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A Charitable Corporate Giving Justification for the Socially Responsible Investment of Pension Funds: A Populist Argument for the Public Use of Private Wealth

Edward S. Adams*
Karl D. Knutsen**

As men intermingle and conditions become more equal, the resources, education and desires of the poor increase. The poor man gets the idea that he can improve his lot and tries to do so by saving. So daily savings create an infinite number of small capital accumulations, the slow fruit of patient labor. These savings are always increasing, but the greater part thereof would remain unproductive as if it were still scattered. This has led to the creation of a philanthropic institution which will, if I am not mistaken, soon become one of the most important political institutions. Charitable men thought of the idea of collecting the poor man’s savings and turning them to profitable use.¹

Paul and Patricia Cooper are a married couple living in Chicago. Paul is a union worker at Ryerson Steel Company and Patricia is a commercial loan officer at First Chicago Bank. The Coopers recycle papers, cans, and bottles. They buy products such as Ben and Jerry’s ice cream because they like the idea of supporting family farmers. The Coopers also make yearly charitable contributions to the American Cancer Society in memory of Paul’s mother who died of cancer.

The Coopers both have generous employer-administered pension plans to which they contribute the maximum allowable amount. When the

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¹ Alexis de Tocqueville, Democracy in America 682 (J.P. Mayer ed. & George Lawrence trans., Anchor Books 1966) (1840).
Coopers see the annual pension summaries provided by their employers, they happily note that their respective pension plans hold much more money than their joint bank account. When the Coopers look more closely at the summaries, however, they notice something troubling. Their pension funds hold the stock of Phillip Morris, a cigarette manufacturer, and Lasser Electronics, a company that habitually has closed unionized American plants and set up nonunion shops in South America. The Coopers are livid. Why, they ask, give to the American Cancer Society when their pension funds own stock in a company that seeks to increase cigarette consumption? Why, they insist, should they invest their retirement savings in a company that may buy Paul's company, fire him, and move his manufacturing job to South America? The Coopers' situation is not unique. Like many Americans, the Coopers are beneficiaries of pension funds that hold shares of corporations the beneficiaries do not like and with which they would prefer not to associate.

Pension funds represent the largest pool of investment capital in the world. In 1987, pension fund assets totaled approximately $1.6 trillion. By 1989, this figure had grown to $2.6 trillion and by 1990, with total assets of $2.7 trillion, corporate pension funds equalled nearly one-half of America's $5.6 trillion Gross National Product. In 1991, pension funds owned approximately sixty percent of all "Standard & Poors 500" stock and about fifty percent of all publicly quoted American shares. This substantial growth will likely continue as the "baby-boom" generation ages and saves for retirement. By the year 2000, pension fund assets could

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conceivably reach $4 trillion.8

The entity or party charged with managing pension funds has a fiduciary duty to act as if it were making investment decisions for itself. Ordinarily, this means that the fiduciary considers only economic criteria in order to maximize returns and increase the fund’s total assets. If the fund manager chooses to engage in “socially responsible investing,”9 by contrast, the manager considers noneconomic criteria in making investment choices. In such an instance, the socially responsible investor uses some combination of negative and positive “screens”10 to implement the fund’s investment strategy in accordance with a broader social, political, or normative framework.11

9. John H. Langbein & Richard A. Posner, Social Investing and the Law of Trusts, 79 Mich. L. Rev. 72, 73 (1980). Professors Langbein and Posner’s article is the seminal work in this area; this Article generally adopts both their definitions and methodology. Nonetheless, their use of the term “social investing” is problematic. See id. at 73 (implying that those who consider only economic criteria are simply “investing”). The use of the adverb “social” to modify the verb “invest” is curious. One would, after all, distinguish someone who drives poorly from someone who drives safely by calling the poor driver “reckless” and not by calling the safe driver “virtuous,” “careful,” or “skillful.” This usage stems from the belief that responsibility is the norm and that it sometimes requires people to act in ways superior to the minimum standards for social behavior set by criminal law. In the case of socially responsible investments and pension funds, however, the prevailing language requires modification of the word “invest” with an adverb suggestive of the complexities of the concept. Because this Article suggests that investing has implications and that investing with an eye towards noneconomic goals may be desirable, it will use the term “socially responsible investing.”
10. Id. at 83; Maria O’Brien Hylton, “Socially Responsible” Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 Am. U. L. Rev. 1, 10 (1992); see also Peter D. Kinder, Social Investing’s Strength Lies in Readiness to Deal with World’s Tough Questions, Pension World, Apr. 1993, at 10 (stating that a “social screen” systematically incorporates “ethical values and objectives into the investment decision-making process”).

Professors Langbein and Posner suggested that a socially responsible investment strategy must include both positive and negative screens. Langbein & Posner, supra note 9, at 73. This suggestion is troublesome. An investor might wish to exclude a single security from a portfolio based upon any number of considerations. Relying on modern portfolio theory (MPT), which operates on the premise that one can minimize overall portfolio risk by carefully selecting a large number of stocks with varying degrees of risk, Professors Langbein and Posner also argued that market analysis is not economically worthwhile and an investor should prefer a portfolio that mirrors the market as a whole and minimizes nonmarket fluctuation. Id. at 82-83.

If, as Professors Langbein and Posner assumed, the efficient market manages risk, one interesting implication is that the exclusion of a single security, or even a small number of securities, for example, may actually have no appreciable effect upon portfolio performance. See infra note 28 (discussing Langbein and Posner’s suggestion of a trade-off between profit maximization and socially responsible investing). While Professors Langbein and Posner asserted that excluding even a small number of securities will have negative implications for a portfolio’s long-term profitability because of market fluctuation, they ignored the normative question of whether the added risk is worth the benefit of the socially responsible exclusion. This Article briefly places this normative issue in a historical context in its discussion of charitable corporate giving.

When an investor uses a negative screen, the investor excludes the securities of an otherwise economically attractive organization because of normative considerations.\textsuperscript{12} For example, an investor employing negative screens might decide not to invest in corporations with poor labor\textsuperscript{13} or environmental records;\textsuperscript{14} companies that produce products the investor finds objectionable, like beef;\textsuperscript{15} munitions,\textsuperscript{16} alcohol, or tobacco; or corporations doing business in particular countries such as South Africa\textsuperscript{17}


12. Langbein & Posner, supra note 9, at 73; Segal, supra note 11, at 74-75.

13. See, e.g., Laura Walbert, Investing Clean and Green, Working Woman, Dec. 1992, at 62, 62 (discussing “ethical” mutual funds that do not invest in securities of corporations known to treat their employees unfavorably); see also Mark Dowle, Clean, Green and Guilt Free Funds, The Nation, Apr. 26, 1993, at 550, 551 (suggesting that investors avoid investing in corporations which exploit labor unions and discriminate against particular groups). The Women’s Equity Mutual Fund For Investment cites ten companies that treat their female employees better than most other companies. Susan Antilla, “Woman-Friendly” Fund Hits First Hitch, Denver Post, Oct. 18, 1993, at 3E. Among others, the Fund cites Avon, Advanced Tissue Technologies, Gannett, and Federal National Mortgage for having women among the highest paid employees; Piper-Jaffray and Scholastic for having a high percentage of women managers; and Unum for running innovative family programs. Id. These rankings, however, have encountered criticism from those who disagree with their methodology. Id.


16. International financier George Soros recently announced that he had sold his 5\% interest in Alliant Techsystems, Inc., a manufacturer of tank ammunition, cluster bombs, and land mines. Soros Sells His Stock in Munitions Maker Alliant Tech Systems, Wall St. J., Mar. 28, 1994, at A5C. In a filing with the Securities and Exchange Commission, Mr. Soros noted that the investment was not compatible with his philanthropic and humanitarian activities. Id.

17. For a discussion of South African divestments, see generally Joel C. Dobris, Arguments in Favor of Fiduciary Divestment of “South African” Securities, 65 Neb. L. Rev. 209
or the former Yugoslavia.

Investors can also use positive screens to encourage behavior they find socially desirable. By employing a positive screen, the investor includes securities in a portfolio that the investor would not select when relying only upon economic considerations. An investor using positive screens may decide to invest, for example, in minority-owned business enterprises, community economic development organizations, organizations that develop low-cost housing, or corporations that make charitable contributions to the community.

Positive screens, although more restrictive than negative screens, are likely to have a greater impact in effecting socially desirable behavior. Investing in a local development company, for example, will have a more direct and therefore greater impact on the community or country than deciding not to invest in a corporation operating in a particular country. On the other hand, by restricting the universe of companies in which the fund can invest, negative screens may invite more portfolio fluctuation.

Traditionally, courts and commentators have held that the fiduciary duty of pension fund managers to maximize profits precludes them from investing in a socially responsible manner. Recently, however, commentators have begun to question the proposition that pension fund trustees cannot accept reasonable financial sacrifices based upon noneconomic considerations.


18. Langbein & Posner, supra note 9, at 73.
20. See, e.g., Funds Put Assets in Social Investments, Pensions & Investments, July 6, 1992, at 33. The Board of Pensions for the mainline Protestant Evangelical Lutheran Church in America (ELCA) recently placed $300,000 of its $2.3 billion portfolio in three social purpose funds which target community and economic development projects. The Board of Pensions has committed an additional $2 million to another fund. As Governor of Arkansas, Bill Clinton also sought to use state pension funds to target state economic development. Christine Philip, Governor Clinton Sought In-State Investments, Pensions & Investments, Feb. 22, 1993, at 32.
21. See, e.g., Dowie, supra note 13, at 551 (discussing the origins of the social-investment movement as a small yet useful source of finance capital for progressive economic endeavors such as construction of low-cost housing); Ellen James Martin, Social Investing’s 1990s Spin, Institutional Investor, Mar. 1993, at 155 (discussing pension fund investments in socially targeted real estate).
22. See Langbein & Posner, supra note 9, at 73-74 (defining social investing and introducing the economic implications of selecting a variety of stocks in accordance with social objectives); Segal, supra note 11, at 35-37 (discussing social investing and providing examples of economic results of diverse socially responsible funds).
23. See infra notes 36-37 and accompanying text.
fund trustee should have the authority to make reasonable attempts at helping the community just as a director of a corporation can make reasonable charitable contributions.\textsuperscript{25}

Expanding upon these developments, this Article proposes a novel justification for the socially responsible investment of pension funds based upon traditional principles of charitable corporate giving and populism.\textsuperscript{26}

The directors of a business corporation owe fiduciary duties to the shareholders to conduct the business of the corporation so as to attempt to secure a profit. But it is well settled that they should recognize that they and the corporation are a part of the community. They may, within proper limits, make gifts of the money of the corporation for charitable purposes, although this may, for the immediate present at least, slightly diminish the profits of the corporation. . . .

A corporation and its directors in the conduct of its business should be aware of its social responsibilities. They should refrain from doing harm to the community, even though there would not be a violation of law in causing such harm, and even though there might be a diminution of immediate profits. . . . Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility.

. . . Of course they may well believe that a corporation that has a proper sense of social obligation is more likely to be successful in the long run than those that are bent upon obtaining the maximum amount of profits. But even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to society.


\textsuperscript{25} Id. at 500. At least one appellate court has recently cited Professor Scott as authority for allowing a municipal pension fund to accept a small loss from the transaction and diversification costs associated with divesting from corporations doing business in South Africa. See Board of Trustees v. Mayor of Baltimore City, 562 A.2d 720, 736-37 (Md. 1989). In Baltimore City, the Baltimore City Council voted to invest the assets of its defined benefit pension plan using a negative screen excluding the securities of companies which invest in South Africa. The Maryland Court of Appeals upheld a lower court decision allowing divestment. Id. at 757. The court cited Professor Scott's treatise and reasoned that a trustee does not violate its duty of loyalty if the financial sacrifices are de minimis. Id. at 736-38. See also Garret M. Smith, Board of Trustees v. City of Baltimore: Public Pension Fund Divestment of South African Securities Upheld, 49 Md. L. Rev. 1030, 1032-40 (1990) (outlining the trial court's approach to addressing the challenges to the city ordinance, which required city employee pension plan funds to divest holdings of businesses and banks in South Africa, and critiquing its findings); Recent Case, 103 Harv. L. Rev. 817 (1990) (discussing Board of Trustees v. City of Baltimore).

\textsuperscript{26} Populism properly refers to the late-nineteenth century agrarian and labor political movement as well as the People's Party of America. Gene Clanton, Populism: The Humane Preference in America, 1890-1900, at xi (1991). The movement resulted from a perceived conflict between eastern bankers and industrialists and western farmers regarding federal currency policy. The movement dissolved when farm product prices rose. See also Robert C. McMath, Jr., American Populism: A Social History, 1877-1898, at 25 (1993). This Article uses the term in its modern sense, however, which generally refers to various popular political
This Article asserts that the justifications employed by courts in the first half of the twentieth century to expand the direct benefit doctrine in the charitable corporate giving context provide a foundation for allowing socially responsible investing in the pension fund context today. In formulating this thesis, Part I of this Article surveys the present limitations placed upon pension fund fiduciaries in the context of socially responsible investing. Part II then describes the traditional legal model of the corporation. Part III reviews the history of charitable corporate giving and introduces the doctrine of direct corporate benefit. More specifically, Part III argues that courts expanded the legally permissible scope of charitable corporate giving as they sought to encourage charitable contributions in response to the changing structure of the country’s economy and the corporate accumulation of surplus social wealth. Part III, then, exposes the doctrine of direct corporate benefit as a fiction designed to allow greater access to private capital for public use. Part IV examines the corresponding changes in the tax code which resulted in the inversion of the traditional direct corporate benefit doctrine under the guise of the direct benefit rule. Finally, Part V demonstrates that the jurisprudential trends surrounding the expansion of permissible charitable corporate giving are best understood by reference to state-level populist influences demanding increased public access to private wealth. Part V suggests that the jurisprudence underlying modern corporate charitable giving presents a persuasive justification for the socially responsible investment of pension funds.

I. A TRADITIONAL ANALYSIS OF CHARITABLE CORPORATE GIVING

In 1980, Professors Langbein and Posner observed that “few individuals have found the trade-off of a lower return at socially responsible investments, movements that have sought to empower their constituents.” Socially responsible investing,

27. Commentators continue to vigorously debate whether socially responsible investing leads to a lower return. See, e.g., Leslie Eaton, Principled Investments: Doing Well By Doing Good, Barron's, Jan. 18, 1993, at 37 (discussing success of socially responsible funds in yielding above average returns); Earl C. Gottschalk, Jr., Many “Nice Guy” Funds Fail to Make Nice Profits, Wall St. J., July 7, 1993, at C1 (discussing failure of socially responsible funds to make better than average returns). Modern portfolio theory suggests that, although excluding a substantial number of securities will inevitably invite portfolio fluctuation and may reduce total return in the long run, excluding a small number of securities will have a minimal effect. On the other hand, consumers have developed a great sensitivity to corporate social behavior. See, e.g., Rosalyn Will et al., Shopping for a Better World 1992 (1991). The emergence of such a movement may present the market with variables it has no experience in analyzing.

28. Langbein & Posner, supra note 9, at 75. Professors Langbein and Posner suggested that there is a trade-off between profit maximization and socially responsible investing. Their modern portfolio theory also suggests that excluding a very small number of securities will not lead to any additional risk of loss. In fact, the modern portfolio theory which Professors Langbein and Posner adopted suggests that small individual investors who do not diversify can invest in a limited socially responsible manner without economic consequence. Thus, an investor who chooses any single security for noneconomic reasons is no worse off in economic
however, has grown dramatically in recent years. In 1985, professional investment managers controlled $100 billion in socially responsible investments for socially concerned investors. By 1993, this figure had grown to over $650 billion.

To some extent, the term "socially responsible investing" is misleading because federal, state, and local law, which explicitly codify certain moral principles and social considerations, regulate all marketable securities and enforceable contracts. These statutes force investors, even modern portfolio theory investors who do not explicitly employ ethical criteria, to invest in some sort of socially responsible manner. To the extent that these laws vindicate particular values, legislative and judicial negative screens affect all marketable investments. One cannot, for example, knowingly invest in...
an illicit drug smuggling venture without becoming part of a conspiracy. Similarly, because corporations must abide by antitrust, civil rights, packaging, and a multitude of other laws, individuals may not opt to invest in securities of corporations that engage in activities violating these laws. All investing, therefore, is unobtrusively and regularly restricted by laws that reflect some sort of societal moral consensus.

The interesting investment issues appear, however, as investments move from the illegal black of the judicial spectrum to the legal but ethically suspect gray—from illegal narcotics to chewing tobacco or from the unsanctioned export of nuclear technology to the domestic manufacture of handguns. The same dynamic, after all, is at work. When something is illegal, it is because a group of people, at one time resembling a majority, prohibited it for some reason. The socially responsible investor, however, does not accept the majority's current doctrine and decides independently whether the activity at issue is objectionable in light of its social and economic consequences. The modern portfolio theory investor, on the other hand, accepts the current doctrine as an economic baseline and considers all legal securities as prospective investments, regardless of potential noneconomic consequences.

33. Obviously, simply making something illegal does not silence the debate over that thing's desirability. Witness, for example, the recent debates over decriminalizing narcotics and legalized gambling. See A Symposium on Drug Decriminalization, 18 Hofstra L. Rev. 457 (1990) (dealing exclusively with the drug legalization debate); see also Richard L. Miller, The Case for Legalizing Drugs (1991) (discussing the various arguments for legalizing drugs); Jeffrey C. Hallam, Rolling the Dice, 85 Nw. U. L. Rev. 240, 262 (1990) (citing Judy Heffner, Legalized Gambling in the States: Who Really Wins?, St. Legislatures, Sept. 1981, at 6, 16); Gregory H. & Sara C. Williams, America's Drug Policy: Who Are the Addicts, 75 Iowa L. Rev. 1119 (1990) (reconsidering the classification of drug addicts); Lisa J. Keyes, Comment, Rethinking the Aim of the "War on Drugs": States' Roles in Preventing Substance Abuse by Pregnant Women, 1992 Wis. L. Rev. 197 (considering various methods of preventing substance abuse by pregnant women).

34. The screens an investor or consumer should choose to employ present a normative question beyond the scope of this Article. It is important, however, to note that, empirically, different individuals make different choices with regard to investment and consumer products. It is clear that not every individual is a blind economic actor and that maximizing return is as normative an investment strategy as any other. Of course, the infinite number of possible investment strategies makes it difficult to design a practical solution to the political issues involved in investing pension funds. See infra note 206 and accompanying text (stating that preferences vary among investors). This Article's analysis of charitable corporate giving suggests, however, that logical conceptual schemes do not always dictate the law's development, and that lack of a conceptually appealing analysis should not prevent inquiry into this issue.

Historically, although individuals have retained the freedom to invest in funds or entities of their choice, pension fund managers could not consider noneconomic criteria in making investment decisions. Commentators almost unanimously agree that the common-law concept of fiduciary responsibility restricts pension fund trustees from employing any noneconomic criteria in making investment decisions. PropONENTS of this view dismiss any notion that pension fund trustees can accept reasonable financial sacrifices based upon social or ethical considerations. As the next two sections suggest, however, an analogy to the history of corporate charitable giving may provide a justification for the socially responsible investment of pension funds.

II. THE CORPORATE MODEL

Corporations are legal entities governed by state statutes. A corporation is an artificial person, owned by individual shareholders, that has its own distinct corporate name. In the general conceptual scheme, the corporation substitutes itself for its shareholders in conducting corporate business and incurring liability.

A board of directors runs the corporation. The shareholders elect

Issues are not properly considered in the business context is not new. See State ex rel. Pillsbury v. Honeywell, Inc., 191 N.W.2d 406, 411 (Minn. 1971) (noting that seeking names of corporate shareholders to influence corporation political behavior is not a proper purpose).

It is true that a portfolio which limits fluctuation has advantages, particularly for the risk-averse. On the other hand, the neutral approach values risk-aversion and makes other sacrifices to vindicate that goal. In short, investing is thoroughly and unavoidably political. The question is not whether to invest based upon political values, but what values to vindicate. The issues socially responsible investors recognize are the same issues that stir political debates at all levels of government. It is also unlikely that any theorist would charge a lack of diversification for failing to invest in a socially stigmatized industry or product. See Dobris, supra note 17, at 232 (observing that the legalization of prostitution in Nevada does not require a fiduciary to invest in brothels, even if they are likely to be profitable).

36. See, e.g., Restatement (Second) of Trusts § 170 (1959) (stating that the "trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary"); Troyer et al., supra note 17, at 156-58 (stating that the trustee's purpose is to provide benefits to the beneficiary and that social considerations are permissible only if incidental).

37. See, e.g., Langbein & Posner, supra note 9, at 96-104 (suggesting that investments made for purposes other than those solely in the interests of the beneficiary would violate ERISA); Ian D. Lanoff, The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?, 31 Lab. L.J. 387, 391-92 (1980) (indicating that a plan which incorporates investments made with social criteria and without consideration of traditional factors would violate ERISA).

these individuals and entrust them with the overall management of the corporation. The corporate charter or articles of incorporation must specify the intended business of the corporation, and statutory law defines the corporation's rights and duties. In their simplest conception, corporations allow several shareholders to pool their resources into a single venture. One of the main advantages of the corporate form, of course, is that it combines this pooling of tremendous resources and profit potential with limited liability to the shareholders. The principle of limited liability arises from a legal fiction that regards the corporate body as separate and distinct from the owners of the corporation.

As creatures of statute, the law traditionally did not allow corporations to contract or operate outside the four corners of their corporate charters. The fundamental notion that corporations are established strictly for the benefit of the shareholders provides the primary foundation for this traditional limitation. As such, in addition to managing the corporation, the directors have a strict duty to maximize shareholder profits within the specified parameters of the corporate articles.

Over fifty years ago, in a preeminent work, Professors Adolf Berle and Gardiner Means questioned this traditional notion of "shareholder primacy" as inconsistent with their view of the corporate form's separation of ownership and control. They asserted that shareholders were generally passive owners—widely diversified risk bearers with little incentive or ability to monitor management's activities in the myriad of corporations in which they invested. Corporate managers, in contrast, typically owned little of the corporation's stock, yet controlled the entity's operations. Because managers had little capital invested in the firm, their primary goal often was to maximize their own utility, rather than maximize shareholder wealth. Professors Berle and Means further suggested that the ability of shareholders to elect directors, and therefore control management, was relatively meaningless in the context of large corporations. Increasingly, they asserted, management controlled the proxy machinery and hence the election's outcome. Management, in short, became a self-perpetuating oligarchy, which in turn left shareholders without any real power.

Modern economic theorists view the problems created by the separation of ownership and control in a different light. These theorists describe the corporation as the central party to a contractual arrangement between managers and owners. This interrelationship necessarily

40. Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 244-45 (1932); see also Matheson & Olson, supra note 4, 1330-33 (discussing history of corporate-governance principles and solutions to separation of ownership and control).
41. Berle & Means, supra note 40, at 66-68.
42. Id. at 121-24.
43. Id. at 84-118.
44. Id. at 124-25.
45. Id.
46. Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior,
involves an agency relationship in which the owners (shareholders) act as principals receiving the benefits of the firm's profitability and growth, with management acting as their agent.\textsuperscript{47} In essence, the owners bear the risks associated with the enterprise, and as specialized decision makers, the managers run the corporation for the benefit of the owners.

The primary benefit of the corporate form is readily apparent. Skilled managers, although lacking capital to finance the firm's investments, can run the corporation, and shareholders, despite their lack of managerial skills, can invest in the firm and realize a return on their investment.\textsuperscript{49} This specialization of functions also allows investors to diversify their portfolios, thereby reducing risk and making investment more attractive.\textsuperscript{49} The agency relationship, however, does not come without cost. Foremost, the agency relationship exposes owners to the risk that the managers will use the owners' funds for management's benefit. This risk creates agency costs—the costs to the principal of obtaining faithful and effective performance from its agent.\textsuperscript{50} From this perspective, the dilemma posed by the separation of ownership and control is not an issue of "shareholder primacy." Rather, it raises the question of how to reduce the agency costs owners incur in monitoring their agents when attempting to prevent fiduciary abuse and indolent "shirking."

Traditionally, corporate law has addressed the agency cost problem by imposing a number of legal obligations on corporate directors. The law imposes liability on managers for any breach of the fiduciary duties of care.

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47. See e.g., id. (illustrating this agency relationship); Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 302 (1983) (describing problems associated with this agency relationship).


49. Modern portfolio theory maintains that investors may reduce their risk by investing in many different companies. See John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 19 (1986) (explaining that "[p]ortfolio theory divides the risk associated with any security into two components: a firm-specific component and a systematic or non-diversifiable component associated with general market conditions"); Fama & Jensen, supra note 48, at 329 ("Common stock allows residual risk to be spread across many residual claimants who individually choose the extent to which they bear risk and who can diversify across organizations offering such claims."); Langbein & Posner, supra note 9, at 83-96 (discussing portfolio adjustments made by the social investor).

The value of modern portfolio theory as more than a theoretical model, however, is still widely debated and subject to qualifications from unorthodox theories. See e.g., Steve Secklo, For Stock Market Advice, Just Call the Meteorologist for Manhattan, Wall St. J., Dec. 28, 1993, at B1 (reporting that University of Massachusetts Finance Professor Edward M. Saunders, Jr. finds that weather is an important factor in day-to-day market performance).

50. See Fama & Jensen, supra note 47, at 304 (defining agency costs as the costs of structuring, monitoring, and bonding a set of contracts among parties with conflicting interests); Jensen & Meckling, supra note 46, at 308-10 (explaining the agency costs between ownership and management).
and loyalty owed to shareholders. Under the duty of care, a manager has a fiduciary duty to act in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the manager reasonably believes to be in the corporation’s best interests. The business judgment rule requires courts to presume that managers have fulfilled their requisite duty of care unless they have acted with gross negligence. The duty of loyalty requires managers to make decisions in the best interests of the corporation and without regard to their own individual interests. In essence, this duty prohibits management from faithlessness and self-dealing. To insure compliance, courts employ a strict standard of review when they consider management decisions involving direct conflicts of interest.

Beyond these duties, other forces constrain managerial indiscretion. Contractual relationships reduce agency costs by providing shareholders with the ability to displace management, through the periodic election of directors, and a means of aligning management’s interests with the firm’s through the use of incentives such as performance based compensation or stock options. Market forces, such as the labor market, as well as production markets and the market for corporate

52. See Melvin A. Eisenberg, The Duty of Care of Corporate Directors and Officers, 51 U. Pitt. L. Rev. 945, 948 (1990) (proposing that a corporate director’s duty of care consists of three distinct duties: (1) the duty to monitor the corporation’s business, (2) the duty to inquire about information which raises cause for concern, and (3) the duty to exercise care in making decisions both procedurally, byinsuring that directors are properly informed of all relevant information, and substantively, by requiring a rational belief that the decision was in best interests of the company). See generally Dennis J. Block et al., The Business Judgment Rule—Fiduciary Duties of Corporate Officers and Directors 28 (1989); William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors § 2.01 (4th ed. 1988).
53. Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984); see also Alan R. Palmiter, Reshaping the Corporate Fiduciary Model: A Director’s Duty of Independence, 67 Tex. L. Rev. 1351, 1358 (1989). Invoking the business judgment rule permits courts to avoid second-guessing the merits of a business decision, provided that no evidence of bad faith or self-dealing on the part of management exists.
55. Block et al., supra note 52, at 73.
56. Palmiter, supra note 53, at 1364-65.
57. See, e.g., Del. Code Ann. tit. 8, § 221 (1991) (providing that the certificate of incorporation may provide shareholders and creditors with the power to vote on such matters).
59. Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 701 (1982) (discussing constraints on management through salary, bonuses, and reputation); Fama, supra note 48, at 292-95 (suggesting that the desire for positive evaluation of ability and such evaluation’s effect on current employment and the marketability for
control may also constrain managerial abuses. Proponents of the market-monitoring theory posit that corporations offering shareholders the highest returns will garner the largest investments and prosper more than other entities, thereby advancing management's interest in job security.

Importantly, the separation of ownership and control inherent in the corporate form also makes it more likely that corporate management will subvert the individual shareholder's ownership interest in the corporation and displace the shareholder's judgment by making corporate charitable gifts. Not only does this usurpation of control obscure the shareholders' rights to control their assets, choose their own charitable causes, or not make any donations at all, it also centralizes control in the managers and away from the individual holders of wealth. Such control, argued theorists Milton Friedman and Friedrich Hayek, subverts the capitalist alternate and future employment will restrain managers from acting inconsistently with the interests of corporate owners).

60. Easterbrook & Fischel, supra note 59, at 701 (asserting that fierce product competition demands a diligently and efficiently managed firm).


63. At the current time, the tax code obscures such decisions because the double taxation of corporate income gives corporations and shareholders strong incentives to make such gifts. Conceptually, however, the analysis remains the same.

64. Some commentators have suggested that government, not individuals or corporations, should choose where to spend surplus wealth. Such a scheme would likely involve a progressive income tax system. On the other hand, government is an even more majoritarian system than corporate governance. Allowing it to distribute surplus social wealth would also stifle minority interests.

65. In... [a free enterprise economy] there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits... Few trends could so thoroughly undermine the very foundation our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible.

66. The claim that business should contribute to the support of charitable activities... is an inappropriate use of corporate funds in a free enterprise society. The corporation is an instrument of the stockholders who own it. If the corporation makes a contribution, it prevents the individual stockholder from himself deciding how he should dispose of his funds.

Milton Friedman, Capitalism and Freedom 133, 135 (1962).

66. Hayek argued that governments should plan economies which decentralize decision making and allow more economic actors to make decisions in order to create greater freedom: “[P]arties in the market should be free to sell and buy at any price at which they
system by centralizing decision making in irresponsible bodies having no right to make such decisions and, more importantly, no incentive to carefully consider the propriety and potential impact of these decisions.

Friedman’s argument is logical and theoretically seductive. First, he correctly observed that allowing corporations to make charitable contributions deprives shareholders of the ability to exercise their own ownership interests in that entity. Second, it is inefficient for centralized bodies to make decisions about charity. Each individual’s interest in promoting a particular political agenda, an alma mater, or a pet charity sways the decision-making calculus. Third, as Friedman implied in his discussion of discrimination, centralizing control in a majoritarian manner will hurt charitable organizations with politically unpopular ideas. After all, even a celebrated corporate giver like the Dayton-Hudson Corporation will not likely contribute to politically unpopular groups.

Friedman’s approach is theoretically sympathetic and logically consistent with the common-law restraints on charitable corporate giving that preceded recent statutory authorization of that practice. However, his analysis ignores the limitations American democratic society has imposed upon corporations over time. Historically, United States citizens have not hesitated to appropriate corporate private property for public use. Moreover, citizens can easily affect corporate profit maximization,
like other matters, through both the state and federal political systems. In fact, several commentators have even suggested that popular support for the existence of corporations arises largely from the practice of corporate charitable giving. Friedman, however, left an important question unanswered: Would individuals, via their pension funds, ultimately make the same sort of charitable contributions that corporations presently make if they also were to receive additional, nonmonetary dividends? This Article addresses that question.

III. A TRADITIONAL ANALYSIS OF CHARITABLE CORPORATE GIVING

Prior to the recent trend of statutory codification, the common law employed the direct corporate benefit doctrine to determine when a corporation's directors could make charitable contributions out of...
corporate assets or profits without violating their duty to maximize shareholder profits. This section suggests that, as accumulated wealth gradually transferred from individual industrialists to corporations, courts stretched the concept of direct corporate benefit to vindicate society's desire to use private resources for public purposes. Because the recent concentration of social wealth in pension funds presents a contemporary analogue to this earlier economic shift, this section establishes a framework on which to base an extension of the doctrine to the context of socially responsible investment of pension funds.

A. Historical Limitations on Corporate Charitable Giving

Charitable giving is an important concept in Judeo-Christian history and culture. Indeed, at times, charitable giving has been perceived as a condition precedent to social acceptance within particular communities. Religious communities, for example, cite the tradition of giving to the downtrodden as a directive to share with the community. Interestingly, these communities traditionally have valued giving for noneconomic reasons. In other words, giving demonstrates belief in and commitment

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74. This Article does not examine the law prior to the industrial revolution. During that time, landowners largely controlled wealth. It seems anecdotally attractive, however, to suggest that royal landowners served much the same charitable giving purpose prior to the eighteenth century. In England, for example, the landed aristocracy endowed Oxford and Cambridge Universities. These universities retain much of those real estate holdings today. See, e.g., 2 T.H. Ashton & J.I. Catto, The History of the University of Oxford 635-57 (1984). Tocqueville, however, reported in 1848 that control of charitable institutions in Europe had moved from corporations and individuals to governments. Tocqueville, supra note 1, at 680. The United States has avoided centralizing control of charitable institutions in the government.


76. The United States is not the only country which has faced the issue of socially responsible investing. The English judicial system recently considered whether the Bishop of Oxford could sell land at below market value to a developer building low-cost housing. The English court did not allow the sale, holding that although a charity may make gifts, it may not sell land at below market rates. See Richard Nobles, Charities and Ethical Investment, Conveyancer & Property Lawyer, Mar-Apr. 1992, at 115-18 (discussing what Nobles calls a peculiar decision in the unreported case of Bishop of Oxford v. The Church Commissioners).

77. The Bible directs the faithful to give 10% of their income to those in need:

When you have finished paying all the tithe of your produce . . . giving it to the Levites, the aliens, the orphans, and the widows, so that they may eat their fill within your towns, then you shall say before the Lord your God: . . . "I have obeyed the Lord my God, doing just as you commanded me . . . ."


78. Instead of emphasizing the value of the contribution to those who can use the money, the story of the poor widow shows the noneconomic and nonutilitarian importance of giving.

[Jesus] sat down opposite the treasury, and watched the crowd putting money into the treasury. Many rich people put in large sums. A poor widow came and put in two small copper coins, which are worth a penny. Then he called his disciples and said to them, "Truly I tell you, this poor widow has put in more than all those who are
to the community.

Nineteenth-century industrialist, philanthropist, and robber-baron Andrew Carnegie similarly believed that wealthy individuals should share their wealth with their respective communities.\(^7\) Carnegie asserted that people who own "enormous fortunes" should manage those resources "to promote the permanent good of the communities from which they have been gathered."\(^8\) Carnegie also predicted "that public sentiment would soon say of one who dies possessed of millions of available wealth with which he might have administered: 'The man who dies rich thus dies disgraced.'"\(^9\) In Carnegie's eyes, a wealthy person who died without having distributed his or her wealth to the community was a bad citizen.\(^2\)

Historically, then, society has consistently valued and sought to encourage charitable giving. As late as the 1950s, however, the legitimacy and legality of charitable giving by corporations remained an uncertain proposition.\(^5\) The common law generally precluded corporations from making charitable gifts because it considered gifts to even the most respected charitable organizations as ultra vires violations of shareholder

contributing to the treasury. For all of them have contributed out of their abundance; but she out of her poverty has put in everything she had, all she had to live on."

Mark 12:41-44 (New Revised Standard). The point of the story, after all, is that the widow needs the money as much as, or more than, the people who the gift will ultimately benefit. See also Luke 21:1-4 (New Revised Standard) (same story).


\(^{80}\) Id. at 685.

\(^{81}\) Id.

\(^{82}\) Interestingly, contemporary society uses this same language of citizenship to describe socially responsible corporate behavior. Society celebrates corporations which make charitable contributions to the community by deeming them "good corporate citizens." Harvard and Columbia Universities, The Council on Economic Priorities, The Business Enterprise Trust, and The Center for Economic and Social Justice all make awards to recognize good corporate behavior. Blaine Townsend, The Corporate Responsibility Hall of Fame, Bus. & Soc'y Rev., Spring 1992, at 47, 48. These organizations recognize corporations which protect the environment, contribute to their respective communities, make significant charitable contributions, and are equal opportunity employers. Id. at 48-49. Some of these organizations also single out for dishonorable mention corporations that engage in practices such as clearcutting redwood forests, compiling poor environmental or safety records, marketing cigarettes to children, failing to disclose information, and failing to make charitable contributions. Id. at 50. For a list of corporations deemed to be good corporate citizens, see Jerry W. Anderson Jr., Corporate Social Responsibility 179-84 (1989); Patrick McVeigh, Ten Top Companies for the 1990s: Dispatches from the Front Lines of Corporate Social Responsibility, Bus. & Soc'y Rev., Spring 1992, at 33, 33-34.

Courts uniformly held that corporate directors, in executing their fiduciary duties to the corporation’s shareholders, could not deviate from the black letter of the corporate charter.

_Harriman v. The First Bryan Baptist Church_ illustrates this strict approach in construing corporate charters. In _Harriman_, the First Bryan Baptist Church sought to raise funds to retire debts it had incurred in the construction of a new church. To raise funds, the church contracted to charter a cruise vessel and sold tickets for passage on the ship. The Supreme Court of Georgia held that the contract violated the church’s corporate charter and consequently was void. Citing language in the charter, the court stated:

The erection of a church-edifice [is within the church’s purpose as a corporation, as is raising money to pay for the erection]. . . . The purpose was a worthy and laudable one . . . but the power to raise money for a proper object does not carry with it unlimited discretion as to the means of raising it. Every corporation must act according to its nature; a trading corporation must trade, a manufacturing corporation must manufacture, a banking corporation must bank, a transportation corporation must carry, and a religious corporation must preach, teach, minister to spiritual edification, and promote works of mercy and benevolence. A church incorporated as such, cannot engage, even for a day, in merchandizing . . . or in transporting freight or passengers. It must derive its income, not from the conduct of any worldly business, but from such property as it may happen to own, and from voluntary contributions.

Thus, the court’s rigid construction of the church’s charter narrowly circumscribed the sphere of activities in which the church legally could engage.

Courts did not hesitate to utilize a similarly restrictive methodology when determining whether a corporation’s charitable donations constituted ultra vires transgressions of the corporation’s charter. In _Brinson Ry. Co. v. Exchange Bank of Springfield_, a railway company sought
to donate funds for the construction of a public school. The company hoped the school would increase the size of the surrounding community situated on the company’s railway line. Although the court acknowledged that the donation “might incidentally increase the transportation business of the railway,” it nevertheless held that the donation exceeded the railway president’s power and was, therefore, ultra vires and void.

Similarly, in Northwestern University v. Wesley Memorial Hospital, the Illinois Supreme Court stated that one charity could not make a gift to another charity when such donations were not a chartered corporate activity. Northwestern University gave Wesley Memorial Hospital $30,000 to provide instructional facilities for Northwestern University medical students. The Illinois Supreme Court undertook an exhaustive discussion of corporate purposes and ultimately allowed the conveyance. The court was very clear, however, in holding that Northwestern University held these funds in trust for the specific charitable purposes enumerated in its charter and that it could not legitimately characterize the conveyance as a charitable gift. Rather, the conveyance was legitimate only because it furthered Northwestern University’s chartered purpose of educating medical doctors.

This stringent adherence to corporate charters continued into the middle part of the twentieth century. Courts continued to follow the black-letter approach and struck down corporate conveyances even when corporate directors could show some direct benefit to the corporation in furtherance of a chartered purpose. In Zion’s Savings Bank & Trust Company v. Tropic & East Fork Irrigation Co., Tropic & East Fork Irrigation contracted with W.F. Holt to purchase water rights on the Sevier River.

93. Id. at 635.
94. Id.
95. Id. The court stated:
   It was beyond the powers of the president of a railway company incorporated under
   the general laws of Georgia as a common carrier, either with or without the consent
   of its board of directors, to donate funds belonging to the corporation, or to execute
   in the corporate name a note to be discounted in behalf of or to raise funds as a
   recognized donation for the erection of a public school, or for the purpose of
   building up or promoting the town in which the school is situated, even though
   the school or town be located on the line of the company’s railway and its transportation
   business might thereby be increased.

96. 125 N.E. 13 (Ill. 1919).
97. Id. at 17.
98. Id. at 15.
99. Id. at 17-18.
100. In other words, Northwestern University’s charter did not authorize the university to
    make gifts to hospitals with which it was not connected. Id.
    (Utah 1942).
103. Id. at 1054.
In exchange for the water rights, Tropic gave Holt's wife a note for $5000. Mrs. Holt assigned the note to the plaintiff bank, which held it as trustee for her and her two children. After making payments for six years, Tropic stopped paying on the note and the trustee filed suit. The Supreme Court of Utah dismissed the suit, holding that the plaintiff had no cause of action. The court concluded that, in purchasing the water rights, Tropic was "acting beyond the privileges conferred ... by its corporate charter and the laws of the state of Utah." The court cited Article XII, section 10 of the Utah Constitution, which states: "No corporation shall engage in any business other than that expressly authorized in its charter, or articles of incorporation." The court concluded that Tropic's charter expressly authorized the company only to build and repair canals. As such, the contract was ultra vires and void.

The common law's conceptual scheme of corporate organization suggested that corporations had no business making charitable contributions. Rather, their sole appropriate task was to maximize profits by executing the activities authorized in their corporate charters. Like Adam Smith's butcher, baker, and brewer, courts held that corporations owed their dinner to self-interest, not to social benevolence.

Notwithstanding these common-law principles, changes in the control of economic wealth, whereby corporations gradually displaced individual entrepreneurs as the principal holders of economic wealth in the United States, "resulted in calls upon corporations for reasonable philanthropic donations." Society, therefore, had to legitimize corporate charitable

104. Id.
105. Id.
106. Id. at 1056.
107. Zion's Sav. Bank, 126 P.2d at 1054. The Articles of Incorporation stated in relevant part:

The object of this corporation is to construct a canal from the East Fork of the Sevier River to Tropic and to keep the same in repair for the conducting of the water of said stream to the town of Tropic also to control the waters of Bryce Canyon for culinary and irrigation purposes for said Town.

Id.
108. Id. (emphasis added) (citing Utah Const. art. XII, § 10).
109. Id. at 1055. See also supra note 107 (quoting the corporation's charter).
111. Adam Smith, The Wealth of Nations 113 (Andrew Skinner ed., 1986) (1776) ("It is not to the benevolence of the butcher, baker or brewer that we owe our dinner, but from their regard for their own self-interest.").

At least one prominent commentator has argued that these structural changes in the economy were felt at a multitude of levels. John H. Langbein, The Twentieth-Century
giving in order to maintain the level of charitable giving promoted by its prevailing ideology and expected by its citizens.\textsuperscript{113} The economic reorganization created a kind of populism which encouraged state legislatures to amend their statutes to allow charitable corporate giving. Beginning in 1920, and continuing through the 1950s, states passed legislation superseding the common-law prohibition against corporate charitable contributions.\textsuperscript{114} Today, "every state... has a statute giving specific authority to corporations to make gifts for charitable... purposes."\textsuperscript{115}

\begin{footnotesize}
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\item[\textsuperscript{113}] Revolution in Family Wealth Transmission, 86 Mich. L. Rev. 722 (1988). As Professor Langbein notes, these changes made estate planning much less important. Because the nature of wealth changed, traditional estate planning could no longer control its distribution. Id. at 737. As Professor Langbein argues, the important transfers of family wealth in late twentieth-century America occur as parents provide for their children's education, not through the historically more important testamentary transfer of land. Because the modern economy has rendered land relatively less important and land was usually transferred through testamentary vehicles, testamentary gifts have become less important to modern society than they were through the beginning of this century. Id. at 724-28.
\item[\textsuperscript{114}] One could argue, however, that the corporation's status as an artificial person obscures the ownership rights of minority shareholders and therefore the corporation should transfer all profits to shareholders who, in turn, may individually contribute to charitable causes of their choice.
\item[\textsuperscript{115}] 6A Fletcher, supra note 83, § 2938, at 744; F. Emerson Andrews, Corporation Giving 233-35 (1952).
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B. The Historical Development of the Doctrine of Direct Corporate Benefit

Prior to this statutory transformation, courts were forced to reconcile populist demands for access to corporate wealth with the common law’s traditional concern for shareholder rights and a general reluctance to sanction charitable corporate giving. This prompted courts to craft an exception to the common-law rules against corporate charitable giving. Under the direct corporate benefit doctrine, courts would validate corporate giving if the donation directly benefited the corporation and generated greater profits for shareholders. Over time, courts have exhibited a willingness to manipulate this malleable doctrine to accommodate ever-increasing societal demands for access to corporate wealth.

One of the earliest cases applying the direct corporate benefit doctrine arose before the institution of the federal income tax. Wealth remained largely in the hands of individuals when the New York Supreme Court decided *Steinway v. Steinway & Sons* in 1896. The Steinway & Sons Corporation donated “property and money” toward the establishment of a church, a school, a free library, and a free bath in Astoria, New York, the site of the Steinway piano factory. Steinway also maintained a program through which it donated pianos to musicians and county fairs. A minority shareholder brought suit against the corporation alleging that by making these contributions the directors breached their

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116. See, e.g., *Knox v. First Sec. Bank of Utah*, 196 F.2d 112, 117 (10th Cir. 1952): “It is elementary that unless authorized by statute or effective charter provision expressly creating the power, a corporation organized solely for conventional business or commercial purposes may not alien its property by gift or indirect channels of diversion without consideration and not in furtherance of its pecuniary interests... The alienation or disposition of property of a corporation in that manner constitutes a violation of the rights of the stockholders and is ultra vires.”

117. 40 N.Y.S. 718 (N.Y. Sup. Ct. 1896). The Steinway & Sons Corporation made its contributions at approximately the same time that Carnegie urged wealthy citizens to share their wealth with the community.

118. Id. at 719. Steinway moved the location of its business from New York City to Astoria, New York, when the corporation needed a new facility. To facilitate the move, Steinway bought 400 acres of land in Astoria and tried to attract the skilled craftsmen required to manufacture pianos by building churches, schools, and recreational facilities. Id.

119. Id. at 722.
fiduciary duty to the shareholders. The court dismissed the suit, holding that the charitable acts directly benefited the corporation and therefore were not violations of the directors' fiduciary duties to the shareholders.

The court found that the contributions to the town had fostered positive labor and community relations, nurtured a productive labor force, and thus foreclosed any labor difficulties or strikes. The court further found that donating the instruments for "charitable purposes... was done... in the expectation that the reputation of the Steinway piano would have wider currency and its sale be thereby increased." Ultimately, Steinway convinced the court that the company's "profitable expansion," steadily increasing dividends, and profit from the appreciation of Astoria real estate holdings evidenced the success of the donations and the directors' good business judgment.

Visibly absent from Steinway, however, was any indication of a noneconomic commitment to the community. The court simply held that acting in a charitable fashion was good for business. Whether the court's analysis was as calculated and bottom-line oriented as the opinion suggests is debatable. The case does, however, illustrate the traditionally narrow application of the direct corporate benefit doctrine.

For the most part, courts initially applied the exception restrictively and were not inclined to readily find that corporate donations yielded direct benefits. In Worthington v. Worthington, a case from the same era as Steinway, the court disallowed a corporate charitable contribution due to lack of a direct corporate benefit. In Worthington, a hydraulics manufacturer donated more than $12,000 worth of equipment to furnish an engineering laboratory at Columbia University. The laboratory boasted the name of the corporation's founder, who also happened to be the father of the corporation's president. Minority shareholders brought suit alleging that in making the gift the directors had violated their fiduciary duties owed to the shareholders. The court agreed, holding that the president of the corporation had taken the corporation's property without paying for it.

Although the two courts applied the same basic analysis, Worthington is distinguishable from Steinway on one important ground: Worthington's gift...
to the university was personal rather than charitable. Because Worthington meant to honor the father of the corporation’s president, the company essentially made the gift to a pet charity. Moreover, the corporation could expect no potential economic benefit as a result of the gift. Had the corporation reasonably expected some benefit, the court probably would have allowed the donation. If, for example, the corporation donated the equipment in order to facilitate research in a joint venture with the university, the corporation could have argued that, although the gift happened to be charitable, it conferred a direct economic benefit on the corporation’s research program.

Rigorous application of the direct corporate benefit doctrine began to wane as surplus social wealth became increasingly concentrated in the corporate sphere.\textsuperscript{131} By the 1950s, courts regularly upheld corporate charitable behavior under a relaxed direct benefit standard. These courts justified their increasing tolerance for corporate charity by emphasizing the importance of corporate wealth to the United States economy. In \textit{Union Pacific Railroad Co. v. Trustees},\textsuperscript{134} the Utah Supreme Court justified a railroad corporation’s gift to a charitable foundation because the gift conferred a direct benefit on the corporation.\textsuperscript{135} The court likened the gift to Union Pacific’s actions in donating supplies and money to the victims of the 1906 San Francisco earthquake, which the court previously had held as a benefit to the corporation and, therefore, an act of charitable giving.\textsuperscript{134} Although the court conceded that in neither instance did the corporation receive any immediate benefit, in both cases the value of the goodwill created by the corporation’s actions was “priceless.”\textsuperscript{135}

The court cited the traditional direct corporate benefit language used by the \textit{Steinway} court in defending corporate gifts that benefit the corporation, but its reasoning betrays the fiction underlying the concept. The court began by reciting a litany of statements made by corporate officials who testified that to their honest beliefs that the gift to the foundation benefited shareholders.\textsuperscript{135} The gifts, the officers asserted, created goodwill toward the corporation, which resulted in increased profitability. Accepting these declarations uncritically, the court belied its purported reliance on the direct benefit doctrine:

Why was the contribution made? We believe that if it were made with the \textit{studied and not unreasonable conviction} that it would benefit the corporation, it should be the type of thing that should rest

\textsuperscript{131} See 6A Fletcher, supra note 83, § 2939, at 747 (“Direct corporate benefit is no longer necessary, but corporate interest remains as a motive.”).
\textsuperscript{132} 329 P.2d 398 (Utah 1958).
\textsuperscript{133} Id. at 401.
\textsuperscript{134} Id. at 400. In 1906, in response to the great San Francisco earthquake, the Union Pacific Railroad shipped 1600 train carloads of food and materials to San Francisco, donated $200,000, and evacuated over 250,000 people.
\textsuperscript{135} Id.
\textsuperscript{136} Id. at 401.
to shareholders had such funds remained unspent.  

The term "not unreasonable" and the court's qualification of "any immediate and direct corporate benefit" suggest that the court lowered the standard for permissible corporate contributions. According to the court's example, the subsidized scholars need not produce any immediate direct benefit to the corporation as long as the corporation does not unreasonably believe that some benefit might ultimately accrue. This standard legitimizes even those activities that are obviously too diffuse to increase the corporation's profits. For example, giving art to a museum arguably may increase productivity among workers who happen to see it and become inspired by it. To say, however, that the gift benefits the shareholders as much as distributing the same money in a dividend seems unreasonable.  

The court's reasoning in two other parts of Union Pacific more clearly explains the assumptions underlying its reasonableness standard. First, the court noted that previous cases had allowed corporations to deduct charitable gifts as business expenses, evidencing a public policy in favor of corporate charitable giving. Second, the court emphasized that corporations had acquired much of the social wealth historically controlled by individuals. The court consequently noted the need to rely upon...

137. Union Pac., 329 P.2d at 401-02 (emphasis added).
138. Such a gift more closely resembles a single company which expends funds to limit its pollution. The company marginally improves the environment as well as society's ability to sustain long-term economic growth. Unless the corporation itself produces a disproportionate amount of pollution, however, it will require the cooperation of other polluters to improve environmental quality enough to sustain long-term growth and profitability. Without the cooperation of others, the corporation's efforts are of marginal benefit to it as well as the community. Although they may make everyone's life a little better, they are unlikely to produce a sufficient marginal increase to make a difference in the profitability of that particular corporation, especially since its competitors may gain an advantage by not making similarly expensive environmental improvements. In this hypothetical, the incentive for the competitor not to make similar improvements actually exists. Like the prisoner's dilemma, this situation requires external coercion to make certain activity more likely. Perhaps in the case of charitable giving, public and consumer sentiment provides the "coercive" force which prevents charitable giving from creating a competitive disadvantage. For a discussion of game theory applied to environmental management, see Arun S. Malik, Permanent Versus Interim Regulations: A Game-Theoretic Analysis, 22 J. Envtl. Econ. & Mgmt. 127, 127-39; Alexander S. Kritikos, Environmental Policy Under Imperfect Information: Comment, 25 J. Envtl. Econ. & Mgmt. 89, 89-91.
139. Union Pac., 329 P.2d at 400 ("In 1935 Congress encouraged corporate contributions to eleemosynary causes by allowing a deduction for tax purposes in such cases."). For a discussion of judicial treatment of the direct benefit doctrine in the context of tax deductions for charitable contributions, see infra Part III.
140. Increasing tax burdens pretty much have relegated large personal fortunes to an almost forgotten era. Many endowment rivers that yesteryear coursed into private education, charitable and religious institutions have become but trickles, portending a thinning of the ranks of top business executives, most of whom were recruited from private institutions. Such dessication initiated new calls upon industry and hence upon the business corporation as a means of securing funds to perpetuate...
“the new concept of corporate responsibility” if society was to maintain the level of charitable giving it had come to expect.\textsuperscript{141} Thus, despite the assertion that the gift benefited the corporation, it was the gift’s broader societal benefit that actually swayed the court.\textsuperscript{142}

In \textit{Memorial Hospital Ass’n v. Pacific Grape Products Co.},\textsuperscript{143} another example of the relaxed direct benefit approach, a food wholesaling corporation’s president, and majority shareholder, pledged $5,000 on the corporation’s behalf to a local hospital’s capital campaign.\textsuperscript{144} Perhaps

almost forgotten era. Many endowment rivers that yesteryear coursed into private education, charitable and religious institutions have become but trickles, portending a thinning of the ranks of top business executives, most of whom were recruited from private institutions. Such dessication initiated new calls upon industry and hence upon the business corporation as a means of securing funds to perpetuate these private institutions.

\textit{Union Pacific}, 329 P.2d at 400.

141. Id. at 401.

142. Id. at 401-02. Importantly, “corporate responsibility,” as the court used the term, differs greatly from the direct corporate benefit that Friedman would require. The court’s understanding of corporate responsibility may also be something more altruistic than the unofficial bargain that commentators, like Kenneth Dayton, believe to exist between the public and corporations. Smith, supra note 72, at 121. One can interpret Dayton’s comments to mean that corporate charitable giving is a quid pro quo for corporate existence, not an altruistic expression of regard for the community.

The language in \textit{Union Pacific} suggests that corporations should take an active part in the community’s well-being because they are citizens of that community. Corporate responsibility, however, is absolutely and completely irrelevant to the notion of direct corporate benefit. The concept of direct corporate benefit suggests that corporations make gifts only to promote their economic interests. Corporate responsibility, in contrast, suggests that corporations make sacrifices for the greater good of the community. It is, moreover, conceptually inconsistent with Friedman’s corporate model to state that a corporation, an artificial body which exists as a separate legal person only to protect its owners from liability, has any responsibility apart from maximizing profits for its owners. The court’s opinion is thus schizophrenic and difficult to reconcile. Although one can reasonably accept either the direct benefit model or the corporate responsibility model, one cannot accept both.

It is interesting to note that Dayton’s and Friedman’s disagreement turns on a rather fundamental assumption about corporate law, an assumption which is also fundamental in philosophy. Although Dayton and Friedman both agreed that a corporation is artificial, Dayton argued that the corporation must give to the community both because of its artificial and its legal fragility. In contrast, Friedman argued that the corporation cannot give to the community precisely because it is artificial and that such decisions rightfully belong to the shareholders as owners.

Dayton’s approach is ontological or utilitarian. He argued that the whole is a thing unto itself. Friedman’s approach is a rights-based, deontological model which suggests that the whole is nothing more than the amalgamation of its individual components. For a discussion of the philosophical foundation of this distinction, see John Rawls, \textit{A Theory of Justice} 27-33 (1971).

143. 290 P.2d 481 (Cal. 1955).

144. Id at 483; see also Schlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968). In \textit{Schlensky}, minority shareholders brought suit against the Chicago Cubs baseball organization to force the club to install lights at Wrigley Field so that the Cubs could play night games which would draw larger crowds. The court held that the team had valid business reasons for limiting its schedule to day games and dismissed the shareholder suit. Id. at 780-81. People
corporation's president later refused to make the payment. The trial court ordered the corporation to complete payment of its pledge and the California Supreme Court affirmed, reasoning:

It is a matter of common knowledge that the trend on the part of the prosperous business concern is steadily in the direction of making substantial charitable contributions in the community in which it is located and does business. Such donations are generally considered for its benefit as a means of increasing good will and promoting patronage. .. . [A]ppellant, operating its industrial plant within the community, would be directly benefited by having such a hospital capable of furnishing needed hospital services to its employees . . . .

The court ostensibly based its decision on the doctrine of direct corporate benefit. However, a wholesaler in a market as competitive as agriculture likely would not derive any benefit from its association with a charitable activity. The small corporation, moreover, effectively would have taken a free-ride on the contributions that others made to the hospital. Thus, the corporation would likely derive the same benefit from the hospital's existence whether or not the corporation made any contributions.

Of all the decisions in this area, A.P. Smith Manufacturing Co. v. Barlowe represents the seminal case recognizing a common-law right of corporations to make charitable contributions. The A.P. Smith Company, a manufacturer of fire hydrants and valves, made a $1,500 gift to

145. The president did not consult his board of directors prior to making the pledge. Memorial Hosp., 290 P.2d at 482.
146. Id.
147. Not only is agriculture the prototypical competitive market, but wholesalers usually concern themselves more with their own profitability and are less concerned with community welfare issues than either consumers or retailers who deal directly with socially interested consumers.
148. At the very least, the court's declaration that the gift directly benefited the corporation was sufficiently novel to merit some further exegesis. If the court was serious about its approach, it should have demonstrated, in specific terms, how it expected the corporation to benefit. Yet, the court's lack of rigorous analysis of any direct benefit is consistent with the time's emerging recognition that public purposes may require access to private wealth. Thus, the court's approach is not altogether surprising. Perhaps the lesson is that instead of rigorously scrutinizing corporate charitable gifts that benefit society, courts should adopt an interpretive canon which construes both law and fact in favor of public benefit. For further commentary on this matter, see William N. Eskridge, Jr., Public Values in Statutory Interpretation, 137 U. Pa. L. Rev. 1097, 1092-94 (1989); Daniel A. Farber & Phillip P. Frickey, Civil Rights Legislation in the 1990s: Is Carolene Products Dead? Reflections on Affirmative Action and the Dynamics of Civil Rights Legislation, 79 Cal. L. Rev. 686, 691-92 (1991); Daniel A. Farber & Phillip P. Frickey, The Jurisprudence of Public Choice, 65 Tex. L. Rev. 873, 908 (1987).
149. 98 A.2d 581 (N.J. 1953).
150. Id at 582. Although New Jersey had a charitable giving statute at the time the case was litigated, the statute explicitly stated that it did not apply to corporations chartered prior to its enactment.
Princeton University. Shareholders questioned whether the gift was in the best interest of the corporation and the directors sought a declaratory judgment confirming the right to make the gift. The New Jersey Supreme Court upheld the gift. As in Union Pac, the court noted that Congress and individual states had changed the applicable tax laws to encourage corporate charitable giving and that the redistribution of wealth from individuals to corporations had hurt the fund-raising efforts of charitable organizations. The court stated:

When the wealth of the nation was primarily in the hands of individuals they discharged their responsibilities as citizens by donating freely for charitable purposes. With the transfer of most of the wealth to corporate hands and the imposition of heavy burdens of individual taxation, they have been unable to keep pace with increased philanthropic needs. . . . Corporations have come to recognize this and with their enlightenment have sought in varying measures, as has the plaintiff by its contribution, to insure and strengthen the society which gives them existence and the means of aiding themselves and their fellow citizens.

The court went on to adopt the concept of corporate responsibility as an independent reason for permitting corporations to make charitable contributions. Although the effect of the decision was limited in those states that already had changed the common law by statute, the court’s recognition of the need for corporate contributions is particularly noteworthy because the court based it on common-law principles. Perhaps, most importantly, this decision provides the means to reinterpret the corporate charitable giving cases by relying upon this new corporate responsibility hermeneutic.

IV. THE CREATION OF THE DIRECT BENEFIT TEST FOR INCOME TAX PURPOSES AND THE CONSEQUENT INVERSION OF THE DIRECT BENEFIT TEST FOR FIDUCIARY PURPOSES

To this point, this Article has argued that as structural economic changes transferred accumulated wealth from individuals to corporations, courts applied the direct benefit test in the corporate context less rigorously to encourage the use of private wealth for public purposes. This section argues that over roughly the same period, courts developed an

151. Id. at 582.
152. Id.
153. Id.
154. A.P. Smith, 98 A.2d at 585-86, 590. The court continued:

Clearly then, the appellants, as individual stockholders whose private interests rest entirely upon the well-being of the plaintiff corporation, ought not be permitted to close their eyes to present-day realities and thwart the long-visioned corporate action in recognizing and voluntarily discharging its high obligations as a constituent of our modern social structure.

Id. at 590.
rigorously to encourage the use of private wealth for public purposes. This section argues that over roughly the same period, courts developed an analogous test in the corporate income tax context. Pursuant to this test, courts questioned whether corporations benefited from gifts made to charitable organizations in determining whether the corporations could properly deduct the gift from gross income.

The concept of direct corporate benefit had very different beginnings and applications in the corporate charitable giving context than in the corporate income tax context. Instead of subtly evolving over a fifty-year period based upon the facts of particular cases as the corporate charitable giving cases did, the tax laws changed dramatically when states began to allow corporations to make charitable contributions.

To maximize charitable giving, courts and legislatures have inverted the law regarding tax deductibility and charitable donations. Under the common law of corporate charitable giving, a corporation could legitimately make a gift and take a tax deduction only if the gift directly benefited the corporation. Current tax law, however, defines a tax-deductible charitable contribution as one that does not directly benefit the corporation. The differing treatment of a particular gift over time, coinciding with the legitimization of corporate giving, provides strong evidence that earlier courts stretched the common law to encourage the transfer of resources from private corporations to public purposes.

A. Deductibility of Corporate Charitable Contributions Under the Common Law: The Direct Benefit Rule

Since 1917, the IRS has allowed individuals to deduct charitable contributions from gross income.\footnote{See Bliss v. Commissioner, 68 F.2d 890 (2d Cir. 1934); 3 Randolph E. Paul & Jacob Mertens, Jr., The Law of Federal Income Tax § 29.01 (1934).} Prior to 1935, however, corporations were not entitled to deduct from gross income contributions or gifts.\footnote{3 Paul & Mertens, supra note 155, § 29.08 (Supp. 1937).} Nevertheless, beginning in the 1930s, courts began creatively applying the direct benefit doctrine in taxation cases to encourage corporate charitable behavior. One approach allowed corporations to take charitable contributions as business-expense deductions. As long as the contributions directly benefited the corporation, the corporation could deduct contributions that also happened to benefit society. Moreover, as in the charitable gift context, to facilitate public access to private wealth, courts defined "direct benefit" loosely enough to permit corporations to make charitable gifts that only minimally benefited the corporation.\footnote{Id. See also supra notes 40-44 (discussing the separation of ownership and control of the corporate form).}

The court's analysis in \textit{Willcuts v. Minnesota Tribune Co.}\footnote{103 F.2d 947 (8th Cir. 1939).} provides a good example of this suspect approach. In 1928, the Minnesota Tribune
corporation donated $208.32 to Minnesota College as part of a capital campaign to retire a $35,000 debt.\textsuperscript{159} The corporation subsequently deducted the gift from its gross income as a business expense.\textsuperscript{160} The Commissioner of Internal Revenue brought suit seeking to disallow the deduction on the grounds that charitable contributions were illegal and not deductible from gross income.\textsuperscript{161}

The corporation convinced the Eighth Circuit Court of Appeals that the corporation made the donation to help the college survive,\textsuperscript{162} which enabled the college to continue to advertise in the corporation’s newspaper.\textsuperscript{163} The court concluded that the corporation had benefited directly from the contribution and that the conveyance was deductible from gross income as a business expense.\textsuperscript{164} The court summarily rejected the Commissioner’s contention that the benefits to the corporation were too remote to justify the deduction.\textsuperscript{165}

The court’s conclusion—that the $200 contribution helped the college to survive—is problematic. To persuasively make that argument, the court would have had to demonstrate that other gifts were dependent upon the corporation’s gift. Even if the newspaper had organized the capital campaign and other contributions were contingent upon the corporation’s financial leadership, however, whether the newspaper’s advertising profits from an ailing educational institution would ever exceed the $200 gift is unclear. In any case, the court did not consider the matter important enough to ascertain the present value of the contribution and balance it against the expected future stream of advertising revenue. Either the court overlooked this rather obvious point, which seems unlikely, or the case illustrates a judicial willingness to tap corporate coffers for socially beneficial causes.

Similarly, in \textit{American Rolling Mill Co. v. Commissioner of Internal Revenue}.\textsuperscript{166}

\textsuperscript{159} Id. at 952.
\textsuperscript{160} Id.
\textsuperscript{161} Id.
\textsuperscript{162} Minnesota College is no longer in existence.
\textsuperscript{163} \textit{Willcuts}, 103 F.2d at 952.
\textsuperscript{164} Id.
\textsuperscript{165} To keep [Minnesota College] in business served to maintain a source of annual advertising income and thus directly benefited the corporation and its shareholders. Such being the fact the expenditure was in consideration of a “benefit flowing directly to the corporation as an incident to its business” and was properly deductible.
\textsuperscript{166} Id. (quoting trial court opinion).
\textsuperscript{167} Id. The Eighth Circuit’s decision in \textit{Willcuts} represented a break from recent precedent decided in the D.C. Circuit Court of Appeals, which had reached a different result two years prior on very similar facts. \textit{See also} Fairmont Creamery Corp. v. Helvering, 89 F.2d 810, 812 (D.C. Cir. 1937). In \textit{Fairmont Creamery}, the D.C. Circuit held that donations to the Y.M.C.A. and Briar Cliff College directly benefited the corporation and were deductible from gross income. The court held that each donation allowed the company to retain the donee’s business. Id. at 813.
Revenue,

the Sixth Circuit addressed the tax deductibility of a charitable contribution as a business expense. The American Rolling Mill corporation claimed tax deductions for $360,000 in contributions to a "civic improvement fund" established by the city in which the corporation manufactured sheet metal and steel. The civic improvement fund ultimately distributed the contributions to the Board of Education, the Girl Scouts, the Y.M.C.A., the Parks Commission, the City Hospital, and similar charities. American Rolling Mill argued that the contributions were deductible as a general business expense under section 234(a)(1) of the Revenue Act of 1918 because the contributions encouraged employees to remain in the community and discouraged strikes. The Commissioner argued that the contributions provided no direct benefit to the corporation and that any measurable benefit was so remote that recognizing it as a business expense would effectively allow corporations to deduct all charitable giving. The court disagreed with the Commissioner. After balancing "the outlays against the benefits to be reasonably expected," the court concluded that if the corporation had not joined with

166. 41 F.2d 314 (6th Cir. 1930).
167. Id.
168. Id.
169. Section 234(a)(1) provided:

(a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity. . . .


170.

It is accepted as true in the industrial world that strikes and shifting labor conditions impair efficiency of production, and that contentment and well-being add to the skill and productivity of workmen. Acting upon that principle, the large industries of the country almost without exception have engaged in mutual interest work in one form or another with their employees, with the view of contributing to their comfort and pleasures, encouraging them to purchase homes, and giving them such interest in the community as to make them an asset of the business. Such work has been considered by the courts as a corporate function having a substantial relation to the progress and success of the industry.

American Rolling Mill, 41 F.2d at 315.

171.

"It is said for the Commissioner that every legitimate business in a city is more or less benefited by any civic enterprise, and that to sustain the deduction in the case at bar would open the door to the deduction of every contribution to any, enterprise that had for its betterment of the people of the surrounding community.

Id.

172. "We think the [Commissioner's] argument is unsound." Id.
other civic groups to improve the community, it may have had to provide similar services for its employees by itself.\textsuperscript{173}

Like the New York Supreme Court in \textit{Steinway}, the Sixth Circuit Court of Appeals in \textit{American Rolling Mill} ostensibly based its opinion upon a direct benefit analysis and concluded that the corporation reaped a greater benefit from making the charitable gift than it would have from declaring a dividend to shareholders. Like \textit{Steinway}, \textit{American Rolling Mill} involved skilled laborers in a town dominated by a single employer. As such, the court's opinion is arguably defensible.\textsuperscript{174} On the other hand, it is difficult to believe that the corporation benefited as much from the contributions to the community as it would have had it not spread the money so diffusely. For example, the corporation could have given the money directly to its employees in the form of higher wages, built an employee recreation center, provided scholarships for the children of employees, or improved working conditions at the plant, thereby concentrating its resources on the well-being of its employees and their families.

It is therefore arguable that the \textit{American Rolling Mill} court, like the \textit{Willcuts} court, did not engage in the type of analysis that it purported to engage in. Rather, both courts appeared to first justify the gifts as socially beneficial transfers and then manipulate their decisions to fit within the existing direct benefit construct. Commentators at the time also speculated that the court was being less than completely candid:

Despite the persistent refusal of Congress to extend to corporations the privilege accorded to individuals of deducting charitable contributions from gross income, the same result has frequently been accomplished in the case of corporate donations for the benefit of employees, by cloaking the donations in the garb of business expenses.\textsuperscript{175}

In sum, \textit{American Rolling Mill} was "in reality a subterfuge for subverting the policy of Congress," which did not allow corporations to deduct charitable contributions.\textsuperscript{176}

\begin{itemize}
  \item \textsuperscript{173} Id. In its balancing analysis, the court suggested that "the nature and size of the industry, its location, the number of its employees . . . and what other employers similarly situated are doing" would be factors relevant to the direct benefit analysis. Id.
  \item \textsuperscript{174} One later court distinguished \textit{American Rolling Mill} based upon that corporation's dominance in a small community. Morgan Const. Co. v. United States, 18 F. Supp. 892, 893 (D. Mass. 1937). In \textit{Morgan}, a corporation argued that its gifts to the local chapter of the Y.M.C.A. created a direct benefit to the corporation under \textit{American Rolling Mill}. The court disagreed:
    \begin{itemize}
      \item The court [in \textit{American Rolling Mill}] was plainly influenced by the fact that plaintiff employed half the community's wage earning population and contributed 36 per cent. of the total civic funds raised in the community. In the instant case, petitioner employs about 750 persons out of a population of 195,000 and contributed less than 1 per cent. of the total . . . funds.
    \end{itemize}
  \item \textsuperscript{175} Recent Decisions, 30 Colum. L. Rev. 1211, 1211 (1930).
  \item \textsuperscript{176} Id. at 1212.
\end{itemize}
B. Deductibility of Corporate Charitable Contributions Under the Tax Code: Inverting the Direct Benefit Rule

In 1935, Congress passed legislation allowing corporations to deduct charitable contributions from gross income.\(^\text{177}\) Under the legislation, corporations could deduct charitable contributions in an amount up to five percent of their gross income regardless of whether the contribution directly benefited the corporation.\(^\text{178}\) The legislation also clarified that contributions from which the corporation benefited were still deductible as business expenses.\(^\text{179}\)

When the states began to pass laws in the 1950s allowing corporate charitable contributions, however, the United States Supreme Court in Commissioner v. Duberstein,\(^\text{180}\) held that a corporation could not take gifts as charitable deductions so long as the gift stemmed from "the constraining force of any moral or legal duty" or, significantly, from the "incentive of anticipated benefit."\(^\text{181}\) Instead of using the direct benefit test to allow corporations to deduct only those gifts which directly benefited the corporation as earlier courts did, the Supreme Court inverted the test and allowed corporations to deduct only those gifts that did not directly benefit the corporation.\(^\text{182}\) The Court's Duberstein analysis has persisted, and under present law a taxpayer must establish that a claimed charitable contribution proceeded from the taxpayer's "detached and disinterested generosity."\(^\text{183}\) The difference between the two direct benefit tests is ostensibly dramatic, but explainable by courts' collective desire to maximize the availability of private resources for public use.

In Singer Co. v. United States,\(^\text{184}\) the court's reasoning reflected a similar utilitarian approach. In Singer Co., the Court of Appeals for the Federal Circuit held that a sewing machine company's sales of sewing machines to junior and senior high schools at a discount were not charitable contributions.\(^\text{185}\) The court conceded that the benefits to the corporation's public image and goodwill alone did not confer a sufficient

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177. 3 Paul & Mertens, supra note 155, § 29.08 (Supp. 1937).
178. Id.
179. Id. The provision, thus, effectively allowed corporations to make charitable contributions in excess of the five percent limit under some circumstances.
181. Id. at 285.
182. Id.
183. Id. See also United States v. Transamerica Corp., 392 F.2d 522, 524 (9th Cir. 1968) (holding that an indirect business advantage which coincides with public advantage does not disqualify a transfer as a charitable contribution, although a direct benefit does); DeJong v. Commissioner, 309 F.2d 373, 377-79 (9th Cir. 1962) (applying Duberstein test to individual taxpayer's payments to private school in "charitable contribution" language); Michael D. Rose & John C. Chommie, Federal Income Taxation § 11.19, at 665 n.3 (3d ed. 1988).
184. 449 F.2d 413 (Ct. Cl. 1971).
185. Id. at 423-24.
benefit to disqualify the discounts as charitable contributions.\textsuperscript{186} Rather, the court characterized the discounts as a marketing program through which the corporation hoped to benefit by acquainting potential consumers with their product: “[T]he benefits to be derived from such discounts were substantial enough to . . . [provide Singer] with a quid pro quo.”\textsuperscript{187} The court concluded that the discounts were not charitable in nature and it did not allow Singer to deduct the discounts from gross income.\textsuperscript{188} In effect, the court’s decision allowed the taxpayers supporting the relevant school districts to enjoy the discounts without depriving the federal treasury of income.

Similarly, in \textit{Foster v. Commissioner},\textsuperscript{189} the United States Tax Court held that a gift that benefits the donor is not deductible from gross income. In \textit{Foster}, the court disallowed a land developer’s charitable deductions for gifts of land to a city because the developer’s partnership directly benefited from the grant.\textsuperscript{190} Foster and his three sons formed a partnership to develop a 2,600 acre tract of land twelve miles south of San Francisco, California.\textsuperscript{191} The partnership gave three parcels of land to the city for park development.\textsuperscript{192} The court held that the partnership made the conveyance with an “expectation of a direct economic benefit” and disallowed the charitable deduction.\textsuperscript{193} As in \textit{Singer}, the \textit{Foster} court

\begin{thebibliography}
\bibitem{186} Id. at 425.
\bibitem{187} Id. at 414.
\bibitem{188} Id. at 424. \textit{See also} Winters v. Commissioner, 468 F.2d 778, 780 (2d Cir. 1972) (determining that payments to a parochial school for an education fund do not constitute charitable contributions when the corporation anticipates an economic benefit). \textit{But see} Allen v. United States, 541 F.2d 786 (9th Cir. 1976). In Allen, a local zoning ordinance required a developer to set aside a certain amount of land for open space if the developer built one-half acre lots. Id. at 787. In an attempt to get approval for a 22-acre development of one-half acre lots, the taxpayer donated nine acres of land to the city for use as open space and took a charitable deduction. Id. The trial court allowed the deduction and the Commissioner appealed. Id.

The Ninth Circuit applied the \textit{Duberstein} test, but held that motive and purpose are questions of fact for the trier of fact to resolve. Id. at 787-88. The court thus affirmed the trial court decision and allowed the deduction. Judge Williams, however, dissented, observing that because the developer’s primary motivation was to gain zoning approval, the gift was not at all disinterested. Id. at 789.

\bibitem{189} 80 T.C. 34 (1984).
\bibitem{190} Id. at 40.
\bibitem{191} Id. at 47.
\bibitem{192} Id.
\bibitem{193} Id. at 60-71. The court believed that the partnership conveyed the property in order to enhance the value of its remaining land and promote its sale. Id. at 111-12. \textit{See also} United States v. American Bar Endowment, 477 U.S. 105, 118 (1986) (“The sine qua non of a charitable contribution is a transfer of money or property without adequate consideration.”); Graham v. Commissioner, 822 F.2d 844, 848 (9th Cir. 1987) (asserting that taxpayer’s primary purpose must be to assist charity and not to secure personal benefit); Stubbs v. United States, 428 F.2d 885, 886-88 (9th Cir. 1970) (determining that taxpayer’s dedication as public property of land abutting taxpayer’s property was not for charitable purpose because of specific and direct economic benefit).

established that a person cannot take a charitable deduction, which would deprive the federal treasury of tax income, when the person made the contribution solely in economic self-interest. Foster, therefore, maximized the amount of private resources available for public use: San Francisco received the parks and the United States Treasury received greater tax revenue.*

The Federal Circuit's ruling in Transamerica Corp. v. United States provides a more recent example of judicial denial of a tax deduction due to the donor's economically self-interested actions. In Transamerica, the plaintiff-corporation claimed a charitable deduction for the value of nitrate-based film stock it donated to the Library of Congress. The nitrate-based film was fragile, potentially explosive, and required transferring to safety film at considerable expense to the Library. The taxpayer's "Instrument of Gift," however, retained exclusive rights to the use and title of the product so that the taxpayer continued to enjoy the use of the film without incurring the expense necessary to preserve its utility. The court held that the taxpayer received something of more than nominal value in exchange for its contribution and disallowed the deduction. By denying the deduction, the court's judgment guaranteed that the public received both the benefit of the gift and the taxes collected.

Given this jurisprudential shift, it is obvious that although at one time deemed to directly benefit its donor, the same gift would not disqualify the corporation from taking a deduction for the identical gift under the current tax code. For example, the A.P. Smith Corporation's gift to Princeton University, originally upheld under the direct benefit doctrine, would nonetheless qualify for a tax deduction today because the court would not consider it as directly benefiting the corporation under current tax analysis. The court would find mere public relations value of the donation insufficient to confer a direct benefit under Singer. Thus, the same gift would still be deductible today, but for different reasons.

* The Federal Circuit encountered the same fact situation in Ottawa Silica Co. v. United States, 699 F.2d 1124 (Fed. Cir. 1983). In Ottawa Silica, a taxpayer sought a deduction for land it donated to the state for the construction of a school. The Federal Circuit held that the taxpayer derived a direct economic benefit from the donation—an increase in the value of his remaining land. Hence, the taxpayer received a quid pro quo and was not entitled to a charitable deduction. Id. at 1132.

195. 902 F.2d 1540 (Fed. Cir. 1990).

196. Id. at 1545.

197. One major exception to the Duberstein direct benefit test has developed in litigation involving nursing homes. Courts have allowed taxpayers to deduct "gifts" to nursing homes even though the donors likely made the contributions in anticipation of very direct benefits. See, e.g., Dowell v. United States, 553 F.2d 1233, 1238 (10th Cir. 1977) (holding that gift to nursing home was charitable); Sedan v. United States, 518 F.2d 242, 245 (7th Cir. 1975) (same); Estate of Wardwell v. Commissioner, 301 F.2d 652, 658 (8th Cir. 1962) (holding that charitable gift to nursing home is charitable even though donor made it the day before the donor was admitted).

198. See Singer Co. v. United States, 449 F.2d 413, 424 (Ct. Cl. 1971).
Under the charitable corporate giving paradigm, a corporation's contribution to charity would be deductible only if it directly benefited the corporation. Under Duberstein's inverted test, however, it would be deductible precisely and only because it did not directly benefit the corporation. Interestingly, the law would consider the same gift to have directly benefited the corporation under one scheme, but not under the other.

Similarly, the fact that the gifts in A.P. Smith and Memorial Hospital Corp. did not confer direct benefits upon their respective corporations allowed those corporations to take charitable deductions. On the other hand, if the courts had found a direct benefit to either corporation, that corporation could have argued that it was entitled to a deduction for a business expense as in Willcuts.

For purposes of this analysis, consider the legal treatment of two separate gifts made by a major manufacturing corporation in 1900 and 1970. The first gift is a donation to a university to endow a professorship in the engineering department. The second gift is a piece of real estate to the municipality pursuant to zoning restrictions involved in the construction of a new plant. In 1900, corporate law allowed both gifts because it considered both to directly benefit the corporation. The gift to the engineering department would have directly benefited the corporation because students who might some day work for the corporation would receive better instruction and another faculty member would have had the resources to conduct potentially beneficial research. The second gift would have benefited the corporation by allowing the corporation to build a new plant. Moreover, both gifts would have been deductible as business expenses because both benefited the corporation.

By 1970, however, the treatment of the two gifts has diverged. Although the law still allows both gifts, the analysis of whether and why they are deductible has changed. The gift to the university is now deductible as a charitable contribution precisely because the law now deems it not to directly benefit the corporation. The second gift of land, however, is still thought to directly benefit the corporation and is therefore not deductible as a charitable contribution, but is deductible as a business expense.

The current tax regime would not consider corporate charitable contributions determined by earlier courts as having directly benefited the corporation to bestow direct benefits upon those corporations today. Instead, it would consider them detached and disinterested, and therefore deductible. The only consistent variable running through these cases and doctrines is the desire of the public and the courts to use private resources for public purposes. When a corporation had direct economic reasons to make a contribution, the relevant community received the full benefit of the donation and the federal government collected additional tax revenues. The public benefit derived from any permissible corporate donation was maximized.
V. THE DOCTRINE OF DIRECT CORPORATE BENEFIT AND PENSION FUNDS

A. The Doctrine of Direct Corporate Benefit as a Fluid Fiction to Encourage Charitable Corporate Behavior

The shift in jurisprudence in the charitable donation and deduction cases represents a fundamental change in the role of direct benefit doctrine in the corporate charitable giving context. Under the former regime, corporations could make charitable contributions, then deduct them as business expenses so long as the corporation received even a remote benefit from the donation. Under the new regime, however, when a corporation benefits as the result of a gift, the law considers the transfer noncharitable and therefore nondeductible.

Recognizing society's desire to accommodate shifts in the concentration of surplus social wealth best reconciles the two regimes. Initially under the former regime, courts narrowly construed the direct benefit test and restricted the permissible scope of corporate giving because individual philanthropists who controlled the vast bulk of the nation's wealth could satisfy society's charitable needs. As wealth began to accumulate in corporations, however, courts had to broadly define "direct benefit" to allow charitable gifts and preserve the level of charitable giving to which society had become accustomed. Under the new regime, which legitimizes deductions for corporate charitable contributions under the Tax Code, courts sought to maximize governmental revenues by defining charitable gifts as those not primarily benefiting the donor.

Together, the two schemes result in the public use of private wealth by maximizing tax revenue and encouraging charitable giving. Interestingly, this evolving approach reflects the tension between the Friedman and Dayton world views. Rational individual shareholders want to maximize their return, control, and autonomy over their investments. On the other hand, society wants to maximize its benefits from private capital and will tolerate corporations and corporate profits only as long as sufficient surplus wealth exists to make side payments, in the form of charitable contributions, to the public. An evolution of charitable giving law to balance these conflicting interests and divide the benefits of accumulated wealth is the type of social change expected from a well-organized, thoughtful, populist movement. At some level, therefore, expectations of corporate giving and the continuing existence of the

199. Fletcher, supra note 83, § 2938, at 743.
201. Economist Martin Feldstein has argued that charitable deductions are an efficient means of encouraging giving for public purposes because society benefits more from the gift to charity than it loses through lost revenue. Michael J. Graetz, Federal Income Taxation 479 (2d ed. 1988).
corporate entity may represent a political bargain between those who
create wealth and the wider group of those who seek to benefit from it.

Professors Langbein and Posner have contended that pension funds
are analogous to the historical model of the corporate form. Echoing
Friedman, they implied that pension funds simply hold the securities of
the same corporations as did the individual investors whose ownership
interests Friedman sought to defend. Their model, however, does not
incorporate the "political bargain" reflected in the corporate model. This
country's legal and judicial institutions have historically encouraged the
use of private resources for public purposes, an approach completely
inconsistent with the strict profit maximization standards that Langbein
and Posner would impose for pension fund fiduciaries. The movement of
wealth from individuals to corporations in the late nineteenth century
prompted courts to expand the scope of permissible charitable corporate
giving. Contemporary society is experiencing a parallel shift of wealth from
individuals and corporations to pension funds. Assuming that society's
need and desire for private wealth has not diminished, allowing pension
fund fiduciaries to engage in socially responsible investing represents a
natural evolutionary step. Thus, the development of the common-law
approach to charitable corporate giving provides a theoretical foundation
and justification for the socially responsible investment of pension funds.

Pension fund beneficiaries, moreover, are distinguishable from
shareholders in a way that makes adherence to the classic legal model of
the corporation inappropriate. Although beneficiaries of a pension fund
technically own a share of the fund, they do not control the securities in
which the fund invests as individual investors can. Unlike a shareholder
who acquires corporate stock voluntarily, pension fund beneficiaries have
no such choice. Even when receiving distributions, the beneficiary recovers
the capital in a limited fashion and over an extended period of time.
Consequently, the enormous social and political potential of capital in this
country's pension funds lies idle, managed in a manner that American
judicial institutions have rejected in the corporate context.202

The reasoning that led individual courts to stretch the direct benefit
dctrine during the first half of the twentieth century provides a sound
foundation for the socially responsible investment of pension funds today.

202. One might argue, however, that individual (noninstitutional) investors and their
representative directors will insure that a company in which the fund has invested will act in a
socially reasonable and charitable manner and that the pension fund thus need not concern
itself with such issues. This position overlooks two important points. First, institutional
investors are such a powerful force in the current economy that they exert enormous control
over particular stocks. In fact, institutional investors have even exerted strong influence on
corporate affairs at the board of directors level. See Matheson & Olson, supra note 4, at 1479-
82. Second, corporations are not in the best position to evaluate their own activities.
Charitable corporations might make gifts to the community. They are not, however, likely to
disapprove of their particular industry. Moreover, they might not venture outside their
particular business to conduct the types of activities that the community needs and thus may
not satisfy society's desire to utilize positive screens.
Society allowed corporations to make charitable contributions when it recognized a depletion in the funds available from individual donors caused by a structural reallocation of resources. Recognizing the need to sustain an accustomed level of charitable contributions, courts facilitated the public’s access to the new source of private wealth: corporate coffers. Similarly, to meet contemporary social concerns about the availability and proper use of capital, courts should allow pension funds to employ socially responsible criteria when making investment decisions.

A necessary implication of this analysis is that courts should allow pension fund fiduciaries to use reasonable social screens in making investment decisions, just as directors of corporations may make reasonable charitable contributions. As in Baltimore City, courts should recognize that a trustee’s use of reasonable socially responsible screens does not violate the duty of loyalty, because any infringement upon that duty is de minimis.

In sum, the charitable corporate giving cases provide a model for defining the reasonable financial sacrifices a fund manager may make for the advancement of other normative considerations. Absent a modern judicial consensus on the permissible scope of socially responsible investment, courts can look to these cases for guidance in balancing the beneficiaries’ interests in profit maximization against society’s interest in philanthropy. Moreover, by explicitly adopting this approach now, courts can ensure that the jurisprudence surrounding socially responsible investment evolves in a coherent and predictable manner.


204. The distinction between defined benefit plans, where the employer guarantees the employee certain benefits over time, and a defined contribution plan, where an employer establishes a fund for the employee, is an important one. With a defined contribution plan, the employee properly and appropriately makes a decision after balancing the trade-offs between possible reductions in return and normative criteria. Similarly, when an employer makes a decision to invest the assets of a defined benefit plan in a socially responsible manner, as in Baltimore City, it assumes the responsibility for the economic consequences of its normative choice. Of course, whether the employer should make such a normative decision with the assets held in trust for the employee is another matter. One might, for example, suggest that the employer give the employee some control over the assets just as individuals have control over the investment of other property.

The more difficult issue, however, is whether an employer offering a defined benefit plan should be required to invest in a socially responsible manner. If so, who should bear the risks and make the choices? Although this Article offers no extensive guidance on this issue, its analysis shows the further desirability of defined contribution plans based upon a normative analysis and the complexities involved in pension fund investing. One might also explore whether Congress should change the tax code to give existing tax benefits only to defined contribution plans. See supra note 203.

205. Board of Trustees v. Mayor of Baltimore City, 562 A.2d 720, 738 (Md. 1989).
B. Satisfying Investor Preferences—A Solution

Economic theory indicates that the utility of beneficiaries may actually be increased if fund managers invest in a socially responsible manner. Investors have different tastes or preferences as reflected by their investment decisions. These investment decisions provide satisfaction or utility to the investor, and when possible, the investor arranges the decisions to maximize satisfaction and to determine the combination of goods and services that maximizes investor well-being. Consider the following assumptions about the preference patterns of investors:

1. The investor is able to rank different combinations or bundles of goods in terms of desirability. Suppose an investor is confronted with three bundles of investments: low risk, low return; moderate risk, moderate return; and high risk, high return. The investor is able to decide whether she prefers moderate risk, moderate return or low risk, low return. If an investor has no preference, then each grouping is essentially viewed as yielding the same level of utility.

2. The investor’s preferences are transitive. If, for instance, there are three bundles of goods, X, Y, and Z, and the investor prefers X to Y and Y to Z, then the investor also will prefer X to Z.

3. The investor always prefers more to less. All other considerations being equal, the investor will prefer a higher return over a lesser return.

Indifference curves are easily applied to investors. To understand indifference curves, first assume that an investor is indifferent among the various groupings denoted in Table 1.

<table>
<thead>
<tr>
<th>Stock funds</th>
<th>Bond funds</th>
<th>Stock funds</th>
<th>Bond funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>A: 10</td>
<td>1</td>
<td>13</td>
<td>2</td>
</tr>
<tr>
<td>B: 7</td>
<td>2</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>C: 5</td>
<td>3</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>D: 4</td>
<td>4</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>E: 3</td>
<td>6</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>F: 2</td>
<td>9</td>
<td>5</td>
<td>10</td>
</tr>
</tbody>
</table>

That is, assume the investor who desires a diversified portfolio finds equally desirable an investment portfolio mix consisting of ten stock mutual funds.

and one bond mutual fund, or seven stock mutual funds and two bond mutual funds, and so on. In turn, assume that each combination in Table 1(b) is as desirable as any other. Significantly, however, note that more stock mutual funds are provided in (b) than in (a). Accordingly, the investor will prefer any combination in (b) over any in (a).

Points on indifference curves represent alternative bundles of investments. In other words, an indifference curve is a locus of points indicating different combinations of goods that yield the consumer the same level of satisfaction. In Figure 1, indifference curve $U_1$ represents the alternative combinations of stock and bond mutual funds detailed in Table 1(a). Stock mutual funds are measured on the vertical axis and bond mutual funds on the horizontal axis. Thus, a point such as W represents a holding of a portfolio of ten stock mutual funds and one bond mutual fund. Significantly, the investor is equally well off consuming any combination of goods shown on $U_1$.

Two characteristics of indifference curves are particularly noteworthy. First, indifference curves are convex, and usually fairly steep at the top and more markedly flat at the bottom. This shape is a function of the relative importance of the two goods to the investor. At the top of the curve, the investor has a substantial number of stock mutual funds and very few bond mutual funds. To move from point W to point X (where there are fewer stock funds and more bond funds), the investor would be willing to give up three stock funds for an additional bond fund. As the investor moves down the curve, however, the situation changes. The investor has more bond funds and fewer stock funds and is consequently less willing to trade stock for bond funds. The rate at which the investor trades these funds for one another is the marginal rate of substitution, which is evidenced in Figure 1 by the slope of the indifference curve.

Second, indifference curves that lie farther from the origin represent higher levels of utility than those closer to the origin. Recall Table 1(b). With all of the levels of stock funds owned, more bond funds are provided than in Table 1(a). The indifference curve $U_2$ in Figure 1 represents this combination of investments. Curve $U_2$ lies farther from the origin than $U_1$ and, accordingly, represents a higher level of utility.

This second characteristic of indifference curve analysis is profoundly significant. Since higher indifference curves correspond to higher levels of well-being, a rational utility-maximizing investor will want to achieve the highest indifference curve possible. However, the investor faces an important limitation. Her total level of wealth limits her investment or consumption decisions. These wealth constraints are illustrated by the investor’s wealth constraints line in Figure 2.

The creation of an investor’s wealth constraint line is relatively straightforward. Assume that an investor has a total of $10,000 to invest and that the investor can purchase either of the two types of funds. To illustrate this concept more fully, also assume that regulatory requirements mandate the purchase of stock mutual fund shares in $1,000 units and the purchase of bond mutual fund shares in $500 units. Thus, if the investor
invested all of her money in stock mutual funds, she could purchase ten units, and if she invested all of her money in bond mutual funds she could purchase twenty units. In Figure 2, the straight line SB, which connects ten units of stock mutual funds and twenty units of bond mutual funds, defines the investor's budget, or wealth line. The wealth line shows all combinations or quantities of stock and bond funds that the investor can purchase.

The position of the wealth line depends upon the size of the budget. If the investor's wealth increases, the wealth line moves farther from the origin; if the investor's wealth declines, the wealth line moves closer to the origin. Figure 2 illustrates these effects. As noted above, line SB denotes the initial wealth line. Suppose now the total wealth of the investor increases to $15,000. A line connecting 15S and 30B ($^{1}S^{1}B^{1}$) now defines a new wealth line. Similarly, if income falls to $5,000, another wealth line will join 5S and 10B. Note that these three wealth lines are parallel. The lack of change in S's and B's prices indicates that the slopes of all three wealth lines are the same.

In addition to income changes, changes in the unit price of the funds also affect the wealth line. To illustrate, assume that purchasing bond mutual funds in $250-per-unit increments becomes possible. To reflect this change, the wealth line will rotate to $SB^{1}$. Point S remains the same because the investors still can purchase only ten stock mutual fund units. Now, however, by investing everything in bond mutual funds, the investor can purchase forty bond mutual fund units. Figure 3 illustrates this effect.

The investor's budget line denotes the combination of investments available to the investor, and the indifference curves show how the investor subjectively ranks all combinations of investments. In Figure 4, the indifference curves $U_{1}$ through $U_{3}$ reflect the investor's preferences. Curve $U_{3}$ is most preferable because it represents the highest level of utility. The budget line SB represents a real investment possibility. Any point along SB (or below it) represents an investment possibility. Points above the wealth line are not feasible investments because the investor lacks the requisite wealth to make those investments. Because investors will seek the highest level of well-being possible given their wealth, equilibrium will occur at point $B^{1}$ where the wealth line and $U_{2}$ are tangent.\textsuperscript{207} Thus, the combination of S and $B^{1}$ represented by the tangency of point B is the equilibrium level of consumption for the investor.

Continuing to assume that it is possible to purchase bond mutual funds in $250-per-unit increments, the regulatory change will affect the investor in two ways: a wealth effect and a substitution effect. The wealth effect occurs because the investor's wealth now goes further as a result of

\textsuperscript{207} Note that although the wealth line includes point A, $B^{1}$'s position on a higher indifference curve, $U_{3}$ makes it preferable to point A. The investor rules out point D because, despite falling within the investor's budget, it has a lower indifference curve and therefore is not the highest possible level of well-being attainable by the investor.
the regulatory change, leaving her better off. The investor can purchase the same number of bond mutual funds as before and still have wealth left over to spend on other investments. The regulatory change, in effect, increases the investor's real wealth. The substitution effect results from the investor's decision to substitute the now lower priced investment for other investments. Because bond mutual funds, with their new unit price, become a relatively more attractive buy, the investor will choose to purchase more of them in comparison to other investments.

Figure 5 shows the total effect of this regulatory change as the increase in consumption of B from $B_1$ to $B_2$. Line $SB$ represents the original wealth line, with the investor in equilibrium at $E$ purchasing $B_1$ units of $B$. The new wealth line $SB_1$ reflects the regulatory change just discussed. The change involves a new equilibrium for the investor at $E_1$, with $B_2$ units of $B$ of being purchased. The total effect of this change, $B_1B_2$, is divisible into a wealth and substitution effect. To identify the substitution effect, the investor's real wealth decreases by an amount sufficient to return the investor to the original indifference curve $U_1$. To nullify the wealth effect, a hypothetical wealth line, $HH'$, is then constructed that is parallel to $SB_1$ and tangent to $U_1$. The tangency occurs at $J$. The $HH'$ wealth line must remain parallel to $SB_1$ to keep the investor on the original indifference curve with the new price of $B$ to determine how the lower price of $B$, isolated from the wealth effect, causes the investor to increase her consumption of $B$. The substitution effect is the difference between the quantity of $B$ consumed at the initial equilibrium $E$, with quantity consumed at $J$. On the horizontal axis, the quantity $BB_j$ represents the increase in consumption associated with the substitution effect.

To consider the wealth effect, assume that the wealth line $HH'$ shifts to the right to coincide with $SB_1$. The vertical distance between $HH'$ and $SB$ represents the gain in real wealth attributable to the decline in the price per unit of bond funds. This rise in wealth alone is responsible for an increase in the purchase of $B$ by the amount of $B_1B_2$ because an increase in real wealth will induce the investor to expand consumption of all investments.

In the instant context, indifference curve analysis suggests that permitting plan fiduciaries to engage in socially responsible investing might actually place plan beneficiaries on higher indifference curves, thus maximizing their utility. Assume, for example, that pension plan participants can choose whether their plan fiduciary will engage in socially responsible investment. Consider Figure 6 below. The vertical axis measures the purely monetary investment return of the pension plan. The horizontal axis denotes the social responsibility of the various investment alternatives. Assume (although as noted above this is subject to factual dispute) that as the participant's return rises, investment is less socially responsible and vice-versa. That is, consider the fact that at the current wealth line $RS$, the participant will have a choice between a myriad of alternatives that are either very profitable and not very socially responsible,
not very profitable and very socially responsible, or some combination in between. Of course, the combination chosen depends on each participant's preferences relating to money and social responsibility, as shown by the indifference curves $U_1$, $U_2$, and $U_3$. In Figure 6, point E represents the participant's equilibrium (showing the most preferred combination of return and acceptance of the investment). Note that at point A the participant could earn a greater return by concerning herself less with being socially responsible, but she would then be on a lower indifference curve.

Posit now the situation suggested by Professors Langbein and Posner in which an advisor tells a participant she can earn an even greater return than she currently earns by investing in a manner that virtually ignores social responsibility. If the rate of return changes, the wealth line rotates about the horizontal intercept. Figure 7 shows RS as the wealth line with a 10% rate of return in both diagrams. If the rate of return rises to 15%, the wealth line shifts to $R'S$. The slope, now greater, shows that for every unit of social responsibility relinquished, the investment earns a higher return than before.

How this investor will respond is an interesting question. Professors Langbein and Posner implied that this scenario reflects reality. Invest in a socially responsible manner and the return falls accordingly, they contended. Assuming, arguendo, that they were right, how might a participant actually respond in this context? Is she really likely to seek the higher return while ignoring social consequences? Which path of action places her on a higher indifference curve?

Recall that an increase in the return rate has two effects: a wealth effect and a substitution effect. The wealth effect is a result of the fact that the higher rate of return raises the participant's wealth for any investment made. That is, at a higher rate of return it will lead the participant to consume more of all goods, including social responsibility. The substitution effect, on the other hand, encourages participants to seek a higher return when the possible rate of return rises because the relative cost of consuming social responsibility increases so the quantity consumed declines. In short, the participant will sacrifice more as her potential prospective return increases.

Because these two returns work in opposing directions, it is impossible to predict whether a participant will seek a higher rate of return in response to a change in the anticipated rate of return. If the wealth effect is greater than the substitution effect, then the degree of social responsibility consumed will increase, as illustrated in Figure 7(a). If the substitution effect predominates, then the participant will seek a higher return at the expense of being socially responsible, as illustrated in Figure 7(b). If the two effects exactly offset each other, then the participant's behavior will not change. Unlike Professors Posner and Langbein, we cannot assert that individuals necessarily will be better off only if they
choose investments which lead to a higher rate of return.\textsuperscript{208}

CONCLUSION

The wealth held in large pension plans in the United States is immense. Traditionally, courts and commentators have held that the fiduciary duty of pension fund managers is to maximize profits. This Article proposes a novel justification for the socially responsible investment of pension funds based upon traditional principles of charitable corporate giving and populism. As this Article asserts, the justifications employed by courts in the first half of the twentieth century to expand the doctrine of direct corporate benefit in the charitable corporate giving context provide a foundation for allowing socially responsible investing in the pension fund context. The Article concludes with an explanation of how beneficiaries may actually be better off if pension funds are allowed to invest in a socially responsible manner.

\textsuperscript{208} As an alternative to allowing pension fund fiduciaries to choose what investments are socially responsible, one might propose a broad, market-based reform permitting individual beneficiaries to control their pension fund investments. Pursuant to such a scenario, individuals might invest their defined contribution in a mutual fund of their choice, much like a 401(k) plan with a broad range of alternative investment vehicles. Under this system, the market would respond to shifts in the prevailing moral or ethical consensus and define plans which represent a broad scope of alternatives, permitting individual beneficiaries to invest according to their own perceived best interests. Individuals would choose how to invest their assets based upon their political or normative beliefs or choose to ignore noneconomic criteria and maximize their returns.

Whether sufficient demand exists for socially responsible pension vehicles is an empirical question the market would answer. Perhaps hundreds of different funds with different positive and negative social screens would emerge and provide pension beneficiaries with a wealth of choices, or perhaps only the existing thirty or so socially responsible mutual funds would attract a marginally higher percentage of the market. Education would certainly become an important part of the marketing in this newly created pension or mutual fund market. In any case, ethical issues would not limit individual workers' choices. This proposal suggests that individuals could employ whatever criteria they choose in investing their pension contributions.
Stock Mutual Funds

Bond Mutual Funds

Figure 1
Stock Mutual Funds

Figure 2
Figure 3
Stock Mutual Funds

Figure 4
Figure 5

Stock Mutual Funds
Figure 6
Monetary Return

Figure 7(a)
Figure 7(b)