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Governing for Genuine Profit

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Governing for Genuine Profit

Michael J. O'Hara*

ABSTRACT

Business corporations can have many purposes. The shareholder wealth maximization goal is the proper one for business. This maximization, however, must look to the long-term as well as the short-term. Terrorism is a major threat to the long-term stability, profitability, and even viability of business corporations. Because of a focus on the short-term to the exclusion of the long-term, businesses are likely to shirk their responsibilities related to terrorism and its causes. A paradigm-shift is necessary to bring business to accept their responsibilities and internalize their costs.

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I. INTRODUCTION

What is the purpose of a business corporation? Because there are many forms of business, that question can have many answers. It is axiomatic in law and economics that a for-profit business exists to maximize profit. For publicly traded firms, profit maximization is rephrased as maximizing shareholder wealth because the discounted

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present value of all future profit streams equals current shareholder wealth.

Narrowly defined, the goal of shareholder wealth maximization can generate business decisions that are fundamentally flawed. Both critics and corporate managers lament that corporate governance today is too focused on the next fiscal quarter rather than the long run.¹ An “efficient” market, when populated by day traders who own shares at neither the start of the day nor at the end of day, further compounds the tendency for myopic management.²

This Article will not challenge the shareholder wealth maximization goal. Instead, this Article will insist on it. All too often, the shareholder wealth maximization goal is praised in name and ignored in practice. The decisions of business corporations are decisions requiring tradeoffs. All tradeoffs are complex and tinged with uncertainty. Accordingly, the scope of governance discretion must be broad. In practice, rather than in theory, all too often the shareholder wealth maximization goal is ignored. Agents of the principal too narrowly define value streams (when it suits the agent’s preference), and both agents and the market misapply discounting to present values.

More fully defining the net that is the business’ profit and accurately applying the concept of discounted present value will orient a firm towards sustainability. That sustainable orientation fosters peace.

II. SEEKING PROFIT

Business corporations are legal persons.³ Business corporations exist because society wishes to encourage business investment. Society encourages shareholders to place their wealth at risk. The encouragement society offers is liability limited to that investment.⁴

1. See, e.g., Joseph McCafferty, *Cease the Day Trader*, CFO: THE MAG. FOR SENIOR FIN. EXECUTIVES, Aug. 1, 1999, at 13 (discussing a small-cap corporation’s frustration with, and efforts to thwart, day trader’s demands for short-term increases in the price of corporate stock). See also Natalia Williams, *Day Traders Watch Tiny Ups and Downs Shootings ‘Nothing to Do with Day-Trading’*, TORONTO STAR, July 30, 1999, News Section (“A trader might buy hundreds of shares of stocks, worth thousands of dollars, then sell them minutes later as the stock rises or falls, hoping to make a quick profit.”); Phillip Coggan et al., *Coca-Cola Snubs Myopia of Wall St.*, FIN. TIMES, Dec. 14, 2002, at 12.

2. See, e.g., McCafferty, *supra* note 1, at 13.

3. CHARLES R.T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 155 (3d ed. 1999) (“[I]n most respects a corporation will be granted the same legal rights and responsibilities as would any person.”). See also *Miles v. Dep’t of Treasury*, 199 N.E. 372, 374 (Ind. 1935) (“Corporations are treated as persons domiciled within the state.”); Paula J. Dalley, *To Whom It May Concern: Fiduciary Duties and Business Associations*, 26 DEL. J. CORP. L. 515, 523 (2001) (“The

Each natural person can tolerate only so much risk. Limited liability allows each investor to place at risk only that fraction of the investor's wealth that can be tolerated.⁵ Limited liability allows additional natural persons to invest and increases the total pool of wealth available for business formation. Business corporations exist to serve society and society bears the cost of limited liability. Corporations that foster sustainable peace serve society well, and those that defeat peace do not.

The corporation's Board of Directors and the Officers are fiduciaries.⁶ They are economic agents for a principal. Their primary fiduciary duty is to husband their shareholders' investment.⁷ The fiduciary duty is to pursue shareholder wealth maximization. The maximization to be pursued is long-run, not short-run, shareholder wealth maximization.⁸

Business corporations seek profit, which is total revenue minus total cost. That is, after subtracting cost, they maximize net revenue. More narrowly defined, the corporation maximizes net revenues that are internal to the corporation. Accounting tracks transactional values that go through the corporation.⁹ Corporations tend to ignore

archetypical legal person is, of course, the corporation.”).

4. O'KELLEY & THOMPSON, *supra* note 3, at 157 (the concept of limited liability “allows a shareholder to risk only a predetermined amount of capital in each . . . investment, instead of potentially risking her entire wealth”). *See also* DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 13-14 (2000) (stating that limited liability means that “stockholders need not pay [a corporation for which they own stock's] debt with their own assets”).

5. O'KELLEY & THOMPSON, *supra* note 3, at 157.

6. *Id.* at 259 (“[O]fficers and other corporate agents are subject to fiduciary duties.”).

7. Though for the purposes of this discussion, this is to be assumed, there is disagreement in the literature as to whether this is a truism. *Compare* O'KELLEY & THOMPSON, *supra* note 3, at 260 (“[D]irectors owe fiduciary duties to the corporation, not to individual shareholders.”), *with* NIGEL GRAHAM MAW ET AL., *MAW ON CORPORATE GOVERNANCE* 4 (1994) (stating that the directors owe, individually and collectively, duties to the shareholders), *and* DENNIS C. MUELLER, *THE MODERN CORPORATION: PROFITS, POWER, GROWTH AND PERFORMANCE* 86-87 (1986) (discussing relative merits of an approach where directors maximize stockholder value and other approaches).

8. For the purposes of this discussion, this is assumed to be what directors *should* do: commentators disagree generally about what motivates corporate directors' actions. *See, e.g.*, John C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 *COLUM. L. REV.* 1145, 1162-73 (1984) (discussing whether parties motivated to take over other corporations are seeking to provide better management for the corporation, allow for synergies between their current corporation and their prospective prey, or to pursue somewhat irrational growth strategies); MUELLER, *supra* note 7, at 44-46 (discussing different theories of motivation posited by economists for directors and bureaucrats).

9. CHARLES H. MEYER, *ACCOUNTING AND FINANCE FOR LAWYERS IN A NUTSHELL* 1 (1995) (“Financial accounting involves the process of recording transactions in the accounting records of a business and periodically [processing them] to produce a [corporation's] set of financial statements.”).

values that are not internalized by the corporation.¹⁰

Values not internalized by the market system are known as externalities or spillovers.¹¹ All market transactions involve spillovers of varying magnitudes and durability. A market failure is said to exist when a spillover's magnitude becomes so large, durable, or predictable that the spillover materially distorts the market's efficiency.¹² For example, education is subsidized because of substantial spillover benefits and pollution is regulated because of substantial spillover costs.¹³ The very existence of the firm is a tribute to market failures. The firm exists because the firm is able to assemble the transactions more efficiently than the market by internalizing otherwise external values.¹⁴

Profit is a net, but net of what? Governing boards and management must choose which spillovers (both costs and benefits) to internalize. They must make trade-offs. A creative executive compensation package is a bundle of values, both internal and external to the firm.¹⁵ The governing board should be no less creative in pursuing sustainable peace.

10. This results from the financial status of corporations being judged almost solely by an examination of their financial statements. Cf. STANLEY SIEGEL & DANIEL A. SIEGEL, ACCOUNTING AND FINANCIAL DISCLOSURE 3-4 (1983) ("Investors and creditors use [financial statements] to determine whether, and to what extent, to extend credit or refuse it, to invest or disinvest."). This phenomenon is in part caused by "bounded" rationality. "Bounded" rationality results from "the capacity of the human mind for formulating and solving complex problems [being] very small compared with the size of the problems whose solution is required for objectively rational behavior in the real world." OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 36 (1996) (quoting HERBERT SIMON, MODELS OF MAN 198 (1957)). Because investors only have a finite amount of time to process whether or not to make a particular decision, they have to use these financial statements as a proxy for a fuller, more personal understanding of the corporation's total value. See SIEGEL & SIEGEL, *supra*, at 4.

11. CARLTON & PERLOFF, *supra* note 4, at 82 ("An externality occurs when consumers or firms do not bear the full cost (benefit) from the harm (good) their actions do to others.").

12. *Id.* ("[D]istortions, or inefficiencies in production due to improper pricing [relative to social costs or benefits], are referred to as market failures.") (emphasis omitted).

13. See *id.* (regarding pollution). See also ROBERT S. PINDYCK & DANIEL L. RUBENFELD, MICROECONOMICS 678-80 (4th ed. 1998) (discussing education).

14. Economists state that because of transaction costs and strategic behavior, situational sub-optimality can result from parties not having a perceived harmony of interest. See generally PINDYCK & RUBENFELD, *supra* note 13, at 665-69. See also generally Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); DOUGLAS G. BAIRD, IN COASE'S FOOTSTEPS (U. Chi. Law & Econ., Working Paper No. 175, 2003), available at <http://papers.ssrn.com>.

15. See MUELLER, *supra* note 7, at 44 (discussing a number of conflicting motivations of directors that have to be both balanced and tamed by their firms).

III. BIASES OF BUSINESS

Business is biased towards revenue. Often, this bias is appropriate because a sustainable firm must capture value. Capturing cost tends to be far easier than capturing revenue.¹⁶ However, the true goal is wealth, not revenue.

Business is biased against cost. This anti-cost bias is greatest against internal costs. In fact, external costs are too often ignored or, worse, are the deliberate consequence of governance. A firm can create the false appearance of increasing profit by externalizing costs.¹⁷ Society, however, sees no profit. Such false profits defeat society's expectations when creating corporations.

Business corporations have another bias: Today is preferred over tomorrow. Managers of risk soon learn that the future is unpredictable and that a bird in the hand is worth more than one in the bush. The precise value of "now" is calculated using discounted present value.¹⁸ However, all too often, business distorts that calculation and, in effect, eats its seed corn.

Business focuses upon cash profit in the form of net revenue. That is, business focuses on out-of-pocket total revenue minus out-of-pocket total cost. This cash profit is only one measure of value and wealth. Cash profit fails to account for spillover costs and spillover benefits. Governing boards should govern with an eye on these spillovers, so the board can select the best set of trade-offs for maximization of the shareholders' wealth.

16. In order to fully maximize revenues, firms would have to charge each customer the maximum price that they would pay for a particular good. PINDYCK & RUBENFELD, *supra* note 13, at 377. States have worked to prevent such "price discrimination." See Robinson-Patman Act § 2(a), 15 U.S.C. § 13(a) (2002) (making most forms of price discrimination, or price difference, between purchasers of goods of like grade and quality illegal under Federal law). Conversely, states are relatively effective, through forcing firms to pay for externalities which they force upon society. See *supra* notes 11-13 and accompanying text.

17. There are a multitude of ways through which to disguise problems in revenues and liquidity of a firm though they are often perceptible to a close reader of a firm's balance sheet. See generally Sally L. Hoffman, *GAAP and the Basic Financial Statements*, in ACCOUNTING & FINANCE FOR LAWYERS 7 (Sally L. Hoffman & Michael Elliot-Jones eds., 1997).

18. Discounted present value is determined by the rate of return and the length of time the money is invested. PINDYCK & RUBENFELD, *supra* note 13, at 547-48. The discounted present value of \$1 paid after n years = $(\$1 / (1 + R)^n)$, where R = the interest rate and n = the number of years invested. *Id.* at 548.

Markets transactions are transactions between participants who are both willing and able to participate in a particular transaction.¹⁹ If a participant is either unwilling (e.g., theft) or is unable (e.g., poor) to participate, then the market neither sees nor registers that transaction.²⁰ Such involuntary transactions generate spillovers or externalities.²¹ Cash profits based on substantial spillovers are false profits.²²

At its essence, board oversight is prioritization in the long run.²³ Prioritization is choosing between options. This choosing requires the acceptance of trade offs. The realm of management is similar in that management also prioritizes and accepts trade-offs. However, the realm of management is the short-term while the realm of the board is the long-term.

The business bias against tomorrow is greatest in management. The board's governance should counteract this management bias. As certainty diminishes, the role of the board increases. Certainty is diminished by externalities that are difficult to quantify. Also, the magnitude of spillovers often is greatest in the future—the realm of board governance. Spillovers, especially when coupled with clumsy applications of discounted present value, can create a false perception of profit.²⁴ Accordingly, cash profit can be a gross misstatement of the firm's value generation. Because the board's governance duty is to maximize shareholder wealth, governance includes choosing which external values to internalize.

19. *Id.* at 20 (discussing basics of supply and demand).

20. *Id.*

21. Any shift in a demand curve away from the social optimum, if caused by an inefficiency, results in a "deadweight loss" to society as a whole. *See generally* CARLTON & PERLOFF, *supra* note 4, at 72. The exact valuation of the deadweight loss can be expressed in terms of the elasticities of supply and demand, and the size of the total involved market. *Id.* at 73 n.10.

22. That is, assuming that one was trying to factor in externalities and to prevent losses to the whole of society. *See supra* notes 9, 11-14, 21 and accompanying text.

23. *See generally* Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968) (discussing corporate director's role of providing judgment and prioritization for the corporation). Changes accompanying the development of the modern corporation, by "clearly remov[ing] the executives responsible for the destiny of the entire enterprise from routine operational activities . . . gave them the time, information, and even psychological commitment for long-term planning and appraisal." WILLIAMSON, *supra* note 10, at 82 (*quoting* ALFRED D. CHANDLER, JR., STRATEGY AND STRUCTURE 382-83 (1962)).

24. *See supra* note 12 and accompanying text (regarding externalities or spillovers); *supra* note 18 and accompanying text (discussing the economic concept of discounted present value).

IV. VALUE OF A DOLLAR TODAY

A dollar tomorrow is worth less than a dollar today. For example, when is \$1,000,000 tomorrow only worth \$1 today?²⁵ At a 20 percent interest rate \$1,000,000 in 70 years is worth but \$1 today; at 10 percent, it's 140 years; at 5 percent, it's 280 years.

The required rate of return reflects a variety of risks, including inflation and business failure.²⁶ Venture capitalists face some of the greatest risks and routinely strive for a rate of return equaling 100%. In effect, \$1,000,000 a mere 14 years in the future is only worth \$1 today. In stark contrast, the Iroquois²⁷ recommended management

25. The text will use rounded numbers. A quick calculation is based on the Rule of 70 and a rounded doubling. The Rule of 70 is an approximation of how many time periods are required to double (if earning interest) or to halve (if paying interest) a dollar value over time. In the Rule of 70, the number 70 is divided by the interest rate stated as an integer. For example, assume annual interest of 7% per year, then 70 divided by 7 yields 10 periods needed to halve or double a value. Next, note that if \$1 is doubled successively 20 times the result is \$1,048,576. Accordingly, the Rule of 70 and 20 doublings indicates that at 7% interest earned, \$1 now is worth approximately \$1,000,000 in 200 years.

The Rule of 70 is an approximation. The accuracy of the approximation depends on the level of the interest rate. The fields of biology and economics, which tend to focus on growth rates in the range between 3% and 5%, tend to use the Rule of 70. In contrast, the field of finance, which tends to focus on rate in the range between 6% and 8%, tend to use the Rule of 72. See generally CARLTON & PERLOFF, *supra* note 4. See also Inv. FAQ, *Analysis – Rule of 72* (Feb. 18, 1998), at <http://invest-faq.com/articles/analy-rule-72.html>.

26. A firm's rate of return is usually defined as a ratio of its profit (revenue minus operating cost, including capital depreciation), π , to the value of the capital stock, $p_K K$,

$$\text{ROR} = [pQ - wL - uK] / p_K K, \text{ where } w \text{ is the wage the firm pays to hire one unit of labor, } u \text{ is the user cost of capital (the cost of using or renting the capital for one period), } p_K \text{ is the purchase price of one unit of capital stock.}$$

Id. at 671. See also 14 WILLIAM MEADE FLETCHER ET AL., *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 6679.40 (perm. ed., rev. vol. 2002) (noting that one way of handling inflation is to adjust the rate of return to match rates available for similar investments.)

27. The Iroquois are a confederation of six Native American nations (not a "tribe"). The six are Mohawks, Oneidas, Onondagas, Cayugas, Senecas, and Tuscaroras. In the American Revolution, the confederacy split. Some supported the patriots, and others supported the British. They never really had an "empire" in the European sense of occupied territory. They had network of alliances. The U.S. system of government draws some inspiration from the Iroquois system. See generally DONALD A. GRINDE, JR. & BRUCE E. JOHANSEN, *EXEMPLAR OF LIBERTY: NATIVE AMERICA AND THE EVOLUTION OF DEMOCRACY* (1991). See also World History Newsletter, *New York* (Nov. 12, 2002), at http://www.worldhistory.com/newsletter17_newyork.htm.

decisions that would serve well the seventh generation.²⁸ Assuming, as Thomas Jefferson did,²⁹ that a generation is 19 years, then the Iroquois recommend management decisions that valued \$1,000,000 in 133 years as worth \$1 today (almost 7 percent). If one recognizes that, in the industrialized world of the 21st century, a generation may now be more like 30 years, then managing for the seventh generation would require a focus of 210 years (or about a 11 percent rate of return).

The key question is: "Will that \$1 be dedicated today for tomorrow's use?" If that \$1 is not dedicated today, then tomorrow most likely will be hard pressed to pay the piper.

V. OLD AND NEW: RISKS AND MANAGEMENT

Today, businesses are buffeted by the old risks of recession and the new risks of terrorism. These demands on business reduce the likelihood business will fund the needs of the future created by the decisions of today. The typical management of old risks focuses on minimizing costs located internally, in part at the cost of ignoring the magnitude of costs located externally.³⁰ This does not bode well for the future. New management of new risks needs to strive to avoid the tragedy of the commons as well as seek out more synchronicities.

The tragedy of the commons is an unintentional over-consumption of a shared resource.³¹ The tragedy of the commons results when many individual users each consume at an individual level that is far less than the sustainable level for the shared resource; however, the aggregation of these many individual uses exceeds the sustainable level.³² In the tragedy of the commons, the shared resource degrades and ultimately is destroyed.

28. The Iroquois believe that all important decisions (not just management) should be made with the seventh generation in mind. This is a way of saying that planning should be done in the interests of generations yet unborn, e.g., long-range. See generally BRUCE E. JOHANSEN, SHAPERS OF THE GREAT DEBATE ON NATIVE AMERICANS: LAND, SPIRIT, AND POWER (2000) (discussing a profile of Iroquois faithkeeper Oren Lyons).

29. HERBERT E. SLOAN, PRINCIPLE AND INTEREST 52 (1995).

30. "Because the maximization of wealth is the primordial economic incentive of the corporate body, it will have compelling incentives to externalize the full costs of production." Paul Stephen Dempsey, *Market Failure and Regulatory Failure as Catalysts for Political Change: The Choice Between Imperfect Regulation and Imperfect Competition*, 46 WASH. & LEE L. REV. 1, 18 (1989) (citing Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243, 1244-45 (1968)).

31. See generally DAVID P. BARASH & CHARLES P. WEBEL, PEACE AND CONFLICT STUDIES 463-64 (2002).

32. *Id.*

Peace reduces business risk and increases profit.³³ Thus, for business, peace is a shared resource. If business does not protect this shared resource, then the tragedy of the commons is the likely result. It is profitable for business to foster peace.

Synchronicity is the essence of business. Profit is a surplus extracted from transactions embedded in multiple, interrelated processes. Timing is critical to profit. The reason the firm exists is the firm better synchronizes some transactions than the market.³⁴ Timing also is critical to peace. Business needs to foster peace as one of the multiple, interrelated processes that generate the profit upon which businesses live.

Business management and board governance need to seek out, and prosper, via synchronicity. Management and governance focus on different processes and different synchronicities. Governance has more of an eye on the distant future, thus governance must anticipate more.³⁵ Governance fails when governance mimics the myopic focus of management. Governance needs a greater anticipation, especially focused on a search for externalities to internalize. Not all externalities should be internalized as part of governance's synchronicity.³⁶ The firm has a small span of control compared with the invisible hand. At its core, however, governance will find synchronicity means that it is profitable for one to be one's brother's keeper.³⁷

How can increasing internal costs be profitable? That is easy to answer. The alternative is far more costly.³⁸ If modern society is to survive, then the seeds of terrorism and their fruit of tremendous loss must be contained.

33. *Id.* at 41 (explaining that military spending has high economic costs. Although military spending does create jobs, comparable spending in the civilian economy creates even more jobs while often addressing critical social needs).

34. "To minimize the cost of transaction failures, business organizations have developed institutional arrangements, which involve a reduction in reliance on the market, to organize production to solve the opportunistic problems associated with market transactions." Henry N. Butler & Barry D. Baysinger, *Vertical Restraints on Trade as Contractual Integration: A Synthesis of Relational Contracting Theory, Transaction-Cost Economics, and Organization Theory*, 32 EMORY L.J. 1009, 1028 (1983) (discussing the advantages of vertical corporate structures over pure market transactions).

35. A.A. Sommer, Jr., *Whom Should the Corporation Serve?: The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 53 (1991).

36. "The objective is still generally shareholder wealth maximization, but tempered by an objective of good corporate citizenship." Janis Sarra, *Corporate Governance in Global Capital Markets, Canadian and International Developments*, 76 TUL. L. REV. 1691, 1709 (2002) (discussing communitarian theory and corporate decision-making).

37. *Id.* at 1709-11.

38. *Id.* at 1709-12.

VI. RISK CAN NOT BE ZERO

Risk can not be zero. This is well understood by managers and boards alike. Also well understood is that the firm can not be all things to all people; the firm must focus on its core competencies.³⁹ Risk—in the context of terrorism—threatens the very existence of the firm, especially its long-term existence. Governance duties necessarily include addressing such a large risk beyond the time focus of management.

Because risk can not be eliminated, containment is the maximum feasible success.⁴⁰ Unfortunately, from the perspective of business success, contained terrorism might be an utter failure. The maximum feasible consequences of terrorism can extinguish the current world order of global capitalism. Many international firms would be forced to shatter and disintegrate if world markets did not exist.⁴¹ As in the case of any organism deprived of its habitat, extinction would soon follow.

Each organism has a limited ability both to bear and to spread losses. A firm or a market can tolerate a one-time loss of some limited magnitude.⁴² Beyond that limit, the firm can not bend, it breaks. Also, just because the firm can absorb the one-time loss, that alone does not mean the firm can survive. In addition to absorbing the one-time loss, the firm must be able to spread the cost across its customer base without making its products too expensive for the customer base.⁴³ It is true that global firms are more resilient than Mom-and-Pop stores, but each has its limits. The maximum feasible consequences of terrorism can exceed even a global firm's ability to bear and spread losses.

The risk that terrorism presents to society and to business is great and is shared. Because the risk of terrorism is great, because it is shared, because it lurks in the future beyond the realm of

39. See generally *id.*

40. "The goal should be to minimize the effects of terrorism, since it can never be completely eliminated." William H. Boger, *International Cooperation in the Prevention and Suppression of Terrorism*, 80 AM. SOC'Y OF INT'L L. PROC. 386, 404 (1986).

41. Joseph J. Norton, "International Finance Law," *An Increasingly Important Component of "International Economic Law": A Tribute to Professor John H. Jackson*, 20 MICH. J. INT'L L. 133, 144 (1999) (discussing the importance of stable financial structures in emerging markets).

42. Joseph L. Motes, III, *A Primer on the Trade and Regulation of Derivative Instruments*, 49 SMU L. REV. 579, 603-04 (1996) (discussing the potential for international market instability or collapse upon the failure or withdrawal of a single major market participant).

43. Daniel A. Barfield, *Better to Give Than to Receive: Should Non-Profit Corporations and Charities Pay Punitive Damages?*, 29 VAL. U. L. REV. 1193, 1216 n.128 (1995) (discussing the ability and limitations of corporations to pass one-time expenses, such as large punitive damage judgments, to consumers).

management and in the realm of governance, there is an increase in the risk of the tragedy of the commons. The probability that business will shirk responsibility is greater. Firms, their boards, and their managers are likely to claim it is not their duty and it is not profitable for them to be their brother's keepers. Nothing could be farther from the truth.

VII. SEEDS AND FRUIT

The seeds of terrorism are in our human condition. Terrorism as a military and as a political tool is fostered by a few conditions.⁴⁴ Terrorism is an attractive military and political tool because it is highly leveraged.⁴⁵ Businesses can appreciate the magnification of market presence and force via leveraging. Leveraging empowers a terrorist to use relatively few resources to cause great losses.⁴⁶ Terrorism is attractive when there is a minimal price of life, in the eyes of the terrorist, both for the terrorist and the enemy.⁴⁷ Life appears less valuable when global capitalism spawns grinding poverty juxtaposed with abundance, when illiteracy and oppression are the norm, and especially when ideological intensity (e.g., perversion of religion) washes over the suffering masses.⁴⁸ These conditions are fertile for the seeds of terrorism. Add to this volatile mixture the chronic temptation of humans to listen to the lesser angels of our nature, and business should expect sustained losses attributable to terrorism. The seeds of terrorism will bear the bitter fruit of substantial losses in place of hoped for profits.⁴⁹

44. CINDY C. COMBS, *TERRORISM IN THE TWENTY-FIRST CENTURY* 8 (1997) (defining terrorism as "a synthesis of war and theater, a dramatization of the most proscribed kind of violence—that which is perpetuated on innocent victims—played before an audience in the hope of creating a mood of fear, for political purposes").

45. George F. Will, *When a Nation's Virtues Draw the Anger of the Weak*, WASH. POST, Sept. 13, 2001, at A1.

46. *Id.*

47. See COMBS, *supra* note 44, at 9 (providing that more people die in car accidents every year in the United States than as a result of acts of terrorism). See Martha Crenshaw, *How Terrorists Think: What Psychology Can Contribute to Understanding Terrorism*, in *TERRORISM: ROOTS, IMPACT, RESPONSES* 70, 73 (Lawrence Howard ed., 1992) (noting that terrorism is economical because it requires little in the way of manpower).

48. Lawrence Howard, *Introduction*, in *TERRORISM: ROOTS, IMPACT, RESPONSES*, *supra* note 47, at 1, 7 (citing as causes of terrorism the presence of unresolved political conflicts and the growing economic hopelessness and political frustration of vast numbers of people, particularly in third-world countries).

49. B.S. Raghaven, *Costs of Terror*, HINDU BUS. LINE (July 22, 2002), available at <http://blonnet.com>.

The fruits of tremendous loss, primarily, are "technological." By technological, it is meant the losses primarily alter the feasible combination of inputs.⁵⁰ The losses of terrorism, primarily, are not the assets lost, but rather are the losses in subsequent output.⁵¹ The losses can be minor or major.

Minor losses would include specific physical assets and (as crass as it may sound) specific human casualties.⁵² The loss of any specific asset is minor, regardless of how many specific assets are lost.⁵³ These losses do not become major merely when many buildings are destroyed or when many people are killed. As humbling as it may be, individual assets and individual humans rarely are critical to total output.

Losses become major when the losses exceed the firm's, the market's, or the society's ability to bear or to spread the loss.⁵⁴ Major losses exist when there are network effects or adverse shifts in the social psychological paradigms.⁵⁵

Often it is said that the whole is greater than the sum of the parts. This is an example of a network effect. Synchronicity generates the network effect. A well-targeted attack generates a negative network effect because a well-targeted attack is leveraged. A well-targeted attack removes a critical input and thus reduces the usefulness of many other inputs.⁵⁶ Without electricity, how useful is a computer? Without a surgeon, how useful is an operating room?

50. *Id.*

51. See, e.g., Sam Zuckerman, *Crisis of Confidence; Individual Actions Could Determine Whether the Economy Strengthens or Weakens*, SAN FRAN. CHRON., Sept. 16, 2001, at E1 (as attention shifts from day to day activity and focuses more on news centered on terrorism, output wanes).

52. Eleanor Wainstein & Susanna W. Purnell, *Effects of Terrorism on Business Operations*, in *MANAGING TERRORISM* 125 (Patrick J. Montana & George S. Roukis eds., 1983).

53. The difference in definitions between minor loss and major loss is rather slight; minor losses could, in fact, constitute a major loss, if, in the aggregate, the loss led to conditions defining the major loss. See generally Wainstein & Purnell, *supra* note 52.

54. Assume for argument that when losses become too large for the firm to absorb or to spread, the losses are defined as major. Thus, when minor losses become too large for a firm to bear or spread, the losses become major losses. See *id.* at 125.

55. See Zuckerman, *supra* note 51.

56. This must be so, by definition, of a critical input; any input critical to production, once removed, effectively cripples production, rendering all other inputs less useful. James R. Ratner, *Should There Be An Essential Facility Doctrine?*, 21 U.C. DAVIS L. REV. 327, 345-46 (1988) (discussing what constitutes an essential input and its effect upon the firm). See also generally SUN TZU, *THE ART OF WAR* (James Clavell ed., 1983).

Network effects can be restored via substitution of inputs if the humans are willing to work.⁵⁷ Accordingly, an adverse shift in social psychological paradigms is a far greater loss than harm to network effects.⁵⁸ The social matrix is necessary for any asset to be productive. If the social matrix collapses, then all assets produce less.⁵⁹

Humans innately fear the unknown. If terrorism can generate mass uncertainty, then terrorism can extinguish trust. Without trust, the social matrix collapses and firms can not earn a profit because their own workers will avoid the firm and the market will be empty.⁶⁰ If terrorists can replace optimism with fatalism, or if terrorists can replace trust with fear, then a major loss is suffered.

VIII. PARADIGM OF GENUINE PROFIT

Businesses face new risks to the firm and to the market. These risks are indigenous to the very social fabric within which business acts. If these risks are not managed, then the existence of the market that sustains the firm and the firm itself are in question. Management of these risks is far from a trivial matter. This management task exceeds the resources and influence of any one government, any collection of governments, or collection of non-governmental organizations. Businesses must contribute to the management of these new risks. For managing these risks, businesses often are better equipped than most, if not all, governments and non-governmental organizations, with advantageous social engagement with the local milieu, resources on site, and market intelligence.

Accordingly, governing boards must propel businesses towards a paradigm of genuine profit. The days of a myopic focus on cash profit are over. It is a governance duty of a corporate board to take ownership of the project to create the shift towards a paradigm of genuine profit.⁶¹ The focus of management, appropriately, is on the

57. WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS* 162 (7th ed. 1998). The authors note that in the event of loss of a given input, substitution of one input for another can be achieved by an increase in the substituting input—here, labor.

58. Phillip A. Karber & R. William Mengel, *Political and Economic Forces Affecting Terrorism*, in *MANAGING TERRORISM*, *supra* note 52, at 35.

59. Wainstein & Purnell, *supra* note 52, at 126-27, 129-30 (describing a situation wherein personnel replacements are made in response to terrorist threats, requiring on-the-job training resulting in a temporary loss of productivity, as well as technical support and maintenance lags also resulting in loss of productivity).

60. *See id.* at 129-30.

61. *See* MUELLER, *supra* note 7, at 44-46; *see also* FRANCIS A. GEVURTZ, *CORPORATION LAW* 273-78 (2000); MAW ET AL., *supra* note 7, at 4, 10-15 (discussing the positive duties of corporate directors).

short-run. Genuine profit requires long-run planning and actions that are not in the realm of management.⁶²

The shift to a paradigm of genuine profit is needed, but may be irrelevant. A paradigm shift that is too small, too infrequent, or too late will not manage the risks of terrorism.⁶³ The scale, scope, and timing of this paradigm shift must be sufficient to alter experiences and expectations on the ground.⁶⁴ Anything less will leave so many seeds of terrorism that the likely harvest will exceed businesses' ability to bear and spread the losses.

Is it foolhardy to expect a sufficient shift towards genuine profit? No. The conference hosted by the William Davidson Institute offers hope. That conference helps belie predictions that the speed of diffusion of terrorist technology will render irrelevant the transformation of corporate governance. We can reasonably hope for a better world when change agents are alert and in motion.

The governing boards, however, must do the heavy lifting. Governing boards must insist that their firms prospect for positive feedback loops and implement a sustainable profit stream. This is not a radical proposal, because it is the stuff of business to generate surplus from well-managed synchronicities.⁶⁵ All business opportunities require prospecting. What must be avoided is a false sense of success from merely grabbing low hanging fruit versus planting and tending the vineyard.⁶⁶ Patient and thoughtful husbandry by governing boards will be needed.

Governing boards must challenge their management teams to search for feedback loops that reinforce and foster peace in addition to capturing cash profit. Every feedback loop is an expansive source of causality.⁶⁷ The resonance of causality can be positive or negative in

62. See McCafferty, *supra* note 1, at 13; MUELLER, *supra* note 7, at 44-46.

63. See Joseph A. Malley, *Preparing and Protecting Property and Personnel Prior to a Terrorist Attack*, in *MANAGING TERRORISM*, *supra* note 52, at 73-90 ("The main objective of this . . . program is to . . . prevent or deter acts of aggression . . . reduce losses . . . when an incident occurs, and expedite return to normalcy or recovery following a terrorist attack.").

64. *Id.* See also Wainstein & Purnell, *supra* note 52, at 128-33 (discussing the effects of terrorism on employees).

65. CARLTON & PERLOFF, *supra* note 4, at 11-13 (discussing the purpose of firms).

66. See Lawrence Lindsey, 28 *BUS. ECON.* 15, 18 (1993) (essentially advocating patience to see results).

67. Feedback loops, by definition, modify the processes of which they are a part; thus, they must be a significant source of causality, producing varied effects in their parent production systems. James B. Zimarowski et al., *An Institutional Perspective on Law and Economics (Chicago Style) in the Context of United States Labor Law*, 35 *ARIZ. L. REV.* 397, 435 (1993) (discussing positive and negative feedback loops).

consequence.⁶⁸ Positive feedback loops, such as those that nurture freedom, offer synchronicities with the core competency of business—generating profit by serving the will of the consumers.⁶⁹ Likewise, negative feedback loops, such as those that nurture terrorism, need to be dampened or the future of business will be bleak.⁷⁰

A corporate focus on genuine profit fosters positive feedback loops and dampens negative feedback loops.⁷¹ A shortsighted pursuit of an episodic profit stream often is falsely profitable.⁷² The shortsighted pursuit of an up-front and non-sustainable profit stream is, however, consistent with the biases of business towards revenue, away from cost, and for today over tomorrow.⁷³ Mere extraction from a market depletes the market and wastes valuable relationship assets established by the corporation.⁷⁴ In contrast, sustainable profit streams are genuinely profitable. A corporate engagement that sees and captures a multitude of value streams—not merely the cash profit value stream—fosters positive feedback loops with the local market and builds sustainable profit streams.⁷⁵ The profitability of the firm increases and, at the same time, peace is reinforced and enhanced by sustainability.

IX. RECOMMENDATION

In short, governing boards must insist that their firm be entrepreneurial. All entrepreneurs engage in risk management as their primary task. When managing risk, an entrepreneur fails to act ethically if focused solely on legal liability, especially when a corporation's owners are shielded from legal liability by limited

68. See DAVID P. BARASH & CHARLES P. WEBEL, *PEACE AND CONFLICT STUDIES* 82, 427-28 (2002)

69. See *id.*

70. *Id.* at 263-65 (quoting St. Augustine, "War is waged so that peace may prevail. . . . But it is a greater glory to slay war with a word than people with a sword, and to gain peace by means of peace and not by means of war.").

71. Dana Roithmayr, *Barriers to Entry: A Market Lock-in Model of Discrimination*, 86 VA. L. REV. 727, 732-33 (2000) (discussing the link between positive feedback loops and corporate market dominance).

72. See Joseph Klesney, *The Moral Trappings of the Short Term Fix* (May 10, 2001), at <http://www.acton.org> ("The impulse to target the short term in response to both gainful and disappointing events in the market can cause headaches for managers in the long run. Expediency is not always the best policy.").

73. *Id.*

74. See CARLTON & PERLOFF, *supra* note 4, at 78-79 (discussing market exit).

75. IRA M. MILLSTEIN ET AL., *CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS* 72 (1998) (advocating the use of long-run value streams, including research investment, employee training, and consideration of public perception of a corporation and societal benefits, and warning against under estimating the value of such streams).

liability. Governing boards should more fully define their firms' responsibility.

Legal and ethical risk management call for intelligence of design and operation. That intelligence is partly measured by the quantity and quality of the outputs relative to the firm's inputs as well as the firm's cherished values. A firm that internalizes externalities based on manageable synchronicities, and thus reaps a sustainable profit stream, manifests such intelligence of design and operation. Such a firm also maximizes shareholder wealth. If governing boards do otherwise, and continue to maximize shareholder wealth based on the knowledge of the price of everything and the value of nothing, then we will all share in the tragedy of our common loss of first, peace, and second, our entire way of life.