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See table of contents

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Article abstract

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The author identifies the following shortcomings of the economic theory of corporations. First, the contractarian interpretation overlooks the role of law and public policy in corporations. Second, using share prices as the yardstick of corporate performance and encouraging practices such as the buyback of shares have serious implications for the competitiveness and sustainability of corporations. Third, there is inadequate attention to the characteristic and normative distinctions between debt and equity. And fourth, hostile takeovers are treated as virtually the only solution to entrenched managements. The problem of managerial power must be reviewed in the light of evidence regarding managerial power and the efficacy of boards. Equally, there is a case for developing a more deliberated, fair, and equitable policy on executive pay.

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LAW, ECONOMICS, AND BEYOND: A CASE FOR RETHEORIZING THE BUSINESS CORPORATION

*P.M. Vasudev**

This essay presents a critical analysis of the economic theory of corporations and its idioms, such as "nexus of contracts", "agency costs", and "shareholder value". It calls for the development of a richer and more inclusive theory of business corporations that draws on the experience of the last three decades and better addresses the needs of the post-Enron, post-AIG world.

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À travers une analyse critique de la théorie économique des entreprises et de ses idiomes, cet essai appelle au développement d'une théorie plus riche et plus inclusive qui profite de l'expérience des trois dernières décennies et qui répond mieux aux besoins d'un monde post-Enron et post-AIG.

L'auteur identifie plusieurs défauts de la théorie économique des entreprises. Premièrement, l'interprétation contractualiste néglige le rôle du droit et de la politique publique dans les entreprises. Deuxièmement, l'utilisation du prix des actions comme mesure de performance des entreprises ainsi que les pratiques telles que le rachat d'actions ont des conséquences importantes pour la compétitivité et la viabilité des entreprises. Troisièmement, il n'y a pas assez d'attention accordée aux distinctions caractéristiques et normatives entre la dette et les actions ainsi que l'encouragement indirect de la dette. Quatrièmement, le fait de traiter l'achat hostile comme étant essentiellement la seule solution à la question de l'enchâssement des cadres est problématique. Le problème du pouvoir des gestionnaires doit être revu à la lumière des faits sur le pouvoir des gestionnaires et sur l'efficacité des conseils. De plus, les politiques de rémunération des cadres doivent être mieux réfléchies, plus justes et plus équitables.

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> It is embarrassing to admit that, after several hundred years, social scientists have not yet developed a thorough understanding of the advantages and disadvantages of publicly held profit seeking corporations versus other forms of organizations such as cooperatives, nonprofit corporations, universities, proprietorships, joint ventures and mutuals.
>
> ~ Michael C. Jensen and William H. Meckling[1]

Introduction

Economic theory of business corporations has been influential in recent decades. Its terminology, including "nexus of contracts", "agency costs", and "shareholder value", has enriched the understanding of contemporary corporations and their governance. Michael C. Jensen and William H. Meckling's article, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure",[2] and Frank H. Easterbrook and Daniel R. Fischel's article, "The Corporate Contract",[3] present classical expositions on economic theory. These works have played an important role in shaping corporate governance.[4]

This essay provides a critical analysis of the economic theory of corporations and proposes the development of a richer and more inclusive theory of business corporations. It reviews the experience of the last three decades and calls for the development of a more expansive theory that can better address the needs of the post-Enron, post-AIG world. The new theory must incorporate the lessons drawn from an economic perspective and pay attention to other significant issues, with the goal of promoting a more responsible governance of public corporations.

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1 "Corporate Governance and 'Economic Democracy': An Attack on Freedom" in C.J. Huizenga, ed., *Proceedings of Corporate Governance: A Definitive Exploration of the Issues* (Los Angeles: UCLA Extension, 1983) 1 at 14 [Jensen & Meckling, "Corporate Governance"].

2 Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J. Financ. Econ. 305 [Jensen & Meckling, "Theory of the Firm"].

3 Frank H. Easterbrook & Daniel R. Fischel, "The Corporate Contract" (1989) 89 Colum. L. Rev. 1416 [Easterbrook & Fischel, "Corporate Contract"].

4 At 2007 Roundtable for the Financial Management Association (Orlando, Fla.: 19 October 2007), Ralph Walkling stated that Jensen and Meckling's theory of the firm "revolutionized the study of corporate finance": Ralph Walkling, "U.S. Corporate Governance: Accomplishments and Failings" (2008) 20:1 J. Appl. Corp. Fin. 28 at 29. Similarly, the work of Easterbrook and Fischel has been described as "perhaps the most significant" since Adolf A. Berle Jr. and Gardiner C. Means published *The Modern Corporation and Private Property* (New York: Macmillan, 1933): Kent Greenfield, *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities* (Chicago: University of Chicago Press, 2006) at 4.

The bull phase in the stock market, which began in the early 1980s, continued almost without interruption until mid-2007. Economic theory, with its shareholder-value maxim, drew affirmation from the market and the constant rise in share prices. Recent events such as the scandals at Enron and WorldCom, the latest failures in the financial sector, and the turmoil in the capital markets since 2007, raise questions about the economic model and its theory. These developments present an opportunity for introspection and refinement of the theory of business corporations.

This essay identifies the following shortcomings of the economic theory of business corporations and their governance:

First, the contractarian interpretation is incomplete, as it overlooks the role of law and public policy in corporations. In addition to the fact that corporations are created under statutes, there is the history of regulatory intervention to consider—for example, in the areas of financial reporting and auditing. More recently, the market failures that culminated in the collapse of Enron and WorldCom at the turn of the century led to the enactment of the *Sarbanes-Oxley Act of 2002* (*SOX*).[5]

Second, the economic theory uses share prices as the yardstick of corporate performance and encourages practices such as the buyback of shares. These approaches have significant implications for the competitiveness and sustainability of corporations, as well as for their culture of governance.

Third, economic theory makes no significant distinction between equity and debt, and encourages corporations to borrow. It overlooks the impact that corporate indebtedness has on stability. The perils of leveraging are evident from the ongoing difficulties of auto majors like General Motors, Ford, and Chrysler.

Fourth, economic theory effectively endorses self-perpetuating managements and treats hostile takeovers and leveraged buyouts as the means of changing corporate control. There is a need to develop a more deliberative and nuanced public policy on the issues of entrenched managements and change of corporate control.

Fifth, the problem of managerial power, which economic theory targeted, continues to persist. Indeed, the recent failures in the financial sector suggest that the problem has now taken a different form and is more acute. The two-pronged approach advocated in economic theory—monitoring by the directors and granting stock options to managers to promote a unity of interests with shareholders—needs to be reviewed in light of fresh evidence about managerial power and the efficacy of boards.

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5 Pub.L. No. 107-204, 116 Stat. 745 [*SOX*].

Equally, there is a case for developing a more nuanced policy on executive pay.

The essay has five parts. Part I outlines the economic theory of corporations. Part II then explores the milieu in which this theory was developed. This context helps elucidate the relevance and acceptance of economic theory, and aids in assessing the theory's suitability for the present. Part III discusses the shortcomings of economic theory listed above. Finally, the conclusion argues for a richer and more inclusive theory of corporations and lays down a tentative framework for a new theory.

This essay aims to provide a critical analysis of corporate theory in recent decades and to contribute a better understanding of the present. A clear understanding of how we arrived at our current situation is essential to the search for possible options for the future. The brief reconstructive analysis in the conclusion is not intended as a comprehensive theory; rather, it outlines potential elements for a new theory of corporations.

I. Economic Theory of Corporations: An Outline

Jensen and Meckling trace their work to Ronald Coase, Adam Smith, and Berle and Means. Coase published "The Nature of the Firm" in 1937.[6] According to Coase, firms essentially resulted from cost advantages. In his model, an entrepreneur-coordinator who both owns and manages the enterprise will select the activities that can be handled internally, and those that can be handled externally. Cost will be the consideration in decision-making. For instance, a car manufacturer will choose between making batteries internally and buying them from an outside manufacturer, depending on relative cost advantages. All the relationships of the firm, both internal and external, will be governed by contracts negotiated among individuals. For internal relationships, the entrepreneur-coordinator will additionally rely on the employer's authority under the common law governing masters and servants.

Adam Smith's concern, on the other hand, was focused on the joint-stock companies of post–*Bubble Act*[7] but pre-industrial Britain. For Smith, a major issue was conflict between the shareholders who contrib-

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6 R.H. Coase, "The Nature of the Firm" (1937) 4 Economica 386. See also R.H. Coase, "The Problem of Social Cost" (1960) 3 J.L. & Econ. 1. The term "firm", as used by Ronald Coase, has since become standard in the economic discourse on corporations, although "companies" or "business corporations" have distinct characteristics. Coase's theory concerned joint business enterprises, or collective activity in which more than one individual participated. His theory was not specifically about the legal entities called corporations.

7 *Royal Exchange and London Assurance Corporation Act, 1719* (U.K.), 6 Geo. I, c. 18 (commonly known as the *Bubble Act*).

uted the capital of companies, and the directors who controlled it.[8] Smith was skeptical that the directors would take good care of the shareholders' capital and business; he believed that conflict between the two was natural and inevitable.

Writing about 150 years later, Berle and Means applied the same principle—namely, conflict between shareholders and managements—to the large industrial corporations that had emerged in the United States.[9] Berle and Means framed the issue in more explicitly political terms: the concentration of power in the corporate boards and the undermining of the property rights of large numbers of retail shareholders who were understood as the "owners" of the corporations. Ownership of corporations by shareholders is an important element in what might be termed the classical framework of corporations. Economic theory retains the proprietary notion associated with shareholders but in less precise terms.

Jensen and Meckling adopted Ronald Coase's ideas on microeconomic theory, along with those of Adam Smith, and Berle and Means on corporate governance, and wove them together into their own theory. In Jensen and Meckling's model, Coase's entrepreneur-coordinator, rechristened as an "owner-manager",[10] sells a part of the equity or ownership to outside investors.[11] Jensen and Meckling's theory is therefore about business enterprises in the corporate form.[12] The following are its core elements:

- Business corporations, or firms, are each a "nexus" of contracts;[13] in other words, they are loose networks of individuals rather than organizations.

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8 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: Random House, 1937) at 699-700.

9 Berle & Means, *supra* note 4.

10 Jensen & Meckling, "Theory of the Firm", *supra* note 2 at 312.

11 Jensen and Meckling avoided often the terms "shares" and "shareholders"; instead, they used transferable "*divisible residual claims*" and "outsiders" who purchase a portion of claims to refer, respectively, to shares and shareholders in corporations (*ibid.* at 311-12 [emphasis in original]).

12 See *ibid.* at 356. Jensen and Meckling are not certain whether their theory would apply to public corporations. For two reasons, however, it is apparent that their theory is more relevant for listed public corporations than for closely held private corporations. First, Jensen and Meckling emphasize "value"—an idea that has greater applicability for listed corporations whose shares are traded in the stock market. Second, conflict between the contributors of capital and its custodians (a central issue in the theory) would be more valid when applied to public corporations. In closely held corporations, there is usually an alignment of ownership and control and little likelihood of conflict between the two.

13 *Ibid.* at 310-11. This phrase proved to be powerful and has been the subject of numerous critiques and commentaries. See e.g. William W. Bratton Jr., "The 'Nexus of Contracts' Corporation: A Critical Appraisal" (1989) 74 Cornell L. Rev. 407.

- Maximizing the value of the firm—presumably share prices—is the goal of corporate governance.[14]
- Investors are imputed with “ownership rights”—an idea that can be traced to the classical law of corporations and the position it gave to shareholders.[15]
- Managers are placed in a nominally inferior position with regard to shareholders, and the “agent-principal” model is used to describe managers’ relationship with shareholders.
- The shares have no voting rights, and as a result, the investors have no control over the managers.[16]
- Managers are perceived as risk-averse and reluctant to make bold decisions. At the same time, they tend to pursue unprofitable growth opportunities that undermine corporate value. Managers use corporate resources, which rightfully belong to shareholders, to provide amenities for themselves and for purposes such as charity.
- Therefore, a major concern of governance ought to be “agency costs”, meaning the sum of managerial remuneration and the cost of monitoring the managers to ensure that they do not extract rents[17] from corporations.
- To resolve conflicts between managers and shareholders and encourage managers to be more enterprising, the interests of the two must be aligned. Granting stock options to managers and making them shareholders are effective ways to achieve this goal. Managers will then act in the interests of maximizing shareholder value.
- The threat of investors selling shares and the consequent fall in share prices keep the managers in check and restrain them from

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[14] This was a point of departure from both Coase’s theory and conventional ideas about corporate performance. Coase’s emphasis was on cost minimization, while corporate law had upheld the goal of profit maximization. See e.g. *Dodge v. Ford Motor Co.,* 204 Mich. 459, 170 N.W. 668 (1919). The innovation of economic theory was “value maximization”.

[15] The term “classical” is used here to refer to the hierarchical structure in corporate law that places shareholders at the top. In this framework, directors are delegates of the shareholders, and managers are, in turn, delegates of the directors. The complaint of Berle and Means about the decline of shareholder power and the rise of directors (*supra* note 4) was based on this model.

[16] Jensen and Meckling avoided the conventional term “directors”. Hence, it is not clear if the “manager” was also a director. Such an arrangement is possible but not necessary.

[17] The term “rent-seeking” is used in economic theory to refer to self-dealing by persons in control.

> rent-seeking or shirking.[18] Hence it does not matter that shareholders, who have no votes, cannot control or regulate managers.

Other than these elements, economic theory does not prescribe any management structures, responsibilities of the board and management, or policies on business strategy, innovation, expansion, or diversification. This is logical because the theory emphasizes contracts, or private arrangements. Governance and operational issues are worked out within individual corporations by contractual methods such as discussion, negotiation, and agreement, and the process is driven by the goal of value maximization. Uniform or standard prescriptions are out of place in the contractarian framework.

The shareholder-value maxim and the grant of stock options to managers promote shared interests between managers and shareholders. As a result, managers develop governance systems and handle operational issues in a manner that maximizes shareholder value. Thus, the shareholder-value maxim is considered innately capable of promoting effective corporate governance as understood in economic theory.

The work of Easterbrook and Fischel in the 1980s was inspired by Jensen and Meckling. It expands upon Jensen and Meckling's ideas regarding corporate shares, the stock market, shareholder value, and managerial power. In the following passage, Easterbrook and Fischel explain the economic conception of corporations and their shares:

> The corporation and its securities are products to as great an extent as the sewing machines or other things the firm makes. Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance structure, and securities people value. The founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure.[19]

The notion that corporations are vehicles that issue securities, and that securities are commodities traded in the stock market are important elements in economic theory. These notions encourage corporations to care as much about shares and share prices as they do about their business. Capital, represented by shares, is no longer merely a resource required for substantive business activity; it is now on par with the business. Indeed, capital drives business decisions.

Managers have to watch share prices constantly and guard against the sale of shares by investors and the consequent fall of price. This paradigm, which can be termed the "stock market model of corporate govern-

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18 Shirking, in economic theory, means the tendency to be inactive.

19 Easterbrook & Fischel, "Corporate Contract", *supra* note 3 at 1419-20.

ance", is a feature of Jensen and Meckling's theory. Easterbrook and Fischel articulate the model as follows:

> The price of stocks traded in public markets is established by professional investors, not by amateurs. These professionals—market makers, arbitrage departments of investment banks, managers of mutual funds and pension trusts, and others—handle huge sums that they are willing to use to purchase undervalued stocks. They study the firm's profits and prospectus and bid or sell accordingly. ... At any given instant, the professional traders are those who have generally been successful at assessing the worth of stock. ... If the terms of corporate provisions and the details of corporate structure have any effects on investors' welfare, this will be reflected in the profits of the firm and hence the eventual price of the stock. Professionals trade among themselves in a way that brings the present value closer to the future value ... Amateur investors then trade at the same price the professionals obtain.[20]

II. Economic Theory: Its Milieu

The economic theory of corporations can be better appreciated in the context of the political and social environment that has existed since the 1960s. Some dominant concerns of the time include:

- decisive managerial power in American corporations, coupled with shareholder passivism;
- growth strategies pursued by managers that delivered little value to shareholders;
- stagnant share prices and the inability of investors to derive capital gains from their shareholding;
- emerging hostility to economic regulation and an emphasis on market freedom; and
- the rise of the law and economics movement and the sidelining of non-economic considerations in policymaking.

Economic theory of corporations reflected the conditions of the era and targeted timely concerns. This explains its warm reception and influence. This part briefly traces the environment in which economic theory was developed. Its three subparts deal with managerial power in corporations (Part II.A), stagnant share prices in the stock market, or the lack of shareholder value (Part II.B), and disillusionment with government regulation and increased emphasis on market arrangements and freedom (Part II.C).

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[20] *Ibid.* at 1430-31 [emphasis added, footnote omitted].

A. Managerial Power and Its Implications

The notion that shareholders own business corporations became prominent in the United States in the late nineteenth century.[21] By the early twentieth century, the corporate-industrial system had become fully developed, and there was considerable participation by the public as retail shareholders of corporations. In 1932, Berle and Means highlighted the enormous powers held by the directors of corporations, and this was the first salvo against managerial power.

In 1941, James Burnham published *The Managerial Revolution*.[22] And in the 1960s, scholars such as Robin Marris[23] and William Baumol[24] wrote about corporations and the powers wielded by their managers.[25] They argued that managers pursued policies that were meant to advance their personal career interests, rather than corporate profits. Another complaint concerned the conservatism of managers and their aversion to risk. The Conglomerate Boom of the 1960s, in which corporations acquired others, has been interpreted as a manifestation of managers' tendency to diversify business and reduce risk.[26]

There were criticisms about the high levels of executive compensation; in essence, managers determined their own salaries.[27] Yet another charge against managers concerned the use of corporate resources, understood as belonging to the owner-shareholders, for general charity and personal image–building. In fact, Milton Friedman's well-known and oft-maligned article, "The Social Responsibility of Business Is to Increase Profits", dealt with managers indulging in social-responsibility projects with corporate

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21 See generally Morton J. Horwitz, "*Santa Clara* Revisited: The Development of Corporate Theory" (1985) 88 W. Va. L. Rev. 173.

22 James Burnham, *The Managerial Revolution: What Is Happening in the World* (New York: John Day Company, 1941).

23 Robin Marris, *The Economic Theory of "Managerial" Capitalism* (London: Macmillan, 1967).

24 William J. Baumol, *Business Behavior, Value and Growth*, rev. ed. (New York: Harcourt, Brace & World, 1967).

25 For a comprehensive account of the rise of managerial power, see Alfred D. Chandler Jr., *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass.: Belknap Press of Harvard University Press, 1977).

26 Yakov Amihud & Baruch Lev, "Risk Reduction as a Managerial Motive for Conglomerate Mergers" (1981) 12 Bell J. Econ. 605.

27 For an account of the 1957 conversation between Senator Kefauver and Homer, the President of Bethlehem Steel Corporation, about the level of executive compensation at the company, see John Kenneth Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1967) at 84-85.

funds.[28] He argued that managers were the stewards of shareholders' money and should not use it for "general social interest".

There was thus an environment of considerable disenchantment with managers. The perception was that managers were taking good care of themselves, but the "owner" shareholders derived little benefit.[29] Indeed, shareholders had no meaningful place in the governance framework.[30] Given the stream of complaints against managers and their power, economic theory zeroed in on "agency costs" as a central issue in corporate governance.

B. Shareholder Reward and Stagnant Share Prices

The stock market was essentially tepid in the 1960s and 1970s. There was no increase in share prices between 1966 and 1976; rather, there was a decline during the eleven-year period. The Dow Jones Industrial Average fell from 969 at the end of 1966 to 859 in 1976, after having peaked at 1,044 in 1973, as shown in Figure 1 below.

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28 Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits" *The New York Times Magazine* (13 September 1970), reprinted in Walter Ch. Zimmerli, Klaus Richter & Markus Holzinger, eds., *Corporate Ethics and Corporate Governance* (Berlin: Springer, 2007) 173. Ironically, Douglas Branson has identified 1970 as the launching year of the corporate social responsibility movement: Douglas M. Branson, "Corporate Governance 'Reform' and the New Corporate Social Responsibility" (2001) 62 U. Pitt. L. Rev. 605 at 611.

29 This is not to ignore the fact that most corporations were paying regular dividends, as will be discussed below.

30 Galbraith (*supra* note 27) was among the critics. He explained how board meetings and annual shareholder meetings, devised as important control mechanisms in the law of corporations, had become empty rituals. Galbraith described the annual shareholder meeting as "our most elaborate exercise in popular illusion" (*ibid.* at 84).

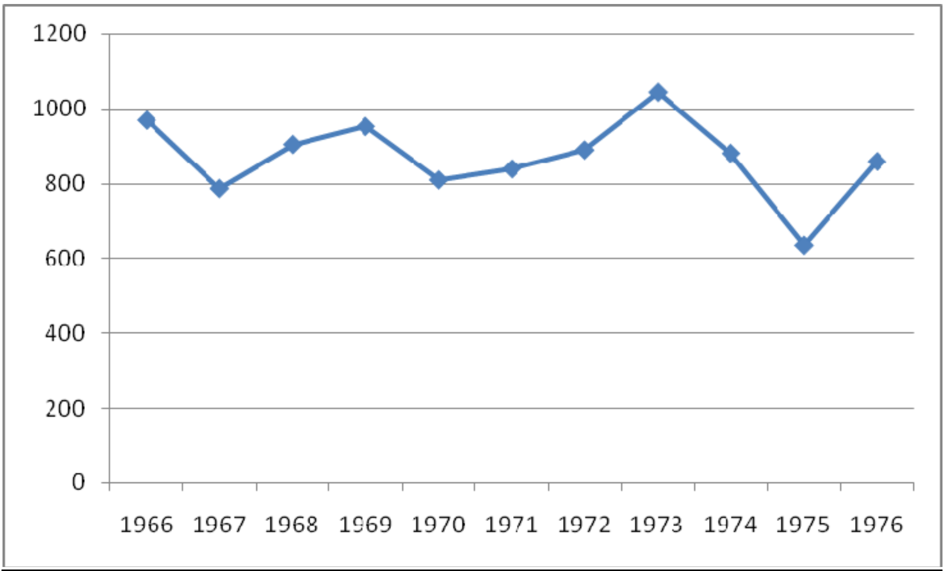

Figure 1. Dow Jones Industrial Average closing value, 1966–1976[31]

It is debatable whether any link existed between the lacklustre performance of the market and the policies and actions of corporate managers.[32] However, the result was indirectly attributed to the managers themselves. An important element of the economic framework is that managers pursue policies that benefit themselves rather than the corporations and, consequently, the shareholders.[33] From 1966 to 1976, there was hardly any share price appreciation that would benefit the shareholders, and this was considered a management failure. Accordingly, economic theory argued strongly in favor of shareholder value and advocated value maximization as the goal of corporate governance.

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[31] This figure shows the Dow Jones Industrial Average Index value at the close of each year, based on Dow Jones historical prices. See Dow Jones Indexes, online: <http://www.djindexes.com> (accessed 30 November 2008).

[32] It is not as though managers had no concern for share prices. It has been written that during the Conglomerate Boom of the 1960s, managers were attempting to stimulate increases in share prices by acquiring or merging with other companies. See George Soros, *The Alchemy of Finance: Reading the Mind of the Market* (New York: Simon & Schuster, 1987) at 56-57; Robert Sobel, *The Age of Giant Corporations: A Microeconomic History of American Business, 1914–1992*, 3d ed. (Westport, Conn.: Greenwood Press, 1993).

[33] The mathematical models used by Jensen and Meckling ("Theory", *supra* note 2) support this point of view.

C. Rise of the Anti-regulation Sentiment and the Law and Economics Movement

Other significant elements in the economic theory of corporations included the increasing disillusionment with economic regulation and the rise of the law and economics movement in the 1970s.

1. The Anti-regulation Sentiment

Government intervention in economic matters, which began with the establishment of the Interstate Commerce Commission in the 1880s and the Federal Trade Commission in 1914, reached its zenith under Franklin Roosevelt's New Deal.[34] It led to a vast expansion of bureaucracy and regulation—irksome thorns in a society founded on the ideal of liberty. By the 1970s, the limitations of bureaucratic regulation of the economy were becoming obvious, and there was an outcry against the administrative state.

The major complaints against regulation were "agency capture" and "special interests regulation"—processes by which the business interests that were supposed to be regulated gained power in the regulatory agencies. The business interests then influenced the regulatory process to suit their own purposes.[35] Regulation had fallen into disrepute, and it could not serve as the solution to any problem, including corporate governance. The solution to problems with public corporations had to be sought elsewhere, namely, in the marketplace.[36]

2. The Law and Economics Movement

Gaining influence in the 1970s, the law and economics movement encouraged the economic analysis of all phenomena—social, legal, and political.[37] Law and economics scholars interpreted the law in financial terms; they focused on its ability to promote "efficiency" or "wealth maximization" and to save on "transaction costs". They adopted tools such as Pareto efficiency and Kaldor-Hicks efficiency from the field of economics

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34 See generally Edward L. Glaeser & Andrei Shleifer, "The Rise of the Regulatory State" (2003) 41 J. Econ. Lit. 401.

35 See e.g. George J. Stigler, "The Theory of Economic Regulation" (1971) 2 Bell. J. Econ. 3; Richard A. Posner, "Theories of Economic Regulation" (1974) 5 Bell. J. Econ. 335.

36 In their agency cost theory published in 1976, Jensen and Meckling were not overtly political and did not clearly state their views against regulation. Their political message became much clearer in their subsequent writings, beginning in the 1980s. See e.g. Jensen & Meckling, "Corporate Governance", *supra* note 1.

37 The law and economics movement has been described as "the intellectual movement that has had the greatest influence on American academic law in the past quarter-century": Anthony T. Kronman, *The Lost Lawyer: Failing Ideals of the Legal Profession* (Cambridge, Mass.: Belknap Press of Harvard University Press, 1993) at 166.

and studied the economic impact of events. Pareto efficiency, or Pareto optimality, is achieved when at least one person is economically benefited and no one else is worse off. The Kaldor-Hicks model, on the other hand, accepts injury to some, provided that the benefit to others is greater than the injury, and that those who derive the benefit can compensate the injured.[38]

Law and economics scholars confined their analysis to the economic dimension and eschewed other aspects—social, political, moral, or environmental—except to the extent that these aspects could be interpreted in financial terms. This analytic tendency is an important feature of the economic theory of corporations. Jensen and Meckling describe their theory as positive, not normative.[39] Accordingly, they make no efforts to address issues such as managerial power or shareholder vulnerability in normative terms. The limited goal of economic theory is to ensure that corporate governance increases shareholder wealth. Understandably, the solution it proposed to the problem of executive compensation, namely, granting options to managers, was purely economic in content.

III. Economic Theory: A Critical Analysis

The major tenets of economic theory—the corporation as a nexus of contracts, the blurred distinction between debt and equity, and the primacy of share prices—have vitally influenced corporate governance in recent decades. Part III, which is broken into five subparts, examines the content and implications of these tenets. Part III.A examines the contractarian interpretation of corporations and describes its incompleteness. Part III.B examines the stress placed by economic theory on shareholder value and its influence on corporate governance.

Part III.C deals with corporate finance and the blurring of boundaries between debt and equity in economic theory. This blurring of boundaries has important consequences for corporate stability, and it has emerged as a critical issue in the ongoing credit crisis. Part III.D examines the change

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38 For a discussion of the concepts, see Richard A. Posner, *Economic Analysis of Law,* 7th ed. (New York: Aspen, 2006) at 12-15. In the Kaldor-Hicks test, the stress is on the ability of the beneficiary to compensate the victim, rather than on the ability of the victim to claim and recover compensation. Posner has argued that the Kaldor-Hicks level of efficiency is quite aligned with "the ethical system of our market-oriented society" and reflects, to some extent, its "fundamental social norms" (*ibid.* at 26).

39 Jensen & Meckling, "Theory of the Firm", *supra* note 2 at 309-10. There is *some* normative content in the theory—for instance, the effort to align the interests of the shareholders and the managers. This effort is normative, although motivated by the economic consideration of increasing shareholder value. It is an indication of the risks inherent in pursuing highly stylized approaches, and it underscores the importance of greater holism in dealing with such issues.

of corporate control and takeovers, as well as economic theory's approach to these issues. Part III.E reviews the prescriptions of economic theory on managerial power, namely, monitoring by directors, executive pay, and aligning managerial and shareholder interests through the grant of stock options to managers.

A. The Corporation as a Nexus of Contracts

Economic theory presents the corporation as a "nexus of contracts". The idea of contract is hardly new to corporations or their law; it was the foundation of the joint-stock companies in Britain in the seventeenth century.[40] In the United States, the contract principle has been used in a variety of contexts, from the corporate charter granted by the state[41] to the later idea that the articles of incorporation were prepared under the general incorporation statutes.[42] The contractarian notion in economic theory, however, is much broader. It offers a contrast to the hierarchical structure in classical corporate law,[43] which places shareholders at the top, as illustrated in the Figure 2 below.

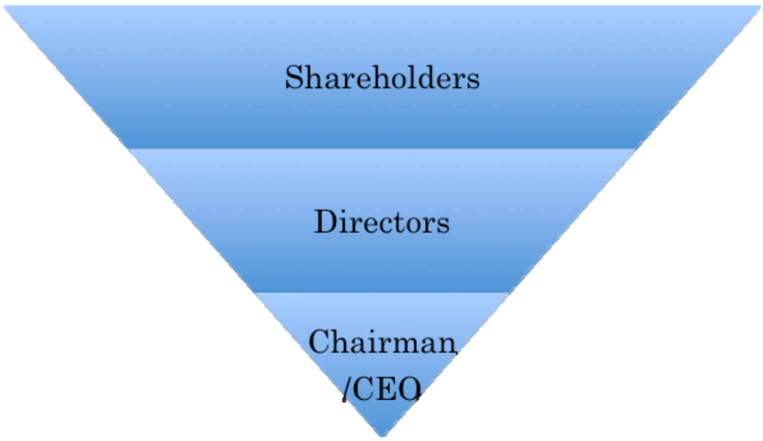

Figure 2. Constitutional hierarchy in classical corporation

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[40] The deeds of settlement used by the joint-stock companies were a contractual document. See William Robert Scott, *The Constitution and Finance of English, Scottish and Irish Joint-Stock Companies to 1720*, vol. 1 (Gloucester, Mass.: Peter Smith, 1968) at 327.

[41] *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819).

[42] See Henry O. Taylor, *A Treatise on the Law of Private Corporations Having Capital Stock* (Philadelphia: Kay & Brother, 1884) at 17-19.

[43] See s*upra* note 15 and accompanying text.

The contractarian framework, on the other hand, is both broader and more egalitarian. It includes other corporate constituencies, such as creditors, suppliers, and employees.[44] The traditional notions of hierarchies and authority are not prominent; instead, the corporation is understood as a loose network, as shown in Figure 3 below.

Figure 3. Standard contractarian account of the firm as a nexus of contracts[45]

The contractarian interpretation shifts the focus to individuals and human behaviour, while discouraging examinations of the corporate form, legal structures, or hierarchies. It rejects the notion that corporations are organizations or entities in themselves. Instead, as Jensen and Meckling argue, corporations are like "the wheat or stock market", where individuals participate and transact business.[46] This nominally egalitarian vision of corporations is quite removed from the classical model of the law of corporations, which contains a hierarchy that places shareholders at the top,

[44] See Jensen & Meckling, "Theory of the Firm", *supra* note 2 at 310.

[45] For this account of the firm, see Stephen M. Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance" (2003) 97 Nw. U.L. Rev. 547 at 554.

[46] Jensen & Meckling, "Theory of the Firm", *supra* note 2 at 311.

directors below them, and managers at the bottom.[47] The nexus of contracts vision reflects the reality of corporations arguably better than the traditional hierarchical model.[48]

The networks of individual actors are bound by contracts; this is the "nexus of contracts" corporation. Here, "contract" is not used in a technical sense, and it would be unfair to strain the model with the technicalities of the law of contract such as offer, acceptance, consideration, and more importantly, a meeting of the minds or free consent.[49] Jensen and Meckling's contractarian model is ideological rather than technical.[50] The emphasis is on liberty and freedom—in other words, a contract as a private arrangement among individuals in contrast with state-ordered or regulated arrangements.[51]

Individuals participating in the market are assumed to have the ability to prepare the best possible contracts. Recently, the influence of this assumption appeared in the Supreme Court of Canada decision, *BCE v. 1976 Debentureholders*.[52] The bondholders of Bell Canada challenged the leveraged buyout of the company on the ground that such burdensome borrowing had not been contemplated when they subscribed to its bonds. Interestingly, given the context of an oppression action, the Court confined its inquiry to the contract among the parties and ruled that the con-

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47 See Figure 2, above.

48 In developing their contractarian thesis, Jensen and Meckling also acknowledge the work of Alchian and Demsetz. See Armen A. Alchian & Harold Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62 Am. Econ. Rev. 777. Alchian and Demsetz reject authority as the organizing principle in corporations and present negotiated agreements as a more accurate explanation. Considering the power that labour unions wielded at that time, this appears reasonable.

49 Berle and Means point out the anomalies arising from treating the articles of incorporation as contracts: Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property*, rev. ed. (New York: Harcourt, Brace & World, 1968) at 128 [Berle & Means, rev. ed.]. Easterbrook and Fischel, however, suggest that these anomalies do not matter in writing that "even the ignorant" investors who know little of corporate transactions can participate in the contractual nexus ("Corporate Contract", *supra* note 3 at 1435). For criticisms of the nexus of contracts conception from the perspective of the law of contract, see Robert C. Clark, "Agency Costs versus Fiduciary Duties" in John W. Pratt & Richard J. Zeckhauser, eds., *Principals and Agents: The Structure of Business* (Boston: Harvard Business School Press, 1985) 55. See also Victor Brudney, "Corporate Governance, Agency Costs, and the Rhetoric of Contract" (1985) 85 Colum. L. Rev. 1403.

50 For a discussion of the ideology underlying the contractarian model of Jensen and Meckling, see Melvin A. Eisenberg, "The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm" (1999) 24 J. Corp. L. 819.

51 The analysis in this part is concerned more with the role of the state in regulating corporate governance, rather than with the role of the courts in adjudicating disputes. Hence, the focus is on statutes and regulations.

52 2008 SCC 69, [2008] 3 S.C.R. 560, 301 D.L.R. (4th) 80 [*BCE*].

tract was the final word. Accordingly, the Court declined to interfere with the transaction.[53]

In their agency costs theory published in 1976, Jensen and Meckling characterize corporations as "legal fictions" but do not expand upon the idea. In 1982, they elaborate on the argument that corporations are private arrangements:

> [T]he corporation is *neither* the creature of the state *nor* the object of special privileges extended by the state. The corporation did not draw its first breath of life from either a minister of state or civil servant. More importantly, the corporation requires for its existence only freedom of contract. Corporate vitality in no way is dependent on *special* dispensation from the authorities.[54]

Easterbrook and Fischel also adhere to the contractarian principle. As legal scholars, however, they were more alive to the logical difficulties inherent in the wholesale rejection of the law. They began by stressing the open character of corporate law and the general freedom corporations have to organize their affairs: "The corporate code in almost every state is an 'enabling' statute. An enabling statute allows managers and investors to write their own tickets, ... without substantive scrutiny from a regulator and without effective restraint on the permissible methods of corporate governance."[55]

On the absence of checks on corporate managers and the limited scope of judicial review of their actions, Easterbrook and Fischel note, "The handiwork of managers is final in all but exceptional or trivial instances. Courts apply the 'business judgment doctrine,' a hands-off approach that

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53 The transaction fell through, however, because the independent auditor certified that Bell Canada would not pass the solvency test after the buyout. This is discussed below.

54 Michael C. Jensen & William H. Meckling, "Reflections on the Corporation as a Social Invention" (*Controlling the Giant Corporation: A Symposium,* Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, 1982) at 7 [emphasis in original]. Jensen and Meckling raise important jurisprudential issues about the role of the state and the rights of individuals. For a discussion of these themes, see Robert Hessen, *In Defense of the Corporation* (Stanford: Hoover Institution Press, Stanford University, 1979). These themes, however, are complex and a full discussion is beyond the scope of this essay. The following discussion therefore does not go into the technicalities and proceeds on the basis that current corporate statutes are valid, as evidenced by the absence of any serious legal challenge to them and the general compliance with their terms. The statutes, which are laws enacted by elected legislatures in modern democratic societies, have a number of mandatory rules, such as the election of directors by shareholders, management by or under the supervision of directors, and the solvency test for applying corporate resources for the benefit of shareholders. These statutes are widely followed and enforced, thus demonstrating the role that public policy plays in the creation and governance of corporations.

55 Easterbrook & Fischel, "Corporate Contract", *supra* note 3 at 1417.

they would never apply to the decisions of administrative agencies or other entities."[56]

Easterbrook and Fischel concede a fairly inconsequential position for the law. They refer to some mandatory rules, such as the fiduciary duties of directors and officers, quorum for meetings, corporate reporting, and division of powers between the stockholders and the directors,[57] but their discussion is brief and tentative. Toward the end of their article, they pose the following questions: "[W]hy law? Why not just abolish corporate law and let people negotiate whatever contracts they please?"[58]

To these basic questions, Easterbrook and Fischel provide the following answer, which is essentially utilitarian:

> [C]orporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting. There are lots of terms, such as rules for voting, establishing quorums, and so on, that almost everyone will want to adopt. Corporate codes and existing judicial decisions supply these terms "for free" to every corporation, enabling the venturers to concentrate on matters that are specific to their undertaking.[59]

Easterbrook and Fischel's description of their own answer as not "entirely satisfactory"[60] is an admission of the limitations of the contractarian approach. It is true that incorporation is now a right, rather than a privilege as it used to be, and the law is minimally intrusive. However, it is equally true that corporate and securities laws do exist. Incorporation is made possible only by following the procedures prescribed under the corporate statutes that, together with securities laws, govern corporations during their existence. Economic theory fails to deal with this fact in a satisfactory manner.[61]

Economic theory has at its centre the powerful "owner-manager", which corresponds to the chief executive officer (CEO) of a corporation. In the law of corporations, management powers lie with the directors. In reality, however, CEOs wield substantial control over the directors.[62] As a result, CEOs hold the powers that are nominally vested in the directors. The powers of the directors are, in turn, defined by the statutes. Begin-

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56 *Ibid.*

57 *Ibid.* at 1417-26.

58 *Ibid.* at 1444.

59 *Ibid.*

60 *Ibid.*

61 For an account of the development of theory on this subject since the nineteenth century, see Bratton, *supra* note 13.

62 See Myles L. Mace, *Directors: Myth and Reality* (Boston: Graduate School of Business Administration, Harvard University, 1971).

ning in the 1880s, all major corporate powers shifted from the shareholders to the directors through a series of statutory amendments.[63] In other words, the powers of the owner-manager/CEO, which are in effect the powers of the board, are essentially derived from statute law. This fact is another important reason for corporate theory to pay attention to statutes.

Given their emphasis on contracts, Jensen and Meckling interpret almost all issues of corporate finance and governance in contractarian terms. They list a number of issues that could be explained by their contractarian theory,[64] including corporate financial reporting and auditing. According to economic theory, corporate reporting and the mechanism of audit results from the voluntary initiative of corporations, or from contracts among investors and managers; regulation plays no role.

This perspective is refuted by the history of corporations. Corporate disclosures and audit are the instruments for promoting transparency and accountability, and the law of corporations has dealt with them throughout history, as discussed below. In recent years, the amendment made to the Delaware statute following the decision in *Smith v. Van Gorkom*,[65] as well as the enactment of *SOX*, provide powerful illustrations of the influence that legislation wields over corporate governance.

1. Reporting by Corporations

American jurisdictions do not have a uniform requirement for the submission of reports by managements. Only twenty-two states have such a requirement in their statutes.[66] The position is different in the United Kingdom, where financial reporting and audit have been mandatory since the first general incorporation statute was enacted in 1844.[67] The gap in the United States was filled by the *Securities Exchange Act of 1934*, which placed public corporations under a duty to submit annual and quarterly financial reports.[68] David Hawkins traces the development of financial reporting by public corporations since before the 1930s, when the matter did not yet fall under the domain of public regulation.[69] Hawkins describes

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63 See generally David Millon, "Theories of the Corporation" (1990) Duke L.J. 201.

64 Jensen & Meckling, "Theory of the Firm", *supra* note 2 at 306.

65 488 A.2d 858 (Del. 1985) (also known as the "Trans Union case").

66 See James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 1780–1970* (Charlottesville, Va.: University of Virginia Press, 1970) at 90.

67 *Joint Stock Companies Act, 1844* (U.K.), 7 & 8 Vict., c. 110.

68 15 U.S.C. § 78m [*Securities Exchange Act*].

69 David F. Hawkins, "The Development of Modern Financial Reporting Practices among American Manufacturing Corporations" (1963) 37 Bus. Hist. Rev. 135.

the situation at the turn of the twentieth century, when the American corporate system was emerging:

> As late [as] 1900, the amount of financial information presented to stockholders by the managers of most publicly owned American manufacturing corporations was meager. The little information actually revealed was "invariably colored by the point of view of the corporation, and frequently unreliable because of 'sins of omission.' " In fact, so secretive were some manufacturing companies that even into the twentieth century they failed to make available to investors any financial information other than the company's capitalization and dividend record. Included among this group was the American Sugar Refining Company, which had some 10,000 stockholders and was one of the most actively traded stocks on the New York Stock Exchange.[70]

On the one hand, there was a tendency toward secrecy, on the formal plea that such secrecy was important for business purposes. On the other hand, there was a view that corporate reports were simply unnecessary.[71] In 1895, the New York Stock Exchange introduced a rule that required listed corporations to submit annual reports,[72] but its efforts were not successful. Recently, Lawrence Mitchell has reviewed the development of corporate reporting in the United States since the late nineteenth century, and his account largely affirms the findings of Hawkins that inadequate disclosure systems remained in place until regulation intervened in the 1930s.[73]

There is little historical evidence to show either that managers voluntarily came forward to submit reports, or that there were contractual arrangements on these issues. Such voluntary arrangements might be possible in small closely held corporations, but public corporations with large numbers of shareholders scattered over wide geographic areas are a different matter. With public corporations, it was legislative intervention that tipped the scales. The acute lack of adequate and uniform systems for corporate disclosures was addressed by the enactment of securities laws, which made reporting by public corporations mandatory.[74]

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70 *Ibid.* at 135, citing Arthur S. Dewing, *Corporate Promotions and Reorganizations* (Cambridge, Mass.: Harvard University Press, 1914) at 12.

71 See Hawkins, *supra* note 69 at 141.

72 See Lance E. Davis & Larry Neal, "The Changing Roles of Regional Stock Exchanges: An International Comparison" (Paper presented at Social Science History Association Annual Meeting, Chicago, Ill., 19-22 November 1998) [unpublished].

73 Lawrence E. Mitchell, *The Speculation Economy: How Finance Triumphed Over Industry* (San Francisco: Berrett-Koehler, 2007) at 106-12.

74 For a history of the enactment of securities laws in the United States in the 1930s, see Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance*, 3d ed. (New York: Aspen, 2003).

2. Audit

Here again, the evidence points to ineffective market arrangements. As noted above, audit has been a mandatory feature of English company law since 1844;[75] however, no similar requirement existed in the corporate statutes of American states. Audit was therefore largely a matter of choice until the *Securities Exchange Act* made it compulsory.[76]

David Hawkins has also studied the emergence of audit in American corporations, and his findings are no different from those on corporate reporting. Corporations were reluctant to allow audits, and although the accountants sought legislative support in the matter, they were not successful. Early in the twentieth century, the New York Stock Exchange and the Investment Bankers Association of America (two influential agencies) made efforts to introduce uniform and compulsory audit and accounting standards for listed corporations, but they, too, were unsuccessful. The stock market crash in 1929 to 1930 gave rise to fresh efforts, and finally, in January 1933, the New York Stock Exchange introduced a rule requiring compulsory audit.[77]

Shortly thereafter, the *Securities Exchange Act* intervened and made audit a statutory requirement for listed corporations. Up to as late as 1933, there was therefore no uniform auditing practice among public corporations. This is not to deny that there were corporate audits, but the question is whether these private arrangements were adequate or satisfactory. David Hawkins's account suggests that they were not, and that statutory intervention was the solution. This conclusion is also supported by a recent study of the development of audit in the United States by Professor John Coffee Jr.[78]

Easterbrook and Fischel consider the legal rules on mandatory disclosures and audits and provide a historical account. They examine contemporary corporate practice during the period before the federal securities laws were enacted in the 1930s. Easterbook and Fischel, however, do not refer to David Hawkins, whose work contradicts their emphasis on the efficacy of market arrangements. After examining the rules on mandatory disclosure in economic theory's framework of self-interest, economic efficiency, and cost, Easterbrook and Fischel concede, "There is also no good evidence that the [statutory] rules are harmful or very costly. We are left, for the moment at least, with arguments rather than proof. And the ar-

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75 The concept of audit, however, existed in Anglo-American organizations even earlier and was adopted in statute. See John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (New York: Oxford University Press, 2006) at 109-10.

76 *Supra* note 68*,* § 78m(a)(2). See also Regulation S-X, 17 C.F.R. § 210 (2010).

77 See Hawkins, *supra* note 69 at 159.

78 *Supra* note 75.

guments are themselves inconclusive."[79] This candid statement reveals the limitations of the contractarian approach of economic theory when applied to the vital issue of corporate reporting and audit. It affirms the public-private character of corporations and the combination of public- and self-regulation that governs these important institutions.

3. Corporate Law and Creditor Protection

The classical model of corporations maintains a significant distinction between share capital and debt. This distinction was once a central element in corporate law, and it defined the corporate control mechanism. Shareholders contributed the capital stock, which was treated as the core of corporations, and was fully exposed to business risks. Shares represented units of the capital, and its holders had proportionate voting rights that enabled them to elect the directors or constitute corporate control. In economic terms, the shareholder capital's exposure to risk justified the shareholders' legal power to elect, regulate, and remove the directors in whom the law vests management rights.

As a recognition of shareholder power, the law now forbids the application of corporate resources for the shareholders' benefit, unless a corporation can meet its liabilities to creditors. This is the foundation of the solvency test in modern corporate law. Creditors, whose capital is also tied up in corporations, have no statutory powers of control; hence, the law intervenes on their behalf to protect their interests.

Shareholders' funds represent the more stable portion of a corporation's capital; share capital is neither entitled to any fixed remuneration nor liable to be repaid, unless the corporation can meet its liabilities to creditors.[80] Creditors' funds, on the other hand, are the floating capital that must be serviced and repaid according to the terms of contract, irrespective of the corporation's financial position.

After providing for the liabilities to creditors, whatever remains in a corporation belongs to its shareholders. This is the basis of the proprietary notion that is associated with shareholders in corporate law and the idea of the residual claimant in economic theory. The shareholder capital's greater exposure to risk and the shareholders' proprietary position are the theoretical justifications for the powers that shareholders have in corporate law. These justifications also explain the absence of similar powers for creditors of all varieties, including bondholders, lending banks, and

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[79] Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991) at 314.

[80] This is equally true of preferred stock or preference shares, which often carry the right to a fixed dividend and are redeemable. Payments to the holders of preference shares would be subject to the solvency test.

vendors who sell goods or services on credit. The law thus has both normative and economic elements, and the solvency test is the statement of its principle of creditor protection. This is a brief description of corporate finance in the classical model.

The Trust Fund Doctrine, developed by American courts in the nineteenth century, treated corporate property as property held in trust for the benefit of creditors.[81] Express protection for creditors was not considered necessary in English company law until the protection of limited liability was introduced for the shareholders in 1855.[82] Soon, the Doctrine of Capital Maintenance was developed. It was similar to the Trust Fund Doctrine and was intended to protect creditors. The principle of creditor protection has subsequently been codified.[83]

Economic theory substantially ignores the principle of creditor protection, which is a longstanding feature of corporate law. Instead, economic theory interprets the relationship between corporations and their creditors in purely contractarian terms.[84] Creditor protection is an expression of the public policy concerns in corporate law—its normative content. Here, the law and contract play complementary roles. The law lays down a ground rule—the solvency test—and leaves it to the corporations and their creditors to develop case-specific arrangements through contract. In this setup, interpreting corporate relationships with creditors in purely contractual terms would be inappropriate. Neglect of the legal principle of creditor protection is not merely a doctrinal issue. As we will see below, economic theory carries the omission further and treats equity and debt almost on par.

4. Recent Experience: *Smith v. Van Gorkom* and *SOX*

The influence of statutes on corporate governance is not merely an historical fact. Statutes actively continue to shape the practices of corpo-

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81 For a recent discussion of the Trust Fund Doctrine, see Henry T.C. Hu & Jay Lawrence Westbrook, "Abolition of the Corporate Duty to Creditors" (2007) 107 Colum. L. Rev. 1331. The authors argue that the traditional distinctions between shareholders and creditors are no longer relevant, and they call for the abolition of the creditor-protection principle in the law of corporations. Courts have applied the Trust Fund Doctrine in the following cases: *Wood v. Dummer*, 3 Mason 308, 30 F. Cas. 435 (C.C.D. Me. 1824); *Railroad Co. v. Howard*, 74 U.S. (7 Wall.) 392 (1868).

82 *Limited Liability Act, 1855* (U.K.), 18 & 19 Vict., c. 133.

83 See e.g. *Companies Act 1985* (U.K.), 1985, c. 6, s. 263. For a comprehensive discussion of creditor protection in English company law, see John Armour, "Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law" (2000) 63 Mod. L. Rev. 355.

84 See Jensen & Meckling, "Theory of the Firm", *supra* note 2 at 337-38.

rations. In *Smith v. Van Gorkom*,[85] the court held that the directors of a corporation breached their duty of care in accepting the share price offered in a takeover. Following this decision, Delaware, with its pro-management bias, amended the statute to provide the flexibility for corporations to relieve their directors from liability for breach of the common law duty of care.[86] In a survey of the top 100 Fortune corporations, Robert Brown Jr. and Sandeep Gopalan found that all but one of the corporations had adopted the waiver of liability provision.[87] This is recent proof of the influence of legislation on corporate governance.

An even more recent illustration of statutory intervention is *SOX*, which was enacted in 2002 in the aftermath of the scandals at Enron, WorldCom, and other major corporations. The financial misstatements by these corporations were only one dimension of the scandals. In addition, the market realities in matters such as auditors' relationship with clients, monitoring by directors, and the functioning of investment analysts revealed serious deficiencies in corporate governance. Once again, the government stepped in with a heavy hand as the nominal guardian of public interest.[88] It is up for debate whether criminalization of corporate reporting and the archaic command-and-control method of regulation as applied in *SOX* are the appropriate means of promoting good corporate governance.

B. Shareholder Reward and Short-termism

Economic theory introduces a new approach to shareholder reward by focusing almost exclusively on share prices. In a recent panel discussion, Michael Jensen explained how he argued that management performance ought to be measured by movements in share prices when he was on the board of directors of Armstrong World Industries.[89] His argument exhibits a different way of thinking—one that treats the stock market and share prices as the barometers of corporate performance.

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85 *Supra* note 65.

86 Del. Code Ann. tit. 8 § 102(b)(7) (West Supp. 2010).

87 J. Robert Brown Jr. & Sandeep Gopalan, "Opting Only In: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom" (2009) 42 Ind. L. Rev. 285.

88 The statute and its promotion by President George W. Bush illustrate the habit of placing the government in a paternalistic position as a force for good, and for setting right the wrongs. This conflicts with the other dominant school of thought in the Anglo-American tradition that fiercely opposes government intervention in the name of liberty, and argues that government intervention only compounds the problems. For the text of President Bush's speech to the Association for a Better New York in July 2002 commending *SOX*, see Remarks on Corporate Social Responsibility in New York City, 2002 Pub. Papers 1194 (9 July 2002), online: <http://www.gpo.gov> [Bush, *2002 Address*].

89 See Walkling, *supra* note 4 at 32.

The principle of shareholder primacy, stated with dramatic effect in *Dodge v. Ford Motor Co.*,[90] places directors under a duty to maximize business profits for the benefit of the shareholders. Economic theory alters that duty, however, by making it a duty to maximize value for shareholders, not profit for the corporations. In the new model, profits are relevant only to the extent of their impact on share prices.

In the traditional profit-maximizing model, corporations pay shareholders a part of their profits as yearly dividends and retain the rest for business use in expansion, diversification, renovation, or as reserves. The theory is that as a result, the corporate business will grow over time and the value of the shares will increase. Dividends as a regular stream of income and capital gains from higher share prices are the two central elements in the conventional scheme of rewarding shareholders.

The dividend model is based on the idea that shareholders' funds represent the capital employed in the business,[91] and this has to be remunerated periodically out of the profits earned by the business. Economic theory holds a different view. It encourages corporations to use profits (more precisely, "free cash flows") for making share repurchases. Dividends are not favoured. Economic theory's approach was propounded at a time when corporations paid dividends quite regularly. In 1981, Martin Feldstein and Jerry Green estimated that over the previous fifteen years, dividends averaged forty-five per cent of the real after-tax profits of corporations.[92] The title of their article "Why Do Companies Pay Dividends?" points to the changing approach.[93]

Economic theorists have provided a number of reasons for their preference for share repurchases over dividends. To begin with, economic theorists point to the agency problem. When managers retain a large part of the earnings, they tend to use it to increase their wealth and power, or to make unprofitable investments.[94] This problem is consistent with the individualistic "nexus of contracts" vision and the absence of the notion that corporations are organizations. Within this framework, the future welfare of the corporation and the plans or investments to get there have

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[90] *Supra* note 14.

[91] The concept of earnings per share can be traced to this idea. It interprets the profits in terms of the capital employed and each unit of the capital.

[92] Martin Feldstein & Jerry Green, "Why Do Companies Pay Dividends?" (1983) 73 Am. Econ. Rev. 17 at 17.

[93] See also Frank H. Easterbrook, "Two Agency-Cost Explanations of Dividends" (1984) 74 Am. Econ. Rev. 650.

[94] See e.g. Gordon Donaldson, *Managing Corporate Wealth: The Operation of a Comprehensive Financial Goals System* (New York: Praeger, 1984) [Donaldson, *Managing Corporate Wealth*]. See also Galbraith, *supra* note 27 at 81.

little relevance. The natural tendency is for individuals to draw the available cash from corporations.

The solution was therefore to ensure that corporations paid out most of their free cash flows to the shareholders, preferably through share repurchases rather than dividends.[95] Share repurchases were preferred because shareholders would pay a lower tax rate on the resulting capital gains.[96] The reduction in the number of outstanding shares, resulting from the repurchases, would also increase the earnings per share for the remaining shares and lead to higher market valuations in the future.

These ideas were influential, as evidenced by events in the 1980s and 1990s. Enormous growth in share repurchases occurred between 1977 and 1987. Bagwell and Shoven found that the payout toward repurchases by the corporations included in their survey increased from $3.36 billion in 1977 to $54.3 billion in 1987.[97] Evidence of increased share prices following repurchase also vindicated economic theory.[98]

Correspondingly, there was a decline in the trend for payment of dividends. Eugene Fama and Kenneth French have estimated that the percentage of corporations paying dividends declined from 66.5 per cent in 1978 to 20.8 per cent in 1999.[99] Dividends did not, however, disappear from the corporate landscape.[100] In a survey of 2,445 firms, Bagwell and Shoven found that the firms' total dividend payouts increased from $29.5 billion in 1977 to over $83 billion in 1987.[101]

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95 See Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers" in *Papers and Proceedings of the Ninety-Eighth Annual Meeting of the American Economic Association* (May 1986), (1986) 76 Am. Econ. Rev. 323 [Jensen, "Agency Costs"].

96 The tax advantage has since been neutralized by the *Jobs and Growth Tax Relief Reconciliation Act of 2003*, Pub. L. No. 108-27, 117 Stat. 752 (2003).

97 Laurie Simon Bagwell & John B. Shoven, "Cash Distributions to Shareholders" (1989) 3:3 J. Econ. Persp. 129 at 131. All dollar figures presented in this essay is in U.S. dollars.

98 See generally Aharon R. Ofer & Anjan V. Thakor, "A Theory of Stock Price Responses to Alternative Corporate Cash Disbursement Methods: Stock Repurchases and Dividends" (1987) 42 J. Fin. 365.

99 Eugene F. Fama & Kenneth R. French, "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?" (2001) 60 J. Fin. Econ. 3.

100 More recently, Julio and Ikenberry surveyed the dividend record of all U.S. industrial corporations from 1984 to 2004 and detected a spike in the trend for dividend payments since 2000. The jump is especially steep in 2002, after the stock market collapsed and Enron and other corporate scandals surfaced at the turn of the century: Brandon Julio & David L. Ikenberry, "Reappearing Dividends" (2004) 16:4 J. Appl. Corp. Fin. 89. See also William W. Bratton, "The New Dividend Puzzle" (2005) 93 Geo. L. J. 845.

101 Bagwell & Shoven, *supra* note 97 at 131.

The shift in the shareholder reward model—from dividends to repurchases—reinforced the preoccupation with share prices.[102] The following critical remarks about share buybacks have been attributed to Alan Greenspan, the former chairman of the Federal Reserve:

> Before 1980, share buybacks were discouraged ... . Returns were driven by dividends. Earnings are a very dubious measure ... . There are so many tools a CEO can use to "craft" an earnings statement, so many ways to mislead. All asset values, after all, are just based on forecast ... . There's been too much gaming of the system until it is broke.[103]

Innovative methods were developed to encourage managers to pay special attention to share prices.[104] One such device was to link the stock options granted to managers with the performance of stock indexes. The compensation package of Kenneth Lay, Chairman of Enron, was based on this formula. Vesting of the stock options granted to Lay was conditional on the price of Enron shares outperforming the Standard & Poor Index.[105]

These trends led to significant changes in the style of governance. Corporations tended to ignore long-term growth and sustainability, and they were unwilling to make investments that did not yield immediate benefits. Also, the corporations aimed to increase share prices, rather than profits or profitability. These trends have made a significant contribution to corporate short-termism. In 1997, Michael Porter explained:

> Maximizing "shareholder value," as measured by current stock price, is explicitly codified in many companies as the corporate goal. The dominant influence on corporate goals is management, who are often subject to limited direct influence either by boards, which are dominated by outside directors with no other links to the firm, or by owners [shareholders], who typically hold fragmented stakes in hun-

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[102] For a recent statement of this idea, see Jeffrey N. Gordon, "The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices" (2007) 59 Stan. L. Rev. 1465.

[103] Ron Suskind, *The Price of Loyalty: George W. Bush, the White House, and the Education of Paul O'Neill* (New York: Simon & Schuster, 2004) at 226 (quoting Alan Greenspan), also cited in Charles W. Murdock, "Corporate Corruption and the Complicity of Congress and the Supreme Court: The Tortuous Path from *Central Bank* to *Stoneridge Investment Partners*" (2009) 6 Berkeley Bus. L.J. 131 at 134.

[104] See e.g. Lucian Bebchuk & Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, Mass.: Harvard University Press, 2004) at 140-42. The authors focus on methods of reducing managers' windfalls from share price increases.

[105] Enron Oregon Corp., Annual Report (Form 10-K) (31 December 1996), Exhibit 10.25 online: SEC Edgar <http://www.sec.gov/edgar> [Enron, *Kenneth Lay*] (employment agreement of Kenneth Lay).

> dreds of different companies. The goals set by American managers are typically framed in terms of ROI or increasing stock price.[106]

Porter identified the following major trends that resulted from the stock-market model of corporate governance:

- sensitivity to current returns and concern about share prices, which discouraged investment;
- preference for investments with measurable financial returns;
- preference for investments in discrete projects over investments for enhancing capabilities on an ongoing basis;[107]
- preference for acquisitions over internal development; and
- greater readiness to invest in high technology and emerging industries.[108]

Peter Hall and David Soskice, who have studied the varieties of capitalism, affirm Porter's conclusions regarding the focus of corporations on the stock market, in what they have classified as "liberal market economies" or "LMEs".[109] They observe that "[s]everal features of the financial systems or markets for corporate governance of liberal market economies encourage firms to be attentive to current earnings and the price of their shares on equity markets."[110] Noting that certain types of "[c]ompanies with readily assessable assets associated with forward income streams ... need not be as concerned about current profitability," Hall and Soskice conclude, that "the markets for corporate governance in LMEs encourage firms to focus on the publicly assessable dimensions of their performance that affect share price, such as current profitability."[111]

Economic theory's encouragement of corporate short-termism is an important issue. The accounting scandals at a number of corporations (in

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106 Michael E. Porter, "Capital Choices: Changing the Way America Invests in Industry" in Donald H. Chew, ed., *Studies in International Corporate Finance and Governance Systems: A Comparison of the U.S., Japan, and Europe* (New York: Oxford University Press, 1997) 5 at 10 [emphasis in original].

107 The current difficulties of the American automobile industry illustrate this trend. Faced with rising gasoline prices and falling sales of fuel-inefficient cars, the manufacturers did not pay adequate attention to market imperatives and failed to make the necessary investments. See e.g. Carol J. Loomis, "The Tragedy of General Motors" *Fortune* 153:3 (20 February 2006) 58, online: Fortune <http://fortune.com>.

108 Enron, *Kenneth Lay*, *supra* note 105 at 11-12.

109 Peter A. Hall & David W. Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001). The liberal market economies identified by Hall and Soskice are the U.S., the U.K., Canada, Australia, and New Zealand.

110 *Ibid.* at 27 [emphasis in original].

111 *Ibid.* at 29.

particular, most of the events at Enron) can be explained in terms of the shareholder-value model of corporate governance that economic theory advocates.[112] Managers and shareholders are both encouraged to focus almost solely on the value that they can personally derive. This is consistent with the individualistic vision of corporations, which has little regard for the corporate organization or its welfare. Michael Jensen realizes the limitations of this approach; he emphasizes the "organization" and long-term value of corporations.[113]

The decline in share prices that commenced in July 2007 calls into question the value-driven model of corporate governance that economic theory advocates. Recent events in capital markets and the steep fall in values are significant indications of the limitations of the shareholder value model of governance and its inherent instability. Even from a utilitarian perspective, the question remains whether corporate governance ought to be driven entirely by the goal of achieving what are apparently fleeting or ephemeral values.[114]

C. Corporate Finance: The Blurring of Boundaries between Debt and Equity

Economic theory does not recognize any significant difference between share capital (equity) and debt. They are bracketed together as sources of corporate finance. This is quite consistent with some other elements in the economic framework discussed above. First, economic theory does not consider the distinction between equity and debt that is made in the law of corporations, or the legal principle of creditor protection. Second, economic theory has eliminated the power of shareholders over directors by assuming that the shareholders have non-voting shares. This naturally culmination in the merging of debt and equity, and treating shareholders' funds and borrowed funds as synonymous.

The first step in the direction of merging equity and debt appears to have been taken by Merton Miller and Franco Modigliani, who compared

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112 The superseding indictment of Enron CEO, Jeffrey Skilling, offers an example. The court described how Skilling and others referred to the broadband business of the company as "giving 'dot-com luster' to Enron's share price": Superseding Indictment, *U.S. v. Skilling*, No. H-04-25 (S.D. Tex. 2004), online: Findlaw <http://news.findlaw.com>.

113 Michael C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" in Donald H. Chew Jr. & Stuart L. Gillan, eds., *Corporate Governance at the Crossroads: A Book of Readings* (Boston: McGraw-Hill/Irwin, 2005) 7 [Jensen, "Value Maximization"].

114 This issue is closely connected with the Efficient Markets Hypothesis (EMH), which attributes to the market both rational intelligence and the consistent ability to determine accurate values for securities. Economic theory places significant faith in the EMH. See e.g. Michael Jensen, "Some Anomalous Evidence Regarding Market Efficiency" (1978) 6 J. Fin. Econ. 95. Unfolding events in the markets also warrant a serious review of EMH.

the tax treatment of dividends and interest.[115] Shareholders are understood as the proprietors of corporations; in receiving dividends, shareholders are simply drawing a part of what belongs to them. Hence, tax laws do not generally recognize dividends as an expense in computing the corporation's profits and there is no tax benefit to a corporation in paying dividends. The case is different, however, with interest paid to creditors; it is allowed as a deduction in determining the taxable profits of corporations.

The underlying rationale—namely, that shareholders are the owners of corporations and dividends are only a payout of a part of what belongs to them—does not receive much attention from Miller and Modigliani. They confine themselves to a simple comparison of the different tax treatment for interest and dividends in economic terms. Their article launched the "dividend puzzle" debate in economic discourse, which significantly influenced corporate policies on shareholder reward in the 1980s and 1990s, discussed above.

The merging of share capital and debt in economic theory is significant. If the choice between debt and equity is to be guided entirely by the tax advantage in paying interest and the resulting higher profits, this consideration would encourage corporations to incur debt. High volumes of debt can, however, undermine stability. Corporations must service and repay their debt on schedule, whereas there is no such compulsion for equity or share capital. A capital structure dominated by debt would pressure companies to generate cash flows continuously. It would affect their ability to handle setbacks or recessionary conditions, both of which are facts of corporate life.[116]

Economic theory does not pay sufficient attention to this aspect of corporate finance. Indeed, Michael Jensen advocates for the use of debt to finance the repurchase of shares. He argues that debt would place the managers under an obligation to make interest and principal payments, and this would reduce the agency costs of free cash flow.[117] As noted above, an important consideration for encouraging increased payouts to the shareholders is the power that managers gain from retaining substan-

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115 Merton H. Miller & Franco Modigliani, "Dividend Policy, Growth, and the Valuation of Shares" (1961) 34 J. Bus. 411. This was itself a revised version of their earlier work that did not consider the tax implications of dividends and interest in the hands of corporations: Franco Modigliani & Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment" (1958) 48 Amer. Econ. Rev. 261.

116 There is evidence that the managers of the 1960s and 1970s were conservative in borrowing, whatever the other complaints against them. See Donaldson, *Managing Corporate Wealth, supra* note 94.

117 Jenson, "Agency Costs", *supra* note 95.

tial parts of corporate earnings.[118] This earnings retention reduces the managers' dependence on capital markets for raising funds.[119]

Economic theory, with its focus on managers, understands the draining of cash flows as a curb on the managers' power. While resorting to debt might reduce the power that managers have over free cash flows, it neglects the consequences of high debt levels on corporate stability and sustainability.[120] The economic approach to corporate finance turns the focus onto cash flows. Corporations must ensure that cash flows are adequate to meet liabilities as they arise. The source of the cash flows is not very important.

The analysis of corporate capital by economic theorists has focused mostly on the relative cost of debt and equity as sources of capital.[121] It was set in a world where both were available in plenty and corporations had the luxury of choosing between them. This has largely been true over the last two decades of monetary and credit expansion. High volumes of debt is not a serious issue in such a setup; a new and a bigger loan could be available for paying off old debts and money could be recycled indefinitely. Economic theory has not paid sufficient attention to phases of contraction such as the recent credit crisis, and the dynamics during such times. Here, the distinction between debt and equity would be in sharp focus, and failure to consider the impact of leverage on corporate stability would be serious.

Recently, there has been evidence of a greater awareness of the perils of debt. The Ford Motor Company, one of the embattled automobile manufacturers, provides a case study on high leverage. It has been reported that Ford planned to reduce its debt by $10.4 billion by converting it into

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[118] See Gordon Donaldson, *Corporate Debt Capacity: A Study of Corporate Debt Policy and the Determination of Corporate Debt Capacity* (Homewood, Ill.: Irwin, 1971).

[119] This gave rise to the idea of "market discipline" that became powerful in the 1980s.

[120] Economic theorists would probably argue that if a company becomes so highly leveraged that there is a risk to its health and stability, the stock market would suitably adjust the price of its shares and this would act as a correcting mechanism.

[121] I do not mean to suggest that economic theory ignores other considerations, such as the restrictions imposed by lenders on the borrowing corporations and the relative level of effort required for raising equity and debt finance. For instance, the "pecking order" hypothesis postulates that managers will likely tap the source that is the easiest to access—internal reserves, debt, and equity, in that order. The "trade off" theory of capital, on the other hand, treats the cost and benefits associated with each source of finance as the criteria influencing corporate decisions. For an overview of the economic theories of corporate capital structure, see Milton Harris & Artur Raviv, "The Theory of Capital Structure" (1991) 46 J. Fin. 297. John Graham and Campbell Harvey question how far managers actually make financial decisions according to the tenets of the hypotheses articulated in economic theory: John R. Graham & Campbell R. Harvey, "The Theory and Practice of Corporate Finance: Evidence from the Field" (2001) 60 J. Fin. Econ. 187.

equity.[122] The ongoing credit crunch and the inability to refinance debt are reminders of the perils of excessive leverage.

The creditor-protection principle in corporate law has not received sufficient attention in recent times, and its weakening has been greatly influenced by economic and financial theories.[123] Indeed, Hu and Westbrook question the continuing relevance of the principle.[124] Hu and Westbrook's approach, however, overlooks the risks of high leverage and its implications for corporate stability.

The solvency test appears to be staging a comeback in the current credit-crunch world. In *BCE*,[125] solvency was a central issue in the high-profile campaign for the leveraged buyout of Bell Canada. The accounting firm certified that Bell Canada would not pass the solvency test, post-buyout, and this led to aborting the deal.[126] The legal principle of solvency, which was originally developed for creditor protection, has significant potential to promote healthier capital structures for corporations by discouraging debt. It ought to be a consideration in corporate finance policies.

In dealing with the governance role of debt, economic theorists understand that lenders' restrictions on corporate borrowers either foster greater discipline and better governance, or alternatively dissuade corporations from borrowing. But the situation is quite different during phases of credit expansion. Lending standards are likely to be looser in such times.[127] Growth of corporate debt in recent decades and its implications for stability are significant areas for future research, both empirical and normative.

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122 Poornima Gupta, "Ford launches major debt restructuring" *Reuters* (4 March 2009), online: Reuters <http://www.reuters.com>.

123 See Armour, *supra* note 83 (referring to the influence of economic theory on the creditor-protection principle of corporate law in recent times).

124 Hu & Westbrook, *supra* note 81.

125 *Supra* note 52.

126 Jacquie McNish, Derek DeCloet & Sinclair Stewart, "Deal on the rocks: BCE fails key test" *The Globe and Mail* (27 November 2008) B1. Considering the history and rationale for creditor protection in corporate law, the reference to a "tiny clause" is particularly ironic.

127 A recent report noted that "*corporate* borrowers binged on credit during the boom years." David Henry & Ben Levisohn, "The Time Bomb in Corporate Debt" *BusinessWeek* 4140 (27 July 2009) 22, online: <http://www.businessweek.com> [emphasis in original].

D. Corporate Control: Constitution and Change

1. Directors' Elections and Takeovers

In law, shareholders, as proprietors, elect and remove the directors. Shareholders presumably have a concern for the welfare of the corporation, and would exercise their power to remove the directors if they did not perform well. This model is based on a certain degree of shareholder commitment and involvement. Here, the ouster of existing directors and the induction of new ones would be internal matters to be handled between existing shareholders and the directors. The principle is similar to elections in a political democracy, where the citizens of a country periodically cast their votes and incumbent legislators often lose the elections.

The reality in corporations has been quite different from the legal model described above, at least since Berle and Means wrote in the 1930s about self-perpetuating boards.[128] Bruce Welling describes the reality in large corporations as follows:

> It is, quite simply, a fact of business life that full-time corporate managers effectively appoint the board of directors, select themselves and their proteges for management positions, and regard the shareholders as a necessary rubber stamp in order to accomplish their long-term managerial schemes.[129]

In 1976, a study found that in more than ninety-eight per cent of the director elections over the previous twenty years, management was able to get its nominees elected.[130] More recently in 2006, a study of 1,741 director elections found that only three of the elections were contested.[131] Entrenched managements are therefore a reality. Recently, this has been formalized with the instrument of "nomination committees" that select candidates for election to the board.[132]

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[128] Berle & Means, *supra* note 4.

[129] Bruce Welling, *Corporate Law in Canada: The Governing Principles* (Toronto: Butterworths, 1984) at 301.

[130] Ralph Nader, Mark Green & Joel Seligman, *Constitutionalizing the Corporation: The Case for Federal Chartering of Giant Corporations* (Washington, D.C.: Corporate Accountability Research Group, 1976), cited in Canada, *Report of the Royal Commission on Corporate Concentration* (Ottawa: Minister of Supply and Services Canada, 1978) at 284.

[131] See Jay Cai, Jacqueline L. Garner & Ralph A. Walkling, "Democracy or Disruption: An Empirical Analysis of Majority Elections" (Paper presented at the 2006 Financial Management Association Meetings, Salt Lake City, Utah) [unpublished].

[132] The charter of the nomination committee of American International Group (AIG) has a typical description of such committees and their function. See *Nominating and Corporate Governance Committee Charter*, online: American International Group, Inc. <http://library.corporate-ir.net>.

Under the economic model, self-appointed managers run the corporations, and the shares issued to outside investors confer no voting rights. This framework reflects the insignificance of the legal principle that shareholders have the power to elect, remove, and regulate the directors, and the reality of powerful and self-perpetuating managers. On this basis, economic theory approaches the issues of constitution and transfer of corporate control—the election and removal of directors—in a manner very different from the legal model.

Given the reality of entrenched management and ineffective shareholders, economic theory encourages external challenge to inefficient managements, through a market for corporate control.[133] If management becomes entrenched and does not perform well, the remedy lies outside the corporation through takeovers. Takeovers and tender offers for shares were already common in the Conglomerate Boom of the 1960s, and the *Williams Act* was enacted in 1968 to regulate cash tender offers.[134] The statute promoted the democratic principle by ensuring that every shareholder had the opportunity to receive the higher price offered for the shares. It was designed to check the controlling groups in corporations from charging a control premium and transferring control to the bidder who offered higher share prices exclusively to these groups.

These developments strengthened the trend toward treating change of corporate control as an external issue; it would happen in the stock market, rather than within the company itself. Adolf Berle describes the position of ordinary shareholders during this period:

> The purchaser of stock does not contribute savings to an enterprise, thus enabling it to increase its plant or operations. He does not take the "risk" of a new or increased economic operation; he merely estimates the chance of the corporation's shares increasing in value. The contribution his purchase makes to anyone other than himself is the maintenance of liquidity for other shareholders who may wish to convert their holdings into cash. Clearly he cannot and does not intend to contribute managerial or entrepreneurial effort or service.[135]

Shareholders' concerns are limited to share prices, and shareholders have little interest in or commitment to the companies in which they hold the shares. But if there is little shareholder value, or increase in prices, this is blamed on the managers. In this environment, the 1980s saw the emergence of a new breed of investors, termed "financial entrepre-

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[133] See generally Henry G. Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. Pol. Econ. 110. The *Williams Act,* which was enacted in the U.S. in 1968 and amended §§ 78(m) and 78(n) of the *Securities Exchange Act* (*supra* note 67) was an attempt to regulate takeovers through tender offers.

[134] The *Williams Act* also added §§ 13(d) and 14(d) to the *Securities Exchange Act* (*supra* note 68).

[135] Berle & Means, rev. ed., *supra* note 49, Preface xxii-xxiii.

neurs",[136] who waged battles for the takeover of corporations. These battles dislodged many of the incumbent managers, and dismantled a number of the conglomerates that were built in the 1960s.[137]

The financial entrepreneurs who attempted these takeovers did not usually hold significant shares in the target corporations. Nor were the takeover battles democratic movements that rallied the shareholders to support the efforts for a change of management. The takeover architects were usually more concerned with the immediate advantages they perceived, such as the cash reserves of target corporations or the value of their assets.[138] They often took on debt to finance the takeover effort, and saddled the target companies with substantial debt. Economic theory termed the practice as a "leveraged buyout", and provided a framework for it.=, It generally appreciating the phenomenon.[139]

On the political side, the financial entrepreneurs argued that they were targeting inefficient and entrenched managements. Removal of such managements, they argued, was the key to unlocking shareholder value and improving efficiency.[140] These ideas were warmly received by economic theorists. Michael Jensen wrote in 1985 that the market for corporate control was "generating large benefits for shareholders and for the economy as a whole."[141] These ideas also gained recognition in law. In *Revlon v. MacAndrews & Forbes Holdings*, the court described the directors of a corporation facing a takeover and imminent breakup as "auctioneers charged with getting the best price for the stockholders at a sale of the company."[142]

Recent empirical work questions the idea of takeovers as disciplining instruments for managers. Anup Agrawal and Jeffrey E. Jaffe surveyed over two thousand corporations that were the targets of takeovers be-

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136 For use of this term, see John C. Coffee Jr., "Shareholders versus Managers: The Strain in the Corporate Web" (1986) 85 Mich. L. Rev. 1.

137 Bryan Burrough and John Helyar have provided a case study of the takeover and dismantling of RJR Nabisco, which captures the corporate culture and the climate in which the takeover battles were fought: Bryan Burrough & John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (New York: HarperPerennial, 1991).

138 Berle & Means, rev. ed., *supra* note 49, Preface xxii-xxiii.

139 See e.g. Michael Jensen, "Is Leverage an Invitation to Bankruptcy?—On the Contrary—It Keeps Shaky Firms Out of Court" *The Wall Street Journal* (1 February 1989), online: The Wall Street Journal, <http://online.wsj.com>.

140 See John Micklethwait & Adrian Wooldridge, *The Company: A Short History of A Revolutionary Idea* (New York: The Modern Library, 2003) at 139.

141 Michael Jensen, "The Efficiency of Takeovers" *The Corporate Board* 6:34 (September/October 1985) 16 at 16.

142 506 A.2d 173 at 182, 54 U.S.L.W. 2483 (Del. 1986).

tween 1926 and 1996, and analyzed their operating and stock performance before the acquisition. They concluded:

> Overall, we do not find much support for the inefficient management hypothesis. Target firms as a group do not underperform over a decade-long pre-bid period, whether performance is measured by operating returns or stock returns.[143]

This evidence casts doubt on the market discipline tenet of economic theory. Developments in recent decades have substantially eroded the legal model of constitution and transfer of corporate control, namely, shareholders electing directors to run companies, and removing them if necessary. The removal of directors and the change of management, which are important for corporate governance, are no longer handled within corporations among their shareholders and the directors.[144] The question is whether the takeover battles fought in the stock market are appropriate alternatives. Placing a check on self-perpetuating management, developing mechanisms for change in corporate control, and infusing new blood into management are important issues for public policy to address.

2. Corporate Shares: Stock Options and Poison Pills

Economic theory's approach to shares is consistent with its understanding of corporate finance outlined above.[145] In the classical model, shares represent units of the capital raised by a corporation from the investors for its business needs, and each investor has voting rights in proportion to the contributed capital. The issuance of and payment for contributed shares were both subject to close supervision in law.[146]

These normative characteristics of shares do not receive much consideration in economic theory. Shares are not understood as valuable instruments with important rights. As a natural corollary, issues like shareholder power and its legitimacy, and the regulation of the issuance of shares have little place in the economic framework of corporations. The insignificance of these ideas is evident from Jensen and Meckling's use of the term "divisible residual claims"[147] to refer to shares, and from Easter-

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143 Anup Agrawal & Jeffrey E. Jaffe, "Do Takeover Targets Underperform? Evidence from Operating and Stock Returns" (2003) 38 J. Fin. & Quant. Analysis 721 at 722.

144 If the idea of external intervention is carried to the political arena, it would be equivalent to a foreign power dislodging the administration of a country on the grounds that it is self-perpetuating or corrupt or inefficient.

145 See Part III.D.1, above.

146 The sanctity of capital stock and shares were eroded by the developments that commenced in the 1880s. See generally Mitchell, *supra* note 73.

147 Jensen & Meckling, "Theory of the Firm", *supra* note 2 at 311 [emphasis in original].

brook and Fischel including them in the generic category of "securities".[148] Economic theory, in effect, endorses a loose regime on the issuance of shares, and the ability of corporations to emit shares virtually at will. Stock options and poison pills, discussed below, are good examples of this mode of thinking.

Stock options are expressly permitted in the current regime of corporate law on the issuance of shares.[149] Originally, the justifications for granting stock options to senior managers were to promote employee ownership of corporations and to increase the employee's sense of commitment. There was also a tax advantage for the managers.[150] Economic theory adopts the idea of stock options, but for different reasons. It advocates the grant of options to managers to encourage them to strive for an increase in share prices. Stock options are a key element in the theory.[151]

Poison pills are instruments devised to protect the incumbent management against hostile takeovers. Martin Lipton, a renowned American corporate lawyer, is credited with the idea of poison pills, which were used extensively by managements to defend themselves in the takeover battles of the 1980s.[152] A poison pill provision in a corporation's charter enables the corporation to issue new shares to selected persons (usually the incumbent management or their supporters) if anyone acquired shares beyond a specified threshold (usually fixed at twenty per cent). The object of a poison pill is to make it more difficult and expensive for the party acquiring the shares to complete the takeover.

The dominance of economic theory in recent decades means that there has been little debate on the normative elements in the law of corporations and their relevance for the present age. It would be a folly to treat corporate shares as no more than instruments traded in the stock market, and to ignore their vital and defining characteristics.[153] It is a serious

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148 See e.g. Easterbrook & Fischel, "Corporate Contract", *supra* note 3 at 1418.

149 See Del. Code Ann., tit. 8 § 157 (West Supp. 2010); *Canada Business Corporations Act,* R.S.C. 1985, c. C-44, s. 29. For a criticism of the statutory sanction for issue of options by corporations, see A.A. Berle Jr., "Investors and the Revised Delaware Corporations Act" (1929) 29 Colum. L. Rev. 563.

150 See e.g. Alfred P. Sloan Jr., *My Years with General Motors* (New York, N.Y.: Doubleday, 1963) at 420-22 (Sloan's discussion of the Stock Option Plan at General Motors).

151 See Jensen & Meckling, "Theory of the Firm", *supra* note 2 at 353.

152 Ronald J. Gilson, "Lipton and Rowe's Apologia for Delaware: A Short Reply" (2002) 27 Del. J. Corp. L. 37.

153 Equity derivatives are another product of recent financial innovation. These instruments retain some but not all of the characteristics of equity shares. For a demonstration of their complexity, see *CSX Corp. v. Children's Investment Fund Management (U.K.) LLP*, 562 F. Supp.2d 511 (S.D.N.Y. 2008) (involving "Total Return Swaps" (TRS) and the voting rights attached to the underlying shares).

matter if shareholders do not exhibit the level of responsibility that is implied in the classical model; contributing factors of the phenomenon need closer examination. Recent trends have, however, been to treat shareholder passivity as a state of nature and to devise systems on that basis.[154]

E. Managerial Power, Executive Compensation, and Stock Options

The powerful position of corporate managers was, as noted above, a major springboard from which economic scholars have developed their theory of corporations. Economic theory offers two prescriptions for curbing managerial power and they both have a normative character. The first encourages the monitoring of managers by directors. The second recommends granting stock options to managers to promote unity of interests between managers and shareholders, and to encourage managers to pursue shareholder value.

1. Managerial Power and the Monitoring Board

The idea that directors oversee managers is generally attributed to economic theory.[155] This notion became increasingly invalid, however, as the twentieth century progressed. The growth in size and complexity of corporate businesses, the rise of powerful managers who worked full time for the companies, and the presence of part-time directors (usually handpicked by the CEO) were important factors that contributed to the decline of directors.[156] Alongside these factors was the reality that shareholders and retail investors were scattered, whando had neither the interest nor the resources required for concerted action to keep the managers in check.

These developments undermined the principle of representative financial democracy in corporate law. As a result, managers were able to con-

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[154] Martin Lipton is a prominent critic of irresponsible shareholder behaviour and the focus on share prices. Lipton's proposal for the so-called poison pill came from a desire to protect corporations, their employees, and other stakeholders against hostile takeovers and the breakup of businesses. The Supreme Court of Delaware referred to this while upholding the broad validity of the poison pill arrangement: *Moran v. Household International*, 500 A.2d 1346 (Del. 1985).

[155] See e.g. Lawrence E. Mitchell, "The Board as a Path toward Corporate Social Responsibility" in Doreen McBarnet, Aurora Voiculescu & Tom Campbell, eds., *The New Corporate Accountability: Corporate Social Responsibility and the Law* (Cambridge: Cambridge University Press, 2007) 279. Mitchell also explains that a clear articulation of the concept of monitoring directors came from Melvin Eisenberg (*ibid.* at 288-290). See Melvin Aron Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Boston: Little, Brown & Co., 1976).

[156] See e.g. William O. Douglas, "Directors Who Do Not Direct" (1934) 47 Harv. L. Rev. 1305; Mace, *supra* note 62.

trol the elections of directors.[157] The directors (an important statutory agency) were thus left without a clear or meaningful role in corporations. Then a theory was developed proposing that directors oversee or monitor managers, and do so on behalf of shareholders.[158] Ironically, this theory, which recognizes directors as representatives of the shareholders, makes little effort to actualize the principle. Instead, it formalizes self-perpetuating boards through the instrument of nomination committees. These committees of directors would recommend other candidates for appointment as directors. The weakness in the theory is quite apparent. It recognizes directors as the representatives of shareholders, but accepts as corporate reality the absence of any meaningful role for the shareholders in director elections. The theory permits the directors to select themselves.

In recognition of the peril of a lack of effective oversight, the concept of independent directors developed in order to promote the integrity of the structure.[159] The idea is that directors would be independent of the managements,[160] allowing them to play an effective monitoring role.

There have been complaints about the efficacy of the monitoring board model, despite recent refinements such as the selection of directors by nomination committees and the emphasis on director independence. The scandals at major corporations such as Enron, WorldCom, Lucent Technologies, and Tyco at the turn of the present century illustrate the deficiencies of this model.[161] The U.S. Senate committee that investigated the role of Enron's board in the scandal was quite critical of the company's directors.[162]

The current credit crisis has produced numerous cases of governance failures in the financial sector—Bear Sterns, Lehman Brothers, and AIG, to name a few. These corporations had state-of-the-art governance structures including nomination committees and independent directors, and

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157 Berle & Means, rev. ed., *supra* note 49 at 82 (the emergence of self-perpetuating boards in major corporations). See also Welling, *supra* note 129.

158 See e.g. General Electric Company, "Governance Principles" at 1, online: General Electric Company <http://www.ge.com> [GE, "Governance Principles"]. This document states: "The board of directors is elected by the shareowners to oversee management and to assure that the long-term interests of the shareowners are being served" (*ibid.*).

159 See generally Gordon, *supra* note 102.

160 See e.g. *SOX*, *supra* note 5, § 301 (definition of "independence").

161 See generally Paul W. MacAvoy & Ira M. Millstein, *The Recurrent Crisis in Corporate Governance* (Stanford: Stanford University Press, 2004).

162 U.S., Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, 107th Cong., *The Role of the Board of Directors in Enron's Collapse*, S. Prt. 107-70 (8 July 2002), online: U.S. Government Printing Office <http://www.gpo.gov>.

accepted the monitoring board principle. The events at these corporations raise questions about the governance model for public corporations based on oversight by boards of directors. [163]

Indeed, the latest round of failures is more serious. Cases such as Enron and WorldCom were tainted by downright criminality, where there was a common practice of concealing things from the directors. But the case is different with the financial corporations in the current round of failures. There is little evidence thus far of criminal misconduct. The factors that led to the financial corporations' downfall—devising exotic instruments and taking excessive risk—were essentially business issues. If classical economic theory chided the managers for being conservative, the recent events suggest a swing of the pendulum to the other extreme—namely, feckless risk-taking.

There has been apparently no substantial change either in managerial power or in director weakness, since economic theory became dominant in corporate governance. If the earlier complaint was that agency costs ate into shareholder wealth, they have now practically eliminated shareholder wealth in the corporations that failed. The following are some issues that must now frame the debate on managerial power:

- the level of deliberation and the degree of responsibility that inform decision making by managers;[164]
- the efficacy of oversight by the directors; and
- most importantly, the formal acceptance of responsibility by the board of directors for the well-being and soundness of corporations.

2. Executive Compensation and Stock Options

The economic framework reserves an important position for executive pay, and stresses its function as an incentive to achieve shareholder value. It seeks to promote commonality of interests between managers and shareholders through the grant of stock options to managers. This model has been popular in recent decades, and the trend has been to pay a major part of managerial compensation in stock options. A study of CEO

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[163] It has been reported that the Securities and Exchange Commission has ordered an inquiry into the role of the directors in the financial corporations: Zachary A. Goldfarb, "SEC to Examine Boards' Role in Financial Crisis" *The Washington Post* (20 February 2009) D1, online: The Washington Post <http://www.washingtonpost.com>.

[164] It must be noted that managers operate in the larger social milieu, and are driven by the prevailing value systems. In this context, Professor Bainbridge's reference to Plato's philosopher kings who ruled purely from a sense of duty (*supra* note 45 at 550-51) is significant. Its practicability is, however, a different question.

remuneration shows that stock options, as a component of executive pay, rose with the Dow Jones Industrial Average Index from 1970 through 2002. Cash pay became a relatively minor component, as shown in the chart below.

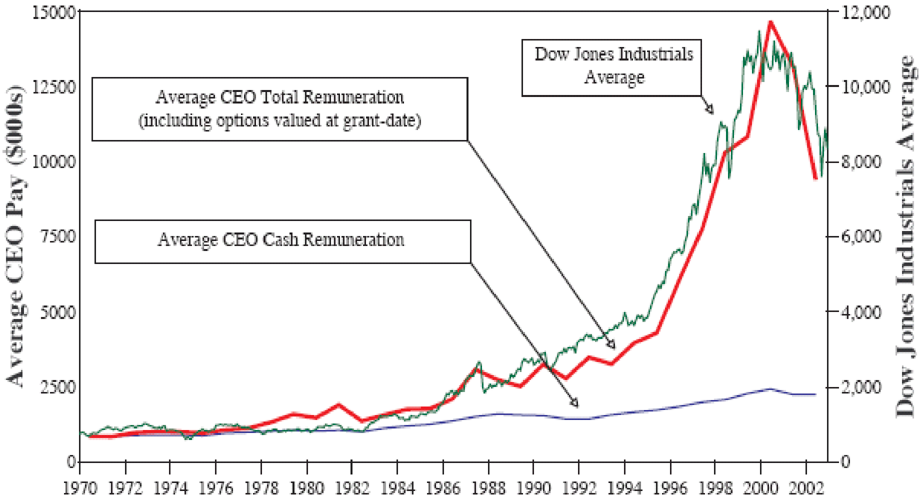

Figure 4. Dow Jones Industrial Average Cash and Total Remuneration for CEOs in S&P 500 Firms, 1970–2002[165]

In the 1970s, CEO pay was almost completely in cash. During the period of twenty-three years shown in the graph above, the average cash compensation of CEOs rose from less than $1 million during most of the 1970s to close to $2.5 million in 2002. The growth in total remuneration (of which stock options were a major part) has become much greater, especially since the bull phase in the stock market began in the 1980s. The average total remuneration for CEOs peaked at close to $15 million in 2000, before the corporate sector and the stock market were shaken by

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[165] Michael C. Jensen & Kevin J. Murphy with the assistance of Eric G. Wruck, "Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them" ECGI-Finance Working Paper No. 44/2004 (July 2004) at 36, online: European Corporate Governance Institute <http://www.ecgi.org> [Jensen & Murphy, "Remuneration"]. The Dow Jones Industrials is based on monthly closing averages. The sample here is based on all CEOs included in the S&P 500, using data from Forbes and ExecuComp. CEO total pay includes cash pay, restricted stock, payouts from long-term pay programs, and the value of stock options granted using ExecuComp's modified Black-Scholes approach. (Total pay prior to 1978 excludes option grants, while total pay between 1978 and 1991 is computed using the amounts realized from exercising stock options during the year, rather than grant-date values.)

Enron and other scandals in 2001 to 2002. At the peak, almost eighty-seven per cent of CEO pay was non-cash.

Between 1992 and 2002, there was impressive growth in the stock options granted to corporate employees, including top managers and CEOs. The value of options, on the date of grant, rose from $22 million in 1992 to $238 million in 2000, just before the implosion of the dot-com bubble in the stock market. The value of stock options was still impressive at $226 million in 2001 (ten times the 1992 figure) and $141 million in 2002 (almost seven times the 1992 figure).

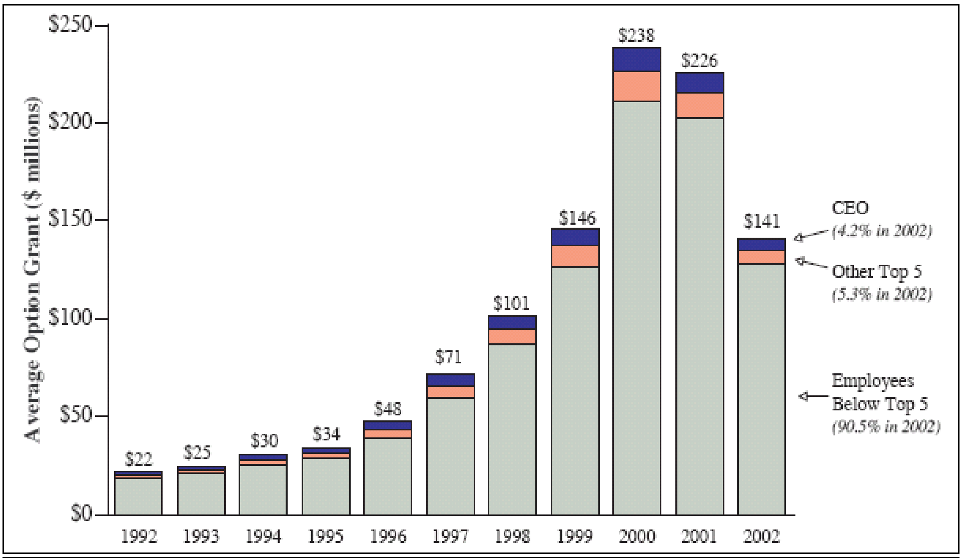

Figure 5. Grant-Date Values of Employee Stock Options in the S&P 500, 1992–2002[166]

Stock options are one part of the issue of executive compensation that has been in the limelight for many decades now. There are a number of other equally significant strands of discourse on executive pay:

- the person(s) charged with determining pay;

[166] *Ibid.* at 37. This figure shows the grant-date value of options (in millions of 2002-constant dollars) granted to all employees in an average S&P 500 firm, based on data from S&P's ExecuComp data. Grants below the top five executives are estimated based on "Percent of Total Grant" disclosures; companies not granting options to any of their top five executives are excluded. Grant-values are based on ExecuComp's Black-Scholes calculations. The number in parentheses indicates the fraction of the grant, on average, that is awarded to the indicated employee (or employee group). Fiscal 2002 results are based on the April 2003 "cut" of ExecuComp, which includes only companies with fiscal closings in December 2002 or earlier.

- the level of compensation;
- the justification of pay in relation to performance, and the definition of performance; and
- relative pay scales in corporations and distributive justice.

In the principal-agent paradigm of economic theory, it would be expected that shareholders, as principals, would determine, or at least have some control over, the pay of the manager-agents. Given the weak position of shareholders, the reality has been quite different. The long-standing complaint is that managers, led by the CEO, determine their own compensation.[167] When the idea of monitoring boards rose in the 1970s, it was believed that directors, as the representatives of shareholders, would play a role in setting executive pay. A more recent innovation is compensation committees. These are committees of the board charged with the responsibility of setting executive pay. Normally all members, or at least a majority of them, would be independent directors.

The theory is that compensation committees, with the strong presence of independent directors, would bring greater objectivity to determining managerial pay. Despite these developments, complaints about the process of determining executive pay persist.[168] There has been a call for greater activism by the directors in setting executive pay and for a more effective shareholder role in ensuring directors' performance of this function.[169]

High executive pay is not generally considered an issue in economic theory. Indeed, there is a hypothesis that the pay levels of CEOs from 1982 to 1988 were lower than those from 1934 to 1938.[170] This argument first emerged as a response to complaints about the high levels of executive compensation in the late 1980s. The recent statements by Michael Jensen are in the same vein—that there can be no objection, in principle, to high executive pay.[171] Economic theory merely tries to ensure that shareholders also benefit through higher share prices. This can be described as the substance of economic theory's approach to the issue of executive pay.

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[167] This understanding is reflected in the exchange between Senator Kefauver and Homer, the president of Bethlehem Steel Corporation: Galbraith, *supra* note 27 at 84-85.

[168] See e.g. Lucian A. Bebchuk & Jesse M. Fried, "Pay without Performance: Overview of the Issues" (2005) 30 J. Corp. L. 647.

[169] *Ibid.* at 672-73.

[170] See Michael C. Jensen & Kevin J. Murphy, "CEO Incentives—It's Not How Much You Pay, But How" *Harvard Business Review* (May–June 1990) 138.

[171] See Walkling, *supra* note 4 at 43-44.

This approach, based on the perennial growth of business and a constant rise in share prices,[172] must be reviewed in light of recent events—the credit crunch, meltdowns in the financial sector, and the general recession. Post-Enron, economic theorists are displaying greater sensitivity to the limitations of their model. They now explain that "[m]aximizing firm value does not mean maximizing the price of the stock."[173]

Economic theorists argue that high executive compensation and bonuses are necessary to incentivize the managers to perform. However, the relationship between pay and performance is not free from controversy. An analysis of selected corporations estimated that between 1993 and 2003, the growth in executive pay was twice as much as that in sales and return on assets, which measures the operating income of companies in relation to the value of their assets shown in the balance sheet.[174] The measures of performance applied here—sales and return on assets—are quite different from mainstream economic theory, which merely stresses value.

Next is the question of distributive justice, or relative pay scales within corporations. CEO pay, which was about 140 times that of the average worker in 1991, climbed to about 500 times that of the average worker twelve years later.[175] This affirms the agency costs insight of economic theory. Equally important, it highlights the power imbalances in corporations and the thinly veiled self-dealing by those in the upper levels of the corporate structure.

The above are some important issues relating to executive pay. Economic theory's recommendation of granting stock options to managers and aligning their interests with those of shareholders is too simple to handle the multidimensional complexity of a modern corporation.[176] Employee compensation, as a governance issue, calls for more comprehensive and nuanced treatment. The issue is again in the limelight, with reports about executive pay structures in the financial sector. In 2003, Warren

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172 These are implicit in the agency-costs theory originally published in 1976: Jensen & Meckling, "Theory of the Firm", *supra* note 2.

173 Jensen & Murphy, "Remuneration", *supra* note 165 at 49 (Recommendation 9). Significantly, there is no further elaboration of the concept of value.

174 Lucian Bebchuk & Yaniv Grinstein, "The Growth of Executive Pay" (2005) 21 Oxford Rev. Econ. Pol. 283.

175 Brett H. McDonnell, "Two Goals for Executive Compensation Reform" (2008) 52 N.Y.L. Sch. L. Rev. 585 at 586.

176 The complexity is evident from the sheer number of recommendations that Jensen and Murphy make on the reform of executive pay ("Remuneration", *supra* note 165). While remaining loyal to the value paradigm, they advance as many as thirty-eight recommendations that deal with issues ranging from board composition to engaging consultants and promoting trust.

Buffett pointed out that some financial corporations booked large profits from the derivatives business by ignoring underlying risks.[177] Bonuses were paid to the managers on the basis of these profits, although the underlying transactions caused huge losses later. This is another illustration of the agency-costs theme.

An indicator of the current mood on the subject of executive pay is seen in the statement issued by the G20 governments. At a recent summit meeting, they agreed on "tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms."[178] Calls for reform are also now heard within the industry.[179]

If the present level of discontent about executive pay is any indication, the compensation committee mechanism has not worked well. It is time to look for refinements and multipronged approaches. The "say on pay" campaign acknowledges that shareholders, as residual claimants, must participate in determining executive compensation. This is merely a beginning. To promote greater objectivity, equity, and accountability in executive pay, shareholder participation must be combined with other devices—both quantitative and qualitative. The following are some potential elements of an executive compensation regime.

One element could be the strengthening of shareholder participation through the requirement of an affirmative vote. This is quite realistic considering the changes in the shareholder landscape in recent decades. Things have come a long way from the uninterested and impotent retail investors portrayed by Adolf Berle and Gardiner C. Means in 1932.[180] Institutional investors, such as pension funds, are now major shareholders and are in a different position. Neither are they focused solely on the short term, nor do they lack the resources to be activist shareholders.[181]

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177 Berkshire Hathaway, *2002 Annual Report*, online: Berkshire Hathaway <http://www.berkshirehathaway.com/reports>. See especially Warren Buffett's letter to the shareholders of Berkshire Hathaway (*ibid.* at 3ff.).

178 Leaders of the Group of Twenty, "The Global Plan for Recovery and Reform" (Communiqué from the London Summit 2009, 2 April 2009) at 4, online: London Summit 2009 <http://www.londonsummit.gov.uk>.

179 Marcy Gordon, "Goldman CEO: Wall St. executive pay needs overhaul" *The Examiner* (7 April 2009), online: The Examiner <http://www.washingtonexaminer.com>.

180 Berle & Means, *supra* note 4.

181 Some studies have questioned the willingness of institutional investors to be effective in their role as corporate shareholders. See e.g. John M. Conley & William M. O'Barr, "The Culture of Capital: An Anthropological Investigation of Institutional Investment" (1992) 70 N.C.L. Rev. 823; Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered" (1993) 93 Colum. L. Rev. 795. Institutional investors

Another potential element could be the weakening emphasis on stock options as a major component of executive compensation. This can reduce the short-term focus of managers and promote stability in the stock market. It can also restore some sanctity to shares as units of business capital and check the tendency for abuse.[182]

And finally, we could promote distributive justice by setting pay ratios between different levels in corporate hierarchies, starting with the CEO to the junior-most employee. This principle would recognize that corporate success is a result of the efforts of everyone, not merely the senior managers, and would ensure that every employee benefits from the success. It would advance equity by placing pay scales in a state of dynamic equilibrium.[183]

Conclusion: A Case for a New Theory of Corporations

The eclipse of public corporations was predicted twenty years ago.[184] However, the eclipse has not happened. On the contrary, public corporations have become more powerful and they control more wealth, as evident from the data below. Sales and profits of the Fortune 500 corporations have grown more than five-fold in the last twenty years.

Year	**Sales** ($ million)	**Profit** ($ million)
1989	2,023,155	114,963
2010	12,083,646	408,548
Growth	597%	355%

Figure 6. Fortune 500 Corporations: Growth in Sales and Profit, 1989–2008[185]

are, however, an evolving breed and there is cause for optimism, as they are structurally well suited to be active and responsible shareholders.

182 For instance, backdating stock options is a long-standing problem. Major corporations, such as Research-in-Motion, have been accused of indulging in the practice. See Tom Krazit, "RIM executives settle option backdating case" *C-Net News* (4 February 2009), online: C-Net News <http://news.cnet.com>.

183 In this respect, dynamic pay ratios are preferable to ceilings on pay, which are based on the unrealistic and static "one-size-fits-all" approach.

184 Michael C. Jensen, "Eclipse of the Public Corporation" *Harvard Business Review* (September–October 1989) 61.

185 Computations based on sales and profits of Fortune 500 U.S. corporations, 1955–2010, online: AggData <http://www.aggdata.com/business/fortune_500>.

Public corporations, their governance, and the capital markets where their securities are traded are subjects of vital public interest. To apply the insights of economic theory and the lessons learned from experience, there is a need to develop a richer, more comprehensive, and inclusive theory of corporations. On one side, there is the classical model with its hierarchical, authoritarian, top-down structure founded on the traditional concepts of property and relying on the principle of authority. It is of doubtful suitability for the spirit of the current age in which respect for the individual has an important place.

On the other side is the economic interpretation. With its "nexus of contracts" idiom, economic theory has a greater focus on individuals and, at least in theory, offers a much broader platform that is more contemporary. It eschews rigid structures and hierarchies, and rejects authority as the governing principle. The contractarian vision can potentially cover a wider range of corporate constituencies, such as employees, creditors and suppliers, and even communities. It can be better aligned with emerging ideas about stakeholders and their significance in corporate governance.

However, economic theory has revealed significant deficiencies. Its agenda for increasing shareholder value is open to criticism, both conceptual and practical. On the conceptual side, the shareholder-value maxim is quite narrow in its approach. It fails to consider other significant dimensions of business corporations. It addresses a very small segment of the corporate constituencies—the shareholders. On the practical side, its encouragement of short-termism has now been realized.[186] Corporate short-termism has two dimensions. One issue is its impact on governance—namely, the lack of attention to longer time frames, and the failure to make appropriate investments, among others. The other issue is about the intrinsic merit of the shareholder-value model.[187] Value or wealth maximization, based on the idea of economic growth as a natural and never-ending process,[188] strikes a discordant note in the milieu of rising consciousness about the environment and the emphasis on sustainable development.

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[186] On stock market centricity of corporate governance and short-termism, see generally Lawrence E. Mitchell, *Corporate Irresponsibility: America's Newest Export* (New Haven, Conn.: Yale University Press, 2001).

[187] The "casino" element in the stock market and its manner of creation of wealth have not received much attention in recent decades, despite the fact that they raise serious ethical questions about the market as an institution in the society.

[188] Michael Jensen is now more alive to the limitations of the growth paradigm of business, especially while operating in mature markets where demand is either stable or saturated. See Joseph Fuller & Michael C. Jensen, "Just Say No to Wall Street: Putting a Stop to the Earnings Game" (2002) 14:4 J. Appl. Corp. Finance 41.

Over the last few decades, the sustained rise in share prices, which appeared to affirm the shareholder-value maxim, is a thing of the past—at least for now.[189] The slide in share prices that commenced in July 2007 has seen the steep decline of the Dow Jones Industrial Average from a peak of 14,000 to under 10,000 in October 2009—a fall of about thirty per cent.[190] The decline is the transient nature of market valuations of corporate shares and the wealth generated in the market. It is not clear how prolonged or steep the decline will be,[191] thus raising questions about the stock market as a reliable store of value or wealth. Pension funds are deeply involved in the market, and instability is even more serious for senior citizens. The market is creating instability at an age when it is ill-equipped to handle it.

Economic theory of corporations is based on the resourceful, evaluative, maximizing individual, or the *homo economicus*.[192] This standard might be convenient and sometimes even appropriate for microeconomic theory.[193] Individuals with acquisitive and domineering qualities are common in all societies, perhaps more so in some than in others. They are possibly common in business corporations. However, a theory of corporations that seeks to be comprehensive and seeks to represent the public policy of a democratic society, cannot ignore the rich variety in humanity, the unequal abilities of individuals, and the differences in the opportunities available to them. It must consider the imbalances that are facts of business reality—for instance, the imbalanced power structure in corporations—and attempt to inculcate a system of values that promotes more harmonious functioning of this significant institution.

Recent events, from the Enron scandal to the current economic crisis, stress the importance of combining economic pursuits with other important considerations such as ethics, sustainability, and social-

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189 A study of the capital markets since the 1690s reveals the recurring pattern of boom-bust cycles in the markets. From this perspective, the trend of rising share values in the last thirty years is not very significant.

190 At this writing in October 2010, the Dow Jones index is around 11,000.

191 See e.g. "George Soros warns jump in stock markets since March is a 'bear-market rally'" *The Telegraph* (April 2009) B1, online: The Telegraph <http://www.telegraph.co.uk>.

192 For a comprehensive critique of this vision of human nature in economic theory, see Michael J. Brennan, "Incentives, Rationality, and Society" (1994) 7:2 J. Appl. Corp. Fin. 31. For a more recent take, see Sumantra Ghoshal, "Bad Management Theories Are Destroying Good Management Practices" (2005) 4 A.M.L.E. 75.

193 The *homo economicus* conceptualization of human nature has been under increasing attack. See generally Paul J. Zak, ed., *Moral Markets: The Critical Role of Values in the Economy* (Princeton, N.J.: Princeton University Press, 2008); George A. Akerlof & Robert J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism* (Princeton, N.J.: Princeton University Press, 2009).

connectedness. Economic activities cannot occur in a vacuum, cut off from the other elements of life—personal, ethical, and spiritual. Recently, this point has been stressed by Charles T. Munger, Vice-Chairman of Berkshire Hathaway Inc.:

> It is important that reform plans mix moral and accounting concepts with traditional economic concepts. Many economists take fierce pride in opposing that sort of mixed reasoning. But what these economists like to think about is functionally intertwined, in complex ways, with what they don't like to think about.[194]

The new paradigm must place greater emphasis on the sustainable and collective element in corporations. Indeed, Michael Jensen himself has stressed the organizational dimension of corporations and the importance of creating long-term value.[195] The organizational principle has no inherent conflict with the ideal of individuality projected by the "nexus of contracts" imagery. Rather, it balances coexistence and individuality. In the endeavour to achieve greater balance between the two, the vision of Roscoe Pound from the early 1900s is valuable:

> Ultimately all interests, individual and public, are secured and maintained because of a social interest in so doing. But this does not mean that individual interests, the details of which the nineteenth century worked out so well, are to be ignored. On the contrary, the chiefest of social interests is the moral and social life of the individual, and thus individual interests become largely identical with a social interest. ... [A]lthough we think socially, we must still think of individual interests, and of that greatest of all claims which a human being may make, the claim to assert his individuality, to exercise freely the will and the reason which God has given him. We must emphasize the social interest in the moral and social life of the individual, but we must remember that it is the life of a free-willing being.[196]

This more refined approach is quite distinct from individualism, which suggests atomization and disconnectedness.[197] The current climate is

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194 Charles T. Munger, "How We Can Restore Confidence" *The Washington Post* (11 February 2009) A19. Interestingly, while advocating legislative intervention, Munger pointedly describes himself in the article as a Republican.

195 Jensen, "Value Maximization", *supra* note 113.

196 Roscoe Pound, "Law and Liberty" in William Allan Neilson *et al.*, eds., *Lectures on the Harvard Classics* (New York: Collier & Son, 1914) 347 at 351.

197 Here, the caution sounded by Roscoe Pound about trying to solve the problems of one age with the ideas of an earlier age is relevant: Hon. Roscoe Pound, "The New Feudal System" (1930) 35 Com. L.J. 397 (address delivered at the annual meeting of the Kentucky State Bar Association, 1930). See also John Tiemstra's more recent commentary on specialization as the source of economic development and growth: John P. Tiemstra, "Rethinking the Costs of Economic Growth: Association for Social Economics Presidential Address, 2008" (2008) 66 Rev. Soc. Econ. 423.

hopefully conducive to the emergence of a "more relational conception of the contractual corporation" that Bratton exhorted in 1989.[198]

Some signs of change are visible. A recent report of the Conference Board, *Revisiting Stock Market Short-Termism*,[199] is evidence of the rising awareness of the inadequacies of the shareholder-value maxim. The reappearance of the dividend model of shareholder reward, which is based on a more long-term philosophy of governance, is another indication of changing trends.[200]

There is a case for developing a new framework for corporations—one that reflects the lessons of the past. It must recognize the hybrid public-private character of corporations. Here, one must question the doctrinaire and internally inconsistent position that economic theory adopts, and its discomfort with the law's role in business corporations. Corporations are creatures of and are governed by the law, which represents the public policy on the subject. In the recent past, statutes have granted corporations considerable free space to organize their affairs. If necessary, the free space can be reviewed in light of thisexperience. The question of how far public policy must concern itself with guiding corporations and their governance must be examined more intensively.

In the present globalized world where plants close in developed countries in order to relocate production to low-cost developing countries, the vulnerability of employees is quite apparent. This is no longer the contractarian world of Alchian and Demsetz where labor unions were powerful and actively negotiated wage agreements with the corporations.[201]

Recognizing the basic fact that corporations are commercial enterprises that operate in competitive markets, a new theory of corporations could accomplish the following. First, it could provide a clearer definition of the institutional position of the stock market—namely, that it is a source of capital for substantive economic activity and for providing liquidity to investors. The role of equity must also be revisited. Business corporations must be encouraged to focus on their business, and be weaned away from their preoccupation with constantly dealing in shares through buybacks and holding treasury shares and so on. This would keep in check the commoditization of corporate shares and the idea that corpo-

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198 Bratton, *supra* note 13 at 411.

199 Matteo Tonello, *Revisiting Stock Market Short-Termism* (New York: Conference Board, 2006), online: The Conference Board of Canada <http://www.conferenceboard.ca>. See also Patrick Bolton, Jose Scheinkman & Wei Xiong, "Executive Compensation and Short-Termist Behaviour in Speculative Markets" (2006) 73 Rev. Econ. Studies 577.

200 See Julio & Ikenberry, *supra* note 100 and accompanying text.

201 Alchian & Demsetz, *supra* note 48.

rations can emit them at will. In turn, this would undermine the speculative tendencies in the market and promote better stability;[202]

Further, it could redefine the criteria for assessing corporate performance, with less emphasis on the "value" and "growth" models that are unsustainable and breed instability. It could also develop mechanisms for determining managerial pay that is fair and equitable, and also rewards individual initiatives and efforts. It could recognize the special rights of shareholders—namely, their voting rights and position as residual claimants—and the promotion of more activist and responsible shareholders, particularly in director elections.[203]

It could also develop a policy on change of corporate control to check managerial tendencies for entrenchment and self-perpetuation. And it could clarify the relationship between directors and senior managers, and streamline that relationship to promote greater responsibility in governance and accountability. It could redefine the role of directors, to encourage transition from a largely passive, monitoring model to responsibility-based active monitoring model.

And finally, it could acknowledge the power imbalances within corporate organizations, and the promotion of a model that fosters responsible exercise of powers by shareholders, directors, and managers, with due regard to the competitiveness and sustainability of the enterprise, and the legitimate interests of all the stakeholders. This is predicated on a movement away from the perception that shareholder governance and stakeholder governance are conflicting models. A more integral governance approach, of the variety advocated here, is in fact gaining traction.[204]

It is now clear that archaic regulation that relies on the "command-and-control" principle and bureaucratic oversight is limiting. Command-and-control techniques and the threat of sanctions are inevitable, but only as the last resort. They are hardly appropriate as instruments to guide the governance of large and complex organizations that operate in competitive markets, or in promoting responsible management practices. Straitjacket regulation or bureaucratic meddling in corporations cannot

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[202] Reform of the stock market (a major subject in itself) is beyond the scope of this essay. However, given the close relationship between public corporations and the market, issues related to the market must inform any debate on corporations and their governance.

[203] For a shareholder-centric model of governance, see Robert A.G. Monks & Allen Sykes, *Capitalism Without Owners Will Fail: A Policymaker's Guide to Reform* (London, U.K.: Centre for the Study of Financial Innovation, 2002).

[204] See e.g. GE, "Governance Principles", *supra* note 158 (references to stakeholder interests); Joint Committee on Corporate Governance, *Beyond Compliance: Building a Governance Culture*, Final Report (November 2001), online: European Corporate Governance Institute <http://www.ecgi.org>.

be the solution. It is also important to remember the shortcomings of the modern democratic state, which contributed to the implosion of the first round of regulation. At the same time, the state, with all its defects and imperfections, remains the last resort, as evidenced by its massive intervention in the economy during the current crisis.

An interdisciplinary approach to regulation can be helpful in promoting responsible governance, without impinging on business freedom and flexibility. In the quest for new paradigms, it would be fruitful to look to disciplines such as finance and business management. Tools like budgeting, risk analysis, and project appraisal that developed in such disciplines can be valuable in steering corporations toward good governance. Indeed, large corporations regularly employ these techniques. The numerous codes of corporate governance that have been developed in recent years are yet another source for new models of corporate governance.[205] Delineating the responsibilities of boards and improving the accountability of managers and directors, combined with procedural safeguards for decision making, are some possibilities.[206]

A multidisciplinary approach to regulation could be effective in guiding corporate decision-making processes and, hopefully, the outcomes would be superior. It is a matter of blending corporate theory with organizational, management, and finance theories. The responsible-governance maxim received an impetus from President George W. Bush who highlighted its importance while commending *SOX* in 2002.[207] More recently, President Barack Obama called for "a new era of responsibility" in his inaugural address.[208]

Business corporations are arguably the most significant economic vehicle. There is a case for exploring the relationship between the economic theory of corporations and the macroeconomic conditions that have emerged in developed countries in recent years—namely, general industrial decline, trade deficits, and stagnant incomes for large sectors of the society. How far the macroeconomic realities can be traced to the govern-

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[205] There is a view that corporations are reluctant to adopt voluntary codes of governance in the absence of significant pressure. See Harry Arthurs, "Corporate Self-Regulation: Political Economy, State Regulation and Reflexive Labour Law" in Brian Bercusson & Cynthia Estlund, eds., *Regulating Labour in the Wake of Globalisation: New Challenges, New Institutions* (Oxford: Hart, 2008) 19.

[206] Chris Riley has predicted the increasing "juridification" of corporate governance—a process that will mean more regulatory standards to guide the management of public corporations: Chris Riley, "The Juridification of Corporate Governance" in John de Lacy, ed., *The Reform of United Kingdom Company Law* (London, U.K.: Cavendish, 2002) 179.

[207] Bush, *2002 Address*, *supra* note 88.

[208] President Barack Obama, "Inaugural Address" (delivered in Washington, D.C., 20 January 2009), online: The White House <http://www.whitehouse.gov>.

ance practices inspired by economic theory is an area for future research. For instance, the relocation of manufacturing to developing countries has been a significant cost-saving device for many corporations,[209] and it has been argued that announcements about plant closures lead to share price increases.[210]

These considerations overlook the loss of jobs in the United States and other developed countries.[211] A contradiction in the model is its continued treatment of the developed countries as major markets. The consumers in these countries are supposed to support the very industries abroad to which they have lost their jobs. American trade deficits, which have mounted in recent decades,[212] raise questions about the sustainability of this model. A recent U.S. national survey found that the loss of manufacturing jobs ranked as voters' second biggest concern after budget deficits and national debt in the United States.[213] It is important that the microeconomic theory of corporations is informed by an understanding of the larger environment in which businesses operate and the probable trends in governance that could be engendered by such a theory.

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209 Oliver E. Williamson and his school of economists, who also trace their ideas to Ronald Coase, have been influential in turning the focus on transaction costs. See e.g. Oliver W. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 J.L. & Econ. 233; Oliver W. Williamson, "The Modern Corporation: Origins, Evolution, Attributes" (1981) 19 J. Econ. Lit. 1537. The large-scale relocation of manufacturing operations to low-cost developing countries since the 1980s, and the now ubiquitous "Made in China" label, can be interpreted in terms of transaction-cost economics.

210 The matter is not free from controversy. A recent study found no share price increases following layoff announcements between 1970 and 1999 by corporations included on the Fortune 500 list. Henry S. Farber & Kevin F. Hallock, "The Changing Relationship between Job Loss Announcements and Stock Prices: 1970–1999" (2009) 16 Labour Econ. 1. Farber and Hallock state that results could be different for smaller corporations.

211 See e.g. Katherine Van Wezel Stone, "Policing Employment Contracts within the Nexus-of-Contracts Firm" (1993) 43 U.T.L.J. 353.

212 The U.S. trade deficit rose from $19 billion in 1980 to over $680 billion in 2008. See U.S. Census Bureau, Foreign Trade Division, "U.S. Trade in Goods and Services—Balance of Payments (BoP) Basis", online: U.S. Census Bureau <http://www.census.gov>.

213 Peter G. Peterson Foundation, "New National Survey Results Show Americans Rank Country's Growing Budget Challenges, Debt and Deficit as a Top Priority for Obama Administration" (4 March 2009), online: Peter G. Peterson Foundation <http://www.pgpf.org>.