REGULATION AND THE UNITED STATES CORPORATION: AN ALTERNATIVE TO LAW-AND-ECONOMICS

Jan G. Deutsch*

The governed ought to pay attention to what governors do rather than what they say. So said Nixon’s Attorney-General. That is not easy advice for a lawyer to apply, though lawyers see law as an instrument of government, a tool for regulating human behavior. Law, for lawyers, consists of precedents, any of which a court can distinguish “on its facts,” even when it is otherwise applicable; and the facts courts find—the basis on which the law claims accurately to reconstruct a long-ago event—are the product of technical and often seemingly arbitrary rules of evidence.

Understanding what government does requires information both from the people being regulated and from those who do the regulating. However, regulators are administrators as well as judges, and most analyses of administrative regulatory activity tell a story of conflict between technical experts and political appointees. That story has informed American political debate since the days of the New Deal, and I intend not to burden my readers with simply one more version of an oft-told tale. To tell a different story, however, requires me to make clear the concepts and models which define the information I wish to present. Thus, I seek to convey the state of mind in terms of which I undertake this Article. Forging such an understanding with the reader requires me to establish many correlations: between words and content, form and substance, personal experience and objective reality. I begin by addressing the philosophical question of the nature of the reality humans communicate to each other.

* Walton Hale Hamilton Professor of Law, Yale Law School. This Article complements my recent critique of Critical Legal Studies. See Deutsch, The Teaching of Corporate Law: A Socratic Investigation of Law and Bureaucracy, 97 Yale L.J. 96 (1987). Thanks to Scott Brewer for helping me, in connection with philosophical propositions, to reconcile accessibility with accuracy. I dedicate this Article to Louis Greenblatt, my Uncle’s former lawyer and a partner of Herbert Tenzer, a benefactor of the Benjamin N. Cardozo School of Law.

I. THE VALUE OF THE UNANSWERABLE QUESTION

A. Communicating the Truth

Philosophy is footnotes to Plato, said Alfred North Whitehead.\(^2\) Plato, however, apparently distrusted artists, and consequently his philosophy, at least as it has been interpreted, is incapable of dealing effectively with the phenomenon of art. Nor is this surprising, since the human activity known as art constructs, analyzes, and attempts to understand the significance of statements and representations that may or may not be the truth. The Platonic philosopher, in other words, values only truth, while the artist searches for something whose significance is more subtle than its truth value.

The technique Plato employs is known as Socratic, meaning dialogues that seek to articulate essential truths, the forms that define the substance of reality. Conversely, art investigates a reality too complex to be reduced to formal terms. An artist attempts to present experience in a communicable form, and any attempt to define the essence of what is being communicated—any dialogue attempting to separate out the personality of the artist, the formal devices being utilized, the experience from which the communication was developed—must be counted by the artist as an attempt to establish an inadequacy, an attempt to prove that something beyond what the artist has done is necessary to make the communication understandable.

Plato's metaphor of the cave—the image of the human experience of appearances as shadows projected on a wall—postulates the possibility that such propositions expressing essential truths exist "outside." Thus, there was room after Plato for a new attempt to link the sounds humans make and the symbols they inscribe to the world they inhabit. Kant replaced the dialogue as a tool for discovering truth with a focus on the possibility of constructing propositions about reality.\(^3\) Kant, in other words, applied the scientific goal to

---


\(^3\) See I. Kant, Critique of Pure Reason 47 (N. Kemp-Smith trans. 1929):
Misled by such a proof of the power of reason, the demand for the extension of knowledge recognizes no limits. The light dove, cleaving the air in her free flight, and feeling its resistance, might imagine that its flight would be still easier in empty space. It was thus that Plato left the world of the senses, as setting too narrow limits to the understanding, and ventured out beyond it on the wings of the ideas, in the empty space of the pure understanding. He did not observe that with all his efforts he made no advance—meeting no resistance that might, as it were, serve as a support on which he could take a stand, to which he could apply his powers, and so set his understanding in motion. It is, indeed, the common fate of human reason to complete its speculative structures as speedily as may be, and only afterwards to enquire whether the foundations are reliable.
epistemology, by critically investigating metaphysical propositions whose meaning was purportedly so clear that they could not be denied.

Kant's objection to pictures of reality was not, however, phrased in terms of the cave. It centered, rather, on the concept of cause and effect, on the question whether, given the unbroken historical record, the sun could be counted on to rise.\(^4\) Science rests on the truth of cause and effect, and it is difficult to argue that humans should not rely on the truth of the proposition that the sun rises in the morning. Kant was able to rely on such propositions by relocating causation inside the mind's cave, in the categories in terms of which perceptions are classified.

Thus, Kant was not weighing the possibility of accurate prediction of the future from historical records; instead he was exploring the possibility of induction, the possibility that humans could demonstrate to a certainty that the sun should rise. The "should" in the prior sentence is being used logically rather than ethically. This distinction underlies the significance of Alfred North Whitehead's collaboration with Bertrand Russell in producing *Principia Mathematica*, an attempt to reduce all of mathematics to logical propositions.\(^5\) *Principia Mathematica* provided a basis on which Whitehead could deny that Kant's views represented an advance on Plato's. If science, which is based on mathematics, describes reality, and mathematics is itself logical, then Plato's cave remains an accurate metaphor for the reality we attempt to discover.

Whitehead was not convinced by *Principia Mathematica*, however, and he eventually produced *Process and Reality*, in which God is defined as the existence of pattern.\(^6\) Whitehead's progression from *Principia Mathematica* to *Process and Reality* makes clear the basis for objecting to Kant's views. To deny humans knowledge of patterned existence is to deny the possibility of an effective system of beliefs. Thus, it may not matter that we cannot be certain of the consequences of our actions, but it does matter that what we are doing has meaning neither for us nor for God. More concretely, we may not care whether reality is logical, but it does seem difficult to accept that our actions are meaningless.

Kant solved this problem with the Golden Rule, the proposition that one should treat others as one desires to be treated. The Golden Rule is a principle with which it is difficult to disagree. However, law

\(^4\) Id. at 111-19, *passim*.


\(^6\) A. Whitehead, supra note 2.
is necessary precisely because humans who agree on a desirable goal are not by that act alone committed to doing what is necessary to achieve it, as a nation can adopt a constitution without extending the rights it guarantees. The Golden Rule thus operates at a level of abstraction that obliterates the distinctions by which groups and individuals define themselves. Living by the Golden Rule is living by rules that were drafted without paying attention to your particular circumstances. Accordingly, the question remains whether a philosophy can be developed that is more than a footnote to Plato, whether an image can be presented that offers a more accurate metaphor for reality than the cave.

Envision, for these purposes, the individual as a plane in the four-dimensional space known as society, space constituted by relationships among the individual planes. Absent a context (such as that provided by a religious or secular cosmology), the space is arbitrary, and the arbitrariness is not dissolved by the fact that the contours of the space can be described with fair accuracy in mathematical terms.

The individual does, however, have a choice, which can be called ethical or moral or spiritual: the choice of treating reality as synonymous with the surface of the plane. The plane, like society, would be constituted by interactions with other planes. But because of the individual nature of the surface, it is possible to postulate the existence of a context. That postulate makes plausible the attempt to achieve a pattern, to make sense of our life in this world, to engage in activities called ethical or moral or spiritual. Of course, within society the plane may be growing or contracting; but it is equally true that both society and the individual may be changing within the fourth dimension of time.

Adopting the image of the plane in preference to that of the cave acknowledges the social nature of reality, the fact that we treat as real what we are taught to believe. Since the plane can be infinite, no limit is postulated on what an individual can believe. But it is misleading to treat infinity as nothing more than a space without limits, just as a definition of eternity as an endless succession of moments sacrifices the reality of spiritual experience to the truth of technical accuracy.

To summarize, reality can be grasped as something richer and more complex than the philosophy contained in Platonic dialogues, raising the issue whether this epistemological possibility entails a morality more concrete than that contained in the Golden Rule. The starting point for my answer is the image of the plane in space, the portrayal of the human as defined by its social nature. The next task
is to delineate the economic and political strands whose combination constitutes the social aspect of reality.

B. Politics and Economics

Hegel's response to the dilemma raised by Kantian epistemology was to postulate the objective reality of Hegelian concepts. By moving Plato's wall pictures—which Kant placed inside the individual's head—"outside," Hegel succeeded in melding the epistemological and ethical strands Kant treated separately. Once thesis and antithesis had been established, the abstraction of the synthesis was no more easily denied than was the validity of the Golden Rule. The Hegelian dialectic—the process by which thesis breeds antithesis, which then merge into a synthesis producing its own contradiction—was made "scientific" by Marx, who claimed that the universe in which it operated was wholly material.

The empirical basis for this claim—that the dialectic operating in the universe "scientifically" explained history—is the proposition that political action is determined by socioeconomic structures produced by the operation of economic forces. There is a good deal of truth in this proposition, but it disregards substantial aspects of political reality. The concept of class in Marxist theory in effect postulates that the individual plane is all of reality, since what makes Marxism "scientific" is its denial of the necessary arbitrariness of the social space. Scientific validity would require Marxism objectively to determine every individual's class membership by his or her place in the socioeconomic structure.

Moreover, Marxism finds it difficult to account for the effectiveness of nationalism as a political force. The connection between nationalism and the more general category of spiritual reality is highlighted by the Thirty Years' War between Catholics and Protestants. That conflict dragged on until a disparity of religions between ruler and subject ceased to be an issue that could be solved only by violence. In other words, an inability to agree on a definition of Christianity was resolved only by acceptance of the proposition that princes could be trusted to do the right thing because by Divine Right they were properly given power over their subjects.

Monarchies were replaced as structures of political power by republics, entities established to enable the achievement of liberty, equality, and fraternity. Marx celebrated the bourgeoisie for having achieved liberty from the contradictions of monarchical authority. His system predicted, and thus to some extent implemented, development of the antithetical forces that produce equality. Misled by the
apparent certainties of mathematics, however, Marx assumed that fra-
ternity could be equated with proletarian solidarity, that an effective
society would result from the fact that the proletariat outnumbered
other socioeconomic classes. In structural terms, the error in Marx’s
theory was the assumption that specialization *vel non* is workable—
that absent political regulatory efforts, individuals would be satisfied
with the niches they occupied in the socioeconomic structure.

Capitalism, on the other hand, replaces solidarity as a governing
principle with competitive division of labor, and assumes that individ-
uals will find satisfaction in a system that is open to change, that offers
opportunities for changing one’s niche. In each case the governing
political force is “outside,” embodied either in a class or a market,
and in each case the individual is confronted with a system in which
the epistemological and ethical strands are intertwined, in which you
are told that competition or solidarity is good for you and assured
that, even if you disagree, it is a social reality with which you will
have to contend. In both systems, therefore, politicians are necessary
to fulfill the authoritative social function performed by the monarch:
to justify the arbitrariness of the social space, to judge how much of
the truth we are required to be told to enable us to do what we ought
to do.

The ultimate competitive activity is warfare, and social reality is
accurately described solely in terms of rational economic calculation
the closer a society comes to a state of war. Given an overriding goal,
even the cost of persuading people to pursue it can accurately be cal-
culated. It is only when the goal is not overriding, not “outside” the
individual, that the social calculus proves incapable of assessing accu-
rately the values that guide our behavior. In short, economics cannot
be separated from politics if we are to deal effectively with reality,
with the social nature of the human animal.

Economics tells us that all human behavior can be analyzed in
terms of choice, but it does not tell us how to behave. Utilitarianism,
the philosophical doctrine that attempted this feat, analyzed human
action as an attempt to pursue pleasure and avoid pain. Like the
Golden Rule, the utilitarian calculus is impossible either to deny or
apply, since it is workable only if one eliminates all those individual
differences through which humans define themselves. The question,
therefore, is the role of political philosophy, the place of theory, in our
lives.

The problem can be posed most clearly by recalling the discuss-
ion of art with which we began, the possibility that reality is too
complex to be reduced to formal connections. As soon as we accept
this possibility, we, with the economists, will accept that theory is
devoted to the margin. But, unlike the economists, our analysis will be
informed by the knowledge that marginal theory involves an admis-
sion that the forces being analyzed are not sufficiently significant to be
designated a cause except within the technical boundaries of the the-
ory itself. Such a beginning does not mean that we can afford to dis-
card theory. We must still set our priorities, ask what we are looking
for, and determine what weight we will give to the evidence we find.
Such a beginning does mean, however, that we are acknowledging the
possibility that logic may, under certain circumstances, be the enemy
of truth, that presenting reality may, in those circumstances, be inconsis-
tent with reasoning about it. Such an acknowledgment underlines
the difficulty of applying a theory to reality. Thus, even if we grant
that development of the theory is necessary, the question remains how
that theory is to be applied to the world in which we live.

C. The Revolutionary Nature of the New Deal

Before being selected as Nixon’s Attorney General, John Mitch-
ell had established himself as an expert in the law governing munici-
pal bonds. Municipal bonds were exempt from the regulatory scheme
developed during the New Deal to govern issuance and trading of
securities. That exemption—recognizing the intimate connection be-
tween such bonds and nonfederal governmental authorities—encapsu-
lates the forces that defined the New Deal, the tensions created by the
disparity between the political entities that constituted the United
States and the national market that structured economic activities.

Until the Civil War, the Supreme Court interpreted the com-
merce clause—the constitutional provision giving the federal Con-
gress authority over commerce among the states—as permitting
challenges to state laws designed to govern economic as opposed to
social matters. Following that conflict, the clause was read more
broadly, as mandating the establishment of a national market, and
thus as overriding any state and local regulations, whatever their
motivations, that had the effect of restricting commercial activities.
Prior to the New Deal, however, the Court had not made clear the
extent to which the ideology of the market was sufficient to override
competing considerations in commerce clause cases. The New Deal
was therefore revolutionary in the Court’s open substitution of the
power of Congress for the power of the law in terms of identifying the
force responsible for regulating the economy.7

---

The New Deal, in other words, was characterized by acceptance of a new truth about government and the law. When Roosevelt said that we "have nothing to fear but fear itself," he was reassuring the society he governed that the law could be replaced by a more effective force, that the economy could be regulated effectively by those who possessed the requisite knowledge. To some extent, Roosevelt was simply reverting to monarchical rhetoric, reassuring the population he ruled that he could be trusted. The promise was more than rhetoric, however, for Roosevelt implemented a structural revolution, legitimating direction of the economy by regulatory authorities. In functional terms, the expert replaced the law, and the application of technical expertise became accepted as something that advanced the public good, rather than something whose contribution had to be assessed by the precepts of law before it could be enforced.

The justification for this shift was efficiency, the fact that judicial scrutiny of technical expertise would interfere with its effective implementation, and this attitude had its impact on the mechanisms of the law itself. Thus, before promulgation of the Federal Rules of Civil Procedure in 1938, the first of which merged law and equity, the operating mechanism of the law had been a dialogue between legal formulas and the extraordinary interventions of equitable proceedings. The maintenance of courts of equity in the face of an expanding common law was founded on a spiritual certainty, on the premise underlying the work of ecclesiastical authorities that secular formulas were insufficient guides for conducting human affairs. Unfortunately, this certainty hardened into the equivalent of a rigid theology, whose provisions became difficult to distinguish from the pleading formulas that governed common law proceedings.

The merger of law and equity was premised on the view that discovery of facts would make pleading the law a matter of form rather than substance, thus making the dialogue of law with equity irrelevant. The result, as lawyers know, has been to make discovery rather than pleading the stage of the proceedings at which lawyers attempt to persuade each other that the costs of resort to law are too onerous. Nor does an appeal to equity under the current system invoke the possibility of seeking relief from a different judge. Under the current system, law and equity are merged in the authority of the sitting court, raising the issue whether the persons staffing it possess an expertise congruent with their expanded authority.

The theory that underlay the New Deal is thus the theory that underlies the Platonic dialogue: the certainty that objective truth exists, and that the path towards it is the examination of contending
positions. So long as we deal with matters bounded by the technical language of a science, such a position is unexceptional. Once we deal with the law, however, we are faced with the task of persuading those to whom the law applies, of arguing that what the court or regulator has done is valid. At this point the question becomes one of communicating what will be accepted as the truth, and that truth must be capable of being stated in terms accessible to the nonspecialist, in language that is persuasive of a substantive reality.

The distinction between technical and substantive language can be made clear in mathematical terms by focusing on the difference between geometry and algebra. Circles and triangles are abstractions, but nonmathematicians are aware of their existence in terms of concrete manifestations. Hence the proofs of geometry, like the proofs of competition and solidarity, are explanations of what is there rather than technical formulae. It is when the mathematical unit loses the individual characteristics of concrete instances that we replace truth with technical certainty, and pay the political price of having to weigh the effectiveness of persuasion against the certainties of coercive power. In other words, it is when our justification is technical that assent without potential coercion becomes an unrealistic expectation.

The courts developed two doctrinal responses to the revolutionary activity of the New Deal. One was the concept of delegation, an insistence that Congress not delegate its political tasks to elected officials. The other was a short-lived attempt to develop a category of "constitutional facts" whose determination would be subject to judicial review. These efforts to constitutionalize restraints on administrative action proved impossible to implement effectively. In today's post-New Deal world, attempts to legitimate bureaucratic coercion take the form of making clear the basis on which policy is being made, the expertise in terms of which the economic aspects of our lives are governed. Such an attempt was made by President John F. Kennedy in 1962, in a speech described by the business press as acceptance of Keynesian ideas.

The speech emphasized awareness that monetary, fiscal, and budgetary policies had economic consequences. Whether Kennedy intended to convey more than the fact that politics and economics cannot be separated his speech does not make clear. In fact, however,

---

Keynes' most significant contribution was to elucidate the extent to which the Platonic image of the cave serves as an apt metaphor for most economic disputation. Keynes made clear that no sensible distinction can be made in the here and now between a fact and a social belief, that it was pointless to attempt to determine whether stock market movements illustrated "rational expectations" or "popular delusions and the madness of crowds." What politics adds to economics, however, can be summarized as the need to strike an appropriate balance between long-run and short-run consequences. In these terms, Keynes pushed his realism to the very edge: "In the long run, we shall all be dead."

The technical accuracy of that statement forms an apposite historical counterpoint to the truism implicit in the reassurance that we "have nothing to fear but fear itself." Thus, one of the crucial facts about the geometric figure of the plane is that there is no logical reason for denying it infinite and eternal existence. If, moreover, we seek the truth rather than the reason of eternity—the faith that moves mountains rather than the logic that life is no more than preparation for death—then eternity for us is not only endless but also present time, not only forever but also the here and now. Whether such a perception of the long-run is synthetic or realistic depends on whether we are making an artistic or philosophical statement, but the operational issue is how we apply in our lives the truth that statement represents, and it is that operational issue which constitutes the stuff of politics.

In terms of the New Deal, we are left with the concept of delegation, and particularly the model that doctrine attempts to apply, in which regulators administer policies promulgated by elected political representatives. The doctrine of delegation has not been effective because of the impact the New Deal had on judicial bureaucracies, its success in making equity superfluous. Law, after all, is itself a regulatory scheme, and, like all such schemes, it attempts to regulate human behavior by postulating desirable structures and goals. Unlike administrative regulatory schemes, law shares with such social ideals as solidarity and competition the property of being perceived simultaneously in terms of structure and goal, of being treated as legitimate. Administrative regulation aspires to, but does not always achieve, such a status.

The reason is not far to seek. Where competition is the guiding principle, regulatory rules are perceived as bars to innovation, as attempts to preserve outmoded structures, or as the unwarranted extension of a prohibition. The issue of delegation has thus arisen wherever
the administrator is given discretion to avoid such consequences, discretion to balance the costs of attaining a goal against the benefits of retaining a structure. Further, it seems unlikely that persons to whom regulatory power is delegated will refuse to exercise it on the ground that the guidance given in the legislative mandate is unconstitutionally inadequate. Short of such refusals, however, the constitutional problem can only be noted rather than solved.

The problem of delegation is relevant only if government regulation is desirable. Accordingly, it is necessary to address the question posed by the ideology of the market, to account for the fact that the problems with which government attempts to deal are not simply left to the mechanism of the economic construct known as the market.

D. A Theory of Regulatory Behavior

The market as a concept and competition as a governing social principle share with Marxism and solidarity the defect of embracing economic logic in disregard of political context. The result is that both are enabled to treat as either nonexistent or irrelevant the arbitrariness of social space, Marxism by locating the truth in a transformed future, and those who argue for the market by denying that they are recommending anything more substantive than a mechanism. Both ways of looking at the world ignore the reality of political structure, the nations that command loyalties cutting across class lines, and the states whose boundaries impose limits on the free flow of goods.

The market, moreover, is itself as much a structure as a mechanism. By interacting in terms of a market mechanism, participants define the rules governing economic activity and thus structure human life. Of course, life in Marxist society is more closely structured in the name of solidarity than life in a market economy in the name of competition. Opposition to capitalism is opposition, however, not to the market but to the process of industrialization, to the replacement of human muscle and brain power by machines. Examining this opposition defines the task of those charged with regulating capitalism, and the sources of that opposition become clear if we examine the political mythology that permitted acceptance of industrialization in the United States.

The American political paradigm is the yeoman farmer, a small property-holder whose labor is meaningful since it feeds both him or herself and others. The farmer is independent of state power, delegating to local authority only what he or she rationally must. We enforce antitrust laws, despite their economic irrationality, because the
yeoman farmer has been transformed by the processes of industrialization into the small business person, and the mythological justification for insisting on competition is the preservation of that paradigmatic status. Meanwhile, farmers have used the increasing specialization of their vocation to demand preferential treatment, and have become one of the most effective pressure groups in industrial society.

As a result, farmers have been pioneers in making Americans aware of a phenomenon that has increasingly structured society: the social consequences of bureaucratic activity. Sooner or later, regulated groups adjust to the regulatory mechanism, which becomes part of the market defined by its activity. At that point, the regulatory process itself functions as a barrier to entry of new competitive forces. Thus the market assimilates the political force attempting to regulate it and questions of regulation and economic efficiency coalesce.

The inquiry raised by this process is what in the history of the United States makes it define itself as a market economy despite significant regulatory activity. The answer begins at the founding, when the commerce clause was drafted to free interstate commerce from the acts of state governments. Further, politics can be seen as interfering with, rather than providing the context for, business, because political parties—the mechanisms by which our politics are structured—go unmentioned in the Constitution. The proper business of our government can be seen as business, in other words, because the framers made no provision in their text for the business of politics.

Other nations do not share that heritage, and more important, the history of other nations began long before development of the technology that made industrialization possible. Machines, capable of depriving humans of work, are always perceived as threatening, and other societies had considerably more tradition on the basis of which to oppose the changes portended by new means of production and the arbitrariness of the numbers with which the market judges performance.

Human beings, like the weather, are unpredictable, and all societies develop traditions to accommodate the resulting arbitrariness, the part chance plays in human life. The promise of the bourgeois revolution was the seeming movement from chance to predictability, from arbitrariness to order. But the promise was illusory, both because of the cyclical nature of business activity and because, as Whitehead discovered, the seeming logic of mathematics is a logic of process rather than substance. Against this background, we must accept the proposition that the reality of human life is as much paradox as order, a
reality which must accommodate the fact that Marxism, the celebration of the bourgeois revolution, gained popularity as the political expression of opposition to the processes historically associated with industrialization.

Bureaucracy in the United States is explicable only in these paradoxical terms. The problem of delegation, for example, has its roots in the fact that the entire structure of the United States government, and especially the Bill of Rights, is designed to prevent governmental coercion from being effective. Consider *Brown v. Board of Education*,\(^\text{10}\) where the judiciary acted to end segregation because the pressures on the executive and legislature were sufficiently powerful to prevent them from acting decisively. Whether *Brown* was proper, whether it would have been better to force the other branches to assume responsibility, is an unanswerable question. But one of the salient points I have been attempting to establish is that development of effective policy requires recognition of the value of the unanswerable question.

Were all questions theoretically answerable, the theoretical case against an open mind would be airtight. The judiciary's recognition of a question as unanswerable, of the need to tolerate opposing views, was encapsulated and rationalized in the phrase "political question," and the most damaging aspect of *Brown*, as the controversies over abortion and reapportionment attest, is the extent to which it has made the category of "political question" anachronistic.

The bureaucrat is a politician balancing the need for competition against the longing for solidarity, the effectiveness of the coercive threat against the value of allegiances derived from obtaining assent by persuasion, the attempt to alleviate the consequences of economic change against recognition of the fact that attempts to delay operation of the economic cycle may make the deferred inflation or recession more severe. The bureaucrat or judge, like the artist, intends to communicate and is aware that the message the artist transmits and the message to which the observer or listener is responding may or may not be the same thing. John Mitchell meant to convey, then, that in the case of politicians, as with other actors or actresses, what is said is only one portion of the meaning of the play. Watching what the actor or actress is doing helps to determine whether the message you are hearing is what the play is about.

\(^{10}\) 347 U.S. 483 (1954).
II. The Demand for Regulation and the United States Corporation

A. Law, Government, and Economic Theory

*The Costs of Accidents* used economic theory to demonstrate that the existence of insurance underlay the way courts applied legal rules in connection with automobile accidents.\(^{11}\) The justification for abandoning litigation was thus that the analysis contained in *The Costs of Accidents* enabled a move from the uncertainty of jury verdicts to the more just system of predictable administrative awards. The consequences of the shift to no-fault have been greater public awareness of the existence of insurance, combined with development of new causes of action used by lawyers to justify awards larger than those available under no-fault.

From the insurance industry's viewpoint, the consequence has been a crisis—potential liability is often considered too large to permit underwriting of risks. It is impossible to be certain that awareness of the existence of insurance and expansion of liability would not both have occurred even absent no-fault. Thus, the extent to which the claim of crisis is self-serving remains unclear. However, it is clear that economic analysis is insufficient to produce the proper solution to the issues presented by automobile accidents.

The authority of economic theory ultimately derives from its status as applied mathematics, which means that we are dealing either with numbers or statistics. A statistical statement is scientifically valid in that we must accept the information it contains as true, but that information is only potentially applicable to any given instance of human behavior. The science of statistics is more accurate than law only when we are speaking of behavior in aggregate terms, and the gap between rule and reality is thus different for law and statistics only so long as we are making statements about a category of events rather than the concrete instance.

What makes economic theory a powerful tool, moreover, is a belief not about statistics, but about the nature of the abstraction known as number. Numbers are characterizations of instances, and because the characterization is wholly abstract—because it signifies only that something has been counted—we tend to overlook the ontological significance of the statement. How do we know that the second instance is the same as the first? that the category is a valid one? that we are counting the same thing? These questions underlie the legal concept

---

of precedent, the mechanism the law uses to determine relevance by deciding which of a myriad of potentially conflicting rules to apply.

In theoretical terms, the applicability of an economic theorem to reality is thus no less mysterious than the objective validity of a given application of precedent. Once the concrete reality of the geometric shape is left behind—once numbers signify something more abstract than lines and points that can be connected—mathematicians will admit that certain numbers can only be designated irrational in that their behavior cannot be predicted, that procedures performed on rational numbers produce results that are not apparent when those procedures are performed on irrational numbers. *The Costs of Accidents* made clear only that the law was no better than mathematics, that its units (known as precedents) sometimes behaved in irrational ways.

In operational terms, moreover, *The Costs of Accidents* rested on a misunderstanding of the insurance industry. Risks are underwritten on the basis of actuarial science, and that science is based on mathematics. To argue that underwriting is based on a mathematical assessment of risk, however, is to ignore the purpose of the actuarial determination, which is to arrive at the premium to be charged. Thus, actuarial calculations are important, but they are not necessarily determinative of the premium amount. That amount is determined as much by marketing as by underwriting considerations, and hence will be influenced by the state of the insurance company’s investment portfolio and share of the insurance market as well as by actuarial calculations.

It might be argued that, over the long-run, no significant deviation from the actuarial calculation could be maintained, and hence that the premium must in the end coalesce with the cost of underwriting. There is something to that argument, as there is something to the argument that law is more than the remedy awarded the winning party by the court. That something more, however, is precisely what *The Costs of Accidents* acknowledged but ignored, since the use of economic analysis in law is premised on the view that strictly legal modes are inadequate.

Restricting oneself to the law, the ultimate question would be why automobile accidents are treated as torts, and the answer requires an attempt to distinguish torts from contracts. Contracts involve private ordering. Even in cases involving contracts, the people involved often prefer to rely on the law rather than arbitration. The something more, therefore, involves recognition of something beyond the private individual, a social reality, a moral imperative, a public rather than a private truth. It is this aspect of reality that is predominant in a mat-
For the rational individual whose decisions economic science describes, there is no qualitative difference between public and private considerations. What matters are relative weights in the economic calculus. The other aspects, the matters with which legal doctrines are concerned, are left for politicians to deal with. Nonpolitical economic analysis describes a process functioning in a vacuum, a human enterprise whose goals, limits, and purposes are all arbitrary givens.

Consider so-called supply-side economics, a doctrine focused on manipulating the side of the economic equation dealing with the supply of goods and services rather than the side dealing with the demand for those things. Supply-side doctrine represents a response to the fact that Keynesian adjustments of demand utilizing tax rates and budget deficits had resulted in inflationary pressures. Because people wanted the benefits of Keynesian financial adjustments without inflation, they longed for an era in which that had seemed to be the case. Thus, supply-side theory is a political exercise in nostalgia. It argues that reducing government regulatory efforts would return us to an era in which United States residents wished to be producers rather than consumers, and in which United States labor unions would be craft rather than industrial organizations, interested solely in wages and craft standards rather than political power and working conditions.

When an attempt is made to deal with the future rather than the past, however, the political and economic strands intertwine. How do we keep the cost of regulation down? The supply-side answer is to let the market function, and at this point the economic aspect of supply-side theory becomes indistinguishable from the legal question of the validity of corporate takeover tactics.

The market for goods and services functions freely when capital circulates freely, and much of the litigation concerning corporate takeovers can be seen as an attempt to develop legal doctrines defining unfair uses of capital where control of corporate enterprises changes hands. When phrased in the language of economics, the opposition to corporate takeovers is presented as giving priority to long-term considerations over short-term financial gains. To a considerable extent, however, such opposition can also be seen as retarding the democratization of control of American productive capacity, as a response to the fact that access to capital since World War II has significantly expanded numerically, geographically, and ethnically.

A shift in focus from corporate control to international trade
transforms the issue into whether United States industry is losing its ability to compete with foreigners, and whether, as a result of the trade deficit, foreign holdings of American assets and securities mean that we have surrendered control over our economy. The two issues—the finances of corporate takeovers and the productivity of American industry—are connected by a structural disparity: there is an international financial market but corporations function within nationally defined economies. In other words, money circulates relatively freely but movement of goods is restricted by rules promulgated by nations seeking to maximize returns from their economies.

The result is demands for protectionist legislation and attempts to make foreign governments take monetary actions that conform to our economic policies. Such measures, however, are effective only insofar as they fail to produce countervailing actions by other states. This situation could be dealt with effectively only if industrialized nations were willing to relinquish some degree of control over their own economies, either by return to a fixed monetary standard (either gold- or commodity-based) or by ceding power to a central monetary authority.

In political terms, the success of supply-side theory has made it difficult for both incumbent managements and nations to maintain control over economic activity. Thus far, the United States Executive has answered these problems by increasing defense spending.

The historical roots of that response can be found in the American Revolution, a colonial rebellion sparked by commercial opposition to the mercantilist policies followed by the British Empire. The economic measures that produced our independence were based on Britain's view that colonies were to trade with the imperial power on terms favorable to her. It was this mercantilist position that led Americans to confuse economic liberty with political freedom. The demands for freedom were stated in political rather than economic terms, but the fact remains that the issue was the right to be free of economic regulation from abroad rather than a desire to replace the monarch with an elected assembly.

The confusion of economic with political considerations has characterized our attitudes ever since. Thus, after the Civil War the commerce clause was interpreted to prevent states and localities from regulating corporations whose operations were national in scope. The result was that only the national government could regulate such corporations effectively. World War II, however, witnessed large corporations being favored by the federal government. The productivity such corporations controlled had been what Keynesian manipulation
was intended to stimulate, and World War II wholly succeeded where the New Deal had been only partly effective. The War could thus be seen as an economic necessity rather than a moral crusade, and it was this view that underlay the refusal of the Communist Bloc to participate in the Marshall Plan. When we proposed that cooperative venture, our intentions were suspect because the Soviet Union perceived our contribution to victory in World War II solely as the utilization of productive industrial capacity while theirs was a devastated homeland and a decimated population. The Soviets felt that a cooperative venture designed to increase industrial capacity did not signify proper appreciation of their contribution to the war effort.

Marxist ideology—the promise that a society will reward its people in terms of needs rather than abilities—can be seen as an organizing social principle. As such it is in competition with nationalism, religious fundamentalism, democratic capitalism, and military and organizational tyranny. If political decisions are the product of economic structure, however, Marxism cannot prevail in the competitive struggle. Rewards, it seems, are the product of competition, and the centralized planning typical of Marxist states succeeds only in lowering the level of competitive economic activity.

On the other hand, were Marxism seen as a political rather than an economic doctrine, as a set of moral imperatives rather than scientific givens, the demand that the individual be rewarded in terms of needs rather than abilities could be read as a demand that economic systems accommodate human needs, that such systems be regulated sufficiently to minimize the exploitation of humans who participate in them. Such a demand involves the insight that planning, once it directs an economic system, becomes part of the problem rather than the solution, and that the relevant question is the nature of humane economic planning.

B. The Corporate State: Defining a Functional Board of Directors

Any response to that question by the United States must focus on the corporation, an entity organized to increase economic leverage. It is not plausible to say that economic power should be kept independent of political direction; what effectively limits power is not the degree to which it is chaotic, but the extent to which it is decentralized. The relevant question for a system without centralized planning, therefore, is internal to the corporation, the entity in which decentralized power is lodged.

For example, how do we ensure that purchase of labor-saving machinery is governed, not only by the accounting conventions ac-
cepted by the chief financial officer, but also by input from the person whose job will either be replaced or made more interesting? The relevant questions cannot, however, all be reduced to technical considerations. Thus, we may accept unions as necessary communication links between labor and management, and presumably none of us approves of racketeering per se. But why, then, has so little attention been given to the fact that the connection between racketeering and labor unions provides management a relatively stable environment at a relatively low cost? Do we wish simply not to acknowledge that the threat of violence can be viewed as cost-effective in any system in which resources are relatively scarce and where the demands of productivity are treated as paramount?

I pose the political question of the economic significance of violence only to demonstrate the need for a context, for the specification and ranking of the goals to be achieved, before economic analysis can be treated as relevant. What follows does not purport either to be economic analysis or to answer political questions. Rather, the remainder of this Article proposes a solution to the shortcomings of the answer given by corporate law to the demand we have been considering.

(i)

Directors must add a new dimension to their activities. They must demonstrate that they have taken measures to permit them effectively to direct the activities of the corporation on whose board they sit. Such measures are now necessary because the responsibility of directors—the need to ensure that the business of the corporation is conducted prudently—is no longer adequately monitored by the processes of either the market or the law.

Until recently, shareholders monitored the activities of directors either by selling their shares or by bringing derivative actions. The market provided a stable baseline from which directors could gauge the significance of the first reaction, and lawyers could advise on the appropriateness of settling derivative suits. However, the utility of both devices has seriously been compromised by the recent takeover phenomenon.

The market for corporate stock must increasingly be distinguished from operational reality—the activities of arbitragers and the decisions of institutional managers—once a company’s shares are in play. Similarly, the derivative suit, like litigation in general, has become simply one more raise of the ante, a device used to force either the target or the raider to expend more resources. In both cases,
therefore, the market and the lawsuit provide information useful in the takeover attempt, rather than informing directors whether their actions have fallen short of the standard of prudence.

Judicial decisions on the merits in takeover litigation, for example, have almost nothing to do with legal principles, but are resolved solely by ascertaining whether the given poison pill or crown jewel sale was or was not a prudent business judgment. More particularly, the new dimension I advocate is a necessary response to *Smith v. Van Gorkom*, a recent Delaware case that held directors liable for sale of a corporation on the ground that they failed to show that sufficient time and consideration had been given to the decision to sell.\(^1\) Analysis of that case provides convincing proof that directors of United States corporations must now add a new dimension to their activities.

(ii)

*Smith v. Van Gorkom* is startling because the duty the directors were held to have violated was a duty of care rather than a duty of loyalty. While in theory directors have always been subject to both duties, almost no decisions hold directors liable solely for negligence in the performance of their duties. Rather, the holding has always been that their fiduciary obligations had been breached. The relevant duty, in other words, has been that of loyalty rather than care.

The distinction is crucial because the two duties set totally different standards for the person whose activities are being judged. The duty of care is a question of relative skill and community standards, a risk that can be covered by insurance, and a wholly economic rather than moral duty. The duty of loyalty is the obligation of a trustee, a standard historically policed by ecclesiastical rather than civil courts. The duty of loyalty is a legal concept originally applied to the activities of those administering wills and trusts. Because successful economic activity requires standards more flexible than those applied to trustees, decisions governing corporate directors increasingly began to speak in terms of a duty of care. That the standards applied were in fact those of a duty of loyalty has been made clear, however, by the shock produced by *Smith v. Van Gorkom*, which did focus on the duty of care. Moreover, *Smith v. Van Gorkom* is incompatible with the business judgment rule as that legal principle has historically been understood in the United States.

\(^{12}\) 488 A.2d 858 (Del. 1985).
Henry Ford symbolizes many things in United States history. Developer of the automobile, promoter of an end to international conflict, family patriarch, and opponent of labor unions, he represents an individualism that manifested itself in a variety of political and economic forms during the nineteenth century. The political manifestation of this individualism was the Progressive movement of the late nineteenth century, which advocated direct democracy at home (reflected in such reforms as the initiative, the referendum, and election of judges) and which attempted to restrict involvement in international affairs to “principled” uses of national power (like convening conferences and formulating agreements to pursue such ends as renouncing the right of nations to resort to arms).

Progressives believed that accumulation of capital made possible by corporate structures permitted persons in control of such entities to wield inordinate economic power. This perception led the Michigan Supreme Court in *Dodge v. Ford Motor Co.*,\(^\text{13}\) to respond to Henry Ford’s plan to expand his production facilities while reducing the selling price of his cars (and minimizing dividends) by warning that:

> The difference between an incidental humanitarian expenditure of corporate funds for the benefit of the employes [sic], like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious. There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders.\(^\text{14}\)

The Michigan Supreme Court’s argument rests on the proposition that only competition, as manifested in the profit motive, puts sufficient pressure on those in control of corporate wealth to prevent abuse of their power. Analogous arguments—that certain competitive practices confer unfair advantages and that the size of certain organizations gives them an unfair competitive advantage—underlie antitrust laws limiting the exercise of corporate power.

The *Dodge v. Ford* court, while it forced the payment of dividends which Ford had attempted to discontinue, refused to enjoin the building of a Ford-owned steel plant at River Rouge, which was opposed precisely because it represented too large an agglomeration of

\(^{13}\) 204 Mich. 459, 170 N.W. 668 (1919).

\(^{14}\) Id. at 506-07, 170 N.W. at 684.
economic power. Most strikingly, the Michigan Supreme Court refused to act in the face of claims that Ford, over shareholder objections, was charging less than the market price for his product. "In view of the fact that the selling price of products may be increased at any time," the court said, "the ultimate results of the larger business cannot be certainly estimated. The judges are not business experts."\(^{15}\)

The *Dodge v. Ford* rhetoric rests on the importance of the profit motive in disciplining corporate activity. However, in operational terms the decision permits invoking the business judgment rubric—the board's judgment about long-term economic consequences—to shield corporate activity from judicial control. It is that state of affairs which is now coming to an end.

(iv)

The problem currently facing boards of directors can be summarized: The business judgment rule, because it embraced both duty of care and duty of loyalty, confused economic and political considerations. So long as shareholders can sell their stock, they have no economic claims on the directors. Consequently, their claims are restricted to violations of the fiduciary principle—breaches of the duty of loyalty.

Once stock markets reflect takeover activity as opposed to long-term economic value, however, courts are forced to consider questions governed solely by the duty of care. Moreover, it has always been true that the capital contributed to a corporation is held in trust by that corporation's directors, and this fact underlies the historical use of duty of loyalty language in policing the activities of directors.

To a great extent, however, the courts could do that job primarily because the stock market was sufficiently public—it sufficiently reflected long-term values—that the cases that came to court were exceptions to the rule, pathological instances rather than the norm. Once the market cannot be relied upon, the burden placed on directors by the duty of care can be seen as a purely political dilemma. The choice is now up to the directors: Either redefine prudence as simply an unwillingness to permit management to take risks, or add to the activities of the board the dimension of ensuring that the interests being furthered at every step are those of the corporation rather than those of any of the myriad of persons and institutions who have an interest in the enterprise. The question is how to implement the latter course.

\(^{15}\) Id. at 508, 170 N.W. at 684.
The ultimate difficulty confronted when attempting to make policy is that one is held responsible for what one cannot control—the future. This difficulty, however, confronts all governing institutions, and a good deal can therefore be learned by analyzing the way Congress does its business. Like the board, Congress gets its information from the same authority that implements its policy, the executive; and, like the board, a successful Congress is part of a government in which the policymaking arm functions to assist, rather than simply to limit, the executive.

Policy, in other words, is simply an articulation of the process by which the government—or the corporation—defines itself. In this context, it is important to distinguish between the chief operating officer and the chief executive officer, even if the same person fills both roles. The board's function is executive rather than operational. It must consider the difficulties management faces in implementing board policies, but the expertise management brings to that process must not be confused with management's preferences about whether a given policy should be adopted. Delegating to management judgments concerning the policies the corporation should follow is an abdication of the board's responsibility.

The board is assigned this responsibility because, like Congress, it embodies the hope that policy will be formulated on a broader basis than that of striking the most efficient compromise among demands from the many constituencies that have an interest in the corporation's—or the government's—operations. The hope that the board will act in the interest of the corporation underlies the resistance to such devices as cumulative voting and disparate voting rights, mechanisms that facilitate specific interest representation on the board. As with all hopes, there is no guarantee of fulfillment, but articulating the goal clarifies how a board can limit its risk and indicates what it takes to demonstrate that a good faith effort has been made to do the job right.

The task is not an easy one. The very executive the board is to help rather than hobble may become enamored of a given policy, and begin to focus on the success of that policy rather than on the long-run interests of the corporation. The board may thus face the task of reconciling disparate and not necessarily commensurate goals. In defining standards for proxy fights, courts faced the need to define the proper function of the board and developed a distinction between per-
sonal and policy disputes.\textsuperscript{16} The distinction has proven impossible to apply,\textsuperscript{17} and it is this experience with the inadequacy of legal controls that underlies my recommendation that boards recognize that their task is political rather than economic, and that the goals they set for the corporations they govern cannot be measured solely in the economic terms of competitive success.

Competition is a process, not a goal, and restricting the enterprise to doing better than the competition is a policy that can command the loyalty of participants in corporate operations only until it is successful. The making of policy demonstrates both the politics of the board and the character of the participants. A successful corporate enterprise makes the time spent in its employ meaningful, and the task assigned to the board of directors is to formulate policies that make this possible.

In terms of its interaction with the chief executive officer, a board's energies should be devoted to the formulation of appropriate questions, a focus on the future, a preference for exhausting alternatives before approving or rejecting a given proposal. The method I am describing—planning that focuses on process rather than result, and that confronts, rather than evades, the necessarily personal elements in decisionmaking—is not restricted to the activities of the board of directors. An effective corporation would use it wherever possible. Its use, however, must begin where power resides—in the deliberations of the board.

\textit{The board must begin actively to assume responsibility for providing direction to the corporate enterprise. In terms of the governmental analogy, it must act as a legislature by prescribing rules for conduct, a task that can successfully be accomplished only by defining the achievable aspirations that provide motivation for corporate personnel.}

The board must resist giving undue deference to the fact either that there is an ongoing corporate culture in place, or that appeal can be taken to the forces of the marketplace. When waste is condoned because it has become an accepted part of operations, or when a level of executive compensation is justified as necessary to meet the market


\textsuperscript{17} See Braude v. Havenner, 38 Cal. App. 3d 526, 532, 113 Cal. Rptr. 386, 389 (1974) ("The rule is uncertain in application because every contest involves or can be made to involve issues of policy.").
rather than to fulfill a corporate goal, the board has revealed that it is not meeting its responsibilities. The new dimension added to the activities of the board is acceptance of the proposition that prudence is a matter of activity rather than passive acceptance of what is.