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Introduction to Economics of Corporate Law

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Introduction

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Scholarly analysis of corporate law in the United States has come to be dominated by an economic approach. Not all research relies on formal economic theory or econometric analysis, but ideas drawn from economics play a major role in most significant published research nowadays. This was not always so. The articles drawn together in these two volumes all represent major milestones along the road that economics has traveled in coming to play this central role in corporate law scholarship.

At the outset, we should make clear what we do and do not propose to cover in these volumes. Our focus is on the analysis of corporate law, drawing mainly upon legal scholarship (although in some cases authors involved in legal scholarship also have significant training in economics). The scholarly worlds of the theory of the firm and of corporate finance are closely related, and have had much influence on the legal scholarship. However, the legal realm provides more than enough material, and deserves a collection of its own. We have also limited ourselves to US scholarship, because that is a very large field on its own, it is the original site of applying modern economic analysis to corporate law, it has had much influence in other countries, and also admittedly because it reflects the limits of our own expertise.

The two pivotal works that launched the economic analysis of corporate law appeared in the 1930s. One was written by an economist—'The Nature of the Firm', by **Ronald Coase** (1937, Chapter 1 Volume I). The other was written by a team of a law professor and an economist—*The Modern Corporation and Private Property*, by Adolf Berle and Gardiner Means.[1] The field then lay fallow for several decades. Scholarship began to appear again in the

1960s with several key articles by **Henry Manne** (one of which appears as Chapter 1 of Volume II in a section devoted to takeovers and takeover defenses). The volume picked up somewhat in the 1970s, and then economic analysis of corporate law really took hold in legal scholarship during the 1980s.

These two volumes divide the seminal articles in the development of the economic analysis of corporate law into six parts. In Volume I, Part I collects several of the key works on the economics of the firm which have most heavily influenced legal scholarship. Part II focuses on the central legal role of the board of directors. Part III collects articles on state competition for corporate charters. In Volume II, Part I focuses on hostile takeovers and board defenses against them. Part II considers the effectiveness of shareholder suits and other agency mechanisms. Part III concludes with several significant articles that introduced a variety of other perspectives.

Volume I

Economics of the Firm

Part I of Volume I begins with the beginning, 'The Nature of the Firm' by **Ronald Coase** (1937, Chapter 1 Volume 1). This article became the starting point for the modern theory of the firm in economics, and that theory in turn has been at the heart of the economic analysis of corporate law. Coase frames his analysis by asking why some economic activities are carried out within business associations rather than in market transactions. Activities within firms are decided by hierarchical instructions from relevant decision-makers, as opposed to being based upon individual actions taken to exchange goods or services at market-determined prices. Coase argues that transaction costs will determine what activities are best undertaken within a firm as opposed to in market transactions. Costs of using markets include search and information costs and enforcement costs, among others. Costs of carrying out activities within firms include agency costs and the limits of the ability of entrepreneurs to make good decisions, among others. As these differing costs vary over time and across industries, the boundaries of firms will vary.

When, several decades later, economists began to take the theory of the internal organization of firms seriously, they used Coase's transaction cost framework as a central organizing concept. In one short article, Coase was necessarily vague as to the nature and types of transaction costs, so a major research topic became achieving a deeper and more nuanced understanding of these costs. The leading figure in this research paradigm was **Oliver Williamson**. Williamson's key insight was that the nature of a contractual relationship changes fundamentally when one or more parties to the relationship has made costly relationship-specific investments. Those who have done so become vulnerable to exploitation, as they cannot exit the relationship without losing significant value from their investment. Governance mechanisms, including the firm, then become helpful to help manage such relationships.

Williamson developed this argument in a large number of articles and books.[2] We have included here one article, 'Corporate Governance' (Williamson 1984, Chapter 3 Volume I), because it focuses on the role of the board of directors, a central topic in corporate law. Williamson characterizes the board as primarily, though not necessarily exclusively, a governance mechanism to protect the interest of equity investors. Such investors have invested in the assets of a firm collectively (as opposed to in particular assets, as is the case for instance for secured creditors who have funded purchase of a particular asset), and in a publicly-traded corporation the equity investors (that is, shareholders) also face a collective action problem, as there are many of them, all or most with individually modest stakes. Other constituencies with other sorts of relationships with the firm will develop other sorts of mechanisms to defend their investments, although in some cases representation on the board of constituencies other than shareholders may be a valuable additional protection.

Many other economists have followed in the path started by Coase and Williamson. Of particular note is the property rights approach pioneered by Oliver Hart and collaborators,[3] which like Williamson focuses on firm-specific investments, but does so using more formal modeling, and viewing governance mechanisms through a lens of property rights, seeing ownership as conferring the right to decide matters not dictated by explicit contractual provisions. Our focus on the legal rather than the economic literature has led us to leave out the major contributions in this literature beyond the articles by Coase and Williamson, but there is a large set of contributions there that has had a significant effect on the economic analysis of corporate law.

The final contribution to the foundational economic theory of the firm that we have included is 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', by **Michael C. Jensen and William Meckling** (1976, Chapter 2 Volume 1). This article has been almost as influential for legal scholarship as Coase. Jensen and Meckling focus more on corporate finance than on the nature of the internal structure of firms or their boundaries with markets. They use concepts from agency theory and corporate finance to explain ownership structure and the mix of debt and equity in financing firms. They argue that the ownership structures which tend to prevail are those which minimize the total agency costs existing between those who provide money to a firm and those who decide how to use that money. Jensen and Meckling have been particularly influential within legal scholarship, as compared with their relative influence within the economic theory of the firm, because of this focus on the relationship between firms and their shareholders, which also is the focus of corporate law.

The Board and Purpose

As noted above, the other work from the 1930s which ultimately helped shape the economic analysis of corporate law was *The Modern Corporation and Private Property*.[4] This book highlighted and brought to national attention the fact that the growth of large public corporations with shares traded on national exchanges had led to a critical new type of business, with a new type of characteristic challenge to public policy. In this company, there were thousands of shareholders all holding a relatively small fraction of the outstanding shares, and no one person or entity owned enough shares to have the ability or incentives to monitor and discipline the managers who ran the firm. This created what has come to be called the separation of ownership and control. In these corporations, a critical question is how the top managers can be motivated to act vigorously to promote the best interests of the corporation, and disciplined where they fail to do so. That question has come to dominate American corporate law and corporate law scholarship. In Part II we collect papers that approach this question through the role of the central legal body within a corporation, the board of directors.

The first paper in this part is by the lead author of that classic book. In ‘Corporate Powers as Powers in Trust’, **Adolf Berle** (1931, Chapter 4 Volume I) argues that whenever the managers exercise the powers granted to them, they must act under an equitable duty to use those powers in a way that benefits all of the shareholders. In building his argument, Berle relies upon the lawyer’s traditional tool of case citation, and does not explicitly draw upon the then still unpublished work with Means. However, one can see a connection. The book raises the question of how managers can be constrained to act in the best interest of a diffuse body of shareholders. Berle’s paper points to fiduciary duty law as a key constraint.

The second chapter in Part II is the famous response to Berle by **E. Merrick Dodd, Jr.** ‘For Whom Are Corporate Managers Trustees?’ (1932, Chapter 5 Volume I). Dodd is sympathetic to the need to motivate and constrain the managers of modern public corporations, and hence to stress the role of an equitable fiduciary duty that always governs any actions corporate managers take. However, Dodd criticizes the formulation by Berle (and many others) that such duty runs only in favor of the shareholders of the corporation. Rather, corporate managers should be seen as exercising their powers in favor of the corporation generally, which includes not just shareholders but also other affected groups, including employees and customers. The Berle–Dodd exchange was the first volley in what has become an ongoing debate between the shareholder and the stakeholder conceptions of the corporation. The debate remains intense today.

The next two chapters in Part II are in part more recent interventions in this debate, and in part meditations on the central role of the board in corporate theory and practice. ‘Director Primacy: The Means and Ends of Corporate Governance’, by **Stephen Bainbridge** (2003, Chapter 6 Volume I), stresses the central role of the board in governing a corporation (in contrast, both Berle and Dodd speak of corporate “managers”, which presumably encompasses both directors and officers; Bainbridge focuses squarely on directors). Bainbridge agrees with Berle that the only proper purpose of the board is to act for the benefit of shareholders. However, in contrast with Berle, Bainbridge argues that the law should generally leave directors only lightly constrained in how they choose to carry out that purpose. In arguing for this position, Bainbridge draws heavily upon the work of economist Kenneth Arrow,[5] following Arrow in emphasizing the competing values of authority and responsibility. Bainbridge uses this framework to argue that the law should generally make a presumption in favor of deferring to board authority. This paper is the first in a series of papers and books exploring the implications of director primacy for corporate law. Collectively, these may be the most sustained theoretical defense of American (and especially Delaware) corporate law.

Writing at about the same time, **Margaret M. Blair and Lynn A. Stout** offered a competing theory of corporate law. Their leading statement of the theory came in 'A Team Production Theory of Corporate Law' (1999, Chapter 7 Volume I). Blair and Stout draw heavily upon the team production strand in the economic theory of the firm, including papers by Alchian and Demsetz,[6] Holmstrom,[7] and Rajan and Zingales.[8] They see corporations as teams of shareholders, employees, and others who combine their inputs to produce a collective output, with the value of each individual input hard to measure. They argue that the board acts as a mediating hierarch, which allows each type of team member to commit to the firm without fear of others taking advantage of their firm-specific investments. By this quite different theoretical route, they come to a destination that strongly resembles Bainbridge in emphasizing the central authority of the board. However, they differ in arguing that the purpose of the board should be to pursue the interests of a variety of stakeholders who have committed to the firm, not just shareholders. Thus, Bainbridge aligns with Berle on the question of the ends of corporate governance, while Blair and Stout align with Dodd. However, on the question as to how strongly we should understand fiduciary duties (along with other accountability mechanisms) to constrain directors, Blair and Stout tend to be relatively deferential to the board, in this respect aligning with Bainbridge against both Berle and Dodd.

The theoretical emphasis on the role of directors reflects an increasing legal and practical emphasis. A leading expression of that emphasis has been a variety of reforms that have changed the composition of the boards of public corporations. Whereas once those boards were dominated by insider officers, today they are dominated by outsiders with no formal role in the corporation other than that of directors. This is justified as necessary to allow directors to fulfill their function of searchingly monitoring the behavior of corporate officers. But has this emphasis on independent directors succeeded? There has been much debate on this point. The next article, by **Sanjai Bhagat and Bernard Black**, is ‘The Uncertain Relationship Between Board Composition and Firm Performance’ (1999, Chapter 8 Volume I). It is an influential survey of a broad range of empirical studies examining the effect of board independence. The authors find that the evidence shows little correlation between director independence and board performance. More independent boards do neither a better nor a worse job than insider-dominated boards, where performance is measured using a host of different metrics.

The final article in Part II is ‘The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability’, by **Donald Langevoort** (Chapter 9 Volume I). The article explores some possible explanations of the empirical results described by Bhagat and Black. In doing so, Langevoort draws upon work in psychology and organizational behavior, an approach shared by many of his influential writings. Looking at boards as teams, Langevoort suggests that an overly sharp emphasis on a confrontational monitoring role can have unintended consequences, causing boards to become dysfunctional and dominated by conflict. Finding a way to blend the role of insiders and outsiders and build trust is critical for creating effective boards. Langevoort suggests that norms rather than legal rules may be more effective in helping encourage effective boards.

State Competition

The final Part of Volume I gathers leading articles on state competition in corporate law. A distinctive feature of US corporate law is that corporations may choose to incorporate in whatever state they please, regardless of how much economic presence they have in that state. States may benefit from fees if they attract many corporations, and perhaps more significantly, lawyers in a state may benefit from their state being an attractive destination for incorporation. This creates incentives for states to be attractive to those who choose where corporations will incorporate. When it comes to publicly traded corporations, one state has dominated the resulting competition for many decades: Delaware. An important question then becomes whether this tends to encourage or discourage socially optimal corporate law. The question is important because it affects any normative evaluation of US corporate law. If one believes the "race to the bottom" thesis that competition tends to encourage sub-optimal law, then one should be skeptical about the substance of much corporate law. If one instead believes the opposite "race to the top" thesis, one should generally presume that most corporate law, especially Delaware corporate law, tends to be socially beneficial. Much ink has been spilled on this subject.

Part III starts with the leading statement of the race to the bottom thesis in the modern literature, **William L. Cary**'s 'Federalism and Corporate Law: Reflections Upon Delaware' (1974, Chapter 10 Volume I). Cary, a former chair of the SEC, argued that Delaware corporate law shows a strong tendency to weaken over time, providing too little constraint on managerial behavior. This holds for both statutory and judicial case law. Cary argues that federal securities law displays healthier rigor. He proposes a federal corporate law for corporations over a certain size in asset value and number of shareholders.

The next article, 'State Law, Shareholder Protection, and the Theory of the Corporation' by **Ralph Winter** (1977, Chapter 11 Volume I) (who became a Second Circuit judge several years after publication), states the fundamental logic of the opposing race to the top thesis. In which state a corporation is incorporated is readily available public information, and shareholders are able to evaluate which state laws provide more or less attractive packages of legal rules. If a corporation's managers have chosen to incorporate in a state which provides a bad set of rules (from the shareholders' perspective), shareholders will recognize this fact and be willing to pay less for shares in such a company. This acts as a critical disciplinary check on any tendency of managers to choose a state law that inappropriately favors them. As long as this share price mechanism works and indeed provides proper incentives in choosing where to incorporate, state competition should lead to optimal legal rules—a race to the top rather than to the bottom.

Winter's race to the top became the prevailing point of view and a core lynchpin in much of the first wave of legal scholarship on the economics of corporate law. A very influential article in establishing the race to the top perspective was **Roberta Romano**'s 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985, Chapter 12 Volume I). This piece is also notable as one of the first major influential examples of empirical econometric scholarship in the economic analysis of corporate law. Econometric analysis has today become extremely common in economics-influenced legal scholarship, but that was not true in the early years. 'Law as a

Product’ is thus a landmark piece not only for its substantive conclusions but also for its use of a formal empirical methodology.

In ‘Is Corporate Law Trivial? A Political and Economic Analysis’ (2001, Chapter 13 Volume I), **Bernard Black** argues for a provocative thesis. As a result of state competition for corporate charters, corporate law is trivial, in the sense that it does not prevent corporate managers from choosing whatever governance rules they want. This is clearest for the many corporate law rules that are default (that is, they apply only in the absence of an agreement to the contrary within a particular corporation), but Black argues that it is largely true even for rules that appear to be mandatory. He argues that most such rules are either market mimicking, in the sense that all corporations would choose them anyway, or avoidable through careful legal planning or choice of state of incorporation.

The next article, ‘Does Delaware Law Improve Firm Value?’ by **Robert Daines** (2001, Chapter 14 Volume I), is a good example of the growing trend towards empirical econometric analysis in legal scholarship of corporate law. The article answers “yes” to the question posed in its title. Daines compares Tobin’s Q, a common estimate of firm value, for similar companies that are incorporated in Delaware versus those incorporated in other states. The results tend to support the race to the top thesis, and call into question the race to the bottom thesis and the triviality thesis. The paper has been quite influential, although there is much dispute over the conclusion. Other papers using either different methodology or a different time period sometimes reach conflicting results—a not uncommon situation for econometric studies.

The final two papers in Part III suggest ways in which neither the race to the top nor the race to the bottom thesis adequately characterizes corporate law federalism in the US. ‘A Regulatory Competition Theory of Indeterminacy in Corporate Law’ by **Ehud Kamar** (1998, Chapter 15 Volume I) suggests that there is no longer a very effective race between states. Delaware's longstanding dominance creates a variety of network benefits. That is, corporations find it helpful to incorporate in the dominant state, even if its law is not necessarily the very best available in substance, and as corporations continue to choose Delaware because of those network effects, Delaware's dominance is reinforced. Delaware strengthens this effect by creating indeterminate rules which must then be interpreted by the state's highly expert and prestigious courts, probably the leading source of Delaware's attractiveness. Statutory language is easy to copy, but experienced and expert judges with a rich body of case law are not. Even if the race tends to the top, excessive ambiguity may prevent that race from getting as far up the mountain as it might otherwise do.

The final paper of Volume I, 'Delaware's Competition' by **Mark Roe** (2003, Chapter 16 Volume I), explores a different respect in which the simple race to the bottom versus top debate may be misleading. Like Kamar and some others, Roe suggests that the race between states may not be very vigorous because of various advantages Delaware gets from its long-term dominance. Roe argues that the real competition for Delaware is the federal government. Various federal actors—Congress, the SEC, and federal courts—can and do intervene through securities law regulation if they believe that state corporate law has moved in an unhealthy direction. Thus, many important elements of corporate governance today are dictated by federal securities regulation rather than state corporate law. Perhaps even more significantly, the content of state corporate law, especially in Delaware, is heavily affected by the threat of federal intervention. Delaware legislators and judges know that if they move the law too far in a direction that displeases the federal regulators, those regulators will act, leading to reduced influence and power for Delaware. They limit themselves accordingly to avoid such federal intervention.

Volume II

Takeovers and Takeover Defenses

Part I discusses takeovers and board defenses against them. Takeovers have long been a matter of enormous debate. The debate significantly turns on how much power boards should have to rebuff attempts to take over their companies. To what extent do boards—and more broadly, "managers," which includes officers—benefit from the specter of their companies being taken over? Does this give them needed discipline when they might otherwise shirk their duties or manage more for themselves than the shareholders? Or does this cause them to manage very much for the short term, making sure, even if necessary by aggressive accounting, to meet quarterly targets, or otherwise manage differently than they otherwise would or that would be best for shareholders? Do those who seek to take over companies have value-maximizing ideas, or do they have ways of enriching themselves at a company's expense?

Scholars who favor giving managers more power to resist takeovers tend to think that other forces provide any needed discipline; they may also think that those attempting takeovers may on balance be worse for shareholders than the managers. By contrast, scholars who favor limiting manager power to resist takeovers tend to think managers are apt to become entrenched, and would use power to resist takeovers to keep their jobs rather than out of a principled view that the particular takeovers at issue were truly undesirable for the company. Less power for managers means more power for shareholders; there are debates as to what form that power should take. Going beyond the broader questions of who should have more or less power, there are also questions as to what form that power should take. Specific features of various techniques available to managers are much discussed, as are the contours of when those techniques should be available.

The paper that began the debate was **Henry Manne**'s 1965 paper 'Mergers and the Market for Corporate Control' (1965, Chapter 1 Volume II). Writing at a time at which many mergers were disfavored and indeed even blocked for antitrust reasons, Manne argued for the benefits of mergers. If a company was not being well-managed, its share price would be low; it could be taken over and managed better to great profit, since the share price would increase to reflect the improved management. While his paper expressly addressed mergers and proxy fights, it has been used as a defense of changes in control of companies generally against 'the other side.' For Manne, the most salient 'other side' at the time was the law disfavoring mergers; with antitrust limitations far less of a factor, the 'other side' is the management itself.

The other papers in this Part expressly address takeovers. In 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981, Chapter 2 Volume II), **Frank H. Easterbrook and Daniel R. Fischel** argue that managers' rights to resist takeovers should be severely limited. For instance, managers should not be able to amend the charter or by-laws with antitakeover amendments, nor should they be able to create antitrust obstacles to an offer. They also should not be able to give potential friendly acquirers information to encourage them to make an offer. While shareholders benefit when managerial resistance leads a hostile bidder to pay a higher price, some offerors will be dissuaded from making offers in the first instance, which would lead managers to manage with less efficiency than they might if offers were likelier to be made.

In the seminal *Unocal* case, *Unocal v. Mesa Petroleum*, decided in 1986, Delaware developed an intermediate standard by which to assess the use of takeover defences. The highly deferential business judgment standard would not be applied, nor would the entire fairness standard, with its searching scrutiny, implicated when paradigmatic loyalty concerns are at issue. Directors would need to demonstrate that they had reasonable grounds for believing that there was a danger to corporate policy and effectiveness and that their response was reasonable in relation to the threat posed. Having made such a demonstration, their decisions then would be afforded business judgment deference. In 'Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to the Proportionality Review?' (1989, Chapter 3 Volume II). **Ronald J. Gilson and Reinier Kraakman** articulated as their aim to give guidance as the intermediate standard was being developed. The authors divided possible threats into three categories: the loss of an opportunity to consider a superior management alternative (opportunity loss); the risk that an offer that treated different shareholders differently (such as a "front loaded two tier" offer which gives those tendering in the first tier superior consideration) would be coercive (structural coercion); and the risk that shareholders would "mistakenly" not believe statements by their management that their company's intrinsic value was higher than the offer price (substantive coercion). The authors noted that a court's review of the evidence with respect to the first two types of threats was in theory quite limited, whereas the review of the third type of threat could and should require far more, as the board demonstrated to the court how it proposed to increase value. Indeed, the authors envisioned that courts would use their independent business judgment in appraising such a demonstration. The authors also described a proportionality test with what one might call "teeth." It seems fair to say that as the law has developed, courts have made it far easier for companies to demonstrate both a cognizable threat and the proportionality of their response to that threat than this article argues would have been appropriate and desirable,

Jeffrey N. Gordon's article 'Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett' (1997, Chapter 4 Volume II) discusses the development of the law at an interesting juncture, before, for instance, deadhand pills were invalidated in Delaware and as shareholder activism was increasingly focusing on giving shareholders a greater role in companies' adoption and deployment of poison pills. Considering the benefits of an active market for corporate control, Gordon sounds a cautionary note against the trend in Delaware to be too deferential to management's use of defensive devices against hostile takeover attempts. A deadhand feature increases the already consider anti-takeover force of poison pills. Poison pills give shareholders other than a hostile acquirer the right to acquire more shares of the target at a reduced price, thus diluting the value of the hostile acquirer's stake. But directors retain the power to not make pills inapplicable to transactions they favor. Thus, shareholders could defeat a pill by mounting a proxy fight and electing directors who would redeem the pill. Deadhand pills provide that they can only be redeemed by the directors who adopted them, denying other directors that power. In cases decided in 1998 and 1999, *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998), and *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281, 1289 (Del. 1998), Delaware outlawed the deadhand poison pill and a similar type of pill, a slowhand pill, which prevented newly-elected directors from voting to redeem a poison pill within some period after they were elected.

But companies have another, highly effective, way of limiting shareholders' ability to force redemption of a poison pill, as **the Lucian Arye Bebchuk, John C. Coates IV and Guhan Subramanian** paper in this volume, 'The Powerful Antitakeover Force of Staggered

Boards: Theory, Evidence, and Policy' (2002, Chapter 5 Volume II), discusses: staggered boards. Staggered boards have different classes of directors; each class's term expires on a different year, such that in any year, only part of the board is up for election. A typical configuration is three classes of directors, with each class's term being three years. Thus, replacing a majority of the directors on such a board would take two years. The authors study how firms with staggered boards fare against hostile takeover attempts. They find that such firms manage to rebuff takeover attempts far more often than firms without staggered boards. They also find that the fact that effective staggered boards increase the likelihood that a firm will stay independent is value-reducing for shareholders. They argue that Delaware's developing jurisprudence on takeover defenses mistakenly assumes that poison pills are not as much of a barrier to takeovers as they actually are. The jurisprudence assumes that by means of a proxy fight, shareholders can elect a board that could redeem a pill that managers would otherwise not redeem. But election in more than one cycle is far more onerous than election in one cycle. The authors counsel that Delaware jurisprudence should take into account the considerable power of the combination of a poison pill and a staggered board.

Shareholder Suits and Other Agency Mechanisms

This Part deals with mechanisms to constrain companies' boards of directors and management. The company—and its shareholders—are the principals. Boards and managements are agents, acting for, and supposedly in the interests of, the company and its shareholders. But they have both the incentive and the ability to act for themselves. An important mechanism to address this issue is shareholder suits for breach of fiduciary duty. Several papers in this Part discuss various aspects of shareholder suits. Other parties might seem to be well-situated to influence director and officer behavior. This Part also includes papers considering how much, and how well, other parties do so.

The first paper in this Part is **Janet Cooper Alexander**'s paper 'Do the Merits Matter? A Study of Settlements in Securities Class Actions' (1991, Chapter 6 Volume II). Alexander's short answer to the question posed in her title, based on her empirical research, is "no." She explains why the merits matter as little as they do: the existence of rules that "make pretrial adjudication essentially unavailable," and that participants have "unusually" strong incentives not to go to trial. She concludes that:

> [w]hen the parties are virtually certain that the case will not be adjudicated on the merits either at trial or by motion, the link between the settlement outcome and a hypothetical trial outcome may be weakened or broken. As a result, settlement outcomes need not approximate—and may not even be significantly affected by—expected trial outcomes. For practical purposes, the merits do not matter. (Chapter 6 Volume II, p. 00)

It follows that the legal regime should not encourage settlements nearly as much as it does.

This Part continues with two articles discussing what director and officer fiduciary duties encompass, and how they are interpreted by the courts. The first is **Melvin Aron Eisenberg**'s 1993 piece 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993, Chapter 7 Volume II). Eisenberg makes a distinction between standards of conduct—rules as to how officers and directors should act, addressed to them—and standards of review, "decision rules which are addressed to judges." He argues that in many cases, the two standards are quite different. Standards of conduct are quite simple, and require directors and officers to act in good faith in the interests of the corporation, reasonably, and when engaged in self-interested conduct, fairly. Standards of review are more complex. There are more, and less, exacting standards, and intermediate standards. The more exacting standards are those of fairness and good faith (where self-interest is at issue); the least exacting are of business judgment and waste (where the duty of care is implicated). Intermediate standards are applicable in a variety of contexts, including where directors decide to prevent or discontinue a shareholder derivative suit. Eisenberg argues that just because directors are not liable, it does not necessarily follow that they have behaved properly. They may not be liable under the applicable and appropriate standard of review, but they may nevertheless have violated the standard of conduct. Stated differently, corporate law seems to have a penumbra that is sometimes beyond what it sanctions; behavior can be characterized as improper notwithstanding that it would not form the basis for legal liability.

In his 1997 article 'Saints and Sinners: How Does Delaware Corporate Law Work?' (1997, Chapter 8 Volume II), **Edward B. Rock** makes a related argument: that Delaware law operates significantly through courts' pronouncements about behavior that do not impose legal liability. Delaware courts give "sermons"—"richly detailed and judgmental factual recitations, combined with explicitly judgmental conclusions," which "sometimes impose legal sanctions but surprisingly often do not" (Chapter 8, Volume II, p. 00). The sermons do not reduce to "rules or algorithms." The standards of conduct conveyed in and by the sermons influence the norms of conduct among important corporate actors; the standards are conveyed to corporate management by corporate counsel, as well as directly through the sermons themselves. Criticisms of shareholder litigation thus may be overstated, given that the law may actually be functioning quite well, albeit through mechanisms other than the straightforward ones through which law, at least in theory, operates.

While Eisenberg considers how directors' and officers' conduct might be affected by court pronouncements that do not impose liability, **Bernard Black, Brian Cheffins and Michael Klausner** explore in their paper 'Outside Director Liability' (Chapter 9 Volume II) the frequency with which outside directors are found monetarily liable. They conclude that outside director monetary liability is exceedingly rare—that "the principal threats to outside directors who perform poorly are the time, aggravation, and potential harm to reputation that a lawsuit can entail" (Chapter 9 Volume II, p. 00).

This Part concerns the mechanisms by which directors and officers behave in ways that are consistent with their roles as agents—in the corporation and the shareholders' best interests. Shareholder suits get a mixed verdict in these papers. Alexander finds them to be not terribly effective; Rock finds that shareholder litigation is effective because it prompts judges to give sermons. Shareholder litigation calling directors to account for breaches of fiduciary duty may influence behavior less than might be hoped if directors don't mind the "time, aggravation and reputational harm" nearly as much as they would have minded the real spectre of monetary liability. **Lucian Arye Bebchuk, Jesse M. Fried and David I. Walker** argue in 'Managerial Power and Rent Extraction in the Design of Executive Compensation' (2002, Chapter 10 Volume II), that in the context of executive compensation, directors are not properly motivated and influenced to act in shareholders' interests. Rather, they may be unduly influenced by managers or "simply ineffectual in overseeing compensation." Managers are thereby able to extract excess pay, or "rents." Moreover, since an important consideration is how the compensation appears to outsiders, camouflage may be used to make compensation appear less like the extraction of rents than it is; for example, compensation may seem to reward successful performance even though it is actually designed to pay out even in the absence of such performance. Options repricing provides an example. According to Bebchuk, Fried and Walker, boards are not doing their jobs properly when it comes to setting executive compensation.

The final two articles in this Part deal with the role of third parties in influencing and constraining director and officer behavior. One article, by John C. Coffee deals with gatekeepers; the other article, by Tom Baker and Sean Griffith, deals with insurers providing director and officer liability insurance.

John C. Coffee, Jr.'s article, published in 2002, is entitled 'Understanding Enron: "It's About the Gatekeepers, Stupid"' (2002, Chapter 11 Volume II). Coffee argues that gatekeepers "reputational intermediaries who provide verification and certification services to investors"—did not prevent Enron's management from committing fraud. Indeed, these intermediaries, auditors, analysts, rating agencies, and bankers acquiesced in managerial fraud. Why would they do so? First, the costs of acquiescence—notably in the form of legal liability—went down while the benefits, in the form of lucrative side-business (such as consulting), went up. As the side businesses, for which the intermediaries' reputations (for not deferring to clients) were not needed, became more lucrative relative to the businesses for which non-deferring reputations were far more needed, and in the euphoria of a bubble where the intermediaries would have been lonely voices indeed, they may have concluded that cashing in on these reputations was a better idea than preserving them for the long term. That the gatekeepers did not do what they were hoped and arguably expected to do is a serious problem for the markets.

This Part concludes with **Tom Baker and Sean J. Griffith**'s paper 'The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer' (2006, Chapter 12 Volume II). All directors and officers of public companies have liability insurance provided (and paid for) by their corporations. One might think the insurers would have significant incentives to monitor the directors and officers. The authors' research provides evidence that notwithstanding this incentive, the insurers do not do so. Directors and officers prefer their autonomy. The insurers presumably charge more for the higher expected losses, but the directors and officers do not bear the added expense. The overall picture the authors paint is bleak: that there is insurance without monitoring means that the effect of the insurance should be more loss-causing behavior. Companies buy the insurance not to spread losses—they have no need of that function. Rather, officers and directors like the insulation from capital markets' scrutiny of liability payments incurred in shareholder litigation. In sum,"[c]orporate managers buy this form of coverage for self-serving reasons, and the coverage itself, because it has almost no means of controlling the problem of moral hazard, reduces the extent to which shareholder litigation aligns managers' and shareholders' incentives" (2006, Chapter 12 Volume II, p. 00). This article, coupled with Alexander's, suggests that shareholder litigation does not and would not be expected to do much to managerial agency costs; Eisenberg and especially Rock's articles suggest, however, that the fiduciary duty regime may nevertheless be helping encourage shareholder value-enhancing norms.

Other Perspectives

The last Part contains three articles with broader, theoretical perspectives on corporate law and corporate governance. The articles all concern how and why corporations have the ownership, management, and other characteristics that they do.

The first is **Mark Roe**'s article 'A Political Theory of American Corporate Finance' (1991, Chapter 13 Volume II). Roe demonstrates that dispersed ownership, and popular distrust of financial institutions together with other political forces, yielded an ownership structure in which the obvious monitors could not monitor. Owners' power thus went to managers. The structure thus created—the Berle–Means corporation—is a political outcome, and not a natural or inevitable result of an evolutionary trajectory. It is "an adaptation, not a necessity." An important impetus for Roe's account was the power of management at the time he was writing. (This power is, now, increasingly met with a counterweight in the form of "shareholder activists.") The stronger and apparently effective monitoring role of, in Germany, financial institutions, in their capacity as shareholders and creditors, and in Japan, of related companies in the same network of companies, provided powerful evidence that alternatives were possible and offered a variety of advantages.

The next article in this Part is 'The End of History in Corporate Law' (2001, Chapter 14 Volume II) by **Henry Hansmann and Reinier Kraakman**. Writing in 2001, a decade after Roe, the authors argue that corporate law and governance are actually converging, and that more convergence can be expected. The convergence at issue is both ideological and legal. As to the former, the authors argue that the shareholder-oriented model of the corporation (which gives ultimate control to shareholders, and in which managers are obligated to manage the corporation in the interests of the shareholders) has triumphed. (Interestingly, the debate on the extent to which corporations have been, are, or should be shareholder oriented is, at this writing, quite vigorous indeed, with many vehement proponents of contrary views.[9] Lynn Stout, for instance, argues that shareholder value is and always has been an ideology, and that US corporate law has "does not, and never has, required directors of public corporations to maximize either share price or shareholder wealth."[10])

As to the latter, they point to what is happening in many developed country jurisdictions with board structure, securities regulation and accounting disclosure, shareholder suits, and takeover regulation, characterizing these are as evidencing and constituting a convergence towards Anglo-American corporate law.

The last article in the volume is also by **Henry Hansmann and Reinier Kraakman**—'The Essential Role of Organizational Law' (2000, Chapter 15 Volume II). While the previous articles in the volume all dealt with corporations, this article deals more broadly with different forms of business organization. Hansmann and Kraakman argue that organizational law, by which they mean the laws establishing different sorts of business organizations, critically serves the purpose of defining the property rights over which participants in an organization can contract. While other commentators stress the importance of limited liability—which shields a firm's owner's personal assets from creditors of the firm—these authors stress the importance of shielding the firm's assets from the claims of the owner's and manager's creditors. Organizational law:

> permits the formation of a floating lien on the pool of assets associated with a firm, and permits as well the assignment of that lien to the constantly changing group of creditors who transact with the firm, while shielding those assets from creditors of the firm's managers and owners. This type of affirmative asset portioning … could not otherwise be accomplished. (Chapter 15, Volume II, p. 00).

Notes

[1] Adolf A. Berle and Gardiner C. Means (1932), *The Modern Corporation and Private Property*, New York, NY: Harcourt Brace and World.

[2] See, e.g., Oliver Williamson (1975), *Markets And Hierarchies: Analysis And Antitrust Implications*, New York, NY: The Free Press; (1985), *The Economic Institutions of Capitalism : Firms, Markets, Relational Contracting*, New York, NY: The Free Press; (1996), *The Mechanisms of Governance*, New York, NY: Oxford University Press.
[3] See, e.g., Oliver D. Hart and Sanford J. Grossman (1986), 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration', *Journal of Political Economy*, **94** (4), 691–719; Oliver Hart (1988), 'Incomplete Contracts and the Theory of the Firm', *Journal of Law, Economics and Organization*, **4** (1), 119–139; Oliver Hart and John Moore (1990), 'Property Rights and the Nature of the Firm', *Journal of Political Economy*, **98** (6), 1119–1158; Oliver Hart (1995), *Firms, Contracts and Financial Structure*, Oxford: Oxford University Press.
[4] Adolf A. Berle and Gardiner C. Means (1932), *The Modern Corporation and Private Property*, New York, NY: Harcourt Brace and World.
[5] Kenneth J. Arrow (1974), *The Limits of Organization*, New York, NY: W.W. Norton & Co.
[6] Armen A. Alchian and Harold L. Demsetz (1972),'Production, Information Costs, and Economic Organization', *American Economic Review*, **62** (5), December, 777–795.
[7] Bengt Holmstrom (1982), 'Moral Hazard in Teams', *Bell Journal of Economics*, **13** (2), 324–340.
[8] Raghuram G. Rajan and Luigi Zingales (1998), 'Power in a Theory of the Firm', *Quarterly Journal of Economics*, **113** (2), 387–432.
[9] See, e.g., Lynn Stout (2012), *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*, San Francisco, CA: Berrett-Koehler Publishers.
[10] Stout (2012, p. 3).