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The Corporate Governance Movement*

*Daniel R. Fischel***

In the past decade a number of commentators have argued that corporations have failed to meet their responsibilities to shareholders and the public. To remedy this perceived failure, these commentators have advocated a variety of corporate governance proposals. In this Article Professor Fischel challenges the notion that any problem exists in the current mode of corporate governance. He contends that reformers have wrongly assumed the existence of a "problem" because of their failure to understand the economic theory underlying the corporate form of firm organization. Professor Fischel argues further that no empirical evidence exists to support the contentions of advocates of corporate regulation. Consequently, he concludes that critics have leveled charges and proposed solutions to a problem that does not exist to promote goals that are unrelated to the purpose of the corporation.

I. INTRODUCTION

The issue of corporate governance has received an enormous amount of attention in the past ten years.[1] Many academics, regu-

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1. The literature is too voluminous to cite in detail. For representative statements, see Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977); Dent, *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U.L. REV. 623 (1981); Schwartz, *Towards New Corporate Goals: Co-Existence With Society*, 60 GEO. L.J. 57 (1971); Soderquist, *Reconciling Shareholders' Rights and Corporate Responsibility: Close and Small Public Corporations*, 33 VAND. L. REV. 1387 (1980); Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 U.C.L.A. L. REV. 343 (1981); Weiss & Schwartz, *Using Disclosure to Activate the Board of Directors*, 41 LAW & CONTEMP. PROBS. 63 (Summer 1977). *See*

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lators, and even businessmen themselves have concluded that something is "wrong" with the way the corporation is governed. Characterizations such as "breakdown in accountability," "widespread illegality," and "lack of legitimacy" have become commonplace. To rectify this dismal state of affairs, commentators have proposed a wide variety of solutions, including a requirement of a stated percentage of independent directors, increased shareholder democracy, and stricter enforcement of fiduciary duties. Critics also have advanced various methods of making corporations more "socially responsible." Several law review symposia[2] and numerous conferences[3] have been dedicated to discussion of these reforms. Bills have been introduced in Congress that would have implemented many of the reform proposals.[4] In 1980 the Securities and Exchange Commission published an exhaustive document entitled "Staff Report on Corporate Accountability"[5] discussing the perceived problem and many of the proposed solutions. Even more recently the American Law Institute issued the long-awaited first draft of its report on corporate governance, which prescribes various changes in the structure of the corporation and in corporation law.[6]

I argue in this Article that the arguments of those who advocate the need for a change in corporate governance are based on a failure to understand the economics of the corporate form of firm organization and are unsupported by any empirical evidence. No evidence exists, for example, to support the widespread claim that the present system of corporate governance operates to the detriment of investors or society as a whole. Even less reason exists to believe that any of the proposed reforms will improve the relative position of investors or society as a whole. The far more plausible hypothesis, once the relevant economic theory and evidence are

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also R. NADER, M. GREEN & SELIGMAN, TAMING THE GIANT CORPORATION (1976); C. STONE, WHERE THE LAW ENDS (1975).

2. *See, e.g., Symposium: Corporate Social Responsibility,* 30 HASTINGS L.J. 1247 (1979); *Symposium on Corporate Governance,* 8 HOFSTRA L. REV. 1 (1979).

3. *See, e.g.,* COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS 1977-1978 (D. Schwartz ed. 1979) [hereinafter cited as COMMENTARIES]; *Ailie House Symposium, An In-Depth Analysis of Federal and State Roles in Regulating Corporate Management,* 31 BUS. LAW. 859 (1976).

4. S. 2567, 96th Cong., 2d Sess. (1980) ("Protection of Shareholders' Rights Act of 1980"); H.R. 7010, 96th Cong., 2d Sess. (1980) ("Corporate Democracy Act of 1980").

5. STAFF OF SECURITIES AND EXCHANGE COMMISSION, CORPORATE ACCOUNTABILITY (Comm. Print 1980) [hereinafter cited as CORPORATE ACCOUNTABILITY].

6. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982).

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properly understood, is that there is no systematic defect in corporate governance.

Since much of the corporate governance movement reflects a lack of understanding of the economics of the corporate form of firm organization, I discuss the theory of the firm in Part II. With this foundation I argue in Part III that there is no problem in corporate governance that needs to be addressed. The remainder of the paper demonstrates the problems with the different proposals that have been advanced to improve corporate governance. Part IV discusses the concept of corporate social responsibility and concludes that the term is empty of content. Part V criticizes the frequent proposals for increased shareholder democracy. Part VI analyzes the likely effect of mandatory independent directors and various committees that have been advocated. Finally, Part VII questions whether shareholders' welfare would be increased if directors were held liable more frequently for breaches of fiduciary duty.

II. The Corporate Form of Firm Organization

A. *The Theory of the Firm*

Firms and markets are alternative modes of organizing economic activity.[7] Thus the entrepreneur interested in engaging in a particular form of economic activity, say selling legal services, has a basic choice to make. One possibility is to enter into separate contractual agreements with a series of individuals knowledgable in law to provide expertise whenever problems arise. The entrepeneur also would have to enter into separate contracts with typists, word processors, copiers, messengers, and other necessary personnel. All of these factors would be paid per unit of output. By entering into these separate exchange transactions in the market, the entrepreneur is able to sell legal services to others.

Because of the costs associated with separately negotiating each of these contracts, the entrepreneur may choose an alternative to a series of market exchanges—the firm. The entrepreneur interested in providing legal services, in other words, can hire lawyers, secretaries, and other factors of production necessary to pro-

7. *See* Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777, 777 (1972); Coase, *The Nature of the Firm*, 4 Economica 386 (1937), *reprinted in* Readings in Price Theory 331, 333 (G. Stigler & K. Boulding eds. 1952); Williamson, *The Modern Corporation: Origins, Evolution Attributes*, 19 J. Econ. Lit. 1537, 1539 (1981).

duce legal services. While relationships with these factors of production in the firm remain contractual, an employer-employee relationship is substituted for a series of complicated exchange transactions in the market. The firm itself is a legal fiction that serves as a nexus for this contracting process.[8]

Many business ventures require large amounts of capital—amounts larger than the entrepreneur realistically could provide or borrow from a bank—in addition to labor. In these situations the firm typically will sell divisible residual claims on the assets and cash flows of the firm in exchange for capital. This is in essence a description of the modern publicly held corporation. Shareholders and bondholders provide firms with needed capital in exchange for an expected rate of return generated by cash flows from the firm's assets. Different groups provide other factors of production: employees supply labor, managers supply managerial talent necessary for coordinating the various inputs, and suppliers supply goods. The publicly held corporation, therefore, is a type of firm that facilitates the organization of production which is particularly effective when a large amount of capital is required.

B. *Agency Costs Inherent in the Corporate Form of Firm Organization*

The corporate form of firm organization has obvious advantages for shareholders (suppliers of capital) and managers.[9] Shareholders can participate in the gains from entrepreneurial ventures even though they lack management skills; managers can pursue profitable business opportunities even though they lack large personal wealth. Both parties benefit from this division of labor.

Certain costs, however, are inherent in this relationship. As residual claimants on the firm's income stream, shareholders want their agents—the firm's managers—to maximize wealth. Because managers cannot capture all of the gains if they are successful, and will not suffer all of the losses should the venture flop, they have less incentive to maximize wealth than if they themselves were the principals. Rather, managers have an incentive to consume excess leisure, perquisites and in general be less dedicated to the goal of wealth maximization than they would be if they were not simply

8. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976).

9. Although I confine my discussion to shareholders and managers, one can generalize the analysis to include other parties (such as employees) who contract voluntarily with the firm.

agents.[10]

Since this conflict of interest is known, and thus will affect the price managers can charge for their services and the price shareholders will pay for shares, both groups have an interest in minimizing any costs attributable to this divergence of interest. If agency costs can be reduced by direct monitoring, for example, the advantageous course for all concerned may be to hire monitors (independent accountants or directors) to limit nonwealth-maximizing behavior by manager-agents.[11] In addition to direct monitoring, managerial contracts can provide managers with incentives to maximize shareholders' welfare.[12]

The market also plays a valuable role in minimizing agency costs. When a firm is profitable, the price of its shares will be high relative to comparable firms that are less efficiently run.[13] This basic proposition has dramatic implications for the incentives of corporate managers to maximize the firm's profits. Since managers' compensation typically is positively correlated with profitability, they have strong incentives to operate efficiently and keep stock prices high.[14] More generally, managers have strong incentives to maximize the market value of their own services within the firm and to other possible employers. Managers can accomplish this objective by creating wealth for stockholders. Since managers work in teams, however, poor performance by some members of the team can affect adversely the fortunes of other members. Thus, managers have incentives to monitor each other to maximize the value of

10. Thus agency costs are in no way unique to corporations but are inherent in any agency relationship.

11. A firm's agency costs include monitoring costs that arise from the agency relationship, as well as the agent's bonding expenditures and the residual loss attributable to the divergence in interest between principals and agents. *See* Jensen & Meckling, *supra* note 8, at 308.

12. *See* Diamond & Verrecchia, *Optimal Managerial Contracts and Equilibrium Security Prices*, 37 J. FIN. 275 (1982).

13. The difference in the price of shares is a direct implication of the efficient capital markets hypothesis, which posits that all information which is publicly available about a firm is rapidly and without bias incorporated in the firm's share prices. For a discussion of this theory, and the substantial empirical evidence supperting it, see Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-68 (1981).

14. *See* W. LEWELLEN, THE OWNERSHIP INCOME OF MANAGEMENT (1971); Ciscel & Carroll, *The Determinants of Executive Salaries: An Econometric Survey*, 62 REV. ECON. & STAT. 7 (1980); Lewellen & Huntsman, *Managerial Pay and Corporate Performance*, 60 AM. ECON. REV. 710, 716 (1979). These studies conclude that a strong positive correlation exists between executives' compensation and profits and the share price performances of their companies.

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their own services.[15]

The product and capital markets also constrain the divergence of interests between managers and investors. A firm that is inefficiently run will have a difficult time selling goods and services on the same terms as more efficiently run firms. Similarly, the poorly run firm will be at a disadvantage in raising equity capital. Even if the inefficient firm does not resort to the new equities market for needed capital, it still is at a disadvantage when negotiating with other sources of capital such as banks. In addition, if the price of a firm's shares falls too low relative to what it would be under superior management, an outsider may attempt to acquire the firm by merger or tender offer and install new managers. The operation of this market for corporate control simultaneously gives managers of all firms who wish to avoid a takeover an incentive to operate efficiently and to keep share prices high and provides a mechanism for displacing inefficient managers.[16]

Finally, legal rules can operate to reduce agency costs. As an alternative or complement to hiring direct monitors, investors and managers could enter into contractual arrangements designed to minimize divergence of interests. But since the number of situations in which a divergence of interests can occur is very large, and because an investor cannot anticipate all of these situations in advance, this type of contracting would be very costly. The imposition by the law of fiduciary duties serves as an alternative or a supplement to hiring direct monitors or writing lengthy and complicated contracts.[17] Optimal fiduciary duties should approximate the bargain that investors and managers would reach if transactions costs were zero. Thus fiduciary duties proscribe theft and otherwise constrain the actions of managers in the situations in which conflicts of interest are likely to arise. Fiduciary duties serve, in other words, as a standard form contractual term in every agency contract.

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15. Fama, *Agency Problems and the Theory of the Firm,* 88 J. POL. ECON. 288 (1980).

16. Easterbrook & Fischel, *supra* note 13, at 1169-74; Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare,* 36 BUS. LAW. 1733, 1735-37 (1981); Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers,* 57 TEX. L. REV. 1, 9 (1978). These articles build on Henry Manne's seminal article, Manne, *Mergers and the Market for Corporate Control,* 73 J. POL. ECON. 110 (1965).

17. This point is discussed in detail in Easterbrook & Fischel, *Corporate Control Transactions,* 91 YALE L.J. 698, 702 (1982). For a discussion of how the rules of voting in corporate law also are designed to reduce agency costs, see Easterbrook & Fischel, *Voting in Corporate Law,* ___ J. LAW & ECON. (forthcoming) (April 1983).

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This combination of direct monitoring, market forces, and legal rules all operate greatly to reduce divergence of interests between investors and managers. Doubtless some divergence will remain, and managers will not always act in the investors' best interest. But the gains from the division of labor inherent in the corporate form of firm organization outweigh the resulting loss to investors.[18] Any attempt to reduce any remaining divergence even further must take into account not only the gains from this reduction, but also the costs, both direct and indirect, that methods of further reduction will impose.

III. Is There a Problem in Corporate Governance that Needs to be Addressed?

Given the sweeping nature of many of the reforms proposed, one would expect that advocates of reform have a well developed theory of the problem. But no such theory exists. Most reformers simply have assumed the existence of a problem without specifying precisely what the problem is.[19] When the existence of a problem is discussed, it is frequently in terms of vague references to lack of accountablilty to shareholders or to society as a whole. Some complain that management is entrenched and not sufficiently dedicated to the goal of maximizing shareholders' wealth;[20] others complain that managements' single-minded dedication to profit maximization is inconsistent with social welfare.[21] The failure to recognize that management cannot be at the same time too little and too much dedicated to profit maximization is itself a strong indictment of the corporate governance movement. More fundamentally, proponents of reforms in corporate governance have failed to demonstrate the existence of any problem of any kind, whether defined as accountability to shareholders or to society as a whole.

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18. If this were not the case, people would not form corporations.

19. The first draft of the American Law Institute Restatement on corporate governance, for example, advocates sweeping changes in the structure of corporations and in corporation law without ever clearly articulating how the present system prejudices investors. *See* Principles of Corporate Governance and Structure: Restatement and Recommendations, *supra* note 6.

20. *See, e.g.*, Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974). *See also* Blumberg, *A Need for Supplementary National Legislation*, in Commentaries, *supra* note 3, at 343; Ratner, *Regulating Management Through Corporation Law*, in Commentaries, *supra* note 3, at 138.

21. *See, e.g.*, Weiss, *supra* note 1; Schwartz, *supra* note 1.

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A. *Accountability to Shareholders*

What does it mean to state that managers lack accountability to shareholders? Surely this characterization does not mean that managers, because of the conflict of interest intrinsic in their relationship with shareholders, will not always act in the shareholders' best interests. Agency costs, as discussed above, are an inevitable consequence of every agency relationship and are outweighed by the gains resulting from an efficient division of labor. Moreover, even if agency costs are substantial—an unlikely prospect because of the market forces giving managers incentives to maximize wealth—shareholders will not be injured if relevant information is incorporated in market prices.[22]

What then is the problem? One of the few attempts to define the existence of a problem appears in the Staff Report of the Securities and Exchange Commission on Corporate Accountability. According to the Report, the 1970's witnessed a breakdown in accountability to shareholders, which was evidenced by "the collapse of several major companies, the hundreds of corporations involved in questionable payments, and corporate noncompliance with environmental and other laws . . . ."[23]

The Report is cloaked in the familiar guise of "shareholder protection" and "accountability to investors" to the exclusion of other goals.[24] It is clear, however, that the Commission has totally

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22. *See supra* note 13 and accompanying text.

Consider two firms, A and B, that are identical in all respects except for the quality of management. Firm A is extremely well managed and efficient. The managers of firm B are lazy, consume excessive perquisites, and are only marginally competent in those rare occasions when they dedicate themselves to profit maximization. At first blush, the shareholders of firm B may appear to be victims of inferior management. In fact, however, there is no reason to believe that the shareholders of firm B will be worse off. The poor management of firm B will cause the price of its shares to fall relative to those of firm A to the point at which the expected returns (assuming equivalent systematic risk) are identical. Whether every investor of the two firms is aware of the difference in management is irrelevant. So long as the information is imbedded in the respective market prices, as it almost certainly would be in an efficient market such as the American stock markets, shareholders of both firms are fully protected. See Fischel, *The Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. (Nov. 1982) (forthcoming) for a discussion of how investors, even naive investors, are protected by an efficient market in securities. *See also* Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 718-19 (1981).

23. CORPORATE ACCOUNTABILITY, *supra* note 5, at 29.

24. The Report states that it "is, first and foremost, about accountability of the corporation to shareholders and investors." *Id.* at 33. The Report dismisses accountability to society as a whole as an issue that "transcend[s] the jurisdiction and expertise of this Commission and appropriately should be considered by others." *Id.*

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blurred the fundamental distinction between conduct that is detrimental to investors—theft, for example—and conduct that may be morally objectionable to some but beneficial to investors.[25] Of the three types of evidence offered to demonstrate the breakdown in accountability, only the first, major financial collapses, is of any special interest to shareholders *qua* shareholders. Since the other two categories, questionable foreign payments and noncompliance with environmental laws, in all probability are explainable as attempts by managers to boost profitability, shareholders are far more likely to be beneficiaries of these practices rather than victims. The Commission is simply disingenuous in its reliance on practices undertaken to benefit investors as evidence of a "breakdown" of accountability to this same group. If anything, the widespread practice of these alleged "abuses" proves precisely the opposite proposition from that stressed in the Report—that managers are in the main fully dedicated to the goal of maximizing shareholders' wealth, and no regulatory intervention in this regard is needed.[26]

This leaves the Report's emphasis on financial collapse, about which several things can be said. It is ludicrous for the Report to assume that financial collapses are attributable to a "breakdown" in corporate accountability as opposed to real economic forces without any supporting evidence. No one would seriously argue, for example, that the current problems facing the United States automobile and steel industries are due primarily to the lack of "meaningful shareholder participation," one of the panaceas emphasized in the Report. Real economic forces such as the escalating price of oil, plant obsolescence, and high labor costs are much more likely to have caused the problems in these industries. To attribute these difficulties to a "breakdown" in corporate accountability is a colossal nonsequitur. It would make as much sense to attribute the poor performance of the stock market in recent years to the proliferation of independent directors during this period.

Moreover, it is not at all clear that financial collapses are as

25. The Commission is not alone in blurring this distinction. *See, e.g.*, Feis, *Is Shareholder Democracy Attainable?*, 31 Bus. Law. 621, 621-22 (1976) ("It is apparent, as one surveys the constant stream of shareholder suits, massive write-downs of assets, criticism of corporate financial reporting, news about illegal and immoral political contributions, international bribery, kickback and payoff arrangements, that too many managements exercise uncontrolled power and take unfair advantage of the shareholders they purport to serve.").

26. *See* Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 Colum. L. Rev. 388, 413-14 (1977).

pressing a concern to shareholders as may first appear. The price of a firm's shares at any given time reflects a variety of different possible future outcomes. Thus a share of stock with a ninety percent chance of going to zero in the future and a ten percent chance of going to twenty should, ignoring risk, sell at two dollars. An investor who purchases the stock at two dollars and then watches it fall to zero will not be cheated, any more than an investor who purchased the same stock would receive an undeserved windfall if the stock went to twenty dollars. The investor's primary concern is whether information regarding the risk of collapse is available at the time of the investment decision. In an efficient market this risk is incorporated in market prices. Investors who purchase at this price are compensated ex ante for the prospect of a financial collapse ex post.

A related reason why shareholders as a class are not that concerned about the prospect of financial collapse is that shareholders of one firm may prosper from the misfortunes of another firm. Thus, when a Braniff announces bankruptcy, shareholders of other airline companies who inherit valuable routes rejoice (assuming no new entry). The risk averse shareholder who wishes to avoid the risk that a firm will go bankrupt has the option of holding a diversified portfolio. Therefore, any of Braniff's shareholders who feared financial collapse could have purchased shares of other airline companies. Gains in holdings of other companies would have offset the losses from holdings in Braniff; the bankruptcy of Braniff therefore would have been a matter of indifference. Thus the option of diversification, an option available to every investor, greatly minimizes investors' concern with financial collapse.[27]

B. *Accountability to Society*

It has become fashionable to argue that the pursuit of profit maximization by corporations is at variance with the public interest.[28] Proponents of this argument, however, face the insuperable

27. The importance of diversification in a variety of contexts is discussed in Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. (Nov. 1982) (forthcoming); Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 17, at 711-14; Langbein & Posner, *Market Funds and Trust-Investment Law*, 1976 AM. BAR FOUND. RESEARCH J. 1, 9-13; Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 79-92 (1980). For a more technical but accessible discussion of diversification, see J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 171-266 (1973).

28. *See, e.g.*, Weiss, *supra* note 1, at 345 ("profit maximization is increasingly at variance with the standards hy which American society judges corporations' contribution to the

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problem of defining what the public interest is, and when the pursuit of profit maximization should be sacrificed for these ends. As Harold Demsetz has remarked, centuries of philosophers and economists have tried and failed to provide any workable definition of "the fair price," "the just wage," or "fair competition," let alone what constitutes "the good society."[29] I do not even attempt to follow this path. My purpose is far more modest—to demonstrate that the arguments of those who claim that corporations are not "socially responsible" have failed to make out a prima facie case.

Although potential conflict exists between profit maximization and pursuit of other goals, far more consistency is present between the two than generally assumed. A successful business venture provides jobs to workers and goods and services that consumers want to buy. While these benefits may not appear to be particularly dramatic, they should not be underestimated, as the tens of thousands of workers in distressed industries who have had to give back concessions previously won or have lost their jobs outright will readily attest. Much the same is true in other areas. Critics commonly assume, for example, that profit maximization is inconsistent with other goals such as providing safe working conditions or maintaining a clean environment. These other goals, however, are most likely to be sacrificed precisely in those times when firms are not profitable because of a perception that the costs they impose are too high. Substantial overlap exists, therefore, between the pursuit of profit maximization and other social goals.

Frequently this harmony of interests exists, but is difficult to perceive. Firms that close plants to move to different geographical areas commonly are accused, for example, of lacking a sense of responsibility to affected workers and the community as a whole. The difficulty with this argument is that it ignores the presumably greater benefits that will accrue to workers and the community in the new locale where the firm can operate more profitably. A firm that causes dislocations by moving a plant is behaving no more "unethically" than a firm that causes dislocations by, say, inventing a new technology that causes competitors to go out of business.[30]

I do not mean to suggest that profit maximization will always

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public welfare.").

29. Demsetz, *Social Responsibility in the Enterprise Economy*, 10 Sw. U.L. Rev. 1, 1 (1978).

30. *See* Lorie, *An Economist's Perception I: A View on the Need to Revise Corporation Statutes*, in Commentaries, *supra* note 3, at 51, 53.

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lead to the socially optimal result. In those situations in which externalities are present—pollution is the most common example—a firm may impose costs on others without providing compensation. But even this situation is misunderstood. If a firm dumps pollutants in a stream, the firm imposes costs on the users of the stream that may exceed the benefits to the firm. It does not follow, however, that pollution is immoral behavior which should be halted. Consider the reciprocal case in which the firm does not pollute because of concern for users of the stream and instead relies on a more expensive method of disposing wastes. In this situation the users of the stream impose costs on the firm's investors, employees, and consumers that may exceed the benefits to users of the stream. Neither polluting nor failing to pollute is *a priori* the "ethically" or "morally" correct course of action. The difficulty is establishing a property right in the stream so that the ultimate result will duplicate what the parties would have bargained for had they been able to do so at no cost.[31] While this itself is a complicated task, it is necessary regardless of what corporate governance structure exists, or, for that matter, regardless of the type of society involved.[32] To view pollution as a question of corporate governance, therefore, only serves to obscure the relevant issues.

In still other cases, such as sensitive foreign payments, some may view profit maximization as inconsistent with a general moral sense of proper behavior. The moral argument, however, is not clear-cut because of the competing goal of making domestic companies effective competitors abroad, which increases trade and, hence, provides benefits to consumers, workers, investors, and the economy as a whole. Indeed, the same tradeoffs are evident in virtually all of the pet programs of those who argue that corporations are not socially responsible—from avoiding investment in South Africa or other countries to making safer products.[33] At the very least, the moral arguments are sufficiently unclear that the failure of corporations to act in a manner desired by certain reformers cannot be reasonably described as a "breakdown" in accountability

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31. *See* Coase, *The Problem of Social Cost,* 3 J.L. & ECON. 1, 19-28 (1960).

32. As Michael Dooley has pointed out, Soviet plants pollute as much or more than those in America but produce goods and services in lesser numbers and of inferior quality. Dooley, *Controlling Giant Corporations: The Question of Legitimacy,* in CORPORATE GOVERNANCE: PAST AND FUTURE 28, 30 (H. Manne ed. 1982).

33. For a discussion of the lack of consensus on any of the goals advanced by proponents of increased corporate social responsibility, see Engel, *An Approach to Corporate Social Responsibility,* 32 STAN. L. REV. 1 (1979).

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or a defect in the way corporations are governed. Under these circumstances the proper course for those who believe in the moral soundness of their positions is to seek redress through the political process and not to attempt to disrupt the voluntary arrangements that private parties have entered into in forming corporations. It appears that it is only because the proponents of reform have largely failed in implementing their objectives through the political processes that they have turned to attempting to achieve these same objectives by altering the governance of corporations.

Perhaps all that can be said is that when a restriction on corporate conduct is embodied in a statute, it should be obeyed. Laws currently exist that restrict pollution,[34] foreign payments,[35] and anticompetitive behavior[36] as well as other practices; when these laws are violated an argument could be made that a breakdown in accountability has occurred. But even here the situation is more complicated than may first appear. Because many laws can be violated inadvertently or by subordinates, the costs of preventing violations may far exceed the gains from avoiding violations.[37] A firm may also find it advantageous to violate a law deliberately and pay the penalty for the same reason that an individual in some cases may prefer to breach a contract and pay damages.[38] Because the gains from breach or violation presumably exceed the social costs (as reflected in the penalty), compliance with the statute or contract is undesirable from a personal as well as a social perspective. The optimal level of violations of law, therefore, is not zero. The remedy for those who believe that the level of violations is too high is to seek to increase the penalty to reflect the "real" social costs of the activity.[39] Once again, however, the solution to the problem, assuming one exists, is in the political process, not in changing the governance of corporations.

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34. *E.g.*, Federal Water Pollution Control Act, 33 U.S.C. §§ 1251-1376 (1978).

35. *E.g.*, Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78m, 78dd-1 to dd-2 (1981).

36. *E.g.*, Sherman Antitrust Act, 15 U.S.C. §§ 1-3 (1976).

37. This point is well illustrated in Engel, *supra* note 33, at 12-18.

38. For a further discussion of this point, see Easterbrook & Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1156-59 (1982).

39. I do not here discuss the interesting issue whether the increase in penalty should be levied on the firm exclusively or on the firm and its agents. *Compare* Posner, *Optimal Sentences for White-Collar Criminals*, 17 AM. CRIM. L. REV. 409 (1980) (penalties should be imposed on the firm exclusively) *with* Coffee, *"No Soul to Damn: No Body to Kick:" An Unscandalized Inquiry Into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386 (1981) (emphasizing the need to punish the firm's agents).

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C. *The Problem of the Nirvana Fallacy*

Thus far I have argued that no evidence exists of any problem in need of reform. But even if some problem could be demonstrated, it would not necessarily follow that reform is desirable. Those who purport to discover discrepancies between an ideal norm and existing imperfect institutional arrangements and then conclude that existing arrangements should be displaced, commit the nirvana fallacy well known in economic literature.[40]

The relevant comparison is not between the ideal and the real, but between different institutional arrangements. Thus one cannot conclude that regulation is superior to the operation of markets because markets are imperfect—regulation may be, and in most cases is likely to be, more imperfect. Similarly, it is a form of the nirvana fallacy to conclude that the structure of corporations or corporation law should be changed because existing institutional arrangements are imperfect. The proper comparison is between the costs and benefits of existing arrangements and the alternatives being proposed. Since corporations are products of voluntary contractual agreements, a strong presumption, as discussed more fully in following sections, exists in favor of the superiority of existing arrangements.

IV. Corporate Social Responsibility

Perhaps the most time-honored debate in all of corporate law is: For whom are managers trustees?[41] Under the traditional view managers are trustees solely for the firm's investors; under the alternative approach they are trustees for a far broader set of constituents including society as a whole. Even if no breakdown in corporate accountability to noninvestor groups has occurred, managers, under this alternative view, are free to pursue goals that do not maximize shareholders' welfare if they believe the public interest is served. I examine this argument and the implications of state chartering of corporations below.

40. The nirvana fallacy is discussed in Demsetz, *Information & Efficiency: Another Viewpoint*, 12 J.L. & Econ. 1 (1969).

41. The debate is at least as old as the famous Berle-Dodd debates of the 1930's. *See* Berle, *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931); Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 Harv. L. Rev. 1365 (1932); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145 (1932).

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A. *Corporate Social Responsibility and the Theory of the Firm*

Those who argue that corporations have a social responsibility and, therefore, that managers have the right, and perhaps the duty, to consider the impact of their decisions on the public interest assume that corporations are capable of having social or moral obligations. This is a fundamental error. A corporation, as discussed above, is nothing more than a legal fiction that serves as a nexus for a mass of contracts which various individuals have voluntarily entered into for their mutual benefit. Since it is a legal fiction, a corporation is incapable of having social or moral obligations much in the same way that inanimate objects are incapable of having these obligations. Only people can have moral obligations or social responsibilities, and only people bear the costs of nonwealth-maximizing behavior.[42]

Participants on both sides of the debate on for whom are managers trustees have failed adequately to appreciate that the issue is not one of public policy but of contract law. Viewed as a contract issue, the question can be analyzed in much more concrete terms. Do investors, as long as corporations lawfully may be formed for profit, have any duty to sacrifice profitable opportunities to benefit some other parties? And do managers, acting as agents for investors, have any right or duty to sacrifice profitable opportunities to benefit some other party?[43] Both questions have the same answer—managers should act to maximize the wealth of investors pursuant to the terms of the contract of their agency relationship.

B. *The Relevance of State Chartering*

Commentators sometimes argue that the issue of corporate social responsibility depends on whether the corporation is a creature of the state or the product of private contract.[44] Because the corporation is a particular type of firm formed by individuals acting voluntarily and for their mutual benefit, it can far more reasonably be

42. *See* Easterbrook & Fischel, *supra* note 38, at 1177; Jensen & Meckling, *supra* note 8, at 31.

43. The analysis does not change if managers are viewed as agents for employees or other groups that have entered into contractual arrangements with the firm. Employees have no duty to accept lower wages than they bargain for, and managers, if they are acting as the employees' agents, have no right to pursue their own notions of the public interest at the employees' expense.

44. For a thorough discussion of this debate, see R. HESSEN, IN DEFENSE OF THE CORPORATION 15-22 (1979).

viewed as the product of private contract than as a creature of the state. Much of corporation law, including fiduciary duties and limitations on distributions for the protection of creditors, can be viewed as standard form contractual provisions that would be negotiated by private contract if not provided by statute. Other typical provisions of corporate law, however, such as limited liability in tort cases, could not be negotiated by private contract. To this extent, corporations have attributes that would not exist absent state statutes. But this does not make corporations creatures of the state. Limited liability in tort cases is more accurately viewed as a subsidy to encourage a certain type of private conduct, forming corporations (particularly close corporations in which corporate governance is not an issue), than as a creation of the conduct itself.

The more important point, however, is that the debate concerning whether the corporation is a creature of the state or the product of private contract is largely irrelevant to the issue of corporate social responsibility. Regardless of which way the corporation is viewed, the state is free to set limits on its actions. The state, for example, could require corporations to pursue ends other than wealth maximization or, at the extreme, outlaw corporations altogether. But states have not done so nor have they made it unlawful to form corporations for profit. State chartering of corporations, therefore, in no way interferes with managers' contractual duty to maximize wealth for investors.

V. Shareholder Democracy

Shareholders under state law have the power to elect directors,[45] approve fundamental corporate changes,[46] and in certain limited situations, initiate action such as the removal of directors.[47] Shareholders have the right under federal law to have shareholder proposals included in the proxy material subject to certain limitations.[48] Federal law also mandates that large amounts of information be disclosed to shareholders to facilitate intelligent voting decisions.[49] Despite these rights and powers, most shareholders have

45. *See, e.g.*, annotations to DEL. CODE ANN. tit. 8, § 141 (1974 & Supp. 1980).

46. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (1974).

47. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242 (1974 & Supp. 1980) (shareholders' power to amend corporate charters); *id.*, §§ 251-58 (shareholders' powers in consolidation and merger).

48. *See* 17 C.F.R. § 240.14a-8 (1981) (setting forth eligibility and timing requirements and limits on number and length of proposals).

49. *See* 17 C.F.R. § 240.14a-3 (1981) (corporation required to furnish shareholders au-

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little interest in running the corporation's affairs.[50] Shareholders routinely elect and reelect management's nominees for directors; shareholder proposals rarely get more than a trivial percentage of the vote.

This lack of shareholder involvement in corporate governance has led the Securities and Exchange Commission and others to question "whether the present corporate governance system retains its legitimacy in the absence of shareholder participation."[51] These observers view the shareholders lack of interest as a "reflection of frustration with the powerlessness of the role of the shareholder/ investor."[52] Shareholders, in other words, would welcome "meaningful" participation if they believed that their votes or views would have any impact on corporate policy. To revitalize corporate democracy—and thereby "significantly enhance" corporate accountability[53]—a variety of reforms have been proposed. These range from allowing shareholders to nominate their own candidates for office,[54] or at the very least having their nominations considered by nominating committees consisting entirely of independent directors,[55] to requiring increased disclosure about nominees for office and management conduct.[56] Reformers have also recom-

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dited balance sheets, audited statements of income and changes in financial position, a list of officers and directors, market price of issuer's common stock, and related security-holder matters).

50. For an explanation of why the rational shareholder prefers to remain passive, see Easterbrook & Fischel, *supra* note 13, at 1171. *See also* Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 184-88 (1979) (shareholders uninterested in increased participation); Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAW. 173, 175-78 (1981) (stockholder does not think of himself as a partial owner of corporation but as holder of an investment contract with corporation).

51. CORPORATE ACCOUNTABILITY, *supra* note 5, at 67.

52. *Id.*

53. S.E.C. Rel. No. 16, 356 (Nov. 21, 1979), *quoted in* CORPORATE ACCOUNTABILITY, *supra* note 5, at 68.

54. *See, e.g.*, M. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976).

55. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, at 97-106; CORPORATE ACCOUNTABILITY, *supra* note 5, at 115-19; ABA, Section of Corporation, Banking and Business Law, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1625-26 (1978); ABA, Section of Corporation, Banking and Business Law, Comm. on Corporate Laws, *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837, 1844 (1979) [hereinafter cited as *Overview Committees*]; ABA, Section of Corporation, Banking and Business Law, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation—Statement of the Business Roundtable*, 33 BUS. LAW. 2083, 2107-09 (1978) [hereinafter cited as *Business Roundtable*].

56. *See, e.g.*, Ferrara, Starr & Steinberg, *Disclosure of Information Bearing on Management Integrity and Competency*, 76 NW. U.L. REV. 555 (1981); Weiss & Schwartz, *supra*

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mended that steps be taken to force institutional investors to take elections of directors more seriously because "more exacting judgments with respect to the election of directors may improve corporate accountability and long-term profitability."[57]

The literature on shareholder democracy illustrates the more general defects in the corporate governance movement. After assuming the existence of a problem in corporate governance, advocates then assume that the problem could be eliminated or greatly reduced if the demand of shareholders for more involvement in running corporations were satisfied. As I discuss below, this latter assumption is, if anything, more implausible than the assumption that a problem exists. Further, generalizing from the example of the shareholder proposal rule, I argue that the real beneficiaries of shareholder democracy are not shareholders at all, but rather regulators and reformers.

A. *Shareholder Democracy and the Theory of the Firm*

The fundamental error of the proponents of shareholder democracy is their failure to recognize that no reason exists why investors, who provide the firm with capital in anticipation of receiving a certain rate of return generated by the firm's assets, should have any input into the firm's decisionmaking processes.[58] On the contrary, investors are willing to supply capital, as opposed to starting and operating the enterprise themselves, precisely because they trust the expertise of professional managers. Moreover, the rational (risk-averse) shareholder may well attempt to diversify his portfolio by investing in many firms or in a mutual fund.[59] The investor who holds securities in multiple firms is unlikely to have the interest or expertise to participate in running any particular firm. The genius of the modern corporation, which the proponents of shareholder democracy overlook or misunderstand, is that it enables individuals who have wealth but lack managerial ability to invest while simultaneously allowing professional managers who lack personal wealth to run enterprises.[60] Shareholders would be

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note 1.

57. CORPORATE ACCOUNTABILITY, *supra* note 5, at 422.

58. *See* Fama, *supra* note 15; Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 918 (1982).

59. *See supra* note 27 and accompanying text.

60. *See* Dooley, *supra* note 32, at 38 ("The limited governance role assigned to shareholders is intentional and is, in fact, the genius of the corporate form"); Easterbrook &

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hurt rather than helped if they were given more power, which no doubt explains why they show no enthusiasm for the constant proposals to increase their role.[61]

Other reasons also explain why one may not realistically expect shareholders to participate willingly in corporate governance. Even if a shareholder discovers something "wrong" with the way the corporation is managed, he has little incentive to resort to the corporate voting machinery for redress. To have any chance of success, such an attempt would entail the expenditure of time, effort, and money to educate other shareholders of the discovery. If a full-fledged proxy fight resulted, the costs would be substantial. But the shareholder-monitor would have great difficulty in recouping these costs because the benefits from improved performance inure to each investor according to the size of his investment, not according to whether he was responsible for the improvement. Because of this free-rider problem, most shareholders lack incentives to expend resources to become informed in elections or to wage proxy contests.[62] If a shareholder is dissatisfied, the more logical course in most cases is simply to sell one's shares.[63] This ability freely to sell shares as an alternative to the difficulties inherent in shareholder voting, and not the lack of a "meaningful" opportunity to participate, explains why shareholders prefer to remain passive. Selling shares is the rational thing to do.[64]

Reformers express a curious disdain for the market in shares,

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Fischel, *Corporate Control Transactions, supra* note 17, at 700.

61. For a discussion of the lack of enthusiasm that investors have shown for an increased role in corporate governance, see Hetherington, *supra* note 50, at 184-88.

62. For a discussion of the role of voting in corporate law and its limitations, see Easterbrook & Fischel, *Voting in Corporate Law, supra* note 17.

63. A theory of the choice between voting and selling out is articulated in A. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970). Professor Hirschman argues that as the exit option becomes more available, the importance of voice or voting diminishes. Because it is hard to imagine a more available exit option than the liquid market in shares, Professor Hirschman's analysis confirms the relative unimportance of shareholder voting. *See* Easterbrook & Fischel, *Voting in Corporate Law*, supra note 17.

64. Commentators frequently argue that institutional investors and other money managers default in their obligations or otherwise act to the detriment of investors by not taking more of an interest in corporate governance. *See* CORPORATE ACCOUNTABILITY, *supra* note 5, at 22; Curzan & Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670, 671, 683-87 (1980). Proponents of these proposals misunderstand the economics of the corporate form of firm organization and shareholder voting. Professional investors are presumably in a better position than reformers or regulators to decide whether devotion of more resources to voting will increase their welfare and that of their beneficiaries. In light of the market in shares, the failure to devote more resources to voting is perfectly consistent with profit maximization.

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as if selling one's shares were somehow immoral or disloyal. The former chairman of the Securities and Exchange Commission, for example, has disparagingly characterized this type of investor as an opportunist who is "nothing more than a short-term speculator in the Company's income stream."[65] This statement, and others like it,[66] demonstrate a striking lack of understanding of the importance and operation of markets in the protection of investors. The professional investor who seeks out information about different firms and buys and sells accordingly contributes to an efficient stock market in which prices incorporate available information. This in turn ensures that the market for capital and corporate control as well as the market for managerial services will function smoothly. These markets are essential in minimizing the divergence of interests between managers and shareholders, and operate to the benefit of uninformed long-term investors as well as short-term "speculators." The ability freely to sell one's shares, therefore, the so-called "Wall Street Rule," is without question the single most important safeguard to all shareholders that managers will act in their best interests.

B. *Shareholder Democracy In Action—The Shareholder Proposal Rule*

The classic embodiment of shareholder democracy is the shareholder proposal rule, which gives shareholders the right, subject to some constraints, to include a proposal in the corporation's proxy materials.[67] Shareholders utilize these proposals relatively infrequently, and the proposals are overwhelmingly defeated when utilized. In the last thirty years, I am unaware of a single successful shareholder proposal that was opposed by management; almost all receive less than five percent of the votes cast.[68] This, of course, is hardly surprising in light of the economics of shareholder voting.

Despite this lack of success, virtually all commentators are lavish in their praise of the shareholder proposal rule.[69] Propo-

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65. WILLIAMS, THE CORPORATION AS A CONTINUING ENTERPRISE, Securities Regulation Institute, San Diego, Calif., Jan. 22, 1981.

66. *See, e.g.*, Weiss & Schwartz, *supra* note 1, at 82.

67. The shareholder proposal rule is codified in rule 14a-8 of the federal proxy rules. *See* 17 C.F.R. § 240.14a-8 (1981).

68. The lack of success of shareholder proposals is well known. *See* CORPORATE ACCOUNTABILITY, *supra* note 5, at 139; Schwartz & Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 635, 639 n.19 (1977).

69. *See* CORPORATE ACCOUNTABILITY, *supra* note 5, at 136-39; Black, *Shareholder Democracy and Corporate Governance*, 5 SEC. REG. L.J. 291, 297-99 (1978); Schwartz & Weiss,

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nents have advanced two arguments in support of the rule. First, they contend that the rule gives shareholders a needed outlet to express their views. Second, they argue that it "sensitizes" management to shareholder concerns about social responsibility and, therefore, has a "healthy indirect impact" on corporate behavior.[70] Neither argument withstands analysis.

No one proposes to deny shareholders who desire to express their views an opportunity to do so. The problem arises because the shareholder proposal rule allows them to do so costlessly with the costs borne by the firm, or, more realistically, by other investors. Not even the first amendment, except in very limited circumstances concerning broadcast frequencies,[71] ensures a right to speech at someone else's expense. The issue in terms of shareholders' welfare is whether individual shareholders would contract for the right to be able to express their views in a shareholder proposal if each shareholder also had to pay a subsidy to any other shareholder who wanted to take advantage of the same opportunity. In light of the economics of shareholder voting (confirmed by the lack of any shareholder interest in shareholder proposals), and the relative ease of selling in the market if dissatisfied, the rule clearly cannot be reconciled with the goal of maximizing shareholders' welfare.

The "healthy indirect impact" argument is even more troublesome. While it is true tbat corporations have taken actions similar to those suggested by sbareholder proposals both before and after a proposal's defeat, whether the action was a result of the proposal or general public sentiment is only conjecture. But let us assume a corporation decides to modify its behavior—say, discontinuing investment in South Africa or ceasing manufacture of war munitions—in direct response to a defeated proposal. While reformers would no doubt be ecstatic about this result, shareholders as a class have little to be excited about. What has occurred is that a tiny minority, subsidized by the vast majority of shareholders, has caused the corporation to abandon a wealth-maximizing strategy favored by the very majority of shareholders who are forced to provide the subsidy. A less "democratic" result or one more inconsistent with the goal of maximizing shareholders' welfare is hard to imagine.

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supra note 68, at 685-86.

70. W. Cary & M. Eisenberg, Cases and Materials on Corporations 337 (1980).

71. Red Lion Broadcasting Co. v. Federal Communications Comm'n, 395 U.S. 367 (1969).

C. *Are Shareholders The Intended Beneficiaries of Shareholder Democracy?*

The gap between the rhetoric and the reality under the shareholder proposal rule raises the question whether shareholders are the intended beneficiaries of shareholder democracy. Other examples of regulation that appeared to ensure more shareholder democracy illustrate the problem. For example, during the 1970's the Securities and Exchange Commission began requiring disclosure by corporations of illegal and perceived antisocial conduct such as sensitive foreign payments and noncompliance with environmental laws.[72] This qualitative (as opposed to quantitative) disclosure was required without any pretense that the information was relevant to the economics of the investment decision.

This required disclosure is hard to reconcile with the goal of maximizing shareholders' welfare. Disclosure is costly, and the firm's existing investors bear these costs. Prohibiting sensitive payments and having a clean environment are undoubtedly of great interest to some, but not to investors *qua* investors. To the extent investors would care at all, they in all probability would favor practices that maximize the economic return on their investment. They certainly would not be in favor of subsidizing the disclosure of moral and political information that is designed to make it less likely that the corporation will engage in profit-maximizing behavior.

Shareholders, thus, are far more likely to be the victims rather than the beneficiaries of much of what masquerades as shareholder democracy. The real beneficiaries appear to be academics, social reformers, and regulators who want corporations to sacrifice wealth maximization in favor of their own notions of moral behavior. While much legislation is based on such moral notions, it is a sham to pursue these goals through the corporate machinery in the name of either shareholders or of democracy.

VI. Independent Directors

The perceived problems of the governance of the modern publicly held corporations have led to a variety of proposals for restructuring the board of directors. Harold Williams, the former chairman of the Securities and Exchange Commission, for exam-

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72. For a critical discussion of these required disclosures, see R. Karmel, Regulation by Prosecution 230-45 (1982).

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ple, has proposed that all directors be independent of management with the only exception being the chief executive officer who could not serve as chairman of the board.[73] Although this proposal has not attracted a great deal of adherents, the notion of independent directors has achieved wide acclaim. Thus, the American Bar Association,[74] The Business Roundtable,[75] and the Securities and Exchange Commission[76] all have recommended that boards of directors should be composed of a majority of independent directors. The first draft of the American Law Institute project has gone further and has proposed that corporations be *required* to have boards with a majority of independent directors.[77] The primary function of independent directors under these proposals would be to "monitor" management as opposed to running the business on a daily basis.[78] Thus, directors would be empowered to select and fire managers, review and approve major corporate decisions, hold management accountable for producing adequate operating results, and institute compliance programs to ensure that management comply with applicable law and avoid self-dealing.[79]

The same organizations and commentators who have advocated boards of independent directors also have placed great weight on audit, nominating and compensation committees. Each of these committees, reformers argue, should consist entirely of independent directors. The primary function of the audit committee would be to select the independent auditor, supervise the relationship between the firm and the independent auditor, and choose appropriate accounting principles. The nominating committee would evaluate candidates for directorships and monitor the performance of existing directors. The compensation committee would determine the compensation of senior management. Faith in the salutory effect of these committees is so strong that the draft of the American Law Institute project has proposed that publicly

73. Harold M. Williams, *Corporate Accountability and Corporate Power* (Oct. 24, 1979) (paper presented at Fairless Lecture Series, Carnegie-Mellon University), *discussed in* Kripke, *supra* note 50, at 178.

74. *See Overview Committee*, *supra* note 55, at 1844, 1849, 1854.

75. *See Business Roundtable*, *supra* note 55, at 2108.

76. CORPORATE ACCOUNTABILITY, *supra* note 5, at 581.

77. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, § 3.03, at 71.

78. Professor Eisenberg originated the concept of the monitoring model. *See* M. EISENBERG, *supra* note 54.

79. *Id.*; *see* PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, § 3.02, at 57-70.

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held corporations be required to have audit and nominating committees consisting entirely of independent directors.[80] These proposals are evaluated below.

A. Independent Directors and Shareholders' Welfare

Unlike the arguments for shareholder democracy, a plausible case can be made that boards dominated by independent directors will increase shareholders' welfare. The reduction of agency costs benefits both managers and shareholders alike. Managers can obtain higher salaries from the gains; shareholders' wealth is increased if divergences of interest are minimized. Conceivably, both parties may increase their welfare by the hiring of independent directors as monitors to scrutinize the behavior of managers.[81]

But costs, both direct and indirect, as well as potential benefits also must be considered. The most obvious direct cost is the cost of salaries, staffs, and increased layers of bureaucracy. Indirect costs, however, probably are more important. Proponents of independent directors draw a sharp distinction between running the business, concededly beyond the competence of independent directors, and various monitoring functions such as choosing managers and approving major corporate plans. This distinction, however, is more apparent than real. Directors whose lack of familiarity and expertise makes them incapable of making ordinary business decisions are presumably even more incapable of making truly important decisions such as deciding whether a merger or development of a new product should go forward or whether the chief executive officer and other senior management should be replaced. Involvement of independent directors in these areas, therefore, may be limited to acting as a rubber stamp of decisions made by those who are more knowledgeable.[82] Alternatively, the firm's decisionmaking may become more cumbersome and less efficient.

Even with respect to deterring self-dealing, the effect of independent directors is unclear. For all but the most obvious frauds, independent directors, who typically serve part-time and have little or no financial stake in the firm, probably will not make a dif-

80. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, § § 3.05-.06, at 82-106. The Restatement recommends compensation committees "as a matter of good corporate practice," but does not require them. *Id.*, § 3.07, at 106-15.

81. *See* Fama, *supra* note 15.

82. *See* Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 632-39 (1982).

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ference.[83] Indeed, one may argue that management directors, particuarly the chief executive officer, will be even more dominant and less accountable, whether in terms of setting salaries or structuring self-interested transactions with the firm, if a majority of the board consists of independent directors who lack the knowledge and incentive to challenge senior management.[84]

A convincing theoretical case cannot be made, therefore, that a board composed of a majority of independent directors will increase shareholders' welfare, and no empirical evidence exists to support this view. Much the same is true with respect to the various committees that have been proposed. Audit and compensation committees may improve monitoring of senior management, but they also may impose costs with no corresponding benefit. Investors may not benefit, for example, from improved accounting principles fomulated by audit committees if they were able to make intelligent investment decisions under the old procedures.[85] Similarly, market constraints and the incentive of managers to monitor each other may be more effective in setting salaries than a committee of uninformed independent directors. Nominating committees almost surely impose costs without any corresponding benefit. Because the creation of these committees is premised on the misguided notion that steps must be taken to increase shareholder democracy, they are likely to be ignored by investors. To the extent that these committees function to frustrate the expectations of those such as controlling shareholders with a large financial stake in the firm by preventing them from placing their nominees on the board, shareholders' welfare will be reduced.[86]

In light of the tenuous case for independent directors both on

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83. *Id.* at 607-30. While I agree with Professor Brudney that independent directors are likely to have minimal impact in improving efficiency and reducing self-dealing, I do not agree with his conclusion that their inadequacy is a justification for increased regulation of corporations. Brudney, in my view, like the proponents of the need for improved corporate governance, wrongly assumes that a problem exists in the way corporations currently are being run.

84. *See* Letts, *Corporate Governance: A Different Slant,* 35 Bus. Law. 1505, 1509-15 (1980).

85. Several studies have concluded that accounting changes in which real earnings are not affected do not fool investors—they do not cause investors to reevaluate the prospects of the firm. *E.g.,* Hong, Kaplan & Mandelker, *Pooling vs. Purchase: The Effects of Accounting for Mergers on Stock Prices,* 53 Acct. Rev. 31 (1978); Sunder, *Relationships Between Accounting Changes and Stock Prices: Problems of Measurement and Some Empirical Evidence,* 11 J. Acct. Research 138 (Supp. 1973).

86. Potential tender offerors, for example, will be deterred from going forward if they are unable to assume control of the board after gaining control. This deterrent effect will reduce shareholders' welfare. *See* Easterbrook & Fischel, *supra* note 13, at 1182-88.

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the board and in various committees, no basis exists for assuming, let alone mandating, that corporations should be organized in a particular manner. A far preferable course would be to allow private parties to organize in whatever manner they wish. If the structure advocated by reformers really will increase shareholders' welfare, it will be undertaken voluntarily,[87] just as firms have always voluntarily hired independent accountants to verify representations made to investors. Firms that are organized in a manner that maximizes investors' welfare are at an advantage in attracting capital, and managers of such firms will maximize the value of their own services. Conversely, firms that fail to adopt a governance structure that increases shareholders' welfare will be targets of takeovers. These incentives to maximize the value of the firm—much more tban legal rules that are based on a shaky theoretical foundation and not supported by any empirical evidence—are likely to result in a firm structure that maximizes investors' welfare.[88]

B. *Is There a Hidden Agenda?*

Thus far I have analyzed proposals for independent directors as if they have been motivated by a desire to maximize investors' wealth. The possibility remains, however, that furtherance of the public interest, however defined, is the main reason for the popularity of independent directors for at least some of the proponents.[89] Independent directors are desirable under this view not because they have the effect of ensuring more effective performance by managers, but because their presence will cause the firm to

87. The number of boards composed of a majority of independent directors has increased dramatically in the last ten years, and this is some evidence that independent directors are beneficial. The significance of the development, however, is obscured hecause many companies changed their boards in response to exhortations by the SEC that threatened mandatory action if steps were not undertaken voluntarily. *See* Kripke, *supra* note 50, at 189-92.

88. For a similar analysis that managers have strong incentives to choose a dividend policy that maximizes investors' welfare, see Fischel, *The Law and Economics of Dividend Policy, supra* note 22, at 1165-68. *See also* Fischel, *supra* note 58 (managers have incentive to incorporate in state that maximizes the wealth of investors).

89. For a forceful argument that this is the case, see Wolfson, *SEC Thinking and Lessons in Bureaucratizing the Corporation*, in CORPORATE GOVERNANCE, *supra* note 32, at 9 (independent directors will be less entrepreneurial and will define success, not by increasing profits, but hy "the approhation of government regulators like the SEC and special interest 'do-good' groups."). For a critique of former Chairman Williams' views that independent directors should he responsible to a wide range of constituencies, see Kripke, *supra* note 50, at 180-86.

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be more sensitive about concerns such as pollution, foreign payments, and minority employment. The lack of competence and incentive to maximize shareholders' wealth is now no longer a drawback but a strength because the very purpose of independent directors is to temper managements' single-minded pursuit of profits.

Consider the use by the Securities and Exchange Commission of injunctive remedies requiring the installation of independent directors and audit committees as a means of settling investigations regarding questionable foreign payments and other alleged unethical or illegal practices.[90] Since the challenged practices in all probability benefited investors, the intent, and presumably the effect of the relief sought by the SEC was to subordinate investors' welfare in favor of making the corporation behave more morally. This emphasis on compliance with law and ethical standards of behavior is a recurrent theme of proposals for independent directors.[91]

Use of independent directors for this purpose raises a variety of problems such as what special competence do independent directors have to determine what the public interest is and the lack of any principle to define when and to what extent profit maximization must be sacrificed to other goals.[92] Although these problems are intractable in themselves, my objection is more fundamental, albeit related. Requiring that boards be dominated by independent directors to compel corporations to behave in a more "socially responsible" way has the effect of obliterating the distinction between a firm—a nexus of contracts voluntarily and lawfully entered into by individuals to maximize their joint welfare—and a public body serving the public interest such as an administrative agency. In evaluating alternative courses of action boards of directors, under this latter approach, would not strive to determine what alternative maximizes wealth, but rather what alternative furthers the public interest, much in the same way that the Federal Communications Commission determines which potential

90. For a discussion of this practice and a summary of the relevant literature, see Note, *The SEC and Court-Appointed Directors: Time to Tailor the Director to Fit the Suit*, 60 WASH. U.L.Q. 507 (1982).

91. *See* PRINCIPLES OF CORPORATE GOVERNANCE STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, §§ 3.01-.08, at 45-125; Dent, *supra* note 1, at 661-80; Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1355, 1374 (1979).

92. *See* Brudney, *supra* note 82, at 639-56.

broadcast licensee will best serve the public interest.[93] Since private parties have shown no interest in abandoning the corporate form of firm organization dedicated to wealth maximization in favor of such quasi-public institutions, they presumably must be coerced. Perhaps this is the real reason why certain reformers, who have been unsuccessful in implementing their objectives through the democratic process, are so insistent on mandatory changes in the structure of corporations.

VII. Increasing the Liability Faced by Corporate Managers

Proponents of the need for improved corporate governance are skeptical of the ability and incentive of corporate managers to act in investors' best interests. Some have argued, for example, that managers make business decisions without marshalling adequate material information.[94] The number of cases in which directors or officers have been found liable for negligence, or breach of the duty of care, however, is extremely small.[95] When derivative suits are brought for breach of duty of care or loyalty, they frequently are dismissed.

Many reformers find this situation unsatisfactory. They claim that "effective duty of care provisions are critical to the proper functioning of modern corporate governance."[96] Advocates of this view argue that legislatures and courts must set high standards of care for corporate managers to improve corporate accountability and not allow directors to escape liability under the business judgment rule.[97] Further, advocates of corporate reform have argued that the derivative suit also must be strengthened so that manag-

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93. For a discussion of the difficulties faced by administrative agencies in applying a public interest standard, see Spitzer, *Multicriteria Choice Processes: An Application of Public Choice Theory to* Bakke, *The FCC, and the Courts,* 88 Yale L.J. 717 (1979). These difficulties, if anything, would be even greater in the corporate context because of the lack of any mechanism for enforcing a public interest standard.

94. *See* Principles of Corporate Governance and Structure: Restatement and Recommendations, *supra* note 6, § 4.01, commentary at 145.

95. *See* Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers,* 77 Yale L.J. 1078, 1099 (1968) (a "search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack.").

96. Principles of Corporate Governance and Structure: Restatement and Recommendations, *supra* note 6, pt. IV, introductory note, at 128.

97. *See id.;* Corporate Accountability, *supra* note 5, at 690 ("Both state legislatures and state courts have important roles to play in promoting corporate accountability. The legislature can set standards of director conduct at a high, yet reasonable level . . . . Courts . . . can respond in this direction."); Dent, *supra* note 1, at 654-61.

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ers who breach duties owed to shareholders are held accountable.[98]

In response to these concerns, the first draft of the corporate governance project of the American Law Institute has proposed revitalizing legal constraints on managements' behavior. To ensure that the fear of liability will provide managers' with an incentive to act in investors' best interests, the project curtails the protection traditionally afforded under the business judgment rule. Thus the project provides that the rule will operate only when directors specifically, attentively, and directly focused on the decisions under review.[99] Decisions that are "nondeliberative" are not protected. Even decisions in which the requisite procedural requirements have been met are not protected if they lack a "rational basis."[100] To ensure an adequate enforcement mechanism if the duty of care or loyalty is breached, the project makes it virtually impossible for the corporation to dismiss a derivative suit challenging particular conduct unless the decision is made by independent directors with separate counsel and documented in a thorough written report.[101] These proposals are evaluated below.

A. The Business Judgment Rule and the Importance of the Market as Opposed to Legal Mechanisms in Reducing Agency Costs

Because proponents of the need for improved corporate governance ignore the various market incentives for managers to act in the best interests of shareholders, they believe that strong legal rules regulating managerial behavior are necessary to avoid exploitation of investors. This belief has been responsible for the widely held (but implausible) view that states have been engaged in a "race to the bottom" in enacting enabling statutes which, by failing to regulate, operate to the detriment of investors.[102] The

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98. *See* PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, pt. VII, introductory note, at 217-23; Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform,* 81 COLUM. L. REV. 261, 302 (1981); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?,* 75 NW. U.L. REV. 96, 144-45 (1980).

99. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, at 133.

100. *Id.*, § 4.01, at 141.

101. *Id.*, § 7.03, at 295-303.

102. Professor Cary popularized the "race to the bottom" thesis. *See* Cary, *supra* note 20. For a persuasive demonstration that managers have no incentive to incorporate in states that minimize the wealth of investors, and could not even if they wanted to without suffering various market penalties, such as the refusal of investors to invest in those firms, see R. WINTER, GOVERNMENT AND THE CORPORATION 9-11 (1978). Winter's thesis is confirmed em-

same notion is responsible for the proposals to increase the liability faced by managers by narrowing the business judgment rule and strengthening the derivative suit.

No basis exists for the assumption that the absence of regulatory constraints will operate to the detriment of investors. On the contrary, the discipline exerted by product and capital markets, the market for managerial services, and the market for corporate control serverely limits the divergence of interest between managers and investors.[103] An understanding of this relative harmony of interests between managers and shareholders clarifies both the rationale of the business judgment rule and the danger created by limiting its operation.

There is no reason to believe that courts can systematically improve on the business decisions made by corporate managers. Courts (and shareholders) do not possess the experience, expertise, or information necessary to make complicated business decisions. Even if courts did possess these attributes, they still would be inferior decisionmakers because they are not constrained by market forces as are corporate managers. The judge who makes a bad business decision is not likely to decrease the market value of his services or risk a takeover in the same way that a corporate manager would.

The business judgment rule embodies these principles.[104] Under the rule courts will not second-guess business decisions made by corporate managers except in the most extreme situations. The rule implicitly recognizes, therefore, that shareholders' welfare is maximized if managers, constrained by markets, make business decisions rather than shareholders or courts. Thus the small number of cases in which courts have second-guessed deci-

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pirically in Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation,* 53 J. Bus. 259 (1980) (share prices go up when firms reincorporate in Delaware). *See also* Fischel, *supra* note 58.

103. Proponents of increased legal intervention do not seem to fully understand the effect of these market mechanisms. The draft of the ALI project, for example, states that "[m]arket mechanisms, even if they were fully effective in holding corporate management accountable for efficiency, are unlikely to be effective in regulating such matters as managerial conflicts of interest, since many self-interested transactions are not sufficiently material in dollar terms to have significant impact on share prices." PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, at 62. This statement is nonsensical. If the only situation in which market mechanisms do not hold managers fully "accountable" is the situation in which no significant impact on share prices occurs, why worry?

104. For a fuller discussion of the business judgment rule, see Easterbrook & Fischel, *supra* note 13, at 1195-97.

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sions by corporate managers is in no way a problem. On the contrary, shareholders almost surely would lose more than they would gain if courts became more actively involved in corporate decisionmaking.

For these reasons shareholders' welfare would be reduced if the business judgment rule were eroded as proposed by some reformers. Consider the provision in the draft of the American Law Institute (ALI) project that decisions will be protected by the business judgment rule only if they result from a deliberative process. What if directors, by virtue of their experience and expertise, are able to make a decision without deliberating at all? Making the decision in this manner, which may appear to be casual to a court, maximizes shareholders' welfare. The costs of gathering and processing information are real costs that should be avoided if they are not justified by anticipated benefits from improved decisionmaking. The managers themselves, not the courts, are best able to determine whether limited resources should be allocated to information gathering or for other purposes. The business judgment rule should shield the procedure for making a decision, as well as the substance of the decision itself, from judicial review. But if the rule only is available when a "deliberative" decision is made, directors will have an incentive to incur costs for gathering information and documenting their decisions even when it is not cost-justified to do so. Shareholders will be the losers.

Much the same is true with the "rational basis" test. It is much too easy for a court, acting after a decision has gone wrong, to conclude that the decision lacked a rational basis or could have been improved upon if more information were gathered. In light of the various market incentives to operate efficiently and keep share prices high, there does not appear to be any need for a process of judicial review that is incapable of identifying or correcting inefficient decisionmaking. By implicitly recognizing the inability of the courts to improve on the business decisions made by managers disciplined by markets, the business judgment rule contributes to the efficient management that shareholders desire.

Other proposals in the draft of the ALI project that are designed to increase the potential liability of directors are equally objectionable. The project, for example, precludes contractual variation of liability standards. As an illustration, the drafters would not allow a director with expertise in banking to limit his involvement to banking matters, even with the full consent of the board. His failure to be involved in other areas would, according to the

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drafters, constitute a breach of fiduciary duty.[105] It is hard to see what could possibly be gained by this highly regulatory approach to board composition and liability standards. Members of the board involved in running the corporation's affairs no doubt have a better sense for the optimal specialization of functions among managers, including such decisions as whether it is desirable to have a director with banking expertise on the board, than do regulators and reformers. Prohibiting private parties from entering into such voluntary arrangements for their mutual benefit will reduce shareholders' welfare.

Similarly, the project strongly suggests that compliance with the duty of care requires managers to install "law compliance programs" even when these programs are not cost justified.[106] The rationale for special emphasis on compliance with law is unclear. Managers have strong incentives to minimize fines or other consequences of regulatory violations for the same reason that they have incentives to minimize all other costs. But if the expected costs of fines are less than the costs of installing compliance programs, the proper course to maximize shareholders' wealth is to do nothing and pay the fines.[107]

B. Strengthening the Derivative Suit

The same disregard of the effect of markets and overemphasis on legal mechanisms in regulating managerial conduct explains the resurgence of interest in the derivative suit as a monitoring device. Certainly instances of blatant self-dealing or other one-time defalcations may occur in which the derivative suit may play a role in deterring misconduct. But the importance of the derivative suit should not be exaggerated. In most situations the derivative suit is ineffective in reducing agency costs. Management that consumes excessive leisure or is not sufficiently diligent in choosing projects, or otherwise does not maximize shareholders' wealth in any of an infinite number of ways short of fraud, has little to fear from the derivative suit. Shareholders and courts, unlike markets, are unable to detect these forms of nonwealth-maximizing behavior.

Another important distinction exists between the operation of

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105. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, *supra* note 6, § 401 commentary, at 154-55.

106. *Id.* at 178.

107. *See* Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963) (holding that directors were not liable for failing to prevent the imposition of fines by installing compliance programs when it was not cost-justified to do so).

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markets and the derivative suit in reducing agency costs. Markets operate automatically and at minimal cost to the firm's investors. The costs incurred by potential takeover bidders to identify mismanaged firms, for example, in no way reduce the wealth of investors of targets. By contrast, the derivative suit imposes significant costs on the firm's investors, the supposed beneficiaries of the action. At the very least, the costs of lawyers' and managers' time diverted from profitable ventures must be borne by the firm's investors. Moreover, shareholders (or their attorneys) may not be able to, nor even have the incentive to, identify conduct that is detrimental to investors. For example, a derivative suit to enjoin conduct that increases investors' wealth such as the making of foreign payments imposes obvious costs on investors. Even in situations in wbich shareholders through their attorneys have correctly identified nonwealth-maximizing behavior, a derivative suit may still impose costs on investors that outweigh any benefits if, for example, the same deterrent effect could be accomplished by other (less costly) means such as a reduction in salary or bonus.

These costs of the derivative suit, and the inferiority of the derivative suit as compared to market mechanisms in reducing agency costs, suggest that its importance has been greatly exaggerted and cast doubt on proposals to strengthen it further.[108] Requiring that management go through a complicated procedure involving hiring new personnel and the compilation of detailed written reports whenever a suit is filed, for example, increases the costs borne by the firm's investors without any assurance that their expenditures are cost-justified. And allowing a derivative suit to go forward because it furthers a federal or state "public policy," even though shareholders welfare is decreased, forces investors to subsidize litigation that operates to their detriment through a tool that is supposedly designed for their benefit. Thus legal rules making it more difficult and costly to dismiss derivative suits are extremely unlikely to increase shareholders' welfare. Absent any evidence that such costs are justified by the existence of a problem, the burden of establishing that they should be incurred has not been met.

VIII. Conclusion

Despite the near consensus that improved corporate governance is necessary, critics have proffered no evidence to demonstrate that any problem exists. Many reformers, as their proposals

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108. *See* Fischel, *supra* note 58, at 941.

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reflect, either ignore or misunderstand the economics of the corporate form of firm organization and the market forces that limit the divergence of interest between managers and investors. It is difficult to escape the conclusion that the corporate governance movement, despite its durability and widely held support, is much ado about nothing.

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