THE COMPLEXITY AND LEGITIMACY OF CORPORATE LAW

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> The nature of man is intricate; the objects of society are of the greatest possible complexity; and therefore no simple disposition or direction of power can be suitable, either to man's nature, or the quality of his affairs.[1]

> I like complexity and contradiction. . . . I speak of a complex and contradictory architecture based on the richness and ambiguity of modern experience. . . .
> . . . By embracing contradiction as well as complexity, I aim for vitality as well as validity.[2]

A central question when considering "new directions in corporate law" is the degree to which the study of corporate law continues to take account of the complexity of its subject. Certain contemporary academic trends are, on the contrary, leading to a simplification of vision and understanding when movement in precisely the opposite direction is needed. In particular, the influence of economic theories of the firm, and translations of these theories into a slogan that defines "the corporation" as merely "a nexus of contracts," threaten to extend a reductionist mode of thinking to areas of corporate law where such models are often not only unhelpful, but destructive. Instead, building a "nonreductionist" model that allows for the complexity of corporate law is essential.[3]

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1. EDMUND BURKE, REFLECTIONS ON THE REVOLUTION IN FRANCE 74 (Anchor Books 1973) (1790).

2. ROBERT VENTURI, COMPLEXITY AND CONTRADICTION IN ARCHITECTURE 16 (2d ed. 1977).

3. *Cf.* Steven D. Smith, *Reductionism in Legal Thought*, 91 COLUM. L. REV. 68, 68, 86-91 (1991) (describing "law's functional multiplicity, as well as the jurisprudential implications of that multiplicity" in terms of three models or "accounts" of law—dispute resolution,

In this Article, I suggest in Part I that recent attempts to define or formulate a unified theory of "the corporation" fail to account for the complexity of corporate law. Following H.L.A. Hart, I argue that it is a mistake to begin theoretical thinking about corporate law with the question, "What is a corporation?" This approach is fraught with analytical difficulty and leads easily to error because of the temptation to impose an initial theory or definition of "the corporation" on a multifaceted corpus of law.

Part II considers positive corporate law in terms of its technical complexity. It attempts to answer the large but manageable question, "What is corporate law about?" In Part II, I review descriptive theories of mandatory, suppletory, and enabling rules in corporate law and provide an overview of some of the basic substantive law. I conclude that corporate law is primarily about the structuring of economic power of businesses that "incorporate" (that is, register under state corporate codes) to secure such advantages as convenience, financial flexibility, and limited liability. I conclude also that the legal meaning and scope of the term "corporation" depends inextricably on the kind of question being asked, and different legal questions yield different answers in different contexts.

Part III then considers the normative complexity implicit in corporate law. I argue that one cannot reduce the subject of corporate law to one normative value, such as an economic objective. Instead, other values inaccessible to a purely economic measure, such as following the law and ethical behavior, remain important. Moreover, the economic objective of corporate law is not unidimensional, but divided within itself. Corporate law involves the simultaneous pursuit and coexistence of a number of ends or purposes, with the mix and predominance of different values depending on particular legal contexts.

Finally, Part IV offers a theory of corporate law to combat simplistic models that have become influential. This theory provides a realistic and workable alternative that takes account of the complexity in corporate law. By "complexity," I do not mean the theory itself is complicated or corporate law is too complicated to understand.[4] Instead, I argue that corporate law

coordination, and meliorative/social justice and order—and arguing in favor of a "nonreductionist alternative" that includes all three). Following this approach responds to Alan Wolfe's admonition: "A system of legal rules ought to recognize the world that it regulates. If the world is complex, the legal rules should be complex." Alan Wolfe, *The Modern Corporation: Private Agent or Public Actor?*, 50 WASH. & LEE L. REV. 1673, 1696 (1993).

4. As discussed in the text, I am concerned here primarily with two kinds of complexity in corporate law: the technical or descriptive complexity of positive corporate law, and the normative complexity that informs corporate law. In addition, what might be called "situational complexity" describes the circumstances facing managers of many large businesses. This kind of complexity is a type of "social complexity" discussed by social scientists. *See, e.g.*, Harlan Wilson, *Complexity as a Theoretical Problem*, *in* ORGANIZED SOCIAL COMPLEXITY: CHALLENGE TO POLITICS AND POLICY 281, 282 & n.2 (Todd R. LaPorte ed., 1975) (distinguishing at least five types of structural complexity: institutional, situational, analytical, ecological, and technological). Herbert Simon, for example, describes the situational complexity faced by decision-

is complex because it embodies a set of conflicting normative principles. I argue further that the normative complexity of corporate law explains, at least in part, its technical complexity. This view supplies a strong theoretical underpinning for corporate law as long as its rules and principles, and their application, meet basic conditions of legal and political legitimacy. And the legitimacy of corporate law, I argue finally, does not require choosing between either an exclusively "economic" or an exclusively "political" model. Corporate law retains legitimacy to the extent that it continues to be created and maintained through sound processes of law-making and law-applying. The technical and normative complexity of corporate law is legitimate, in other words, in accordance with the quality of the deliberative procedures of democratic government and judicial administration.

I. THE POVERTY OF LEGAL THEORIES OF THE CORPORATION

Currently, prevalent theoretical approaches to thinking about corporate law begin with its ostensible subject, namely, "the corporation." These approaches begin with the question, "What is the corporation?" Responses vary. Without pausing to discuss the different approaches in detail, some theorists answer that the corporation is a legal fiction. Others claim the corporation is created only by a "concession" of rights to a business "entity" by the political state.[5] Still others respond that the concession

makers in terms of "bounded rationality":

> The bounded rationality of humans does not allow us to grasp the complex situations that provide the environments for our actions in their entirety. The first step in rational action is to focus attention on specific (strategic) aspects of the total situation, and to form a model of the situation in terms of those aspects that lie in that focus of attention. Rational computation takes place in the context of this model, rather than in the response to the whole external reality.

Herbert A. Simon, *Organizations and Markets*, 5 J. ECON. PERSP. 25, 37 (1991); *see also* DANILO ZOLO, DEMOCRACY AND COMPLEXITY: A REALIST APPROACH 2-3 (David McKie trans., 1992) (describing complexity as "the cognitive situation in which agents, whether they are individuals or social groups, find themselves. The relations which agents construct and project on their environment in their attempts at self-orientation—i.e., at arrangement, planning, manipulation—will be more or less complex according to circumstances.") I refer to this kind of complexity below, *infra* notes 119-20, 128-29 and accompanying text, and Part III.A.2, in connection with the difficulty of making business judgments about short-term and long-term strategies and tradeoffs.

Although situational and other types of social complexity may lead to certain kinds of policy recommendations with respect to the substance of corporate law, and thus may serve as an additional normative value implicit in corporate law in certain contexts, I avoid confronting here many sorts of social complexity. For an introduction to the complexity of the idea of social complexity, see Herbert A. Simon, *The Architecture of Complexity*, 106 PROC. AM. PHIL. SOC'Y 467 (1962). In addition, I do not use the term complexity to refer to the emerging "science" of complexity or complexity theory, although these ideas may have some application to thinking about corporate law. For an introduction, see M. MITCHELL WALDROP, COMPLEXITY: THE EMERGING SCIENCE AT THE EDGE OF ORDER AND CHAOS (1992).

5. Contemporary commentators largely discount the concession theory for its failure to account for economic reality. *See, e.g.*, ROBERT HESSEN, IN DEFENSE OF THE CORPORATION 2-

theory does not comport with modern economic reality. Instead, they advance a "nexus of contracts" theory of the corporation, arguing that the corporation is merely the aggregate of the many contractual relationships of which it is composed.[6] From the contractarian perspective, the important issue for corporate law becomes how to hold corporate "agents," namely, directors and managers, accountable to their "principals," namely, shareholders and debtholders.[7] Another approach emphasizes a trust law analogy, with directors and managers cast as "trustees" for shareholder "beneficiaries."[8] Alternatively, a different type of contractarian theory adopts a broad definition of relevant interests of the corporate "constituency." The important issue for corporate law then becomes how to make corporate trustees, again the directors and managers, take into account the interests

22 (1979); William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 434-36 (1989). However, the concession theory of the corporation apparently remains persuasive to some, for example, the United States Supreme Court. *See, e.g.*, CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987) (quoting with approval Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819)) (corporation as "mere creature of law"); *cf.* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 188 (1991) ("The Anglo-American corporate form is a creation of the state, conceived originally as a privilege to be conferred on specified entities for the public good and welfare.").

6. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976) ("Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. . . . It is important to recognize that most organizations are simply *legal fictions which serve as a nexus for a set of contracting relationships among individuals*") (footnotes omitted). A number of legal commentators have adopted variations on this theme. A leading example is Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989):

> The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy.

Id. at 1418; *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991):

> [W]e often speak of the corporation as a "nexus of contracts" or a set of implicit and explicit contracts. This reference, too, is shorthand for the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves. The form of reference is a reminder that the corporation is a voluntary adventure, and that we must always examine the terms on which real people have agreed to participate.

Id. at 12.

7. Jensen and Meckling adopt this perspective in their original formulation. Jensen & Meckling, *supra* note 6, at 308-10, 312-13, 327-29, 333-34, 357. For a critical description of this approach, see Bratton, *supra* note 5, at 417-19. For comprehensive application of the basic principles of this perspective, taking account of the complexities involved in the contemporary context of institutional investors, see Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

8. *See, e.g.*, *In re* USACafes L.P. Litig., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,056, at 90,322, 90,325 (Del. Ch. June 7, 1991) ("corporate directors, even though not strictly trustees, were early on regarded as fiduciaries for corporate stockholders").

of their beneficiaries, which may include both shareholders and other groups, such as the corporation's employees.[9]

Although many different theories of the corporation are advanced, all seem to suffer from beginning with a general theory of the corporation. An important recent example is the fashionable idea of viewing the corporation as a "nexus of contracts." Although it remains persuasive for some, leading legal scholars discredit the theory.[10] Dean Robert Clark demonstrates that a corporation cannot be considered a nexus of actual legal contracts, and metaphorical thinking about "implicit or standardized" contracts is "troublesome" and "treacherous."[11] Along similar lines, other scholars point out that contractarian theories of the corporation fail to account for many "mandatory rules" of corporate law.[12] These theories also fail to account for the important role that courts must play in enforcing contracts allowed by "enabling rules," not to mention the role of state legislatures.[13] Further, Clark and others dispose of the theory that one can properly consider managers and directors of a corporation as legal "agents" of shareholders. This influential theory, originating in theories of finance, is incorrect as a matter of positive corporate law.[14]

9. *See, e.g.*, David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45 (1991).

10. *See, e.g.*, Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Robert C. Clark, *Agency Costs versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55-79 (John W. Pratt & Richard J. Zeckhauser eds., 1985); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449 (1989).

11. Clark, *supra* note 10, at 59-71; *see also* Jean Braucher, *Contract versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697, 698 (1990) (noting that "difficulty is presented by the fact that contractarian theorists to some extent use the idea of contract metaphorically").

12. *See, e.g.*, Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporation Law*, 89 COLUM. L. REV. 1549 (1989). *But see, e.g.*, Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1599-1602, 1616 (1989) (arguing that many "mandatory" rules may be avoided, although admitting that some mandatory rules are desirable "when externalities are present").

13. *See, e.g.*, John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989).

14. In Clark's words,

> A review of elementary corporate law shows that [the] power of the principal to direct the activities of the agent does not apply to the stockholders as against the directors or officers of their corporation. By statute in every state, the board of directors of a corporation has the power and duty to manage or supervise its business. The stockholders do not. To appreciate the point fully, consider the following activities: setting the ultimate goal of the corporation—for example, whether its legal purpose will be to maximize profits; choosing the corporation's line of business—for

In short, a survey of competing theories of "the corporation" leaves one to conclude that none has survived intact.[15] It is worth inquiring whether this failure of theory is not endemic to its topic.[16] Given the general failure of attempts to construct a unified theory of the corporation, I do not propose to start with any particular theory of the corporation. Perhaps it is wiser to step back from the fray and reconsider whether such a theory is helpful or even possible.

In this connection, it is useful to dust off a neglected but important article by H.L.A. Hart.[17] In his inaugural lecture, *Definition and Theory*

> example, whether it will engage in retailing general merchandise or refining oil; hiring and firing the full-time executives who will actually run the company; and exercising supervisory power with respect to the day-to-day operations of the business. Stockholders of a large scale corporation *do not* do these things; as a matter of efficient operation of a large firm with numerous residual claimants they *should not* do them; and under the typical corporate statute and case law they *cannot* do them.

Clark, *supra* note 10, at 56-57; *see also* Brudney, *supra* note 10, at 1428-30.

Strictly economic theories of agency may be distinguished, however, and then applied as a matter of policy in enacting or interpreting positive corporate law. *See, e.g.*, Black, *Agents Watching Agents*, *supra* note 7; Black, *Shareholder Passivity Reexamied*, *supra* note 7.

15. I do not propose to prove this conclusion in detail here. For a critique of leading corporate legal theories, see Gerald E. Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1276, 1305-77 (1984). Professor Frug usefully distinguishes among (1) "formalist" models that involve "agency" and "trustee" theories, (2) "expertise" models that involve reliance on professional corporate management, (3) "judicial review" models that rely on the power of courts to oversee corporate actions and decisionmaking, and (4) "market" or "pluralist" models that rely on either "the discipline of the market" or "demands of the political process" to control the growth and power of corporate bureaucracies. *Id.* Unfortunately, after rejecting all of these models, Frug adopts the impossible view that corporate bureaucracies represent a "form of human domination" that must be wholly overthrown and replaced. *Id.* at 1277-78. Following Max Weber and other authorities that Frug cites, but whose arguments he then ignores, I would argue instead that large corporations, and the bureaucracies they often entail, are "realities of a modern, complex society." *See id.* at 1280 & n.13. Given the productive capacities of "scale and scope" of large enterprises, not to mention the social power they represent, large corporate enterprises are here to stay. *See, e.g.*, ALFRED D. CHANDLER, SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM 1-46 (1990) (describing the rise of modern industrial enterprise and the economic efficiencies involved). The relevant question then becomes how best to deal with them legally and as a matter of public policy. For further discussion, *see infra* Part III.A.3.

Nevertheless, Frug's analysis of corporate legal theory deserves to be taken more seriously than it has been. With Dean Clark, I would argue that the truth lies in a complex combination of the various theories outlined and criticized by Frug. *See* Frug, *supra*, at 1377 n.356 ("Robert Clark's forthcoming corporate law treatise is premised on the assertion that corporate law can be made coherent through some combination of all four models. . . ."); *see also* ROBERT C. CLARK, CORPORATE LAW 32 (1986) ("if presented and understood properly, the numerous topics dealt with in corporate law courses can be seen to form a surprisingly unified and coherent whole").

16. Although I quickly dismiss many theories of the corporation (including "aggregate" theories, "entity" theories, "realist" theories, and others) without extended treatment, I hope it will become apparent in the discussion below why, as an analytical matter, theories are likely to fail when they begin with the question, "What is the corporation?"

17. H.L.A. HART, *Definition and Theory in Jurisprudence*, *in* ESSAYS IN JURISPRUDENCE AND PHILOSOPHY 21-48 (1983).

in Jurisprudence, delivered at Oxford in 1953, Hart reviews "three great theories of corporate personality, each of which has dealt deadly blows to the other."[18] According to each theory, a corporation is rightly considered (a) "really just a collective name or abbreviation for some complex but still plain facts about ordinary persons," (b) "the name of a fictitious person," or (c) "the name of a real person existing with a real will and life, but not a body of its own."[19] Hart argues that these concepts of the corporation, classified in his time as "Fiction or Realist or Concessionist" theories, do not help to clarify thinking about corporate law.[20] Instead, they represent "a criss-cross between logical and political criteria."[21]

Perhaps theoretical thinking about corporate law has not progressed much beyond the debates of the early 1950s. The recently minted nexus of contracts theory of the corporation, for example, sounds very similar to some of the theories Hart describes.[22] And contemporary debates over theories of the corporation remain political, often to the exclusion of careful legal analysis. Professor Victor Brudney observes, for example, that the ascendant "rhetoric of contract" in corporate theory "serves an ideological purpose," namely, to establish business corporations as exclusively "private" as opposed to "public" institutions.[23]

Inevitably, ideological baggage appears on the ground floor of any corporate theory if the first question asked is "What is a corporation?" The problem with beginning in this fashion, according to Hart, is that "though these theories spring from the effort to define notions actually involved in the practice of a legal system, they rarely throw light on the precise work they do there."[24] Theories of the corporation abstracted from the practical reality of corporate law risk failing to describe the phenomenon they wish to define in advance. Instead, Hart continues, words like "cor-

18. *Id.* at 24.

19. *Id.*

20. *Id.* at 25.

21. *Id.*

22. *See supra* note 6 and accompanying text (noting some of the leading contractarian theories of the corporation).

23. Brudney, *supra* note 10, at 1408-09. In a study of the relatively new corporate constituency statutes, I also found the academic debate heavily rhetorical and result-oriented. Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 16-18, 71-84 (1992).

I do not discuss here whether or to what extent the "public/private" distinction is helpful in thinking about the structure of corporate law. Other contributions have placed some reliance on this approach. *See, e.g.*, Wolfe, *supra* note 3. *But see* Christopher D. Stone, *Corporate Vices and Corporate Virtues: Do Public/Private Distinctions Matter?*, 130 U. PA. L. REV. 1441, 1506 (1982) (arguing that "the weight once accorded public/private is in fact lessening" in part because "private business corporations are being treated increasingly like public bodies" through regulation of their activities). In constitutional law, the public/private distinction makes more sense, although it is not without difficulty. *See* Louis Michael Seidman, *Public Principle and Private Choice: The Uneasy Case for a Boundary Maintenance Theory of Constitutional Law*, 96 YALE L.J. 1006 (1987).

24. HART, *supra* note 17, at 25.

poration" are in legal practice "very often . . . neutral between competing theories."[25] Corporate theorists who prefabricate various versions of "the corporation" separate themselves from the world of practice and "stand apart with their heads at least in the clouds."[26]

Beginning with a definition or theory of the corporation is not especially helpful because the idea of a corporation is a complex one that presupposes a legal system. To say "corporation" is not like saying "chair" or "dog." The reality to which "corporation" refers is more complex than an easily identifiable material thing or animal, and any attempt to force a preconceived theory on a complex legal reality results in what Hart calls "contrivances varying with tastes."[27] The idea of the corporation is complex precisely because it involves various relationships that presuppose the rules and principles, and methods of enforcement and compliance, that compose a legal system.[28] Describing the corporation, therefore, should not begin with a definition of what a corporation is.

To illustrate, Hart gives examples of terms used in games. In a game of cards, what is a "trick"? A good, simple explanation is as follows: "When you have a game and among its rules is one providing that when each of [the] players has played a card then the player who has put down the highest card scores a point, in these circumstances that player is said to have 'taken a trick.'"[29] This explanation does not resort to a definition or synonym for "trick." One must instead explain the idea in terms of the rules of the game in which it is used. Hart makes fun of those who may insist on a more precise definition of a "trick," and the parallel to similar attempts to define a "corporation" is obvious:

> Suppose now that after such an explanation [a] questioner presses on: 'That is all very well, that explains "taking a trick"; but I still want to know what the word "trick" means just by itself. I want a definition of "trick"; I want something which can be substituted for it whenever it is used.' If we yield to this demand for a single-word definition we might reply: 'The trick is just a collective name for the four cards.' But someone may object: 'The trick is not just a name for the four cards because these four cards will not always constitute a trick. It must therefore be some entity to which the four cards belong.' A third might say: 'No, the trick is a fictitious entity which the players pretend exists and to which by a fiction which is part of the game they ascribe the cards.' But in so simple a case we would not tolerate these theories, fraught as they are with mystery and empty of any guidance as to the use made of the word within the game . . . .[30]

Hart also employs examples from the game of cricket,[31] but let me translate Hart's examples freely in terms of American baseball.

What is a baseball team? Or, to be more concrete, what are the Philadelphia Phillies? One answer is that the Phillies consist of about thirty or thirty-five players. Counting up the players on the team provides an "aggregate" theory of the Phillies. For some purposes, this description is perfectly sufficient. However, an aggregate definition of the Phillies cannot explain how the Phillies are said to "score runs" during a game. Instead, one must resort to a description of the rules of the game and how various acts by members of the Philadelphia team can combine to "score runs" (for example, by one batter hitting a triple and another hitting a single or "sacrifice fly" to "score" the runner by advancing him "home"). In this description, the Phillies do not act individually or in the aggregate. Instead, they act as a unified team to achieve one of the basic objectives of the game, namely, scoring runs.

Consider also the example Hart gives of an "out."[32] One cannot define an out in cricket, or in baseball, except in terms of the rules of the game. One must explain how a player is out (and called out by an umpire). In baseball, a hitter is called out if he or she hits a ball into the air and it is caught "on the fly" by a defensive player, or if the hitter hits a "ground ball" which is thrown to first base before the hitter runs there, or if the hitter is "tagged" or "forced out" at another base, or if the hitter gets three "strikes" ("strike" is also described in terms of the rules of the game, that is, a pitch swung at, but not hit, or a pitch thrown in the "strike zone"—another explanation needed!—but not swung at or hit "fair"). An "out," in other words, cannot be easily defined. It is a complex idea that makes sense only in the context of a system of rules. It must be explained in context to be understood.

The point of these examples is not to argue in favor of aggregate or entity, or fictional or realist, theories of either baseball teams or corporations. The point is rather that these kinds of theories are senseless or at

25. *Id.*

26. *Id.*

27. In Hart's words,

> [I]f applied to legal words like . . . 'corporation' the common mode of definition suggests that these words, like ordinary words, stand for or describe some thing, person, quality, process, or event; when the difficulty of finding these becomes apparent, different contrivances varying with tastes are used to explain or explain away the anomaly.

Id. at 32.

28. Hart writes:

> Consider [the] statement[] made on a particular occasion by a judge or an ordinary lawyer. . . . such as . . . 'A & Company, Ltd. have a contract with B.' It is obvious that the use of [this] sentence[] silently assumes a special and very complicated setting, namely the existence of a legal system with all that this implies by way of general obedience, the operation of the sanctions of the system, and the general likelihood that this will continue. But though this complex situation is assumed in the use of [this] statement[] . . . [it does] not *state* that it exists.

Id. at 27.

29. *Id.* at 33.

30. *Id.* Hart follows Wittgenstein in using games as an aid to philosophical analysis. *See, e.g.*, RAY MONK, LUDWIG WITTGENSTEIN: THE DUTY OF GENIUS 336-46 (discussing Wittgenstein's use of language games as technique for "dissolving philosophical confusion").

31. HART, *supra* note 17, at 27-30.

32. *Id.*

least irresolvable as long as they fail to take into account the complex rule-oriented context in which they are used. It is dangerous and misleading to speak of "a corporation" as if it is severable from the legal system to which it is essentially related and outside of which it cannot properly be understood.[33]

Following Hart's advice, then, I do not begin with the question, "What is a corporation?" This is the cardinal error committed by many contemporary theorists of the corporation, and I specifically want to avoid it. Although beginning study of a subject by trying to define it may sound like common sense, Hart demonstrates that some complex legal ideas are not amenable to this approach, and the idea of the corporation is one of them.[34] Because consideration of the corporation cannot be divorced from its legal context, my analysis instead begins with a brief description of the technical rules of positive corporate law.

II. Technical Complexity: The Structure of Corporate Power

Like baseball, corporate law is composed of complex rules.[35] Some writers who purport to define the nature of the corporation or to advance theories of the corporation apparently do not know the "rules of the game" they are discussing. Some are economists who have not bothered to study the sometimes difficult rules of corporate law.[36] Others are social gadflies

33. As Hart writes,

> Here can be seen the essential elements of the language of legal corporations. For in law, the lives of ten men that overlap but do not coincide may fall under separate rules under which they have separate rights and duties, and then they are a collection of individuals for the law; but their actions may fall under rules of a different kind which make what is to be done by any one or more of them depend in complex ways on what was done or occurred earlier. And then we may speak in appropriately unified ways of the sequence so unified, using a terminology like that of corporation law which will show that it is *this* sort of rule we are applying to the facts. But here the unity of the rule may mislead us when we come to define this terminology. It may cast a shadow: we may look for an identical continuing thing or person or quality *in* the sequence. We may find it—in 'corporate spirit.' This is real enough; but it is a secret of success not a criterion of identity.

Id. at 30.

34. Some "fundamental legal notions" cannot "be defined, only described." *Id.* at 47 (citing John Austin, Lectures on Jurisprudence (1875) and James Bryce, Studies in History and Jurisprudence (1901)).

35. Anyone who doubts the rules of baseball are complex should attempt to explain them to a foreign observer. The rules of corporate law are somewhat more complex than those of baseball.

36. Corporate lawyers have, for the most part, returned the favor. Professor Robert Hamilton, the Reporter for the widely influential Revised Model Business Corporation Act (RMBCA), has reflected on the slight influence of economists in the drafting process as follows:

> Economists have developed quite a different theory of state corporation statutes [compared to the legal theories informing the drafters of the RMBCA, namely, the ABA's Committee on Corporate Laws]. According to them, the purpose of a corporation statute is to serve as a substitute for private contract: in other words, a corporation statute should not be regulatory at all, but, instead, should be an efficiency-creating device that avoids costs associated with drafting and redrafting recurrent provisions by codifying these provisions.
>
> The economist's approach toward corporation statutes is certainly not the theory on which the RMBCA was drafted. This theory was never expressly considered or explored by the Committee on Corporate Laws during the drafting process. Further, I suspect that most practicing attorneys would not accept the underlying premise of this argument that corporations are purely contractual in nature. Contract-type argument were raised by Committee members in a number of contexts. . . . But all members appeared to recognize that although corporation law obviously does have contractual aspects, some regulation was necessary.

Robert W. Hamilton, *Reflections of a Reporter*, 63 Tex. L. Rev. 1455, 1467 (1985) (explanation added).

who speak of corporations as if they are hulking artificial monsters roaming the social landscape, but who have little clear idea of the legal term, "corporation," they so easily bandy about.[37]

This Part briefly outlines some of the basic areas of corporate law and some of its leading positive legal principles. My purpose is to provide an overview of the complex nature of the relationships about which corporate law is concerned and to survey some useful ways to think about the different kinds of rules that compose corporate law.

At the outset, it is important to point out that corporate law is not only complex in the way that some adherents of the nexus of contracts theory see it as complex. Professors Jensen and Meckling, for example, describe this complexity in the following terms:

> The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. . . . There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.[38]

Although it is a truism that corporate law concerns relationships of individuals, often a multitude of individuals, who are grouped into various categories including shareholders, creditors, employees, managers, and directors, Jensen and Meckling adopt a seriously flawed understanding of corporate law. To be sure, a legal analysis can proceed from group to

37. These commentators pick up on Justice Brandeis's description of the "corporate system" as "the Frankenstein Monster which states have created by their corporation laws," but do not bother to understand the specific context of the "race of laxity" about which he was speaking. *See* Louis K. Liggett Co. v. Lee, 288 U.S. 517, 567 (1933); *see also* Alfred F. Conard, Corporations in Perspective 441 (1976) (describing Herman Kahn's view that "corporations appeared as the monster that preempts most of the nation's productive resources, and spews out its capricious variety of goods and services") (citing Herman Kahn, The Future of the Corporation (1973)).

38. Jensen & Meckling, *supra* note 6, at 311 (emphasis and footnote deleted).

group: from considering the rights of shareholders, to the rights of managers, to the rights of creditors, to the rights of employees. But this is precisely the kind of approach that Hart warns vehemently against, because it assumes a certain theory of the corporation, in this case, an aggregate theory that a corporation is merely the sum of its parts or groups of parts—a nexus of contracts. It reduces a corporation to the individual "rights" of its component members.[39] This approach is wrong-headed because, by focusing on the trees, it misses the forest that is corporate law.

Before proceeding to a view of the corporate forest, it is important to note also that even with respect to the component corporate trees, the approach advocated by Jensen and Meckling and those who follow them seems based on a rather rudimentary understanding of contract law, with little or no reference to corporate law.[40] The nexus of contracts approach

39. Definition of "rights" has difficulties similar to definition of a "corporation." Talk of "rights" is sensible only in the context of an effectively functioning legal system. *See* HART, *supra* note 17, at 27. "Rights" in this context refers, of course, to legal rights rather than moral or human rights. For Hart's discussion of the latter, see H.L.A. HART, *Between Utility and Rights*, *in* ESSAYS IN JURISPRUDENCE AND PHILOSOPHY 198-222 (1983); H.L.A. Hart, *Are There Any Natural Rights?*, 64 PHIL. REV. 175 (1955).

40. In a footnote to the passage quoted above, *see supra* text accompanying note 38, Jensen and Meckling elaborate on the role of law in their theory of the firm as follows:

> This view of the firm points up the important role which the legal system and the law play in social organizations, especially, the organization of economic activity. Statutory laws sets [sic] bounds on the kinds of contracts into which individuals and organizations may enter without risking criminal prosecution. The police powers of the state are available and used to enforce performance of contracts or to enforce the collection of damages for non-performance. The courts adjudicate conflicts between contracting parties and establish precedents which form the body of common law. All of these government activities affect both the kinds of contracts executed and the extent to which contracting is relied upon. This in turn determines the usefulness, productivity, profitability and viability of various forms of organization. Moreover, new laws as well as court decisions often can and do change the rights of contracting parties ex post, and they can and do serve as a vehicle for redistribution of wealth.

Jensen & Meckling, *supra* note 6, at 311 n.14. This footnote is fascinating in light of the influence this article has had on legal thinking. Note first that a common-law view of the development of contract is adopted to the exclusion of the most important body of statutory law in the commercial area, namely, the Uniform Commercial Code. Also absent is any recognition of the complexity of contract law, with its various substantive and procedural limitations. *See, e.g.*, Coffee, *supra* note 10, at 936-39; *see also* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 23-163, 188-240 (1993) (discussing policy modifications of contract law concerning "commodification," "externalities," "coercion," "imperfect information," "paternalism," and "discrimination"); Braucher, *supra* note 11, at 712-38 (discussing normative limits to contractual bargaining regarding "consent," "interpretation," and "supplying terms"). More importantly, a striking omission in this "legal" footnote in a leading theory of *the corporation* is any mention of *corporate law*! In fairness, note that Jensen and Meckling later provide some discussion of the "limited liability" granted by corporate law. Jensen & Meckling, *supra* note 6, at 331-32. For a contractarian account of corporate law giving an extended account of the role of limited liability, see EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, *supra* note 6, at 40-62 (describing limited liability as "a distinguishing feature of corporate law—perhaps *the* distinguishing feature").

therefore often fails to account for important *legal* differences *within* groups. Shareholders, for example, are of different types. They are either voting or nonvoting and possess different kinds of rights according to the type or "class" of their stock.[41] Creditors also fall into different legally defined categories: general or secured, senior or junior, commercial (short-term) or investment (long-term).[42] Bonds, debentures, and notes come in a host of varieties with different kinds of covenants and restrictions.[43] Employees are at different levels. They are managers or rank-and-file workers, career-oriented or independent contractors, unionized or nonunionized. Even directors of the board are grouped in different categories for legal purposes: outside so-called "independent" directors or inside "executive" directors.[44] All of these important legal distinctions, supplied not only by contract but also in large part by corporate law, as well as labor, securities, bankruptcy, and tax law, are too often overlooked in contractarian theories. As a result, these theories present an oversimplified picture of "the corporation."

The forest of corporate law is *not* focused fundamentally on the participants in a business, "enabling" them to make contracts together and somehow providing a convenient central "nexus" around which a "corporate contract" revolves. This description provides a normative model for what some believe the specific content corporate law *should be*, but it does not describe the reality of what corporate law *is*. Instead, I propose the following general description of the nature of corporate law: *Corporate law, like most law, is primarily about the rule-oriented structuring of social power, and it is specifically about the rules that structure the organization of economic power.* Corporate law is primarily concerned with business, that is, the structure of economic power in the form of its institutions and processes.[45] Its subject is not primarily economics, although economic policy

41. *See, e.g.*, EDWARD P. WELCH & ANDREW J. TUREZYN, FOLK ON THE DELAWARE GENERAL CORPORATION LAW: FUNDAMENTALS 254-72 (1993) (quoting and discussing DEL. CODE ANN. tit. 8, § 151 (1983) and describing different classes of stock allowable under Delaware law).

42. *See, e.g.*, WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 6-7, 54-55, 244-45 (5th ed. 1993); BAYLESS MANNING & JAMES J. HANKS, LEGAL CAPITAL 98-102 (3d ed. 1990).

43. *See, e.g.*, KLEIN & COFFEE, *supra* note 42, at 235-53; MANNING & HANKS, *supra* note 42, at 103-13; Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 423-31 (1986).

44. The outside/inside distinction is essential in the United States. In some parts of Europe, notably Germany, there is an important distinction in a two-tier system of corporate governance between supervisory directors and managing directors. *See, e.g.*, Alfred F. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1461-67 (1984); *see also* Christian J. Meier-Schatz, *Corporate Governance and Legal Rules: A Transnational Look at Concepts and Problems of Internal Management Control*, 13 J. CORP. L. 431, 442-50 (1988).

45. *Cf.* Earl Latham, *The Body Politic of the Corporation*, *in* THE CORPORATION IN MODERN SOCIETY 218, 220 (Edward S. Mason ed., 1966) ("A mature political conception of the corporation must view it as a rationalized system for the accumulation, control, and administration of power."). Of course, the law of business associations is broader than corporate

must obviously play a central role in the development of corporate law.[46] The most basic rules of corporate law involve the structure and governance of businesses that "incorporate," which means simply filing with a state government "founding documents" (usually a certificate of incorporation and any required supporting documents).[47] Beyond the ministerial requirements of the founding act, corporate law also structures and, at least to a certain extent, circumscribes the activities of incorporated businesses and the participants associated with them. Moreover, the powers and restrictions of corporate law are formulated with a view (at least in theory) toward achieving a set of rules for incorporated businesses that conduce to the public advantage. In the words of Professor Melvin Eisenberg, "corporate law is constitutional law" in this fundamental sense.[48]

State statutes confer broad general powers on corporations to enter into contracts, to own real and personal property, to sue and be sued, to appoint agents, to transact business, and even to make payments and charitable donations in the "name of the corporation."[49] In this regard, a corporation is properly considered an entity.[50] It is true that real businesses and real people lie behind this legally created entity, and there are real dangers in "reification" of the corporation.[51] At the same time, it remains accurate to

law, including the law of agency, partnerships, limited partnerships, and limited liability companies, and the law of enterprise organizations is broader still, including the law of nonprofit organizations, including nonprofit corporations.

46. The most comprehensive contemporary account of how economic policy should structure the rules of corporate law is given in EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, *supra* note 6. To the extent their theory depends on a definition or theory of "the corporate contract," however, the account offered here implicitly criticizes their theory of the corporation. *See id.* at 1-39 (describing version of "the corporate contract"); *see also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 391-97 (4th ed. 1992) (describing the corporation in economic terms as "a standard contract").

47. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 102-105 (1983).

48. MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 1 (1976). During a presentation of an earlier draft, one commentator suggested that I am asserting a revised "concession" theory of the corporation. But I do not believe that government, through modern corporation statutes, grants sovereign power to business corporations (although concession theory may make some sense in an historical account of corporate law). Instead, government sets the rules by which business can be done in the corporate form and rules with respect to corresponding rights and duties of individuals and groups of individuals participating in corporate enterprises. This is not concession theory. It has more in common with "structural" theories of corporate law. *See, e.g., id.* at 1-6.

49. *E.g.*, DEL. CODE ANN. tit. 8, § 122 (1983); REV. MODEL BUS. CORP. ACT § 3.02 (1984). These powers are nothing new. They were recognized by "the jurists of the Roman Empire, the canonical contemporaries of Innocent IV, [and] the 15th century English justices." CONARD, *supra* note 37, at 441.

50. CONARD, *supra* note 37, at 441-43.

51. *See, e.g.*, KLEIN & COFFEE, *supra* note 42, at 109-10, 271-72. My favorite statement on reification is by Felix Cohen:

> Nobody has ever seen a corporation. What right have we to believe in corporations if we don't believe in angels? To be sure, some of us have seen corporate funds, corporate transactions, etc. (just as some of us have seen angelic deeds, angelic countenances, etc). But this does not give us the right to hypostatize, to "thingify," the corporation. . . .

Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 811 (1935).

say that a creditor, for example, may have a right against "a corporation" in the corporate name, and for purposes of collecting on a debt the creditor may sue "the corporation" without worrying about whom it represents or what it is.[52]

Corporate law also provides that corporate power must be exercised according to certain mandatory rules, which "govern defined issues in a manner that cannot be varied by corporate actors."[53] For example, all publicly held corporations must have a board of directors.[54] Corporate law requires shareholders to elect the members of the board of directors through regularly scheduled annual elections[55] or special elections for special occasions.[56] Perpetual directorships are therefore universally banned.[57] Fiduciary duties of directors and management are also mandatory.[58]

At the same time, much of corporate law is instead suppletory, providing default or off-the-rack rules that apply "unless corporate actors adopt other rules in a specified manner."[59] And even more corporate law is enabling, giving "legal effect to rules that corporate actors adopt in a specified manner."[60]

Those who advocate a strongly contractarian view of corporate law emphasize the enabling character of corporate law, the actual extent of

52. In this respect, the entity theory of the corporation has been described by Professor Hamilton as follows:

> The nature of the fictitious entity that is a corporation is never precisely defined. A corporation can be envisioned as an artificial person having most of the same powers, rights, and duties that an individual has. This artificial person has no flesh, no blood, no eyes, or mouth but it may nevertheless do many things that real people do: it may sue and be sued, enter into contracts, purchase property, run a business, and so forth.

ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 482 (1989).

53. Eisenberg, *supra* note 12, at 1461.

54. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1983) (with exception if included in certificate of incorporation); REV. MODEL BUS. CORP. ACT § 8.01 (1984) (with exception for corporations with 50 or fewer shareholders).

55. *E.g.*, DEL. CODE ANN. tit. 8, § 211(b) (1983); REV. MODEL BUS. CORP. ACT § 7.01 (1984).

56. *E.g.*, DEL. CODE ANN. tit. 8, § 211(d) (1983) (by board or according to by-laws); REV. MODEL BUS. CORP. ACT § 7.02 (1984) (by board, by 10% of shareholder votes, or according to by-laws).

57. EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, *supra* note 6, at 3.

58. *See* Clark, *supra* note 10, at 64. Professor Gordon provides a list of mandatory rules in the relatively lax law of Delaware. Gordon, *supra* note 12, at 1553-54 n.16. His list is contested, in part, by Professor Romano. Romano, *supra* note 12, at 1599-1602.

59. Eisenberg, *supra* note 12, at 1461; *see also* Coffee, *supra* note 10, at 932.

60. Eisenberg, *supra* note 12, at 1461; *see also* Coffee, *supra* note 13, at 1618 (describing "structure of American corporate law" as "partly enabling, partly mandatory in character").

which is debated.[61] To whatever degree corporate law is enabling, however, participants in the debate often overlook a central feature of enabling rules: they too provide legal legitimacy to a certain way of organizing economic power through the corporate form.[62] Enabling rules say, "Yes, it is alright to set up a central management with decentralized financing structured by the issuance of shares of stock and through loan agreements. It is alright to organize economic power in the manner that you wish."

Some commentators who are influenced by the nexus of contracts model extol the contractual freedom of enabling rules and, by hypothesis, the increased social wealth that should, according to economic theory, result. Skeptics emphasize that enabling rules do not provide the regulatory oversight that mandatory rules make possible. The best outcome probably lies in some balanced mix of enabling and mandatory rules, depending on the circumstances and the type of legal rule in question.[63] Situations likely to result in "market failure" require mandatory rules, while circumstances of "regulatory failure" call for suppletory or enabling rules to allow the market to operate through contracting.[64] My purpose, however, is not to take a position one way or another concerning the debate over mandatory and enabling rules.[65] My thesis that corporate law concerns the structure of economic power does not depend on the mix of enabling, suppletory, or mandatory rules that are adopted. A regime of entirely enabling corporate law would nonetheless confer legal power to structure corporate businesses in a particular manner.

In this context, it is helpful to introduce another of H.L.A. Hart's distinctions, namely, the difference between "power-conferring" and "duty-imposing" rules.[66] This distinction parallels the enabling and mandatory rules of corporate law. Hart's distinction is more telling, however, because it makes clear that the enabling rules of corporate law are power-conferring in the same sense as, for example, the power-conferring rules of contract

61. *See, e.g.*, Easterbrook & Fischel, *The Corporate Contract*, *supra* note 6; Romano, *supra* note 12. The best collection of articles on the enabling/mandatory debate is Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

62. *See infra* Part IV for further consideration of legitimacy and corporate law.

63. Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989):

> Within the law of corporations, the question of limits to contractual freedom is one of great theoretical and practical importance. It is a question with which every scholar of corporate law must wrestle. . . . [I]t appears that much thinking still needs to be done—on the part of regulators and deregulators. . . .

Id. at 1415.

64. Eisenberg, *supra* note 12, at 1524. Eisenberg contrasts the "Nirvana Fallacy," which "consists of believing that just because markets are not perfect, mandatory rules would be better," with the "Heavenly Market Fallacy," which takes the view that "because regulation is imperfect, any market, no matter how terribly flawed, is heavenly, and therefore to be preferred to a mandatory legal rule." *Id.* at 1524-25.

65. *See* Symposium, *supra* note 61 (collecting articles discussing debate).

66. H.L.A. HART, THE CONCEPT OF LAW 40-41 (1961).

law.[67] For both enabling corporate law and contract law, a judgment is made about the social desirability of having a market-based system, and the law provides rules by which the system operates. Neither enabling corporate law nor contract law is *given* ex ante, for example, by the science of economics.[68] Instead a society over time chooses collectively to adopt a market-based system, provides a legal underpinning for it, and, through law, creates conditions necessary for markets to operate and, incidentally, for market-based economics to have a subject.[69] Recognition of this fact is important, because a danger in the current theoretical debate concerns the assumption that "contracts" are somehow natural. They are not.[70] Instead, markets are, at least to a significant extent, created by power-conferring rules of a legal system.

Understanding that different policy considerations concerning the desirability of markets in particular contexts yield different kinds of rules—whether conceived as enabling or mandatory, or power-conferring or duty-imposing—means that in corporate law an absolutist choice among mandatory, suppletory, and enabling rules is not required.[71] Different situations may call for different types of rules. The resulting overall mix of legal rules may, one hopes, achieve the optimum social policy desired.[72] This result

67. Hart uses contract law as an example of power-conferring rules. *Id.*

68. *See, e.g.*, Thomas Lee Hazen, *The Short-Term/Long-Term Dicholotomy and Investment Theory: Implications for Securities Markets Regulation and for Corporate Law*, 70 N.C. L. REV. 137, 307 (1991) (describing the "value-neutral" view of economics as a "fallacy"). *But see* Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 987-98 (1993) (arguing that scientific evidence supports contractarian claims for corporate system of entirely enabling rules).

69. *See, e.g.*, Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389 (1993). Professor Frankel correctly describes the creation of markets as requiring not only contract law, but property law. *Id.* at 389-91. Corporate law involves a mix of contract and property law, as well as trust, agency, administrative, and constitutional law. To reduce corporate law to contractual principles alone is inconceivable.

On the historical role of law and politics in the formation of markets, see, for example, KARL POLANYI, THE GREAT TRANSFORMATION: THE POLITICAL AND ECONOMIC ORIGINS OF OUR TIME 43-102 (Beacon Press 1957) (1944).

70. *See, e.g.*, Braucher, *supra* note 11, at 699:

> [C]ontractarians neglect the implications of the fact that contracts are not self-enforcing. Contractarians view non-contractual legal approaches as "regulatory;" in contrast, they see contract as a device by which parties control their relations and achieve their desires by consent. Their approach thus misconceives contract because all law, including contract, is regulatory.

71. As a matter of jurisprudence, "suppletory" rules can be classified as a variant of "enabling" rules because the option is left to those to whom power has been conferred to change the suppletory rule, thus in effect changing it from a "mandatory" rule to an "enabling" one.

72. Professor Eisenberg, for example, believes optimistically that

> [C]orporation law taken as a whole . . . contains a significant number of core mandatory rules to govern divergencies of interest between top managers and shareholders. And to a significant extent, these are just the mandatory rules that corporation law should contain.

Eisenberg, *supra* note 12, at 1485.

depends, of course, on what the rules are and how they are applied and enforced. However, to the extent that a mix of mandatory, suppletory, and enabling rules is chosen, the level of technical complexity of corporate law increases. Part of the technical complexity owes to the combination and interaction of different types of regulatory rules. Mandatory rules are duty-imposing. Enabling rules are power-conferring. Supplementary rules are also power-conferring, either by default or by choice.[73] The combination of all of them, different rules for different circumstances, composes the technical complexity of corporate law.

In this connection, consider Professor Bernard Black's suggestion that corporate law is, for the most part, "trivial."[74] Black argues that investors and managers are able, at least with the help of clever lawyers,[75] to "establish[] any set of governance rules they want."[76] Therefore, "the mandatory/enabling balance . . . isn't really there."[77] Corporate law is in fact fully enabling because any mandatory rules are "either avoidable or have no bite."[78] Even if Black's "triviality hypothesis" proved correct, corporate law would nonetheless remain important. Even if corporate law were entirely enabling, it would describe the rules by which economic power is socially structured, which is not a trivial matter, although corporate law would then collapse into a specialized category of contract and property law.[79]

In addition, Black and others who downplay the importance of mandatory rules overlook one large category of cases—a complex subset of corporate law all its own—which may best illustrate my thesis that the technical rules of corporate law are primarily about structuring economic organizational power. Take, for example, the "trivial" but mandatory rule that sets a deadline for notice of shareholders' meetings.[80] Professor Black

73. *See supra* note 71 (describing suppletory rules as really a variation of enabling rules).

74. Bernard S. Black, *Is Corporate Law Trivial?*, 84 NW. U. L. REV. 542, 544 (1990) (suggesting "triviality hypothesis" where "appearances notwithstanding, state corporate law is trivial" and "what is left of state corporate law is an empty shell that has form but no content").

75. Black suggests that instead of black-letter corporate law, "we [law professors] teach corporate law courses where the central themes include how complex organizations are structured, and how corporate law and planning by corporate lawyers can facilitate those structures." *Id.* at 593.

76. *Id.* at 544.

77. *Id.* at 551.

78. *Id.*

79. Although contractarian theorists emphasize contract law, it is impossible that even an entirely enabling corporate law would not involve rules of property, given that one of the basic aspects of a corporate enterprise is the power to divide shares of property ownership, giving rights to property not only to shareholders but also creditors. *See* MANNING & HANKS, *supra* note 42, at 5-19 (discussing nature of "legal capital"); *see also* Frankel, *supra* note 69.

80. Professor Gordon calls this type of rule, of the mandatory species, "procedural" and gives this example. Gordon, *supra* note 12, at 1591 & n.129 (citing DEL. CODE ANN. tit. 8, § 222(b) (1983 & Supp. 1988) (notice of shareholder meeting neither greater than 60 days nor less than 10 days before the meeting) and DEL. CODE ANN. tit. 8, § 213(a) (1983) (same for setting record date)).

gives this rule as an example of an "unimportant" rule.[81] Although ordinarily mundane, however, the rule for notice of a shareholders' meeting can become suddenly important when the issue is one of corporate control. Talk of triviality is banished in these cases, and lawyers search out applicable mandatory rules of corporate law and use them as weapons.[82] This ostensibly trivial rule became crucial, for example, in the leading Delaware case of *Aprahamian v. HBO & Co.*[83] The Chancery Court held an incumbent board, by changing the date for an annual meeting, to have impermissibly tampered with the shareholder election machinery.[84]

Not only does corporate law set the rules for everyday governance, it also provides rules for successorship and changes in control. Mergers ordinarily occur through board action, with or without shareholder approval, depending on the particular situation and the state law involved.[85] Outside of the usual course, change in control of a corporation can occur through proxy fight or tender offer.[86] Both processes are regulated by state corporate law and by federal securities laws.[87] Given the stakes involved, namely, economic power, control cases are heavily litigated.[88] This case law is technically complex, both factually and legally.[89]

81. Black, *supra* note 74, at 560-61 ("Delaware . . . requires companies to give written notice of a shareholder meeting no more than sixty days before the meeting. This seems silly. What's wrong with ninety days notice? The maximum period may survive because it's easy to give notice no more than sixty days before the meeting date. Other examples of unimportant rules are as numerous as our imagination in considering unlikely situations.").

82. Black's model of educating corporate lawyers or planners, *see supra* note 75, may neglect educational needs of another sort of lawyer, namely, the litigator. Also, corporate planners should know the hazards of their plans, which often lie in one or another mandatory corporate law enforceable in court.

83. 531 A.2d 1204 (Del. Ch. 1987).

84. Aprahamian v. HBO & Co., 531 A.2d 1204, 1205-07 (Del. Ch. 1987). Of course, this violation of an admittedly trivial formal rule was not all there was to the decision. An important policy concern was that of "corporate democracy." *Id.* ("In the interests of corporate democracy, those in charge of the election machinery of the corporation must be held to the strictest possible standards in providing for and conducting corporate elections."). In any event, abridgement of the procedural rule was sufficient for the Chancery Court to remove the case from the protection of the business judgment rule and to shift to the directors the burden of proof regarding manipulation of the election machinery, which was the true substantive, but still mandatory test. *Id.* at 1207; *see also* Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1118-24 (Del. Ch. 1990) (finding "inequitable manipulation" in board's change of record date for annual meeting after hostile proxy-tender offer was announced, although recognizing that meeting dates could be "postponed at least in some circumstances").

85. This area alone is very complex. For an overview of the basic law of mergers, consolidations, and sales of assets under Delaware law, see WELCH & TUREZYN, *supra* note 41, at 553-721. For general discussion of these topics, see CLARK, *supra* note 15, at 401-530.

86. *See* LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 497 (1988).

87. *See id.* at 449-541 (discussing federal securities rules concerning proxies and tender offers); CLARK, *supra* note 15, at 531-92 (discussing tender offers); EISENBERG, *supra* note 48, at 97-127 (discussing state proxy machinery).

88. For an overview of leading cases under Delaware law, see WELCH & TUREZYN, *supra* note 41, at 86-187.

89. *See id.*

Usually, the mandatory rules at issue in control cases concern whether corporate boards have properly complied with their fiduciary duties when either defending against unwanted takeover attempts or authorizing mergers or acquisitions that affect the basic governing structure of the corporation.[90] In these kinds of cases, where case law is thick, the central function of corporate law in structuring business power is readily apparent.

Considerable research, debate, and discussion continues about the relative merits of a "free market in corporate control." Neoclassical economists and similarly minded lawyers tend to argue that loosening some of the major impediments to hostile takeovers (proxy fights and tender offers) would promote goals of social wealth maximization and economic efficiency.[91] State antitakeover statutes are a favorite target, because they have essentially shut down the hostile takeover market prevalent in the 1980s.[92] This argument, however, is not one of corporate theory, but economic policy. Economics may point the way toward correct social policy and, hence, desirable corporate legal rules for control situations. But economic policy cannot supply a complete theory of corporate law. Corporate law is not primarily about economics; it is about economic power.

Take for example, cases involving corporate control. As anyone who has been closely connected with a hostile takeover can attest, corporate control contests are about exactly that—control—in other words, power. In court, economic policy arguments are marshalled by competing factions to try to sway judges and to achieve contestants' goals. For litigants in control cases, economic policy is more a tool than an end.

At the time of this writing, a control contest dominates the press and illustrates my contention. Paramount Communications had structured a cozy merger with Viacom, and with hostile takeovers in abeyance since the late 1980s,[93] the parties relaxed and looked forward to the combination.[94] Viacom's share-priced offer for Paramount was about $7.5 billion.[95] But QVC Network spoiled the party by putting forward a competing hostile bid valued at about $9.5 billion.[96] After Paramount's board refused QVC's offer, the Delaware Chancery Court struck down the lock-up provision and

90. *See id.*; *see also* Paramount Communications, Inc. v. QVC Network, Inc., Nos. 427,1993, 428,1993, 1993 WL 544314 (Del. Dec. 9, 1993).

91. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-82 (1981); Easterbrook & Fischel, *The Corporate Contract*, *supra* note 6, at 1416-18.

92. I review the different forms of state antitakeover statutes in Orts, *supra* note 23, at 37-39. *See also* John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1438-55 (1991).

93. I discuss reasons for the decline and possible return of hostile takeovers in Orts, *supra* note 23, at 35-37.

94. Geraldine Fabrikant, *Giant Merger Set in Entertainment*, N.Y. TIMES, Sept. 13, 1993, at A1.

95. Laura Landro & Johnnie L. Roberts, *QVC's $9.5 Billion Bid for Paramount Brings Industry Titans to Fray*, WALL ST. J., Sept. 21, 1993, at A1.

96. *Id.*

poison pill adopted in the Viacom-Paramount merger agreement,[97] and the Delaware Supreme Court affirmed.[98] As this Article goes to press, an auction is underway, and the outcome is uncertain.[99]

The point of the example, however, has little to do with the eventual legal outcome. From the press, one learns what insiders (and their lawyers) know for certain in any hostile takeover and, for that matter, virtually any merger or acquisition. Although legal arguments are cast in terms of "best interests of the shareholders," "reasonable care," "business judgment," and whatever other operational legal terms and standards apply, the underlying issue is one of economic power and corporate control. In reality, these battles usually involve huge personal egos, the wealthy and influential powers-that-be of corporate America. In the case of Paramount-Viacom-QVC, for example, one could predict with great certainty that Martin Davis, the CEO of Paramount, would not negotiate a friendly deal with Barry Diller, the CEO of QVC, because the two had "expressed frosty contempt toward each other" ever since Diller had resigned from Paramount (formerly named Gulf & Western).[100]

Examples of this kind can be found in virtually any contest for corporate control, large or small. An earlier contest involving Paramount and the planned combination of Time Warner, which resulted in the landmark decision, *Paramount Communications, Inc. v. Time Inc.*,[101] provides another case study of personal egos vying for power.[102] Allies, especially lawyers and investment bankers, line up behind their respective leaders. Headline

97. QVC Network, Inc. v. Paramount Communications, Inc., 635 A.2d 1245 (Del. Ch. 1993).

98. Paramount Communications, Inc. v. QVC Network, Inc., 427,1993, 428,1993, 1993 WL 544314 (Del. Dec. 9, 1993).

99. Geraldine Fabrikant, *Viacom Seen Questioning a Higher Bid*, N.Y. TIMES, Jan. 5, 1994, at D1; Laura Landro, *More Than Paramount Is at Stake as New Bids Are Readied in Buyout*, WALL ST. J., Dec. 20, 1993, at A1; Johnnie L. Roberts & Randall Smith, *Paramount Opts To Put Itself Up for Auction*, WALL ST. J., Dec. 15, 1993, at A3.

100. Landro & Roberts, *supra* note 95, at A5. As the *Wall Street Journal* described the contest,

> The battle for Paramount will pit the most powerful moguls in the entertainment industry against each other in a contest for one of the only remaining independent entertainment and media companies in the U.S. The main players are among the most ruthless and strong-willed in the industry, with long and complex ties . . . .

Id. at A1; *see also* Floyd Norris, *Can't Tell Viacom From QVC?*, N.Y. TIMES, Jan. 30, 1994, § 4, at 3 (describing the contest as "a drama of revenge and betrayal" involving "some of the more flamboyant characters in corporate casting"). *But see* Landro, *supra* note 99, at A10 (quoting Barry Diller as saying his bidding for Paramount is "totally responsible and not filled with an ounce of ego").

101. 571 A.2d 1140 (Del. 1989). How much of a landmark *Paramount v. Time* will remain depends on the Delaware Supreme Court's final opinion in *Paramount v. QVC*. *See supra* notes 97-98 and accompanying text.

102. For a behind-the-scenes account, see Bill Saporito, *The Inside Story of Time Warner*, FORTUNE, Nov. 20, 1989, excerpted in RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 42-64 (1993).

takeovers are commonly described as "battles" and "wars," and use of the terms is not accidental.[103]

The law of mergers and acquisitions illustrates the rule that corporate law is fundamentally about the structuring of economic power. As one federal district court judge said in the mid-1980s case of *Warner Communications, Inc. v. Murdoch*,[104]

> The conduct of corporate affairs often produces highly charged, hostile battles for corporate control; battles which often resemble a corporate form of feudal warfare. Invariably, these battles are taken out of the marketplace and brought into court, whereby courts are asked to serve as arbiters between the warring factions.[105]

These conflicts are not about abstract economic theories, but about the structure of concrete economic relationships, which corporate law regulates one way or another.

I do not continue in this Part to attempt a recapitulation of corporate law in all of its technical complexity. I have outlined some of the major kinds of rules in corporate law, and given some examples. Most readers, I suspect, will agree with the proposition that "corporate law is complex."[106]

This is not to say that corporate law is impossibly difficult for mere mortals to comprehend. As Professor Eisenberg points out, "Complexity in determining the law is not equivalent to intellectual difficulty in understanding the law. Corporation law is no more intellectually difficult or inaccessible than most other bodies of law . . . ."[107] Similarly, Chancellor William T. Allen remarks about his corporate law docket: "It's not sub-

103. *See, e.g.*, Landro & Roberts, *supra* note 95, at A1.

104. 581 F. Supp. 1482 (D. Del. 1984).

105. *Id.* at 1485.

106. If authority for the proposition is needed, it is available. Professor Eisenberg, the Chief Reporter of the ALI's *Principles of Corporate Governance*, comments on "the unusual complexity of corporate law." Melvin Aron Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 BUS. LAW. 1271, 1274 (1993). Reasons for this complexity include not only the "conflicts, tensions, and cross-currents among the law of fifty states," but also the fact that corporate law is an impure "mixture of common law, statutory law, procedural rules, and corporate practice." *Id.* at 1272-73. Anecdotal evidence of the complexity of corporate law derives from a description of the size of some primary sources that set forth some of its basic principles. The new *Principles of Corporate Governance*, for example, runs to over one thousand pages, and it is meant to provide a relatively concise "analysis" of the law. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Proposed Final Draft, Mar. 31, 1992) [hereinafter ALI]. Even so, as Eisenberg notes, "the *Principles* do not cover all of corporate law—much less the entire subject of business associations—but only a limited number of selected and relatively well-defined topics in corporate law." Eisenberg, *supra*, at 1272. The topics covered include "the objective and conduct of the business corporation, the structure of the corporation, the duty of care, the duty of fair dealing, the role of directors and shareholders in transactions in control and tender offers, and remedies." *Id.*

107. Eisenberg, *supra* note 106, at 1273-74.

atomic physics. Reasonably intelligent people can decide these cases."[108] The point is only that the body of corporate law is composed of a complex set of statutes and judicial decisions, rules and precedents, law and practice, which regulates a multitude of detailed issues in various circumstances.

Because corporate law is technically complex, it is not easy to restate in a few words. This understanding lends credence to Hart's injunction to exercise caution when thinking about ideas, like "the corporation," which presuppose a complex set of rules of a legal system. Starting with the question "What is a corporation?" is less helpful than beginning with the actual rules of the system. This Part has shown some ways in which corporate law is technically complex. The next Part suggests that the technical complexity of corporate law results at least in part from a related complexity in the normative purposes that corporate law is meant to serve.

III. NORMATIVE COMPLEXITY: MULTIPLE VALUES IN CORPORATE LAW

Many areas of law involve trading off competing values, depending on particular circumstances, and corporate law is no exception. Tort law, for example, often involves competing values of compensating accident victims and conceptions of fault and negligence. Contract law embraces conflicts between values of economic efficiency and procedural and substantive fairness. Deterrence and retribution are twin purposes of criminal law.

In this Part, I argue that the technical complexity of corporate law derives in part from the normative complexity of its purposes, and that normative complexity itself adds another dimension needed for a full theoretical understanding of corporate law. The policies underlying corporate law cannot be reduced to a unidimensional value, such as the economic objective of "maximizing shareholders' wealth" or even, more generally, "economic efficiency."

I focus first on the normative complexity within the economic objective itself and find more diversity than many commentators would like to believe.[109] I then challenge the view that the economic objective expresses the sole value of importance in corporate law. A unidimensional economic view of corporate law is an incorrect empirical description of corporate law.[110] First, it ignores an obvious implicit value of any body of law: the norm of following the law.[111] Second, it fails to account for issues that relate to an "ethical dimension" of corporate law.[112]

108. Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683, 691 (1992) (citing Lindsey Gruson, *Tiny Delaware's Corporate Clout*, N.Y. TIMES, June 1, 1986, at F6 (quoting Chancellor Allen)).

109. *See infra* Part III.A.

110. In this respect, I agree with Lyman Johnson's claim that "corporate law's torrid love affair with economics threatens to blind scholars to the limitations (and risks) of adhering to a single all-purpose outlook." Lyman Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215, 2217 (1992) (book review).

111. *See infra* Part III.B.

112. *See infra* Part III.C.

A. The Divided Economic Objective

A favorite claim by law-and-economics reformers is that the principles of corporate law reduce to a single goal: maximize profit and shareholder wealth. Even if accepted provisionally as the purpose corporate law should serve, this goal is not self-executing. It is unhelpful ritualistically to invoke the maxim of maximizing profit and wealth. Instead, one must ask how a business can accomplish the goal, through what methods, and in what circumstances. When one asks these questions, and seriously attempts answers, the economic objective of corporate law divides in several different ways that are not easily unified.

1. Profit Versus Wealth

An initial distinction concerns a difference between two components of the "economic objective" as defined by the *Principles of Corporate Governance* of the American Law Institute (ALI).[113] According to the ALI, "a corporation should . . . conduct its business activities with a view to enhancing corporate profit and shareholder gain."[114] A common assumption is that profit and wealth are synonymous. As Professor Henry Hu shows, however, modern financial theory undermines the presumed identity between "corporate profit" and "shareholder gain."[115]

First, Hu argues that if managers of public corporations are truly to manage for shareholders, they should drop the fiction of managing for "the corporation."[116] Given the now widespread practice of diversified portfolio investment, shareholders may well wish to take greater risks than a more conservative management whose goals may include the continued existence of "the corporation," that is, the corporate business as a going concern, and, often implicitly, the continued tenure of management. In Hu's words,

> [A] diversified shareholder would *not* want the managers of a publicly held corporation to act in a way intended to ensure the well-being of the corporation. If managers were to focus on the total risk of an investment project instead of the nondiversifiable risk, for instance, they might enhance the health of the firm, but they would probably not maximize the share price. Shareholders, regardless of their individual risk preferences, generally would want managers instead to focus primarily on nondiversifiable risk in evaluating corporate investment opportunities.[117]

113. ALI, *supra* note 106, § 2.01(a) cmt. f, at 72. To its credit, the ALI's *Principles* implicitly avoids the pitfalls of definitions or theories of "the corporation" by defining corporation tautologically as "a corporation incorporated under a business corporation law or an analogue thereof." *Id.*, § 1.12(a), at 17. Analogues of corporation laws include specific (banking corporations), as well as general, corporation codes. *Id.*, § 1.12 cmt., at 17.

114. *Id.*, § 2.01(a), at 69. Qualifications given to this economic objective are discussed *infra* Part III.B and III.C.

115. Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. Rev. 277, 294 (1990).

116. The analysis in this section applies only to public corporations in which the interests of shareholders and managers may separate. It does not apply to close corporations in which the managers are also the only or the predominant shareholders.

Whether it is realistic to expect managers to take these kinds of risks is another question, as is whether this kind of increased risk-taking is desirable from a broader social perspective.[118] At the ground-floor level of defining the economic objective, however, Hu's point is well taken.

Second, Hu emphasizes that corporate law leaves the time frame of corporate investment decisions to the discretion of management. The resulting "operational ambiguity"[119] relates to the problem of long-term versus short-term horizons discussed below.[120] The point also applies to the problem of profit versus wealth. Choice of short or long time horizons adds considerable complexity to a workable conception of the economic objective.[121]

Third, Hu argues that modern financial theory outstrips traditional methods of accounting for "corporate earnings."[122] If management sets goals in terms of profits reported through traditional methods of corporate accounting, overly risk-averse strategies of corporate management and investment result. More risky and uncertain strategic decisions to invest, for example, in research and development or potentially revolutionary products (with greater corresponding risks of failure as well as success) reduce the bottom line in accounting reports of corporate earnings.[123]

In fact, many corporate managers appear already to have learned some of the lessons of financial theory emphasized by Hu.[124] In a recent study, Professor Michael Useem finds that managers of seven major companies that recently experienced intensified shareholder pressure have adopted

117. Hu, *supra* note 115, at 299-300.

118. Even though some degree of economic productivity may be lost as a result, there may be social benefit to relatively stable business institutions that provide relatively stable levels of production and services to customers and relatively stable levels of employment to workers within the company. Creditors also often prefer companies to make less risky investment decisions.

119. Hu, *supra* note 115, at 301-02.

120. *See infra* Part III.A.2.

121. For a schematic diagram and further discussion of how time horizons complicate the task of corporate management, see Orts, *supra* note 23, at 72-73 n.381.

122. Hu, *supra* note 115, at 302-06.

123. As Hu explains,

> A dollar invested in . . . strategic pricing or in research and development . . . depresses reported earnings far more than a dollar invested in capital expenditures. A fixation on reported earnings could thus lead to investment decisions being dictated not by the cash flow and other real economic attributes of investment opportunities, but also by the happenstance of accounting conventions.

Id. at 305.

124. Hu argues for a policy of managing for "blissful" shareholder wealth maximization, which ignores possibly irrational and uninformed fluctuation in stock price and tries instead to assess what the stock price of a publicly traded company should be, all things considered. *Id.* at 357-61.

sophisticated methods of estimating shareholder value.[125] He adds that the managers "understood that [shareholder value] was distinct from traditional accounting measures of corporate achievement such as revenue growth or return on equity."[126]

The difference between managing for corporate profit or shareholder wealth remains important. The economic objective is neither easily defined nor uncontroversially given. It is radically ambiguous. It reproduces the divergence of interests between shareholders and managers (and other groups) that crops up elsewhere in corporate law. Different interests within a corporate enterprise have different agenda for "profit" and for "wealth."[127]

Indeed, the ambiguity between shareholders' and managers' interests is only the beginning. One can extend Professor Hu's analysis to include other competing corporate interests. Not only managers and shareholders, but creditors, employees, and others aim to profit and acquire wealth from an ongoing corporate business. The law of corporate governance involves a more complex game than allowed for by simplistic economic assumptions of wealth maximization.[128] Additional complexities include business judgments that managers make concerning other corporate claimants. For example, rank-and-file employees wish to get salary raises and assurances of job security, and creditors wish to secure contractual prohibition of certain actions for credit security, thus potentially decreasing both profit and wealth available for shareholders and managers.[129] Such everyday complexities of

125. MICHAEL USEEM, EXECUTIVE DEFENSE: SHAREHOLDER POWER AND CORPORATE REORGANIZATION 4-5, 10-11 (1993). Managers of the companies studied "generally chose to define shareholder value as a combination of stock dividends and share appreciation, accumulated over a period of years." *Id.* at 11.

126. *Id.* (explanation added). Useem documents managerial change in response to shareholder pressure in the following areas: (1) "flattening" of corporate hierarchies, moving responsibility for success and failure down the corporate ladder; (2) more information focused on shareholder value and more widely distributed among managers; (3) managerial decision-making "more explicitly judged on the basis of the anticipated value to shareholders;" (4) reduction or "downsizing" of professional and managerial staffs; and (5) tying of executive performance to shareholder value through variable compensation schemes. *Id.* at 57-88, 101-11.

127. *Cf.* Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1263 (1992) ("The internal law of corporations is built upon the problem of competition . . . among the various groups of individuals that animate the corporation.").

128. *See, e.g.*, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); Katherine Van Wezel Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 U. CHI. L. REV. 73 (1988).

129. The ALI recognizes the need for management to respond to the needs of other interests involved in the business:

> The modern corporation by its nature creates interdependencies with a variety of groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of the communities in which the corporation operates. The long-term profitability of the corporation generally depends on meeting the fair expectations of such groups. Short-term profits may properly be subordinated to recognition that responsible maintenance of these interdependencies is likely to contribute to long-term profitability and shareholder gain. The corporation's business may be conducted accordingly.

ALI, *supra* note 106, at § 2.01 cmt. f, at 72-73.

business management only increase the ambiguity of the economic objective.

2. Long-Term Versus Short-Term Horizons

The difference between corporate profit and shareholder wealth also implicates the more familiar problem of time horizons in setting goals for a corporate business.[130] Although some economists respond that efficient capital markets overcome this problem, it is not clear these markets are as efficient as proponents claim, or, even if capital markets accurately reflect available information, they may not accurately reflect the value of long-term planning.

In addition, the economic interests of different shareholders may conflict. Shareholders have different time and risk preferences that managers must somehow factor together, if they are to represent fairly the artificially unified interest of "the shareholders" in general.[131] In this sense, one can speak of a shareholder reification problem analogous to the well-known tendency to reify the corporation.[132] As Professor Hu colorfully describes the problem, "Managers would like to be able to make investment decisions that benefit both shareholders who are widows or orphans in need of sure and immediate succor and those who are cowboy capitalists willing to wait for the big score."[133]

One response to the problem of blending long-term and short-term shareholder value is to say simply that the securities markets already take this issue into account.[134] However, the notion that the markets accurately reflect long-term fundamental values of companies has come under sustained fire. Without going into great detail, scholars have raised serious questions

130. For a leading discussion of long-term versus short-term issues in corporate law, see Hazen, *supra* note 68. *See also* John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313 (1992).

131. As Professor Useem describes this difficulty,

> In the logic of ownership-disciplined alignment, shareholder value becomes the central yardstick of organizational life. It is both a driver and measure of decisions and designs, and its specific definition thus has fundamental bearing on the thrust of organizational change. In its simplest form, a company's shareholder value can be defined as the worth of the firm as judged by the stockholders. In its complex reality, shareholder value became a blend of diverse stockholder preferences and managerial constructions of them.

USEEM, *supra* note 125, at 10.

132. *See supra* note 51 and accompanying text (discussing reification of corporation).

133. Hu, *supra* note 115, at 287.

134. *See, e.g.*, Hazen, *supra* note 68, at 143-62, 178-80 (critically discussing efficient market theory and portfolio investment theory in context of short-term and long-term management practices and concluding that "it seems abundantly clear that most corporate managers are focusing too much on short-term considerations" despite supposedly efficient markets). *But cf.* USEEM, *supra* note 125, at 37 ("Contrary to some conventional wisdom, institutional investors tend to take long-term positions in many of their companies. But this should not be surprising, since their holdings are so large that high turnover would be costly if not impractical.").

about how efficient the capital markets are, and in what ways.[135] These questions give reason for caution before elevating principles of efficient market theory to the status of entrenched legal policy.[136]

More importantly, even the "strong" version of the so-called Efficient Market Hypothesis, which claims that "prices instantaneously and accurately reflect not only all publicly available data but all relevant information that can be known,"[137] does not require that the information reflected is relevant to long-term performance. On the contrary, capital markets may systematically undervalue plans or strategies beyond a time horizon of, say, a generation or two.[138]

Even if the capital markets processed available information as efficiently and accurately as possible, the distinction between managing for the long-term versus the short-term remains. Short-term and long-term strategies often differ. Drastic cost-cutting, for example, may easily achieve short-term results, improving the bottom line for a few quarters. But in the long-term, severe cost-cutting may seriously harm a business.[139]

Long-term strategic thinking also involves problems of uncertainty in analysis and decisionmaking. Professor Aron Katsenelinboigen captures the problem of making decisions in the face of uncertainty in his theory of "indeterministic economics."[140] Businesses face considerable economic

135. For a brief overview, see MARSHALL E. BLUME ET AL., REVOLUTION ON WALL STREET: THE RISE AND DECLINE OF THE NEW YORK STOCK EXCHANGE 85-102 (1993). *See also* Hu, *supra* note 115, at 339-42.

136. *See, e.g.*, Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 764-65 (1985); William K.S. Wang, *Some Arguments that the Stock Market Is Not Efficient*, 19 U. CAL. DAVIS L. REV. 341 (1986). *But see* Ronald J. Gilson & Reiner Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 545 (1984).

137. Hazen, *supra* note 68, at 155 (citing SIMON M. KEANE, STOCK MARKET EFFICIENCY—THEORY, EVIDENCE AND IMPLICATIONS 10 (1983)).

138. The human life-span as an outside limit to the time horizons of investments in capital markets may not yet have received sufficient attention. Some very wealthy investors may have an intergenerational outlook, but my guess is that they are by no means the rule. Most investors are looking to make money in their own lifetimes.

139. A former CEO of two companies informed me at a conference recently that he knew of two other CEOs who had adopted radical "downsizing" strategies on the advice of management consultants with little or no consideration of long-term strategy.

140. ARON KATSENELINBOIGEN, INDETERMINISTIC ECONOMICS (1992). Following a systems theory approach, Katsenelinboigen describes the "indeterminism" of systems as follows:

> From the functional perspective, the degree of indeterminism of a system may be defined as the degree of influence it can exert upon development as manifest in the varying degree of uncertainty. In other words, the degree of indeterminism incorporates two factors: the impact of the action and its uncertainty. The stronger the impact upon development, the more the system is determined, and, consequently, the lesser is the degree of indeterminism. From the structural point of view, the degree of indeterminism is defined as the degree of completeness and consistency of the links of the system. In terms of process, the degree of indeterminism can be viewed as the extent of amenability of the processes taking place in the system to change. From the standpoint of an operator, the degree of indeterminism reflects the power of the operator that executes the various processes.

Id. at 38.

uncertainty and indeterminacy.[141]

Katsenelinboigen illustrates the problem with an example from the game of chess. In chess, the number of possible moves in any situation is finite. Therefore, it is theoretically possible for a computer to generate all the possible moves in each situation and recommend a solution. However, because the number of possible moves is so great (10^{120}), even supercomputers must make choices in an environment characterized by significant indeterminacy.[142]

One traditional method of constraining indeterminism in chess is to follow standard openings. Manageable principles for playing end-games also emerge when the number of pieces are few and the objective (the opponent's King) stands plainly in view.[143] Most interesting and complex, however, is the middle-game. After a standard opening has been followed, lots of pieces remain on the board, and objectives for long-term success are difficult to find and to follow. Here, various styles of play emerge that are "associated with strategic vision of the game."[144] One example is the "positional style," which focuses on "limited goals," such as developing one's pieces into powerful positions on the board or mounting a positional attack on an opponent's flank.[145] A second example is the "combinational style," which focuses on achieving a specific intermediate objective, such as seizing the opponent's Queen. "A characteristic feature of combinational style," Katsenelinboigen says, "is the formulation of a narrow objective together with a completely specified program of its achievement."[146]

Strategic thinking in chess is relevant by analogy to corporate decision-making. Katsenelinboigen argues that the "classical approach" to business behavior follows a variation of the combinational style, aiming for the traditional profit objective. These methods are "connective" or "combinational-connective" in that they aim to set objectives for profits over a particular period, and then, to the extent possible, they "connect" various operational steps with the objective.[147] These methods are, according to Katsenelinboigen, "the easiest to teach," because they rely on straightfor-

141. *Id.* at 56-59, 280-90.

142. *Id.* at 47. Even supercomputers cannot simply run every possibility in a chess program. As Katsenelinboigen notes, given the huge number of possible moves in a chess game, "the execution of [the] algorithm, even by the fastest operators in the guise of computers operating at the speed of light, might take hundreds of thousands of years." *Id.* He later notes that the best computer program, taking many "intelligent" short-cuts, is "formidable" and performs at "a level of a weak grandmaster." *Id.* at 70 (citing Feng-hsiung Hsu et al., *A Grandmaster Chess Machine*, SCI. AM., Oct. 1990, at 44).

143. *Id.* at 69.

144. *Id.* at 71.

145. *Id.* at 70-71.

146. *Id.* at 72.

147. *Id.* at 75-76.

ward applications of a "programming (scientific) method."[148] But Katsenelinboigen states:

> Much more intractable is the positional style and the goal-selection aspect of the combinational method. They are less routine and depend to a large extent on the subjective abilities of the leader [of a business]. Instruction in this area must aim at enriching the leaders' intuition, helping them with conceptual recognition of what they are doing. In other words, learning the positional style could help leaders formulate and solve problems by enabling them to express explicitly the many intuitive considerations that were previously taken into account implicitly in the course of decision making.[149]

Here lies the difficult problem of selecting gifted leaders to run large enterprises wisely and in accordance with the best long-term strategy.

A more concrete example may help to bring home the point with respect to the uncertain and indeterminate nature of pursuing the economic objective in the long-term. Instead of following standard approaches to increasing profits, a better long-term strategy following a positional style might focus on an intermediate goal, such as increasing market share.[150] The Japanese automobile manufacturing and marketing success over American companies may provide a good example of this kind of long-term strategic thinking.[151]

Complex strategic issues involved in modern business management do not easily reduce to standardized legal formula, even if based on economic criteria. Corporate law must take account of the difficulty of trading off short-term and long-term planning horizons and the corresponding complexity of corporate decisionmaking that affects shareholders, creditors, employees, and other interested groups.[152]

3. Central Management

Partly in response to difficult issues of finding the best strategy for a corporate business, corporate law provides a standard form for a professional central management.[153] In practice, a great number of different factors complicate the economic objective. Central management is one response to the increasing practical complexity of business decisionmaking.[154]

For the most part, central management has been successful in purely economic terms.[155] Alfred Chandler has demonstrated how the corporate organizational transformation developed efficiencies of scale and scope that helped to spark a phenomenal period of economic growth in the twentieth century.[156] Hierarchical business organizations can also save on transaction costs when it is cheaper to provide goods or services internally rather than through market purchases or sales.[157] Central management provides yet another kind of efficiency in enabling managerial divisions of labor, through specialized educational training of future managers and differentiation of managerial occupations within businesses.[158]

Corporate law contributes to these types of economic efficiencies by providing a framework, and legal and political legitimacy, allowing hierarchical business organizations of a specific type to develop. It enables and encourages the creation of centralized management through widespread contributions of capital to business enterprises. Corporate law provides rules to constrain central management to act on behalf of the interests of capital contributors. Doctrines like the duty of loyalty express constraints on the

148. *Id.* at 77.

149. *Id.* (explanation added). Katsenelinboigen recognizes teaching limits for advanced strategic styles of leadership. Referring again to the chess analogy, he writes,

> [I]t is quite apparent that the achieved level of play is directly correlated to individual abilities. There is a limit to the level of play that can be achieved by teaching a person of average aptitude; beyond this level, teaching is practically ineffectual. It is well known that a positional sacrifice (not the routine kind) is not recommended for players below master's strength. But becoming a master takes more than just learning. Similar considerations apply in teaching the positional style (not to mention charismatic style) to business leaders.

Id. at 77-78.

150. *See id.* at 249-62 (discussing quantitative methods of analyzing firm performance).

151. *See, e.g.*, Edward N. Luttwak, *With a Rare Opportunity, Ford Blew It*, N.Y. TIMES, Oct. 24, 1993, § 3, at 11.

152. *See supra* notes 120-21, 128-29 and accompanying text.

153. *See* JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970, at 158 ("For both small and large enterprises the corporation provided a defined, legally protected, and practically firm position of authority for those in central control.").

154. For an introduction to some works in organizational theory dealing with institutional responses to the problem of complexity in decisionmaking, see Herbert A. Simon, *Rational Decision Making in Business Organizations*, 69 AM. ECON. REV. 493 (1979). *See also supra* note 4.

155. By "success" here I mean the increase of social wealth in general. However, the rise of the corporate form may also have helped to increase the gap between rich and poor citizens.

156. CHANDLER, *supra* note 15. Chandler describes economies of scale as "those that result when the increased size of a single operating unit producing or distributing a single product reduces the unit cost of production or distribution." *Id.* at 17. Economies of scope are "economies of joint production or distribution" that result "from the use of processes within a single operating unit to produce or distribute more than one product." *Id.*; *see also* ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977).

157. As Chandler describes this economic efficiency of centralized management,

> Transaction costs are those involved in the transfer of goods and services from one operating unit to another. When these transactions are carried out between firms or between individuals, they usually involve the transfer of property rights and are defined in contractual terms. When they are carried out within the enterprise, they are defined by accounting procedures. The costs of such transactions are reduced by a more efficient exchange of goods and services *between* units, whereas the economies of scale and scope are closely tied to the more efficient use of facilities and skills *within* such units.

CHANDLER, *supra* note 15, at 17. The foremost contemporary advocate of transaction costs economics is Oliver Williamson. *See, e.g.*, OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985).

158. *See* CHANDLER, *supra* note 156, at 8-9, 464-68.

power of central managers to take advantage of their positions to serve themselves, rather than the business they are hired to run.

If the creation of a legal form supportive of central management structures provides real economic gains to society, then the hierarchical business structures enabled by corporate law constitute another aspect of the economic objective. This structural aspect of corporate law is independent of the narrower strategic aspects of the economic objective concerning choices of profit or wealth goals and short-term or long-term planning.

4. Capital Accumulation

Another structural aspect of the economic objective of corporate law, corollary to that of central management, concerns the needs and worries of those who wish to contribute capital to large and small enterprises. The corporate form greatly enhances social powers of capital accumulation through the reduction of risk to individual investors and the resulting extension of time for applying accumulated capital in long-term projects.[159]

Although this principle is either too easily forgotten or taken for granted in contemporary debates, the goal of enabling broad-based capital accumulation for enterprise has historically been an important function of corporate law.[160] For small firms, corporate law has provided a "standard form" or, in contemporary terminology, "suppletory rules" for the easy assembly of groups of relatively passive investors and active managers.[161] And the legal principle of limited liability has given investors assurance of a definite and certain investment risk.[162]

The social policy of granting limited liability to corporations, within certain limits, is an economic one.[163] The traditional justification is to allow capital formation, without immediate risk to shareholders. But courts and

159. As Professor Abram Chayes summarizes this aspect of the economic objective,

> The corporation is necessary because the objects pursued are beyond the reach of the members as individuals. The needed amounts of capital are too great, the risk is too high, the duration of the enterprise too long. The corporation is the legal institution which can hold the aggregated capital of many over a period of time unaffected by the death or withdrawal of individuals.

Abram Chayes, *The Modern Corporation and the Rule of Law*, *in* THE CORPORATION IN MODERN SOCIETY 25, 34 (Edward S. Mason ed., 1966).

160. HURST, *supra* note 153, at 158 (a "prime business utility provided by corporation law was help in mustering capital").

161. *Id.* at 158-59. Limited liability is of lesser use to small firms than large ones, given the practice of creditors insisting on personal guarantees and given the limitations of adequate capitalization and other "veil piercing" considerations.

162. *Id.* at 159. Hurst urges, however, that "we must not exaggerate the role of corporation law in mobilizing capital for the large enterprise." The growth of the investment banking and the stock exchanges were probably of greater moment. *Id.*

163. The limits of limited liability are expressed primarily by the "piercing the corporate veil" doctrine. A comprehensive source is STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL (1992).

legislation extend limited liability to cover even single-shareholder corporations.[164] In these cases, the rationale must be that limited liability encourages business activity in general, as long as certain steps are taken, such as assuring adequate capitalization.[165]

Recently, limited liability has been challenged as a matter of social policy.[166] How the debate will develop depends on how the economic effects of limited liability are judged, as well as perceived fairness values that may be involved.[167] The point here is only that capital accumulation, commonly thought to be aided by the rule of limited liability, adds another type of economic value to the normative complexity of the economic objective.

5. Protection of Investors

Related to the rule of limited liability are other corporate law doctrines designed to protect shareholders. An example is the duty of loyalty, now renamed, in certain circumstances, the "duty of fair dealing."[168] A corporate officer or director wishing to enter into an interested transaction with the corporation must disclose the contemplated transaction beforehand and have it authorized, disclose the transaction afterward and have it appropriately ratified, or prove the transaction is intrinsically fair.[169]

Other examples of law meant to protect investors come from outside corporate law. The securities laws are designed with a purpose to protect investors by requiring disclosure.[170] Bankruptcy law aims to protect creditors, as well as allowing for debtors to reorganize or start again with a clean slate.[171] And remedies of contract and tort law remain available to investors.

Protection of investors provides yet another variant of the economic objective. Some may view this aspect of corporate law as unduly paternalistic. The ideological predisposition of those who favor contracts as an

164. *See, e.g.*, DEL. CODE ANN. tit. 8, § 101(a) (1983).

165. *See, e.g.*, PRESSER, *supra* note 163, at 1-44 to 1-53.

166. *See, e.g.*, David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

167. As Professor Leebron notes, however, "[d]espite the recent burst of scholarship, few topics are liable to strike the reader as less likely to produce changes in the law than an analysis of limited liability." Leebron, *supra* note 166, at 1566.

168. ALI, *supra* note 106, at 264. Reference to "duty of fair dealing" rather than "duty of loyalty" is meant to distinguish cases involving conflicts of interest other than those in which a corporate director or officer has "a pecuniary interest" in the transaction. *Id.*

169. This is a very cursory restatement. *See id.*, § 5.02, at 277-78. For discussion of the considerable variation among state statutes in this area, see *id.*, Reporter's Note, at 312-25.

170. Although other themes are present in the securities laws, "there is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure." Loss, *supra* note 86, at 7.

171. *See, e.g.*, JAMES J. WHITE & RAYMOND T. NIMMER, BANKRUPTCY: CASES AND MATERIALS 52-53 (2d ed. 1992) (describing the three major goals of bankruptcy law as providing (1) a "fresh start" to individual debtors, (2) "a set of equitable rules for the division of the debtor's property among various creditors," and (3) "a mechanism for the rehabilitation of a business debtor who has the capacity to stay in business and to pay most or all of its debt").

answer to every problem, however, may overlook problems created by consolidated economic power and central managerial control. The power to cheat or mislead or "shirk" (in the favorite idiom of law-and-economists) coincides with the greater efficiency corporate law allows in the organization of centralized management and decentralized financing. Protectionist corporate law is one traditional form of response.[172]

6. Protection of Other Interests?

Corporate law may also include protectionist principles that favor other groups, in addition to shareholders, who have interests in the corporate business. In at least one area, corporate law has taken a small step in this direction. Corporate constituency statutes specifically authorize directors and managers to take account of interests beyond those of shareholders, including the interests of creditors, employees, and local communities, and perhaps even social interests such as the quality of natural environment.[173] These statutes take only a small step, because except in extraordinary situations, such as corporate control contests or governance of nearly insolvent corporations, the statutes only reaffirm traditional prerogatives of managerial discretion in running the corporate enterprise.[174]

172. For a critical discussion of the concept of legal paternalism, see TREBILCOCK, *supra* note 40, at 147-63. Paternalistic principles of corporate law often focus on traditional criteria concerned with "the pre-conditions for the exercise of autonomous choices," including freedom from "compulsion" and "ignorance of the circumstances." *Id.* at 148 & tbl. 1 (citing JOEL FEINBERG, HARM TO SELF 113 (1986)).

173. Pennsylvania's constituency statute, for example, provides:

> In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate:
>
> (1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.
>
> (2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.
>
> (3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.
>
> (4) All other pertinent factors.

15 PA. CONS. STAT. ANN. § 1715(a) (Supp. 1993).

The statutes do not include the natural environment among the listed interests and issues that corporate directors and managers may consider. However, broad, catch-all clauses of "other pertinent factors" and "short-term and long-term interests" are often included. *E.g.*, *id.*; *see also* Orts, *supra* note 23, at 29 & nn.64-65. One could interpret these clauses to authorize consideration of broader social policy issues relevant to the corporate business.

In addition to the quality of the natural environment, another candidate for the current agenda of corporate social responsibility is the quality of educational systems, which produce the primary resource of managers and employees.

174. *See* Orts, *supra* note 23, at 41-44, 92-122; *see also* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1002 (1992) ("[O]ne might argue that the statutes do no more than to bring the law's rhetoric into line with its reality.").

Some commentators argue that courts should expansively interpret constituency statutes to accord legally enforceable rights to nonshareholder interests.[175] These arguments, however, call for a brand of judicial activism that would ignore the plain meaning of the statutes, which intend clearly to provide managerial discretion, rather than to multiply mandatory managerial duties.[176] More traditional commentators argue that courts should instead ignore the clear import of constituency statutes, on the ground that broadening the range of managerial discretion would be too confusing.[177] From a jurisprudential point of view, this approach is disturbingly antidemocratic. In contrast to both extreme positions, I have read constituency statutes to support the traditional legal protection given to corporate management in considering a complex array of factors in decisionmaking, including the interests of the various groups specified in the statutes.[178] Although some may criticize the statutes as not going far enough to protect these other interests, it remains important that the statutes explicitly allow directors and managers to consider them. Constituency statutes in this way expand the allowable parameters of the economic objective.

Through constituency statutes, as well as through traditional common-law doctrines of the business judgment rule and the duty of care, corporate law permits decisionmaking that includes in the economic objective other interests beyond those of shareholders. Expanding the economic objective in this way is left to managerial discretion. At present, the economic objective does not extend to granting enforceable rights to these nontraditional interests. Perhaps it should, but that is an issue for policymakers to make in the appropriate places: Congress, state legislatures, and courts.

Even without admitting other groups beyond shareholders to the governing table, the economic objective of corporate law is divided within itself. It is therefore much more complex than some might wish.

175. *See, e.g.*, Millon, *supra* note 9, at 255-70; Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 630-40 (1992); O'Connor, *supra* note 9, at 1232-34.

176. I make this argument in greater detail in Orts, *supra* note 23, at 79-84. Possible exceptions are Connecticut's and Idaho's statutes, which are written in mandatory language. CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1993) (directors in making corporate control decisions "shall consider" long-term as well as short-term interests, the interests of "the corporation's employees, customers, creditors and suppliers," and "community and societal considerations"); IDAHO CODE § 30-1602, -1702 (Supp. 1993) (directors "shall consider" long-term as well as short-term interests and, presumably in control situations, "the possibility that these interests may be best served by the continued independence of the corporation").

177. *See, e.g.*, Committee on Corporate Laws, American Bar Association, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2253, 2268-69 (1990); Charles Hansen, *Other Constituencies Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1375 (1991). I criticize this interpretation in Orts, *supra* note 23, at 72-79.

178. Orts, *supra* note 23, at 84-122. In my view, constituency statutes apply with different force in different circumstances, for example, decisionmaking in a normal situation as compared to a crisis situation such as a control contest or near-insolvency. *Id.*

B. *Following the Law*

In addition to the purpose of providing a sufficiently flexible regulatory framework for economic organization in pursuit of a broadly complex economic objective, corporate law, as itself a bona fide type of *law*, embodies the self-referential value of following the law. Some law-and-economists forget this truism when they argue that only economic policy should inform corporate law. They claim that if society desires business to cherish other values, then other types of laws besides corporate law should impose those values. For example, labor and employment law, not corporate law, should cover concerns of employees. Environmental law, not corporate law, should protect the natural environment. Corporate law, they maintain, should remain pure of social values extrinsic to the economic objective.[179]

This view overlooks the fact that corporate law, even to the extent it is enabling, expresses policy preferences about the legal structure of business. Law, even when serving economic purposes, remains an expression of social power. As such, it deserves to be followed as the law, as long as it meets requirements of political and legal legitimacy.[180]

It is circular to argue that corporate law should adhere to economic policy prescriptions, and then to argue that the law should be followed because it correctly prescribes economic policy. In other words, law-and-economists sometimes purport to stand outside the law and outside economics, or inside both at the same time. The truth is that one perspective or the other must be adopted when discussing any particular subject in corporate law. From the standpoint of economics, one can attempt to explain why the law is the way that it is, or one can argue in favor of a particular law or general direction for law reform, on economic grounds. From the standpoint of law, however, one must first understand what the particular legal rule or principle is, inquire how to interpret it, and finally consider how the rule or principle applies in concrete, real-world circumstances.[181]

179. Dean Robert Clark describes this view as "dualism." Dualists believe in a strict separation between the "private" realm, including corporate law, and the "public" realm of social regulation. They maintain that shareholder wealth maximization is the unitary goal of corporate law. *See* CLARK, *supra* note 15, at 677-81. For a view questioning the usefulness of the public/private distinction in corporate law, see Stone, *supra* note 23.

180. Of course, the legitimacy of a legal system and its positive law does not necessarily mean that a particular law should be obeyed in a particular circumstance. There are moral reasons for deciding not to follow the law (e.g., civil disobedience, breaking a law to save a person from serious harm). The legitimacy of law and legal systems is discussed below in connection with corporate law. *See infra* Part IV.

181. Roscoe Pound describes these distinctions as follows:

> Three steps are involved in the adjudication of a controversy according to law: (1) Finding the law, ascertaining which of the many rules in the legal system is to be applied, or, if none is applicable, reaching a rule for the cause (which may or may not stand as a rule for subsequent cases) on the basis of given materials in some way which the legal system points out; (2) interpreting the rule so chosen or ascertained, that is, determining its meaning as it was framed and with respect to its intended scope; (3) applying to the cause in hand the rule so found and interpreted.

ROSCOE POUND, INTRODUCTION TO THE PHILOSOPHY OF LAW 48 (rev. ed. 1954).

With this basic legal understanding, it then becomes possible to adopt a critical perspective on the actual law[182] and look to see what economics and other normative disciplines (including ethics, political science, sociology, and psychology) say about how the law *should* operate as a matter of justifying the existing law or recommending law reform. Given the necessary division between the essentially legal exercise of ascertaining the law and the critical exercise of analyzing the law's policy implications, unity of law and economics is impossible.

A good example is by way of counter-example. When clothed in academic garb, Judge Frank H. Easterbrook staunchly advocates a free market in corporate control.[183] Nevertheless, in *Amanda Acquisition Corp. v. Universal Foods Corp.*,[184] he upheld an antitakeover business combination statute as a valid and constitutional exercise of state power. "If our views of the wisdom of state law mattered," said Judge Easterbrook, "Wisconsin's takeover statute would not survive."[185] But he then upheld the law, writing:

> Skepticism about the wisdom of a state's law does not lead to the conclusion that the law is beyond the state's power, however. We have not been elected custodians of investors' wealth. States need not treat investors' welfare as their summum bonum. Perhaps they choose to protect managers' welfare instead, or believe that the current economic literature reaches an incorrect conclusion and that despite appearances takeovers injure investors in the long run. Unless a federal statute or the Constitution bars the way, Wisconsin's choice must be respected.[186]

Tongue-in-cheek language notwithstanding, *Amanda Acquisition* testifies to the authority of positive law and provides a good example of a judge who refuses to bend principles of legitimate statutory interpretation to his view of correct social and economic policy.[187]

The normative principle of following the law also refers to more than the positive prescriptions of corporate law. It concerns whether corporate actors follow more general laws and the question of when it is permissible to break the law. Consider, in this connection, two of Dean Robert Clark's ideal types of "views about the corporation's proper role."[188]

182. Elsewhere, I describe this second-order level of analysis as taking the perspective of "critical legality." Eric W. Orts, *Positive Law and Systemic Legitimacy: A Comment on Hart and Habermas*, 6 RATIO JURIS 245, 252 (1993).

183. *See, e.g.*, EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, *supra* note 6, at 109-24; Easterbrook & Fischel, *supra* note 91.

184. 877 F.2d 496 (7th Cir. 1989).

185. Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 500 (1989).

186. *Id.* at 502.

187. For further discussion of Judge Easterbrook's decision in *Amanda Acquisition*, see Dennis Honabach & Roger Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 CHI.-KENT L. REV. 681, 736-42 (1989).

188. CLARK, *supra* note 15, at 677.

The first is the "shareholder wealth maximization" model discussed above.[189] On this view, some argue that corporate actors should perform a cost-benefit analysis with respect to whether particular laws should be followed.[190] In some cases, the law may contemplate that parties make exactly this kind of calculation. Contract law is a good example, where a party may choose to break a contract and pay for damages, usually without moral opprobrium.[191] In other cases, a choice about whether to follow the law is not usually considered available. Environmental law provides an example. Even if most environmental laws are not criminal, many people believe that corporate actors have a moral duty to follow them.[192]

Somewhat surprisingly, Dean Clark describes a second ideal type advocating "voluntary compliance with the law" as "modest idealism."[193] In Clark's words, this view holds that "corporate managers should cause their corporations to comply with applicable laws and regulations even when noncompliance would increase the corporation's net present value."[194] He gives an example of regulation of water pollution.[195] Is it acceptable for

189. *See supra* Part III.A and III.B. Clark actually adopts two ideal types that have shareholder wealth maximization as a basic description. "Dualism" refers to a "norm of strict profit maximization" and strictly separates this private function from any public obligations. CLARK, *supra* note 15, at 677-78; *see supra* note 179 (discussing dualist view of corporate law). "Monism" operates according to the same economic principle, but sees a "long-run identity between public and private interests," which translates into allowing for "some set of 'socially responsible' corporate activities that it is good for corporations to foster because doing so will eventually create a better climate or culture in which business can operate." CLARK, *supra* note 15, at 681.

190. As Professor Eisenberg has characterized this view,

> The concept that a corporation ought to act within the boundaries set by law might seem self-evident. Unfortunately, it is not. Some persons take the position that a corporation is free to decide whether to obey a given legal rule on the basis of a kind of cost-benefit analysis, in which probable corporate gains are weighed either against probable social costs, measured by the dollar [amount of] liability imposed for engaging in such conduct, or probable corporate losses, measured by dollar [amount of] liability discounted for likelihood of detection.

Melvin Aron Eisenberg, *Corporate Legitimacy, Conduct, and Governance—Two Models of the Corporation*, 17 CREIGHTON L. REV. 1, 8 (1983).

191. *See, e.g.*, *id.* at 10 ("while a breach of contract may violate the moral norm that promises should be kept, it is not clear that the obligation of contract is separately supported by the norm of obedience to law").

192. In fact, given the complexity of environmental regulation, it is often difficult for businesses to achieve full compliance with all environmental regulations that affect them. A "good faith" effort to comply in these situations may furnish a moral equivalent.

193. CLARK, *supra* note 15, at 684.

194. *Id.* at 684-85.

195. The example is worth repeating:

> Consider . . . a complex water pollution statute and the elaborate administrative regulations that implement it. For a given corporation that has long been accustomed to discharge pollutants into rivers next to its factories, the estimated cost of compliance is $10 million. There is no honest doubt, let us assume, about which regulations apply to the corporation, whether they are legally valid, and how they are supposed to be met. There is only a small probability, however, that if the corporation fails to comply with the regulations its noncompliance will be both discovered and corrected (through successful legal proceedings) by the regulators. The corporation expects that if there is discovery and successful enforcement, it will incur additional legal fees, a modest fine, and delayed expenditure of $10 million for compliance. Using their best business judgment, the managers discount these costs by their probability of occurrence and by their futurity, and they conclude that the estimated present value of these costs of noncompliance is only $2 million. Thus, compared to compliance, noncompliance has a net present value of $8 million. From a purely profit-maximizing point of view, the managers may decide not to comply with the pollution regulations, unless and until the regulators bring legal proceedings specifically against their corporation. The modest idealist would say that the managers should not be guided by a cost-benefit analysis that takes the probability of successful enforcement into account, but should cause their corporation to comply with the regulations promptly.

Id. at 685.

corporate managers to calculate whether the costs of compliance outweigh the estimated penalty discounted by the chances of getting caught? Or must managers try to "do the right thing" and comply with the law (at least to the greatest extent feasible)?[196]

It is telling that Clark describes the view that advocates following the law as "modest idealism." An ethical value is implicit in the view that one should follow the law. The idea that businesses may take a different view—namely, to maximize shareholder wealth without regard to duties of legal compliance that conflict with this objective—paints a pessimistic picture of corporate law and, one must add, the possibility of socially enlightened corporate management. Milton Friedman, however, provides cause for optimism. Although a prophet of "profit maximization," he agrees that the economic objective of corporate law is limited by "the basic rules of society," including those "embodied in law."[197]

C. *The Ethical Dimension*

Both the economic objective and the value of following the law are aspects of the normative complexity of corporate law that involve ethical or moral judgments. In other words, both the economic objective and value of following the law are judged good for society.[198] My claim in this section is that an ethical dimension of corporate law extends beyond this level of normative complexity.

196. I add the parenthetical qualification because at least in some complex regulatory situations in environmental law it may not be possible to know for certain that one's business is in compliance or fully in compliance at all times, even with the best available technologies in place. Or it sometimes occurs, again given the complexity of environmental regulation, that complying with one environmental regulation actually conflicts with complying with another.

197. *See infra* note 204.

198. Professor Bratton discusses the ethical underpinning of economic arguments for shareholder wealth maximization in terms of the overall economic welfare of society. William W. Bratton, *Confronting the Ethical Case Against the Ethical Case for Constituency Rights*, 50 WASH. & LEE L. REV. 1449, 1462-64 (1993).

1. Justice and Corporate Law

Dean Karen Newman argues in *The Just Organization* that the broad normative value of "justice" should become a major component of the structure and culture of business.[199] I consider here the role corporate law may play in the context of this aspiration.

Consider first Dean Newman's description of a just organization. A just organization develops a "culture" that includes "the norms, values, and assumptions that form the foundation for interaction in the firm."[200] In turn, an organization's culture is composed of "subcultures" or what are usefully called "moral climates," namely, "the perceptions of the organization's members about practices and procedures that have moral content, that exist in the realm of what the firm values, believes in, and considers right."[201]

Corporate law makes room for these kinds of considerations. Returning to the ALI's statement of the economic objective in section 2.01, an explicit carve-out is made not only for the value of following the law discussed above,[202] but also for ethical considerations.

> Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:
> (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
> (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
> (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.[203]

Some extremists may respond that allowing for ethical considerations and broadly philanthropic purposes in corporate law is disruptive. They may prefer a purer, exclusively economic, focus.[204] At least with respect to

199. Karen L. Newman, *The Just Organization: Creating and Maintaining Justice in Work Environments*, 50 WASH. & LEE L. REV. 1489 (1993).

200. *Id.* at 1496.

201. *Id.*

202. *See supra* Part III.B.

203. ALI, *supra* note 106, § 2.01(b), at 69.

204. Dean Clark describes the practical argument for this perspective:

> A single, objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests. . . . [B]etter monitoring means that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do, and do it efficiently.

CLARK, *supra* note 15, at 679. Interestingly, one of those often quoted for maintaining this strict focus on the economic objective, Milton Friedman, in fact, makes an exception for ethics as well as for law. Friedman writes:

> In a free-enterprise, private-property system, a corporate executive is an employe of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible *while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.*

Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 32, 33 (emphasis added). Proof that Milton Friedman is at least a "modest idealist" in Clark's typology, and perhaps more!

everyday management, however, corporate law as it is now allows for noneconomic considerations of ethics and justice.[205]

The controversial constituency statutes, for example, confirm an ethical dimension in corporate law.[206] By explicitly permitting managers discretion to consider interests beyond shareholders, constituency statutes give managers legal elbow room to be ethical, although they are not forced to be good.[207]

The corporate right to make charitable contributions noted in the ALI's section 2.01(3) is also explicitly recognized in state statutes.[208] Virtually all states have adopted statutes allowing charitable giving from corporations, and the levels of contribution are substantial.[209]

Another area in which corporate law admits an ethical dimension is reflected in the very language of *fiduciary* duties, especially the duties of *care* and *loyalty*. Even though substantive application of these legal duties may often fall short of what some may desire ideally, the overtly ethical language used to describe the *duties* of corporate executives probably has real effect.[210]

In connection with the ethical dimension, it is also important to emphasize that equity, and the power of courts to look to considerations of fairness, plays a large role in corporate law, especially in the important

205. In certain situations, the economic objective takes precedence. For instance, when a decision is made to sell a company, the rule in Delaware is a relatively straightforward economic one of selling to the highest bidder. Paramount Communications, Inc. v. QVC Network, Inc., Nos. 427,1993, 428,1993, 1993 WL 544314, at *6-9 (Del. Dec. 9, 1993); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989).

206. *See supra* Part III.A.6.

207. *See supra* text accompanying notes 173-78.

208. ALI, *supra* note 106, § 2.01, at 92-93; *e.g.*, REV. MODEL BUS. CORP. ACT § 3.02(13) (1984).

209. ALI, *supra* note 106, § 2.01, at 92-93 (noting that "[v]irtually all states have now adopted statutory provisions relating to corporate contributions"). Historically, corporate giving has risen from about .5% of pretax net income in the 1930s, to the level of a "one-percent rule" in the 1950s and holding constant through the 1970s, and increasing to an average of around two percent in the late 1980s and early 1990s. Michael Useem, *Introduction* to F. EMERSON ANDREWS, CORPORATION GIVING 4-5 (1993). For Fortune 500 companies in 1990, charitable contributions amounted to about one percent of worldwide pretax net income. ALI, *supra* note 106, § 2.01, at 92 (citing The Conference Board, Survey of Corporate Contributions (1990)).

210. Clark, *supra* note 10, at 75-76, 78-79 (arguing language courts use in describing fiduciary duties amounts to "sermonizing," but "moral rhetoric" can sometimes "bolster norms in some contexts"); Marleen A. O'Connor, *How Should We Talk About Fiduciary Duty? Directors' Conflict-of-Interest Transactions and the ALI's Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 954, 965-69 (1993) (arguing that "fiduciary rhetoric" plays "socializing role" in corporate law).

Delaware courts.[211] Indeed, the equitable power of courts to consider basic fairness in making and applying corporate law overlays an expansive ethical quilt on the body of corporate law.[212]

Dean Newman also argues specifically for recognition of the importance of a just work environment for employees. Included is a need for procedural fairness in decisionmaking about employment.[213] Although corporate managers commonly turn to the written rules of employment or labor law in these situations, Newman counsels a more proactive ethical approach. Simply following the law is not enough. Traditional protections of the business judgment rule and the duty of care, together with constituency statutes, give managers plenty of latitude to build just organizations. They can legally heed Dean Newman's call if they wish.

If it is true, as Newman claims, that just organizations will improve employee performance, one would expect that the economic markets will select for justice. As Newman writes,

> The first question to ask is why people should try to build and maintain just organizations. What good does justice do in an organization? Our results suggest that the perception of voice—the opportunity to be heard, be informed, and be involved—is critical for increasing employees' commitment to the firm, securing their willingness to work hard, and producing better performance outcomes . . . .
>
> In addition, the perception that one is treated with honesty and respect by coworkers results in greater work effort. Therefore, the first reason to create just organizations is to improve organizational performance.[214]

Perhaps justice in economic organization can come this easily, and it is only a matter of time before managers see the true connection between justice and economic efficiency. However, in the nature of things, I suspect that Newman's second reason for pursuing justice—that "it is a valuable goal in and of itself"[215]—will sometimes require trading off economic values. These are tough ethical choices that corporate law allows managers to make, but does not require.

2. Ethics in Corporate Finance: The Case of Marriott

To illustrate another aspect of the ethical dimension in corporate law, consider the recent reorganization of Marriott Corporation. On October 5,

211. The Delaware Court of Chancery, of course, is a court of equity.

212. Chancellor Allen has remarked: "This court, being a court of equity, tries to bring to its function the most sensitive regard for the moral sentiments that lie below the surface of legal rules." Massey, *supra* note 108, at 698 (quoting Mazzetti v. Sheppard, No. 8198, slip op. at 10 (Del. Ch. Apr. 6, 1987)).

213. Newman, *supra* note 199, at 1499-1501.

214. *Id.* at 1511.

215. *Id.*

1992, Marriott Corporation announced that it planned to spin off its hotel operations from its real estate business to create two separate companies, Marriott International (mainly the hotel business) and Marriott Host (mainly real estate).[216] Marriott shareholders were to receive a special dividend of shares in Marriott International.[217] The price of Marriott shares jumped up 12% on the day of the announcement.[218] Not so happy was the plight of Marriott's bondholders. The reorganization plan called for Marriott Host to receive almost all of the old Marriott Corporation's debt.[219] More precisely, Marriott Host would retain almost $3 *billion* of the long-term debt, while Marriott International would bear only about $20 *million*. And because the Marriott Host side of the business had, in the previous year, only $1.7 billion in revenue and $350 million cash flow, as compared with $7.4 billion in revenue and $500 million cash flow for Marriott International, the bond market quickly corrected for the new risk.[220] The worth of Marriott bonds fell 30% in two days.[221] Bonds and preferred stock were immediately downgraded.[222] Formerly investment-grade bonds were reclassified as junk.[223]

Bondholders predictably reacted to Marriott's plan of reorganization with passion. One institutional bondholder exclaimed, "It really is just an outrage."[224] A spokesman for Marriott responded with a calm and stately invocation of corporate law: "We have a fiduciary obligation to stockholders, and this transaction is in the best interests of stockholders." "Our obligation to bondholders," he continued in the language of the law, but with hidden laughter, "is to make all the bond payments on time and to pay off the principal on time. We plan to fulfill that obligation."[225]

The trouble of course was that the bondholders had failed to negotiate covenants in the bond issues to protect themselves against restructurings like the one Marriott was undertaking. Some bondholders blamed themselves, observing that investors, in rushing to lock in certain rates, often bought bonds without protection.[226] Others who may also have blamed themselves, also blamed Marriott's management, and filed lawsuits in federal court and in Delaware.

216. Eben Shapiro, *Marriott to Spin Off Hotel-Management Business*, N.Y. TIMES, Oct. 6, 1992, at D1.

217. *Id.*

218. Constance Mitchell, *Marriott Plan Enrages Holders of Its Bonds*, WALL ST. J., Oct. 7, 1992, at C1, C19.

219. *Id.*

220. Robin G. Blumenthal, *Marriott to Split Its Business into 2 Entities*, WALL ST. J., Oct. 6, 1992, at A3, A11.

221. Mitchell, *supra* note 218, at C1.

222. Blumenthal, *supra* note 220, at A11.

223. Anne Newman, *Marriott Corp. Modifies Plan to Split in Two*, WALL ST. J., Mar. 12, 1993, at A2.

224. Mitchell, *supra* note 218, at C1.

225. *Id.* at C19.

226. *Id.*

In federal district court in Maryland, fifteen institutional investors who held Marriott bonds sued under the federal securities laws.[227] They alleged that Marriott's management had failed to disclose plans to restructure the corporation by splitting it in two.[228] Although the court dismissed for lack of evidence claims based on plans made before April 1992, it allowed to go forward securities and state common-law claims about plans after that date.[229] Allegedly, Marriott had hired a team of prominent investment bankers and law firms to formulate the reorganization plan, code-named "Project Chariot."[230] Also, plaintiffs alleged that at least one member of the board of directors, a professor at Harvard Business School, resigned in protest over the unfairness of the plan.[231]

In reaction to displeasure of its bondholders, and perhaps to adverse publicity as well, Marriott modified its plan in March 1993, negotiating with institutional holders of $400 million of the debt. Under the revised plan, $450 million of debt was forwarded to Marriott International, and an exchange plan was adopted to improve the rates in a proposed debt swap.[232] After Judge Alexander Harvey denied Marriott's motion to dismiss,[233] Marriott shareholders approved the spinoff in July 1993. By that time, stock prices for Marriott had increased 60%.[234] Marriott family members owned 25% of the outstanding shares.[235] The split was completed in October 1993.[236] Although some bondholders have been made close to whole, one of the lawyers who continued with the federal suit remarked, "This was a very unfair transaction."[237]

Meanwhile, preferred shareholders, in much the same boat as the bondholders, were not faring better in Delaware Chancery Court. Four institutional investors, including among them the President and Fellows of

227. As is usual, but often inconsequential, the complaint also included state law claims of fraud and negligent misrepresentation.

228. PPM Am., Inc. v. Marriott Corp., 820 F. Supp. 970, 971-72 (D. Md. 1993).

229. *Id.* at 979-80.

230. *Id.* at 972.

231. *Id.*

232. Other details included Marriott International agreeing to provide as much as $125 million in financing for the Philadelphia Marriott under construction and to provide $200 million extra in a credit line to Marriott Host. Marriott Corporation also agreed to issue $70 million in stock to retire bonds. Newman, *supra* note 223, at A2.

233. This included denial of a motion for partial summary judgment.

234. Jyoti Thottam, *Marriott Holders Approve Plan to Split Real Estate and Hotels, Making 2 Firms*, WALL ST. J., July 26, 1993, at B4.

235. *Id.*

236. *Plan to Split into Two Businesses Completed*, N.Y. TIMES, Oct. 9, 1993, at 41.

237. Thottam, *supra* note 234, at B4 (quoting Larry Kill). Suggesting a bit of evidence that the capital markets may not be as efficient as some like to think, Marriott International had little trouble selling $150 million in new 10-year notes in early December 1993. One professional market analyst complained, "They are not paying a big penalty for what they have done to their bond holders." Jonathan Fuerbringer, *Brief Memory Aids Marriott Issue*, N.Y. TIMES, Dec. 3, 1993, at D14 (quoting Stephen Clark).

Harvard College, filed suit in Delaware to stop the spinoff.[238] They held more than 50% of Marriott's only issued cumulative convertible preferred stock (Series A).[239] Plaintiffs claimed the special dividend planned for common shareholders violated their rights as preferred shareholders.[240]

Chancellor Allen issued two opinions in the case. First, he held that under the circumstances, the Marriott directors owed no duty of care to the preferred shareholders. Although some Delaware Chancery cases had found a duty of care to extend to preferred shareholders in certain circumstances,[241] Chancellor Allen remarked that "it is often not analytically helpful to ask the global question whether (or to assert that) the board of directors does or does not owe fiduciary duties . . . to the holders of preferred stock."[242] He concluded that "the question whether duties . . . are implicated by corporate action affecting preferred stock is a question that demands reference to the particularities of context to fashion a sound reply."[243] Because the preferred stock in *Marriott* carried conversion rights into common, and because the conversion rights contemplated the possibility of special dividends in a provision for adjusting the conversion price in just such an event,[244] Chancellor Allen held that the Marriott directors did not owe fiduciary duties to the preferred shareholders under the circumstances. Instead, whether "this transaction does wrongfully favor the common stock is a question of contract law."[245]

The second case addressed the contract claims.[246] There, the preferred shareholders alleged violation of their contractual rights (1) to choose whether to exercise their conversion rights, (2) to be accorded a dividend preference over common shareholders, (3) to vote for or against the proposed spinoff, and (4) to be fully protected under the conversion provision.[247] Plaintiffs also alleged an elaborate "machiavellian" scheme of fraud.[248] To make a long story short, Chancellor Allen held that none of the claims had sufficient merit to grant a preliminary injunction against the planned spinoff.

238. HB Korenvaes Investments, L.P. v. Marriott Corp., No. 12922, 1993 Del. Ch. LEXIS 90 (Del. Ch. June 9, 1993).

239. *Id.* at *2.

240. *Id.* at *4-5.

241. *Id.* at *15-16 (citing Porges v. Vadsco Sales Corp., 32 A.2d 148 (Del. Ch. 1943); MacFarlane v. North Am. Cement Corp., 157 A. 396 (Del. Ch. 1928)). Chancellor Allen also distinguished one of his own opinions in which he had recently held that a merger negotiated by a board elected solely by common stockholders had to be shown "not unfair to the preferred stock." *Id.* at *16 (citing *In re* FLS Holdings, Inc., No. 12623, 1993 Del. Ch. LEXIS 57 (Del. Ch. Apr. 2, 1993)).

242. *Id.* at *16.

243. *Id.* at *17.

244. *Id.* at *18-19.

245. *Id.* at *21.

246. HB Korenvaes Investments, L.P. v. Marriott Corp., No. 12922, 1993 Del. Ch. LEXIS 105 (Del. Ch. July 1, 1993).

247. *Id.* at *2-3.

248. *Id.* at *3, *24.

Because the plaintiffs' conversion privileges would not survive the spinoff,[249] they felt forced by the merger to convert their shares into common. Chancellor Allen found persuasive language in the conversion provision that specifically contemplated the possibility of a special dividend being paid, and he held that plaintiffs were not likely to prevail on the merits. The spinoff could go forward.

Although all the chips have not fallen in the *Marriott* series of cases and transactions,[250] enough has happened to offer some thoughts on the ethical dimension of corporate law. First, although bondholders have no absolute legal claim to fiduciary duties from directors, at least in Delaware,[251] the sheer massiveness of the potential unfairness involved leads one to question whether some sort of fiduciary duty to bondholders should apply.[252] The apparent wealth transfer to the Marriott family alone—a 60% increase from about $17 per share to around $26 per share, with the Marriott family holding about 25% of the total (25 million shares), yields a lot of money (roughly $225 millon)—at least raises the question whether corporate law should sanction what looks like an overt taking from unwary or unthinking investors.

Professor Kenneth Lehn, however, argues that "[g]ranting extracontractual rights to bondholders would throw roadblocks in the way of

249. *See, e.g.*, Richard M. Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CAL. L. REV. 243, 287-88 (1954) ("Mergers and consolidations which create a new company and end the existence of the constituent corporations also end conversion privileges.").

250. As of this writing, all but one of the bondholder suits had settled. Fuerbringer, *supra* note 237. The *PPM America* case remained. *Id.*

251. *See, e.g.*, Simons v. Cogan, 549 A.2d 300 (Del. 1988) (no fiduciary duty to convertible debenture holder until conversion to stock). This rule is relaxed in near-insolvency situations. *See, e.g.*, Credit Lyonnais Bank Nederland v. Pathe Communications, C.A. No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991); Geyer v. Ingersoll Publications Co., No. 12406 (Del. Ch. June 18, 1992); *see also* Orts, *supra* note 23, at 115-23 (discussing possible affect of constituency statutes on near-insolvency situations in connection with *Credit Lyonnais*).

252. The argument in favor of some level of fiduciary duty to bondholders is made in Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165 (1990); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988). Others argue for expanded interpretation of contractual principles to protect bondholders within the traditional framework. *E.g.*, William W. Bratton, Jr., *Corporate Debt Relationships: Legal Restructuring in a Time of Restructuring*, 1989 DUKE L.J. 92 (1988); *cf. also* Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821 (1992) (suggesting that voluntary debt adjustments unfairly disadvantage public bondholders); John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207 (1991) (discussing problem of bondholder coercion by issuers who unfairly use threat of bankruptcy or adverse indenture amendments). *But see, e.g.*, David M.W. Harvey, *Bondholders' Rights and the Case for a Fiduciary Duty*, 65 ST. JOHN'S L. REV. 1023, 1026 (1991) (concluding that "negotiation of improved covenants and careful credit pricing is a better objective than a revolution in bondholder remedies"); Thomas R. Hurst & Larry J. McGuinness, *The Corporation, the Bondholder and Fiduciary Duties*, 10 J.L. & COMM. 187, 209 (1991) ("[A]ll of the case law to date is, if anything, squarely opposed to the idea that a fiduciary duty to bondholders can effectively create substantive rights for the bondholder which go beyond those contained in the indenture covenants.").

corporate restructurings that promote economic efficiency."[253] But what does he mean by economic efficiency? In the *Marriott* cases, it seems clear that a significant amount of stock gain was acquired at the expense of bondholder losses. This transfer does not support an argument for economic efficiency, except to say that it may prove more efficient for some to offload indebtedness and risk to others.

As a matter of policy, it may make sense to retain the traditional rule that bondholders must contract for protections from events such as spinoffs that may otherwise harm them. In the *Marriott* cases, the covenants in the bond indentures were "quite skimpy," neglecting to include, for example, "event risk covenants."[254] And perhaps investors should have known about the potential of a spinoff, given that "[d]ozens of spinoffs have been announced by large companies in recent years."[255] One wonders, however, what might come next. Are bondholders, as a matter of law, to remain at the mercy of creative financial restructuring? Are their investments always to be subject to the possibility of a new way to circumvent formalistic contracts? Or are there limits?

Chancellor Allen, in his opinions, seems to recognize ethical limits. In the case of the preferred shareholders, however, it appears that the preferred share contract provided exactly for the possibility of the "event risk" of a spinoff. Because the event was clearly foreseen and negotiated in contractual terms, the court refused to reach out and decide the case on undeveloped legal principles. At the same time, the close attention to facts and fairness in the *Marriott* cases gives good reason to doubt apocalyptic claims about what will happen if fiduciary duties are recognized for preferred shareholders and bondholders when circumstances warrant. In this sense, the emerging law of nonshareholder fiduciary duties illustrates how the ethical dimension of corporate law animates directions in its development.

3. Toward Ethical Corporate Law

One of the reasons Professor Lehn does not wish to see expansion of corporate fiduciary duties to include bondholders who suffer losses in cases like *Marriott* is that he fears that "[p]roviding bondholders with protections that they did not contract for could pave the way for other stakeholders to assert similar claims."[256] Lehn worries that employees, for example, "could argue that a spinoff or other restructuring harmed them and that they should be compensated for their losses, even though their labor contracts do not call for such compensation."[257]

This kind of worry makes some sense, but not much. First, the days may be numbered when one can safely count employees outside the subject

253. Kenneth Lehn, *The Lessons of Marriott*, WALL ST. J., Mar. 11, 1993, at A14.

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id.* For an argument for precisely this kind of movement in corporate law toward protecting employees, see O'Connor, *supra* note 9.

area of corporate law.[258] Second, even if Lehn's point is accepted, his "slippery slope" argument is not very persuasive. Courts draw lines and make distinctions all the time from case to case. Fear of slippery slopes or camel's noses in tents should deter neither judges, nor legislators, from using their legitimate powers to move corporate law toward more just results.[259]

Reformers of all stripes should remember that corporate law carries within it a complex array of normative values, not only economic values, which themselves are often divided and difficult to fathom, but also values of abiding by the law and other principles of ethical business behavior. Tradeoffs among values are sometimes required, and intelligent law reform, whether through legislatures or the courts, requires an awareness of the various purposes served by different rules in different contexts. Reformers as well as traditionalists should make choices with a full realization of the conflicting normative complexity involved in the subject of corporate law.

IV. The Legitimacy of a Complex Corporate Law

I began this Article with a discussion of H.L.A. Hart's injunction not to begin theorizing about corporate law with a definition of "the corporation." The admonition is perspicacious, because corporate law does not follow any unified conception of the corporation. What is needed is a theory of corporate law that takes into account its technical and normative complexity.[260]

Technical complexity in corporate law may result from normative conflicts, as well as from a reflection of the complexity of modern business practice.[261] Some simplification of the technical complexity of corporate law may be desirable.[262] But the social complexity of business and modern society probably poses limits to the extent the technical complexity of corporate law can be reduced, although valiant efforts such as the ALI's *Principles of Corporate Governance* are nonetheless worthy.[263]

258. *See, e.g.*, Coffee, *supra* note 128; Stone, *supra* note 128.

259. *Cf.* Frederick Schauer, *Slippery Slopes*, 99 Harv. L. Rev. 361 (1985).

260. *Cf.* F.S.C. Northrup, The Complexity of Legal and Ethical Experience 5 (1959) ("Since legal experience is complex, especially so in the contemporary world . . . we must expect to have to go where the specific character of the complexities takes us and to be led to a theory and method of law which is complex also.").

261. *See, e.g.*, Geoffrey C. Hazard, Jr., *Foreword* to American Law Institute, Principles of Corporate Governance: Analysis and Recommendations at x (Proposed Final Draft, Mar. 31, 1992) ("Corporate governance involves the management of substantial enterprises. The general management of a substantial enterprise is a complex and dynamic process requiring continual practical responses by necessarily fallible agents exercising power and authority under conditions that are usually subject to unremitting change and often great uncertainty."); *see also supra* notes 4, 119-21, 130-52 and accompanying text.

262. For a general discussion of the phenomenon of legal complexity and prospects for law reform efforts to reduce it, see Peter H. Schuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 Duke L.J. 1 (1992).

263. ALI, *supra* note 106. The ALI's *Principles* in fact illustrate how the subject matter of corporate law virtually compels a complex theory to account for it. Some commentators representing diverse ideological orientations condemn the *Principles* as failing to enact or advance their particular theories of the corporation or corporate law. *See, e.g.*, Symposium, *The American Law Institute's* Principles of Corporate Governance, 61 Geo. Wash. L. Rev. 871 (1993) (in which, despite the diversity of scholarly commentary, it is difficult to find a good word said about the *Principles*). In my view, the ALI's refusal to adopt any universal theory of the corporation is a considerable virtue.

In addition, technical complexity is not always bad. On one hand, a complex body of law may increase transaction costs for those attempting to follow it.[264] In the case of corporate law, companies must hire very expensive lawyers to find the law and to divine likely judicial reactions concerning complex deals or litigation. On the other hand, technical legal complexity may reflect growing complexity in society generally.[265] For example, more complexity in corporate finance is likely to increase complexity in corporate law.

Even though legal complexity is often spoken of as "an evil to be minimized," it can also result in "benefits from rules that are more precisely tailored to particular behavior."[266] Corporate fiduciary duties provide a good example. Predicting exactly how a court will apply a general fiduciary principle to a particular transaction is often difficult, especially given the fast-paced movement of the law and the complexity of factual business situations. But a more complex body of law may make prediction in a specific case easier and surer. If so, then a greater degree of certainty in knowing what types of corporate behavior courts will accept or condemn may offset greater expenditures in transaction costs. In other words, by expressing more detailed standards for appropriate behavior, technical legal complexity may provide social benefits.[267]

The normative complexity of corporate law is another matter. As noted above, the ALI's *Principles of Corporate Governance* recognizes the normative complexity of corporate law.[268] Many who are influenced strongly

264. Schuck, *supra* note 262, at 18 ("A more complex law entails many significant transaction costs which must be accounted for.").

265. *Id.* ("If we suppose that legal rules are largely epiphenomenal, reflecting the underlying social conditions to which they relate, then we might want law's complexity to keep pace with society's. Social complexity is growing remorselessly.").

266. Louis Kaplow, A Model of the Optimal Complexity of Rules 23 (National Bureau of Economic Research Working Paper No. 3958, 1992).

267. *Id.* at 1 ("Rules that are more complex can be more precisely tailored to acts, thereby allowing better control of behavior."); *id.* at 23 ("For example, the more is spent by individuals before acting to understand the applicable rules, the more individuals' behavior will conform to the desired outcome. Thus, evaluations of complexity and measurements of compliance costs will be useful in formulating policy only if considered in connection with the effects of more highly differentiated rules on behavior.").

268. *See supra* text accompanying notes 202-03. I distinguish between technical and normative complexity in corporate law for purposes of orderly explanation. I do not suggest that two types of rules, technical and normative, exist in contradistinction. As Chancellor Allen has observed,

> [A] judgment concerning the wisdom of a specific legal rule requires "thick" substantive information about the systemwide operation of the rule under review and its

by economic models, however, have a lot to say about how corporate law can be made more single-mindedly efficient. In many instances, their advice has already been followed. But this path toward a more efficient corporate law may have other normative costs. A theory of corporate law must take into account the complex nature of its subject, including the fact that many of the rules of corporate law have developed over time and reflect not only economic, but other normative principles.[269] Policymakers must choose how economic goals are to be framed and how corporate enterprises may proceed to achieve them. They must also choose what normative constraints, such as the values of following the law and ethical business behavior, should remain or should be added to the body of corporate legal principles.

If nothing else, one reason to suggest a complex conception of corporate law is to oppose competing economic theories of the corporation, which are both multifarious and often nefarious. Not only must reductionist theories of corporate law be disputed when they make no sense or fail to comport with realities of corporate law, but alternative theories must be proposed and defended.[270] Otherwise, slogans like "the corporation is a nexus of contracts" capture the imagination, and the sure and confident answers of analyses that look mainly to a single variable will succeed in moving the law in a certain direction with potentially dangerous social consequences.

Corporate law involves the rules of the game that govern a complex set of legal relationships. It is set in motion by relatively simple documents filed by businesses with the government, which create for some purposes a single "corporate entity." But corporate law is also concerned with an array of rules and principles governing the resulting economic relationships and business structures. No such thing as "a corporation" exists that is severable from the complexity of its legal relationships. To say Exxon is the sum of its parts—its employees, managers, shareholders, creditors, and other defined participants—along with contracts made among these participants and property held in Exxon's name on behalf of various participants, leaves out key issues of legal structure and governance. Corporate law helps to connect the myriad of economic relationships within Exxon in the form of express or relational contracts, thus providing something of a roadmap of economic connections.[271] More importantly, corporate law provides the legal framework for the positive freedoms and negative constraints that structure corporate power. Corporate law provides for the board of directors and its committees, a management hierarchy, rules by which corporate business functions—charter, by-laws, corporate codes of conduct—and statutory and common-law rules of permissible business behavior. Only when the complex nature of these various legal rules and relationships is comprehended, or at least imagined, does it make sense to speak of Exxon, metaphorically, as "a corporation."[272]

From this perspective, economic theories of the firm are seriously inadequate. They tend to focus only on economic and financial relationships involved in a corporation, and to the extent they include legal matters, their discussion is usually confined to such principles as limited liability.[273] This is too grudging a view of the role of law. The economic and financial relationships contemplated are governed by corporate legal rules, some mandatory and some enabling. Even if what has been unhappily called "enablingism" in corporate law prevailed completely, supplanting all mandatory rules of corporate law with free contracting principles, law would remain essential.[274] The corporate contracts would depend on the legal structures of both courts (for the resolution of disputes and the doctrinal development of corporate contract law) and lawyers (both as drafters of corporate documents and litigators of how to interpret them).

Economic theories of the firm also tend to ignore the relationships of power that the rules of corporate law set in place. A corporation is not merely a nexus of contracts among individuals; it also involves relationships of power, control, and discretionary authority. And the laws that govern these relationships of economic power are normatively, as well as technically, complex. What a corporation is depends always on the legal context of why the question is being asked.

Given the normative and technical complexity of corporate law, the "legitimacy" of the business corporation as a complex legal and economic phenomenon remains an enduring theoretical issue. Professor Richard Buxbaum writes:

> It is fashionable today to disparage concern with the social and political legitimacy of corporate economic actors. This is due in part to scholarly doubts about the reasons for concern and in part to a resurgent corporatist ideology per se. In greatest part, however, it is due to a despairing optimism, a kind of perverse panglossian

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> alternatives and a clear understanding concerning the various ends (values) the system (and, thus, the rule) ought (normatively) to seek to promote.

William T. Allen, *Law and Markets as Social Products*, *in* THE BATTLE FOR CORPORATE CONTROL 153 (Arnold W. Sametz ed., 1990). In corporate law, technical and normative complexity interrelate and coexist.

269. Professor Bratton recognizes this aspect of corporate law when he writes, for example, that "the fiduciary rules that we have in corporate law come down to us as artifacts of ethical judgments rendered in the past." Bratton, *supra* note 198, at 1454.

270. As Professor Bratton writes about the "Chicago story" with its "prevailing vision of the corporation as a wealth-creating mechanism," "[i]t really will take a theory to beat this theory." *Id.* at 1464.

271. *See* Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483, 492 ("And the corporation itself is one of the greatest relational contracts ever.").

272. The theory advanced here shares similarities with the theory of corporate law advanced by Professor Bratton. *See, e.g.*, William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 185 (1992) (suggesting that "the corporation is a complex of relationships—legal, political, and social, as well as economic").

273. *See supra* note 40.

274. *See* Walter Werner, *Corporation Law in Search of Its Future*, 81 COLUM. L. REV. 1611, 1653 (1981) (citing Donald Schwartz, *The Paradigm of Federal Chartering*, *in* COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 332-33 (Donald E. Schwartz ed., 1979) (footnotes omitted)); *see supra* text accompanying notes 60-62.

> view about our economic health and the role of the corporation in maintaining or resurrecting it. . . .
>
> I believe that the insistence on legitimacy is inevitable and unchanging, because it is voiced by those whose fates are affected by decisions in which they do not participate—decisions made by powerholders whom they do not elect.[275]

In a similar vein, Professor George Lodge concludes that the legal idea of the corporation is "floating in [a] philosophic limbo, dangerously vulnerable to the charge of illegitimacy and to the charge that it is not amenable to community control."[276]

My own view is that the legitimacy of the corporation rests ultimately on the same grounds that it always has: the legitimacy of the political and legal system that sanctions and structures it. Given the normative complexity of corporate law it cannot be otherwise. Corporate law cannot refer for justification to a single normative value within it—either economic rationality or ethical goodness. Instead, corporate law, like all law, relies for its legitimacy on the political and legal system of which it is a part.

Some elaboration of the term "legitimacy" is required. Claims that business corporations must be legitimate have been criticized as referring to a "vague" term borrowed from political science.[277] Without going into detail, I suggest that a legal theory of legitimacy may be understood on three levels: legal validity, empirical legitimacy, and systemic legitimacy.[278]

Corporations satisfy the first level of legal validity by ordinary compliance with corporate legal rules and by acquiescing in the jurisdiction and authority of the courts. One can imagine a future society where managers of a large business corporation might grow so cynical, corrupt, and powerful that they would flout the organized legal system. Such a regime of corporatist tyranny would violate the basic norm of legal validity in a democracy.[279]

Empirical legitimacy refers to the extent to which the people in a society, namely, the general public, believe in the moral authority of the basic structures of social power, in this case the legally constituted economic power of business corporations. Events can shake this public faith. The rampant paper entrepreneurialism of the 1980s, for example, may have caused a relative decline in the empirical legitimacy of the corporate system.[280] A similar crisis in confidence during the 1970s brought concerns about corporate legitimacy to the front burner of academic commentary.[281]

Finally, systemic legitimacy refers to the extent to which "power is acquired and exercised according to justifiable rules, and with evidence of consent."[282] To my mind, this is the type of legitimacy with which corporate law theorists should be most concerned. The systemic legitimacy of corporate law depends on the extent to which the processes of corporate governance and power are tied to rational "law-making" and "law-applying" principles and procedures.[283] For example, corporate law raises legitimacy problems in connection with the "race for the bottom," whereby corporate managers have historically been able to ratchet-down the level of regulatory oversight of their business activities.[284] An outstanding question is whether and to what extent this "race" has harmed the systemic legitimacy of corporate law. One should not, by the way, prejudge the issue. It could well turn out, for example, that although the historical race has been toward laxity, the result has nonetheless been democratically ratified by rational apathy of citizens to the resulting legal environment. Delaware may, in other words, do a very good job of providing the kind of procedures and personnel needed for systemic legitimacy.[285]

Although I am attempting to use the concept of legitimacy more precisely here, a perceived need for the legitimacy of corporate law is not new. The concept burst on the academic scene in 1970 with publication of James Willard Hurst's *The Legitimacy of the Business Corporation in the Law of the United States*.[286] As Hurst points out, two major normative grounds have informed the historical development of corporate law: "utility," which is an old word for economic efficiency, and "responsibility." Hurst is the first to use these terms with respect to the legitimacy of corporate law.[287]

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275. Richard M. Buxbaum, *Corporate Legitimacy, Economic Theory, and Legal Doctrine*, 45 OHIO ST. L.J. 515, 517 (1984).

276. GEORGE C. LODGE, THE NEW AMERICAN IDEOLOGY 18 (1975).

277. *See, e.g.*, Werner, *supra* note 274, at 1629 (the idea of legitimacy is "vague even in its native field of political science and no less so in the corporate context").

278. For elaboration of this theoretical model of types of legitimacy, see Orts, *supra* note 182, at 267-70.

279. A number of technical legal issues also go to whether, for certain purposes, a "corporation" is recognized as legally valid. These issues include defective or de facto incorporation and disregard of the corporate entity (or "piercing the corporate veil"). *See, e.g.*, ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS: CASES AND MATERIALS 234-95 (4th ed. 1990).

280. For the original discussion of "paper entrepreneurialism" and its possible causes and effects, see ROBERT B. REICH, THE NEXT AMERICAN FRONTIER 140-72 (1983).

281. For an historical overview, see Werner, *supra* note 274, at 1627-29, 1647-49.

282. Orts, *supra* note 182, at 267 (quoting DAVID BEETHAM, THE LEGITIMATION OF POWER 15-20 (1991)).

283. *See, e.g.*, *id.* at 268 (discussing "law-making" and "law-applying" conditions of "procedural rationality" in Jürgen Habermas's social theory).

284. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974) (describing his view of "the race for the bottom"). *But see, e.g.*, Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 920 (1982) (arguing from economic view that competition among states is "a climb to the top").

285. *See, e.g.*, LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 5-9 (1993) (emphasizing respect for Delaware courts, especially Court of Chancery, as well as developed body of corporate case law); *see also* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 37-44 (1993) (emphasizing Delaware's legal and human capital, but also noting factors that may tend to undercut legitimacy, such as Delaware's dependence on corporate franchise taxes, its constitutional requirement of supermajority for amending Delaware's corporate code, and its "reputation for responsiveness to corporate concerns").

286. *See* HURST, *supra* note 153.

287. *Id.* at 58-111; *see also* Werner, *supra* note 274, at 1627-28.

In his words, "[w]hat law permits or accepts, what it enforces or compels, should be socially useful and socially responsible."[288] Because the two values may diverge, choices must be made, through political and legal processes which must themselves be legitimate, concerning what normative values corporate law will follow.

Let me emphasize how my theory of the legitimacy of corporate law differs from Hurst's. I agree that utility and responsibility remain important values that are necessary for corporate law to remain viable. One reason business corporations are accepted by the public is the perceived utility gained from a relatively strict pursuit of the economic objective, as well as the perceived responsibility that directors and managers exhibit in doing their jobs. To the extent that these perceptions waver, the empirical legitimacy of the corporate system is threatened. More deeply, to the extent the values of utility and responsibility become unhinged from the legally constituted procedures of democratic government and judicial administration, the systemic legitimacy of the corporate system falls into doubt. Although Hurst uses "responsibility" to refer mainly to the traditional measure of managerial accountability to shareholders, as well as legal regulation of business external to corporate law (antitrust, tax, and other specialized laws),[289] I would give the concept further scope so as to include other aspects of the normative complexity of corporate law, such as its ethical dimension.[290]

The complexity of corporate law, therefore, requires a legal and political "metatheory" to contain and justify it.[291] Some may claim that a unidimensional goal is necessary, resulting in recommendations for technical and normative "reduction" of corporate law. This approach, however, risks losing many of the traditional virtues of corporate law as it has developed. Corporate law is complex, but on a metatheoretical level this is good, because the reality of business and society that it comprehends is also complex. What holds together the divergent technical and normative complexity of corporate law is a basic faith in the legitimacy of the political and legal system that supports it.

This theory of the legitimacy of corporate law can be usefully contrasted with other theories that have been advanced. My theory does not, for example, follow either the "Political Model" or the "Economic Model" outlined by Professor Melvin Eisenberg.[292]

According to the Political Model, the corporation is "essentially a political institution, and the groups it most directly affects are its constituencies."[293] Therefore, "the corporation's legitimacy depends upon the extent to which it is governed by principles appropriate to a democratic state."[294] The Political Model leads to proposals for splitting the economic objective to include constituent groups, establishing a "balancing" role for the board to mediate conflicting constituent interests, and placing constituent directors on the board.[295]

288. HURST, *supra* note 153, at 58.
289. *Id.* at 108-11.
290. *See supra* Part III.C.
291. *Cf.* Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 924 (1984) (noting that construction of corporate law's general typology will be helpful in assessing policy recommendations).
292. *See* Eisenberg, *supra* note 190, at 1.

In comparison, the Economic Model "assume[s] that the corporation is an economic institution, and that, as an empirical matter, the corporate system is legitimated through three major bases."[296]

> The first is a belief that placing control of the factors of production and distribution in the hands of privately appointed corporate managers, who are accountable for their performance and who act in the interest and subject to the ultimate control of those who own the corporation, achieves a more efficient utilization of economic resources than that achievable under alternative economic systems. The second is a belief that corporate managers are in fact accountable for their performance. The third is a belief that the shareholders, as the owners of the corporation, have the ultimate right to control it.[297]

Eisenberg himself adheres to this view. He concludes that "it is sufficient to point out that in our society control solely by virtue of ownership—hands-on or hands-off—is a fully legitimating principle. . . ."[298]

It is this last statement with which I disagree. Although economic efficiency provides an important normative justification for much of corporate law, it is not sufficient for the legitimacy of an entire body of law and the social institutions that operate according to that law. An efficient corporate fascism is an extreme example that proves the point. Such a system is not legitimate because it is not tied sufficiently to democratic government and rational legal procedures. Economic efficiency or utility alone cannot justify the structures of economic power set up under corporate law. Instead, corporate law must derive from political and judicial bodies that are recognized (critically and empirically) as legitimate. This higher social, political, and legal level provides a source for the legitimacy of corporate law that avoids the bind in which Eisenberg puts himself when he adopts the Economic Model.

Other normative principles, even when they occasionally conflict with the primary economic objective of corporate law, may nonetheless remain fully legitimate within a broader legal and political system. At this level, choices made in particular circumstances in particular areas of corporate

293. *Id.* at 2.
294. *Id.*
295. *Id.* at 2-3.
296. *Id.* at 5.
297. *Id.*
298. *Id.*

law may legitimately reflect a mix of values. The economic subject of corporate law often answers to economic logic, either in practice or in critical proposals for reform, but not always. In some areas, legal and political decisionmakers in the system may determine that other normative concerns are more important than competing economic values.[299]

This does not mean that instead I am endorsing the Political Model. Professor Lynne Dallas takes this approach, and my view differs also with hers.[300] Like Eisenberg, Dallas advances two competing "models of corporate governance," an "Efficiency Model" which is similar if not identical to Eisenberg's Economic Model, and a "Power Model" which is similar to Eisenberg's Political Model.[301] Dallas generally endorses her Power Model.[302] However, considerable problems are raised by "politicizing" corporate law in this manner, not the least of which is the predictable decline in the economic efficiency of business enterprises that would result.[303] Huge costs to social utility and economic productivity would result from adoption of various political proposals recommending a "version of the corporation as the Republic in miniature."[304] And this predictable decline of social utility is probably the main reason why these proposals have remained only ideas on paper.[305]

My argument, in contrast, is that the technical and normative complexity of corporate law, and its structuring of incorporated businesses, is legitimated through rational mechanisms of legal rules and process.[306] Neither a strict Economic Model—requiring a clear showing of utility for every rule—nor a Political Model of democratic corporate government needs to be followed for legitimacy to result. Instead, the processes of corporate law provide the necessary structure for governance of corporate enterprises. State legislatures and courts provide the essential legal underpinning for "the corporation."[307] As Chancellor Allen has said, "it is the corporate law that governs the inner-working of corporations and thus it is corporate law that legitimizes and limits the exercise of corporate power within the corporation."[308]

Given the immense social power and influence of modern business corporations, issues of corporate law are too important to be left only to courts, experts, or interested parties in litigation. The public at large should also be concerned. As Professor Chayes advises,

> Though our problem is elusive,. . . we ignore it at our peril. Like societies before us, we will be ill-advised to rely exclusively on the conscience or benevolence of the wielders of power to secure that it be exercised for the ends we value. Power in its manifold guises must be submitted to the rule of law: that is, to the governance of reason.[309]

CONCLUSION

I have argued for a nonreductionist theory of corporate law that respects its technical and normative complexity. And I have advanced these arguments in terms of an analysis of how corporate law actually operates.

First, I established that corporate law is complex in the sense of involving a number of technical rules expressed in state corporate codes, as well as common-law principles such as fiduciary duties. Exceptions and special rules govern various particular subjects and circumstances. More generally, corporate law is concerned with the structure of organized economic power. In regulating the major type of business form in contemporary society,

299. Professor Bratton captures this multi-dimensional normative aspect of corporate law in his conception of a "mediative approach," by which he means "legal mediation" that "uses practical reason to synchronize the competing demands and values of actors through the appeal to legal principle." Bratton, *supra* note 272, at 214. As Bratton states correctly, "Where two valid but inconsistent normative directives come to bear on a problem, mediation is required. The choice between the two is a matter of judgment." *Id.* I extend the analysis to include the question of the legitimacy of what Bratton calls, somewhat mechanically, "the mediative device," *id.* at 185, namely, the institutions of courts and legislatures, and how well they fulfill their purposes of rational law-making and law-applying.

300. Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REF. 19 (1988).

301. *Id.* at 22-44.

302. *Id.* at 25-27, 34-36, 39-48.

303. When I presented an earlier draft of this Article at Rutgers-Newark School of Law, I was asked for the basis of my belief that democratic employee-owned and operated businesses would prove less efficient than hierarchically organized ones. A response is to ask why, if economic democracy is more efficient, there are not more such enterprises in existence. If it is true that hierarchical enterprises are, at least sometimes, more efficient than democratic ones, then many people who want jobs may prefer to allow hierarchical enterprises to organize and compete in society.

304. Chayes, *supra* note 159, at 39. Chayes, however, advances an argument along the lines of constituency representation in corporate governance, especially for employees. *Id.* at 41-45.

305. Several prominent authors made proposals for political reform of corporate governance in the 1970s. *See, e.g.*, RALPH NADER ET AL., TAMING THE GIANT CORPORATION 118-31 (1976) (proposing "constituency directors"); CHRISTOPHER D. STONE, WHERE LAW ENDS 157-83 (1975) (proposing "public directors").

306. As Professor Chayes argues,

> [T]o the extent that we are prepared to recognize centers of significant nongovernmental power within our society, they too must be subjected to the rule of law. It is implicit in the ideal . . . that the processes and institutions of the society be organized so as to give reasonable assurance that significant power will be exercised not arbitrarily, but in a manner that can be rationally related to the legitimate purposes of society.

Chayes, *supra* note 159, at 31.

307. *Cf.* Mitchell, *supra* note 127, at 1309 (observing that "to the extent that democratic processes are necessary to legitimate any substantial public or quasi-public power, those processes are implicit in the legislation that creates and empowers the corporation").

308. Massey, *supra* note 108, at 688 (quoting William T. Allen, Competing Conceptions of the Corporation in American Law, Rocco J. Tresolini Lecture in Law at Lehigh University (Oct. 29, 1990)).

309. Chayes, *supra* note 159, at 45.

corporate law is a mix of power-conferring (enabling and suppletory) and duty-imposing (mandatory) rules.

Second, corporate law is normatively complex. It involves different types of economic values, not just one magical principle of shareholder wealth maximization. Even if one wished to reduce corporate law by a totalitarian implementation of economics, this science, as applied to the complex matter of business organization, does not yield uncontroversial results. One reason is that the "economic correctness" of any particular legal rule or principle often depends on the perspective from which the question is asked. Is the point of view of shareholders the only one that matters? If so, which shareholders matter most? Should large institutional investors predominate? Are the interests of short-term and long-term investors necessarily consonant? Moreover, should the rules and principles of corporate law sometimes look beyond shareholders? For instance, should corporate law sometimes protect creditors or employees?

And beyond economics, beyond the economic interests of participants in corporate enterprises, a ruthlessly efficient corporate law may have adverse social effects with respect to a range of noneconomic factors managers may otherwise want to consider in making decisions. For example, would a totally efficient corporate law allow managers to consider the impact business decisions may have on the natural environment? May they adopt proactive programs to benefit the environment (for example, recycling and waste reduction programs or environmental management and auditing systems) even if they adversely affect the bottom line? What about a host of other ethical issues that confront businesses daily?

In fact, positive corporate law already answers many of these questions, implicitly if not explicitly. It embraces a number of different kinds of economic and social values. Often, economic considerations prevail, but in many areas corporate law also takes to heart other ethical, legal, and political principles.

Understanding the complex nature of corporate law teaches some lessons for proponents of law reform. First, the technical complexity of corporate law suggests that piecemeal reform may lead to better results than attempting to overhaul the entire subject. If large changes are desired, then a detailed survey of the existing law is needed first to avoid unanticipated adverse consequences. Corporate law is a very large and complicated social machine with which to tinker. Second, the normative complexity of corporate law should be kept firmly in mind as new directions are sought.[310] New directions

310. A number of developments suggest that corporate law is destined to take new directions in one way or another. As Chancellor Allen observes, "There are unmistakable signs that we may be on the cusp of a new era [in corporate law]." Massey, *supra* note 108, at 778 (quoting William T. Allen, A Glimpse of the Struggle for Board Autonomy in American Corporation Law, Address at Stanford University Law School (Apr. 5, 1990)). Two trends contributing to the flux are the rise of institutional investors and increasing concern for the impact of corporate law on interests beyond those of shareholders. *See, e.g.*, Lyman Johnson & David Millon, *Corporate Takeovers and Corporate Law: Who's in Control?*, 61 GEO. WASH. L. REV. 1177,

in corporate law are exciting to contemplate. At the same time, many traditional legal principles retain a great deal of strength, if only courts and legislatures would reinvigorate them.

Finally, if reductionist models are followed, corporate law will not turn in a happy direction. Neither reconfiguring corporate law to fit an image of economic perfection nor transforming it in line with a utopia of democratic participation comports with the complexity of modern business. Forcing the world into rigid theoretical boxes is dangerous. Instead, a search for new directions in corporate law would do better to explore particular areas of the subject and consider carefully how best to achieve the most desirable social policy in each area. Usually, a mix of economic, political, and moral principles, in different measures for different circumstances, will provide the most suitable recipe. Wise policymakers—not only legislatures and courts, but also academics and public-spirited lawyers and citizens—should not convert the framework of corporate law into either an unfeeling gauntlet of economic madness nor an overly sanguine vision of do-good business. New directions in corporate law should instead take society on a course that is morally and politically uplifting, as well as economically productive. Corporate law must remain complex to retain its legitimacy.

1199-1203 (1993). *But see, e.g.*, Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423-24 & n.2, 1435 n.40 (1993); Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1054 n.108 (1993) (expressing doubt about long-term significance of these two trends and arguing that much of the debate over "new directions in corporate law" is not really "new").