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The Transformation of the American Law Institute

Jonathan R. Macey*

Introduction

Few law reform efforts in this century have been as controversial as the often bitter fourteen-year battle within the American Law Institute (ALI or Institute) over its efforts to articulate a set of rules about American corporate law. This epic struggle ended on May 13, 1992, when the ALI formally approved the Principles of Corporate Governance[1] at its annual meeting in Washington.

This Article analyzes the law reform process at the ALI from a sociological, anthropological, and public choice perspective. Thus, rather than provide yet another critique of the various substantive provisions of the Principles of Corporate Governance, this Article examines the process of law reform itself. I begin with the assumption that the ALI consists of a highly prestigious group of extremely well-informed individuals with tremendous personal integrity. Starting with this assumption, I develop a two-part hypothesis for why the Corporate Governance Project (Project) became so mired in controversy and divisiveness. First, I hypothesize that, despite their good intentions, the lawyers and law professors working on the Project were “captured” by a world view that both systematically overstated

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the value of lawyers in society and systematically understated the value of market processes in society. In other words, the people initially involved in the Project embraced a "lawyer-centric" view of law reform. This Project exalts the role of lawyers and litigation in corporate governance and overstates the extent to which process-oriented reforms are likely to succeed in improving the governance of the American public corporation.

The first part of my hypothesis explains why the ALI adopted what to many outside observers appeared to be a bizarre and hostile perspective on the American business community. It explains why proponents of the ALI's corporate governance perspective pushed for what they characterized as the "modernization" of corporate law despite what was accurately described as the "lack of an articulated theoretical predicate for the structural reforms advocated." Finally, the first part of the hypothesis explains why the ALI was so surprised by the vigorous opposition to its earlier proposals.

Second, I hypothesize that during the course of the corporate governance law reform process, an important paradigm shift was taking place within the ranks of the corporate bar. In particular, the teaching and scholarship of the budding law and economics movement was beginning to have an impact on practitioners. This new, interdisciplinary approach to the study of the legal system permitted lawyers to gain a better perspective on the processes they were studying. In particular, the law and economics perspective allowed lawyers to gain a rigorous understanding of both the theoretical infrastructure and the underlying purposes of corporate law. This greater perspective, in turn, gave industry critics of the Project a group of intellectually powerful allies within the community of legal academics that traditionally had formed the ALI's core constituency. Put simply, over time a sort of "holy alliance" emerged between the law and economics scholars studying the Project and such business groups as the Business Roundtable. Not surprisingly, the Business Roundtable voiced strong objections to the ALI's proposals because they reflected a deep hostility to the judgment and motives of corporate managers. The scholarship emanating from the law and economics movement supplied the business community with an intellectual basis for its attacks on the ALI. Thus, whereas the first part of my hypothesis explains why the Project reflected such a peculiarly ahistorical command-and-control policy perspective, the

3. See text accompanying notes 5, 18, and 59.
4. See infra notes 69-81.
5. The Business Roundtable is a group comprised of leaders of American business formed to promote the interests of the American business community.
second part of my hypothesis explains why this policy perspective ultimately was modified significantly to reflect a somewhat more market-oriented point of view.

I. Why Did the ALI Believe Reform Was Necessary?

The ALI embarked on its Project in 1978 for reasons that were never entirely clear. The ALI's own justifications for the Project are circular at best and downright content-free at worst. For example, in 1982, Roswell Perkins, the President of the ALI, claimed that the "effort began with a growing belief on the part of Herbert Wechsler, the ALI's director during the late 70's, that the time had come for a major effort in the field of corporate structure and governance." Of course, Perkins gave no reason why the time for a major reform effort had come.

ALI officials also attempted to defend the huge commitment of time and resources devoted to the Project by harkening back to the ALI's charter, which called for the organization "to promote the clarification and simplification of the law and its better adaptation to social needs . . . ." This explanation is highly suspect in the light of the Delaware corporate code's and the American Bar Association's Model Business Corporation Act's service as clear, simple expressions of corporate law. Both are widely regarded as sophisticated and extremely well-suited to societal needs. In particular, commentators view the success of the Delaware corporate code as a result of that state's ability to reduce "uncertainty concerning the consequences of actions and hence the transaction costs of doing business."

Despite their vagueness and probable inaccuracy, these explanations are revealing. They suggest that the ALI was motivated to embark on its reform effort by internal bureaucratic incentives rather than by external public policy concerns. In particular, the ALI probably was concerned that rival groups, such as the American Bar Association, were gaining dominance over this important field of American law. The ALI's initial interest in the Project is best characterized as little more than a bureaucratic exercise in turf-grabbing. Indeed, the ALI itself admitted that it decided to embark upon its reform efforts because it observed other groups successfully encroaching on its traditional turf, the drafting of "statements of guiding principles" of corporate law. The ALI seemed particularly

7. Id.
10. Perkins, supra note 6, at 3.
concerned by the efforts of the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association, which published both a model corporate code\textsuperscript{11} and the \textit{Corporate Director's Guidebook}.\textsuperscript{12}

In addition, some of the early supporters of the Project viewed the endeavor as a useful strategy for heading off an effort by Ralph Nader and others to have the federal government play a larger role in the corporate governance movement, either through federal chartering or through the gradual expansion of the Securities and Exchange Commission's authority over corporate governance issues.\textsuperscript{13} Other supporters, sympathetic to Nader, thought the Project might be an easier way to achieve the Naderite objective of federalizing corporate law. The latter view came to dominate the Project, which ultimately became "a continuation of a reform movement begun, in part, by academics who have challenged the premises underlying traditional state corporation laws. In the early 1970s, that movement focused upon the perceived need for a federal corporation statute."\textsuperscript{14}

All that was crystal clear from the outset was that there was never a general consensus within the ALI about what was wrong with existing corporate law or why the ALI needed to direct its massive intellectual artillery toward changing it. Put another way, the Project lacked a theoretical model. Without such a model, the ALI had no basis for analyzing and defending its preferred menu of corporate governance rules.

Because it lacked a conceptual framework or theoretical model, the Project not surprisingly dealt with specific provisions and ignored basic conceptual matters.\textsuperscript{15} But this strategy did not succeed in rescuing the ALI from controversy. The ALI's Reporters decided to ignore interstitial details and to direct their attention to the most important aspect of corporate law: the management of the American
The ALI's focus on governance and management issues signalled corporate America that the ALI not only thought there was something wrong with the way American firms were managed, but that the remedy consisted of adding lawyers to the governance process.

II. The Structure and Institutional Bias of the ALI

The ALI is perhaps the most elite group of lawyers in the United States. Selected from the ranks of distinguished scholars and practitioners, the Institute is best known for drafting "Restatements of the Law" in various areas. These Restatements provide lawyers and judges with carefully formulated descriptions of the law and traditionally have served as authoritative guides for both legal briefs and judicial opinions.

The ALI's characterization of its corporate governance principles as a "restatement" of existing law quickly met with skepticism. As early as 1984, the Litigation Section of the American Bar Association noted that:

[T]he Project was designed to effect major changes in the law of corporate governance. As stated in [the formal report of a Committee of the Litigation Section] the Project in its then current form would have expanded the substantive duties of directors, reduced the protections of the business judgment rule, and . . . narrowed the use of intracorporate mechanisms to approve conflict transactions. It would have then gone on to make derivative litigation (used to enforce the expanded duties) easier to institute and to maintain, and more difficult to terminate and to settle. It would also have narrowed the opportunity for directors to obtain the indemnification and insurance needed to cover the expanded risks the Project had created.  

Under heavy pressure from outside critics, the ALI ultimately disregarded its characterization of its Project as a "restatement" of existing law. The ALI dropped the term "Restatement" from its reform effort and renamed the Project "Principles of Corporate Governance: Analysis and Recommendations." But controversy still raged. The ALI's work still was expected to have a significant impact on the law. Indeed, even before the ALI formally approved the final report in 1992, courts in nine jurisdictions had adopted the pronouncements in the tentative drafts as law.

In particular, outside critics charged that:

The Reporters identify the Project with the ALI's Restatement tradition—an identification that is unwarranted but that will inevitably have a detrimental effect on the case-by-case development of corporate governance principles. The Reporters' presentation of the Project as part of the ALI Restatement tradition creates a real

17. Hansen et al., supra note 14, at 90 n.3. See also Eisenberg, supra note 16, at 498.
18. See, e.g., infra note 86.
danger the Reporters' views will be accepted by the courts and legislators as a true "Restatement" of existing law rather than the wish-list of reformers that it actually is.\textsuperscript{19}

The name change turned out to be a mixed blessing that did little, if anything, to allay the controversy surrounding the Project. The ALI explained its name change in the Forward to Tentative Draft No. 2, published in 1984.\textsuperscript{20} The ALI acknowledged that the document did not purport to restate existing law, but then suggested that at least some portions of the document do restate existing law, and that the "black letter recommendations with respect to corporation law [would not be] preceded by the words 'Corporate law should provide' because the word 'provide' was thought by some to imply a call for legislative as distinguished from judicial implementation, contrary in many instances to the intention of the formulation."\textsuperscript{21}

Thus, rather than altering the Project to restate existing law, the ALI continued to urge radical changes to existing law. The ALI went out of its way to emphasize that dropping the normative, value-laden phrase "corporate law should provide" from its proposals did not mean that the ALI was no longer urging law reform. Rather, at the same time that the ALI stopped characterizing the Project as a Restatement, it began advocating the view that courts should implement its recommendations unilaterally, without legislative approval.\textsuperscript{22}

Thus, very early in the history of the Project, the Institute took the position that its own views of corporate governance issues should trump the rules promulgated by state legislatures. This bizarre anti-majoritarian perspective might be understandable if the ALI were operating in areas in which the Institute's lawyers could claim special expertise—for example, in legal as opposed to business issues. But the ALI made it clear that its proposals went well beyond the confines of corporate law to include the ALI's opinions about what constituted "good corporate practice" by corporate officers and directors.

In other words, the ALI reformulated its corporate governance proposals to contain some statements about the proper scope and content of corporate law, but also included statements about how to manage the day-to-day operations of corporations. Even the ALI admitted that the legal significance of its recommendations about

\textsuperscript{19} Hansen et al., \textit{supra} note 14, at 91.
\textsuperscript{20} Herbert Wechsler, \textit{Foreword} to \textit{AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS} at vii, vii-viii (Tentative Draft No. 2, 1984) [hereinafter Tentative Draft No. 2].
\textsuperscript{21} \textit{Id.} at viii.
\textsuperscript{22} See Eisenberg, \textit{supra} note 16, at 498.
good corporate practice was unclear. But the ALI never attempted to articulate the source of its supposed expertise over corporate strategic planning. Put differently, the Project represented a subtle attempt by a powerful and distinguished group of lawyers to remove primary governance authority over the public corporation from the hands of corporate management and boards of directors and to place it in the hands of corporate lawyers and courts.

The ALI proposed to alter the locus of decision-making authority within the corporation by sharply curtailing the power of corporate boards of directors to terminate lawsuits against board members, senior management, and certain other parties. Under existing principles of corporate law, a decision by a corporation's board of directors to terminate a lawsuit on the grounds that the suit is not in the best interests of the corporation is entitled to great deference by courts so long as a majority of directors is not tainted by a conflict of interest. The justification for extending broad power to corporate boards to terminate shareholder litigation is that the members of the board of directors of a particular corporation are best able to determine if the pursuit of a particular cause of action is in the best interests of that corporation. The ALI, on the other hand, took the view that the boards of directors were hopelessly biased toward managers and against shareholders. This view led inevitably to the conclusion that courts and plaintiffs' attorneys should be given expanded authority to evaluate claims against corporations.

The best way to view the struggle between the ALI and corporate groups such as the Business Roundtable is as a struggle for control over the decisionmaking process in the public corporation. Lawyers and business executives come from radically different cultures. Each culture has a distinct vision of how decisions ought to be made. In particular, the business culture places a very high premium on two values that the legal culture largely ignores: speed and cost containment in decisionmaking. By contrast, the legal culture places a very high premium on two values that the business culture largely ignores. These values, which pervade the legal culture, are process and advocacy.

Part II of the ALI's Report addresses the "objective" and "conduct" of the corporation. Although this focus may seem natural to lawyers, to a person with a business perspective, it seems odd. From

23. Wechsler, supra note 20, at viii.
25. Courts, in the proper circumstances, will sterilize a Board's decision to terminate shareholder litigation through use of the business judgement rule, which is predicated upon the presumption that Boards are best able to determine the interests of the corporation which they control.
the business perspective, a corporation’s objective is clear. That objective is to make profits. So long as the corporation pursues this objective within the bounds of the law, the conduct of the corporation should not concern lawyers. The ALI takes the view that, though the corporation has as its objective the twin goals of enhancing corporate profit and shareholder gain, corporations may devote resources to public welfare, humanitarian, educational, and philanthropic purposes, even if corporate profit and shareholder gain are not thereby enhanced.27

This provision seems bizarre. Although corporate philanthropy often serves corporate and shareholder interests, when corporate philanthropy does not serve shareholder interests, it is indefensible to allow management to use shareholders’ money to pursue their own private view of the good. If managers of public corporations, who generally are not considered undercompensated by any measure, wish to aid some humanitarian, educational, or philanthropic cause, they should do so with their own, and not their shareholders’, resources. From the ALI’s perspective, of course, these provisions benefit society by increasing the flow of funds to worthy causes. But from a business perspective—particularly that of investors—the ALI’s provisions simply empower corporate management to divert corporate resources for private interests that they are able to describe as philanthropic.

The ALI’s treatment of the business judgment rule provides another example of the basic difference between the way that the legal culture views the corporate world and the way that the business culture views the corporate world. Under Section 4.01(c) of the Principles, a decision by a member of a board of directors is entitled to the protections of the business judgment rule only if three conditions are met.

First, the director must not be interested in the subject of the business judgment.28 Second, the director must be informed with respect to the subject of the business judgment to an appropriate extent.29 The appropriate extent will be determined by an objective standard, because the director or officer will only be entitled to protection “to the extent that the director or officer reasonably believes to be appropriate under the circumstances.”30 Third, a director must believe that the business judgment is in the best interests of the corporation.31

The controversial aspect of Section 4.01 is the requirement that a

27. Proposed Final Draft, supra note 1, § 2.01(b)(3).
28. Id. § 4.01(c)(1).
29. Id. § 4.01(c)(2).
30. Id.
31. Id. § 4.01(c)(3).
director be informed to the extent that she reasonably believes to be appropriate under the circumstances. The business community and the legal community have radically different views about what sort of information-gathering is appropriate under most circumstances. As noted above, this divergence in views results from the fact that the business culture tends to value speed and cost containment in decision-making more than the legal culture, whereas the legal culture values process and advocacy in decision-making more than the business culture.\(^3\)

In the official comment to Section 4.01, the ALI cites *Casey v. Woodruff*\(^3\) for the proposition that for a business decision to be an informed one, the directors must have exercised "reasonable diligence" in coming to their conclusions.\(^4\) This perspective finds its most complete expression in another case that the ALI cites with approval, *Smith v. Van Gorkom*\(^5\) (Trans Union), which has become something of an epic wonder in the corporate world.

In that decision, the Delaware Supreme Court held that a corporate board of directors had violated its fiduciary duty of care to shareholders and thus was subject to massive personal liability for failing to devote sufficient attention to process and advocacy before approving a cash-out merger offer which would have given shareholders a substantial premium over the pre-merger market price for their securities.\(^6\) The *Van Gorkom* court based its opinion on its conclusion that the board of directors making the underlying decision was grossly negligent for recommending the merger to the company's shareholders without having constructed an "appropriate procedural framework for the decisional process".\(^7\)

In essence, the Court decided in *Trans Union* that the board of directors was grossly negligent for making a business decision without the benefits of a deliberative process resembling an adjudication. In other words, the court in *Trans Union* decided that the hasty decision-making process made by the board was *per se* actionable. The court never even considered the possibility that the board might have decided that the costs of engaging in such deliberation might outweigh the benefits. In particular, the deliberative process would be costly if it resulted in a delay that caused the bidder to withdraw its bid, thereby depriving the shareholders of the opportunity to obtain the substantial premium for their shares being offered.

In a nutshell, the Delaware Supreme Court in *Trans Union* faults the directors of Trans Union for not engaging a sufficient number

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32. See supra note 26 and accompanying text.
34. Id. at 643; see Proposed Final Draft, supra note 1, § 4.01(c) cmt. e, at 233-36.
35. 488 A.2d 858 (Del. 1985).
36. Id. at 864.
of lawyers and investment bankers to provide a suitable paper record to justify the transaction.\(^{38}\)

Thus, the Delaware Supreme Court's decision in Trans Union reflects what might best be described as a lawyer-centric view of the world. The values of deliberation and process are exalted, to the detriment of the values of efficiency and cost-containment that are dear to the world of business.\(^{39}\) The business decision facing the Trans Union board was a simple one: whether the price being offered should be accepted.

From a business perspective, the directors probably thought they had all the information they needed. The firm's shares were traded on the New York Stock Exchange. The directors knew that the price being offered was fifty percent above the existing market price for the firm's securities, and that this price represented the best valuation of the most sophisticated capital market in the world.\(^{40}\) The directors also knew that they had been trying to sell the firm for some time with no success, and that the offeror insisted that his offer remain open for only a short time and be contingent on the firm refraining from actively soliciting other offers.\(^{41}\)

Thus, from the perspective of efficiency and cost-containment, the directors took the view that they had all the information they needed. In particular, the directors realized that delay would involve significant costs, and that if they held out for more money they were "risking winding up with nothing."\(^{42}\) The opinion in Trans Union, like the Project as a whole, represents a victory for the legal community over the business community. Like the ALI's analysis and recommendations, at the margin, the decision will result in a transfer of wealth from the business community to the legal and investment banking communities. As Geoffrey Miller and I have observed:

\[\text{T}he\text{ remedy prescribed by Trans Union is far more than a nostrum. To be sure, the case will increase the use of investment bankers and lawyers in corporate decision-making. We agree with the proposition that in general the increased "papering" of board decisions will not substantially raise the level of deliberations. In this respect, the case appears as a boon to investment bankers and lawyers, but as a net cost for shareholders of Delaware corporations and for the nation's economy generally.}\]\(^{43}\)

\(^{38}\) \textit{Id.; see also} Jonathan R. Macey & Geoffrey P. Miller, Trans Union Reconsidered, \textit{98 Yale L. J.} 127 (1988).

\(^{39}\) See supra note 26.

\(^{40}\) \textit{Van Gorkom}, 488 A.2d at 869 n. 9.


\(^{42}\) Fischel, supra note 41, at 1449.

\(^{43}\) Macey & Miller, supra note 38, at 139. By forcing corporate boards to keep a
Trans Union thus shows the extent to which the values of the legal profession, which stresses the virtues of advocacy and process and ignores other values such as efficiency and cost containment, are internalized by lawyers, including lawyers who serve as judges.

The final battle in the fourteen-year war to win approval of the Principles concerned the so-called demand requirement, the process by which a shareholder is required to petition a board of directors to address alleged wrongdoing by a director or officer as a pre-condition to filing a derivative lawsuit on behalf of the corporation against that officer or director. The business perspective would favor giving the board of directors broad, perhaps unfettered discretionary authority to reject a shareholder's demand. A business perspective also would require that courts accord the board substantial deference when reviewing a board's recommendation to decline to take action against an officer or director. By contrast, the ALI would expand the authority of state judges to review a board's decision to reject a shareholder's demands to take action against officers and directors.

The battle lines between the legal community and the business community over the demand requirement were clearly drawn before the start of the ALI's annual meeting on May 12, 1992. The ALI's Reporters wanted to change the pre-existing rules regarding demand in several ways. First, the Reporters wanted to create a new two-tiered standard of review, whereby courts would give a lower level of deference to corporate boards in duty-of-loyalty cases than in duty-of-care cases. The Reporters also wanted to give courts expanded power to engage in de novo review of all motions to dismiss lawsuits against insiders and drew additional distinctions between lawsuits brought against insiders and lawsuits brought against third parties unaffiliated with the corporation.

The most striking difference between the Reporters' approach and the business approach was that the Reporters would have required corporate boards of directors to provide courts with statements defending their actions in all cases, even those in which a majority of the directors of the corporation were independent and not implicated in the shareholders' obligations. In other words, under the ALI's approach, a shareholder would be able to obtain paper trail, the court is in essence compelling corporate boards to spend additional funds on bankers' opinion letters and valuation studies and lawyers' safety letters and counselling. Id.

44. This debate concerned Proposed Final Draft, supra note 1, § 7.03(a).
45. See id. §§ 7.08-.10.
47. Id. at 517-19.
48. Id.
49. Id. at 515.
judicial review of his derivative suit regardless of the action taken by a board of directors.

Critics of the Reporters' proposal noted that courts reviewing board decisions to reject plaintiffs' demands could not merely address their attention to the adequacy of the plaintiffs' complaint, but would be required to engage in some level of substantive review of board decisions regardless of how independent the directors were or what sort of violations were being alleged. Moreover, critics noted that the Reporters failed to consider the costs of their proposal:

[T]he Reporters apparently regard as relevant costs only the contingent fee of the derivative plaintiff's attorney. Costs incurred by the corporation related to the action are apparently disregarded in the stockholders' calculation of the expected net (private or public) benefits of the action. The derivative suit is thus a "free lunch," so far as the stockholders of the affected firm are concerned.

From a business perspective, there are significant costs to derivative litigation beyond the contingency fee. Among these costs are the costs of defending the lawsuit, including not just the lawyers' fees, but also the cost of the time lost by management in depositions, in complying with discovery requests, in testifying, and in consulting with their attorneys. Moreover, defending these lawsuits involves more inchoate costs, such as the loss of reputational capital by the firm, and the loss of morale among the workers.

From the lawyers' perspective, the proposed recommendations improved the quality of corporate governance in two ways. The proposal improved the board's decisionmaking process by permitting judicial review of the board's decisional procedures. The Reporters also reasoned that their proposal improved the decisional process involving whether to reject a shareholder's demand by making it more adversarial in nature. Indeed, the Reporters were quite frank about their purpose, noting that encouraging more derivative lawsuits provided "the necessary opportunity for judicial law-making, both in updating the common law and in filling the inevitable gaps left by legislation. In this respect, the action has an educational and socializing function."

During the debates over these controversial provisions, the ALI Reporters retreated slightly and accepted an amendment that made

50. Id. at 517-19.
51. Id. at 529.
52. See Joy v. North, 692 F.2d 880, 892 (2d Cir. 1982).
54. Id. at 11.
it somewhat easier for corporate boards to obtain dismissal of derivative complaints. Under the adopted version of Section 7.04(a), corporations are entitled to make a representation to a plaintiff that her demand for remedial action is being rejected by a board (or board committee) comprised of disinterested directors who comprise a majority of the board, and who, as a group, are capable of making an objective judgment in the circumstances.\(^\text{55}\) If the board makes such a representation, the plaintiff’s complaint must be dismissed unless the plaintiff can plead with particularity that the board’s representations were incorrect, or that the board’s decision-making process in rejecting the demand violated the business judgment rule, or other appropriate standards.\(^\text{56}\) A corporation would be entitled to obtain dismissal of a plaintiff’s suit prior to discovery if the complaint did not plead these facts with sufficient particularity.

In sum, although the compromises adopted at the ALI’s May 1992 meeting did not give the business community everything it wanted, critics agree that the outcome “gives explicit attention and effect to the decision of disinterested directors to reject demand.”\(^\text{57}\) In the end, even Charles Hansen, a prominent corporate lawyer and perhaps the most outspoken and articulate critic of the ALI’s anti-business bias, voted for the compromise “in the interests of comity” because it returned to the board “a very meaningful role for a disinterested board in handling derivative litigation.”\(^\text{58}\) On the other hand, not everybody on the lawyer-centric side of the debate was so complacent. In an outraged editorial, Monroe Freedman complained that:

> Corporate lawyers take care of their own—their own firms, that is, followed by their own clients. . . .

> The corporate bar (ALI) adopted “principles” that permit corporate defendants who have been charged with wrongdoing to take control of, and then dismiss, the suits against them. Moreover, reversing the original drafts by the law professors who served as reporters for the project, the adopted principles would allow corporate defendants to do this without court approval.\(^\text{59}\)

But the compromise in the final hours was only one of many that the ALI Reporters accepted during the fourteen-year life of the controversial Project. As the next two Sections explain, the controversy surrounding the ALI’s report can be traced to two sources. First, the intellectual revolution caused by the law and economics movement caught up with the Project. This scholarly movement gave considerable intellectual firepower to the groups whose interests were adversely affected by the Reporters’ work.

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56. \textit{Id.}
57. This reaction of the ALI’s critics was summarized in \textit{ALI Wraps Up Corporation Law Project, Works on Lawyer Ethics, Complex Trials}, 60 U.S.L.W. 2727, 2728 (May 26, 1992).
58. \textit{Id.}
Second, the ALI became a victim of its own success. Although corporate America frequently lobbies Congress and state legislatures to obtain legislation that is consistent with their interests, business interest groups considered it inappropriate to lobby the prestigious American Law Institute. But the influence of the ALI has grown considerably since its inception in 1923. It is no longer a cozy intellectual enclave where academic and practicing lawyers can come together to discuss law reform at a lofty intellectual level. Although the ALI's publications technically are not binding on state or federal judges, courts typically rely on them, particularly where judges face novel or difficult issues of first impression in their jurisdiction. As the ALI's prestige has grown, its practical influence on real world outcomes has grown as well. And, as its practical influence has grown, interest groups increasingly have found it in their interest to devote resources to influencing the outcomes of the ALI's decisional process. The final section of this paper will discuss the ethical implications of that phenomenon.

III. The Shifting Paradigm

When the Project was begun in 1978, corporate law was in the midst of an intellectual revolution that would lead to a major change in the way scholars view the role of corporate law. In particular, the law and economics movement was replacing the traditional view that shareholders were helpless pawns ruthlessly exploited by management with the view that a variety of market forces operates, albeit imperfectly, to cause corporate management to maximize profits.

Traditional thinking was that continued shareholder litigation should be encouraged as a means for controlling deviance by corporate managers and directors. The new market-oriented perspective held that the best way to protect shareholders was by enforcing the contracts among shareholders, officers, and directors, and by fashioning legal rules that encourage the operation of market forces to constrain opportunistic management.

This new perspective was "astonishingly unrepresented" in the early days of the Project, as Ralph Winter, a prominent federal judge closely associated with the law and economics movement, noted at the time. Judge Winter observed that, of the four Reporters, ten Consultants, and forty-five Advisers to the ALI's Corporate Governance Project, in the early days, only one Adviser was affiliated with the modern law and economics approach to corporate

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60. See infra note 86.
61. See infra notes 70-77.
law.\textsuperscript{63}

As a result of the underrepresentation, and much to the shock of the distinguished older scholars at the helm of the Project, prominent scholars familiar with the new paradigm began to criticize the ALI's efforts. For example, in 1983, Henry Manne, a prominent member of the law and economics movement, labeled the ALI's early recommendations "a new threat to the corporate free enterprise system," because the proposals would have removed corporate authority from the hands of boards of directors within the corporation and markets and into the hands of courts and lawyers.\textsuperscript{64}

The generation of scholars who served as Reporters for the Project came of age when intellectual discourse about corporate law and public policy toward corporate governance was dominated by the world view of Adolph Berle and Gardiner Means.\textsuperscript{65} This intellectual approach, which dominated public discourse for fifty years, portrayed managers as out of control. Berle and Means attributed this to the "separation of ownership and control"—another term for a division of labor in which some people specialize in risk-bearing through investment, while others specialize in management. When thousands of people hold investment interests in a firm, none has much incentive to oversee the managers. Each investor, rightly thinking that his efforts can do little, will be passive. The investors are scattered, uncoordinated, and helpless. They have ownership without control; the managers have control without ownership.

Berle and Means also thought that corporations were growing in size and influence. . . . The managers, responsible to no one, could exploit investors and consumers alike.\textsuperscript{66}

This view of corporate America, in which investors were subject to wholesale exploitation by the managers of the firms in which they chose to invest, provided the intellectual "underpinning of the ALI's proposals on corporate governance."\textsuperscript{67} Consistent with Berle and Means' perspective, the ALI's initial proposals and commentary appeared to "rest on the Berle and Means diagnosis of helplessness. [The Reporters] believe that managers have seized control, [and] that investors are powerless."\textsuperscript{68}

Soon a group of scholars applying economic analysis to legal rules began to present new theories and data to refute the Berle and Means paradigm. In an important article in 1984, then-Professor Frank Easterbrook, a prominent member of this group, described some of the work of the Chief Reporter of the Project as "filled with

\textsuperscript{63} Id. at 529 n.1.
\textsuperscript{64} See Macey, supra note 13, at A21.
\textsuperscript{65} ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
\textsuperscript{67} Id. at 541.
\textsuperscript{68} Id.
unsupported assertions that managers and state law exploit investors”; it “does not cite, let alone discuss, any contrary data and theory.”

Where the followers of Berle and Means thought they saw pervasive and systematic market failure, the scholars working in law and economics found considerable evidence that market forces provided shareholders with a large measure of protection by effectively controlling managerial shirking. In particular, competition in the capital markets, the product markets, the managerial labor markets, and the market for corporate control combined to ensure not only that managers would work to maximize profits, but also that corporations would seek to register their corporate charters in corporate domiciles that lowered costs and provided shareholders with incentives to invest.

Proponents of an economic approach to law observed that if firms did not locate in jurisdictions with corporate rules that maximized shareholder wealth, they would be at a disadvantage in raising debt or equity capital relative to corporations chartered in other states. Management must induce investors freely to choose their firm's stock instead of, among other things, stock in companies incorporated in other states or other countries, bonds, bank accounts, certificates of deposit, partnerships...present consumption, etc... [A] corporation's ability to compete effectively in product markets is related to its ability to raise capital, and management's tenure in office is related to the price of stock. If management is to secure initial capital and have continuous access to ready capital in the future, it must attract investors away from the almost infinite variety of competing opportunities. Moreover, to retain its position, management has a powerful incentive to keep the price of stock high enough to prevent takeovers, a result obtained by making the corporation an attractive investment.

Considerable support for the law and economics perspective—that the benefits of heightened regulation of the corporate governance process outweigh the costs—came from growing acceptance of the so-called economic theory of regulation or “public choice.” The economic theory of regulation provided a theoretical predicate for many peoples' intuitions about the political process. This theory modeled the political process from an economic perspective. It

69. Id. at 541 n.3 (discussing Melvin A. Eisenberg, The Modernization of Corporate Law: An Essay for Bill Cary, 37 U. MIAMI L. REV. 187 (1983)).
70. Id. at 553-57.
71. See Fischel, supra note 8, at 917, 920-21.
demonstrated that political outcomes generally reflect the preferences of narrowly focused, self-aggrandizing, special interest groups. In particular, under the public choice model, regulation does not serve the interests of the public, but rather the interests of the entities being regulated. As Professor Easterbrook observed, the pro-regulatory philosophy of the ALI Reporters was subject to considerable doubt due to the fact that “[r]egulation is increasingly seen as the consequence of interest-group politics, in which the regulated firms themselves obtain regulation in order to forestall competition.”

Finally, the arguments made by those in the law and economics movement against the pro-regulatory approach of the ALI were bolstered by the more rigorous analytical methods of the lawyer-economists studying corporate law. In particular, the economics movement developed models that were sufficiently precise to lend themselves to empirical analysis. This ability to analyze and test their hypotheses formally saved the law and economics scholars from the charge that their conclusions were blinded by ideological faith in market forces. To this charge, the law and economics scholars were able to present scientific evidence that allowed them to claim that the existing, market-oriented legal norms were superior to the ALI’s proposed norms from the perspective of the investing public.

Soon, numbers of distinguished corporate lawyers joined the market-oriented academics in opposing the ALI’s early efforts. This opposition was largely due to the fact that the ALI decided to describe its early efforts as one of its “Restatements” of existing law. This characterization prompted incredulity. Charles Hansen, a prominent corporate lawyer and member of the ALI, wrote in 1990 that the ALI’s positions “do not reflect current law but rather call for fundamental and unwarranted changes in existing law.” Like the market-oriented scholars, the corporate lawyers were concerned that the Project was an attempt radically to transform America’s corporate law into a regime in which plaintiffs’ attorneys could challenge corporate actions in court over a wide range of issues regardless of whether a majority of independent directors on the corporation’s board viewed the shareholder’s action as beneficial to the corporation.

The criticisms of the early versions of the Project from market-

74. Id. at 46-51.
75. Easterbrook, supra note 66, at 541.
76. See generally id. at 557-64 (assessing manager self-interest by examining stock ownership, sources of compensation, relation between performance and compensation, and relation between performance and structure of ownership).
77. Id. at 571.
79. See supra text accompanying notes 17-18.
80. Hansen et al., supra note 14, at 90.
oriented legal scholars and corporate practitioners were joined by attacks from corporate America. The American Corporate Counsel Association, the American Society of Corporate Secretaries, the Business Roundtable, and the National Association of Manufacturers all acted in various ways to influence the ALI's deliberations.

There were rumors and allegations that corporations were trying to protect their interests both by hiring members of the ALI to represent their interests in that body's deliberations and by firing law firms that strongly supported the ALI's efforts to transform American corporate law. The ALI reacted to these lobbying efforts with outrage and dismay. Roswell Perkins, then-president of the ALI and partner in the prestigious New York law firm Debevoise & Plimpton, expressed his concern that the ALI not become a "'forum for power plays by clients'" and told ALI members that "'the precept of leaving one's client at the door must be honored if we are to preserve our integrity as an organization.'" 81

IV. The Ethics of the Politics

The allegations of political maneuvering by interested groups such as the Business Roundtable were grounded in fact. 82 The issue is whether there is anything wrong with these activities. Should such lobbying and influence peddling be considered unethical? Is it a threat to the "integrity" of the ALI? I wish to address these questions in this section because, as suggested in the preceding section, to this point it has been taken for granted that such lobbying is improper. 83 But, a closer analysis of both the important societal role played by the ALI and the structural bias of its own membership, which is comprised exclusively of lawyers, leads inexorably to the conclusion that the lobbying and political maneuvering of interested groups was only right and proper.

First, the vigorous lobbying by corporate interests was just that—lobbying. The efforts of interest groups "ranged from corporate-sponsored luncheons and telephone letter-writing campaigns to a get-out-the-vote drive that helped produce an unusually large turnout of more than 500 members at the (annual meeting at which the corporate governance proposals were put forward for membership vote)." 84 Ronald Gilson, a Reporter and professor at Stanford Law

81. Freedman, supra note 59, at 20 (quoting President Perkins at the ALI's 1991 annual meeting).
82. See infra notes 84-93 and accompanying text.
83. See supra note 81 and accompanying text.
School, observed, "I've never felt like a Congressman before." 85

The corporate world was treating the ALI's Reporters like members of Congress because they were acting like members of Congress. The ALI had consciously and deliberately departed from its accustomed role of creating and publishing "Restatements" and had promulgated a set of rules of corporate governance that were likely to have a considerable effect on the corporate world. The corporate world was well aware that the ALI's rules were likely to have a strong impact on corporate governance norms for two reasons. First, the extraordinary prestige enjoyed by the ALI would, by itself, produce this outcome. Second, well before the Report had been finalized, a number of courts had begun to cite even the most preliminary work of the Reporters as authoritative. 86 Indeed, at least one court cited as authoritative portions of the Principles that were later abandoned by the ALI itself. 87

Because the ALI's rules were likely to have a substantial impact on their welfare, corporate interests predictably decided to expend resources to influence the outcomes within the ALI. Moreover, to the extent that corporate officers and directors believed that the ALI recommendations would harm their firms' shareholders by raising their firms' costs of doing business, such officers and directors would have a duty to express their views to the ALI's leadership in order to protect their shareholders' interests.

The right to petition Congress for redress is an integral part of Anglo-Saxon jurisprudence. Indeed, the right to petition policymakers for redress of grievances was established by King John's signing of the Magna Carta in 1215. In addition to the freedoms of speech, association and assembly, the right to petition Congress is an integral aspect of freedom of expression. 88 Significantly, the Supreme Court has held that the right to petition Congress is not limited to political causes but extends to economic causes and business interests. 89 Firms even enjoy an exception from the general provisions of the antitrust laws for their lobbying efforts. 90 The efforts of the business community to influence the outcomes within

85. Id. One of the Reporters, Professor John Coffee of Columbia, also observed: "[T]here was a hell of a lot of lobbying." Id.


the ALI's governing process were wholly consonant with this rich tradition.

Some might argue that the introduction of business interests into the ALI's deliberative process would skew the Institute's efforts away from consumer interests, whose views also were wholly unrepresented. But this argument ignores the fact that, without the involvement of the business community, the only interests being represented within the ALI were the interests of the *legal community*. As noted above, considering only the interests of the legal community would not produce an impartial, public-regarding outcome. Rather, such an exclusive focus would result only in a set of policy prescriptions that exalted the process and advocacy values of the legal system at the expense of the values of efficiency and cost containment.91 Thus, excluding the lobbying efforts of business was more likely to produce an outcome that expanded the demand for lawyers than to produce an outcome that provided discernible benefits for investors or consumers.

Similarly, the argument that lobbying by business was unethical also ignores the fact that discrete, well organized groups are *always* better represented in legislative processes than disparate, unorganized groups such as consumers.92 Moreover, business interests were more likely to reflect consumers' preferences, at least to some extent, than the lawyers were. This is because lawyers are sociologically biased towards establishing rules that increase transaction costs, while business interests are sociologically biased towards rules that decrease such costs.

The President of the ALI found it "'particularly distasteful'" that business interests were imposing economic pressure to cause ALI members to change their views.93 In theory, of course, President Perkins' justification for excluding business interests was that ALI members should be impartial policy-makers. In practice, the result was that the only institutional perspective reflected in early drafts of the Project was that of the legal profession. That group can hardly be considered disinterested or unbiased.

Conclusion

The ALI's effort to reform American corporate law began with a series of early ALI drafts that embraced the view that the authority to govern the affairs of America's public corporations should be removed from corporate boardrooms to the state courtrooms. Gradually, as a result of relentless lobbying, the process within the ALI

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91. *See supra* note 26 and accompanying text.
opened up. Attendance at ALI meetings discussing corporate governance issues tripled as a result of the controversy surrounding the Project. Over time, representatives from the law and economics movement obtained greater representation among the Reporters, Consultants, and Advisers to the Project. The hundreds of scholarly articles and conferences devoted to the ALI's proposals had an influence despite the fact that many of these projects enjoyed corporate sponsorship. Gradually, even some of the traditional scholars associated with the Project began to see the merit in their opponents' perspectives. By the time the ALI membership approved the 1,068-page Final Draft at its annual meeting in May 1992, even the complaints of such old opponents as Henry Manne and Charles Hansen had diminished to a considerable extent.

Although the ALI set out fourteen years ago to transform American corporate law, American corporate law will hardly be affected by the modest reforms that finally were approved. Ironically, the most radical transformation has been within the ALI itself. The ALI is no longer the quiet, elite, academic enclave it was fourteen years ago. It is now a very public, democratic, quasi-legislative body subject to all the usual controversy and intrigue.

Thus, the real story of the ALI's Corporate Governance Project is the story of the transformation of an institution. When the Project began, the ALI considered itself a genteel, republican, deliberative body, confident that its own intellectual might and civic virtue would produce public benefits. In the end, the pluralists had conquered the republicans, as interest group politics came to dominate the latter years of the ALI's deliberations.

The final outcome reflects the inelegant interest-group consensus that is the natural byproduct of pluralist debate. The result is, at least to some extent, a strong endorsement of the power of ideas—particularly economic ideas—in a political arena. Though the final result may be the inelegant manifestations of a series of difficult compromises, it is a vast improvement over the earlier drafts.

94. See Macey, supra note 13, at A21.
95. The term "republican" as used here does not refer to political party affiliation. Rather, the term is used as it is in political theory—to refer to the republican belief in the ability of decision-makers to subordinate their own private interests to the public good. See Cass R. Sunstein, Beyond the Republican Revival, 97 YALE L.J. 1539, 1540 (1988).