THE NEW

CORPORATE GOVERNANCE

IN THEORY
AND PRACTICE

** * STEPHEN M. BAINBRIDGE

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PREFACE

Legal scholarship tends to be critical of the status quo. Few self-respecting legal academics will end an article or book without some sort of reform proposal. This is perfectly understandable, of course. Academic rewards skew towards the new and novel. Mea culpa. A rather different concern, however, motivated the body of work that culminated in this book; namely, to understand the existing statutory framework of corporate governance in U.S. law.

"The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation," commands § 141(a) of the Delaware General Corporation Law. The drafters of the Model Business Corporation Act tell us that the corporation code of every state but one (Missouri, whose code is oddly silent) have some such formulation.² I call this the director primacy model of corporate governance.

Why is director primacy almost universally enshrined in corporate statutes? Why not shareholder primacy, in which management power is

See Stephen M. Bainbridge, Unocal at 20: Director Primacy in Corporate Takeovers, 31 Del. J. Corp. L. 769 (2006); Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 Harv. L. Rev. 1735 (2006); Stephen M. Bainbridge, The Case for Limited Shareholder Voting Rights, 53 UCLA L. Rev. 601 (2006); Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 Vand. L. Rev. 83 (2004); Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547 (2003); Stephen M. Bainbridge, The Board of Directors as Nexus of Contracts, 88 Iowa L. Rev. 1 (2002); Stephen M. Bainbridge, Director Primacy in Corporate Takeovers: Preliminary Reflections, 55 Stan. L. Rev. 791 (2002); Stephen M. Bainbridge, Director v. Shareholder Primacy in the Convergence Debate, 16 Transnat'l Lawyer 45 (2002); Stephen M. Bainbridge, Why a Board? Group Decision Making in Corporate Governance, 55 Vand. L. Rev. 1 (2002).

² Model Bus. Corp. Act. Ann. § 8.11 stat. comp.

vested in the shareholders, who own the corporation? (Later we'll question the relevance of ownership in this context, but for now we follow conventional wisdom.) Alternatively, why not managerialism, in which management authority is vested in the Chief Executive Officer (CEO) or an executive committee of top management?

I set out not to reform the statutory allocation of power, but simply to understand it. My premise is that corporate law tends towards efficiency. A state generates revenue from franchise and other taxes imposed on firms that incorporate in the state. The more firms that choose to incorporate in a given state, the more revenue the state generates. Delaware, the runaway winner in this competition, generates so much revenue from incorporations that its resident taxpayers reportedly save thousands of dollars a year.

In order to attract capital, managers must offer investors attractive terms. Among those terms are the corporate governance rules imposed on investors by the law of the state of incorporation. Accordingly, managers have an incentive to incorporate in states offering terms preferred by investors. In turn, states have an incentive to attract incorporations by offering such terms. State competition for charters therefore results in a race to the top, driving corporate law towards efficient outcomes.

The foregoing claims are strongly contested in the literature, of course, and even those of us who generally accept the race to the top argument acknowledge the need for caveats and amendments when the question is examined in detail. We'll look at the relevant arguments and evidence in more detail below. For present purposes, however, I ask the reader simply to assume for the sake of argument that the race to the top is generally valid. If so, we need an account of why states "raced" to a governance structure topped by a board of directors.

The public corporation is a large, complex, and geographically dispersed entity with multiple stakeholders. Participatory democracy would be untenable in such an organization. We're dealing with vast numbers of people with radically asymmetric information and fundamentally competing interests. Under such conditions, collective action problems will prove intractable, even if the mechanics of allowing thousands of stakeholders to meaningfully participate in decision making could be solved.

Instead, it will be more efficient for decision-making authority to be assigned to some central person or group. This explains why corporate decision making is representative rather than participatory, relying on fiat rather than consensus. Hence, for example, the account to this point

explains why shareholders have exceedingly limited control rights in the public corporation. (As for why other constituencies are entirely excluded from *de jure* control rights: we will take up that question in detail below.)

But why a board of directors rather than an individual autocrat? In Chapter 2, we'll see that groups tend to outperform individuals at tasks entailing the exercise of critical evaluative judgment, which is precisely the job of the top decision maker in any complex organization. Equally, if not more important, however, assigning decision-making authority to a group proves a useful adaptive response to the principal-agent problem inherent in the corporate separation of ownership and control. Director primacy is thus essential to the functioning of the modern public corporation.

My prior work in this area convinced a growing number of scholars and commentators that "corporate governance is best characterized as based on 'director primacy." Likewise, other commentators opine that

- "Although theorists have long debated how to best describe the public company, a new theory of the firm has emerged that appears more complete than its predecessors: Professor Stephen M. Bainbridge's model of director primacy."
- "Bainbridge has developed a coherent and comprehensive theory of Director Primacy. Simply put, 'Bainbridge-style' Director Primacy places the board of directors at the center of the firm. It is both a normative and predictive theory: Directors should manage and

³ Larry Ribstein, Why Corporations?, 1 Berkeley Bus. L.J. 183, 196 (2004).

Seth W. Ashby, Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence, 2005 U. Ill. L. Rev. 521, 533 (2005). See also, e.g., Iman Anabtawi, Some Skepticism About Increasing Shareholder Power, 53 UCLA L. Rev. 561, 562 (2006) ("In Stephen Bainbridge's director-primacy theory, for example, the board of directors is a mechanism for solving the organizational design problem that arises when one views the firm as a nexus of contracts among various factors of production, each with differing interests and information."); Douglas G. Baird & Robert K. Rasmussen, Private Debt and the Missing Lever of Corporate Governance, 154 U. Pa. L. Rev. 1209, 1213 n.8 (2006) ("Stephen Bainbridge has put forth a normative conception of the corporation suggesting that nearly absolute authority is and should be vested in a corporation's board of directors."); James McConvill & Mirko Bagaric, Towards Mandatory Shareholder Committees in Australian Companies, 28 Melb. U. L. Rev. 125, 128 n.15 (2004) ("The concept of 'director primacy' was recently developed by Professor Stephen Bainbridge, of the University of California Law School.").

control the corporation; directors do manage and control the corporation."⁵

- "For the most part, director primacy is descriptively accurate and
 offers a compelling normative justification for why the board, and
 not the shareholders or the courts, should be the institution that
 decides what a corporation does."6
- "Although 'Delaware has not explicitly embraced director primacy,' the relevant statutory provisions and the [cases] have largely intimated that directors retain authority and need not passively allow either exogenous events or shareholder action to determine corporate decision-making."
- "Delaware jurisprudence favors director primacy in terms of the definitive decisionmaking power, while simultaneously requiring directors to be ultimately concerned with the shareholders' interest....
 [T]he Delaware jurisprudence, while not explicitly affirming 'director primacy,' does implicitly leave the directors to make decisions with shareholders expressing their views only in specific and limited situations."

To be sure, director primacy has its critics. Some see it as normatively unattractive, while others see it as lacking descriptive power. This book is intended in large part to answer these critics, while also restating, revising, and expanding the director primacy model.

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⁵ Charles R.T. O'Kelley, The Entrepreneur and the Theory of the Modern Corporation, 31 J. Corp. L. 753, 774 (2006).

Wayne O. Hanewicz, Director Primacy, Omnicare, and the Function of Corporate Law, 71 Tenn. L. Rev. 511, 514 (2004).

Harry G. Hutchison, Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm, 36 Loy. U. Chi. L.J. 1111, 1194 (2005).

⁸ Kevin L. Turner, Settling the Debate: A Response to Professor Bebchuk's Proposed Reform of Hostile Takeover Defenses, 57 Ala. L. Rev. 907, 927–28 (2006).

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A number of friends in the corporate law academy provided extensive comments on the proposal for this manuscript—which proved invaluable in outlining and writing the text—including: Iman Anabtawi, Bill Klein, Larry Mitchell, Larry Ribstein, Gordon Smith, and an anonymous reviewer.

⁹ Michael P. Dooley, Two Models of Corporate Governance, 47 Bus. Law. 461 (1992).

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Introduction

Porty years ago, managerialism dominated corporate governance in the United States. In both theory and practice, a team of senior managers ran the corporation with little or no interference from other stakeholders. Shareholders were essentially powerless and typically quiescent. Boards of directors were little more than rubber stamps.

Today, American corporate governance looks very different. The Imperial CEO is a declining breed. Some classes of shareholders have become quite restive, indeed. Most important for our purposes, boards are increasingly active in monitoring top management rather than serving as mere pawns of the CEO.

Several important trends coalesced in recent decades to encourage more active and effective board oversight. Much director compensation now comes as stock rather than cash, which helps to align director and shareholder interests. Courts have made clear that effective board processes and oversight are essential if board decisions are to receive the deference traditionally accorded to them under the business judgment rule, especially insofar as structural decisions are concerned (such as those relating to corporate takeovers). Director conduct is further constrained, some say, by activist shareholders. The Sarbanes-Oxley Act mandated enhanced director independence from management, as did changes in stock exchange listing standards.

Charles M. Elson, Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure, 50 SMU L. Rev. 127, 130–31 (1996).

² See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

³ Daniel P. Forbes & Frances J. Milliken, Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups, 24 Acad. Mgmt. Rev. 489 (1999).

Today, as a result of these forces, boards of directors typically are smaller than their antecedents, meet more often, are more independent from management, own more stock, and have better access to information. As *The Economist* reported in 2003, "boards are undoubtedly becoming less deferential. . . . Boards have also become smaller and more hardworking. . . . Probably the most important change, though, is the growing tendency for boards to meet in what Americans confusingly call 'executive session,' which excludes the CEO and all other executives." In sum, boards are becoming change agents rather than rubber stamps.

In this book, I offer an interdisciplinary analysis of the emerging board-centered system of corporate governance. I draw on doctrinal legal analysis, behavioral economic insights into how individuals and groups make decisions, the work of new institutional economics on organizational structure, and management studies of corporate governance. Using those tools, I trace the process by which this new corporate governance system emerged. How did we move from the managerial revolution famously celebrated by Alfred Chandler to the director independence model recently codified in the Sarbanes-Oxley Act and other post-Enron corporate governance mandates? In addition, of course, the book will look at the future. Despite the extensive changes made to the legal structure of corporate governance post-Enron, many legal academics and shareholder activists want to see still more changes, mainly designed to empower shareholders relative to both boards and managers. In the latter portions of this book, I explore whether such changes are desirable. (In short, no.)

On the Necessity of Models

If analysis is to transcend mere description, we must situate it in a normative model. Inevitably, however, any such model is constrained by the limits of human cognition. Accordingly, we must make simplifying assumptions. Milton Friedman therefore argued that a model is properly judged by its predictive power with respect to the phenomena it purports to explain, not by whether it is a valid description of an objective reality. As such, "the relevant question to ask about the 'assumptions' of a theory is

Who Is in Charge?, The Economist, Oct. 25, 2003.

not whether they are descriptively 'realistic,' for they never are, but whether they are sufficiently good approximations for the purpose in hand." ⁵

The predictive power of any model of the corporation must be measured by the model's ability to predict the separation of ownership and control, the formal institutional governance structures following from their separation, and the legal rules responsive to their separation. Shareholders, who are said to "own" the firm, have virtually no power to control either its day-to-day operation or its long-term policies. Instead, the firm is controlled by its board of directors and subordinate managers, whose equity stake is often small.⁶ As we shall see, most commentators see this separation as a problem to be solved. In contrast, I will argue that the separation of ownership and control is the unique genius of the modern American public corporation.

The Basic Dichotomy: Consensus Versus Authority

Any organization needs a governance system that facilitates efficient decision making. The two basic options are "consensus" and "authority." The former is defined as "any reasonable and acceptable means of aggregating [the] individual interests" of the organization's constituents. The latter is characterized by the existence of a central agency to which all relevant information is transmitted and that is empowered to make decisions binding on the whole.

Organizations tend to use consensus-based structures where each member of the organization has comparable information and interests. This is so because, under such conditions, and assuming there are no serious collective action problems to be overcome, decision-maker preferences can be aggregated at low cost. In contrast, authority-based decision-making structures arise where there are important information asymmetries among the organization's members or where those members have competing interests.

Milton Friedman, The Methodology of Positive Economics, in Essays in Positive Economics 23, 27 (1985).

⁶ Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 84–89 (1932).

⁷ Kenneth J. Arrow, The Limits of Organization 68–70 (1974).

⁸ Id. at 69.

U.S. law provides business organizations with an array of off-the-rack governance systems ranging from the almost purely consensus-based partnership form to the almost purely authority-based corporate form. Consensus is facilitated in the partnership because each partner has equal rights to participate in management of the firm on a one-vote-per-partner basis. Most decisions are made by majority vote, although a few particularly significant actions require unanimity. These rules work well in this context because all partners are entitled to share equally in profits and losses, giving them essentially identical interests (namely, higher profits), and are entitled to equal access to information, which helps to prevent serious information asymmetries from arising. In addition, the small size characteristic of most partnerships means that collective action problems generally are not serious in this setting.

At the other extreme, a publicly held corporation's decision-making structure is principally authority-based. Corporation statutes effectively separate ownership from control. Indeed, this *de jure* separation of ownership and control is one of the chief features distinguishing the corporation from other forms of business organizations.

The Separation of Ownership and Control

Corporation law virtually carves the separation of ownership and control into stone. Under all corporation statutes, the key players in the formal decision-making structure are the members of the board of directors who are empowered to make or delegate to employees most decisions affecting the business and affairs of the corporation. Shareholders have essentially no power to initiate corporate action and, indeed, are entitled to approve or disapprove only a very few board actions. The vote thus confers neither decision-making nor even oversight rights on shareholders in any meaningful sense. By virtue of the business judgment rule and the closely related rules governing shareholder litigation, moreover, indirect shareholder oversight of directors through litigation is also foreclosed.

Although the separation of ownership and control is one of the corporation's essential attributes, it is also one of the most controversial ones. This controversy began taking its modern shape in what still may be the

⁹ As with most partnership rules, the off-the-rack rule is subject to contrary agreement among the parties. Unif. Partnership Act § 18(e) (1914).