-maker) or the group level. Consciousness, though possible, is not necessary.[295] In fact, it could be claimed that the most cynical players – those who will donate explicitly to influence the opinion of investors on

[293] Jonathan Wright, supra note 244, p. 109.
[294] Cf., David S. Wilson, *Darwin's Cathedral* 35, 219 (2002). The corporation itself grew importantly and pervasively in an amazingly short period of time (see Alfred Chandler, *The Visible Hand* (1977)).
[295] Grafen, p. 528 (explaining that for an honest signaling equilibrium to be established, "Consciousness in neither assumed nor excluded – it is irrelevant"). See generally David S. Wilson, *Darwin's Cathedral* 76-79 (2002); Robert Wright, *The Moral Animal* 254 (1994) ("everyday human behavior is often a product of subterranean forces – rational forces, perhaps, but not consciously rational").

the value of their future projects – might "overdue" the handicap. The target-audience might not view such donations as handicaps, and will discount their meaning. Costly signaling is always a matter of nuances and subtleties.[296]

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To sum: although many theories have been developed to explain cooperative behavior, both in evolutionary research and in economics, the specific subset of unconditional altruism still remains elusive. Costly signaling theory fairs relatively well (if not the best) in this relevant for our purposes subset.[297] Therefore, when trying to explain CP – a phenomenon which involves to a meaningful extent unconditional altruism in an extremely competitive environment – costly signaling is the first place to go to for insights.

True, several CP expenditures could be explained also under competing models, even better than by costly signaling. But the empirical findings on the phenomenon suggest that *the Ockham's razor principle makes costly signaling the fittest explanation for CP*: the HP has the widest application – it can explain better the largest amount of manifestations of the phenomenon. Therefore, even if not perfect, it is the fittest.[298]

<u>Chapter III – legal implications:</u>

In the previous chapter, I presented my thesis: CP can be explained in terms of costly signaling, benefiting the company precisely because it reduces its resources. This part will try to sketch the main legal implications for accepting such thesis. Naturally, we shall do it by referring to

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[296] To illustrate, think of a novo-rich individual explicitly and tackily signaling his wealth by consuming observable goods (cars, jewelry, etc); as opposed to a true "aristocrat" signaling his richness more subtly (by donations; by investing in his kids' education; etc). On the dangers of over-promoting CSR activities, see Craig M. Sasse & Ryan T. Trahan, *Rethinking the New Corporate Philanthropy*, 50 Business Horizons 29, 37 (2007).
[297] Millet & Dewitte, supra note 199, p. 317.
[298] Costly signaling is also the most elegant, parsimonious of all plausible explanations to CP.

existing CP laws, surveyed in part I.3 supra. Accordingly, this chapter will begin by stating how in general a legal system should treat such phenomenon, and then underscore the ways in which existing CP laws are both over-inclusive and under-inclusive, offering possible implementations.

The basic desirable approach – laissez-faire:

Basically, if CP is to be seen as a costly signal, then *we should not regulate it more then we regulate expenditures on "regular" advertising*. The latter are regulated under a Business Judgment Review, and so should the former. Why restrict CP, when we give managers great leeway to engage in massive advertising campaigns and other similar expenditures?[299]

In this sense, my ultimate point is the same as that of some contractual theory scholars: "the law should step aside and pay less concern to this issue". *What the law should do is police fraudulent activity, but not to second-guess non-fraudulent efficiency problems, such as charitable activities*.[300] The difference between my approach and the traditional contractarian one lies behind the unnoticed distinction between "regular" natural selection and signal selection.[301] This unnoticed distinction explains why the frequent criticism from legal scholars

[299] In Eisenberg's words: "the mere possibility that philanthropic contributions may involve conflicts of interest should not be a reason for prohibiting corporate conduct that falls within the social-conduct norm, any more than the mere possibility of conventional conflicts of interest is a reason for prohibiting corporations from engaging in conventional business transactions". Eisenberg, 28 Stetson, at p. 24. On the abovementioned leeway, see also Butler & McChesney, p. 1202, at footnote 28.

[300] Manne, pp. 708, 714.

To emphasize: If we are afraid of the managers giving money away to their peers in a way that is not fair to the corporation, then we have the duty of loyalty (note that the courts would consider also psychic elements when determining "interestedness" – see Balotti & Hanks, p. 984 (referring to the *RJR Nabisco* case)). If we are afraid of the corporation giving money that is not "its own", then we have the corporate law protection of creditors provisions, as well as fraudulent conveyance laws. The same argument can be made in response to those who will try to point to the Enron debacle as an example of misuse of CP money (donating to the charities of the directors' likings, making the directors not really "independent". See Gordon Moore et al., *The Business of Giving*, 8466 Economist, p. 3, 25.2.2006).

[301] Contractarian approach is also based on Darwinian logic: "Given freedom of entry into market, the *survival* of a particular kind of behavior in the business is perhaps ultimately the best test we have of whether that behavior is desirable or undesirable… If apparently non-profit oriented behavior persists, there must be some market related explanation that economists can appropriately search out". [*emphasis added*] Manne, p. 714. But its reliance on Darwinian logic is misguided, because it does not account enough for the missing pieces in Darwin's puzzle. Yes, there might be a Darwinian mechanism according to which apparently efficiency-reducing behavior persists; but we cannot simply assume that every state is efficient. There could be, under some circumstances, a *specific* explanation

on current CP laws (see part I.3.c supra) is misguided. A common criticism is that allowing wide latitude for CP is inconsistent with traditional corporate doctrines (like the waste doctrine). But signal selection tells us that CP is fit with maximizing shareholders profits. CP benefits the corporation, given the existing asymmetric information. Thus it cannot be thought of as "waste" in the doctrine sense. And signal selection forces make the need for directorial oversight over the level of CP almost equivalent to the need to oversight regular advertising expenditures. In short, introducing the plausible signal selection forces in play in CP might help us rid ourselves of the "paradoxical" conception of CP by corporate law literature. Corporate law scholars that adhere to traditional economic analysis rely heavily on basic Darwinian logic; but their reliance ignores the fact that there were missing pieces in Darwin's puzzle – like cooperative behavior. Costly signaling is one way to fill this gap in understanding. And it is highly relevant for CP.

<u>Current law is problematic</u>:

A corporate lawyer might intuitively respond to my suggestion: "tell us something new", meaning that existing doctrine has already evolved in a way that rarely challenges expenditures on CP. However, this approach – emphasizing the fit between the bottom line of my approach and that of existing law – ignores some inherent, visible problems in current law, as well as some more hidden ones. To recapitulate, the current CP law, as demarcated by the *Barlow-Theodora Holding* line of cases, allows CP as long as it is determined ex post by the courts that a donation was made in order to create some sort of long-term, indirect value to the corporation. Although in practice managers can easily avail themselves by adhering to value-creating motivations in making donations, this formula is still problematic, if only for the three following reasons.

– but you have to recognize it and explain how it works. Such explanation in our context is signal selection. But we cannot apply it automatically every time; doing so runs the risk of collapsing the explanation into a "just-so" theory (see part II.3). But enough with purely logical arguments; let us go back to the law…

First, *Current CP law creates uncertainties, and is difficult to implement*. We cannot really assess ex post (or ex ante) the inner motives of the management when making the donation.[302] Trying to assert whether they were cynic is futile. Moreover, we cannot determine in the time of the trial (not to mention ex ante) what would be the long-term consequences of such donation. It is difficult to judge whether it was reasonable to expect that the donation would yield long-term amorphous benefits.

Second, these uncertainties, resulting from the creation of the fiction of long-term benefit, come with real costs. One set of costs often left unnoticed, is the one stemming from the *negative expressive value of current CP law*.[303] It is not only that we *cannot* assess motivations and expectations to create long-term value by donating; it is also that we *ought* not. By doing it, we are sending a wrong message to society: *if you donate cynically, then you're OK; but if you donate whole-heartedly, then you are breaching trust!*

To better understand this second, critical disadvantage of current CP law, we need to overview shortly the literature on the expressive aspects of the law. The law has been long recognized to have an expressive influence on behavior.[304] The law does not only change the expected costs of behavior by sanctioning it; it also does it by expressing messages regarding this behavior. It is not only what the law *does* that matters; it is also what the law *says*. Therefore, when studying the law's affects, one should not focus only on sanctions (like traditional law and

[302] See Balotti & Hanks, pp. 991, 995 (claiming that a benefit requirement is subjective and speculative).

Perhaps the best way to illustrate it would be to look at the exception: the *Dodge v. Ford* case. Only Henry Ford could have revealed the fallacy of the "benefit" requirement, because only he refused to "admit" that his motivation for not distributing dividends was some amorphous long-term profits. Instead, he insisted that he wants to do good, to distribute the discretionary resources he created to the larger society. Manne elaborated on the point.

[303] Cf., Balotti & Hanks, p. 991 (a benefit requirement ignores the unique nature and context of CP, engrained in the American deep tradition of philanthropy).

[304] See, for example: Robert Cooter, *Expressive Law and Economics*, 27 J. of Leg. Stud 585 (1998) (hereinafter: Cooter); Cass R. Sunstein, *Symposium: Law, Economics & Norms: On the Expressive Function of Law*, 144 U. Pa. L. Rev. 2021 (1996); Lawrence Lessig, *The Regulation of Social Meaning,* 62 U. Chi. L. Rev. 943 (1995); Dan M Kahan, *What Do Alternative Sanctions Mean?*, 63 U. Chi. L. Rev. 591 (1996).

economics often does), but also take into consideration the independent expressive aspects. What are these effects? How exactly the law operates expressively? Several independent but non-mutually-exclusive models were suggested: The *attitudinal* model, according to which law can change the expected costs of behavior by signaling the common attitude of approval/disapproval towards this behavior[305]; the *focal point* model, according to which in situations of multiple equilibria, the law can provide a coordination function[306]; the *internalization* model, according to which the law can cause people to feel guilt when not complying with it (just by what the law says; regardless of what it does)[307]; and the *informational* (Condorcet) model – the law can signal the law-makers' private information about the costs of a given behavior.[308]

Applying this framework to the CP context, it seems that the internalization and informational aspects are insignificant. We are not dealing with a complete ban or a duty to donate, but rather with enabling laws. The relevant cause of the expressive aspects of CP laws probably stems from the attitudinal aspects. By creating a fiction that every corporate donation is about managers cynically trying to get long-term benefits for their shareholders, the courts are signaling a disapproval of "cooperative" corporate behavior. This might reduce the chances that decision-makers would signal by way of altruism, because they will view unconditional altruism

[305] Richard H. McAdams, *An Attitudinal Theory of Expressive Law,* 79 Or. L. Rev. 339 (2000).

The assumptions that underlie this model are: (1) individuals value approval; (2) individuals possess only imperfect information about patterns of approval (do not exactly know what others approve of); (3) the law – either legislation or case-law – is positively correlated with patterns of approval. Once we accept these (plausible, in my mind) assumptions, we conclude that what the law says (regardless of what the law does) might cause individuals to change their beliefs regarding patterns of approval. This could lead in some circumstances to changes in behavior.

[306] See Cooter, pp. 592-596; Richard H. McAdams, *A Focal Point Theory of Expressive Law,* 86 Va. L. Rev. 1649 (2000). The argument, in a nutshell: The law would make certain good equilibrium focal, creating expectations that others would behave according to the new focal point, thus resulting in a change in behavior.

[307] See Cooter. This is because people generally internalize a duty to obey the law - Cooter is relying heavily here on H.L.A. Hart in his *The Concept of Law* (1961).

[308] Note: unlike in the attitudinal model, the information signaled here is not about public attitudes. Dhammika Dharmapala & Richard McAdams, *The Condorcet Jury Theorem and the Expressive Function of Law: A Theory of Informative Law,* 5 American Law & Economics Review 1 (2003). The argument runs as follows: Legislative decision-making involves information aggregation; this information causes individuals to update their beliefs regarding the costs and benefits of the given behavior, resulting in a change in behavior.

as being unacceptable.[309] Other problems might stem from promoting what Berle referred to as managerial reverse hypocrisy.[310]

Another aspect of the negative expressive value is its effect on the company's target-audiences. It might be useful at this point to emphasize that handicapping altruism is not a totally unconditional altruism. It might be unconditioned on donees' response; but it still is conditioned upon its effects on the target-audience of the donor who assess his quality.[311] By dressing the sheep in wolf's clothing (courts looking at every donation as done with indirect quid pro quo in mind), we are diluting the positive perception of philanthropy. And anything that might dilute the pre-existing attention of target-audiences towards CP might reduce signaling through altruism.

There is also a *third* problem for existing CP law, closely related to that created the attitudinal channel of expressive law, and observable when looking at the phenomenon through the sociobiology perspective. If CP is indeed serving a costly signaling function, than it could theoretically be replaced by other costly signaling mechanisms that share similar traits. A company has many ways to handicap itself. An over-stringent regulation, either in sanctions or in expressive aspects, might tip the focal point in favor of another mechanism for signaling. It could *push companies to costly signaling by ways of* ***waste****, other than by way of* ***altruism***. Perhaps we already see some existing examples of such signaling by mere waste, in the forms of CEOs' inflated pay and company private jets…. Recall from part II.3, that from the point of view of the

[309] This point was reflected in Eisenberg, 28 Stetson, at p. 16: "We shouldn't be too cynical here… requiring corporations to publicly present a purely profit-maximizing justification for such activities would actually reduce profits. Furthermore, we don't want to force executives who are doing something partly because they think it's the right thing to do to falsely and opaquely justify their conduct as if their only motivation was to maximize".

[310] Balotti & Hanks, p. 968. A similar mechanism has been noted to develop in response to detection of non-altruists (originally in the context of RA models): self-deception mechanisms are being selected, because they help their bearers to escape detection by others. Again, applied to our context, this signals the problem with trying to detect and punish altruists – such attempts create selection forces for individuals to convince themselves that they are not altruists, but cynical. See Robert Wright, *The Moral Animal* 263-286 (1994); Piliavin & Charng, supra note 197, at p. 48.

[311] See Lotem et al., supra note 202, at p. 203.

policy-maker, who see the group (=society) as a whole, not crowding out signaling by altruism is crucial. Consider how this argument is reflected (unconsciously?) in the words of a former chairman of the SEC, when addressing the question why he did not regulate heavier CP:

> "Philanthropy is something that has a long, long tradition in America, and we are all quite proud of it. Among other things, it makes America unique, particularly compare to the business communities of Europe and Asia. Americans, as individuals and as reflected in their institutions, have a deep commitment to philanthropy… therefore… I would not want to touch the issue of 'regulating' corporate philanthropy with a 500 foot pole."[312]

Looking at CP not as a society-level advantage but rather as misnomer can push corporate signaling towards wasteful signals. For example, the advantage of altruistic handicaps in being less prone to perception errors of signalers might be diluted when looking at CP through a cynical prism. It is plausible that this is the biggest challenge faced by policy makers in our context: how to channel corporate signaling in general towards altruistic instead of wasteful activities; how to harness corporate signaling to achieve allocative efficiency.[313]

<u>Qualifications: in what aspects is current law under-inclusive and what can be done?</u>

So far I have suggested regulating expenditures on philanthropy in the same way that we regulate expenditures on advertisement – hands off. But there are some aspects of CP in which the analogy to advertisement is less useful. In some aspects, the "signal selection" market forces would not prevent CP from being more prone to abuse. Consider the identity of the recipients of the donations (the question "to whom", as opposed to the questions "how much", "when" and "how" to donate).[314] If a donation signals better ability to generate cash-flows, than the identity

[312] 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).

[313] For a similar argument in the CSR context, see Elhauge, supra note 101, at p. 15. It was already suggested generally that pushing signaling to altruism instead of waste is how the ideological leftists should "use" evolutionary theory. P. C. Grosvenor, *Evolutionary Psychology and the Intellectual Left,* 45 Perspectives in Biology and Medicine 433, 443 (2002); Gad Saad, supra note 281, p. 96.

[314] A note on the distinction between my approach to existing ones which also targeted donations to pet charities: Balotti & Hanks' approach is based on categorization of CP to: (1) CP with some benefit to the company (direct/indirect); (2) CP which is about personal aggrandizement; and (3) CP with no demonstrable benefit to the

of the recipients matter less. The investors pay attention to the fact that companies can dispose of cash; they care less about where exactly is this cash being disposed.

What is so problematic about that? One could claim that the corporation and its shareholders would profit the same from a pet-charity donation.[315] So why should we care? Consider four examples. *First*, there is the society point of view, the social welfare argument: managers could make donations to a less worthy causes, and reap private gains (donate to political causes, friends and family's NGOs, etc). *Second*, CP can be used in that way to bypass the ban on political involvement, which congress obviously considered being socially desirable.[316] *Third*, CP to politicized organizations infringes shareholders free speech and associational interests.[317] *Fourth*, such use of CP can distort the linkage of pay to performance (managers gaining discretion over CP funds, achieving camouflaged pay), or compromise oversight functions of the board.[318]

We should come up with a mechanism that constrains these costs, while avoiding the abovementioned problems of over-regulating the decisions to donate in a given amount.[319] How can we "touch" only the "to whom" question? There would be some inherent problems, like remedies problems and crowding out problems. Remedies problem arise with donations to pet charities, because we cannot measure gains to the insider; and cannot measure firm's loss (there

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corporation and no personal benefit to its managers. See p. 968. In contrast, my approach collapses categories (1) and (3). There is no need to distinct between CPs based on perceived benefits – it cannot and should not be done. So we are left to deal – carefully! – with category (2).

[315] Balotti & Hanks, p. 985.

[316] See Kahn, 44 UCLA, p. 644.

[317] See Kahn, 44 UCLA, pp. 657-661; Brudney & Ferrell. This is because every theory of corporate speech is based on some notion of shareholders' consent (either factual or not); while consent cannot be based on inadequate information – like the one we have in the CP context. Compare to footnote 105 supra.

[318] See Richard w. Painter, *Commentary on Brudney and Ferrell*, 69 U. Chi. L. Rev. 1219, 1227-1228 (2002) (hereinafter: Painter).

[319] For a survey of some potential problems of such regulation, see Barnard, p. 1169.

will still be some signaling benefits to the company).[320] Crowding out problems would arise because governmental interfering with private helping dilutes the value of the activity.[321]

Corporate law scholars suggested to address the "to whom" question through the "who decides" question. That is, reallocate the decision-making power and put more of it in the hands of shareholders – mitigating the problems from pet charities donations mentioned above.[322] Problematic aspects with such proposals were already pointed out.[323] The proposed costly signaling explanation to CP might add another layer to the claims that this suggestion is unwarranted. Once we understand the signaling function of CP, it is hard to see why shareholders should decide on such expenditure, so long as we assume that managers are better posited to make expenditures with similar functions (as is clearly the case). If there is indeed benefit to the corporation from the donation, then it is more likely that managers would be better posited to extract this benefit.[324] If the level of CP is being decided according to a function of its connection to the quality at hand – ability to generate future cash flows; then it is plausible that giving shareholders power over CP decisions would distort the effective operation of this function.

Brudeny & Ferrell further suggested to tackle the "to whom" problems through CP tax laws. They proposed to allow deduction only for CP in which shareholders have chosen the recipients. I think that introducing the sociobiology literature shed light on the problematic aspects of this proposal; rendering it undesirable in my opinion. Keep in mind the distinction between the two categories of handicaps: altruism and sheer waste. If asymmetric information

[320] Butler & McChesney, pp. 1209-1210.
[321] Compare: Richard M. Titmus, *The Gift Relationship* (1971); David S. Wilson & Elliot Sober, *The Fall and Rise and Fall and Rise and Fall and Rise of Altruism in Evolutionary Biology*, in: Altruism and Altruistic Love (Post et al., eds., 2001); Piliavrin & Charng, p. 43.
[322] See especially Brudney & Ferrell.
[323] See Painter; Sasse & Trahan, supra note 296, pp. 34-35.
[324] Compare: Painter, pp. 1219-1220; Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. Chi. L. Rev. 1103, 1117 (2002).

exists and companies need to signal their non-readily observable quality, and if indeed those signals would have to be costly to be reliable as well, then the level of costly signaling would remain relatively stable. Accepting Brudeny & Ferrell's proposal runs the risk of just pushing the signaling activity away from altruism, towards waste (company headquarters/jets? Inflated executives pay?). This is because managers would be likely to opt for a more readily option of signaling, one on which they can exert more discretion and do not have to adhere to shareholders. Companies would donate less and waste more.[325] We will end up perhaps with better corporate free-speech but with an arguably worse allocation of wealth in society.[326]

So this is what we should *not* do. But what *should* we do? I believe that the mechanism to deal with inefficient and unjust selection of beneficiaries without reducing the amount of donations, should involve indirect regulation, such as in the form of disclosure. For example, managers should be obliged to disclose a self-interested donation (i.e., donation to a beneficiary to which they have personal/financial ties), once a certain quantitative threshold (measured in relative/absolute terms) has been met.[327] Coming up with a detailed mechanism design for the regulation of cooperative corporate behavior is a great challenge for future research.[328]

Chapter IV – initial directions for future research

For considerations of clarity, length and time, this research only touched upon some of the thesis' possible implications. I have focused on surveying the existing situation, offering a new

[325] Compare: Painter, p. 1220 (under "reduction of corporate donation").
[326] Note: there are many other problems with letting shareholders decide on the "to whom" question – like the slippery slope of donations to controversial charities that will induce intra-company conflicts, or the administrative costs of implementing shareholders decision on CP (see for example Painter, pp. 1221-1223). All are valid and should be addressed, but not here – our new take on the phenomenon do not add much to their understanding.
[327] Eisenberg elaborated on that, and I am intuitively inclined to accept the bases for his disclosure proposal. See Eisenberg, 28 Stetson, at pp. 24-25. Kahn (44 UCLA) is another notable example for a call for more disclosure of CP. For a survey, see Barnard, pp. 1167-1170.
[328] …Yet another challenge I intent to take in my SJD dissertation.

explanation, and sketching several immediate legal implications. But accepting costly signaling as a valid framework to analyze CP entails much more. During my work on this paper, I have learned about the limitations and implications of studying corporate non-maximizing behavior with various conceptual tools. And I identified at least three directions of future inquiry. First, many explanations and implications in the narrow context of corporate philanthropy were left untouched here, and should be examined. Second, considerations for understanding CP laid here could be used – with relevant adaptations – to analyze the much wider phenomena of cooperative corporate behavior (CSR) in future work. Finally, the corporate finance literature might be implemented once signaling benefits and interchangeabilities of CP, dividends and conspicuous on-job consumption are being revealed. I intend to pursue these directions in future work, and elaborated elsewhere on my initial ideas in those contexts.[329] Below I sketch in very broad strokes just one subset of future directions for inquiry: the ones more closely-related to the subject matter of this paper (i.e., the narrow CP issue, not the wider CSR issues).

First, we could *reevaluate the function of slack resources*. The form of the signal tells us something about its meaning; companies that signal high level of slack must benefit from this level of slack. Why? How? In part II.3.b supra I offered some initial insights (e.g., in pro-cyclical and/or innovative industries slack is more positively perceived). This merits more attention.

Second, we could *reevaluate the function of dividends*. Once we acknowledge that companies can use several non-mutually exclusive channels to signal future profitability/cash flows, the dividend puzzle literature needs to be revisited.[330]

[329] See my SJD dissertation proposal for an elaboration.
[330] Deshmukh, supra note 233 (Deshmukh suggested that certain data supports the pecking order explanation and refutes the signaling explanation for dividends; but he should have controlled for use of CP as a substitute for dividends, before making such conclusions).

Third, we could look at *other types of costs to the signaler,* such as predation costs: the costs from attracting an unintended observer or an unintended reaction from the target-audience.[331] A relevant example would be *activist hedge funds,* which might target companies that communicate their ability to generate high slack, in order to "take advantage" of this slack (in a way that insiders would dislike, to say the least).

Fourth, we need to look at *comparative aspects of CP*. This paper has been U.S-centric. How is the phenomenon manifested and regulated in other countries and cultures? I can offer here only initial directions: in Britain and Western Europe CP was increasingly growing since the 1980's, though it is still modest compared to CP in the U.S.[332] The role of in-kind donations is relatively bigger there.[333] The decision-makers are taking a more "cynic", marketing-oriented approach to CP there.[334] In Japan, it was noted that companies used to emphasize more giving to the company's employees rather to unrelated third-parties[335]; at the same time, Japanese giant firms tended to copy American patterns of CP when donating internationally (in the U.S., for example).[336] In Latin America, CP is also increasing rapidly, and the reported motivation behind it varies.[337] In any case, it is clear that there is a lot of cross-cultural variation in corporate signaling, both in terms of the level of signaling and the form they take (the mix of

[331] To clarify: these costs are relevant even when the receivers "believe" that the signal conveys the message the signaler intended it to convey. In our context: they will believe that high level of CP suggests the belief of the insiders in the positive value of the company's future projects; but that does not mean that they will do with this information what the signalers expected/wanted them to do with it…

[332] David Campbell et al., *Corporate Philanthropy in the U.K. 1985-2000: Some Empirical Findings,* 39 Journal of Business Ethics 29, 35 (2002); Brammer & Millington, supra note 68, at p. 29; Adams & Hardwick, p. 643.

[333] Roger Bennett, *Corporate Philanthropy in France, Germany and the UK,* 15 International Marketing Review 458, 459 (1998).

[334] See Bennett, *Id*; *See also* Adams & Hardwick, p. 643.

[335] See Haley, at p. 501 (Haley also provides other cross-national data there).

[336] Nancy R. London, *Japanese Corporate Philanthropy* (1991).

[337] See Carol M. Sanchez, *Motives for Corporate Philanthropy in El Salvador: Altruism and Political Legitimacy,* 27 Journal of Business Ethics 363 (2000).

dividends/donations/waste/ etc).[338] Understanding this cross-cultural variation and its causes is a subject for vast future research.

Fifth, many areas are still in need of *empirical research*. In this paper I relied on existing systematic data, but the thesis presented here suggests some further less examined directions, and many testable predictions for future empirical work. For example, we should examine the effect of the degree of asymmetric information between a company and its investors on CP.[339]

Finally and perhaps most interestingly, we could revisit our costly signaling model of CP, introducing possibilities of different target-audiences. Perhaps in some circumstances CP is best explained not as signaling cash flow to investors, but rather as signaling commitment to certain "cooperating" values to employees. CP might as well be, under the circumstances, a motivation tool for attracting and retaining high-quality labor.[340] Or perhaps in other circumstances CP is about signaling to regulators. In companies that enjoy supra-competitive profits, arguably the signal selection pressures would be modest if we take the investors or consumers as target-audience. So maybe what explains CP there is rather attempts to convey messages to the anti-trust regulators that those companies use their monopolist rents in a "nice", responsible manner – minimizing the dead-weight losses to society (or at least disguising it good).

Conclusion:

The thesis presented in this paper – that CP is companies' way to tell the world how good they are – is not counterintuitive. The model I apply to the corporate context – costly signaling – is not new to corporate law scholars. What this paper was set to achieve was rather a better

[338] See Bird & Smith, p. 233.
[339] …As was done in the dividend puzzle literature. See for example Deshmukh, supra note 233, p. 111.
[340] Prof. Roe has emphasized this point to me, along with many others.

understanding of the already familiar. The motivation behind this is that better understanding of the extreme case of non-profit-maximizing corporate activity, might tell us a lot about other non-profit-maximizing activities, and about corporations in general.

I do not think that my explanation is exhaustive. I believe that no CP program can be said to be solely about one model. Rather, it is generally context-sensitive, dependent, inter alia, on product markets competition, company-culture, regulatory environment, and errors.[341] Even if CP has a signaling function, it might also have other functions, and the mix of signaling and non-signaling functions would vary, depending on the specific players (some managers may derive more managerial utility from CP; some might be more public-spirited when engaging in it; others will do it purely for signaling benefits). My claim here is "only" that costly signaling theory accounts in the most parsimonious and wide-applicable way for CP, and thus under the Ockham's razor principle it should be accepted as the fittest explanation.

I also do not think that my suggested explanation is inherently stable. Signaling between humans is dynamic, and the specific corporate context is very dynamic in itself. It might be that the costly signaling explanation for CP is already becoming or will shortly become anachronistic; fit "only" to account for the *historical* evolution. For example, lower information costs might reduce the need for signaling; or growing CSR movement might make CP less efficiency-reducing. This dynamic nature of the matter should be considered in future research.

In the immediate level, my thesis might promote settling the never-ending debate over the puzzles and paradoxes of CP in the academia. No need to look for motivation to enhance the efficiency of the company. Some phenomena in some circumstances can be efficiency-reducing and still adaptive. CP is a good example. It is thus "rational" and legitimate. Finally, even though the issue seems to be settled in the case law, my thesis might contribute to exposing and then

[341] CP at the Crossroads, p. IX.

mitigating the oft-unnoticed negative expressive value created by current law, along with its negative distributional effects.