Can Culture Constrain the Economic Model of Corporate Law?

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INTRODUCTION

Are there boundaries to the economic model of the structure of corporate law? If so, where do they begin?

Much scholarship in this Symposium deepens the model of corporate law as a three-player contract among shareholders, managers, and the board. It is a model that Frank Easterbrook and Daniel Fischel used ten years ago here at The University of Chicago Law School in their book, The Economic Structure of Corporate Law, which culminated and accumulated their work on the contractarian model of the corporate law. Corporate law is—or in its normative version should be—a contractarian arrangement between and among managers, the board, and shareholders. Corporate law should be a set of default rules among these players, as the most likely rules the players would adopt, or as the rules that would be the easiest to contract

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away from (if the parties did not want them). Fiduciary duties in this model represent the ex ante contract that managers and shareholders would have reached. Corporate law and corporate law judges referee, in this view, that three-player game. Corporate structure results from players adapting their corporate institutions and decisionmaking to the economic task at hand.2

In its positive form, the contractarian perspective saw Delaware as coming close to the economic model, with most of Delaware corporate law (except probably for takeover barriers) conforming to the model. The Symposium articles fit this tradition. So the existence of barriers to takeover tell some that the resulting increase in managerial agency costs would drive up managerial compensation,3 while it tells others that the higher agency costs increase the demand for other tools (such as more incentive-based compensation and more board independence), tools that would constrain these higher agency costs.4 Or it could tell others that the economic model could be better applied if the board had less authority to decide on a takeover and shareholders had more.5 Or it could tell others that the three-player contract might be readjusted by giving the board yet more authority—via three-year terms—subject to a “campaign financing” law that would have the company pay the expenses for (some) shareholder-initiated proxy fights: more security for managers in the short run, with lowered costs to shareholders who challenge managers in the medium run.6

These views let us know that there is more to be said—and debated—on how best to implement the economic model of corporate law, a model that focuses on the three-player game of allocating decisionmaking authority among managers, the board, and shareholders. It is the model that has dominated corporate law scholarship and that continues to dominate it. And it is a good model for us in the United

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2 The corporation is, in this view, a more complicated contract, one that contracts with suppliers, employees, and so on; but corporate law focuses on the three-player contract.
States because the constraints that the articles impose on the model are attenuated, weak, and unimportant here.

But to see why the model works so well, we should look for its boundaries; and the Symposium articles show us where we should be exploring if we wanted to find those boundaries. That is, can we trace the lines in the articles to discern the boundaries of that contractarian model? Is there a limit, where other factors outside of the three-player contractarian model kick in, factors that we would have to understand if we were to explain the corporation well?

There is such a limit, and if we look at the bigger picture that the Articles sketch out, we can catch glimmers of how culture could limit the economic model. So here, I use the articles from this Symposium to sketch out an outer limit, a boundary, to the economic model, where that model starts to do less well as a positive matter in explaining what institutions we see and which ones are effective (and where those of us who think as a normative matter that the economic model in the end usually best maximizes welfare might seek to roll back these limits even farther).

In Part I of these Remarks, I trace out the economic model of how takeovers, if impeded, should induce substitute institutions that keep the corporate pie from diminishing too much in size, but that divide up that corporate pie differently. In Part II, I sketch out how culture, such as attitudes toward wealth, can facilitate or retard that Coasean restructuring; almost automatic in the United States, that new division of the pie still would encounter resistance elsewhere. Culture can vary the costliness of substitutes in the economic model. And by varying costs, culture can vary the efficacy of the substitutes. Culture could limit this Coasean restructuring, but in the United States, it does not.

In Part III, I expand this notion of cultural boundaries: even basic corporate law characteristics, such the efficacy of controls on interested party transactions, could be a function not just of finance, economic rationality, and institutional capacity, but also of cultural background. Identical institutions could produce widely varying results if we vary just one cultural consideration: varying attitudes toward wealth can vastly vary the efficacy of these institutions, the ease of ownership separation, and whether the Berle-Means firm will dominate an economy or be a minor, secondary business institution.

In Part IV, I look at the interaction between culture and economics, how and when economics dominates culture, and how and when each is independent. In Part V, I trace out two political limits to the economic model—one known and one revealed in the Symposium—of how legislative politics and judicial sympathies can cap and limit the economic model.
I. THE ECONOMIC MODEL WITHOUT LIMIT

A. Antitakeover Law Pressure on the Three-Party Bargain

Let us start with the perspective that takeovers reduce managerial agency costs to shareholders. It is the usual perspective but not a unanimous one. But let us pass on that debate here. And let us posit that we operate in the "space" where product, capital, and labor market competition do not fully constrain the managers to work for shareholders. (No need to sketch out limits to these markets: We all know those limits exist, although opinions differ as to where the line is.) In that "space," we posit, takeovers make managers work for shareholders.

But then antitakeover structures (such as poison pills), legislation, and court decisions (which the legislature does not overturn) impede takeovers. (One limit to an economic model might be right here. Why do courts constrain takeovers, and why do legislatures let those decisions stand or add to the barriers? Three-party efficiency might be an answer. But the shape of the corporation is partly determined by why the polity validates antitakeover mechanisms, such as the pill. It is not economically foreordained—more on that below.)

So antitakeover structures make managers less loyal to shareholders. Managerial agency costs rise, so the demand for takeovers persists and, indeed, increases. If managerial agency costs rise, players would then pay "more" for takeovers.

B. The Coasean Bargain Redone

In Marcel Kahan and Edward Rock's model, with the gates open for high compensation, we see an institution that "buys" managers off from opposing takeovers. True, managers can now "just say no" (most of the time). But money can change their minds. It would be awk-

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7 Compare Moran v Household International, Inc, 500 A2d 1346 (Del 1985) (holding that the directors' poison pill defense was within the business judgment rule), with Smith v Van Gorkom, 488 A2d 858 (Del 1985) (holding that the business judgment rule did not protect decisions by directors who were not reasonably informed). The former validated the poison pill and was upheld. The latter lambasted directors and was effectively repealed. See 8 Del Code Ann § 102(b)(7) (1991 & Supp 1993) (permitting corporations to eliminate personal liability of directors for breach of duty of care).

8 So it is logically possible that Bebchuk, 69 U Chi L Rev 973 (cited in note 5) (arguing that it is preferable to give boards less veto power over takeovers), sketches out the appropriate economic model but that politics trumps it. Or, via Coase, there are several possible models, and the political muscle of managers determines which one of the plausible models wins out. Indeed, this might constitute one of the boundaries to economic analysis. And managers may win more often or more easily if they have political allies. Is the result wealth-maximizing or do managers win because they "have the votes"? One answer is that legislatures listen to managers, especially when the bystanders (employees, consumers, average citizens) are wary of hostile takeovers. Let us put this potential limit aside for now, although it potentially cabins the pure economic model.
ward—and visibly in violation of corporate law duties—if the offering company directly presented managers a check for $20 million on condition that those managers drop their opposition to a hostile bid and managers cashed that check. But if there are preexisting options in place with a value of $20 million if the takeover vests, then the managers see the personal value to them of the bid going forward. And then they often acquiesce.

The economic model, in a first cut at the issue, is vindicated. Managers have a "property" right to resist takeovers, but in a Coasean bargain—indirect, to be sure, and perhaps not the perfect way for the three parties to do these things—the managers get paid to give up their property right. If the value and efficiency of the transaction is large enough, it goes forward, as it would have before the antitakeover laws, devices, and decisions arose, but managers get a bigger piece of the pie than they did before.

One need not evaluate here whether the increased managerial compensation is "incentive" compensation or "rent extraction." The check could be seen as tribute to powerful managers, who extract value from the firm, or it could be seen as a payment contingent on takeover, thereby aligning managerial incentives with shareholder value. All we need to know at first is that it is high enough to induce managers to accede to what would otherwise be a hostile takeover. The takeover-induced pie is, we can believe, about the same in size, but its division changes. (We pass over how much this Coasean re-bargain re-creates the incentives ex ante: Some takeovers do not go forward even with the option-vesting "pay-off" because managers resist or the offeror withdraws a takeover offer that the increased compensation made more costly. And takeovers' incentive effects on managers are reduced by the antitakeover institutional structure, because managers know that a takeover will put them out of a job but will pay them handsomely, so there is less for them to fear ex ante, when running the firm. Yet they presumably compete more heavily for that big piece of the pie that the CEO can extract. How it all sorts out—more efficient overall, less efficient overall, or a change in orientation—is not fully clear in the model. The reequilibration possibly is not the best way for the players to handle corporate control transfers, but is

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9 Compare Kevin J. Murphy, Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options, 69 U Chi L Rev 847 (2002) (arguing that increased managerial compensation is based on incentives), with Bebchuk, Fried, and Walker, 69 U Chi L Rev 751 (cited in note 3) (arguing that increased managerial compensation is due to rent-extraction by managers).

10 Or, managers are in fact getting incentive compensation. The incentive, though is not day-to-day compensation, but an incentive to sell the firm to the highest bidder.

11 See Reinier Kraakman, The Best of All Possible Worlds (or Pretty Darn Close), 69 U Chi L Rev 933 (2002).
just a second or third best. But the point that we get some substitution
effect, and possibly a large substitution effect—Kahan and Rock’s ba-
sic point—is well taken. We will stick with it.)

Thus sketched out, we see the economic model in action. The rule
changes, and there is a Coasean reequilibration. (The only “bound-
dary” to the economic model thus far is the question of why managers
win so often in getting antitakeover decisions legislation, the question
we have put aside. But once we take that political boundary as
“given,” as exogenous, the maximizing economic model is back in
play.) If the substitute is close enough, Coase once again shows us
how parties can contract around the rules to make the result effi-
cient—conceivably as efficient as where we started.

That’s enough. And we could stop there. But . . .

II. CULTURAL LIMITS TO THE ECONOMIC MODEL?

Not so fast. Imagine that costs afflict the substitute. If the substi-
tutes were highly costly—for some firms or in varying degrees for all
firms—then a Coasean reequilibration would be harder. Large, mana-
gerial-run firms would be less subject to takeover, and probably run
less well. Some, maybe many, larger managerial-run firms would be
less effective and in time out-competed by smaller ones.

The substitute here for the pure hostile takeover is the quasi-
friendly offer with vesting of heavy stock options that buy off manag-
ners from their opposition. No other substitute, remember, works as
well (we have assumed), and this substitute, even if imperfect, is pretty
good.

But what if there were costs—big costs—to the substitute?

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12 And for this parenthetical reason, Kahan and Rock’s optimistic variation—with com-
pen-sation perfectly offsetting the pill—seems possible, but only if serendipity reigns. See Kahan
and Rock, 69 U Chi L Rev 871 (cited in note 4). The question would be how big a loss the three
players suffer—that is, how imperfect the compensation substitute is. A reservation here is that
the new equilibrium, even one with an identical number of takeovers, could be—indeed, should
be, theoretically—at a lower level of shareholder welfare. But this reservation does not implicate
their main claim that there are substitutes, however imperfect.

13 This contractarian argument could partially explain the lull in takeovers at the very end
of the 1980s and in the early 1990s. Paramount’s approximation of a “just say no” defense for
boards maybe really did shut down takeovers. See Paramount Communications, Inc v Time, Inc,
571 A2d 1140 (Del 1989). But then it took a few years for option mechanisms to kick in to
weaken managers’ determination to resist takeovers.

14 Note the comparative effect: indirect compensation buys managers off from opposing
takeovers. As such, comparing takeover law among heterogeneous jurisdictions would thus not
predict takeover incidence. That is, law could be the same across countries, or the same in a single
country across time, but if compensatory side payments let managers get bought out, takeovers
happen. If side payments do not work, takeovers do not happen. Rules could be the same, but if
compensatory norms vary, takeover results differ.
I am going to modulate the quality of this substitute with culture, with a preference extracted from the Symposium articles. When we do, everything changes.

Suppose that the new institutional arrangement induces organizational degradation in many firms (by, say, demoralizing enough employees in an important way), but the original arrangement did not. This is of course purely academic: according to the Kahan-Rock analysis—and this is plausible—Americans are not allergic to the substitute. CEOs get hyperpay, and the incidence of takeovers stays about the same, they suggest, without any other big cost to the economy.

But let us think about culture. And let us think about how cultural traits—or at least one trait—could differ from that which we have. That is, we know that in some general way culture affects what we do, but the usual perspective of culture is so wide, so general, and so thin that its analytic impact is correspondingly low. So let us take one cultural trait, and only one—attitudes to wealth—vary it, and see how varying it could affect the micro-institutions of the public firm.

When we do, as I said, everything changes.

A. As Affecting the Quality of Institutional Substitutes

Where is that one cultural assumption that makes the Coasean model work so nicely? Bebchuk, Fried, and Walker analyze CEO pay, concluding that the internal checks do not constrain CEO pay. Rather, they say, an “outrage” constraint caps pay. At some point the press, or the directors’ sense of what is right, kicks in and prevents pay from going higher.15

That outrage constraint is staggeringly high in the United States. Indeed, Kevin Murphy says that the American outrage constraint is so high that it probably has not yet been reached and probably does not yet much constrain executive pay.16 Lots of money can go into managerial hands before directors, or the press, are outraged. Hence, because it is staggeringly high, there is plenty of room for the Kahan-Rock Coasean buy-out mechanism to work its magic. The firm can reequilibrate. The only question is whether the new substitute arrangements are just about as good as the old ones.

But where does that potential for outrage come from? And what if the outrage constraint were not staggeringly high but staggeringly low? Consider the possibility that the board’s directors could not possibly allow, say, more than $500,000 in bonuses in any one year. No human being should make more money than that, they think. And further, imagine that the vesting of (a mere) $500,000 in stock options is

16 See Murphy, 60 U Chi L Rev at 855–57 (cited in note 9).
not enough to induce managers to accept the takeover bid. Then the target firm managers do not acquiesce in the bid, and since takeover law gives them the trump cards to resist a hostile bid, they defeat (most) hostile bids.

The consequence: higher managerial agency costs, fewer bids. The players might search for other substitutes (even better boards, say), but by hypothesis we do not have any other perfect or near-perfect substitutes. We will get an equilibrium eventually—maybe smaller firms, for example, with denser contracting relations among them—but it will not be the same equilibrium we see here.

B. As Degrading the Organization

"Outrage" could link up to the firm's microstructure. It might not just be the directors' internal sense of rightness and outrage, the mechanism that Bebchuk, Fried, and Walker posit. What if the firm's employees would be demoralized, or up in arms, if the CEO got $20 million in a bonus or in exercisable stock options?

Then directors would have a problem: yes, they could buy off the CEO (into takeover acquiescence) via high compensation and thereby restrain managerial agency costs (or reduce their negative consequences), but to do so would demean the organization. Hence, some directors would not take the substitute, because the firm's organizational structure is allergic to that new strain of compensation. Those firms would be immune from takeovers. And hence, those firms' managers would be more entrenched, and managerial agency costs higher in that set of firms.

And, hence, we have just traced out a cultural limit to the economic model. Yes, we get a new equilibrium in the division of authority among the three players as takeover law becomes pro-manager and validates (nearly) a "just say no" defense, but the quality of that equilibrium is determined in part by culture: the size of the internal outrage and organizational degradation that high executive pay induces is the cultural variable. And if culture made high pay highly costly to the organization, then the recalibration of authority would yield a less productive firm.

In the United States that cultural cost is nil or nearly so. But in other imaginable cultures, the result would differ. The American re-equilibration is plausible in the Kahan and Rock model because any American cultural constraint on pay is far out, hardly constraining at all.

And hence, far off on the horizon, we glimpse a potential cultural constraint to the economic model.

C. As Reconfiguring a Persisting Economic Model

We could absorb this cultural limit into the economic model by saying that culture is just an exogenous constraint. This move works logically, but the model is uninteresting if every time a maneuver worked badly for maximization we just dubbed the constraint an exogenous limit.

It would be better to look at culture here as primarily outside the American corporate model. Part of that boundary of outrage is demarcated by where compensation (in size and type) demeans the quality of the organization. At some point, it is not just a general outrage that is in play in, say, the press, the boardroom, public opinion, or the CEO's own conscience, but outrage among the employees on the shop floor or in middle managers looking at their computer screens. If enough people in the organization are outraged, that outrage can demean organizational cohesiveness and, eventually, the firm's performance and its stock price. One might understand the beginning of outrage to be co-terminous with the beginning of organizational degradation.

In one sense, perhaps boards (and senior managers) would operate in the stockholders' interests even here, eventually. Managers—to the extent they are unconstrained—end up with the highest compensation possible, until the level and type of compensation degrades the firm. One might see this as putting an outside, board-based boundary on managerial acquisitiveness, or one might see this as solely limited by the senior managers' own calculations: at some point they cannot get more because for them to take more would kill the golden goose.

As compensation approaches that boundary, the organization begins to degrade. That degradation feeds back into the value of the stock the senior managers have, thereby limiting managers. It also diminishes managers' utility otherwise: they would preside over a deteriorating organization, which would diminish their sense of self, their happiness, and so forth. In the United States that boundary is so very far out in the compensation spectrum that the trade-off hardly happens; in other nations it is much closer. Hence, a high level of pay and pay highly sensitive to general stock market performance induce less outrage in the United States than one could imagine, and less outrage than it would create elsewhere.

If these cultural restraints were in play, that would not end economic adaptation. The players would seek to upgrade other substitutes (such as better boards) or fight harder for different rules. But by hypothesis, these are highly imperfect (actually nonexistent, in the simple model we started with). Shareholders might try even harder to
roll-back antitakeover rules, overturn Paramount Communications, Inc v Time Inc, and so forth. They might win, they might lose, but whether they win or lose would depend as much on their political power as the efficiency of the three-player bargain. As Kahan and Rock tell us, the shareholders tried to roll back the rules, but they failed. They might have succeeded if they tried again and harder. But they still might have failed.

Or (and this could be important) the nature of the firm might change in a way Coase described long ago, not in the social cost article but in the nature of the firm inquiry: If cultural constraints impeded takeovers, and if substitutes were unavailable, managerial agency costs—a type of transaction cost—would rise. And, as Coase told us, if the transaction costs inside the large firm rise, and that rise made the large firm more costly relative to smaller firms, we would get a new firm-versus-market tradeoff. We would get more small firms, perhaps with denser relational contracts among them, and fewer very large firms.

And thus the economic model, of a three-player bargain that is easy to remake as rules change, works as long as culture does not seriously constrain the substitute. That is, as long as the “outrage constraint” is high enough to allow stock-based compensation that changes CEO resistance to a hostile takeover. But culture might constrain the substitute. If it does, all bets are off.

And if it does, and if the other substitutes are functionally imperfect, we have just mapped out a cultural boundary to the economic model.

D. As Distant in the United States, and Closer-in Abroad

We can make this more real. I once was looking for the mechanics of incentive compensation in Europe, looking in part at tax rules that constrain heavy use of incentive compensation in French public companies. In a conversation with a Paris-based compensation consultant, I asked how the French tax rules worked. Indeed, the tax rules were not generally as favorable as the American rules to the firm and the incentivized managers.

But then the consultant went on. He next complained about Americans (such as myself) who looked at the rules and the numbers, trying to find the incentive effects from the tax rules, an effort reveal-

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18 571 A2d 1140 (Del 1989).
ing, he said, that we did not really understand the French company. A more basic reason explained why high incentive compensation had not yet, as of then, worked well for many French firms. The average French person, he said, hates the rich. Hate, he said. Not envy, as I might say would be the dominant American parallel trait. Not admiration, as might lace some of American culture.

There are analogous sentiments in those other cultures: A legendary European manager (Percy Barnevik) just retired, as I am writing, with a multimillion dollar retirement benefit, a benefit that induced widespread disgust, with the “Swedish prime minister . . . saying he was ‘distressed’ over the size of [the] pension” and with a Swedish economist (not a sociologist) saying: “He has fallen from grace . . . Sweden is unforgiving when it comes to greed.”²⁰ And the reaction has historically been a general one, not one tied to a specific person or a single financial event:

Some countries—notably Germany, Spain, Belgium and Sweden—simply haven’t caught on to the stock-options trends yet [in 1998], either because tax laws penalize them, or options aren’t considered entirely ethical . . . . The idea of a corporate official having access to millions of dollars of his group’s stock appeared antithetical to Sweden’s egalitarian tradition.²¹

That lack of “ethics” could be manifold: because the incentive pay demeaned the managers, who should be professionals and not be explicitly motivated by money, or who should do a professional job and then receive an honorarium, or because the incentive pay “unethically” made managers into “mere” agents of shareholders instead of professionals who stood above the fray in running the corporation. Whatever the reason, the price of the Coasean rebargain is made that much higher by the cultural constraint. One might imagine a mirror cultural image for the rich: more ashamed, not self-justifying (“I provided value, hence I got rich” might be a common American reflection—or “I was lucky”), and more interested in hiding the result.

²⁰ David Woodruff and Almar Latour, Barnevik Gets Harsh Verdict in Court of Public Opinion: Former ABB Chief Is Disgraced in Pension Plan, Wall St J Eur A1 (Feb 18, 2002). The company was said to have sought to get much of that pension back, and Barnevik is said to have agreed to return more than half. ABB: Percy Barnevik et Goeran Lindahl restituent une part de leurs indemnités, Les Echos 18 (Mar 11, 2002). And although Barnevik had to resign from several prestigious European board positions, id, he seemed likely to hold on to his American board seat at General Motors. See Danny Hakim, G.M. Keeps Options Open on Director, NY Times C8 (Feb 19, 2002).

These are not American-style sentiments here—or at least the American sentiment, even if substantively similar, is much, much paler. Surely these are not dominant American sentiments. Hence, compensation can be constrained by culture (but isn’t here). Even a shareholder-oriented board would think twice about rewarding senior managers if it would degrade the organization, de-motivate middle management, or even induce work stoppages.

An American economics-oriented analyst might then think that this imagined alternative culture, exemplified perhaps by the French possibility, would be inefficient. And, true, inside that three-player game, the three players in America would have fewer options to re-equilibrate than they now do. But that does not necessarily make the other cultures poorer, less efficient, or less fair. People’s preferences are paid attention to, and the resulting equilibrium might yield a dollar or two less in GNP, as conventionally measured; but if the cultural preference differs, aggregate utility would be higher there if structures bend to the preference.

The key point is not that one society or another is better off, but that culture would affect how the three-player contractarian corporate model played out. The Coasean rebargain would not work the same for them, in the alternative culture, as it works here and now, in America’s real culture. And the Coasean “Nature of the Firm” organizational adjustment could dominate the Coasean “Social Cost” contractarian adjustment.

III. CAN CULTURE EVER AFFECT CORPORATE LAW AND INTERESTED PARTY TRANSACTIONS?

Why stop there? Couldn’t the apparent efficiency of corporate law’s core—constraining interested party transactions—be affected, indeed determined, by this one single cultural constraint? Consider two countries that constrain interested-party transactions well but imperfectly: most interested-party transactions do not get through. But, Swiss-cheese-like, the institutions—primarily legal and judicial—impede most but are not impermeable. More could get through if the self-interested players persisted.

So posit that American law is pretty good overall on this score, but—Swiss-cheese-like—has holes. And, of course we have one of the economic model’s basic insights in play here: The best corporate law

22 This French possibility is from a conversation a few years ago. If real then, it probably is less real now for France, as compensation in more firms there creeps up toward American-style pay. See Proxinvest, La rémunération des dirigeants du CAC 40 5 (2001); Fay Sophie, Les patrons français autant payés que les Américains, Le Monde (Feb 6, 2002).

23 See generally Gary S. Becker and Kevin M. Murphy, Social Economics: Market Behavior in a Social Environment (Belknap 2000).
for shareholders does not constrain managers completely but does so ("only") optimally. Constraints have costs: Some worthwhile transactions would be deterred if the constraints were too tight, and constraints have costs as the organization becomes more bureaucratic and less supple. Hence, even a purely shareholder-oriented system would have some bad transactions getting through the Swiss cheese now and then. Enron might tell us that the holes in the Swiss cheese have become too big in the United States, but if the system self-corrects well and does not over-correct, holes would persist because costs to perfection would persist.

Imagine then a country with a clone of American corporate law: quite good but without purporting to constrain or succeeding in constraining all interested-party transactions. Some get through. But the one difference is culture, and again we focus on only one cultural trait and its potential effect on corporate structure. We stick with the same difference we have been focusing on: the "outrage" constraint on executive compensation is much, much lower in this clone country. Directors cannot pay senior managers more than, say, a few hundred thousand dollars per year in total compensation. "No one," one could imagine the players in this alternative culture thinking, "is worth more than $500,000 in annual pay."

Compare these two countries in managerial propensity to push the firm into interested-party transactions. Managers have less to gain from self-dealing transactions in a country like the United States because high executive compensation (whether of the rent-extraction or the incentive variety) already makes them super-rich. But in a country where the "outrage constraint" is much lower—where the rich are hated, where culture is different, where the insider-managers have to (a) hide their wealth, and (b) engineer opaque transactions to put more money in their pockets—then the managers have a higher demand to hide insider trades, to obscure related-party transactions via corporate selling to a controlled entity, and to get more out of the firm in high perqs (those company-paid benefits that can make their lives comfortable).

Corporate law might be equally stable, efficacious, and so forth in these two nations—the real United States and the culturally differing clone—but there would be more "bad" (but mostly hidden) transactions in the culture where the outrage constraint was lower. Or, stated differently, we see an equal number of "bad" transactions in both cultures. But in the cultures where the outrage-constraint is inconsequen-

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24 See Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U Chi L Rev 1233, 1249 (arguing that Enron's problems are "symptomatic of troubling if not egregious behavior elsewhere").
tial (for example, the United States), we see these transactions in the form of high CEO compensation. And in the outrage-constrained cultures (think: France, Germany, Italy, Scandinavia), we see these transactions in the form of corporate manipulations (insider trading, related party sales, and so forth).

This—the American result—may be the cheapest managerial pursuit of self-interest. Once the manager is paid his or her expected potential in diverting value away from outside shareholders, the managers would not (in this model) engage in any more interested-party transactions.

Why? Not necessarily because they think more money cannot be had, but because of a diminishing marginal utility of money. After the, say, $20 million in compensation is had, the manager is less interested in the $2 million interested-party transaction. His sense of self-worth would be demeaned in any case by having to stoop to engineer such a deal, and with $20 million already in his bank account, the utility of the transaction to the manager is lower. And with that Swiss-cheese corporate law in place, the manager engineering that kind of a transaction puts the $20 million at risk in two ways: (1) he or she might get caught and lose that good job (and the $20 million too), and (2) secret interested-party transactions often distort the firm’s operations. That distortion can lower firm value and, if the $20 million comes in an equity interest (a stream of stock options, for example), the manager who pursues a $2 million dollar interested-party transaction that means firm value by more than 10 percent would not make money by engineering the deal.

So he or she retreats from pushing the transaction. And overall, that country might be thought to have better corporate law than the one where the manager—paid a “mere” $500,000—goes ahead with the insider trading or the interested-party transaction or the very high perqs. But it is culture that is making the difference here, not the baseline quality of corporate law or its enforcement.

IV. CULTURAL ENDOGENEITY: HOW ECONOMICS CONSTRAINS CULTURE

The world is surely more complicated than the three characteristics we have focused on thus far: takeovers as the only constraint on

25 I am here working through one cultural constraint and its effect on when outrage at managerial compensation kicks in. But one could work through a slew of such cultural constraints and see how they could affect corporate law and corporate structure. Not just: When does outrage kick in? But also: When does managerial self-restraint kick in? Why and when do players act professionally? Why and when do they act in a self-interested fashion? Or, how does one build “unit cohesion” both at the top and throughout the organization, loyalty beyond that which law requires?
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managers; compensation as the only way of making takeovers work; and cultural attitudes toward wealth as the only constraint on compensation.

One complexity is endogeneity. Cultures are a mix of traits: envy and jealousy; admiration for and resentment of those who succeed; respect for wealth and hatred of the rich, and so on. Mechanisms that succeed economically can reinforce the supporting cultural traits and suppress those that hinder the successful mechanisms.

So culture could change as corporate structures change, and there is evidence that this has been happening in Europe. But endogeneity has its own limits. Some cultural traits are so embedded that they do not change. Those that would be most susceptible to change are those that are only implicated by one new modern institution. But if the trait fits many institutions, only one of which is changing and only one of which is impeded by the constraint, that constraint will tend to endure more than the constraint that is only implicated by one changing institution. In a sense, cultural traits can be part of networks, and if only one part of the network is pressing on the constraint economically, while the others do not press (or in fact support) it, then the trait can and will persist.

V. POLITICAL AND SOCIAL LIMITS?

Managers and shareholders have been at odds in takeover contests. The rules of the game now favor managers, with takeover rules coming close now to the "just say no" defense that managers and their lawyers have long favored. Economically oriented analysis usually sees this as inefficient or—even in a friendly analysis of the pill, such as Kahan and Rock's—efficient but only after players adjust and re-equilibrate (with higher managerial compensation inducing protected managers to accept takeover bids).

As such, the economic model in its positive form needs to explain the usual antitakeover results. Here, for a brief moment, I will trace what might be a plausible economic story, sketching a possible basis for this antitakeover result to be efficient (or at least not wildly costly) in that three-player bargain. Then I shall return to our search for boundaries to the economic model.

The economic model might try to explain antitakeover results with an implicit contracts perspective. That is, one might imagine that stockholders would want to give managers discretion and authority,

26 See, for example, Proxinvest, La Rémunération des Dirigeants du CAC 40 at 5 (cited in note 22) (concluding that executive pay in France is approaching that in the United States).
27 See Martin Lipton, Pills, Poils and Professors Redux, 69 U Chi L Rev 1037 (2002) (arguing that, to be effective in negotiations, boards need to have the power to resist a takeover).
that they would believe that managers would work best if given free rein. One could certainly imagine employment systems that did so (academic tenure comes to mind). And the new literature on IPO charter terms might support a yet-to-be-developed implicit contract theory. That is, the new IPO charter literature shows that despite the presence of dominant stockholders, the newly public firms use anti-takeover terms in the charters, terms that the dominant stockholders have the means and, as usually thought, the incentives to eliminate. While an agency cost failure could explain this result, it is at least possible that there is some efficiency effect that has yet to be well understood, probably one in which autonomy yields better (or at least equal) results.

Let us put aside the potential efficiency story for takeover protection—one that is not yet convincing to us, because most of the benefits seem available by other, cheaper means. Let us look at how other boundaries limit the three-party bargain.

Managers usually win in making takeover law. Their positional advantage in the firm gives them leverage on how firms throw their weight around in the political arena. The mechanism is similar to how Victor Brudney and Allen Ferrell argue corporate charitable contributions represent managerial goals, not shareholder goals. One can and should see managers' takeover wins as partly due to their positional advantage in the firm being writ large into the polity. Corporate governance conflicts inside the firm—between managers and the board on one hand and shareholders on the other—can spill over into the polity. And who wins can depend on authority inside the firm and how alliances play out in the polity.

Once those internal conflicts spill over, agency costs could be projected onto the polity, as managers try to use corporate resources to pay for political influence. True, that kind of direct influence has long been illegal, and managers' use of corporate resources must be more indirect.


29 Field and Karpoff, Takeover Defenses at IPO Firms at 30 (cited in note 28) (pointing out that the separation of ownership and management is present at the IPO stage between manager and non-manager shareholders).

30 See Brudney and Ferrell, 69 U Chi L Rev at 1199 (cited in note 5).

But the polity can still determine some division of the spoils. This too places a limit on the economic model of corporate law. Antitakeover law was that much easier for managers to get in Ohio, Illinois, and Pennsylvania because players outside the three-party bargain—labor and "innocent" bystanders—were skeptical of takeovers. Incumbent labor, after all, has votes: it gave legislatures both a reason to favor antitakeover rules and a reason to hesitate when considering whether to overturn judge-made antitakeover rules. (Incumbent employees have votes, and since takeover law has to survive in the political arena before it gets to the economic arena, takeover law is less pro-shareholder than it would be otherwise.) These Ohio, Illinois, and Pennsylvania results left "space" for Delaware to go where it wanted to go.3

The judges' article in this Symposium introduces another political/social element in Delaware into the equation, one that reaches the antitakeover result more directly, and one that goes outside the three-player economic model. Chancellor William Allen and Vice Chancellors Jack Jacobs and Leo Strine tell us that in the back of the Delaware judges' minds sometimes are stakeholder interests, interests that cannot be—or should not be—slighted. Could this be tracing out one more boundary for the pure economic model? In one form, it could be this: There are differing allocations of authority among the three economic players at the top: more board authority in one, less in another. But unless one model or another is convincing to the chancellors, maybe convincing beyond all reasonable doubt, other considerations come into play, such as the chancellors' sympathy for the employees at the target (or at least at some targets). And hence corporate law is made with considerations beyond the economic coming into play, considerations that tip the balance between one economic model and another. And hence, we have one more boundary to the economic model of the public firm.

32 It is not obvious that if one wanted to bring employees/stakeholders to the table, the best way to do it would be to give managers more discretion, with that discretion reviewable primarily by the Chancery Court. Neither the managers nor the judges are primarily attuned to stakeholder interests. Hence, a political claim would be of an implicit "deal": incumbent employees could not get what they would want (job protection?), but could only get an implicit alliance with managers to slow down the takeover machine. Or, more cynically, managers had to adopt an employee-oriented rhetoric to stabilize antitakeover law in a way that benefited themselves.
33 The first is emeritus, the second two sitting.
34 See Lipton, 69 U Chi L Rev 1037 (cited in note 27) (arguing that boards need strong defensive powers to be strong negotiators for target shareholders).
35 See Bebchuk, 69 U Chi L Rev 973 (cited in note 5) (arguing that for target shareholders it is undesirable for boards to have a veto over outside offers to buy those shares).
CONCLUSION: GLIMPSES OF BOUNDARIES TO THE ECONOMIC MODEL OF THE CORPORATION

The economic model works well in explaining American corporate law and American corporate structures. It explains well much that we see because cultural constraints that could kick in early do not.

Explaining this or that feature by pointing to culture without specification generally is too easy. To get a better handle than we have so far on how culture can affect corporate law, law's efficacy, or the corporate structures that we do see, we should begin small, or at least narrowly, and examine how one specific cultural constraint can affect the microstructure of corporate governance in the firm.

The Articles give us one possibility: the "outrage" that is said to constrain executive pay from going even higher. If the internal outrage constraint to executive pay were low, not high (that is, if the constraint were not as weak as it is in the United States), the boundary for the economic model would be drawn differently. The Coasean bargain that keeps takeovers going in the face of hostile laws, structures, and court decisions would be less easily reversed, or not reversed at all. Takeovers would be less frequent. If other tools of making managers loyal to shareholders were much more imperfect, then performance of the large public firm would degrade, and presumably ownership structures would change: There would be a comparative advantage for closely-held corporations over public firms. Firms would be smaller and more closely held, with denser relational contracts among them. The adjustment would be more akin to the Coasean firm-versus-market adjustment of The Nature of the Firm than the internal contractarian adjustment of The Problem of Social Cost.

More could be said about how varying just this single cultural constraint could affect corporate results. Corporate law could be the same in two nations, but cultural differences could determine how managers extract rents (visibly via excess compensation or veiled via interested party transactions). If managerial compensation is very high, managers could rationally decline to pursue interested party transactions that they have a high chance of "getting away with." But if culture constrained compensation, then managers' "demand" for these transactions could be higher.

And that is just culture. Think about the Coasean possibility that several allocations of authority among shareholders, managers, and boards are (roughly) equally efficient. Most of the time, the three players decide what to do. But when they dispute results, they usually turn to other authorities to resolve their disputes—the judges or the legislators who can invoke principles and sentiments outside of the three-player bargain. Voters' skepticism about takeovers has been
noted before, as has legislators' susceptibility to labor influence. The articles in this Symposium tell us even more: The simple sympathy of the chancellors for the employees can influence some results, presumably when the direction that other considerations point to is uncertain, unclear, or moot.

And hence, out in the haze of the corporate horizon, we can catch glimmers of boundaries to the economic model of the firm.

