

# Corporate citizen

By [Stewart Herman](#) in the [March 27, 2002](#) issue

## In Review



### **Corporate Irresponsibility: America's Newest Export**

Lawrence E. Mitchell  
Yale University Press

Despite his book's title, Lawrence Mitchell is not throwing bricks at corporate America. A research professor at the George Washington Law School, Mitchell indicts

corporations from within the leviathan—that is, from within the legal framework that shapes American businesses. His argument is accessible, flamboyant, and disturbing to anyone whose future is secured by TIAA-CREF or church pension funds. It is both a personal—even penitential—moral inventory of investment strategy and an exercise in civic thought.

Mitchell thinks U.S. law has frozen the business corporation at a very early stage of moral development. For Mitchell (who cites the work of psychologist Jean Piaget), authentic moral development requires that individuals grow in their capacity to choose ends and freely develop the rules they live by. But American law encourages corporations to maximize stockholder profit, and confines the major players—stockholders, managers and board members—to morally stunted roles in pursuit of that profit.

Stockholders fare the worst in Mitchell's analysis, for he sees them as devoted to short-term gratification. "Individual stockholders are encouraged to behave as if their single goal were the consumption of corporate wealth." The legal device of "limited liability" limits their financial responsibility to the amount of their investment; this device alone removes any incentive for them to exercise moral responsibility in their fractional ownership. "Limited liability means never having to say you're sorry."

Other provisions in the law exacerbate the problem by giving stockholders too much leverage: only stockholders have voting rights; when displeased, they can badger managements with "derivative" suits; and when opportunity beckons, they can sell the corporation right out from under management.

Who are these stockholders? In the U.S., stock is held by almost 49 percent of households, encompassing some 78 million individuals. This startling figure once might have been seen as a reassuring barometer of widespread ownership in the capitalist system, but for Mitchell it masks a discouraging reality: only a tiny fraction of investment by stockholders serves the socially useful end of bankrolling new ventures; most serves to feed the endless daily churning of stock prices. Almost 20 percent of daily trades on the New York Stock Exchange and over 75 percent of those on the Internet are by day traders, whom Mitchell calls "the mercenaries of the corporate world, claiming allegiance to no corporation at all and moving in for the kill to take advantage of price movements with speed and stealth."

Of course, the image of a sharp speculator hardly fits the ordinary investor. Most of us cautiously invest in mutual funds rather than risk our savings in individual companies. We shudder in sympathy with Enron employees, who were mauled precisely because they were induced to invest too much in their own company. We prudently diversify our portfolios to reduce risk. Mitchell reports that only 15 percent of stockholding households invest entirely in individual companies, while almost half invest exclusively in mutual funds. Such diversification is an altogether reasonable strategy.

But the very act of spreading risks among dozens and hundreds of companies, Mitchell observes, encourages the average investor to be ignorant and passive. We effectively cede our right of corporate ownership to the firms that manage our funds. We don't know much about the companies we invest in. Our risks are so widely distributed that all we need to do is track the gains and losses of any individual company as measured through dividends and stock-price fluctuations. Though as investors we possess—collectively—considerable latent leverage, we lack the will or knowledge to use it to any end larger than the maximization of personal wealth.

Let's put Mitchell's argument to a personal test: Ask yourself if you even peruse annual financial-performance statements. Do you throw away those proxy cards each year instead of mailing in your vote?

One might retort that there are other ways to exercise corporate citizenship. After all, those monthly deductions from our paychecks flow to huge corporate investors who by virtue of their very size can afford to ignore short-term fluctuations in the stock prices. Can't we leave it to them to nudge management toward strategies of long-term benefit? Might not such "pension fund socialism," as Peter Drucker once put it, provide us with useful and powerful proxies for achieving broader social goals, such as equal opportunity and environmental protection?

Mitchell devotes a chapter to debunking such wishes. To be sure, the latent power of such funds is large. Institutional investors control 58 percent of the equity in the 1,000 largest U.S. corporations, and pension funds oversee fully half of that institutional investment. But even the most respected pension funds, such as TIAA-CREF and the State of California's CalPERS, limit their energies to maximizing the wealth of future retirees, and largely ignore broader social agendas. Pension fund managers might have the knowledge to select and the muscle to support companies which pass up short-term gains for long-term benefits, but even the more

progressive ones apparently choose not to do so.

“Traditional stockholders . . . are encouraged to act as if they had no conscience, no soul, no responsibility for their ownership.” Anyone who has struggled to nudge church pension funds to stay clear of destructive corporate practices will be tempted to agree. Social good all too often falls before the desire for shareholder value.

What, then, to do? Mitchell suggests that incentives be created to make stockholders behave like long-term investors. Rational investors are not likely to give up the safety of mutual funds, but they might be persuaded to try funds that engage in the responsible corporate citizenship he commends. Indeed, a few funds such as Ariel Mutual Funds of Chicago track individual companies closely and invest for the long term.

The remainder of Mitchell’s argument concerns the moral stunting of executives and board members. What corporations really need, he argues, are knowledgeable investors who will tolerate and encourage the pursuit of long-term strategies that have no short-term payoff, as occurs in the European model of business corporations. “It is time that we freed corporate managers to do the right thing, to provide exactly the kind of economic leadership that our corporate capitalism ideally leaves it to business leaders to provide.” This recommendation will seem wildly counterintuitive to those schooled by Reinhold Niebuhr’s ethical realism, but it merits a look.

In Mitchell’s view, corporate managers are now tied to the whims of stockholders. Executives must report on their performance much too frequently—four times a year. Buffeted by the speculative winds of Wall Street, they are constrained to inflate the price of their stock. Focus on short-term performance is reinforced by the massive stock options built into their compensation. These perverse incentives should be removed. The compensation executives receive through stock options should be limited, and a punitive tax—say, 75 percent—placed on profits made through day-trading. The current quarterly reporting period should be eliminated, or at least lengthened to as much as every five years. Management should be encouraged to report business progress in qualitative terms, rather than strictly by the numbers.

More than once, Mitchell asks us to believe that most executives and managers want to work for the convergent long-term interests of the corporation and the

society. But the recent Enron meltdown should dispel any doubts on that score. Legal safeguards are needed.

However, as Mitchell points out, the law is an ambiguous help at best. On the one hand, the constraints and permissions which law provides—the very structure of the corporation which the law creates—restrains executives and board members from exercising thoughtful and responsible moral agency. On the other hand, the law is pitifully ineffective as a tool for punishing malefactors. The plight of corporate board members in their struggle with stockholders illustrates the paradox. On the one hand, board members need protection from the churning of stockholder desire. “Boards of directors need to be free to do what it is they do best, and that is to manage (or provide for the management of) corporations for the long term.” Mitchell proposes, therefore, that board members be elected for life, or at least for terms of five years or more, and that there be laws to restrain them from abusing such undemocratic privilege. On the other hand, he devotes a chapter to arguing—with morbid glee—that current fiduciary law offers stockholders no effective means to punish such abuse, should it occur.

We are left, it seems, with a lousy choice. Either leave board members to fester in a system that encourages them to stifle their fiduciary duties and long-term social interests, or cut them loose and simply trust that they will be honest.

The problem is as old and deep as human nature: what are two parties to do when they awaken to the fact that one cannot simply control the other, whether by fiat, threat or simple coercion? Stockholders cannot ensure that board members will not “self-deal”; corporate managers cannot protect themselves from the short-term greed of stockholders; the public cannot gain long-term responsibility from either board members or corporate managers without granting them long-term autonomy. They all face the always difficult question: what kind and degree of trust can they afford to extend to each other?

Mitchell answers this question from within the ideological world of political liberalism. While “pathological” liberalism has created the stereotype of the corporation as a morally stunted monster, the more salutary core of liberalism aims at responsibly autonomous behavior. The major actors on behalf of the corporation—stockholders, board members and corporate managers—therefore ought to be given sufficient scope of action to develop full-fledged moral citizenship. The primary move must be one of extending trust.

This line of thought appears strikingly at odds with broader social trends—especially the need to legally define relationships in every particular, precisely so we won't have to entrust ourselves to the behavior of others. Mitchell's proposal lacks a thorough account of what counterpressures might serve to render economic actors more accountable as stewards of wealth. Ultimately, the moral failures he outlines push us to think about theological categories of covenant and covenant-building—categories that help remedy the “pathological” aspects of liberalism.

Mitchell may not find this thought-world a helpful resource for thinking about cures for corporate irresponsibility. But from within his own guild, he could contribute a detailed exploration of what incentives for covenant-making might be structured into corporate law. I hope he will take up this challenge, for we sorely need such practical advice.