THE DEVELOPMENT OF THE LAW OF CORPORATE GOVERNANCE

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In the recent ALI Tentative Drafts there are suggestions for corporate law reform which repeat themes, well rehearsed for almost two generations, criticizing that body of law. The persistence of the criticism has not been rewarded, however, for, with the exception of federal securities legislation, both statutory and case law have generally moved in a direction contrary to that demanded by the critics. This is somewhat surprising, since an allied body of criticism directed at consumer and antitrust law achieved considerable success.

One reason for the failure of the criticism of the law of corporate governance to bring about change has been the critics' propensity to offer somewhat drastic solutions to very ill-defined problems, the seeming attractiveness of the cure obviating the necessity for a diagnosis. Another reason has been the failure to distinguish between the very different and often inconsistent goals which such change might have. Many critics of existing corporate law simultaneously bandy about terms such as "investor protection," "shareholder democracy" and "corporate social responsibility," without hinting that they may be inconsistent even at the slogan level. Others join proposals for increasing the power of shareholders with calls for blatantly anti-investor legislation.

Representatives of the business community, moreover, have not enhanced the intellectual level of the debate. Instead of demanding a better definition of the putative problem or attention to the distinctions among goals of particular reforms, they have sought to determine what concessions might appease the critics. The ensuing debate has resembled a series of guerrilla attacks on changing targets of opportunity while a ponderous defense force seeks peace by offering sacrificial lambs which merely whet the appetite of the attackers.

My former colleague at Yale, Judge Robert Bork, has described a meeting with businessmen on this subject. Quoting Judge Bork:

> I remember a talk in which a prominent businessman said that he and his colleagues were concerned that the large American corporation does not possess legitimacy in the eyes

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> of the rest of society. He asked how they could alter their modes of corporate governance in particular, in order to be accepted into the society as legitimate members. . . .I recall having two reactions to his approach. The first was surprise at the triviality of the response suggested. A change in corporate governance . . . will have very little impact, if any, upon the public perception of the corporation and its role in the society. Anti-corporate sentiment is directed to the entire role of business and free enterprise in our lives. Fiddling with corporate governance for no better reason than to defuse hostility and head off punishing "reforms" is like tinkering with a leaky faucet in the hope of averting the Johnstown flood.
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> My other reaction was surprise at the mood of defeat, of lowered morale, that suffuses meetings to discuss problems of this sort. It is as though a large fraction of the community of business leaders wants to make preemptive concessions, as if they meet not to plan a fight against wrongheaded movement but to discuss how best to negotiate the terms of surrender.

The response of businessmen to the wave of criticism of the existing body of corporate law has actually legitimized the assumption that it is deficient. This legitimation has come about as a consequence of the critics' realization that the presence of business representatives on a group studying corporate law reform will lead neither to an informative debate nor to serious resistance to calls for legal change. Thus, Professor Wechsler's somewhat defensive foreward to the ALI Tentative Draft I emphasized that business representatives joined the calls for change, as though that fact is a suitable substitute for an empirical demonstration of actual deficiencies in the body of corporate law.

In aid of clarifying the issues to some degree, I would suggest that discussion of change in the law of corporate governance distinguish between proposals designed to further social and political goals and those designed to enhance the efficiency of the capital markets.

The regulation of corporate governance in the name of social or political goals raises issues having to do with notions of concentration of political power and with the role of government relative to the private sector—issues which relate to basic notions about freedom in a democratic society. Some argue that business corporations are centers of power which ought to be subject to public control. Others argue that such measures will increase the concentration of power in govern-

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ment. This discussion should not proceed upon the assumption that professors of corporate law and members of the business community are primary sources of wisdom. Where such basic normative choices are at stake, expertise in the legal doctrines of corporate governance is a most dispensable qualification. Moreover, it is an even greater error to look to representatives of the business community as reliable defenders of capitalism and free markets. This is so partly for reasons described above and partly because members of the business community have particularized interests of their own to defend, e.g., they frequently favor protectionist legislation impeding corporate takeovers, and ought not be expected to mount a principled defense of either democratic capitalism or competition in particular controversies. This aspect of the debate, therefore, must be expanded to include the larger community and ought not be regarded as an issue of law reform.

Let me turn now to another goal behind the change in the law of corporate governance—regulation enhancing the efficiency of capital markets. Although this is a less complex debate which involves the relative role of market forces and legal rules, it too has been carried on in a state of some confusion. This is partly because much of the most insistent criticism of the relation of corporate management to shareholders has come from persons who appear, on other issues, to exhibit an outspoken anti-investor viewpoint, and not from the investment community itself. Moreover, discussion of proposed changes on both sides of the debate appears at times to be little more than rank speculation. Consider, for example, the controversy surrounding the ALI Tentative Draft as to the duty of care owed by officers and directors to the corporation and the effect of the so-called business judgment rule. Looking at the debate alone, one can hardly be sure that the time-honored rules benefit shareholders less than the changes proposed. As to whether a problem exists, there certainly has been precious little protest from the investment community about the business judgment rule. The great bulk of agitation has come from one group of academics, largely professors of law. Even that discussion, however, entails little more than an occasional reference to the Penn Central bankruptcy, unadorned by a showing that a different legal rule would have led to a different business outcome. At bottom, the seeming laxity of existing rules is taken as evidence itself of the need for change.

There are, of course, counterarguments. Any change in the duty of care may be costly to shareholders generally, for it may create incentives for overcautious corporate decisions. Some business opportunities offer potentially great profits at the risk of substantial losses, while alternatives offer less risk with potentially lower gains. The undiver-

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sified shareholder may prefer the latter, less risky, but also potentially less profitable, course. In the case of the diversified shareholder, however, the seemingly more risky alternative may well be the best choice, since great losses in some cases will be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, the law need not give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A duty of care which deters the choice of seemingly riskier alternatives thus may not be in the interests of shareholders generally. Since corporate management has a larger stake in the survival of a particular corporation than does a diversified shareholder—indeed, since management's viewpoint is closer to that of the undiversified shareholder, its self-interest may cause it to be too cautious so far as shareholders generally are concerned. If that is so, any change in the law tending to penalize seemingly risky decisions may cause net losses to shareholders generally.

I do not set out this analysis to persuade anyone of its merits but simply to demonstrate the difficulty of focusing upon the seriousness of the supposed problem and of discerning the correct solution. In truth, both sides are simply speculating.

And this brings me to my principal argument, which is that speculation is not necessary to the development of the law of corporate governance so far as the efficiency of capital markets is concerned. There is a process by which legal rules optimizing relationships between corporate management and shareholders can be discerned. Historically, states have competed to attract corporate charters for revenue purposes and this competition has been the single greatest influence on the development of the law of corporate governance. I have articulated elsewhere and continue to believe that this competition among states leads to optimal rules governing the relationship of shareholders to corporations.

Corporations must attract capital from a vast range of competing offers, and any state which rigs its corporate code against investors will drive debt and equity capital away. If Delaware, for example, permits corporate management to ignore the interests of shareholders and other states do not, then earnings of Delaware corporations will be less than earnings of comparable corporations chartered in other states. Shares in Delaware corporations will trade at lower prices. A corporation with lower earnings will be at a disadvantage in raising both debt and equity capital and will be at a disadvantage in the product market. The decline of share price will increase chances of a takeover replacing management. Corporations must, therefore, seek legal systems

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more attractive to capital, and states desiring corporate charters will try to provide legal systems that optimize the shareholder-corporation relationship.

It is thus not in the interest of either Delaware corporate management or the Delaware treasury for corporations chartered there to be at a disadvantage in raising debt or equity capital in relation to corporations chartered in other states. Management must induce investors to choose freely their firm's stock or bonds instead of, among other things, stocks and bonds in companies incorporated in other states or other countries, bank accounts, certificates of deposit, partnerships, individual proprietorships, joint ventures, real estate or present consumption. 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 its stock. 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.

This analysis is not dependent upon consumers of securities or lenders understanding the intricacies of corporate law or knowing of the alleged permissiveness of the Delaware code. A simple comparison of earnings of various corporations, for example, will affect the price of Delaware stocks. Moreover, institutional investors—not to mention investment counselors—cannot be unaware of such critical facts. Their role in the capital market is so critical that their knowledge alone will sharply affect share price and the interest rate available to a corporate borrower. If Delaware were really leading a "race for the bottom," as has so frequently been alleged, we would have seen debentures with restrictions as to the state of incorporation long ago. I would submit, rather, that the race is to the top.

So long as we are assured that the states continue to compete for chartering business, the need to undertake a study of the law of corporate governance is minimal or non-existent, and there is grave doubt about the need for extensive reform. In short, the law of corporate governance has failed to change in response to its critics largely because such changes do not benefit the parties it governs. To change rules, such as the duty of care and the business judgment rule, simply because of the claims of a small group of law professors is to ignore the quite reliable forces which have shaped the law in the first place.

One final word: my skepticism about the need for a study is not diminished by the fact that the ALI draft even seems to fail to recognize that it is adopting the highly controversial viewpoint of one school

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of academic thought. Indeed, the ALI draft has appeared at a time when there is more challenge than ever before in the academic world to this viewpoint. Every student editor of a law journal today knows that there is a large body of reputable academic opinion in major law schools which holds a radically different view. So far as I can tell in the materials available to me, this school of thought, which now has influence in academia, in the profession and in the courts, is astonishingly unrepresented in the ALI project.[1] The fact that the viewpoint excluded is the only one which opposes on principled grounds *both* changes in the business judgment rule *and* legal impediments to takeovers may well explain this omission. It is not up to me to suggest to a private organization like the American Law Institute how to structure its inquiries, but if it desires the credibility which attends a true canvass of views, then it should consider restructuring the project in terms of documenting the problems creating the need for a study, defining the goals of the proposed solutions, and ensuring the representativeness of the participants.

1. This statement is as delivered. Professor Kaplan later rebuked me for not recognizing that of the four Reporters, ten Consultants and forty-five Advisers, one Adviser was in fact associated with the modern school of thought. I stand corrected.

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