Corporate Legitimacy, Economic Theory, and Legal Doctrine

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I. INTRODUCTION

The subjects of this symposium are expressions of a common and recurring theme: the relationship of the corporation to society. This theme typically encompasses what we might call external legal questions: the facilitation or regulation of corporate activity by society. Today, however, we should understand it also to include questions of enterprise relations with other economic groups inherently enmeshed with corporate enterprise—groups such as workers, suppliers, and enterprise-dependent communities—and even, perhaps surprisingly, traditional "internal affairs" questions of shareholder-management relations.[1]

My aim in this address is two-fold: first, to describe what modern economic and social theories concerned with the structure and conduct of American enterprise say about corporate relations with society in general and with these specific economic groups in particular; and second, to identify some legal issues which need to be faced in light of these newer theoretical discussions. I offer no prescriptions or solutions. At best I suggest some approaches to thinking about these problems. It should also be obvious to the reader that neither the following description nor the sketch of issues originates with me. They are in the air, so to speak, and many scholars and commentators have continuously addressed these themes from the time that modern

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This is a revised version of a paper given at the symposium introduced at p. 513 above. The informal structure of the address has not been changed, however, and the citations have been kept to a minimum. The revision has benefited from comments by symposium participants, as well as by faculty and student members of a seminar on corporation law theory taught by my colleagues Robert Cooter and Melvin Eisenberg. I thank them and Professor George Hay of the Cornell Law School for their help.

1. This is a modern version of the "enterprise law" approach formulated in Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947). While that essay concerned the affiliated enterprise system and the effort to capture it within corporation law doctrines, third party (especially creditor) relations with the enterprise provided much of the motive for the study. In Europe, it is those relations, as well as the general though technical problems of bringing affiliated enterprises within traditional corporation law and the special case of labor participation in management, that have led to extensive discussion and elaborate definition of an "enterprise law" concept to replace "corporation law." An early English language report on some of those issues is Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23 (1966); a more recent but less extensive review of these developments in the context of the political theories in which they are embedded is R. JENNINGS & R. BUXBAUM, CORPORATIONS—CASES AND MATERIALS 441–42, 157–70 (5th ed. 1979).

A paper by Romano, Metapolitics and Corporate Law Reform, Stanford Law School Law and Economics Program, Working Paper No. 13 (1983), which was circulated after this address was prepared and which suggests a framework of political theories useful to corporation law debates, provides a substantial number of references to aspects of the "corporation law-enterprise law" distinction.

A study which also appeared after this one was prepared, Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984), analyzes the need for these constituencies to be a part of the governance structure from a "commitment-dependency" perspective with which the following argument is congruent.

corporations became objects of scholarly and governmental attention until the present.[2]

I must make one disclaimer at the outset, even at the cost of appearing disingenuous. My grasp of many modern economic theories and analyses of law is less than surefooted, as Mrs. Malaprop might put it. More to the point, the effort to address my specific concerns in a protective manner—that is, protected against economists' various positions with qualifications matching those positions' normative or empirical assumptions—would expand this discussion to the length of a small monograph, would shade the basic message to the point of invisibility, and would move the discussion onto the agenda of others. It is, I believe, possible to cite authority that would mitigate the charge of economic illiteracy, but in a setting such as this, I prefer to hew to my theme even at the cost of oversimplification.

That theme is a simple one: We are learning much from the analysis of law from economic perspectives, but at least so far very little of the product of those analyses can be put to direct use to fashion legal doctrine or rules in the wide field of enterprise law. There are two reasons for this situation. First, the conclusions of much of the work to date still rest on strong assumptions about the workings of real institutions; yet the work of courts, and even to some degree of legislatures, is inside the *terra incognita* defined by those assumptions. Second, much of the economic analysis bearing on enterprises and enterprise law is not as holistic or universal as it should be. It focuses too much on markets and their effect on firms, and not enough on the effect of firms, particularly of large enterprises, on social institutions including, but not limited to, markets.[3] The current focus is legitimate but at best leads to even broader

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2. One early collection of essays, including the editor's introduction, that embodies much of the still debated agenda is THE CORPORATION IN MODERN SOCIETY (E. Mason ed. 1959) [hereinafter cited as ESSAYS I]. A useful later collection is SOCIAL RESPONSIBILITY AND THE BUSINESS PREDICAMENT (J. McKie ed. 1974) [hereinafter cited as ESSAYS II]. Concerning the need for agreement on social values as a necessary condition to discussion of these issues, *compare* Manning, *Thinking Straight About Corporate Law Reform*, 41 LAW & CONTEMP. PROBS. 3 (Summer 1977) *with* Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979) (these two works illustrate a clash brought out well in Romano, *supra* note 1).

3. A more qualified way of explaining this would be to say that the obviously powerful formal models of enterprise-market and enterprise-society relationships, narratively identifiable by the labels "the firm," "information," "public goods," and "negative externalities," if scientific, are hypotheses and need experimental or empirical verification. That is harder to do in the social sciences than in the natural and physical sciences. The usual methods of demonstration—null hypotheses and multiple regression analyses—may provide means to exclude causal factors, but they are less successful with "parameter estimations"—demonstrating the *magnitude* of admitted causal factors, at least in these large, "social" fact complexes. *See* Fisher, *Multiple Regression in Legal Proceedings*, 80 COLUM. L. REV. 702, 704, 730 (1980); Rubinfeld & Steiner, *Quantitative Methods in Antitrust Litigation*, 46 LAW & CONTEMP. PROBS. 69 (Autumn 1983). This is the major problem of economic analysis. The difficulty of demonstrating the magnitude of causal factors is compounded by the "noise level" of complex interactions in large scale social settings, the "noise" obscuring causally significant factors. Mathematical rigor and massive, computer-based computational power may provide reasonable levels of confidence for certain descriptive purposes, and thus, for decisionmakers for certain prescriptive purposes. However, they do not, and perhaps cannot, come close enough to those levels of confidence in the socially important field of large organizations and their structures, governance, and control to justify potentially harmful large changes in legal rules. Basing important social and legal prescriptions on theories at that level of uncertainty is not to be recommended any more than muddling along without scientific clarity—at least so long as the muddling is, typically enough, slow and reversible.

The increasing integration within organization theory of internal firm hierarchy-"markets" and traditional markets (the "big firm" question) does not bear on this point; although it may in time, and in turn, help integrate historical explanations of internal enterprise structure with economic analysis. *See infra* text accompanying notes 16 and 53.

assumptions and thus to aggravation of the first problem; at worst, it leads to distortion of the issues and irrelevancy of the theories.

Also, economic analyses relating to enterprises and enterprise law create serious problems for courts and agencies. There are institutional limits on the ability of courts and agencies to function in complex social settings. It is difficult enough for courts to adjudicate claims brought by politically responsible claimants, such as the government, against complex and internally opaque enterprises. The adjudication of claims brought by politically unaccountable claimants is even more difficult.[4] Nothing is more tempting in the latter case than to mask a judicial *non liquet* behind an exorbitant use of economic theory, especially when formulations of many of the theories invite such misuse. Nothing, however, is more dangerous to legal institutions.

II. The Social Impact of the Corporation

It is fashionable today to disparage concern with the social and political legitimacy of corporate economic actors.[5] This is due in part to scholarly doubts about the reasons for concern and in part to a resurgent corporatist ideology per se. In greatest part, however, it is due to a despairing optimism, a kind of perverse panglossian view about our economic health and the role of the corporation in maintaining or resurrecting it. This is the best of all possible worlds, and if we meddle with it we might make it even worse. Nevertheless, as the number increases of those who more adamantly trust their private and public shepherds the more the boat rocks, so does the number of those who for that very reason demand an accounting from the private enterprise sector of its role in the economic process.[6]

I believe that the insistence on legitimacy is inevitable and unchanging, because it is voiced by those whose fates are affected by decisions in which they do not participate—decisions made by powerholders whom they do not elect. Let me begin with a simplistic hypothetical. If one person contracts with another for an exchange of assets or services on the basis of mutual advantage, this has spillover consequences to third parties. These third parties may be potential suppliers of labor, commodities, or money to the original parties, or they may be totally unrelated persons who bear the external burdens of that exchange because existing law does not adequately allocate those burdens to the exchanging parties themselves. Nevertheless, if arising only from random, small bilateral exchanges, the burdens on third parties will not be great. If, however, thousands of parties enter into an exchange relationship in a

4. Sometimes reactions to this difficulty surface in explicit terms. *See, e.g.*, Lewis v. Anderson, 453 A.2d 474, 475 n.1 (Del. Ch. 1982), *aff'd*, 477 A.2d 1040 (Del. 1984); Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 Tex. L. Rev. 1447, 1450 n.18 (1966).

5. As little as a decade ago that concern was the leading agenda item. *See* Essays I and Essays II, *supra* note 2. Bearing witness to the shift is Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 Hofstra L. Rev. 183, 200–06 (1979).

6. *See* R. Dahl & C. Lindblom, Politics, Economics, and Welfare xxi–xlvii (1976). Just this aspect of public acceptance of corporations as a fact of life is a major focus of an interesting recent attempt to demonstrate the inadequacies of a progressive pluralist political philosophy to justify private corporate control of the means of production. *See* Manley, *Neo-Pluralism: A Class Analysis of Pluralism I and Pluralism II*, 77 Am. Pol. Sci. Rev. 368, 372–73 (1983), and see the responses of Dahl and Lindblom, *id.* at 384, 386.

congruent fashion, the spillover effects of the exchange may well become a matter of intense concern to the two types of third parties. The thousands of congruently directed contracting parties provide an institutional identity—that of a corporation—to the exchange. The corporation has collective bidding and bid-withholding powers that affect, to a high degree, suppliers of labor, commodities, or money, as well as other persons bearing the externalities of the exchanges. The magnitude of the external effects of the aggregate (corporate) exchange inevitably arouses public concern.

Some of that concern may result in an agenda of public legislation, leading to antitrust or collective bargaining laws demanded by affected parties of the first type, such as laborers or suppliers. This concern may also lead to environmental protection laws which are demanded by the second type of affected parties, that is, persons totally unrelated to the exchanges. Indeed, and this is a critical point to our concern with "internal affairs" rules, if some of the original exchanging parties begin to see themselves as passive suppliers of a commodity—capital—to an already existing corporate frame of original contracts, public concern may lead to investment protection or securities regulation statutes. The overall point remains the same: We expect to see a social concern with this manifold aggregation of exchange relations—this corporation—that manifests itself in a varying catalog of legal controls of the corporation's structure and conduct.

The immediate response to this admittedly vague and general sketch of why concern with corporate legitimacy itself is legitimate, is a response of mitigation. Unlike thousands of congruent, contractual exchanges, which suggest an image of willful collusion or cartelization, the pooled capital of thousands of owners is the necessary and inevitable consequence of technically achievable and socially desirable specialization of productive and distributive functions—the technological aspect of efficient resource allocation. Pooled capital is necessary to build a steel mill or to fabricate cheap automobile fenders made from the steel sheets purchased from that steel mill, or to distribute to and secure the use of those fenders by garages or consumers. In addition, it takes specialized management of that pooled capital to coordinate the tasks achievable through advanced technology in this specialized and thus concentrated fashion.[7]

In summary, there is an economic, and therefore a social, justification for the existence of corporate structures. Corporations display an internal differentiation of capital and management function, and an external as well as internal concentration of economic, and thus social, power. This differentiation and this power are inherent and inevitable in the pooled ownership of means of production and distribution.[8] This

7. This much is common ground even among those who differ on who should own this form of the means of production. Similarly, even those who oppose a high level of specialization and concentration do not argue for the corporation's total disappearance.

8. In assuming the correlation of organization and ownership, *i.e.*, the private ordering of these units, I assume only an historical, not an inherent, correlation. For a recent discussion of this question in the setting of information theory, which builds on well known earlier debates, see R. NELSON & S. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE 358-65 (1982).

economic, and therefore social, justification thus counterbalances the social concern with the reflective, spillover effects of the concentrated power inherent in the contractual pooling of the surplus savings of thousands of individuals in the modern large corporation.

The antitrust analogy is worth extending to this context. We have little sympathy with collusion or cartelization by which participants seek the benefit of massed power without having provided the *quid pro quo* of efficient resource pooling. We have more sympathy with mergers, and even monopolies, for though they achieve the same degree of power they, at least, have committed previously independent small productive units to integrated ownership and control, thereby providing at least some efficient resource use through varying economies of scale. The corporation by definition is analogous to the merger and not to the cartel concept. Though originating in contract like any cartel, the corporation achieves a pooling of resources under unitary control promising the efficiencies we associate with an acceptable merger. It is true that any individual contracting party—any shareholder—may leave the combination just as any cartel member may leave the cartel. Nevertheless, so long as transferability of and a market for shares exist, the classification of the corporation under the benign form of this antitrust analogy is not affected.

The analogy remains useful as we begin to distinguish the corporation from the cartel or the merger and begin to look in more detail at each side of the equation—at the social concern with power and at the social concern with efficiency. From the antitrust perspective, it is not size but relative size in a relevant market that matters. Even a producer which is small in absolute terms may exercise market power, assuming an equally small relevant market and, what is harder to believe, assuming high barriers to competitive entry into that market. From our perspective, however, power in relevant market terms is only one consideration; it is power to affect the interests of the work force, of the supplier, and of the community that matters. For example, as to some of these external effects the simple absolute size of the enterprise may not correlate with the possibility that it arouses social concern; an enterprise which may be a giant in antitrust terms may be only a pygmy in its effect on the workplace, supplier, or community in a small, protected market. The largest producer in the smoked-glasses-for-eclipses market may be so small that no union is interested in organizing its workers, and no United Way fund drive is interested in soliciting its contribution.

There may, however, be specific, even serious, impact on those affected social interests that correlates neither with size nor with relevant market considerations. The smoked-glass firm may pollute the air or the water table because of its particular method of production and because of the public law's failure to prevent externalization of costs, and thus arouse social concerns to a degree quite out of line with its overall size or relevant market position. In short, while externally affected parties may on the whole be the less concerned the smaller the corporation (that is, the fewer the congruent contracts), neither this nor the relevant market size correlation holds *a priori* in terms of the external effects on society.

Please recall that I am only speaking of the social concern with corporate power at this stage. Acceptance of the social effects of corporate power, however, is a

function of balancing the countervailing issue of utility against the social problems thus created. Until now, I have belabored only the obvious point that these effects indeed do raise social and therefore political concerns, and that to convince the polity of the legitimacy of its behavior, and thus indirectly of its existence, the corporation has to demonstrate the economic efficiency—the social utility—of its behavior. That the corporation is a legitimate wielder of economic and thus of social power can be demonstrated only by recurrent engagement in that balancing demonstration. It cannot be asserted out of hand, or once and for all, by disparaging or deprecating the social concern with its power, let alone by denying the legitimacy of that concern. It certainly cannot be demonstrated by emphasizing the private form of enterprise and its formal separation from public power-wielding structures in justification of that legitimacy.[9]

III. The Economic Justification of Corporate Power

A. *The Modern Organizational Thesis*

Within the past decade a modern version of the managerialist thesis of large corporate structure and behavior has achieved a wide consensus. That thesis is derived chiefly from Alfred Chandler,[10] and in part from students of corporate finance. It is a combined thesis that has great and direct significance for current debates about corporate governance and legitimacy, and I take the liberty of sketching it briefly and inadequately.

The development of a national transportation and communication infrastructure, accelerated by the demands of the Civil War, created an organizational revolution in the distribution of goods that led to the upstream involvement of farm, mine, and factory in mass, large scale distribution establishments. The development of that same infrastructure, joined by technological breakthroughs permitting high volume production, also led to an even more spectacular organizational revolution in the production of goods. Both developments were characterized by their shortening of the product and credit throughput time within firms; both led to the internalization within the enterprise of what had previously been separate market transactions. This permitted the achievement of efficiencies including, but by no means limited to, those achievable by vertical integration. The internal structuring of these new modes of production and distribution within the firm further led to what may in the long run have been the more important aspect of this organizational revolution, the improvement, in Chandler's terms, of administrative coordination and allocation. As he suggests, "far more economies result from the careful coordination of flow through the processes of production and distribution than from increasing the size of producing or distributing units in terms of capital facilities or number of workers."[11]

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9. For an explanation of the contractarian argument see, e.g., R. Hessen, In Defense of the Corporation 13–22 (1979).

10. *See* A. Chandler, The Visible Hand—The Managerial Revolution in American Business (1977).

11. *Id.* at 490. The well known work of O. Williamson, Markets and Hierarchies (1975), models this sense of internal organization and suggests explanations based on organization theory for the viability of these "internalized" market-mimicking structures. *See also* Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. Econ. Lit. 1537 (1981).

When we add the financial element, Chandler's work again is a starting point. Chandler has recorded the importance of "financial capitalism" in the growth of firms that were applying these distributive, production, and administrative efficiencies. Its importance was foremost for those that grew by merger, but it had significance even for those that grew through internal expansion fueled by retained earnings or new capital. Chandler emphasizes the vital importance of the old-line investment bankers, such as J. P. Morgan, to this late nineteenth century development that culminated in the financially-fueled merger mania of 1890–1905.[12] He deprecates only the continuing importance today of this vital, but to him transitory, connection: "[By the 1950s] [i]n those sectors where modern multi-unit enterprise had come to dominate, managerial capitalism had gained ascendancy over . . . financial capitalism."[13]

B. *The Market Dimension of the Organizational Thesis*

The limited recognition of the relationship of enterprises and capital markets is, of course, only a part of the picture. It focuses, as Chandler emphasizes, on financial capitalism as a possible determinant of the size, structure, and behavior of large corporations. That issue is in a sense also our issue, yet the emphasis is different. Chandler's emphasis is suggested by this broad conclusion: "The rise of modern business enterprise in American industry . . . was little affected by public policy, capital markets, or entrepreneurial talents because it was part of a more fundamental economic development. . . [—] the organizational response to fundamental changes in processes of production and distribution . . . ."[14]

For us, however, the question is whether the relationship of enterprises to markets permits the conclusion that markets—whether product and service markets, capital markets, or the modern capital-market derived markets for management and corporate control—operate effectively enough as boundaries on management and on enterprise behavior to guarantee that the modern large enterprise is efficient and thus is balancing out the social utility-political power equation. From that perspective the implications of the following market-related comment of Chandler is relevant to the legitimation problem:

> Modern business enterprise became a viable institution only after the visible hand of management proved to be more efficient than the invisible hand of market forces in coordinating the flow of materials through the economy . . . [—only after there arose] a managerial hierarchy capable of taking the place of the market in coordinating, monitoring, and planning for the activities of a large number of operating units.[15]

Some current legal scholars accept the institutional form of this description and yet deny its consequences. Thus, it is said that managers lease the factors of enterprise activity: capital, labor, commodities; yet it is also said that these factors, especially capital, are still autonomous markets in the sense that they constrain these

12. *See* A. CHANDLER, *supra* note 10, at 145–75 *passim*.
13. *Id.* at 493; *see also id.* at 373, 416.
14. *Id.* at 376.
15. *Id.* at 339.

manager-owned enterprises to operate efficiently. It is this inherently contradictory view of the role of markets that requires further examination.

C. *Organizational Theory and Market Theory: Coexistence or Congruence*

We have to contend with the apparent inability of two major forms of economic inquiry—the institutional and the theoretical—to enter into dialogue with each other.[16] This communication failure is a special example of what one of the greatest political economists of this century, Walter Eucken, called the Great Antinomy—the contradictions between economic theory and economic reality.[17] Though he was speaking of an older set of pre-Keynesian theories, Eucken's charge remains valid today. On the one hand we have the market theorists; on the other hand, we have the institutional scholars. Among the institutional scholars, Chandler is the closest to bridging the gap between theory and reality because of his rigorous method of inquiry; but this same group also includes not only provocative generalizers, like Galbraith with his "technostructure" argument,[18] but also more formally analytical scholars.[19] Their work is premised on the understanding of large organizations as information-processing decisional systems, and these scholars have helped us to understand better both the technological and social imperatives that create large organizations, and the relationships of organizational structure to the setting and achieving of organizational goals. In addition, they have brought us to an understand-

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16. There is a longstanding "institutional-theoretical" debate among social theorists, most recently associated with Polanyi and Parsons respectively, which mirrors, or underlies, this economic debate. For a succinct statement joining the issue, in a form of a response to T. PARSONS & N. SMELSER, ECONOMY AND SOCIETY (1956), see Pearson, *Parsons and Smelser on the Economy*, in TRADE AND MARKET IN THE EARLY EMPIRES: ECONOMIES IN HISTORY AND THEORY 307 (K. Polanyi, C. Arensberg & H. Pearson eds. 1957).

A well known statement of the intellectual history of this issue is in K. POLANYI, THE GREAT TRANSFORMATION 132 (1944) (citation to paperback ed. 1957):

> [The movement towards a self-regulating market and the contrary movement towards control of its dislocation costs] can be personified as the action of two organizing principles in society, each of them setting itself specific institutional aims, having the support of definite social forces and using its own distinctive methods. The one was the principle of economic liberalism, aiming at the establishment of a self-regulating market, relying on the support of the trading classes, and using largely *laissez-faire* and free trade as its methods; the other was the principle of social protection aiming at the conservation of man and nature as well as productive organization, relying on the varying support of those most immediately affected by the deleterious action of the market—primarily, but not exclusively, the working and the landed classes—and using protective legislation, restrictive associations, and other instruments of intervention as its methods.

It is separately worth noting that this argument, even this specific statement of the dichotomy, has gained new currency. *See* Swaney, *Communication—Rival and Missing Interpretations of Market Society: A Comment on Hirschman*, 21 J. ECON. LIT. 1489 (1983).

17. W. EUCKEN, THE FOUNDATIONS OF ECONOMICS 41–44 (T. Hutchison trans. 1950).

18. *See* J. GALBRAITH, THE NEW INDUSTRIAL STATE 62–74, 91–103, 156–66 (3d rev. ed. 1978). For a discussion of these theories, see Bower, *On the Amoral Organization*, in THE CORPORATE SOCIETY 178 (R. Marris ed. 1974).

19. I refer here to those who try to model the specific "retention power" of the large firm vis-a-vis the competitive pressures of capital as well as product markets, rather than to those associated with the universal hypotheses such as Arrow or Coase. *See, e.g.*, R. MARRIS, THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM (1964). The current status of implementation of the general types of theories, especially that of Coase, in the broad field that includes institutional issues is briefly sketched in Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J. LAW & ECON. 351 (1983), a study published after this paper was written. For a recent evaluation of internalization theory that indirectly confirms this "efficiency-effectiveness" distinction, see Teece, *Technological and Organizational Factors in the Theory of the Multinational Enterprise*, in THE GROWTH OF INTERNATIONAL BUSINESS 51 (M. Casson ed. 1983) (building on Williamson's categories).

ing of the power of large organizations within their social, political, or economic environment, and of the inherent structural problems of such organizations in responding to signals from affected external environments (when those signals are not themselves manipulated by these large organizations).

These institutional theorists, whatever their individual views on the ability of those external environments—markets—to function as constraints on producers, do not identify the discipline of these markets as a major control of the organizational structure, organizational behavior, or organizational performance of large producers. At best they see these organizations and markets as engaged in highly complex interactions in which an enormous number of factors are relevant to specific questions relating to whether a given organization is competitive and is promoting the efficient allocation of resources. In other words, they believe large, complex organizations are absolutely necessary to produce goods and services in certain types of societies, and that in our society and a few other northwestern societies these structures are producing goods and services quite well.

This absolute sense of effective production, however, is not the same thing as the relative concept of efficient production. Efficient production is the production of goods and services at prices tending toward producers' marginal costs—costs that innovation, under the spur of uncontrollable competitive pressure, helps to reduce. Effective competition is a simpler but equally powerful and descriptively more accurate concept. The concept of effective competition is premised on the assumption that no disaggregated producer universe, even if each unit worked under the spur of fully effective ideal competition, possibly could produce goods and services as cheaply as can a universe of far fewer producer units, each of which has sped up the process of converting factors of production into commodities by the internalization of factor collection and conversion.[20]

The concept of effective competition is the heart and soul of the economy of today. Not only do we as a polity, as a society, and as a culture live with it, but our political, social, and cultural institutions are largely derived from it. Large unions with many units can obtain recognition of their goals only from large and absolutely effective rather than relatively efficient enterprises.[21] Large institutional investors and creditors providing the bulk of capital and credit intermediation to producers can effectuate their transmission functions only vis-a-vis large and therefore governable structures.[22] Imagine the costs of unionizing, financing, and regulating an almost

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20. I recognize that in the firm model this formulation of effective production collapses into the standard version of efficient production because of the inherent transaction costs associated with a long and complex chain of market transactions. From the perspective of the difference in the power relations of classic and modern producers with their various markets, however, it is useful to recall the difference between those two forms of production.

Compare the industrial organization literature on the argument that even loose oligopolistic structures may be optimal from the perspective of effective competition, and see especially A. PHILLIPS, MARKET STRUCTURE, ORGANIZATION AND PERFORMANCE (1962). A good statement of the more radical argument that competition, as a process of discovery, is not dependent on market structure is the 1946 essay of F. HAYEK, *The Meaning of Competition*, in INDIVIDUALISM AND ECONOMIC ORDER 92, 100 (1948), more fully elaborated in Hayek, *Der Wettbewerb als Entdeckungsverfahren*, FREIBURGER STUDIEN: GESAMMELTE AUFSATZE VON F. A. VON HAYEK 249 (1969).

21. *See, e.g.*, Winter, *Collective Bargaining and Competition: The Application of Antitrust Standards to Union Activities*, 73 YALE L.J. 14, 19-20 (1963).

22. *Cf.*, though in a slightly different context, Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises* (Book Review), 94 HARV. L. REV. 561 (1981).

infinitely large number of almost atomistically small producer units, whose aggregate workforce impact, financial needs, and social impact by definition would be greater than those of more effective large producers. In addition, these numerous small producer units, spare and selfish under the relentless spur of competition, would be largely intractable toward civic concerns. Compare this group with those large producers whose overall effectiveness provides the margin of surplus that generates the means and therefore the inclination to increase, or at least stabilize, their payments to factor providers, and to accept a certain amount of internalization of costs of production that the environment-government feels are being unfairly externalized.[23] To put it most vividly and culturally, imagine a United Way fund drive that had to raise all of its money painfully from millions of shareholders or workers individually rather than from a few corporate donation committees.

This obviously simplistic picture is sketched not to reinvent old though quite valid notions of countervailing power, but to emphasize the nature of the interaction between the corporate system and the social environment. It is not an interaction of blind and individually helpless forces through the anonymous, unconscious, and therefore legitimate modalities of markets, in some only slightly more sophisticated version of the invisible hand. It is the interaction of two visible hands; two sets of power-holding groups, limited in number, conscious in motivation and action, and stable within fairly wide and long-lasting parameters, though never as wide or durable as the participants might wish. Objective factors admittedly limit the interaction. These may be totally exogenous forces like war, oil, and blight; socially endogenous but enterprise-external forces like monetary or fiscal policies, antitrust or social welfare legislation; or totally enterprise-endogenous ones like managerial skills. It is, however, a dangerous mischaracterization to conceive of these limits or to perceive the conscious interaction between those limited groups as adding up to some modern equivalent of classical efficiency. It is dangerous because of quite specific legal consequences that are drawn from that mischaracterization; consequences that are felt all the way to the details of the business judgment rule, to take a substantive example, and to the details of the division of regulatory powers between federal and state sovereigns, to take an institutional one.

In turning to these examples in the context of the themes of this symposium, I need to justify the turn from what has been primarily a focus on the external impact of large and powerful enterprises on suppliers, customers, labor, and the larger social environment generally, to a focus on the internal impact, if I may put it that way, of these firms on their owners. After all, I have defined the field as enterprise law, and its core is corporation law, not antitrust, labor, or environmental law.

There are two related justifications for looking at both public (*e.g.*, environmental) law and private (corporate) law from a common (enterprise law) point of view. First, as already shown, the boundary between private corporate law and public

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23. This description should recall, though it varies, the Schumpeterian description of surplus retention needed for innovation. The surplus retention of firms in an imperfectly competitive market may be used for a social purpose. In crudest terms, a part of the wealth that is generated by being big and powerful—and that can be generated only by being big and powerful—becomes a transfer payment to government and social groups for continuing the truce.

investor protection law has become blurred.[24] Thus, it would not be too primitive an approach to assume at least their integration. Second, if the large firm is effective, productive, and competitive, without being subject to the savage pressure of classic competition, it should be fruitful to pose a similar frame of reference for the enterprise's interaction with the capital market—that is, its shareholders—and for its interaction with such special variants of the capital market as the market for control and the market for management.

IV. LEGAL CONSEQUENCES OF THE CLASH OF THEORIES: THE TAKEOVER BID EXAMPLE

Let me move closer to some of the specific themes of this colloquium by focusing on the way in which two major hypotheses of market theory purport to deal with the institutional situation I have sketched, and by focusing on the problems raised by any direct transmutation of these hypotheses into guides for legal rules. The first specific concept is an aspect of the well known efficient capital market hypothesis; the second, an aspect of agency theory bearing on controls on self-aggrandizing behavior of corporate agents such as directors or officers. These two concepts in turn bear on current debates over the rules governing takeover bids and addressing both the bidder and the management of the target. The second concept also bears on current debates over the proper scope of the business judgment rule in its substantive as well as in its procedural-remedial aspects. These two subjects and their legal framework will be discussed in turn.

The capital market theoretically functions efficiently in that its mechanisms permit constant and fast adjustment of prices of shares of public companies on the basis of company-specific as well as general information.[25] Given only a few weak assumptions about uniform and rational investor motivation and behavior, this constantly adjusted market price also approximates the intrinsic value of the specific corporation.[26] When relatively poor management, which can mean anything from self-indulgent management to inefficient use of the corporation's resources, drives stock market value below intrinsic value, takeover opportunities develop. Supported by financial intermediaries that are themselves driven to be efficient in allowing bidders to mobilize capital and credit at low cost, takeover bids reallocate the target's resources efficiently and thus realize the potential intrinsic value of the corporation and readjust the market value for its shares to approximate intrinsic value.[27]

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24. *See* Friendly, *In Praise of* Erie*—and of the New Federal Common Law*, 39 N.Y.U. L. REV. 383 (1964).

25. A standard reference is J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE (1973). The recent article of Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984), provides a comprehensive statement of the hypothesis and its tests, as well as full references to the literature. The authors' formulation of an information-theoretical explanation of the hypothesis is separately interesting.

26. The intrinsic value of a corporation can be defined as the market value it has when optimally using its resources, including potentially available resources. Except in this sense, the very concept of an intrinsic value other than a market statement of value is troublesome, perhaps meaningless, in the context of this formulation.

27. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in*

A. *The Bidder*

Let me put aside for the moment the consequences this hypothesis has on the role of target management, and apply the previous discussion only to the bidder side of the takeover transaction. As asserted earlier, investor behavior, among other elements of the environment within which the corporation operates, is as much a function as it is a determinant of corporate structure, behavior, and performance. Since in the world of large organizations a given shareholder has only a minuscule and, in governance terms, an impotent position within the collective ownership of the corporation—the shareholder has no voice and develops no loyalty—only easy exit remains among the attributes of dominion over this asset.[28] Easy transferability of shares over a functioning stock market is thus a condition of investment, as is easy entrance. This "easy come, easy go" situation means that this species of rational investor invests in the investment, not in the corporation. The focus of attention is on the stock market, not on the corporation.[29] As Professor Werner has vividly demonstrated,[30] this situation also has transformed the shareholder from king of the corporation[31] to king of the market.[32] Indeed, shareholders now enjoy a universal market for their surplus savings that permits almost costless transferability among financial markets, a market not limited to the corporate share market. It should not be forgotten that exit is an exercise of power, and that the king of a corporation whose subjects can costlessly flee the kingdom and costlessly settle in other kingdoms has power only over physical space and objects, and is in turn easy prey to invasion.

Tender Offers, 33 STAN. L. REV. 819 (1981). While each study focuses on the issue evident in its title, both share the common ground stated in the text. For the strongest assertion that changes in control, whether by merger, proxy contest, or takeover, regulate abuse or inadequate use of agency power by management, see Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

28. *See* A. HIRSCHMAN, EXIT, VOICE AND LOYALTY, (1970). In A. HIRSCHMAN, ESSAYS IN TRESPASSING 213 (1981), Hirschman interestingly considers the implications of his earlier discussion in the context of management-shareholder relations.

29. In an interesting report that was published after this paper was written, a not so facetious comment by a financial sector leader caricatures this development:

> [G]iven Wall Street's traditional role as financial doctor to American industry, what is the Street doing to help in the rebuilding of the American economy?
>
> The executive talks of the billions of dollars changing hands each day, the giant corporations absorbing each other, the huge fluctuations of the markets. Finally, he answers the question, index finger stabbing the soaring earnings reports of brokerages in that day's paper. "We," he exclaims, "are the new economy!"

Smith, *The Wiring of Wall Street*, N.Y. Times, Oct. 23, 1983, (Magazine), at 44, 70.

30. Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388 (1977).

31. Whether shareholders ever controlled corporations is the subject of a separate debate, *see* Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1634–35, 1662–63 (1981); *see also* Hetherington, *supra* note 5, at 194, on which I do not enter here—except for one tidbit.

I owe to Herberger, *Das Inhaberpapier als "spirituelle Dampfmaschine,"* 1 RECHTSHISTORISCHES JOURNAL 180 (1982), the following quotation from J. KUNTZE, DIE LEHRE VON DEN INHABERPAPIEREN ODER OBLIGATIONEN AU PORTEUR 9 (1857) (my translation):

> With the share [actually, the bearer share] the problem of creating an investment in large enterprises which is at one and the same time nonrevocable and yet can always be liquidated is solved. The capital represented by the share is permanently dedicated to the association purpose, but the owners of this capital can change from hour to hour. The aggregate of the locked-in capital investments is subject to the greatest possible centralization, but the position of the participants is the freest and most autonomous which one can imagine in a corporation. . . . [I]n short, our economic culture had entered a stage from which it would have been impossible to progress, had not the bearer share, that spiritual steam engine, offered itself as a transportation medium for capital.

A worthy rival to Nicholas Murray Butler!

32. Werner, *supra* note 30, at 406.

This situation supports two preliminary hypotheses. In the first, one can presume that the separation of exit from voice permits the establishment of a market in "exit"—in stock—that is not correlated to the market for "voice"—control. In simplest terms, assume a universe of only 100 large, powerful corporations, each with 1,000,000 roughly equal shareholders. The power of each corporation as such in terms of industrial organization—in product and labor markets, for instance—is a function of being one of 100 potential transacting parties (I assume one "voice," one "control," per enterprise). In the capital market, however, each corporation is a price taker. Potential transactions among 1,000,000 owners set the stock price, with the corporation being only a datum, not an actor, in that market. Indeed, absent loyalty, the shares of all 100 corporations are fungible. Thus, a potential 100,000,000 parties each using all 100 corporations as data, not actors, are involved. Finally, since these traits make capital markets just one fungible set among all financial markets, the number of transacting parties may be even larger. Most significantly, the 100 corporations as an aggregate set is only a single datum among hundreds of others.

Another way to view the same basic situation, however, is to assume that a large corporation achieves independence from the market for its own shares as part of its general product and factor autonomy. The "organizational surplus" that large companies thus would have achieved[33] includes, quite literally, the surplus reinvested in growth and the credit line available from a credit supply market which bargains with the company as an equal, rather than forcing the role of a price taker upon the company. In this view the original function of the stock market is reduced to a distant, mediated, and only occasional reference point for the supply of capital, and thus to an exogenous, but not critical or close constraint. Under this view, further, the "organizational surplus" is not necessarily, and perhaps not typically, reflected in the pricing of such companies' stock.

The result of combining these approaches may be paradoxical. The metaphor of the kingdom without borders applies originally only to the relationship of a company to its shareholders. As to the relationship of a company to its customers, suppliers, workers, and environment the metaphor has far less force. The sketched "combined" metaphor, however, suggests that the actual power relation between management and shareholder partakes of both extremes. The enterprise, represented by management, can keep a larger proportion of the value derived from the capital-contributing exchange transaction "in house" than a competitive, efficient transaction would allow. Yet the possibility of shareholder revolt via the sale of "voice"—*i.e.*, via accepting a shareholder bid—remains. As a result, company reaction to the valuation of its shares may be based in part on management's personal, subjective concerns with its fate; but probably it is based as much on enterprise-derived ("objective") grounds, on how the organization, given its goals, reacts to the seemingly irrational bases on which disloyal, voiceless shareholders value their stock.[34]

33. *See supra* note 19.
34. *See* Werner, *supra* note 30.

1. *Market Analysis*

We can examine this charge of irrational valuation activity from two perspectives. The first accepts the stock market's behavior without questioning the reasons therefor, and goes on to sketch the consequences of that behavior to the agency and control market hypotheses which currently figure so prominently in the takeover bid debate. That approach is taken here. The second approach to the stock-value issue, however, seeks to understand the basis for the market behavior, building on the just-reviewed institutional-organizational basis of the enterprise-shareholder power relationship, and specifically on this concept of organizational surplus and its retention, unreflected in share prices, within the enterprise. At present no more than some preliminary hypotheses and assertions can be developed. Even in that sketchy form, however, they may illuminate the behavior of stock prices, and therefore will be developed briefly following the further description of that behavior and its consequences for currently prevailing theory.

That description alone suggests some significant doubts about the role of takeover bids in policing management efficiency. On the investor and market side, these "irrational bases" of stock valuation form behavior patterns like those of gamblers who want to grab the brass ring while holding on to the carousel with both hands.[35] They trade in an unlearned random fashion next to professionals who trade in a learned and slightly less random fashion, while both groups at times trade next to insiders who trade only occasionally but nonrandomly, since they control the objective facts on which trading occurs when they do enter the market.[36] Out of this rich behavior pattern emerge price and value signals which are not well geared to the agency control mission of identifying suboptimal corporate performers. It is irrelevant to the efficient capital market hypothesis that we live with price volatility and with persistent price variations among companies with similar financial performance characteristics. But to the extent there exist oscillatory and persistent variations from what a control bid or a management press release tells us is "intrinsic value," we have problems with the role of share prices as signals for organizational corrective actions. None of this, of course, contradicts or is unexplainable within the efficient capital market hypothesis, but it does combine to make the hypothesis trivial from the perspective of public policy and legal rules.

One reason for the triviality of the hypothesis is that these short term and oscillatory phenomena have long term effects. As described by Professor Werner, a firm's management, sensitive for valid or invalid reasons to the impact of share prices

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35. *Cf.* Smith, *supra* note 29, at 109:

Yet many Wall Street leaders are nervous about the larger implications of the new technology. "The nightmare," says Ulric Weil, the Morgan Stanley analyst, "would be that under the impetus of electronics we will have total automation of the whole function of the stock exchange, the market making, the trading. Wall Street would become nothing else but the great casino in the sky, a gigantic apparatus for legitimized legal gambling on a worldwide scale. We would have no pretension to serving a social function such as capital formation, providing the lubricant for the industrial society."

36. Gilson & Kraakman, *supra* note 25 discuss this within the context of the weak, semi-strong, and strong versions of the efficient capital market hypothesis developed in Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

on the organization, may operate with the goal of improving or maintaining share prices, or at least protecting them against lags and oscillations.[37] This share price protection has consequences for the overall productive effectiveness of large organizations, the key concept underlying this entire discussion and accounting for the existence of these structures. Even this, however, might not be so bad were it not for a second effect[38] of the increased opportunity for takeover bids created by the possibly efficient but certainly unstable price for shares of stock.

It is not necessary to review the mechanism by which price "disparities" and volatility provide takeover opportunities, whether by identifying temporary targets or by providing bidders with temporary advantages in the use of their own stock as the currency for such bids. Two additional institutional phenomena, however, which also contribute to distortions of the market merit discussion. Both can be fit into existing descriptions of the efficient capital market hypothesis, although ultimately they are irrelevant to it. They bear specifically on the argument that takeover bids (by definition varying from current market prices) identify suboptimal use of resources by targets and thus aid the efficient allocation of resources.

The first phenomenon is that of institutional investors, particularly the mutual stock fund and the pension fund investors.[39] In terms of volatility of holdings and trades and in terms of motivation to trade, the institutional investors, whose overall predominance in stock ownership and stock trading is well known, multiply the distortions of the market quantitatively as well as qualitatively. Quantitatively, the institutional investors deepen the distortions simply by increasing the size of specific trades, even though these trades are typically off-board. Also, the institutional investors shorten the timeframe within which buy or sell signals of similar size reach the market, and thereby generate wider, deeper, and perhaps longer price disequilibria in the market than would otherwise exist, disequilibria which permit or at least encourage the previously mentioned takeover opportunities. Qualitatively, institutional investors increase market distortions because the attention span and bloc market limitations inherent in institutional investment limit the mutual fund and pension fund investors to a small proportion of all stocks. They thus create a two-tier set of stocks. One set suffers a permanent markdown of market value from intrinsic value because of this relegation, and thus may be subject to permanent raids by members of the second set.[40] Furthermore, the mutual fund itself may suffer from bad

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37. Werner, *supra* note 30, at 403.

38. This second effect was identified in Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983). *See* Gilson & Kraakman, *supra* note 25, at 553 n.19 for a criticism of Lowenstein's blurring of the efficient capital market and efficient management control market hypotheses.

The just published substantial contribution of Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984) appeared too late for me to integrate into the present discussion. Coffee's position, however, seems fully congruent with the discussion presented in the accompanying text.

39. As to the following discussion, see Lowenstein, *supra* note 38, at 297–304; *see also*, Smith, *supra* note 29 for the recent sobering review of "time compression" (and its consequences) that computerized information flow has generated for institutional investors; *cf.* Blumstein, *A Case Study on Wall Street: How News Feeds Volatility*, N.Y. Times, March 13, 1984, at 1, col. 1.

40. Gilson & Kraakman, *supra* note 25, at 571 n.69 suggest a permanent discount phenomenon for the "informationally naked" stock that is not followed by professionals or held by institutions. For some information on the

management or from extrinisic pressures that lead it to make "sell" decisions unrelated to the value of an innocent member of its holdings. As a result, further distortion may appear.

All of these assertions are, of course, speculations that not only need factual demonstration, but even then would require further inquiry to determine whether the off-board bloc market as such is so uncompetitive as to trigger price distortions. If both groups of factual assumptions are valid, however, they suggest that a run on corporate resources may occur, causing strains on a corporate system innocent of efficiency violations, similar to those caused by runs on banking resources. The difference in the corporate context is that the company whose shares are the subject of the run is not insured.

On the bidder side, the mechanisms and motivations of the financial markets that supply the bidder with low cost capital and credit for its bid also lead to distortions in the opportunities for takeovers. The intrinsic undercapitalization of commercial banks and investment banks has led to a search for opportunities to earn up-front revenues from the lending of bank credit to customers and from the provision of agent functions such as syndicate managing. This search for revenues spurs the financing of takeover bids at prices that do not reflect the costs of the particular transaction. This also indirectly distorts the takeover bid calculation itself. In addition, just as commercial banks' fees for issuing standby letters of credit are lower than guaranty bond premiums (because, unlike the latter, they are not actuarially derived but are based on other bank-customer relationships), so takeover bid financing may well be available for reasons and on terms reflective of other past, present, or future relationships between bank and bidder. This further distorts the bidding process. Indeed, to the degree that a bank short on profits gambles on the quick fix of front-end commission activity through the extension of takeover bid credit at distorted prices, it adds to the price distortions of the stock market in a manner similar to the previously mentioned bank run analogy.

Here again I have neither stated a challenge to the efficient capital market hypothesis nor demonstrated the factual validity of my own hypotheses. Further, even if factually confirmed, these hypotheses do not categorically gainsay the possibility that takeover bids may, in fact, aid efficiency. Nevertheless, if competitive or regulatory distortions in the banking sector do cause more takeover bid activity than would otherwise occur, the efficiency claim for takeover bids is to that extent more compromised.[41] In sum, price distortions in the stock market caused by credit suppliers and by institutional investors render the efficient takeover bid hypothesis at the very least more difficult to support.

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number and nature of listed firms that are so followed and held, see Lowenstein, *supra* note 38, at 297–304. The technology explosion described by Smith, *supra* note 29, however, may lead to wider stock holdings and probably also to more information about those holdings.

41. It is interesting that despite earlier intimations that the Federal Reserve Board might be concerned about this issue, the SEC Advisory Committee on Tender Offers was not encouraged to go into this matter. Its report contains a surprisingly offhand and conclusory reference and recommendation on this point, but no supporting evidence. *See* SEC Advisory Committee on Tender Offers, Report of Recommendations (July 8, 1983), *reprinted in* FED. SEC. L. REP. (CCH) No. 1028, at 13–14, 59 (extra ed. July 15, 1983). Regarding the potentially distortive role of investment bankers' advisory fees, see Salmans, *Merger Advisers Under Fire*, N.Y. Times, Oct. 4, 1982, at D1, col. 3.

Journalistic descriptions of many takeover battles and empirical studies of the fate of bidder stock market prices after takeovers suggest that even this and Lowenstein's related explanations are too narrow. It seems that the motivation for takeover bids often is totally unrelated to special opportunities caused by discrepancies between market price and intrinsic or potential value. The motivation is explainable more simply by the decision of bidders to accept the risks of growth first, in light of the uncertainty of later market reaction. Only through later market reaction to the share price of the enterprise is a judgment of the efficiency of the initial takeover decision made. The real capital market test of efficient resource allocation, in short, turns out to be on the bidder, not on the target. In itself, of course, that is not surprising but appropriate. If, however, as in fact seems to be the case, the market judgment of the takeover decision is as often negative as positive, then the efficiency function of takeover bids operates only in a random and weak fashion.[42] Transfers of value between shareholders of bidder and target companies, of course, are taking place, but the social benefit is small. The case for efficient allocation of resources then rests only on the far weaker notion that takeover bids are sometimes a necessary control on target management efficiency.[43] Since takeovers appear to have no systematic impact on weak management or suboptimal resource use, however, takeover threats cannot affect management behavior except in an inconsistent manner. If doing well is no protection, the incentive to avoid doing badly is weak.

This hypothesis can be supported by bringing the discussion back to the effect of the distortions of the takeover bid phenomenon and the effect of the distortions of the general share pricing market mechanism on the effective performance of large enterprises, on their management's behavior, and thus on the legal rules and public policies bearing on their behavior.

Some metaphors will focus the effects I have been discussing. Management keeps too much of its eye on the stock market or, at least at times, on the unexpected bidder for control. The enterprise thus is operated for reasons, in ways, and with results antithetical to the goal of absolutely effective production that its exogenously derived organizational structure permits. The driver is watching the passengers and the cars behind him, not the road, let alone the road signs. The problem can also be stated through a political analogy. Imagine a representative form of government in which the people vote daily through their individual interactive television sets for the retention or replacement of their representatives. They do this without cost other than consideration of their civic investment in representative government. What is more, challengers can appear on the screen "below cost" at any time, and attempt to secure their own election by debating incumbents who feel called upon to reply to each challenge. In this analogy a constant ongoing recall battle would replace the traditional fixed term of office. Obviously this would have a deleterious effect on the very function of representative government, a form required by the growth of any polity

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42. For a brief but suggestive overview see R. MARRIS, THE THEORY AND FUTURE OF THE CORPORATE ECONOMY AND SOCIETY 100-04 (1979).

43. For data on comparative market performance of acquired firms, the normal surrogate for efficiency, see Gilson, *supra* note 27, at 852.

beyond the town meeting level. A larger polity requires representative government which, as a concept of agency, requires discretion in that agent if it is to achieve its constituents' shared goals. The ability of the principals to "communicate" through unilateral decisions on the market or through solitary button-pushing on a television set is not the same thing as voting, politically or in corporations, even by proxy, let alone in person. Instant aggregation of sentiment is not instant intercommunication except of the ever-changing result; instant aggregation, therefore, cannot substitute for effective government of large numbers of citizens through representatives.

With all appropriate qualifications—particularly as to noncomparability of price and nonprice means of expressing preferences—I submit that this is the correct, although perhaps abstract, version of the efficiency challenge that faces many large corporations today. A large organization is already internally structured to focus heavily on the financial aspects of its underlying productive functions; too much so, some students of conglomerate structures would argue. To the extent leadership of the large corporation is driven by the external developments of the capital market, it is excessively concerned with matters that compromise its basic purpose and justification. As a result, much greater and, in the macroeconomic sense, truly significant problems of dysfunctionality have arisen.[44]

2. *Organizational Analysis*

As earlier suggested, there remains a second and less subjective inquiry, not only into actual stock market price-setting behavior, but into the objective elements of the enterprise-shareholder division of enterprise surplus that underlies and explains the seemingly irrational behavior of passive investors. Two types of transactions, recently occurring with some frequency, will illustrate this approach.

Management-initiated leveraged buyouts of outside shareholders by definition contradict the efficiency explanation of takeover bids.[45] The same management whose performance at least contributed to, if it did not wholly cause, the preexisting

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44. The debate about productivity and innovation, of course, involves a much larger range of government-economy interactions ("industrial policy"). However, a substantial amount of scholarly and political inquiry into the performance of corporations from the perspective of an imbalance between "engineering" and "financial" goals has begun. For the reports of Harvard Business School Professors Hayes and Abernathy on the dangers of excessive concern with short run profits, see Wayne, *Management Gospel Gone Wrong*, N.Y. Times, May 30, 1982, at sec. 3, p. 1, col. 2; *see also* W. ABERNATHY, K. CLARK & A. KANTROW, INDUSTRIAL RENAISSANCE (1983). *But cf.* Arenson, *Manufacturing in U.S. Called Sound by a Study*, N.Y. Times, Sept. 5, 1983, at 31, col. 1 for a review of recent studies on the subject.

To the extent management control research enters this debate, it can do so best through the organization theory hypotheses exemplified in an essay appearing after this paper was written. *See* Williamson, *supra* note 19, at 363, 362:

> Specifically, I suggest that the conglomerate is usefully regarded as an evolutionary refinement, whereby the organizational principles responsible for checks on managerial discretion and the operating integrity of the original multidivisional structure have been extended beyond their immediate applications within the firm to include a competence to manage newly acquired assets as well.
>
> The conception of the firm as a governance structure rather than as a production function is thus the key to understanding the phenomenon of takeover by tender offer.

45. *See* Speech by SEC Commissioner Longstreth, Management Buyouts: Are Public Shareholders Getting a Fair Deal? (Oct. 6, 1983), *reprinted in* [1983–1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,436; *see also* recent journalistic discussions of this issue in Bleakley, *S.E.C. Chief Cautions on Leveraged Buyouts*, N.Y. Times, June 8, 1984, at D1, col. 1; Cuff, *Perils of Leveraged Buyouts*, N.Y. Times, May 14, 1984, at D1, col. 3. In addition, see *Leading Deals and Dealmakers in the First Half of This Year*, N.Y. Times, July 3, 1984, at D6, col. 1 for a listing of both mergers and leveraged buyouts.

stock price levels remains in place after the bid is accepted. Thus, that element of the price differential explanation is eliminated. Further, the bid is paid for by financing which is secured in turn by the very assets that powered the enterprise operation before the takeover. Thus, the synergistic combination of bidder and target assets is eliminated as an explanation of the price differential. What remains, other than an explanation suggesting the presence of an organizational surplus which had not previously been reflected in share prices, and which now is used by management to buy out the outside ownership interest?[46]

Recent major friendly as well as hostile takeover bids which revealed price differences staggering in absolute as well as relative terms—the Socal-Gulf transaction chief among them—offer a second contradictory example.[47] Socal paid $80 per share for Gulf stock previously priced by a deep and informed market at $40 per share, for an aggregate "surplus" transfer of well over $6,000,000,000 above and beyond the preexisting market price. Gulf's oil reserves, which explain the decision, were publicly known. Socal's exploitation plans for those reserves are not stated to differ from those earlier held by Gulf. Socal borrowed the funds to pay for this $13,000,000,000-plus purchase from the commercial banking sector, obviously affecting even its balance sheet debt-equity proportions in a material fashion. The stock market price for Socal shares did not change as a result of the transaction. This combination of elements can only be explained by postulating that the preexisting organizational surplus inherent in Gulf was more than $6,000,000,000, and that Socal transferred over $6,000,000,000 of its larger organizational surplus to Gulf shareholders in order to effect a transaction perceived to be mutually profitable.

If this explanation is credible, it suggests that the Chandler thesis of large and effective enterprise systems applies not only to enterprise-supplier, enterprise-customer, and enterprise-environment relationships, but also to enterprise-shareholder relationships. That takeover bids reward some lucky investors by finally permitting them to realize on a previously unreflected element of their stock value may be nice, but it has nothing to do with efficiency considerations. It is only a redistributive event, shifting wealth from one group to another.[48] Indeed, in the

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46. I believe it would not be seriously argued that the "procedural" benefits of going private, especially the elimination of reporting requirements, can explain either the frequency of these transactions or the magnitude of the surplus at issue. Whether the comfort and the ability to take long range views of managerial strategy that accompany the leveraged buyout explain either or both attributes is a subject worth discussion. For an impressionistic though apparently typical glimpse of this motivation, see Cuff, *Finding Happiness in Buyout*, N.Y. Times, May 26, 1984, at 33, col. 3.

47. While this transaction occurred only after this paper was presented, I use the event as the most vivid and instructive of similar, including earlier, ones. The information in the text is taken from the running accounts of the merger negotiations in the *New York Times* and *Wall Street Journal*. I have stylized the information, and in particular have slightly overstated the stability of the stock market valuations and rounded out the values, as well as ignored the interim price run-up due to the Pickens bid, see *infra* note 48. In neither case, however, is this done in a way that distorts or undercuts the basic point.

The only substantial qualification I would make to the text statement concerns the value one might place on the rationalization of distribution chains and of refinery utilization which the merger brought about. *See* Lueck, *Benefits for New Oil Giants*, N.Y. Times, March 21, 1984, at D1, col. 3. It is extremely doubtful, however, whether these two sources of operating efficiencies come within an order of magnitude of the "surplus" figures discussed in the following text.

48. In one sense, of course, it might seem that "inefficiency"—defined only by its here-questioned surrogate, market value—is being controlled by such mergers, in the market-for-management sense argued by the mentioned

industrial organization sense it has highly disturbing though attenuated implications for concentration and market power.

It is thus perfectly understandable that in a kind of early farewell address, former SEC Chairman Williams questioned legal rules that unambivalently foster the takeover phenomenon.[49] It is by the same token inappropriate for legal scholars to disparage such concerns in reliance on institutionally unmanageable competitive free market theories. It was also, thus, extremely questionable for the Supreme Court in *Edgar v. MITE Corp.*[50] to tie the commerce clause to an institutionally and theoretically unsupportable version of the efficient capital market hypothesis in declaring state takeover statutes unconstitutional. They may well for other reasons be deemed unconstitutional intrusions into the reserved domain of the negative commerce clause or into the preemptive domain of the Williams Act and its sanctity under the supremacy clause; but state takeover statutes cannot be deemed unconstitutional for the reason that the force of the capital market hypothesis, a kind of mechanistic version of Herbert Spencer's pseudo-Darwinist social statics theory, compels this result.[51] In short, the economic concepts clustered around market theories, when considered alongside the concepts clustered around organizational theories, cast doubt on the conclusion that rules enabling the phenomenon of the modern takeover to flourish are categorically justified by allocative, let alone other, considerations.

I do not mean to imply that modern extensions of welfare economics, particularly those insights gathered under the umbrella label of "property rights" theory, fail to see or, in formal terms, to account for the institutional realities comprehended within organization theory. Indeed, by internalizing the objective phenomenon of the invisible hand within the firm and then by substituting effect for intent at the level of individual decision making—thus objectifying the subjective and limited notion of profit-maximization—the property rights theorists were able to claim inclusion of the tension between individual goals and organizational goals and of the tension between organizational power and external power within their formulations. A recent review of the theory puts it as follows:

> The rejection of profit maximization as the fundamental behavioral postulate . . . [and] the shift to utility as the maxima open up new possibilities for studying

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proponents of takeover bid activity. *See supra* text accompanying notes 25–27; *see also supra* note 27. If, however, the most inviting target is the effective producer, then the transfer of part of a bidder's (*e.g.*, Socal's) organizational surplus to shareholders of a target (*e.g.*, Gulf) remains "only" a distributive consideration. *See* Easterbrook & Fischel, *supra* note 27, at 1175. Further, one should recall that Socal's interest in Gulf was activated by the maverick Pickens/Mesa, whose proposed use of Gulf assets (partial liquidation and royalty trusts) held profound and profoundly disturbing implications for the management structure of this industry. *See* Nulty, *Boone Pickens, Company Hunter*, FORTUNE, Dec. 26, 1983, at 54. This sequence, at the least, suggests the legitimacy of an inquiry into whether one might characterize the premium as paid, in part, to preserve the continuing generation of this surplus for the bidding enterprise (not to mention for its lucky, nonparticipating free riders among the other Five Sisters).

49. Address by Chairman Williams, U.C.S.D. Conference on Securities Regulation, Tender Offers and the Corporate Directors (Jan. 17, 1980), *reprinted in* [1979–1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445.

50. 456 U.S. 624 (1982).

51. *Compare* Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 270–71, 287–89 (1977) *with* Buxbaum, *Federalism and Company Law*, 82 MICH. L. REV. 1163 (1984). It is not accidental that, at a larger level, reference to Spencer's view of economic life again is surfacing. *See* Silk, *The Spencer Prophecies*, N.Y. Times, July 29, 1983, at D2, col. 1.

> different patterns of managerial behavior, and permit greater insight into the operation of business firms in various socio-economic environments . . . .
>
> [Of course, to] engage in something more than purely formal discussion, the utility function must be given specific interpretation [*i.e.*, content] . . . . [The] property rights approach can be understood as an attempt to formulate empirically meaningful optimization problems by associating the utility function with the individual decision maker [*i.e.*, not with the firm] and then introducing specific content into the function.[52]

But the devil lies in the detail; to wit, in specific content poured into the function. From that perspective there is something unsettling about the simultaneous existence of two complete economic theories of the capitalist persuasion, each by its own terms purporting to encompass the entire universe of economic phenomena, and each relegating the principal organizing vision of the other to the level of one among many dependent variables.[53] Years ago Professor Amsterdam developed a vivid simile for such a situation: the counting buttons above a pool table, strung on parallel wires, flicked by the players' cues from opposite sides, and always destined to pass by each other as they tallied the players' scores.[54] In that situation one role of the law is both to honor and to test what is socially useful about any theory—its descriptive and predictive power—and then to help society implement its politically derived values by rendering prescriptions that are effective because they are based upon an understanding of these continuously tested descriptive and predictive theories.

The economic theories do not themselves generate ethical or value judgments. One can be moved to believe in a utilitarian, a libertarian, or a wealth-maximizing social ethic, because one is influenced by the enriched understanding of economic phenomena generated by a powerful, descriptive, and predictive economic theory, just as one may be moved to a communist social ethic by the Marxist explanation of the processes of both production and consciousness. Nevertheless, in each case, what to the insider is an ethical value, is to the outsider "only" an epistemological problem.

B. *The Target's Management*

The control of the takeover bid and bidder seizes only one horn of the dilemma. If we have doubts about excessive reliance upon mystical market forces to act as control rules on the bidder in my tender offer control example, how much more nervous must we be about relying on market forces to hold the management of the target company in check. There are economists who not only depend on the ability of the capital market to function as a control on management behavior[55] (as an efficient way to reduce the so-called "agency costs" inherent in shareholders' dependence on needed management discretion), but who would trust the market to operate in lieu of

52. Furubotn & Pejovich, *Property Rights and Economic Theory: A Survey of Recent Literature*, 10 J. ECON. LIT. 1137, 1138 (1972).

53. *See supra* note 16.

54. Note, *The Void-for-Vagueness Doctrine in the Supreme Court*, 109 U. PA. L. REV. 67, 67 (1960).

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

legal controls at this neuralgic point. As lawyers, I hope we do not need a formal economic analysis to question whether a management about to be ousted by a bid, which possibly reflects a market test of management—*i.e.*, which responds to past management behavior signalling relatively high agency costs and relatively low investor returns—now will be converted to believe that resistance to the takeover is illegitimate.

It is easy for incumbent management, in rationalizing its defensive behavior, to conjure with the doubts about the legitimacy of the takeover bid in efficiency terms. Once that countervailing argument can be made, the immunity bath provided in form by the business judgment rule begins to grow in importance and to be available for maneuvers which boggle the mind. Admittedly, the Seventh Circuit is not alone in its use of "business judgment" as a rule for all seasons; but it is difficult to read the opinion in *Panter v. Marshall Field & Co.*[56] without a real sense of shock at the inability of that panel to appreciate or react to the behavior of Marshall Field management faced with the Carter-Hawley-Hale bid. For permanent escape from the control of market as well as of legal discipline, the response of Bell & Howell management to a recent bid, a response undoubtedly nurtured in that heady Chicago air of its executive offices, though subject to Delaware law, is so aggressive as to awaken in all of us an urgent sense of the need to rethink this entire subject.[57]

After learning of the interest of National Education Corporation, already an owner of just under five percent of Bell & Howell's stock, in a merger with Bell & Howell, the latter's directors used the flexibility inherent in a typical "blank stock" charter authorization to strike back by issuing an astonishing series of preferred stock. It was identical with common stock except for two critical points. First, an eighty percent class vote of its holders was required for approval of statutory mergers of certain types, including of course the type likely to eventuate as the second stage of a successful hostile bid. Second, a redemption as well as a conversion right was granted, available to each preferred shareholder once a single shareholder achieved forty percent ownership of the common stock—except for the preferred shareholder who owned that bloc. To add insult to injury, this preferred stock was not to be sold or even parked with friends, as that would have taken too long; instead, it was simply to be stuffed into envelopes and mailed out as a stock dividend on the outstanding common. Despite doubts that the egg later could be unscrambled, the vice chancellor refused to issue a preliminary injunction against the impending stock issuance.

This kind of managerial usurpation blocks the signalling effect of disinvestment for two reasons which, in combination, render the constraints of the market on management inadequate even in the eyes of an extreme proponent of the market control view. First, the time frame for that constraint to operate is extremely long; the

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56. 646 F.2d 271, 284, 293–95 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); compare the dissent, *id.* at 299–304, on the basic question of testing target directors' motivation.

57. *See* National Educ. Corp. v. Bell & Howell Co., No. 7278 (Del. Ch. Aug. 25, 1983); *see also* Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707 (5th Cir. 1984) (court upheld the right of defensive management to issue debentures and accompanying warrants); *cf.* Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1984).

The gambit already has made book in more recent battles; *see* Getschow, *Superior Oil's Latest Takeover Defense Irks Some Big Holders, Stirs Suit by Keck*, Wall St. J., Nov. 28, 1983, at 2, col. 3. For substantial current documentation of these various repellent tactics, see the instructive material in SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER (R. Winter, M. Stumpf & G. Hawkins eds. 1983) and *id.* at 266.

entrenched management must go through an entire cycle of relatively poor performance and disinvestment before it feels the force of the market constraint. This assumes, I believe reasonably, that the voiceless owners still would find simple exit cheaper than recapture of their voice—their votes to dismiss the management. Second, and equally important, the enabling authority of the board of directors to pull such a stunt—the formal authorization of blank stock placed in the charter by the action of that primordial shareholder, the Corporation Trust Company—is so stretched by this particular issuance that even an extreme contractarian would find disappointed expectations and a disparity very close to a disclosure question at least in the first such event.

This kind of permanent entrenchment, however, can be achieved by means less egregious than managerial aggrandizement. Herzel, who has often written to support incumbent managements' rights to block takeover bids, in a recent coauthored paper proposed a maneuver that puts the efficient capital market hypothesis as well as the agency cost control theorists in a logical and neat dilemma.[58] He has proposed a shareholder vote to adopt a charter amendment that would forbid the consummation of a takeover bid unless approved by the incumbent management—the ultimate in shareholder-effectuated protective charter provisions.

This proposal does more than simply remove the "disappointed expectations" objection raised by the kind of director action that is only indirectly supportable on the basis of general shareholder delegation of enabling actions to management. Rather, it puts the shareholders into the position of having voiced their collective will in favor of abdicating their right of special exit (via a takeover bidder) as against general exit (via the stock market). The cycle of market effect on management behavior in this scenario, just as in *Bell & Howell*, takes an inordinately long time. In this proposed context, however, the owners have calculated that the opportunity to obtain increasing returns from management's ability to concentrate on its primary functions outweighs the risk that the owners' agency costs would increase because of management's lengthened immunity from the consequences of its sloth, venality, or even of other dysfunctional situations.

I think most of us would not be happy with that or similar examples of extreme managerial entrenchment. Yet it follows from the line of argument about the capital market's ability to control agency costs without really having been contemplated as a likely use of that theory.

V. Business Judgment and the Derivative Suit

The same sense of discomfort should be provoked by a somewhat analogous development outside the field of takeover bids—the general area of corporate derivative litigation. When we turn to that field, and I will limit my discussion to the question of the independent review committee of the board, we also begin to appreciate certain judicial and institutional reasons for surrender to extreme deferential versions of the business judgment rule; and, what is more central to the theme of this

58. Herzel & Schmidt, *Is There Anything Wrong with Hostile Tender Offers?*, 6 Corp. L. Rev. 329, 335 (1983).

discussion, for surrender to the siren song of economic theory as a justification for this deference.[59]

A. *Institutional Concerns and Economic Theory*

The basic problem is well known. Derivative suits often have a socially insignificant motivation; that is, they are often based not on the economic interest of the nominal plaintiff, but on that of a larger yet unconcerned group, the plaintiff's fellow investors. In this aspect, derivative suits resemble public interest litigation, though over a private, not public, good. Unlike public interest litigation, which itself is not free of theoretical detractors, this private collective interest litigation does not have an organization of clients behind it who are explicitly committed to the goal of the litigation. Much private collective interest litigation instead is motivated by fee recovery. The attorney stands in court unmediated by a client's specific organizational goals, unless one so characterizes the collective shareholders, and that of course is the nub of the problem. The derivative suit is a contest between two parties, each claiming to be the true representative of that inert, passive group of investors who generally have traded their voice and their loyalty for exit.

Given this situation, the theory of the derivative suit and the nature of the remedy sought are crucial. If the suit is based on disloyalty—as in derivative suits based on directors' conflict of interests—the legitimacy of the new representative generally will be subsumed in the review of the merits of the charge and not debated in preliminary form. If, on the other hand, the charge challenges management's perspective of its role—as in the quintessential corporate bribery cases—the underlying dispute over the social role of the corporation itself implicates the legitimacy of the litigant as a preliminary matter. It is no accident that the courts first endorsed the use of the independent review committee to end derivative suits in post-Watergate morality plays in which the personal motivation of the director-defendants was not seriously at issue,[60] and that the courts have begun to call a halt to the practice of using independent review committees in just those classic situations of egregiously imprudent or disloyal behavior.[61] The derivative suit appended to rule 14a-9 proxy solicitation charges is something of a special case,[62] because there the charge of mismanagement is only a preliminary aspect of the full disclosure problem. Even in

59. *See, e.g.*, Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 972–94.

60. I date this trend from Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976), though a partial forerunner was developed earlier in the mutual fund advisory fee setting, in *In re* Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). *See* Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982) and Shlensky v. Dorsey, 574 F.2d 131 (3d Cir. 1978) for other suggestions of this attitude in slightly different settings.

61. *See, e.g.*, Joy v. North, 692 F.2d 880, 891–92 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); Zapata Corp. v. Maldonado, 430 A.2d 779, 186–89, (Del. 1981). *But see* the restrictive reading of the new Delaware approach in Abramowitz v. Posner, 672 F.2d 1025 (2d Cir. 1982), which is interpreted in Lewis v. Graves, 701 F.2d 245 (2d Cir. 1983). *Compare* Lewis v. Curtis, 671 F.2d 779 (2d Cir.), *cert. denied*, 459 U.S. 880 (1982) and, in the Investment Company Act context, Fox v. Reich & Tang, Inc., 692 F.2d 250 (2d Cir. 1982), *aff'd sub nom.* Daily Income Fund, Inc. v. Fox, 104 S. Ct. 831 (1984). More recently, the Delaware Supreme Court, in a demand requirement case, has indirectly undercut *Zapata*; *see* Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

62. *See* J. I. Case Co. v. Borak, 377 U.S. 426 (1964) in which the Court disregarded the special case of the characterization of the rule 14a-9 anti-merger suit as direct or derivative.

these cases, however, the difference between the two types of behavior clearly makes a difference to the courts' reception of the nondisclosure allegation.[63]

This distinction also is related to the issue of remedy. In both situations, it is true, the remedy sought may be only behavioral sanctions of monetary recovery or injunctive relief from the director-defendants. In the policy dispute cases, however, this remedy has powerful structural implications, since it necessarily challenges the propriety of basic managerial styles and decisions and, in addition, requires recoveries from defendants in no way related to their personal benefits. Traditional conflict of interests judgments, by contrast, do not challenge "normal" managerial behavior and do result in a reasonable correlation between benefit and penalty.[64]

Under these conditions the reluctance of courts to second-guess management in situations beyond the easy ones of open misconduct becomes institutionally understandable, as does their reluctance to extend the definition of misconduct beyond simple and traditional cases. The explicit refusal of the Supreme Court to impose section 16(b) liability for short swing profits upon investment banking partnerships in *Blau v. Lehman*,[65] because of the uncertain but serious implications of such a rule on the financial intermediation function of such investment houses, illustrates this condition. It is analogous to the reluctance of the federal courts to grant structural remedies such as divestiture in private actions under antimerger legislation.

It is an interesting, but as yet unanswerable, question whether the primary cause of judicial reluctance to implement restraints on bidder behavior, target management's responsive and forestalling behavior, and sophisticated forms of questionable management generally, is an institutional aversion to an intrusion into the core of these other institutions' method of governance. It may well be, instead, the courts' dislike of being impelled into a difficult arena by randomly surfacing private plaintiffs with all their varying degrees of motivation and resources. Whichever reason is primary, the courts are reluctant to ply their normal trade in this setting. That reluctance is only another manifestation of the larger institutional reality that economic relations today are between organized large groups or firms and not between an almost infinitely large number of almost infinitesimally small units. What courts do to adjudicate disputes and adjust relations between the latter is considerably less risky to the totality of such relations than what they do to adjust relations among giants or to adjust the behavior of such giants. Paradoxically but understandably, the issue is seen as legitimately posed only when posed between giants—when, to put it in extreme form, the derivative suit at least has the blessing of the mythical Federal Bureau of Derivative Suit Initiation Review Board.[66]

My present concern, however, is not with such ultimate issues but with the partial though sufficiently important issue involving the relation between economic

63. *Compare* Limmer v. General Tele. & Elec. Corp., [1977–1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,111 (S.D.N.Y. March 21, 1977) *with* Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979); *see also* Maher v. Zapata Corp., 714 F.2d 436 (5th Cir. 1983) for an interesting discussion in the context of a settlement review.

64. *Cf.* Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 719 (1984).

65. 368 U.S. 403, 409–13 (1962). *See* Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78 p(b) (1982).

66. *Cf., e.g.,* the right of the Ontario Director of Corporations to apply for permission to bring a derivative suit on behalf of minority shareholders, in Business Corporations Act, ch. 4, 1982 Ont. Stat. §§ 245, 247; *see also* Canada Business Corporations Act, ch. 33, 1974–76 Can. Stat. §§ 232, 234.

theories and judicial behavior. Faced with these problems, it is more and more tempting to rationalize legitimate judicial deference on the basis of some theoretical approach turned normative, either through its own claim or through judicial (and therefore prescriptive) borrowing. A good example is the corporate bribery situation or, indeed, any situation in which a shareholder, through a derivative suit, attempts to hold management accountable for pursuing corporate profits by using methods which conflict with the plaintiff's understanding of public law constraints.

Some theorists conceive of a corporation as a nexus of control relations among present management, voiceless shareholders, financial creditors, suppliers, and laborers. Recently, Easterbrook and Fischel, using this construct and the little seen but much proclaimed market for management's performance as the substitute for legal control of management's behavior, delivered themselves of the following theoretical prescription:

> [M]anagers do not have an ethical duty to obey economic regulatory laws just because the laws exist. They must determine the importance of these laws. The penalties Congress names for disobedience are a measure of how much it wants firms to sacrifice in order to adhere to the rules; the idea of optimal sanctions is based on the supposition that managers not only may but also should violate the rules when it is profitable to do so.[67]

In fairness to them, this amazing comment, their public law version of the "efficient breach" theorem, was a rhetorical ploy used to support the much less problematical assertion that defensive management's theoretically derived position of absolute neutrality toward takeover bids should extend to forbid target management from initiating antitrust litigation against the bidding company. What should concern us, however, is the entirely realistic danger that such a prescription, based on this extreme theory of market governance, might become a legitimating recourse for a court institutionally averse to letting Joan Gall overrule the Exxon board of directors. It is this ill-digested perception of the interplay of economic theory and law that my discussion and, I trust, the symposium are intended to address.

I would not go so far as to say that courts should be institutionally foreclosed from finding their social values in social science to the extent that their social values are functionally necessary to their adjudicating roles. But at least courts face their own legitimating constraints in the way they process facts and norms within an adversary context. The recent warning of Judge Higginbotham of the danger to judicial legitimacy posed by the substitution of social theory, not only for the traditional role of (even evolving) precedent or statute, but even for the fact-finding process, is an important reminder of the risks involved in this species of judicial activism.[68] It is troublesome enough, but inescapable in modern society, that courts

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67. Easterbrook & Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1177 n.57 (1982).

68. *See* Dobson v. Camden, 705 F.2d 759 (5th Cir. 1983).

I join the majority in their implicit concession that economics must inform decisions regarding tort liability. While ultimately choices among potential tort rules may turn on notions of "fairness" as viewed through the eyes of each judge's ethical regimen, those choices will only be guesses if the judges are inadequately informed of their impact. At the same time I fear this undertaking at the appellate level without the benefit of briefs and oral argument. The doctrinal support of our academic critics is yet an inadequate source. While the deficiency in the literature is rapidly being corrected, . . . we are yet to develop an orderly means for its assimilation at the appellate level. Resort to the increasingly available materials now turns on little more than whether an individual

have quasi-legislative functions—not because of abdication by regular legislatures, but because the interconnectedness of large scale institutions gives even individual judicial decisions a resonance that rivals legislation in its generalizing effects. It would be worrisome indeed if judges first believed and then appointed house theologians to turn a necessity into a virtue. The *deus ex machina* is not a judge, and it does not take much theatergoing to alert society to that fact.

B. *A Problem of Taxonomy*

An additional warning needs to be sounded about a legal preconception that might distort otherwise appropriate assimilation of economic thinking in legal doctrine. The economic discussion of exchange relations and property rights presupposes functioning markets for capital, and in a more problematic sense, for control and management. It recognizes, though it does not typically render operational, that markets are not dichotomous; that is, that there are not simply "market" relations and "nonmarket" relations, but that instead there is in fact a continuum from well functioning to poorly functioning to nonexisting markets. The law, at least corporation law, has tended in recent decades to distinguish public corporations from close corporations. This distinction, while cast in dichotomous form,[69] is at the same time made in full recognition that corporations, too, exist along a continuum of size and of public or passive ownership of shares, as well as along other axes such as volume of production, number of employees, and so forth. It is a peculiarly difficult problem to overlay economic discussions that postulate markets upon this corporation law dichotomy; and it is most difficult to avoid the assumption that market discipline can substitute for legal discipline in the entire range above the technical close corporation range. While it is relatively easy to obtain consensus on the existence of this problem, it is relatively difficult to find operational solutions for it.

A related difficulty appears even in the upper ranges of the publicly held or large corporation universe. Since Professor Eisenberg's demonstration,[70] it has been accepted factually that sizable ownership, and therefore decision-influencing blocs, exist fairly high into the Fortune 500 list. Applied to the theme of this discussion, recognition of that fact does not require disparagement of markets as a discipline on management. Rather, this recognition requires care that at least in certain areas (less in the takeover field than in the area of business judgment deference to ongoing

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judge is sufficiently confident in his own technical competence to undertake the effort. This may present a greater risk of misreading consequences than the traditional visceral calls. Moreover it strikes me as anomalous that we hedge the use of data-based studies with a host of rules when they are used as evidence to decide a single case but drop all bars when they are relied upon to define rules for all cases. This is more than an academic observation. The coincidence of the present legislative role of the judiciary and the maturation of the social sciences will inevitably put at issue our adjective responses to their plain relevance. It may also put at issue our judicial role.

Id. at 775 n.1 (Higginbotham, J., dissenting); *see also* Higginbotham, *A Brief Reflection on Judicial Use of Social Science Data*, 46 LAW & CONTEMP. PROBS. 7 (Autumn 1983).

69. This is true of the newer partial close corporation codes, as well as of doctrinal discussions. *See, e.g.*, Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981) which discusses the need for such typology despite recognition of the continuum.

70. M. EISENBERG, THE STRUCTURE OF THE CORPORATION 43–56 (1976).

managerial decisions) the ability of management controls to check agency costs not be overcome by shareholder control influence. Thus, in this large and almost unbounded group of corporations, relatively strong fiduciary rules need to be honored. To this extent, a good portion of the market control hypothesis might be factually inapplicable.

Indeed, one could take the argument further. Simple insider frauds aside, major transactions raising fiduciary issues can only occur within companies with conflicted ownership positions (again, I put aside for this purpose the takeover question). The existence of excessive agency costs might in such cases better be seen not as an issue for market versus legal controls, but as an *a priori* demonstration that there is no market in the sense postulated by its proponents.[71] If this is true, much of the agency theory discussion could be mooted. At the least, it could be limited to the legally less provocative case of directors' failure to monitor inside executive behavior which is generating excessive agency costs. That case is not the stuff of which derivative suits are made. At least in the case of suits dealing with conflict of interests problems, therefore, the whole notion of business judgment deference, whether in the substantive or in the procedural sense, seems out of place.

VI. Conclusion

That corporations are neither large or small nor "market" or "nonmarket," but range along a continuum, might serve as a metaphor for this entire discussion about the role of economic theory and legal doctrine. It is not my intention to disparage the important and growing role of economic insights for the successful evolution of legal doctrine in this complex society. Much of tort law and of contract law, for example, has been clarified and revitalized by exposure to the light of economic analysis. In a more general sense, the simple reminder that laws and legal institutions are no more exempt from cost-benefit analysis than are private acts and transactions has been one of the more salutary lessons for our pragmatic, fast-moving society.

When it comes to the application of these insights to complex and powerful social institutions, however, special care must be taken before behavioral rules are derived from theoretical and analytical scientific statements. Even within the frame of reference of economics, the capacity for harm resulting from error may be so great that the possibility of error should be minimized. Similarly, still within the economic perspective, the particular analysis may be challenged by contending theorems of greater explanatory power. That may well be happening today as the school of developmental economics takes on a more rigorous analytical cast, with still unknown consequences for classical welfare analysis.[72] Finally, outside of the discipline's frame of reference, countervailing considerations derived from the political process may override otherwise unexceptionable legal consequences of economic analysis. That is perfectly understood by economists, but not always remembered by the users of these analyses.

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71. *Cf.* Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. Rev. 738 (1978).

72. *See, e.g.*, R. Nelson & S. Winter, *supra* note 8.

The deference that our legal institutions pay to the workings of large organizations is an inevitable consequence of the fact that much human activity today occurs within complex organizations. That the individual has little claim to attention in political and social settings is echoed, though to a smaller extent, in the judicial forum. I have not argued in this discussion the merits of any particular legal rule, but I have argued against letting this echo of the individual-organization mismatch substitute for substantive analysis. To the extent that this is perceived to be a problem, lawyers and legislators may need to turn their attention to providing an organizational equilibrium for litigation from which judges, in turn, can take assurance that their involvement and the effects of their actions will be socially responsible.

Judicial appointment of an independent special counsel, in consultation with plaintiffs' as well as defendants' counsel, would be one small example of this kind of effort in the derivative suit and business judgment area.[73] Introduction of an expedited system of advisory votes by the shareholders of a target company on important directorial actions (like "crown jewel" sales or "spoiler" acquisitions) would be one small example, among many, of mixed institutional-substantive responses in the takeover bid area.[74] Larger institutional proposals such as semi-private derivative suits based on nontraditional theories are equally worthy of discussion. There is enough to do at this middle level of doctrinal and institutional change.

These are not easy problems, and they are not congenial to those who would deal only with doctrine. They also are problems not congenial to those who would deal only in economic analysis of the sort I have questioned.[75] But a marriage of modern market modeling with a modern version of institutional economics is possible, and few would argue against its desirability. In that research program, as well as in the use of its products in the reshaping of legal doctrine and legal institutions, lawyers will have an ample professional role to play.

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73. This has occurred, though not frequently, in the appointment of independent counsel to review indemnification proposals when the directors have a personal interest therein. *See* Rowen v. LeMars Mutual Ins. Co., 230 N.W.2d 905, 915–16 (Iowa 1975); Niedermeyer v. Niedermeyer, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,123 (D. Ore. Aug. 21, 1973). *But see* Messing v. FDI, Inc., 439 F. Supp. 776, 783 (D.N.J. 1977).

74. The concept is proposed as to several common target management defensive transactions (though explicitly not as to this one) in SEC Advisory Committee on Tender Offers, Report of Recommendations, *supra* note 41. Many other recommendations there (such as "sunset" controls on pre-dispute protective charter amendments), while of course open to discussion on their merits, are excellent examples of this kind of "mid-level" legal work.

The SEC has resisted "federalizing" rules on defensive behavior in general; *see* Statement of John S. R. Shad, Chairman of the SEC, before Hearings of the House Subcommittee on Telecommunications, Consumer Protection, and Finance Concerning the Recommendation of the SEC Advisory Committee on Tender Offers [1983–1984 Transfer Binder] FED. SEC. L. REP. ¶ 83,511 (Mar. 28, 1984). It is considering specific problems, in particular "golden parachutes;" *see* Ingersoll, *SEC Seeks to Prohibit Many of the Tactics Used by Firms to Avert Hostile Takeovers*, Wall St. J., May 10, 1984, at 7, col. 1. Congress has become active, too. The farthest advanced congressional action in this area is the Tender Offer Reform Act of 1984, H.R. 5693, 98th Cong., 2d Sess. (1984). See the description of H.R. 5693 in *Tender Offer Bill Approved by House Subcommittee*, FED. SEC. L. REP. (CCH) No. 1079, at 13 (July 5, 1984) and in Wynter, *Some Takeover Defenses Barred in Proposed Bill*, Wall St. J., Aug. 3, 1984, at 4, col. 4 (reporting approval by the House Committee on Banking and Commerce); *see also* the Senate Bill introduced by Senator D'Amato, S. 2784, 98th Cong., 2d Sess. (1984).

75. *See also* Kelman, *The Past and Future of Legal Scholarship*, 33 J. LEGAL EDUC. 432 (1983) (on black letter rules from both disciplines).