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Welfare, Dialectic, and Mediation in Corporate Law

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INTRODUCTION

Bill Klein extends an idealistic and progressive invitation with the *Criteria for Good Laws of Business Association*[1] (the Criteria). The structure of our debates, he says, prevents us from joining the issue. The discourse will move forward if we can isolate core components on which we agree and disagree. The invitation, thus directed, is well-constructed. To facilitate engagement, each criterion is set out as *pari passu* with each other. And there is a good reason for the inclusion of each listed criterion. Each has an established place in public and private law jurisprudence. Each has influenced results, coming forth as salient in one or another area of law, in one or another regulation or case. We can, then, agree in the abstract to take each criterion seriously. Klein bids us then to cull, modify, and restate, so as to identify more clearly the goals we hold out for corporate law. The remainder of this essay takes up that invitation, taking our debates to the Criteria, taking the Criteria to our debates, and taking both to the law itself. It suggests that the criteria on which we can agree lie at a higher level of generality than the Criteria: corporate law makes us all welfare consequentialists[2] who agree that good corporate law is about encouraging productivity. We differ over the means to that end in debates that have over time evolved away from the ideological and toward the functional. Absent an *ex ante* set of empirically verifiable formulas for productive business organization, we are left to our debates.

Part I offers a contrasting conceptual framework—a list of ongoing, unresolved debates and their principal components. Part II goes on to identify two core and generally accepted objectives in the corporate law we have inherited—freedom of action for management and the minimization of the cost of capital. Part III evaluates the two theoretical paradigms that dominated corporate law during the 20th century, the trust paradigm of Berle and Means and the contractarian paradigm of law and economics, showing that each in turn lost salience due to a failure to adhere strictly to the core objectives thus identified. Part IV considers the firm's legal boundaries, showing that they too follow from the core objectives and that their adherence to those objectives

1. 2 BERKELEY BUS. L.J. 13 (2005).

2. At least in the tight confines of corporate law discussions. In the context of our debates, a morally motivated case for, say, constituent rights will be accompanied by a fully developed consequential case. A given discussant's grounding of a case in economic welfare does not necessarily imply a philosophical attachment to consequentialism.

triggers resistance to theoretical calls for social responsibility and constituent empowerment. Part V turns to the terms of the shareholder-manager agency relation, a subject matter implicating tensions between the dual purposes of freedom of action for management and the minimization of the cost of capital. Corporate law mediates these tensions with open-ended terms and piecemeal resolutions. Although theorists have offered meta-level means to resolve the tensions, the practice has never responded by endorsing these theories.

I. CATEGORIES OF DEBATE

The Criteria come forth as a series of independent normative assertions. They do not interact, interrogating one another. Such an interactive process would trigger debates with predictable patterns. Four such patterns are described below, each comprised of binary opposite positions. Multiple conceptual overlaps spill across the four categories; political, methodological, and doctrinal affinities vary from debate to debate. Thus might a given discussant gravitate to a right-side position in one debate and a left-side position in another debate. But one constant perspective unifies one side of the binaries in all four categories: mainstream law and economics writers are likely to gravitate to the right side in every discussion.

Category (1): Debates about the appropriate scope of regulation and the degree of reliance accorded private ordering in solving problems. Three binaries describe positions taken in these debates:

Public v. private

Mandatory v. enabling

Federal v. state

The public/private contrast concerns the characterization of the problem, public denoting a wide range of affected interests and subject matter appropriate for regulation and private denoting a narrow range of interests limited to a class of voluntary participants. The mandatory/enabling contrast goes to the mode of regulatory response, with mandates constraining choices of actors in firms and enabling responses leaving them the option of framing their own regulations. The federal/state binary references the historic pattern of regulatory allocation. Under an informal federalism norm, federal law addresses trading markets, adding disclosure, antifraud, and insider trading mandates in pursuit of a stated public interest. All other corporate subject matters concern internal affairs and presumptively are left to the states. The states, constrained by the charter competition system, privilege private ordering and enabling solutions. But, because the federal-state regulatory allocation is not set constitutionally, the presumption favoring state control periodically yields to new federal regulation, triggering ongoing debate.

Category (2): Debates about the objectives of regulation and normative *priorities*. Five binaries capture the tenor of these debates:

Trust v. contract

Fairness v. efficiency

Substance v. process

Protection of expectations v. dynamism

State enforcement v. reputational enforcement

Positions described by these binaries amount to more particular expressions of the concepts motivating the first category of debates: a public characterization and a willingness to motivate the left-side binaries, while a private characterization and a preference for private ordering solutions motivate those on the right side. The left side implants the concept of trust at the legal firm's core. It asserts that corporate law empowers managers without imposing the requisite degree of responsibility. It follows that corporate law should impose substantive duties of fair dealing to protect the expectations of the firm's disempowered actors. Private ordering being inadequate to achieve these purposes, state enforcement is necessary. Arguments from the right side use the concept of contract to impel the legal firm toward the end of permitting more efficient dispositions of assets in a dynamic economic environment. A preference for reputational enforcement follows. For some it also follows that fiduciary law should be subject to reversal by private ordering. And, where fiduciary interventions do occur, process solutions that remit decision to actors within the firm are preferred to direct review of management action.

Category (3): Debates about the boundaries of the firm and the firm's responsibility to outsiders. Here a single binary captures the matters at stake:

Outsiders (other constituents) v. insiders (shareholders and managers)

The outsiders appear on a standard list of corporate constituents excluded from corporate fiduciary protection and remitted to self-protection through contract—employees, creditors, suppliers, customers, and communities. Debates over this hard result touch on a range of subject matters, including limited liability, takeover defense, employee rights, and financial contract interpretation. Discussants draw on the concepts described in categories (1) and (2), ranging public values, fairness, and protection of expectations against private ordering, contract, and dynamism.

Category (4): Debates about the terms of the corporate agency relationship and the allocation of authority within the firm. Here three binaries suggest themselves:

Entity v. agency

Management discretion v. shareholder choice

Managerialism v. shareholder value

These debates follow from a theoretical ambiguity at the base of corporate doctrine. In the classical doctrinal conception, the corporation is an entity and the powers of the board of directors are original and undelegated. Even as the shareholders elect the board, they are not accorded the rights of principals in an agency relationship. Unfortunately for the goal of doctrinal coherence, corporate law also frequently lapses into an agency characterization, the lapses being much encouraged by the economic theory of agency. The ambiguity in the legal model opens the way for an ongoing contest over the line dividing management and shareholder authority within the firm, a contest centered on topics like shareholder access, proxy regulation, and takeover defense.

Summary. The dialectic presentation implies that the debates do not resolve, with meta-political preferences and unverified notions about productive incentive alignments determining arguments made and conclusions drawn. But dialectic can lead to synthesis, if not in the abstract, then in history. Indeed, legal doctrine synthesizes dialectically opposed positions in practice. Famous cases achieve high-profile status for the very reason that binary opposites from theoretical debates come to play on their facts. Courts work through the dialectic tensions in situation-specific ways, making no attempt at general theoretical resolution. The process is similar, although more highly politicized, when a proposed regulation of the Securities and Exchange Commission works its way through the notice and comment process. Restating, the law mediates theoretical disputes in specific situations.

II. DOCTRINAL CONTEXT: THE PURPOSES OF CORPORATE LAW

If it is synthesis that interests us, then we need to look at practice as well as theory. Concepts competing in our dialectical debates have operated in history so as to determine regulatory results, bequeathing a context. Now, a regulatory framework cannot by virtue of its own existence establish its own legitimacy (or goodness). It takes a theory to do that. Nor does competitive evolution in history guarantee a single, first-best contextual outcome. Comparative corporate governance teaches us that ours is only one of many possible legal frameworks within which actors can competitively produce a widget or construct and operate a communications network.[3] Nor, finally, can it be asserted that the context controls. The normative enterprise is theoretical, and at a theoretical level everything remains contestable even if the doctrinal context tends toward stasis.

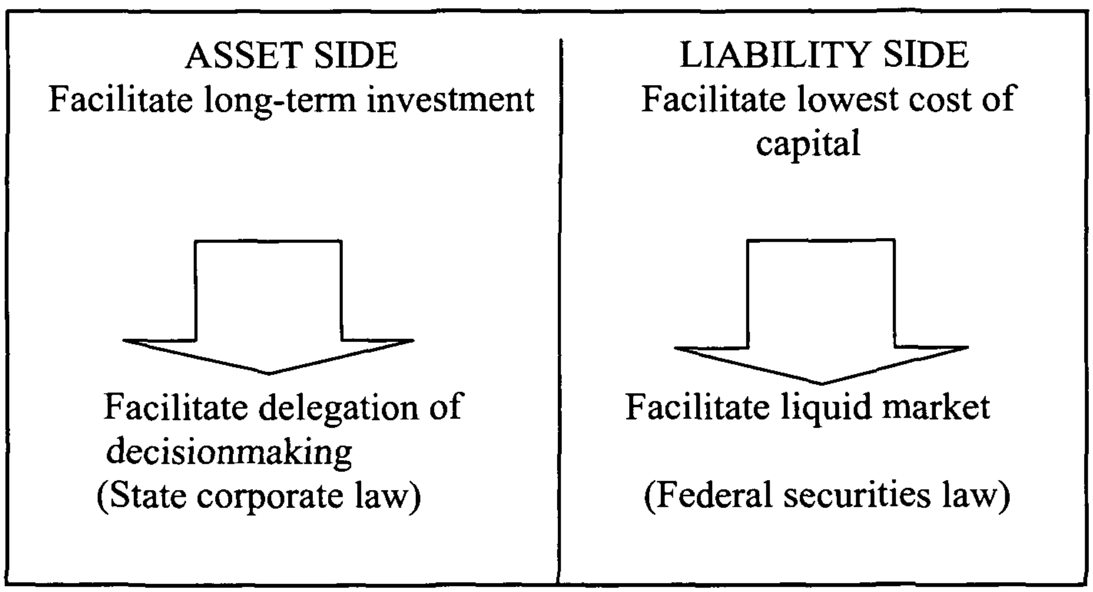
But the context does provide a framework for taking stock of our categories of debate and for sorting the Criteria. Some of the debates go directly to

3. *See, e.g.*, Marco Becht et al., *Corporate Governance and Control* 58 (ECGI Finance Working Paper No. 02, 2002), *available at* http://ssrn.com/abstract=343461 ("It is not possible to conclude on the basis of economic analysis alone that there is a unique set of optimal rules that are universally applicable to all corporations and economies, just as there is no single political constitution that is universally best for all nations.").

cutting-edge doctrinal issues; others proceed despite settled doctrinal results, challenging the context. Similarly, some Criteria prove salient and determine results. Others matter less. Some matter not at all. If we were to accept all of the Criteria in theory, the sorting process would teach us how good or bad corporate law is. Contrariwise, to the extent we accept a doctrinal result that traverses a criterion, we eliminate it from the list. In the alterative, we may just disagree about the fit between the Criteria and the context, returning to our dialectical debates.

Turning to the context, a bottom line purpose of corporate law can be identified readily. The purpose is economic: drawing on the usual formulation, corporate law seeks to maximize the wealth generated by firms. That usual formulation might be relaxed in recognition of the fact that no one really knows when wealth has been maximized: corporate law should facilitate the attempt to maximize the value of the firm. A narrower formulation favored by many—maximizing shareholder value—is deliberately avoided here. The shareholder value maximization norm follows from a particular theory of the optimal incentive alignment within the firm, a concept contestable in theory.[4] That theory, while influential in practice, has never been determinative.

The general purpose of wealth maximization can be broken down into two primary components, each of which implies a corollary.



4. Reference is made to theoretical models addressing optimal arrangements for sharing and transferring control between debt and equity interests. *See, e.g.*, Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992); Mathias Dewatripont & Jean Tirole, *A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence*, 109 Q.J. ECON. 1027 (1994). *See also* Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got There, What Are the Problems, and How to Fix Them* 15 (ECGI Finance Working Paper No. 44, 2004), *available at* http://ssrn.com/abstract=561305 ("[C]onsistent with 'stakeholder theory' value-maximizing firms will be concerned about relations with all their constituencies. A firm cannot maximize value if it ignores the interest of its stakeholders.").

One set can be situated on the left side of the balance sheet, and the other on the right side. On the left side, it is corporate law's job to encourage long-term investment and the risk-taking implicated therein. That purpose implies a corollary—facilitation of a delegation of decision-making authority from the providers of capital to the expert managers who deploy it. (The corollary extends over to the right side of the balance sheet to include substantial management discretion over financing.) On the right side, it is corporate law's job to facilitate investment in producing assets at the lowest possible cost of capital. A corollary again is implied: the law should secure the presence of liquid trading markets in corporate securities. With the objectives in place, corporate law articulates means to the ends. The evaluative framework is functional and consequential, so the word "effective" may better describe the emerging criteria than does the term "good."

This sounds like an attempt at high theory: abstract criteria placed on the table to compete with Klein's. And, in fact, at this level of generality, I would predict widespread theoretical concurrence. Even so, the present exercise is descriptive and the subject matter is the doctrine. State corporate law emerged in its present form in New Jersey between 1888 and 1896, taking shape as an enabling regime that accorded management a zone of freedom of action respecting assets and finance. The means to the end was mandated management agenda control over investment and financing decisions, the terms of the corporate contract, and corporate combinations. The framework changed little during the twentieth century. Subsequent innovation occurred primarily at the federal level, centering on the federal securities laws. There the purpose was the assurance of liquidity, an essential means to the end of the lowest possible cost of capital in a system characterized by widespread holding of securities.

III. THE SCOPE AND NORMATIVE CONTENT OF REGULATION

Now let us check for the fit between the corporate law purposes just identified and the dialectics described in debate categories (1) and (2). To highlight the fit, this section traces the evolution of corporate legal theory. Two theoretical paradigms dominated corporate law in the mid- to late-20th century, succeeding one another in time. The first, a trust paradigm, received articulation in 1932 by Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property*. It was eclipsed around 1980 by a market paradigm that originated in economics during the 1960s and 1970s. By now, both have lost salience. In both cases the loss results from failure to adhere to corporate law's bottom-line objectives.

Let us look first at Berle and Means. Enabling corporate law, they said, had facilitated the appearance and success of the large, mass-producing, management-controlled corporation. This had been a reactive rather than a purposive development—a change that followed from underlying economic facts. But the law thereby had become implicated in the creation and perpetuation of an unsatisfactory separation of ownership and control. The big corporations of the 20th century had split the classical entrepreneurial function between salaried executives, who sat atop hierarchical organizations, and anonymous equity participants, who held small stakes and prized market liquidity over participation. This presented problems of competence and responsibility absent in an ideal, classical capitalist world inhabited by self-employed individual producers. In the classical model, market competition effectively controlled the producers, constraining both the incompetent and the greedy and legitimating private economic power. But corporate mass production on a large capital base broke those parameters, with firms taking on significant attributes and powers, social as well as economic. Industrial oligarchs exercised unified control over the wealth under their charge, and the law played a role in investing the power.[5] Therefore, said Berle and Means, corporate property should no longer be deemed private property.[6] That assertion in turn supported a presumption favoring new regulation.

Berle and Means recommended no pervasive system of government oversight, however. Instead they focused on the problem of management self-dealing in an enabling context. Corporate insiders were writing their own contracts, with immunity clauses and waivers of shareholder rights allowing much diversion of corporate profit to managers' pockets.[7] The law, said Berle and Means, would do a better job if it were rewritten to follow basic principles of trust law. More particularly, there should be a pervasive equitable limitation on powers granted to corporate management (or any other group within the corporation) by the enabling system: power should be exercisable only for the ratable benefit of all the shareholders.[8] Berle and Means had in mind an overarching standard that would constrain the enabling system *ex post*: no language in a corporate charter could deny or defeat the fundamental equitable control of the court.[9] Meanwhile, enforcement of the equitable limitation safely could be remitted to the state judiciary. In Berle and Means' view, charter competition impacted only statutes, leaving the common law of fiduciary duties as the one area of corporate law remaining robust: "[f]lexible and realistic" judges, "if untrammeled by statute," could be expected to find solutions to problems that demanded a remedy.[10]

While Berle and Means limited the trust paradigm's class of beneficiaries to

5. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4, 131 (Transaction Publishers 1991) (1932).

6. *Id.* at 219.

7. *Id.* at 128, 220, 312.

8. *Id.* at 220.

9. *Id.* at 242.

10. *Id.* at 197, 295.

the corporation's shareholders, many of their paradigm's subsequent proponents expanded the zone of beneficiary to debate category (3) to include other corporate constituents and the public interest. The "public" characterization in *The Modern Corporation and Private Property* invited the extension. So did the book's emphasis on managerial power: to mid-20th century anti-managerialists, power implied responsibility and, given the separation of ownership and control, responsibility needed to be imposed in law.[11]

Events did not unfold in accordance with the Berle and Means description, however. The "public" characterization never made the theory-practice transition and the courts stubbornly refrained from casting themselves in the role of management controllers. Fiduciary duty was in any event too narrow a framework in which to integrate corporate law and management power into the wider social and political context. Eventually, events overtook the trust paradigm. By the 1970s, new views emerged about the best means to the generally accepted end of creating wealth. A sense of national competitive failure combined with a loss of faith in regulatory solutions to undermine the trust paradigm.

Market displaced trust. The market paradigm rebutted both the trust paradigm's description of separated ownership and control and its call for regulation. This economic perspective recast the firm as an incident of contracting among rational economic actors. The firm became a series of contracts joining inputs to outputs, with equity capital as one of the inputs and corporate law as a part of the input's governing contract.[12] The imperfections identified under the trust paradigm reemerged under the denomination "agency costs," costs that firms must minimize due to the free market's competitive force. Managers were no longer seen as empowered actors and responsibility was no longer seen as a problem. When managers failed, they got removed—either a hostile offeror took over the company and threw them out,[13] the firm with a high agency-cost base failed to survive in the product market, or poor managers failed to survive in the management labor market. Their incentives accordingly were focused on long-run productive success for the firm. Given these market deterrents, corporate property again became private, the regulatory agenda went blank, and a powerful presumption arose against new intervention.[14]

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11. *See* RALPH NADER ET AL., TAMING THE GIANT CORPORATION 1, 7 (1976); *see also* Robert A. Dahl, *Governing the Giant Corporation*, *in* CORPORATE POWER IN AMERICA 2 (Ralph Nader & Mark Green eds., 1972).

12. *See* Michael Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 310 (1976).

13. This point originated in Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

14. William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U.

The market paradigm presented an ideological mirror image to the trust paradigm and accordingly suited deregulatory policy agendas. Indeed, that fit alone should have carried it to unquestioned and continued ascendancy in corporate law discussions. But it instead ran into an unanticipated public choice problem when the enabling system transformed itself in the process of dealing with hostile takeovers. Historically, corporate control always had been contestable in the trading market. But, prior to the 1980s such contests as occurred did not fundamentally challenge management empowerment. Low stock market valuations changed that. Corporate law responded by interposing frictions that substantially diminished the takeover threat and preserved freedom of action for management. This undermined the market paradigm's positive story, which relied on market contracting to import incentive compatibility to the agency relationship.

The market paradigm also failed to synchronize with corporate law at a normative level. Corporate law seeks to create wealth and looks at freedom of contract only as a means to the end. The market paradigm's proponents stressed individual freedom and contract as ends in themselves. But corporate law is not a place were a commitment to individual freedom causes a zone of right to be identified and protected for its own sake. Nor does corporate law's facilitation of exchange imply something approaching the economic ideal of property rights in a zöne of free contract. Corporate law routinely suppresses alternative contractual arrangements in order to secure its left- and right-side objectives. The states' "enabling" codes build on a pair of core mandates. The delegation of power to management is mandatory (the exception in Delaware General Corporation Law 141(a) being irrelevant to the governance of large firms), as is management agenda control respecting the terms of the corporate contract. Ultimate, albeit indirect, shareholder control also is mandated: one class of shares must retain full voting rights. It also should be noted that corporate law evolves in an ongoing process of identifying and correcting perceived contract failures, again toward the end of clearing the field for management freedom of action and market liquidity. State anti-takeover law performs the former function. The federal corporate law regime performs the latter function, protecting liquidity by requiring management truth-telling.

If there was an era in which free contract came close to describing corporate law, it was the 1920s, after New Jersey stripped most of the mandates from its corporate code in the late-19th century and before Congress enacted the federal securities laws. But the meaning of free contract in corporate contexts was evolving even in the 1920s away from the Victorian preference for individual choice toward a more facilitative, majoritarian regime. Simply, deal-

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L. REV. 180, 186-90 (1992).

making by insiders trumped freedom of contract.[15] With the exception of a brief period around twenty years ago, when contractarianism was hotly debated in corporate legal theory, no one has ever thought that the shareholder-manager relationship could satisfactorily be dealt with in the legal framework of a Victorian dicker over Dobbin, least of all the Victorians themselves.

The "nexus of contracts" corporation, then, never worked as description. The contractarians' descriptive claims instead served as talking points in a wider normative campaign against regulatory innovation, particularly in fiduciary law. That anti-regulatory campaign retains vitality, pursuing the dual goals of management freedom of action as against regulators and shareholder choice as against management. Interestingly, the campaign now proceeds on both fronts as a rearguard action. A quarter century of contractarian reinforcement of the primacy of state law toward the end of protecting management freedom from regulation made no difference when a Congress frightened by voter disgust with corporate scandals enacted the Sarbanes-Oxley Act. The battle over shareholder choice was lost during the 1980s, when anti-takeover regulation chilled the market for corporate control. Although state law never accords management freedom of action an absolute trump over shareholder choice and mediates between the two, the underlay of charter competition weights the mediation so as to render it relatively impervious to the stronger normative claims of the contractarians and their economic theory of agency.

No overarching meta-theory has succeeded the trust and market paradigms to dominate thinking in the field. Even as welfare consequentialism prevails, today no master set of instructions drives theoretical discussions about the means to the end. Today's theorists tend to think in terms of incentive compatibility and to confront incentive problems piecemeal. Management self-dealing reemerges as a serious problem. The trust paradigm's stress on fiduciary instructions persists as a result. And its separation of ownership and control remains in the operative description, no longer absolutely determinative but still salient. The market paradigm's deregulatory presumption retains force, although fewer and fewer observers look to spontaneous order to solve agency problems. The nexus of contracts slowly recedes. But it will never disappear because contract remains what it always has been: a significant component of corporate arrangements. Meanwhile, hierarchy has returned to legal descriptions of the firm. Economics remains the dominant interdisciplinary referent, but the methodological menu is expanding. As ever, financial results

15. The development of the law of corporate reorganization followed similar lines. Before the Bankruptcy Act of 1934, the federal courts' equity receivership maintained formal fidelity to individual choice even as it sought in practice to facilitate recapitalizations on a cram-down basis. It took Congressional intervention during the Depression to surmount the conceptual barrier and mandate a majoritarian reorganization regime.

in history are the primary determinants. Meanwhile, debates retain a dialectic quality, focused on the binaries in debate category (4).

IV. THE BOUNDARIES OF THE FIRM AND LEGITIMACY

The Criteria seek to touch all the bases, emerging as an exhaustive catalog of normative possibilities. In so doing they sweep in precepts suggesting that good laws for business associations should follow from and synchronize with precepts prevailing in the wider system of public and private law. They do this as they perform their primary job of establishing, encasing, and regulating business organizations. Thus do fairness, redistribution, and protection of the weak (I(C), (E), and (F)) vie with cost reduction (IV), and corporate power and legitimacy in society (III) show up as concerns coequal with wealth creation (II).

Corporate doctrine, however, is for the most part impervious to legitimacy concerns. Corporate law does not attempt to confer legitimacy, even as it does bestow limited liability. The incorporating states and their regime of general incorporation long ago surrendered substantive review of the business project in order to clear the field for action. Legitimacy is left to management to garner or lose depending on how well it does its job, and the performance criterion is financial. This ongoing process operates firm by firm and across firms as a whole. State corporate law facilitates the process without determining the result. It wants managers to succeed and so empowers them. But it anticipates failure when it requires at least one class of shareholders to retain the vote.[16] Financial failure also tends to prompt additional securities regulation. The venue is the securities regime rather than state law for three reasons. First, failure registers most clearly in stock prices; secondly, financially embarrassed managers have a tendency to fall out of compliance with the mandatory disclosure regime; and, thirdly, charter competition tends to keep the states out of the enforcement business. Contrariwise, the political clout of managers waxes during strong stock markets, facilitating access to Congress and state legislatures for beneficial regulation (or deregulation).

Real-world success and failure thus matter a great deal in corporate law, defining legitimacy. But legitimacy in the higher sense of responsible empowerment matters little. A negative proof is offered. If legitimacy mattered, corporate law would find some plausible way to assign responsibility for corporate externalities. Consider in this regard the law of piercing the veil, which holds out the possibility of assigning responsibility for tortious externalities to the firm's shareholders. These rules make perfect sense when viewed from the point of view of classical doctrinal theory. Limited liability

16. Losers in a given firm get a backstop of sorts from the federal bankruptcy regime. But, across bankrupt firms as a whole, the trend over time has been less forgiving.

comes with entity status, and can be lost if the shareholders fail to respect the entity's legal earmarks: if the firm is run as an "agent or instrumentality" of its shareholders rather than as a separate entity, the shareholders' limited liability can be lost. Yet, viewing the matter from the point of view of economic substance, agency is what the enterprise is all about. There results a license to externalize maintainable by rote observance of formalities. The result is indefensible as a matter of economic theory, and questionable under a long list of Criteria: avoidance of harshness (I(B)), redistribution (I(E)), protection of the weak (I(F)), allocation of loss to the proper person (I(G)), evenhandedness (I(I)), legitimation of management's role and exercise of power (III(E)), and abuse of power (III(F)). Yet the core purposes of capital-raising and freedom of action are much enhanced.

If legitimacy mattered, corporate law would not draw a bright line between insiders and outsiders, disavowing all responsibility for the latter. It would find ways to bring disempowered constituents into the tent. Its refusal so to do dates back at least to *Dodge v. Ford Motor Co.*[17] Such exceptions as have opened up serve the end of enhancing management's freedom of action rather than the end of integrating corporate governance into the wider social settlement embodied in regulation. Thus do the *ALI Principles of Corporate Governance* describe the firm's objective with the hedged phrase "with a view to enhancing corporate profit and shareholder gain."[18] The hedge permits management to effect distributions within the firm, relaxing the shareholder value norm at the shareholders' expense without imposing duties of social responsibility. The same goes for the corporate charity permission and the admission of constituent interest in takeover defense contexts. The exceptions implicate redistribution (I(E)) and protection of the weak (I(F)), but only on a spillover basis.

Corporate law's cavalier infliction of tortious externalities and insistence on contract as the means of engagement by outsiders are tolerated only because outside regulation makes significant adjustments to ameliorate unacceptable results. Labor, environmental, and consumer protection regulation all serve this end, not to mention the antitrust laws and the Internal Revenue Code. Their common purpose is to contain the discretion vested in managers by corporate law. This outside regulation makes the world safe for the corporate law delegation and thereby makes firms and corporate law legitimate by indirection. This inside/outside settlement dates back to the early-20th century, survived the Depression intact, and today seems more stable than ever.

Still, the system is fully defensible in theory only on the assumption that the backstop regulations adequately protect the public interest. The assumption

17. 170 N.W. 668 (Mich. 1919).

18. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 2.01 (1994).

remains highly contestable, causing the same to follow for corporate law's investiture of power to go forth to injure and exploit. It follows that observers who seek to integrate corporate law within models of democratic society are never satisfied with the inside/outside settlement. Each generation renews the category (3) debates concerning constituents and responsibility in the teeth of the stable doctrinal settlement. The critics draw liberally on the Criteria. They would avoid harshness (I(B)), promote fairness (I(C)), protect constituent expectations (I(D)), redistribute wealth away from managers and shareholders (I(E)), protect the weak (I(F)), promote evenhandedness (I(I)), insist on full disclosure of the social consequences of corporate acts (I(J)), and promote public involvement in business (III(C)), all toward the end of legitimizing management power (III(E)).

This awkward system can be defended, and the Criteria bear on the case. Caveat emptor (II(G)) looms large: if one is a constituent who does not enjoy the special protection of one of the supplemental regulatory regimes, caveat emptor is all corporate law holds out. Reference to the enforcement of private bargains (I(A)) is more problematic. It is true that wealth transfers from employees and senior security holders to managers and shareholders are defended in contractual terms. But to look at the jurisprudence is to see results obtained through formalistic interpretation of the bargains' contents. Interpretation proceeds with no thought of avoiding harshness (I(B)), being fair (I(C)), being evenhanded (I(I)), protecting the weak (I(F)), or, in some cases, even effectuating the parties' expectations. Formalism prevails, making winners of the empowered and losers of the powerless. The jurisprudence smirks in its complicity. In corporate law, winning has its privileges and optimality is always Kaldor-Hicks.

The best that can be said is that coherence is enhanced. The constituents learn that they need to go somewhere other than corporate law for assistance. Corporate law remains uncluttered with complex instructions that might inhibit freedom of action or have unintended effects, triggering uncertainty (II(F)). Corporate actors can rely on the division of regulatory function (I(D), IV(D)), and things go much more smoothly and cheaply (IV(B) and (C)). There is a legitimacy point too. The widespread acceptance of corporate law's lack of evenhandedness does not really follow from deeply held contractarian beliefs and free market partisanship. We value the end, not the means, and the end is economic opportunity. Corporate law's consequential appeal to wealth creation registers positively in the polity at some deep level. The median voter accepts a system that aggressively divides us into winners and losers so long as it identifies with the winners, or at least holds out a hope for a place for her children in the winner's circle.

All of this suffices to put the burden of persuasion on the critics, who have never managed to produce an alternative model that surmounts coherence objections and resonates in the context of our social settlement. They seem always to end up in an awkward alliance of convenience with management apologists, taking Dodd's side in the Berle-Dodd debate of 1932.[19] In that famous encounter, two progressives differed on the question as to how society should deal with management power. Dodd had us modeling managers as statesmen, appealing to their better instincts. Unfortunately for Dodd's case, managers have not hewn to the statesmanlike path. Berle made an agency argument: managers had to be controlled somehow and imposed fidelity to the shareholder interest was the best means to the end. The next part takes up that case.

V. AGENCY

Agency is corporate legal theory's flashpoint topic. The doctrine itself triggers the debate by simultaneously dispensing the two organizational models: entity, which privileges management empowerment; and agency, which suggests shareholder-centered controls on management discretion. To isolate the points of tension, return to the left side/right side picture of corporate law's objectives.

On the left side of the balance sheet, corporate law mandates delegation and invests management with discretion, letting success or failure emerge in practice. It then makes a second mandate, remitting the vote for the board of directors to the shareholders, expecting the vote's aggressive exercise in case of failure. But the shareholder collective action problem makes the dual dispensation problematic. Two great points of conflict arise. One goes to shareholder access and the proxy solicitation process. The other concerns the hostile takeover. The entity characterization and the end of encouraging risk-taking and long-term investment suggest that existing barriers to shareholder intervention well serve the end of wealth creation. The agency characterization, with its corollaries of principal control and shareholder choice, suggest that a stronger threat of removal and shareholder legislative intervention would improve operating results.

Turning to the right side of the balance sheet, corporate law protects liquidity, facilitating exit as the primary shareholder defense against adverse selection problems. Management proponents focus on this, suggesting that the old Wall Street Rule still suffices to protect the shareholder interest (and simultaneously questioning the intensity of federal regulations designed to keep the exit door open). But corporate law also seeks to reduce the cost of capital on the right side, even as it accords management discretion over financing

19. *See* Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

decisions. This objective again raises the takeover question, with shareholder choice advocates pointing to the cost of equity capital to counter the left-side claim of perverse effects on investment incentives made by management's defenders. Right-side questions come up about other terms of the agency relation as well. Opportunistic managers can self-deal at the expense of the marginal interest holder, causing the cost of equity capital to rise. To the extent that the law can intervene to control such conduct cost-effectively, it arguably should do so, even though the intervention entails review of management decisions and constrains freedom of action. Here we enter the territory of the duty of loyalty and the ongoing and always contested job of drawing the territorial line between business judgment and transactional scrutiny.

Resolutions of disputes over the terms of the agency comprise the core territory of the corporate law mediation. We have mediation rather than solutions because both sides tell plausible stories about wealth impacts. Apparent but unverified welfare gains and perverse incentives crop up everywhere in this vicinity—the negative effects of management entrenchment vie with those of the short-term focus of institutional shareholders; the deadweight costs of management pocket-lining vie with those implicated by systems of enforcement; and the beneficial financial effects of equal returns for equally situated shareholders vie with the negative effects of constraints on transactional freedom. We have no empirical means to determine correct, across-the-board outcomes for disputes such as these. But, under the deregulatory presumption bequeathed by the contractarians, the theoretical burden of persuasion lies with those arguing for regulatory innovation.

Contemporary trends in the practice follow suit. Under the deregulatory presumption, the focus devolves on governance processes, with heavy reliance being placed on the institution of the board of directors. Self-regulatory strategies prevail, their plausibility bolstered by the appearance of activist institutional investors. We see this in the proliferation of voluntary codes of good practice and accompanying hortatory discussions among governance experts. We also see it in Delaware fiduciary law, which relies ever more heavily on internal processes to solve conflict of interest problems. At the same time, high-profile compliance failures by unsuccessful managers have prompted politicians to embed self-regulatory governance agenda items in the federal mandatory disclosure system. The overall result is anything but deregulatory, feeding our dialectical debates.

The Criteria echo the dialectic. As we fill in the inevitable omitted terms in the agency relationship, we could reference the Criteria to restrain ourselves, emphasizing the enforcement of private bargains (I(A)) and freedom of action (I(H)), and resolving doubts against regulatory innovation by protecting expectations in announced governmental policies (I(D)). Alternatively, we could enforce the traditional regime of fiduciary prohibition, guided by fairness

(I(C)), the avoidance of harshness (I(B)), protection of the weak (I(F)), and evenhandedness (I(I)). Continuing this back and forth, we could turn to self-regulation, maximizing self-enforcement (IV(B)) and limiting the cost of government operation (IV(A)). But if we do that to excess, we end up relying more and more on the gatekeepers—outside directors, auditors, and counsel—increasing private compliance costs (IV(C)). In addition, in a dynamic environment, self-regulation under judicial supervision tends to lead to unstable case law, as seen in Delaware in recent decades. This traverses the notion that we should not change the rules (II(F), IV(D)). In the present environment, the only criterion bearing on agency that I would predict would garner universal endorsement is full disclosure (I(J)). And even as to that, a mandatory/enabling dispute would break out soon enough.

CONCLUSION

We will not know what good corporate law is until we have a verifiable, generally accepted template for a productive governance. Meanwhile, we debate our opinions on the matter, opinions highly sensitive to results in real world firms. Caution prevails, favoring the inherited legal context.