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### Collected Lectures and Talks on Corporate Law, Legal Theory, History, Finance, and Governance

William Wilson Bratton

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COLLECTED LECTURES AND TALKS ON CORPORATE LAW,  
LEGAL THEORY, HISTORY, FINANCE, AND GOVERNANCE

*William W. Bratton*

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## I. CORPORATE LEGAL THEORY

### AN ANATOMY OF CORPORATE LEGAL THEORY

Inaugural Lecture, Peter P. Weidenbruch, Jr., Professorship in Business Law, presented on October 19, 2007 at the Georgetown University Law Center

#### SALUTATION

If you asked me five years ago what I had accomplished as an academic I would have told you I was really proud of three things, two of which involved faculty politics. There was also one article—an article that wasn't about business law. Four years ago, I got a fourth thing to be proud of when I became a member of the Georgetown Law faculty. You know, in academic life the only capital is reputation and the only income is recognition. For me, joining this faculty made me fully funded and fully paid. That makes today's installation a sort of unexpected bonus, but it is very welcome nonetheless because it gives me two more things to be proud of. First, it has prompted me to admit to myself that I am proud of my work in business law. And, second, I am very proud to take a professorship named for our colleague Peter Weidenbruch. Peter, in taking it, I commit myself to doing my best to live up to your example in our community.

#### INTRODUCTION

This presentation's title makes quite a claim, so I'd best begin by explaining it. Some years back our erstwhile colleague, Mitu Gulati, organized a conference to honor his mentor, Bill Klein of UCLA. Bill had this paper in his drawer that laid out the properties of good corporate law. Bill had doubts about the paper but Mitu thought it should be published. So Mitu organized a conference at which Bill brought out the paper and a room full of people made comments. I was a commentator and I found that in order to register *my* thoughts on Bill's thoughts, I had to lay out the parameters of the things corporate law professors fight about—the points of ongoing debate in corporate legal theory. That comment was published along with Bill's paper,<sup>1</sup> but I don't recommend that you read it unless you read Bill's paper first, otherwise, it makes no sense.

I thought that was a shame, quite apart from my great respect for Bill Klein. So some time later I took out the comment and removed every reference to Klein's paper and expanded and rearranged to see what it

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1. William W. Bratton, *Welfare, Dialectic, and Mediation in Corporate Law*, 2 BERKELEY BUS. L.J. 59 (2005).

looked like. I was well pleased. The last thing I did was add today's title, which effects a reference to a book by Reiner Kraakman and others entitled, *An Anatomy of Corporate Law*. That's an ambitious project that aspires to synthesize elements of corporate law common in the legal systems of every developed country. I greatly admire it, but note that, while descriptive, the book has some normative presuppositions—the implications of which remain largely unfronted. So I felt justified in purloining and modifying its title.

Having gotten that far, I wasn't quite sure what to do with the paper, so it went back into the drawer, where it has sat quietly much as did Bill Klein's original. I took it out last summer to send to a collaborator as a way of explaining some points I was making in discussions about a project. But I changed my mind and didn't send it because on the rereading I was no longer well-pleased. One of the problems with a paper that merges and restates one's views on fundamentals is that one's views can change. Sometimes it indeed is better to let a project germinate.

This lecture is a step in the project's reconstruction.

#### THE PURPOSE OF THE FIRM

Unlike the Kraakman book, my paper does not aspire to synthesize—corporate legal theory is more a series of ongoing and unresolved debates than a unitary system of assertions. But the paper does start out with some general synthetic assertions—points as to which I believe everyone in the field concurs.

The synthesis starts with the assertion that corporate legal theory, although the occasion of unruly debate, has implicit boundaries. The boundaries follow from two positive observations. First, because corporate law addresses only a limited set of matters concerning business organizations, corporate legal theory is not all encompassing. Second comes a fact about what corporations do—they exist to create wealth by producing goods and services at a profit. There would be no reason to put up with them if they *didn't* thus succeed as economic producers. Indeed, real world firms that fail to do so disappear in the long run.

The home truth about production for-profit in turn implies an objective function for corporate law. But, setting it out in a form that garners general agreement is difficult, notoriously difficult. So for the moment I will stick with a minimalist assertion: corporations exist to create wealth by producing goods and services at a profit, corporate law is there to help them do so.

This minimally stated objective function can be expanded by reference to the inherited doctrinal context. Corporate law has pursued the stated objective in history so as to determine regulatory results,

bequeathing a context. The context provides a base for fleshing out the objective function's terms. The exercise carries risks, of course. A body of law's statement of its own purpose and zone of operation carries more positive than normative weight, and for now I want to stay on the positive side of the line. I had better—a regulatory framework cannot by virtue of its own long past and present existence establish its own legitimacy. Nor does competitive evolution in history guarantee a single, first-best outcome. Nor, finally, can one assert that an inherited regulatory context controls by right, for at a theoretical level everything remains contestable even if the doctrinal context tends toward stasis.

Having entered the caveats, I proceed. Our corporate law emerged in its present form in the state of New Jersey between 1888 and 1896. It took shape as an enabling regime that accorded management a wide zone of freedom of action respecting production management and financial policy. Two legal mandates provided the means to the ends. Management was to have absolute control over investment and financial decisions, and agenda control respecting both the terms of the corporate contract and end period decisions like mergers. Beyond those two mandates lay a largely enabling regime. The framework changed little during the twentieth century. Subsequent innovation occurred primarily at the national level, centered on the capital markets and the federal securities laws. There, the purpose was the assurance of liquidity, a means to the end of the lowest possible cost of capital in a system characterized by widespread holding of securities.

The doctrinal template suggests a more particular statement of the general purpose of encouraging wealth creation. It can be broken down into two primary components, each of which implies a regulatory corollary, one pair situated on the left side of the balance sheet and the other on the right side. On the left side, it is corporate law's job to encourage long-term investment and the risk-taking implicated therein. The corollary is that the law should facilitate a delegation of decision-making authority from the providers of capital to the expert managers who deploy it. (The corollary extends over to the right side of the balance sheet to include substantial management discretion over financing). On the right side, it is corporate law's job to facilitate investment in producing assets at the lowest cost of capital. At least one corollary again is implied—the law should secure the presence of liquid trading markets in corporate securities.

At this point, I need to confront the objective function as usually formulated in the field: under this, corporate law seeks to *maximize* the wealth generated by firms. The restatement presents some problems. The first is positive. You can *model* maximization—that's what economics

does. But in the real world of going concerns no one really knows when wealth is being maximized, and, even if someone derived a plausible maximizing template, corporate law would make no attempt to impose it. So I prefer to relax and restate: corporate law facilitates the firm's *attempt* to maximize the value it produces.

The inclusion of the maximand takes us across the line to normativity, even in my relaxed restatement. The step cannot be avoided. Corporate law has no choice but to acknowledge the maximand to succeed in its mission of facilitation. To see why, all one has to do is depict the firm at the competitive margin, where if it fails to maximize, it ceases to exist. Corporate law therefore must facilitate the *firm's* attempt to maximize. As thus restated, the objective function operates as a parameter in corporate legal theory—no assertion about law or policy that fails to recognize and work with it registers in debates in the field.

But there's still a problem. Competitive life and death at the margin tends not to be a day-to-day concern in the real world. At the same time, maximizing the value produced inside the firm implies externalization of the costs it incurs to the outside. The simple theoretical move of cautioning that maximization occurs net of externalities does not suffice to address the problem, given real world competitive pressures and regulatory slack. Corporate law accordingly cannot in theory devote itself to firm maximization without also acknowledging some authority that mediates between those inside the firm and those outside. Just where that mediating authority should be located and how it should be structured is a point of controversy.

Meanwhile, the maximand emerges more benign than at first appearance. It does not and cannot foreclose questions and initiatives respecting the corporation's relations with outside society and corporate law's appropriate role in integrating firms within society, so long as the proponent takes care to recognize and interrogate the firm's economic objective.

There is also a philosophical implication here: corporate legal theory makes all discussants welfare consequentialists who keep their eyes on productivity, whatever their economic, political, or ethical predispositions. I am not myself a philosophical consequentialist, and a range of meta-ethical presuppositions certainly motivate corporate law discussants. But evaluations always in the end center on economic results. And, as the maximand implies, the determinative consequence above all other consequences is economic success, usually measured in financial terms. It is determinative because legitimacy for both the firm and the law that governs it follows from success.

Finally, note that I deliberately avoid a narrower formulation favored by most in the field—that the firm and hence corporate law should facilitate maximization of *shareholder* value. The shareholder maximization norm follows from a particular conception of the optimal incentive alignment within the firm, a conception contestable in theory. Nor has it ever dictated the *law's* terms, even as it has had its moments of influence. So it's a debate point, rather than a point of general agreement.

#### DEBATES

The objective in place, corporate legal theory articulates means to the end, and at this point there no longer will be general agreement. Instead, there are four categories of debate, each characterized by binary opposite positions. Political, methodological, and doctrinal affinities vary from debate to debate. Some debates are positive, some are normative, some are both. You can be on the left side in one debate and on the right in another without necessarily being inconsistent. But an organizational principle does inform my presentation—first generation law and economics writers gravitated to the right side of every one of my binaries.

*Category I:* The appropriate scope of regulation and reliance on private ordering

- Public vs. private
- State concession vs. contract
- Mandatory vs. enabling
- Federal vs. state (US)

*Category II:* Modes of regulation and normative priorities

- Trust vs. contract
- Fairness vs. efficiency
- Substance vs. process
- Expectations vs. dynamic change
- State enforcement vs. reputational enforcement

*Category III:* The terms of the corporate agency relationship and the allocation of authority within the firm

- Trust vs. agency
- Management discretion vs. shareholder choice
- Firm value vs. shareholder value

*Category IV:* The boundaries of the firm and responsibility to outsiders

- Outsiders (other constituents) vs. insiders (shareholders and managers)
- Social welfare vs. corporate profit
- Public vs. private

#### CATEGORIES I AND II

Category I covers debates about the appropriate scope of regulation and the degree of reliance accorded state authority, or alternatively, private ordering, in organizing firms and solving problems. Four binaries describe positions taken in these debates: public v. private; state concession v. contract; mandatory v. enabling; and, in this country, federal v. state.

Category II covers debates about the objectives of regulation and normative priorities. Here I have five binaries: trust v. contract; fairness v. efficiency; substance v. process; protection of expectations v. economic dynamism; and state enforcement v. reputational enforcement.

The two Categories overlap—the Category II binaries amount to more particular expressions of perspectives motivating Category I debates. But nine binaries seemed too many for any one category. I am thinking about culling the number of binaries and collapsing the two categories into one, but am not sure.

In any event, rather than breaking out these debates one by one, I'll tell you a story about the intellectual history of corporate legal theory over the last seventy-five years.

The story begins in 1980, when I started teaching. I started my first Corporations class with a line from a mentor, William L. Cary of the Columbia law faculty. Said Cary, "Business should be conducted fairly, honestly, and competently." This sounds obvious, but a prescriptive follow-up was implied—that the law should make sure that this happens. That in turn implicated the left side binaries in Categories I and II. As Adolf Berle—Cary's predecessor at Columbia—had asserted in 1932, ownership and control had separated in large firms, creating a responsibility vacuum, a vacuum that implicated the public interest. Additional legal mandates were needed to solve the problem. Because state law, which had been captured by management, would not provide them, additional federal intervention was necessary. Fair conduct meant modeling management duties along the lines of trust law, as Berle had advocated. Investors *expected* such additional protection; that expectation in turn justified the intervention, an intervention that would in the long run lower the cost of equity capital. Thus had they taught me at Columbia Law.

A year and a half later I was researching debt and equity in corporate capital structures for my first article. I found myself at the Columbia Business Library reading economics for the first time in my life. The papers kept citing back to Jensen and Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*.<sup>2</sup> Few remember it now, but that famous paper had a lot to say about capital structure. I started it from the beginning and came across a remarkable sentence: "The firm is a legal fiction that serves as a nexus for a set of contracting relations among individual factors of production." It felt like a boom around my head as I assimilated the point. That one sentence introduced me to the very existence of the right side binaries, destabilizing assumptions and opening new possibilities. The sentence said that businesses should not be treated as institutions and, more importantly, regulation had no productive role to play in their governance, which should be left to the actors with stakes in the game. Contract meant enabling state law without mandates. *Diversified* investors wanted all pies maximized and didn't worry about ex-post protection of their own expectations respecting the slicing. So stop worrying about fairness. As to competence, markets took care of adverse selection problems. As to honesty, well, that *was* a problem, but maybe the common law of fraud would suffice.

I thought I had made this great discovery. But I soon found out that others were ahead of me on this curve. People like Ralph Winter at Yale and Frank Easterbrook and Dan Fischel at Chicago had already started to translate economic contract into legal theory. The rest of the corporate law professoriate was beginning a decade-long process of trying to figure out just what the sentence meant. That discussion proceeded against a dramatic background—there was a widespread sense of national competitive failure; the long era of confidence in regulation had *ended*; we had hostile takeovers, leveraged restructurings, junk bonds and plant closings; and a top to bottom reconstruction of corporate fiduciary law in the Delaware courts.

The theoretical discussion of the time looks a little strange today. It was a descriptive debate. Chicago was claiming that all of corporate law *really was* a contract. For the other side, which included me, still the faithful student of Berlian teachers, part of the answer was, well, no it wasn't. The contract description was inaccurate in material respects. The Chicago response to that was, well, those objections weren't *economics*, and if it wasn't economics, it didn't count.

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

That meant that the descriptive debate about the nature of the firm was as much about the methodological mode of description as about the firm itself. It was a one-sided affair. When Jensen and Meckling showed up, most people, including me, had no idea what to do with an assertion from an economic model. The model, in its self-contained and stylized way, made powerful statements about how things worked. No one knew anything about the microeconomics it was addressing. No one had any experience with the process of taking a theoretical model, checking assumptions, and critically asking about real-world predictive power. No one had been told that partial-equilibrium models like that of Jensen and Meckling are not taken to have normative traction within proper economics. And we were being told we weren't even qualified to ask questions. If we had known any social science, it would have gone differently.

This does not go to say that Chicago just held out Jensen and Meckling as a sacred text and rested the case. It was translated very skillfully, removed from an assumption-laden framework and generalized on an informal basis. The story, told by Easterbrook and Fischel, had three parts. Note that I stress the past tense.

The first part was a rebuttal of the mid-century institutional description of corporate managers as empowered actors in the economy and society, a description instantiated in corporate law in the Berle and Means model of separation of ownership and control. The rebuttal was that contract trumped *management* power because contracting actors in the stock market could take the power away by tendering to a hostile offeror; and a hostile offeror would show up whenever management did a bad job. And, at the time, that was happening every day. The separation of ownership and control was pronounced dead.

In the second part of the story, contract trumped *sovereign* power. Corporate law was not the mandate of an empowered sovereign because firms *could choose* their jurisdictions, with most firms going to Delaware. Choice of jurisdiction turned the lawgiver's relationship to the firm into a matter of mutual consent. There was no delegation of authority to the firm, no concession of power.

The third part of the story had to confront the fact that even Delaware law had mandates, including fiduciary law. That was the tricky part: how to make contract trump existing mandate. Chicago took a substance-over-form approach and offered us the majoritarian default. Corporate law was for the most part comprised of default rules that gave actors what they would have contracted for had they thought about it. If they wanted something else, they could contract out. Closure was thereby achieved. It all seemed to work. But then a couple of things happened.

The first thing that happened was academic. The claim that everything was contract in substance if not in form never really worked descriptively. Although most corporate rules are default rules—and had been so since the late nineteenth century—there were several mandates in the way—most importantly, fiduciary law. To make the contract story work, there had to be a successful normative assault on that mandate: even though fiduciary duties are what most shareholders want, shareholders should be permitted to opt out.

The corporate law community focused carefully on that claim: the question was whether opting out could operate satisfactorily in real world public firms. And the consensus answer was no. The institutional framework was ill-suited to contract because management had agenda control, the shareholders had collective action problems, and information asymmetries imbalanced the playing field. So the mandate was justified. Once that question was decided, the closure was broken and the strong form contractual description had nothing left to offer.

The second thing happened in state legislatures. The real-world nexus of contracts only made sense if the competing states cooperated and kept their hands off the hostile tender offer. Chicago was juggling several balls in the air. It used the states as responsive contractual lawmakers, with the story of competitive responsiveness serving to support a normative presumption against federal intervention. At the same time, it tried to persuade the states to do away with defensive barriers against hostile offers. But, as often happens with regulatory competition stories, it turned out that competition among the states did not by itself solve public choice problems. The states gave management additional defenses, defecting against the nexus of contracts. It was interest group politics as usual, and it empowered the managers.

The dominos kept falling. Institutional shareholders woke up and started complaining about management entrenchment. That brought back the corporation of Adolf Berle and his 1932 co-author Gardiner Means and their separation of ownership and control description, albeit without the normative overlay of trust and fiduciary enforcement of decades earlier. The return of separated ownership and control had devastating implications for the nexus of contracts—institutional activism is all about surmounting collective action problems so as to import something like arm's length bargaining in the shareholder-manager relationship.

The contractarians struggled to keep the game going—it was argued at first that with a little aggregation the collective action problem could be surmounted. Maybe investment institutions could pool resources on a spontaneous order basis and organize a national pool of activist director candidates. Maybe, but it didn't happen. Law and economics had taught

us to look at incentives and the incentives worked otherwise. That meant that the market couldn't correct governance problems by itself, because the structures were second best. Suddenly, everything in corporate law was about surmounting, ending, solving the problem of separation of ownership and control so as finally to put Berle and Means to sleep. For some, the activist hedge funds are right now finally doing just that; but I think it is as yet far, far from clear that the incentives are there.<sup>3</sup>

From there the discourse went global, with Americans looking to large investment institutions and shareholders elsewhere for strategies for overcoming shareholder collective action problems here, while people in Europe and Asia looked to us for more flexible ways of designing corporate law, and, more importantly, to our securities regulation systems. While Americans wanted active shareholders holding large blocks of stock, Europeans wanted their blockholdings to start dissolving into deeper, more liquid securities markets like those in English speaking countries. In the course of the discussion, the *economists* suddenly discovered that law mattered, which meant the nexus of contracts mattered not at all.

Even as all of that transpired, the caravan of economic theory moved on, still modeling a contractual firm, but one whose contracts are incomplete. Where Jensen and Meckling had started out asserting that we should expect 100% contractual solutions to governance problems, incomplete contracts theory describes huge gaps in firm governance structures where the institution of contract is inadequate to solve problems, gaps that are filled by control allocation mechanisms. And it is *just* at the point of control allocation where American corporate law imposes one of its four great mandates—board agenda control over charter amendments and mergers. This of course has the effect of vesting control in incumbent management. And so long as corporate capital structures do not provide foolproof control transfer mechanisms that remove ineffective managers, the problem of separation of ownership and control remains very real.

The economics of incomplete contracts is an economics of power. Now, it does not use that term; microeconomics expunges the concept of power. But it nonetheless has evolved so as to confront power in its treatment of corporations. We return again to the firm of Berle and Means, with the contractarian model of corporate law, a moribund theory.

But that does not mean that the left side won these debates. The nexus of contracts' theoretical legacy turns out to have been more important than the nexus itself. As I noted before, the debate also was about the

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3. Had this lecture been given in 2019, I would change this point, and concurred with those who deem the hedge funds to have solved the problem of separated ownership and control.

methodological mode of description, and even as the strong form contractual description failed, economic analysis, in particular the agency model, did not. They remain. But, with power allocation back on the table, the economic framework turns out to be much more capacious than anybody thought twenty years ago. I work within it much more than I work outside of it. When I want to point out that neoclassical agency assumptions that tend to be taken for granted in corporate legal theory are unsafe, my first recourse generally is financial economics. It nearly always gives me just what I need. Where it does not, microeconomics as writ more broadly fills the gap.

The economics also came with a powerful normative implication—there's a widely accepted presumption against new regulation. The contractarians won that point. I personally don't share it, but I can't ignore it and have to take care to address it. But, at the same time, the *deregulatory* movement of the 1980s has lost most of its force.

Some of the left side binaries retain their vitality in the securities law context. But with state corporate law and corporate governance more generally, they have lost ground. Trust, fairness, and substance are all still there but don't weigh nearly as heavily as they used to. Berle and Means survive with the separation of ownership and control even as their other point—that corporate property is public property—waxed in the mid-twentieth century and then waned. That point is still there in the structure, but outside of securities law, the political economic context does not favor it.

Finally, I note that the law itself, as it pursued the objective of wealth creation during the twentieth century, remained relatively impervious to theoretical initiatives on both sides of these debates. Positions taken in these discussions tend to follow from metapolitical preferences. The law itself tends to be more practical. Yes, the state corporate law framework is largely enabling, but it also rests on four ironclad mandates—fiduciary duty, which protects the cost of equity capital; management investment and financing discretion, which assures freedom of action; management agenda control, which does the same thing; and shareholder election of the board, which at least makes possible the removal of managers who don't achieve financial success, which, as noted, is the determinative consequence of consequences.

Management keeps itself free of new regulation so long as it succeeds financially. But the general presumption in its favor can yield in reaction to failure. In this functional universe, neither of contract and individual freedom nor protection of trust reposed are primary motivating values in lawmaking.

## CATEGORY III

On to Category III. These debates go the terms of the corporate agency relationship and the allocation of authority within the firm, matters I've already been traversing in the story I just told. Here three binaries suggest themselves: entity v. agency; management discretion v. shareholder choice; and managerialism v. shareholder value.

This is where the action has been in corporate legal theory for the last decade or so. Here we find two other erstwhile Georgetown colleagues, Lynn Stout and Margaret Blair, making the arguments on the left side. Steve Bainbridge of UCLA debates from the left in the first two binaries and from the right in the third, while Lucian Bebchuk, Reinier Kraakman, Henry Hansmann, and the law and economics establishment debate from the right in all three. I've done some work here too, unpacking the notion of shareholder value with implications favoring the left side.

The *history* here is episodic. The governing law changed quickly and emphatically in management's favor in the late nineteenth century. The right side reappeared and pushed back a bit after World War II, but given the general assumption that ownership and control were separate, no one thought much could be done. It took the takeover wars of the 1980s to bring these topics to the fore. Those wars ended with the takeover blocked by a combination of legislation and hostile case law, but with a new interest group of institutional investors registering objections. During the prosperous 1990s, the institutions tried various strategies to overcome their collective action problems and get control of corporate legislative agendas. The theoretical discussion deepened, with the anti-managerial impulse that formerly registered in Category II from the left side redirected here to the right to address the allocation of authority within the firm. But victories were few and far between, as a rising stock market cured all ills.

That changed when the century turned and the market collapsed. Enron fell, taking with it settled assumptions about the functioning of the disclosure system. Sarbanes-Oxley followed, but only whetted the right side's appetite for reform. The issue concerns voting and agenda control within the firm. And every time the discussion's level of intensity seems to drop, we get some new scandal. If we eventually do see reforms that shift power from managers to shareholders, it will be management's own fault.

At a theoretical level, these debates don't resolve. In fact, I would argue that the lack of resolution amounts to a deep structure in state corporate law. The doctrine itself triggers these debates by simultaneously dispensing two organizational models—entity, which privileges management empowerment, and agency, which suggests shareholder centered controls on management discretion. Ambiguity crops up on both

sides of my balance sheet-based points of agreement. On the asset side, we need management freedom of action to invest long term, but also shareholder power to intervene in the event of failure. On the liability side, we need management discretion respecting financial decisions, but we also need shareholder rights keyed to keeping down the cost of equity capital and preserving market liquidity.

Here corporate law, when it articulates the terms of the agency, in effect mediates ongoing disputes rather than settling on clear solutions. We have mediation rather than solution because both sides of these debates tell plausible stories about wealth impacts. The shareholder side points to the negative effects of management entrenchment. And it's a fair point. But the management side has a fair response when it points to the short-term focus of institutional shareholders. The shareholder side points to the deadweight costs of management pocket-lining through excess pay and manipulative accounting and nondisclosure. Fair enough, but enforcement systems implicate their own costs and its far from clear that enhanced shareholder input and agenda access will lead firms in a productive direction.

At a theoretical level, the right side in one sense has the upper hand, because the separation of ownership and control remains corporate law's unsolved structural problem and they at least confront it directly. But the left has its own claim to theoretical primacy—if there's a guiding political metaprinciple here, it is caution, which of course works in favor of the inherited legal context. We end up going back and forth, with apparent but unverified welfare gains constantly ranging against apparent perverse effects and incentive problems, and we as yet have no empirical means to determine correct outcomes.

Pending the articulation of a verifiable, generally accepted template that fills in the terms of the agency relationship, the debate will go on, with the opinions of the day being highly sensitive to results in real world firms. All other things equal, I used to be right side anti-managerialist here. But I am gradually changing sides.

#### CATEGORY IV

I at long last reach Category IV.

These debates concern the boundaries of the firm and the firm's responsibility to outsiders. This is the territory where corporate social responsibility intervenes from the left. Three binaries capture the matters at stake: first, outsiders (other constituents) versus insiders (shareholders and managers), and, second, social welfare versus corporate profit. The third is public versus private, which I note takes us back to the first binary in Category I to start the whole thing over.

In this Category, corporate law makes an emphatic doctrinal response that excludes outsiders, exposing them to injury. There follows a constant flow of theoretical protest. Each generation takes up the matter anew, but the protests somehow never make a dent in the practical settlement. The protests are motivated by the notion that corporate law should follow from and synchronize with norms prevailing in the wider system of public and private law—that it needs somehow to interpolate a social welfare function. Take that notion seriously and corporate power and legitimacy come up as concerns possibly co-equal with economics.

Unfortunately, our corporate law institution, viewed narrowly, has no aspirations in this Category. It disavowed social legitimacy as a concern in 1888 when New Jersey opened up the first charter shop, pitched to firms wanting to get out from under state level antitrust regulation. Ever since, legitimacy in corporate law has been defined by real world financial success and failure.

This historical settlement is of course contestable. But the contestants confront a serious problem. Corporate law's purpose is to encourage attempts to create wealth—to clear the field for play. How does one interpolate into it a social welfare function with distributive and protective directives, particularly in a world where encouragement of wealth creation means clearing a field for maximization, whatever that is?

The question leads to two embedded objections to corporate social responsibility initiatives. First, the doctrine's bright-line firm boundary and insistence on putting wealth creation first imports coherence to the governance system. Second, outside regulation is the better solution to the responsibility problem. It has to be there, if only to make the world safe for the corporate law delegation. It thereby makes firms and corporate law legitimate by indirection.

This inside/outside settlement leaves many unsatisfied. But it was very much the settlement Adolf Berle envisioned a half century ago, and if you will permit me one last historical story, it is worth looking at his account.

Berle, who set out his trust model of internal corporate regulation in the 1930s, went on to encase it in a wider political economy in his post-war writings.

In Berle's view, markets didn't work and a stable economy only would follow from national economic planning. He thought that corporations should be managed for their shareholders on a trust basis, but that they also should come to a big regulatory table at which the state set the social welfare function. That accomplished, it was the corporation's duty to cooperate. Now, the big regulatory table did not exist in fact, but Berle perceived a political equilibrium that forced cooperation on

corporate managers. On one side they faced a federal government ready to slam down new regulation if they ceased cooperating. On the other side, they faced a public ready to register political dissatisfaction if corporations failed to serve its heir needs. Managers, caught between the two and incented to stave off new regulation, played cooperatively in the context of the inside/outside settlement. Berle modeled them as quasi-public servants who worked with the state to enhance social welfare primarily by providing the people with economic security. Berle integrated the corporation in an all-encompassing political, social and economic theory that held out closure.

But it all started to fall apart in his last years. Berle's construct was vulnerable to attack from the new microeconomic right because it was based on a heroic assumption. Berle viewed the production function as endogenous—he thought the technocrats would keep the machines humming productively whatever the regulatory and governance structure. That assumption was over time refuted by both agency theory and economic experience. Incentives then came to the fore, and along with them the push back against the regulatory state.

Berle's construct also ran into problems on the left. Corporate social responsibility as we know it today descends from the next generation of progressives—actors who were not getting the new federal regulation they desired when the New Deal settlement fell apart in the 1960s and 1970s. In response, they sought to redesign the legal firm to incorporate a social welfare directive therein. That was not Berle's view—but then he never had to confront the deregulatory turn. Looking back at his vision today, one gets a sense of something lost.

The inside/outside settlement remains with us but now has different, harder implications. We put up with it as a polity, despite the state's retreat, because we value the end of economic opportunity. By hypothesis, our median voter accepts a system that aggressively divides us into winners and losers because it identifies with the winners, or at least holds out hopes for its children's place in the winner's circle.

The result is to place the burden of persuasion firmly on the settlement's critics. The corporate social responsibility side has never managed to surmount the burden to produce an alternative model that meets coherence objections and resonates in the context of our social settlement. It has every reason to continue to try and should in any event continue to criticize—it is important that the settlement's proponents not be permitted to delude themselves with Pareto optimality stories about the system's consequences.

Meanwhile, the social responsibility party has joined the corporate governance movement, there to importune management to do good. This

presupposes a zone of management discretion, and so, in one final ironic turn, the progressive voice today sides with management power in the Category III debates and views the shareholders as more likely to be hostile than friendly.

Unfortunately, the strategy of precatory dialogue opens them to criticism from the left. Importuning only results in management doing things that it wants to do anyway and diverts political energy from the more effective goal of new regulation. That's a good point. But forced to choose, I'd leave the social investment community, the NGOs and the other corporate governance do-gooders on their present trajectory. We'll get a return to tight regulatory controls only in the wake of an economic disaster. Present regulatory energy should be directed to making sure that doesn't happen.

#### CONCLUSION

Concluding, Berle is my story's thesis and Chicago its antithesis. Berle propounded a theory of the corporation that held out closure by eradicating markets from the picture and substituting the state; Chicago's theory also held out closure, effected by eradicating the state and describing everything as a market transaction. Closure is great, but both moves denuded both theories of real-world robustness. But each nonetheless held sway in turn—Berle's as the support for a left side presumption favoring regulation in Categories I and II, a presumption that held sway from the depth of the depression until 1980, the year I started teaching, and Chicago's as the support for the presumption against new regulation that has prevailed ever since in Categories I and II. The original shift to Berle occurred in the wake of a period of economic failure, so did the 1980 shift to the right. A shift back presupposes a future failure. Categories I and II went quiet after 1990 and the Category III debates emerged from secondary to primary status. I view them as a draw and hope the standoff endures, with the law mediating across the ambiguity in the agency relationship. As to Category IV, the inside/outside settlement has not changed in my time and shows no sign of doing so, even as I deem the debates to be of utmost importance.

## II. CORPORATE LEGAL HISTORY

### A. ADOLF BERLE: AMERICAN CORPORATIST

Penn Law Faculty Ad Hoc, February 16, 2008

Accompanying Article:

William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*,  
34 J. CORP. L. 99 (2008)

#### INTRODUCTION

Two years ago I was minding my own business when I get a cold call from Michael Wachter. He said straightaway that he wanted to write an article with me about Adolf Berle. I said that I had already written an article about Adolf Berle. He said he knew but that more needed to be said. "Berle was a corporatist. He drafted the NIRA." I said, "No he wasn't. He was a legal pluralist," with a cite to a paper by Dalia Tsuk. "And he didn't draft the NIRA, he went back to New York after the inauguration in 1933."

Michael told me he wanted me to look at a paper he had written about corporatism and labor unions, then in draft. After I had done that, he called again to explain that he wanted to take the paper's description of corporatism to Berle. And then he gave me the punch line. Corporate law's shareholder primacy camp, said Michael, looks to Berle for a theoretical predecessor. They're wrong. Said Michael, "Berle wasn't a shareholder guy." I said, "Ok, but it's more complicated. Berle talked out of both sides of his mouth on the matter, leaving contradictory texts. There are unsolved puzzles on the table about the meaning of Berle's classic works." It turned out that we were both right.

The classic corporate law texts in question are Berle and Means, *The Modern Corporation and Private Property*, published in 1932, along with some articles, all of which appeared before the book was published—Berle's 1931 article, *Corporate Powers as Powers in Trust*, Merrick Dodd's 1932 response, *For Whom Are Corporate Managers Trustees?*, and Berle's 1932 rebuttal of Dodd.

There's a generally accepted historical picture that puts Berle in the position of great grandfather to today's shareholder primacy advocates and shows Dodd as the great grandfather of today's corporate social responsibility advocates. But also, there's some noise on the screen. The first stems from contradictions within Berle's body of work. While most see him as shareholder friendly, some CSR people have claimed their own Berlian roots in *The Modern Corporation's* last six pages. Meanwhile, I

and a few others see Dodd as a run of the mine managerialist and not CSR. Questions also arise due to changes of position in the later writings of both Berle and Dodd. Dodd reversed his position in 1941, to be followed in 1954 by Berle's concession that Dodd had been proven correct. You may not remember, but you read about all this when you took Corporations.

With Michael's description of corporatism on one side and the unsolved puzzles regarding the meaning of Berle, Berle and Means, and Dodd on the other side, we agreed to go ahead to see if we could solve all the puzzles. I knew we had succeeded one day soon thereafter when I got another call from Michael: "Dodd's a corporatist too! They're all a bunch of corporatists!"

Our reading, then, marks both Berle and Dodd as corporatists, working from Michael's typology of twentieth century political economy and its distinction among corporatism, pluralism, and communism. For the sake of expedition, let's put communism to one side and contrast corporatism with pluralism. Pluralism, as we all know, looks to the preferences of individuals in calculating welfare for government policy. Outcomes are determined by competition for individual votes in a political marketplace. Interest groups are out there but have no political status beyond the aggregation of their members' interests. *Property rights rule*. Now let's turn to corporatism, which accepts property rights too. But it also enfranchises groups, emphasizing cooperative relationships among them and between them and the state. Two principles dominate. First, there is an objectively cognizable "public interest" articulated by the government after consultation with the major groups. Second, once the public interest is expressed, the groups are expected to adjust and support it. Property rights yield at that point.

I've noticed that writers on twentieth century American political thought tend to avoid the term corporatism, preferring various alternatives—distinctions between America and Europe play a role in that, but corporatism's links to Hitler and Mussolini doubtless also figure in. But corporatism wasn't just European fascism. It also was Latin America after World War II, and to some extent Europe as well; see the German dual board. To a cognizable extent, it is China today. And it was also U.S. politics in 1932.

We make two assertions: first, if you take this description of corporatism to the classic Berle and Dodd texts and read them in historical context, you can explain every line in them and solve all the puzzles. Second, once you've done this there's no basis for connecting Berle with shareholder primacy and not much of a basis for connecting either Berle or Dodd with CSR.

But, making the case is tricky. As of 1932, there are only six pages in Berle's published work that support it, and those pages can be read as CSR. And, as of that time, the rest of published Berle does admit of an acontextual read as shareholder primacy.

We surmount the problem by following Berle over time, describing an evolution in three phases: Early, Middle, and Late. Early Berle was indeed a shareholder advocate and lasted until 1931. Middle Berle springs into existence as a political actor in 1931–1932, and is a corporatist. But, because the final six pages of *Modern Corporation* provide too thin a basis for this claim, we establish it by reference to Berle's political role as a member of FDR's Brains Trust. We conclude the proof with a look at Late Berle, the post-war political economist.

#### FROM EARLY TO MIDDLE BERLE

We start with Berle in his downtown law office in the 1920s, writing articles about growing management power and what to do about it. He suggested several things—self-organization by investment bankers, monitoring by investment institutions, and stricter stock exchange rules. There's an intriguing resemblance to today's contractarianism, but you have to be careful with it. Berle was positioning himself as a progressive reformer, and his positions are better analogized to the contemporary industrial pluralism of John R. Commons. For present purposes there are two key points: first, like Commons, Berle wrote off the courts as agents of reform, and, second, Berle was not yet worrying about the corporation's role in the broader political economy, at least not in his law review articles.

Work on *The Modern Corporation* began in 1928, when Berle engaged Means, a young institutional economist, who showed him that 200 corporations controlled one-third of the national wealth and predicted that by 1950, 200 corporations would control 70% of the national wealth. At that point Berle started to change.

He dropped his contractual strategy, adjusted his view of the courts, and emerged with a trust model of corporate law. Most of *The Modern Corporation* was devoted to its exposition. Berle took a piece of that part of the unpublished book and ran it in *Harvard Law Review* in 1931, an article that lays out the problem of management power and proposes fiduciary duty as a means of addressing it. That brought Berle to the public as a shareholder advocate making three fundamental points: one, managers were trustees of the shareholders; two, managers should only exercise their wide-ranging powers for the shareholders' ratable benefit; and, three, the judiciary should vigorously enforce the trust.

With that paper published, Middle Berle shows up in the chronology, but yet not in academic print. This was Berle, the public intellectual, rather

than Berle the corporate lawyer. Like many others at the time, he believed that free market capitalism was inherently dysfunctional and had brought the country to the brink of ruin. In early 1932, he joined FDR's Brains Trust where, together with his Columbia colleagues Ray Moley and Rexford Tugwell, he made up the faction of campaign advisors that Ellis Hawley later would term the "planners." They advocated acceptance of concentrated industry together with government economic planning and fought against an opposing faction of Brandeisian liberals who favored market competition, trust busting, and small business. That September, FDR gave the planners the nod, putting out their views in his famous New Individualism or Commonwealth Club speech, a speech written by Berle (and his wife Beatrice).

The speech treated everyday management practice as a *political* problem: ordinary citizens had a right to economic security, a right infringed by corporate managers, the "princes of property." To address the problem, Berle pulled out his trust model, but substituted citizens for shareholders as the beneficiary. Continued sufferance of management power depended on the trust's fulfillment: the princes had to assume responsibility for the public good, end their internecine disputes, come together as industrial groups, and cooperate toward a common end. Should any group defect from cooperation, the government would intervene with punishment. Thus coordinated, firms could adjust production to consumption and distribute wealth more equitably. The chaotic marketplace would be disciplined by "an economic constitutional order."

This is fully formed Middle Berle expounding themes he continued to develop for the rest of his life. We think the term corporatism aptly describes the substance of both the speech and the NIRA, the statute that attempted to realize its vision in public policy. In fact, Berle did return to New York after FDR's nomination and wasn't one of the NIRA's drafters, but his fellow Brains Trusters were, and it certainly reflected his point of view. The paper sets out its main terms, highlighting section 7a, which accorded labor a place at the big new corporatist table. The paper also describes the NIRA's collapse, but that lay in the future.

#### THE TEXTS

So, where Early Berle addressed only corporate law issues, Middle Berle articulated a national political economy. Both used the same trust model with apparently inconsistent ends. We can bring them closer together, if not merge them into a coherent whole, by reference to *The Modern Corporation*, published in 1932.

The book sandwiches the shareholder trust model inside of opening and concluding parts that address the broader implications of

management's social and economic power. Ownership and control had separated, empowering managers. Classical economic assumptions about owner control and responsibility no longer obtained. Standard individualist defenses against government intervention could no longer be countenanced. Instead, we needed to cross the public/private divide and deem corporate property to be public property.

Now, if corporate property was public property a question needed to be addressed: Was the corporation about social welfare, or as the book's trust model implied, about shareholder welfare? The book took up the question in its last six pages, the only ones in which Middle Berle made an appearance. There, Berle redeployed the trust model for the citizen beneficiaries of the Commonwealth Club speech: since the shareholders had given up responsibility for corporate property, other constituents should join them as beneficiaries; passive shareholder property rights would give way to a system of community obligations centered on employee security and business stabilization. Management must develop into a "purely neutral technocracy."

Strong stuff indeed, but the book offered no further policy instructions, corporatist or otherwise. Meanwhile, it set out two versions of the trust model only to leave them hanging in mutual tension. We think this unsatisfactory conclusion reflected rapid evolution of Berle's views at the end of the republication period.

So, there's the book. Now assume it is early 1932 with Berle working on the galleys.

Here Dodd enters the picture in the *Harvard Law Review's* May 1932 issue, slamming Berle's 1931 shareholder trust article from the left. Said Dodd, the view that corporations exist for their shareholders makes no sense in the present crisis—they should instead act as social institutions, providing economic security for employees. He assured the reader that managers would undertake this trust in a responsible way, citing conservative business leaders like Owen Young and Gerald Swope of General Electric.

Read out of context, this models a constituency-based firm under management control not much different from today's Blair-Stout team production model. But it had a more specific meaning at the time. In May 1932, many expected some kind of corporatist reform from a soon-to-be-elected Democratic Administration. But, two competing visions of what that might look like were in circulation. One came from managers and their allies—Ellis Hawley terms this group the "business commonwealth." It wanted a delegation of authority to management to run the economy free of product market competition. Young and Swope had clear cut political

profiles as this position's advocates. Dodd, by working them into his text, aligned himself with the business commonwealth.

Interestingly, Young and Swope did not stand for the proposition that corporations should share with constituents. Instead, they viewed employee security as part of a new labor relations model that would ultimately yield production efficiencies. But the model, initiated at GE in the 1920s, had not proved competitive under depression conditions—Young and Swope went into politics looking for government policies that would backstop their business plan.

The *opposing* corporatist model came from academics like Berle—the planners. They opposed an open delegation to management and wanted strict government oversight of the planning process. And, unlike the managers, they wanted labor brought to the negotiating table.

Berle accordingly must have gotten quite a jolt when Dodd took him to public task for having left labor out of the corporate law picture in the 1931 article. Dodd attacked the shareholder trust from the left, even as Berle in fact stood well to Dodd's left. How to respond? Well, the book wasn't out yet. So why not answer with a preview of the Commonwealth Club speech? That doesn't seem to have been an option—Berle was inside the campaign and FDR hadn't yet opted to go with the planners. Moreover, it's one thing to lay out a policy proposal in a speech; doing so in a law review is quite another.

So, Berle's response, published in the *Harvard Law Review's* next issue,<sup>4</sup> avoided any mention of ultimate policy goals and concentrated on the infirmities of the business commonwealth model. Why empower managers when unbridled management power was the problem? Controls were needed, and trust duties to shareholders were the only ones available, at least at present. And, when the time finally came to address the problem in a *serious* way, lawyers like Berle would be better equipped than managers. This is roughly the move Berle makes in the book—he tells the reader something new is coming without saying what he expects it to be, only laying groundwork.

Berle's response thus addresses only the situation a few months before the 1932 election and accordingly doesn't stand for shareholder primacy. Indeed, it puts shareholders in their place, according them legitimacy only as passive recipients of wealth created, because as recipients they represented to some extent the welfare of the general public. Decades later, he would add that full legitimacy for the shareholder interest would only come when wealth was so widely distributed that the

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4. One can infer that Berle's response was completed before the May 1932 issue was published.

shareholder interest in fact proxied for the public interest. The shareholder primacy gloss really came from Dodd.

Dodd returned in 1941 to do an about face, dropping business commonwealth corporatism and returning corporate law to its narrow, private, profit-seeking box. With the economic crisis past, he returned to normalcy. Citing Berle with approval, he argued that corporate law's purpose was to protect the shareholders from empowered managers, who now could not be trusted. Happily, the situation was under control because the new federal securities laws contained management. Observers today may disagree with that last point. But, otherwise, Dodd's 1941 reversal is only text under discussion that admits an easy transfer to today's context.

#### LATE BERLE

Late Berle fired the debate's last shot in 1954, making a famous concession—Dodd had been proven right over time; managers could be trusted after all.

But this no more meant what it seems to say any more than Berle's 1932 response meant what it seems to say. Berle only admitted that later events had gone Dodd's way; he did not concede to having been wrong at the time of publication in 1932. Comes the question, what had changed in subsequent history to justify the adjustment? For Berle, everything had changed in 100 days in 1933, when a new American Economic Republic had been founded. Two conditions rendered corporate power benign in the new republic—first, government management of the economy from an unchallenged position of higher authority and, second, a solid political consensus in support. Absent those conditions, there is no basis for inferring from Berle an endorsement of management in a primary role as an economic and social allocator.

Late Berle thought that the post-war regulatory state had in substance accomplished the objectives of the NIRA and formal corporatism. He assumed that the state could and did accurately articulate the social welfare function, guiding and pushing the markets to the right result with the cooperative engagement of interested parties. He described a benign equipoise amongst strong organizations, an equipoise constrained by a wider public consensus that empowered the central government in the role of welfare maximizer. And he remained suspicious of competing interest groups—you can call him many things, but pluralist in today's sense is not one of them.

Corporate managers emerged as quasi-public servants, but not in the way advocated by Dodd in 1932. For Late Berle, managers, whether they liked it or not, were caught between the regulatory state and the public consensus. Failure to satisfy the public meant new regulation; avoidance

of new regulation meant satisfying the public. As a practical matter, then, managers could not avoid public duties. Shareholders, in contrast, remained what they had been in 1932—passive collectors of dividends with no productive role to play in the political economy.

#### COUNTERFACTUALS

Now let's fast forward to today. We have shareholder primacy, a counter managerialist view that does not necessarily reject shareholder value as the ultimate end but defends management discretion and corporate social responsibility, and its ultimate objective to insert social welfare enhancement into the corporation's set of legal instructions.

Who has what claim on Dodd or Berle?

Dodd in 1932 as CSR? Not if you accept our substantive link to Swope and Young, who were corporate maximizers peddling a new model of labor relations. Moreover, Dodd in 1941 pulled corporate law back from the wider political economy to reinsert it in its small box of statutes and case law. He's best remembered as a managerialist.

Berle as shareholder primacy? Not after 1931. The corporatism of Middle and Late Berle followed from assumptions antithetical to shareholder primacy, rendering any normative connections to today's discussants incidental and tenuous.

The best you can do for shareholder primacy is focus on Berle's descriptive contribution—the separation of ownership and control—which remains the problem shareholder primacy wants to solve. But today's discussion proceeds in a private, property rights context. Making a connection means ignoring Berle's normative perspective, and for Berle, the whole point of the separation diagnosis was normative. It meant that property rights did not assure responsible operation and depicted managers as an illegitimate aristocracy—they were “princes of property,” rather than the “neutral technocrats” Berle wanted because they made public welfare decisions without being publicly accountable. Including shareholders into the decision-making process (assuming there was a meaningful way to do so) wouldn't solve the problem.

Indeed, as between shareholder primacy and management discretion, we can more easily imagine Berle choosing the managers from a fallback position. Any movement to empower shareholders would make him suspicious. Today's debate poses a choice between governance interruptions by market intermediaries and governance from within the corporate institution. Given the choice, much in Berle signals that he would put his anti-managerial suspicions to one side to privilege internal control. He prized stability above-all and mistrusted markets as deployers of capital.

How about Berle as CSR? It's a stronger claim, but it too fails in the end. Berle envisioned and sanctioned CSR only within a corporatist framework. His post-war consensus story specified that the public demanded CSR only at "reasonable" levels. Today's CSR descends from progressives in the 1960s and 1970s who were not getting the new regulation they wanted and no longer saw the post-New Deal regulatory state as a responsive agency. This led to a corporate law push to insert social welfare maximization into the legal model. There's no authority for that in Berle, who envisioned the legal entity going to the corporatist table for social welfare instructions. Indeed, Berle readily can be imagined making the standard objection to today's CSR: so far as concerns corporate pursuit of social goals, outside regulation works better than an open-ended internal social welfare instruction because it makes for a more coherent governance system and enhances political legitimacy.

#### CLOSE

So, Berle answered the question "for whom is the corporation managed" with a political economy that integrated a theory of corporate law within a theory of social welfare maximization. Today's shareholder primacy more supplants than succeeds him. We have shareholder primacy precisely because corporatism lost out to pluralism and markets. Berle's legacy is that he and Means identified the separation of ownership and control that remains corporate law's core problem, a problem now seen from a completely different normative perspective. Corporate legal theory must confront it and hold out a cure. Shareholder primacy does that and so takes over as the favored policy position, but only within the small corporate law box.

## B. THE MODERN CORPORATION'S LAST CHAPTER

Berle I, November 7, 2009

## Accompanying Article:

William W. Bratton & Michael L. Wachter, *Tracking Berle's Footsteps: The Trail of The Modern Corporation's Last Chapter*, 33 SEATTLE U. L. REV. 849 (2010)

## INTRODUCTION

Those game enough to work through all 300 pages of *The Modern Corporation and Private Property* in a search for the origins of, or insights about today's corporate law topics will discover two lines of thought that coexist in tension. One line, set out in Books II and III, resonates comfortably with today's shareholder-centered corporate legal theory. Here the book teaches that even as ownership and control had separated, managers are trustees for their shareholders and may only exercise their wide-ranging powers for the shareholders' benefit. The other line of thought emerges in Books I and IV, where *The Modern Corporation* encases this shareholder trust model in discussions of corporate power and social welfare, discussions that resonate today with those who advocate corporate social responsibility. Here Berle crossed the public-private line to recharacterize corporate property as public property, and assert that separated ownership and control implies public responsibilities. Berle carries this private to public line of thought to a logical conclusion of sorts in the book's last chapter, Book IV, Part IV, six pages entitled *The New Concept of the Corporation*. Here the shareholder interest, the focal point of most of the book, wholly gives way to community obligations and managers become "purely neutral technocrats" pursuing social welfare maximization.

A couple of years ago, we published a paper that explained the book's seeming contradictions by reference to the context in which it was written. The book had a long gestation, spanning the late 1920s, the Crash, and the early years of the Great Depression, a time when Berle joined many others in reordering his political views. He began as a friend of the shareholders during the boom years and ended up, during the depths of the Depression, as an advocate of corporate advancement of national social welfare policies. Different parts of the book capture Berle at different points in the timeline. The last chapter gives us Berle as he addresses debates over the appropriate policy response to the economic crisis, debates still underway upon book's publication in 1932. Many looked to FDR not only to win the election, but to follow the lead of many European

leaders of the time and adopt corporatism as the political economy of the United States. Berle, who joined FDR's inner circle during the 1932 campaign, was a leading advocate of a corporatist approach. Our earlier paper highlights the conceptual overlap between the last chapter and the Commonwealth Club speech that Berle (and his wife Beatrice) wrote for FDR. The speech, the most radical of the 1932 campaign, presaged the economic program of the New Deal, in particular the corporatist National Industrial Recovery Act enacted in June 1933.

Our paper for this conference returns to the last chapter to take a new look at it and trace its later footsteps. Our inquiry has two phases. We first examine Berle's later writing on political economy to see the footsteps change direction, but only slightly, as Berle modified his corporatism to suit the post-war political economy. We then look at the world after Berle, with its retreating regulatory state and turn to market controls. We find traces of the last chapter even here, as legal compliance *per se* emerges as the margin at which society confronts empowered managers.

#### THE LAST CHAPTER

First, to the last chapter itself. It builds on the point that those who have power in our society inevitably come into conflict with the populace because the power's exercise impacts the public interest. The chapter predicts that the impacted population will want to redirect the power's exercise for its own general benefit. The prediction does not, however, imply a particular policy prescription. Particular outcomes of this conflict, said Berle, will vary across different political economies and over time.

He does suggest three possible alternative courses for corporate power in the United States in 1932. First, we could leave management unregulated, but only if we wanted corporate plundering. Second, we could hew to the book's shareholder trust model. But the last chapter turns on the shareholders, dismissing them out of hand as "inactive and irresponsible." So we get the third alternative. We could start anew, rethinking the corporation for the community's benefit. Well, how, exactly? The book does not tell us. It was up to the community to put forward its demands with "clarity" and force.

Thus, do we see *The Modern Corporation* doing what Berle manifestly thought to be its job—to clear the field of private property rights so that the new regulatory state could get on with it. But the last chapter does give us a brief, very brief, suggestion as to what that new regulation might look like, and this follows the corporatist template.

Corporatism? Yes, corporatism. Corporatism wasn't just European fascism. It also was Latin America after World War II, and to some extent Europe as well (see the German dual board). To some extent it is China

today. And it was also U.S. politics in 1932. You can place corporatism with pluralism and communism as one of the twentieth century's three great -isms. Putting communism to one side and looking closer to home, let us start with pluralism. This looks to the preferences of individuals in calculating welfare for government policy. Outcomes are determined by competition for individual votes in a political marketplace. Interest groups are out there but have no political status beyond the aggregation of their members' interests. *Property rights rule*. Now let us compare corporatism, which accepts property rights too. But it also enfranchises groups, emphasizing cooperative relationships among them and between them and the state. Two principles dominate. First, there is an objectively cognizable "public interest" articulated by the government after consultation with the major groups. Second, once the public interest is expressed, the groups are expected to adjust and support it. Property rights yield at that point.

And that's what the last chapter tells us: corporate property rights will yield once a system of community obligations has been worked out. Here's the payoff quote:

Should the corporate leaders . . . set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which will divert a portion of the profits from the owners of passive property, and should the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way.

Managers would emerge as "purely neutral" technocrats making allocative decisions across groups in society "on the basis of public policy rather than private cupidity," possibly becoming more powerful than government itself.

With this vision of empowered manager-technocrats, the last chapter finally goes for broke. But the flourish needs to be read carefully. Berle's managers become empowered only if they successfully redirect their resources to social welfare enhancement. And their power is only that of technocrats, experts who realize an instruction delivered by outside political forces. The vision presupposes a source of policy instructions vested in a higher power still, a role to be filled by the national government that articulates the public interest. And, because an empowered central government is a basic assumption, there is nothing in the last chapter for a modern proponent of corporate social responsibility in a deregulatory state.

But then there isn't much in *The Modern Corporation* for modern proponents of shareholder primacy either. Berle retains a reputation as a shareholder guy because of *The Modern Corporation's* other line of

thought, centered on a shareholder trust model. Berle forcefully advanced that line of thought in 1932 as an alternative to management empowerment in a famous back and forth with E. Merrick Dodd. But, as the last chapter shows, Berle saw the trust model as an either/or alternative to a regime of management piracy, a choice posed under the pre-New Deal regulatory status quo. Given that status quo, and absent a big-stick state, Berle went with the shareholder trust as the least dangerous alternative. Given a state-controlled economy, Berle saw things very differently, with the public displacing the shareholders as trust beneficiaries and the directors owing their primary allegiance to the national interest as articulated by the corporatist state.

Finally, we can distill all of this situation specificity from the last chapter to find three points that still speak to us directly today. First, demands for corporate social responsiveness are inevitable. Second, the political and social particulars will vary with the context. And, third, public demands, in order to register, will need to be stated clearly and forcefully.

#### POST-WAR BERLE

The last chapter's grand vision soon achieved real world manifestation in the NIRA. But the NIRA quickly fell apart. It looked to cooperative alliances that never coalesced, and, absent cooperation, its economic plan foundered on internal contradictions. Berle's grand vision disappeared along with it. Berle accepted the result.

Ironically, Berle also came to accept Merrick Dodd's benign view of corporate managers. He and Dodd went back and forth several times. Berle fired the last shot in 1954, making a famous concession—Dodd had been proven right over time; managers could be trusted after all. Those who mistake Berle for a shareholder primacy advocate have been puzzling over the concession to Dodd ever since.

But Berle was only admitting that later events had gone Dodd's way; he did not concede to having been wrong at the time of publication in the *Harvard Law Review* in 1932. Comes the question: What had changed in subsequent history to justify the adjustment? For Berle, everything had changed in 100 days in 1933, when a new American Economic Republic had been founded.

Before 1933, the economy and the polity had been separated, with the economy left to go its automatic way. But the "open market" could not prevent periodically catastrophic rises or falls in prices. There needed to be a planned equation of supply to demand, and the transition from the destructive regime of autonomous market controls to the superior system of state planning had occurred in 1933.

Two conditions rendered corporate power benign in the new republic—first, government management of the economy from an unchallenged position of higher authority and, second, a solid political consensus in support. Absent those conditions, there is no basis for inferring from Berle an endorsement of management in a primary role as an economic and social allocator.

Berle thought that the regulatory system that emerged had accomplished the objectives of the NIRA and formal corporatism. He described a strong regulatory state that operated under a pragmatic political settlement toward an end point in accord with corporatist precepts. He thought there was no practical alternative: absent strong central economic planning, capitalism would only return to the crisis of 1932. Fortunately, the state could and did accurately articulate the social welfare function, guiding and pushing the markets to the right result.

This presupposed the cooperative engagement of interested parties. Berle described a benign equipoise amongst strong organizations, an equipoise constrained by a wider public consensus that empowered the central government in the role of welfare maximizer. Post-war interest group pluralism never registered with Berle. It made him suspicious because it assumed good results from competition in pursuit of self-interested goals and failure to cooperate.

Meanwhile, management power had been tamed within the benign equipoise. The concentration of productive functions in the hands of a few was a positive development if it provided the means to realize a planned economy sensitive to the interests of the community as a whole. In the American Economic Republic managers emerged as quasi-public servants. Whether they liked it or not, they were caught between the regulatory state and the public consensus. Failure to satisfy the public meant new regulation; avoidance of new regulation meant satisfying the public. As a practical matter then, managers could not avoid public duties.

Shareholders, in contrast, remained what they had been in 1932—passive collectors of dividends with no productive role to play in the political economy. Corporate law, meanwhile, should not be a primary mode of regulation—Berle approved of post-war extensions of the protection of the business judgment rule. Management, now tamed by the big stick state, should not be constrained by the state corporate law apparatus. Nor did capital market constraints matter either. Corporations got new equity capital by retaining earnings and only rarely went to Wall Street to sell stock. The markets served only to provide liquidity to passive property holders, there was no disciplinary value added. The shareholders, earlier thrown up against Dodd as a countervailing interest, dropped out of the governance picture. Federal bureaucrats now did the law enforcement.

## THE LAST CHAPTER POST-BERLE

The framework of corporate legal theory changed abruptly after Berle's death in 1971. The precipitating economic context featured stagflation, a failing stock market, the retreat of organized labor, and a perception of national competitive decline in new global markets. Together these problematized the productive and financial performance of corporate managers. Management power again became a problem.

The last chapter tells us that demands for corporate social responsiveness are inevitable and that political and social particulars will vary with the context. And so they have. Berle had viewed the production function as an exogenous variable—he thought the industrial production machine could bring forth limitless wealth so long as the planners mediated supply and demand. Now productivity was the question and corporate social responsiveness came to be seen in terms of optimal economic results. The problem of management power was reframed as a problem of management incentives. Shareholder value maximization came to be seen as a proxy for optimal economic results, situating the shareholder interest at the economic margin as the search for an optimal corporate incentive structure commenced. The searchers favored market decisions over regulatory mandates.

If management incentives are a problem, then the inherited legal model of the corporation could not be dismissed as antique but serviceable, as Berle had done. It needed to be revived. And so corporate governance was born. If structural barriers prevented shareholders from controlling managers, then the structure of the board of directors needed revision to make it an effective monitor of management performance. The corporate governance system now supplements the independent board with an ever-expanding list of best practices. Together, these ever more constrain management power.

But what of the big-stick state, and the last chapter's vision of demands emanating from the general public, the demands that needed to be stated clearly and forcefully? Berle's public demanded economic stability and job security. Once the economy was regulated and stabilized, management power dropped out as a frontline political problem. Berle did not expect the problem to reemerge, at least absent another economic crisis.

But an economic crisis did follow, and it proved Berle right. The legitimacy of management power depends on economic performance. Economic failure denudes management of legitimacy, and triggers clear and forceful public demands. It happened in the 1930s. It happened again in the 1970s, again after Enron, and it is happening now. Scandals crystallized the demands in the earlier cases, and so we got the Foreign

Corrupt Practices Act and Sarbanes-Oxley. As befits new regulation in a deregulatory era, neither much implicated the economic substance of corporate management even as both constrained management power.

SOX taught us an additional lesson. It was enacted by a frightened Congress, and so marked the emergence of the shareholder class as an independent force in the political landscape. Now, Berle thought that the shareholder interest could proxy for the public interest only if shareholding was proportionately distributed across the population. There's much to be said for Berle's point, and we certainly have not reached that point of identity. Even so, the politicians now model the median voter as a 401(k) holder. The federal securities laws' truth-telling mandates assume greater importance as a result.

And there's a second reason for the focus on truth-telling. In Berle's American Economic Republic, the regulator set the price. Today the market does that, and now that economic discipline of managers is a primary policy goal, the stock market itself assumes a leading regulatory role. It does its job better if information asymmetries are minimized, further enhancing the importance of truth-telling mandates.

What follows is an ongoing mediation between corporate power, now manifested in the insiders' informational superiority, and the outside economy, now protected by disclosure rules. As the last chapter predicts, this mediating process has traversed the public-private divide repeatedly. Is the public enforcement apparatus insufficient for the job? No problem, we'll delegate to the plaintiff's bar. And if the enforcing lawyers' rents have to be funded out of the shareholders' residual claim, so what? Didn't Berle tell us that corporate property is public property?

If the combined armies of public and private enforcers do not assure us of compliance, we'll go inside the corporation and force it help out. When I look at compliance systems, I tend to see the mandates and costs; the big stick state in raw form; the public pounding the private. But there's something else going on. A compliance officer is a cop, a private sector cop pursuing a public goal. It's there to make sure the empowered actors inside the corporation cooperate with the public's clearly stated demands, and so in sense wields delegated public authority. More than a trace of *The Modern Corporation's* last chapter survives as these arrangements proliferate. We continue to harness corporations to serve public purposes, and the differences lie less in the means than the ends.

C. *THE MODERN CORPORATION'S MISSING CHAPTER:  
GARDINER MEANS AND THE ADMINISTERED PRICE*

Berle X, June 17, 2018

Accompanying Article:

William W. Bratton, *The Modern Corporation and Private Property  
Revisited: Gardiner Means and the Administered Price*, 42 SEATTLE U.  
L. REV. 591 (2018)

INTRODUCTION

This story begins at the 1982 Hoover Institute Conference on *The Modern Corporation and Private Property (MCP)*. Many of you will have read some or all of the conference papers, published in the *Journal of Law and Economics* in 1983. For the unacquainted, it was a gathering of the Chicago tribe ostensibly to reconsider and reassess *MCP* on its fiftieth anniversary, but in fact to bury it once and for all as a source of learning in law, economics, and policy formulation. You don't actually have to read the papers to access their bottom-line points: first, contrary to Berle and Means, free markets and corporate contracting work together to constrain management moral hazard; and second, while ownership and control are indeed separate, no *structural* infirmity follows.

It was a star-studded event, with papers from Demsetz, Fama and Jensen, and Stigler, plus a long comment from Oliver Williamson. The Demsetz and Fama-Jensen papers bear careful reinspection, by the way, but let's put that to one side.

My interest today lies in a paper and a comment delivered at the conference by the surviving co-author, the octogenarian Gardiner Means. I found both the paper and the comment somewhat mystifying when I first read them back in the 1980s. You see, everybody else at the conference addressed microeconomics and governance, talking past Means; Means in turn talked past them, going on about product pricing, repeating old points in a hostile environment populated by a new and different generation just now really hitting its stride. I came away wondering whether he should have turned down the invitation. His stuff looked shopworn and irrelevant in a highly creative and innovative environment. They would have been ready to hold him up to ridicule and it looked like he'd played right into their hands.

That read lingered in the memory. So when Chuck asked me to return to Berle and Means for this year's historically oriented conference, I told him that I'd go back to Means at the 1982 event. I suspected I'd end up focusing more on the conference than on Means—maybe a comment on

the Demsetz and Fama-Jensen papers. But I instead found myself using Means's 1982 contributions as signposts pointing to an unexplored access route to the gestation of *MCP*. The two texts show us how to reconstruct Means's perspective on *MCP*, and thereby enhance our understanding of the corporatist rhetoric in its Books I and IV. You know, the stuff about the corporate profit stream no longer being private property, the need for a convincing system of community obligations, and the vision of corporate managers as purely neutral technocrats.

#### PALO ALTO, 1982

Let's go back to Palo Alto in 1982. Two of the papers launched direct attacks on *MCP*. That is, they didn't just pronounce the book irrelevant given a Chicago view of the world and instead sought to show that it had been descriptively inaccurate as of the date of publication. The more interesting of the two came from George Stigler and Claire Friedland. They took Means's breakdown of the 200 largest corporations into different control categories and regressed 1920s and 1930s data about management salaries and corporate profits. If the book was right, corporations with separated ownership and control should pay more to their managers and earn less for their shareholders. But nothing statistically significant popped up, arguably falsifying the book. This was bravura stuff in 1982.

The less interesting comment came from a Hoover fellow named Robert Hessen, who accused Berle and Means of ignoring numerous instances of separated ownership and control in the law of property and of business organizations—separation of ownership and control, he said, was nothing special. It was the classic substandard hometown paper, albeit the work of a hometown scholar at the top of his game. As it was also a direct attack, Means got the comment.

Means shrugged the paper off, dismissing it as irrelevant and thereby skewering it, simultaneously impliedly dismissing Stigler and Friedland.

To make the case for irrelevance, Means told us where he himself had been coming from back in 1932. You can't, he said, understand *MCP* if you focus exclusively on separation of ownership and control, which was what Hessen and Stigler had been doing. The book never said that big corporations can't produce efficiently. It never said they somehow fall outside of the private property system. The book instead addressed the question whether public policies formulated in a world of small producers still made sense when giant firms with dispersed owners did a big chunk of the producing. The point in the book that really mattered was the projection of deepening concentration. So, he said, to understand *MCP*,

you should consult pages 45 and 46, which come at the end of Book I, Chapter III.

Let us do so. Pages 45 and 46 set out a list of five implications of Chapter III's statistical showings.

*Point 1.* We need to study the behavior of large rather than small producing units. Fine.

*Point 2.* The nature of competition has changed and now duopoly matters more than the behavior of small competitors. OK, but mysterious, because the duopoly is neither defined nor described, and not otherwise discussed in the chapter.

*Point 3.* An increasing amount of corporate production is for use rather than sale and therefore the profit motive no longer drives decision-making in producing companies. This seems like an important point, for if the profit motive no longer drives corporate decision-making, then a lot of inherited theoretical and policy assumptions about corporate production need reformulation. But what did a trend in make or buy decision-making at vertically integrated producers have to do with the profit motive itself? There are two points here and they don't link.

*Point 4.* The nature of capital has changed; it is now comprised more of going concern value than tangible asset value. Sure. That's what value creation is all about. But what did this have to do with increasing concentration and the absent profit motive?

*Point 5.* Blind market forces no longer control the economy; economic power is now concentrated in a small number of hands, making corporations social institutions. This is the same radical stuff you get again at the end of the Book. But what is it about concentration that makes corporations social institutions? Why doesn't the *social* bearing just lead straight to Thurman Arnold and the trust busting of the second Roosevelt Administration and the post-war period?

So, Means tells us that pages 45 and 46 are for him the heart of the book. But one comes away less than fully enlightened after encountering the pages. Here again, as in Book IV, Chapter IV, *MCP* makes vague, radical gestures without explaining itself.

#### NEW YORK, 1927-1933

For explication we have to learn something about Means. Steady, serious, unflappable, iconoclastic, individualistic; an outdoorsman and an outsider. Loving husband to Caroline Ware, who was herself an American original—an academic historian at Vassar in an era when few women got appointments and later a New Dealer right along with Gardiner, making pioneering contributions in the field of consumer protection. Means and

Ware are immensely likable. Significantly, *Means* never held an academic appointment.

He was Berle's contemporary—they were born within a year of one another and became acquainted during World War I at officers' candidate school in Plattsburg, New York. After the war, Means did relief work in Turkey, where he got a close-hand look at a primitive village producing and trading economy. He had a formative insight: where *this* was the classical economy described by Adam Smith, producer pricing in the industrial economy at home followed from a different process.

Back home in the 1920s, Means started a company that manufactured upscale blankets, and simultaneously went to Harvard Business School, graduating in 1927. He reenrolled for an economics Ph.D. that same year, simultaneously signing on with Berle to do the statistical work on the grant project that became *MCPP*. Beatrice Berle and Caroline Ware, who had been good friends since Vassar, brokered the engagement. Means thereafter worked out of Berle's office in Kent Hall for a number of years. Like Berle, he joined the FDR campaign in 1932. Unlike Berle, he took a job in Washington in 1933, beginning what would become a series of federal jobs as Henry Wallace's economist in residence at the Agriculture Department.

The statistical chapters in Book I of *MCPP* went on to comprise the lion's share of Means's Harvard dissertation. He submitted in 1933, after the book's publication. The dissertation, called *The Corporate Revolution*, also had a concluding theoretical part that explored the implications of the statistics for microeconomic theory, a discussion not included in *MCPP*. Means *got* his Ph.D. in 1933, but only for the statistical chapters. The committee rejected the theoretical part, resulting in its deletion from the approved version. The dissertation's theoretical chapter survives in draft amongst the Means papers at the FDR library.

My Berle X paper characterizes it as *MCPP*'s missing chapter. I know, I know, this looks like the standard law review ploy of finding that something is missing just so you can fill the resulting gap and justify the paper. But this time it's really true. The five points on pages 45 and 46 derive from the theoretical part of the dissertation. Had the thesis chapter been included as Book I Chapter IV of *MCPP*, the points on pages 45 and 46 and the cryptic normative assertions in the final chapter would have made perfect sense.

#### THE MISSING CHAPTER

So let's go to the theoretical part of the dissertation. Its basic assertion is that the classical Smithian picture of a competitive, self-correcting, disciplining free-market economy no longer sufficed to explain

what was going on. It poses a supplemental explanation in the form of Means's theory of the administered price, a theory he would continue to elaborate for the rest of his career, up to and including the article he contributed to the 1982 Hoover symposium.

There are four more particular points.

*First point.* As regarding many products, markets no longer set the price; prices were administered by managers. Supply and demand curves were no longer descriptive; a lot of prices were inflexible. Product markets ceased to equate supply and demand, except by coincidence. Not that supply and demand were impervious to one another—there would be a long-run tendency for the discrepancy to decrease, but an absolute discrepancy would persist.

The upshot was that a drop in demand did not necessarily trigger a fall in price. A rational manager might instead maintain the price and cut production, laying off labor. The choice was made within a zone of administrative discretion.

Means's statistical showing of increasing industry concentration comes to bear at this point: the more concentrated the industry and the less intense the competition, the more administered the price, and the greater the impact of management decisions on the performance of the wider economy. The duopoly mentioned in the book is defined: in one part of the economy, agriculture for example, the market set the prices in the classic Smithian way; in the other part, the prices were administered.

All of this explained the Great Depression, at least impliedly: Administered prices meant instability for the economy as a whole, because demand drops did not assuredly mean price drops, the price drops that were supposed to have increased the value of money, to have stimulated demand, and thereby to have restored full employment.

*Second point.* Many of the amounts that make up the cost of goods sold (COGS) are indeterminate and do not follow from the production process. This is an accounting point that bolsters the picture of administered prices. Said Means, as overhead comes to comprise more and more of the cost of goods sold, COGS comes to reflect the economics of the firm as a whole and not the economics bound up in the production of a particular product. A producer thus will not react to a fall in demand on a product-by-product basis but will make decisions that make sense for the firm as a whole.

*Third point.* The process of saving and investment is now dualistic, with a corporate segment and an individual segment. Corporations invested in products—stuff that produces goods and services; individuals, in contrast, invested in corporate securities. Thus were the economy's savings being invested in two different markets in which prices could

diverge, even as the value came from the same capital and production function. Distortions could follow. For example, given a negative shock, individuals would draw down on their savings. Stock prices would fall, causing the savings accumulation to shrink simultaneously. The savings retrenchment would thus not result in increased demand for goods. Meanwhile, individual shareholders had no access to the assets in which their capital had been invested—those were under the control of the managers. It followed that managers rather than *savers* were making the economy's most important savings decisions. It also seemed that we had a second explanation for the persistence of the Great Depression.

*Fourth point.* The profit motive no longer explains production activity. This point also shows up on *MCP*P pages 45 and 46, albeit without explication. In the thesis it's backed up by points one to three. It goes on to lead to a very interesting inquiry into the identification of the appropriate residual interest holder of the corporation. Some in those days argued for the shareholders, but others argued for the managers as residual holders on incentive grounds—they were the ones doing the producing after all—so if you wanted to maximize, you needed to give *them* the upside. It followed that all the shareholders were entitled to was a reasonable return sufficient to induce the raising of additional equity capital or otherwise keep them contented enough to vote in management's favor at the annual meeting.

Means, having laid out this economic analysis, then declined to follow it and ended the thesis more or less where he and Berle had ended the book. The economic logic, said Means, only made sense on the classical side of the duopoly. On the corporate side, where the profit motive was no longer the engine driving the train, it made no sense to do incentive analysis in hopes that discipline somehow would follow.

In the end Means made no attempt to answer the question posed. He simply stated that a new answer needed to be derived and that the administered price would be central to the process of derivation. But of course he thereby said a lot: if the residual interest holder was neither the equity nor management, it had to be society as a whole.

But what more particularly did that imply? Not Thurman Arnold. With the dissertation's theory part, we finally get an idea of the regulator-to-be's marching orders. The neutral technocrat needed to figure out how to administer the price in the interest of the economy as a whole rather than in the exclusive interest of the producing entity.

*MCP*P would have made a lot more sense if this stuff had been included. So why didn't that happen? Caution maybe—an editorial decision to keep it simple if vague and not invite attack at a theoretical level. There was also the small matter of a conflict with what Berle was

saying in a *Harvard Law Review* debate with E. Merrick Dodd. Or maybe Means figured the stuff wasn't yet ready for publication. Truth to tell, the theoretical part of the thesis is, um, pretty sketchy. Means would spend a career filling in the missing details and updating as economic events unfolded.

#### WASHINGTON, 1933–1988

Means stayed in government until 1943. But his period of great influence came early, during the first Roosevelt Administration when the planners ran the policy show under the NIRA. Interestingly, Means and the other leading planner-economists, Rexford Tugwell and Mordechai Ezekiel, didn't like the way the NIRA managed prices because it left too much power with the managers. They wanted a more balanced set of constituent inputs and a setup that put the administrators in charge.

They nonetheless lost their influence when the NIRA went down, for, in the second Roosevelt Administration no one was interested in bringing back an even more invasive iteration of the NIRA. Means and his friends were displaced by the Neo-Keynesian Alvin Hansen, who had a theory of secular stagnation and prescribed the less bitter medicine of government stimulus of investment.

Hansen would get his own comeuppance in turn, when *post-war* Keynesians dropped secular stagnation, reintegrated with orthodox economics, and contented themselves with recommending short-run fine tuning pursuant to a mechanistic formula.

But Hansen's fall didn't bring Means back. He left government in 1943 and went into the think tanks. He stayed there until 1959, out in the theoretical and policy wilderness. Always a multitasker, he started a business raising zoysia grass, and kept it up successfully until 1963, when he was 67.

Unlike Means, Berle made major adjustments as circumstances changed and so emerged after the war with his academic reputation enhanced by new work. He told a happy story that suited the country's mood. The big-stick state that emerged from the New Deal had brought corporations under control, making them publicly responsive without having to socialize them. If the corporations wanted to avoid new command and control regulation they had to satisfy the public. They behaved cooperatively as a result, leading to a satisfactory political-economic balance.

Interestingly, when Berle talked economics in his post-war writing, the storyline was right out of Means. Prices didn't result from supply and demand; management had discretion to set the level of production; instability resulted, necessitating planned equation of supply to demand.

How, given that the government wasn't actually doing this planning, could Berle mouth Means's party line and still whistle the happy tune? For Berle, private planning in the industrial oligopolies would do; he didn't need a public administrator, now that managers really were neutral technocrats.

But Berle was in for a reversal, albeit a posthumous one for the most part. Political and economic reversals after his death in 1971 put an end to happy story conditions. He is accordingly remembered for *MCPP* and his corporate law work rather than for the post-war political economy that made up a big part of his output.

Means, in contrast, made a comeback as the economy deteriorated in the 1970s. He had, after all, always been the guy you needed to talk to when things really got dysfunctional. He had taken a step back in from the wilderness when inflation went to the policy stove's front burner in the 1960s. They started wanting his testimony at congressional committee hearings. The stagflation of the 1970s went on to rehabilitate him completely, even as it brought down the post-war Keynesians, who had no way to explain it. Means did have a theory, a theory he first put out—get ready—in his preface to the 1967 edition of *MCPP*.

He elaborated further on his theory of stagflation in his 1982 Hoover symposium contribution. It was as if the Ph.D. thesis was getting a new section to account for recent developments. Most of the basic assumptions were unchanged—the administered price, the individual corporation's incentive to maintain profits in the wake of a demand drop, and the duopolistic economy are all still there. It's just that instead of leaving the price where it is when demand drops, the managers find various reasons to raise it. We had passed a tipping point, said Means, at which the administered side of the duopoly had come sufficiently to dominate the economy as to cause more prices to go up than to decline when demand dropped.

Ironically, the economic conditions that made possible Means's late-in-life victory lap had finally dissipated even as he wrote the symposium paper. No one knew it at the time, but inflation was going to the back burner for the indefinite future and the Reagan expansion was only just beginning. But I doubt anyone in the audience at Hoover was paying much attention to Means in any event. They were celebrating their own return from the wilderness, a wilderness to which people like Berle and Means had consigned their neoclassical forebears back in 1932.

But there were twists and turns ahead for the neoclassicists as well. They must have left Palo Alto thinking that they had succeeded in burying the dysfunctional Berle and Means corporation once and for all, replacing it with a vision of free-market correction and discipline. We now know, of course, that the separation of ownership and control came back as the

problem corporate law needed to solve with the eclipse of the hostile takeover after 1989. That comeback, as Michael Wachter and I have shown, had much less to do with what *MCP* actually says than with what people have come to believe that it says by reading it together with the Berle–Dodd debate. The late-twentieth and early-twenty-first century assault on the Berle and Means corporation was about wielding shareholder power to solve the problem of separation of ownership control so that the market success story told at Hoover in 1982 finally could be realized in fact. As with Berle and Means in 1932, there was a regulatory program, but a program directed only to dislodging embedded roadblocks in the road to market efficiency, rather than program following from the assumption that there was no such thing as market efficiency.

The recent arrival of activist hedge funds has upended the late twentieth century story in turn. It seems that those barriers weren't so embedded after all, and that the market correction story told at Hoover has more vitality than we thought. It's just that the correction, rather than occurring instantly like it does in a microeconomic model, can take a couple of decades. Meanwhile, the Berle and Means corporation has finally been eclipsed, at least for now.

This long story has a theme. The protagonist is the economy, the performance of which consistently upends both theorists who ask for too much in the way of successful coordination from its free market side, and theorists who go too far in dismissing its coordinative capabilities.

## D. THE SEPARATION OF CORPORATE LAW AND SOCIAL WELFARE

2016 Washington and Lee University Laura D. Glass Law Review  
Symposium in Honor of the Scholarship of Lyman Johnson and  
David Millon, October 26, 2016

## Accompanying Article:

William W. Bratton, *The Separation of Corporate Law and Social Welfare*, 74 WASH. & LEE L. REV. 767 (2017)

When I sat down to think about what I was going to talk about this morning, I took out and reread two of David and Lyman's papers from the late 1980s, *Missing the Point About State Takeover Statutes*<sup>5</sup> and *Misreading the Williams Act*.<sup>6</sup> Both papers are still fresh, and everything David and Lyman say in them is still true. But I didn't get today's panel into focus until I thought back to a conference David and Lyman organized here, with the Law Review, in the fall of 1993, at which Chancellor William T. Allen gave the keynote. There was evident friction between the substance of Chancellor Allen's remarks and the thrust of the rest of the conference. One might have expected more consonance between the conference's themes and the author of the *Time-Warner* opinion and an article run in the *Cardozo Law Review* around the same time. But there wasn't, and there were reasons for that.

I took that memory as my start point. I'm going to look at the fundamental changes that occurred in those years, the changes that generated those frictions, comparing the vision of the corporation and of the role it played in society that prevailed during the immediate post-war period with the very different vision we have today, and trace the path we took from there to here.

As is usual with me, I'll view the corporate past through the eyes of Adolf Berle, who, in his post-war writings, described an American Economic Republic—a sort of latter-day constitutional settlement directed to production and employment. It prevailed until around 1970, and centered on a broad consensus about the role of corporations in society. Berle thought that corporate power, which he had problematized in a famous book published in 1932, had been rendered benign in his new republic. Two factors were responsible: first, government management of the economy from an unchallenged position of higher authority and, second, a solid supporting political consensus supporting the status quo.

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5. Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846 (1989).

6. Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862 (1989).

The public consensus in turn depended on corporate performance—price stability, jobs, and benefits.

Berle described a benign equipoise amongst strong organizations, an equipoise constrained by a wider public consensus that empowered the central government in the role of welfare maximizer—he saw a state that guided and pushed markets to the right result with the cooperative engagement of interested parties. Managers were caught inside a web of countervailing powers and had no way to get out of control. The strands in the web were product market price competition, labor unions, trade associations, public opinion, management's own sense of responsibility, and most importantly, government regulation.

The managers emerged as quasi-public servants. Whether they liked it or not, they were caught between the regulatory state and the public consensus. Failure to satisfy the public meant new regulation; avoidance of new regulation meant satisfying the public. So public duties could not, as a practical matter, be avoided, and managers emerged playing a role as economic and social allocators, actively assuming public functions. In the 1950s, while other countries were instituting national health systems and generous state pension schemes for senior citizens, in the United States the *corporations* took on the great part of the welfare burden. This was, in part, an accident of history—pensions and medical benefits found their way into a high-profile settlement between General Motors and its unions in 1948, a settlement that was copied across the industrial landscape and modified over time to labor's advantage as industries went from settlement to settlement.

It was, not coincidentally, the golden age of American management. Commentators in those days described a new economy that had evolved past Adam Smith's atomistic free market strivers so that forward motion came from innovative technocrats in management suites. The shareholders sort of dropped out of the picture. Berle explained why. All they did was passively collect dividends and then consume or save. As such, they played no productive role in the economy. Well, what about stock market controls? No longer important. Corporations now did equity financing with retained earnings or borrowed. The function of the stock market was to hold out liquidity for the benefit of the rich, good-for-nothing grandchildren of the entrepreneurs who had founded the great companies. Monitoring? Government authorities now monitored the markets, thank you. Finally, shareholder voting was a meaningless ritual.

As rich consumers, the shareholders did play a role in social welfare enhancement as providers. As such, they were entitled to society's thanks, but not its political solicitude. The shareholder interest would emerge as a legitimate force in society, said Berle, only when shareholder wealth was

so widely distributed as to benefit every American family. Only in such a distributive utopia could the shareholder interest serve as a proxy for social welfare and thus hold out political economic salience.

Finally, there wasn't much in the way of discussion of corporate social responsibility. Regulation and ancillary government pressure took care of externalities. The economy was growing, the constituents were content, and managers were seen as under control. Compliance wasn't much of a problem either, because managers proceeded decorously when dealing with the government.

Conflicts did simmer under the surface. They became manifest during the 1970s and played themselves out during the 1980s. This was the era during which corporate social responsibility and constituent rights came to the forefront of corporate policy debates, CSR in the 1970s and constituencies in the 1980s. Simultaneously, shareholder value maximization rose to prominence to pose a countervailing vision of the corporation's place in society. A resolution followed: the shareholders won. Social responsibility would not be imposed on companies and constituents would get no rights, and, indeed, would see their positions deteriorate considerably.

The economic background was unstable during the early part of this period—the economic bill for the Vietnam War came due in 1972 and 1973, when the stock market collapsed and the economy went into a severe recession aggravated by the Mid-East oil crisis. The stock market didn't really recover until August of 1982—a whole decade in which there was no money to be made long in stocks even as inflation rose steeply. It was called stagflation and it undermined the economic assumptions of the managerial golden age. The appearance of international competition in manufactured goods added to the stock of chronic problems. We were no longer a closed continental economy in which domestic corporations competed only against one another. People started to ask questions about how well managers were doing their jobs.

The conceptual framework surrounding corporations changed substantially as a result. First, corporate governance was invented. I date this with the appearance of Melvin Eisenberg's book *The Structure of the Corporation* in 1976, but Eisenberg was crystallizing ideas that had been circulating for a decade. We would ask the board for monitoring, not management, a function that presupposed independence and a committee structure keyed to monitoring functions. All of a sudden there was something that could be *done* about corporations. The term "corporate governance" came into circulation, with best practices as the focus of the new mode of discussion.

Two years earlier, in 1974, Jensen and Meckling had published their famous paper, *Agency Costs and the Theory of the Firm*, which coined another new term and for the first time brought microeconomic analysis to the study of interior corporate arrangements, confirming the suggestion that corporate governance mattered for productivity. But there's also a critical point of distinction: while Eisenberg stands for the invention of corporate governance and the need for governance reform, Jensen and Meckling are the theoretical start point for the assumptions that the purpose of the corporation is shareholder value maximization and that market forces by themselves could discipline managers effectively—a complete reversal of the assumptions that underlay the American Economic Republic.

At the same time, the old New Deal political coalition that created and maintained the strong regulatory state fell apart. Managers, formerly cooperative in the face of overwhelming state power, defected, and started to play a hostile game against regulatory initiatives. Simply, they were no longer afraid of non-compliance. Deregulation also started in the 1970s, and picked up speed after 1980. Interestingly, it meant removal of an existing regime only in a handful of industries. For the most part, deregulation meant not repeal but inaction—we just left things the way they were, even as corporate risk taking and externalization pursued new paths. Such initiatives as did occur tended to be self-regulatory, bespeaking a remarkable reliance on the newly-created thing called corporate governance.

The political left did not disappear quietly. Progressives, who in the 1970s still considered themselves the country's natural ruling group, became manifestly frustrated—they were dissatisfied with the level of new regulation, and outraged by corporate non-cooperation, even as they despaired of marshalling political backing for new initiatives. The American corporate social responsibility movement arose as a result, and its policy entrepreneurs looked to governance institutions for reform platforms. It didn't lead to much.

But, for a time, managers felt threatened. Anti-corporate sentiment was gaining more and more political salience—partly as an expression of frustration by the left and partly because of a growing sense that American companies were performing badly, even as a new political economic equilibrium was taking a regressive turn. A new outlet appeared to channel and partially appease this negative sentiment—not taxation, not redistribution, not a stable environment for working families, but compliance with law. Thus did the foreign bribes scandal result in the Foreign Corrupt Practices Act of 1978, which, much like New Deal initiatives, leaned on the corporation to get with the public program. But

whereas *before* the objective was cooperative participation in a national effort to enhance social welfare, *now* we had a narrower objective: to the extent we do have regulation, comply with it.

Meanwhile, the frightened managers turned to the same focal point as did everyone else—corporate governance—and tried to capture it, voluntarily embracing best practices to stave off more invasive initiatives. They succeeded to an extent, but not enough to stem a growing assault on their prerogatives. The basic picture was changing: instead of seeing managers as effective technocrats, we once again saw excess management empowerment, now mixed with both greed and incompetence, to leave us with out-of-control agency costs that were said to be choking the economy.

In the 1980s, the locus of conflict shifted from the public sphere to corporations themselves. The markets, suppressed in the course of the New Deal settlement, came back to retake the forward role in corporate governance, a position that has been steadily solidifying ever since. Market control and shareholder value maximization operate in tandem. They are the same thing.

Numerous factors combined to effect the change. Reagan came in, and the left was marginalized. Labor unions markedly declined in influence. Antitrust policies that inhibited same-industry mergers were abandoned. Competition from abroad intensified. As the junk bond became available, ideas about acceptable levels of leverage changed markedly so that high leverage became a means to facilitate corporate control transfers. The prime targets were the most extreme product of post-war managerialism, conglomerate structures, which had come to be seen as dysfunctional, because they fostered suboptimal reinvestment of cash flows.

We all know the result. At its end point, thinking about corporations had shifted fundamentally. Maximization of shareholder value came in, management became an incentive incompatible cost center, and a long-standing but vague association with social welfare dropped out.

There was a lot of carnage as the adjustment was made. A couple of generations of corporate employees, who had justifiably expected that their companies held out careers, lost their jobs. Billions of dollars of wealth shifted as their human capital investments were sacrificed in order to enhance shareholder value. Unsurprisingly, constituent concerns displaced social responsibility concerns at the forefront of progressive critique of the operation of corporate law, with David and Lyman at the forefront, but fighting a rearguard action. There was even a law reform movement—a succession of bills were introduced in Washington to ameliorate the dislocation experienced by the subject employees. None were enacted and the initiative faded away during the 1990s. Henceforth,

the corporate law case for the employees' interests would be tied to the case for management empowerment vis-a-vis shareholders, and subordinated thereto—the message of Blair and Stout.

The job losses didn't stop with the restructurings of the 1980s. America's large corporations have been steadily lightening their payrolls ever since. Manufacture is outsourced wherever possible, usually abroad. It's no wonder that during the last twenty years the focus of corporate social responsibility inquiry has shifted to low-wage, dangerous workplaces abroad, because that's where stuff gets made. The employers are for the most part contractors and subcontractors. So, unacceptable situations in foreign workshops get fixed only when a company—like Nike—gets called out publicly regarding its suppliers' practices and cleans up its supply chain in order to protect its brand from bad publicity.

The change is pervasive. The great corporate successes of the present age, Apple and Google, employ thirty- or forty-thousand people each, where back in the 1950s and 1960s, the big, successful companies employed hundreds and hundreds of thousands. The employment numbers fall off drastically at other successful tech companies.

Simply, big corporations have lost their position as the focal point of the lives of most Americans. In the golden age, they were the places where talented people made careers. Restructuring put an end to that. Now, instead of careers, we have jobs. And it's looking like jobs are disappearing as well—there's a shift away from jobs and employers to tasks and piece-work contracts. In the golden age, big corporations handled the accumulation of retirement savings. That stopped too, as employers shifted from defined benefit pension plans to defined contribution plans. In the golden age, big corporations took care of medical benefits for most Americans. But that burden eventually ripened into a competitive disadvantage as regards companies in countries that chose to put government welfare schemes in place instead. Hence, Obamacare.

I recall sitting around during the 1990s waiting to see a trade-off account of the takeover and leveraged restructuring era that seriously posed the question whether the destruction of human capital along with the ancillary costs of debt due to over-leverage might have outweighed the shareholder benefits. Nothing like that emerged. Instead, we got overleverage as a cost-beneficial external shock that redirected the management's incentives in the right direction.

American *society* has been adjusting ever since to increased instability, decreased opportunity, and widening inequality. Such is the prestige of markets, that few perceive this to be a problem. And, management, which tried and failed to capture the newly important governance system, was itself captured in turn. During the golden age

managers took it out as salary under what today would look like egalitarian pay structures. Now they take it out in equity compensation arrangements that tie their fortunes to the stock price. For all their complaining, they got with the program, and did well.

But wait, cannot we pose a positive counterbalance due to the widening of the shareholder base due to the proliferation of pension fund savings? Spokespeople for institutional intermediaries keep telling us we should be congratulated because 50% of American families now hold shares. Actually it's closer to 40% and the most of the outward spread occurred during the 1980s. It tailed off thereafter and even at times receded. We ended up with the top 1% of households by wealth owning 38% of the stock, and the top 5% owning 69%. The bottom 80% owns just 9%. Simply, there is occasion for egalitarian applause. Shareholder value does not proxy for social welfare.

The scope of active corporate legal theory has narrowed as corporate law and social welfare have become separated. Today's is a small-scale policy discussion about the balance of power between shareholders and managers in which most participants obsess on excess, embedded agency costs and model shareholders as a permanently disadvantaged group with an outstanding, unmet regulatory entitlement. It is a picture that resonates less and less, for the central trend since 1990 has been progressive agency cost *reduction* at the instance of market forces—just what Jensen and Meckling predicted. With the benefit of hindsight, it's now clear that the shareholders decisively won their battle with management between 1985 and 1990, and did so without a significant regulatory assist.

Corporate law is going to stay with this narrow status quo absent some future negative external shock. Of course, we did have one of those in 2008, but not enough of one to change anything, just a blip. But what about unproductive short-termism—don't we have to do something about that? I don't see any evidence from practice to back up the claim of a systematic crimp on productivity. Can't shareholder power have perverse effects? You bet. But negative effects will appear company by company. The same will go for excess agency costs. Agency costs aren't embedded and have been substantially reduced, speaking systematically. Any residual problems will show up company by company.

If anything, corporate legal theory is going to get smaller still. The days of a separation of ownership and control as an over-arching political economic problem that corporate law needs to solve are over. If shareholder empowerment is here to stay and will not turn out to have systematic perverse effects—big ifs, but that's what I am predicting—shareholder-management relations will fall from back from the policy margin to become a field in which decision-making is customarily left to

the business judgments of parties with direct stakes. Ours will become a field in which the basic assumption is that private ordering confronts the problems and effects any changes. From a policy perspective, corporate law is going to look more and more like the rest of private law, as a field in which parties capable of self-protection bargain over outcomes. I am not forgetting about the externalities inflicted between there and here. But we made up our collective mind to ignore them by 1990. Corporate law follows from the national social settlement, and not vice versa. If you want to change it, change the settlement.

### III. CORPORATE LEGAL THEORY

#### A. THE CASE AGAINST SHAREHOLDER EMPOWERMENT

University of Pennsylvania Law School Institute for Law & Economics  
Corporate Roundtable, December 11, 2009

Accompanying Article:

William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010)

#### INTRODUCTION

This paper's point, that shareholder empowerment forces managers to manage to the market price and that perverse effects follow, is not new. There's a line of financial economic models to this effect that goes back to the late 1980s. Michael has made the point in two papers on hostile tender offers. I have made the point in passing in several papers addressed to issues arising in the post-Enron regulatory environment. But the point has never registered in our field as paradigmatic proposition. Our ambition is to make that happen.

Here's the lay of the land. The dominant view in corporate law is that management power presents a problem that needs to be solved. The view was originally framed by Berle and Means in terms of property and accountability—corporations wielded significant economic power because they owned the means of production. But their ownership, vested in the shareholders, had separated from the power to control the resources, which had befallen on the managers. It followed that we had power without accountability. In the collective corporate law memory, Berle and Means then invoke the shareholder interest as a countervailing power. And thus do we continue to talk about the Berle and Means corporation as the problem that corporate law needs to solve.

But now the theoretical framework is economic contract rather than legal property, and the problem is stated in terms of principal-agent relations. The shareholders are the principals and the managers are the agents. Agency costs are excessive because the legal structure of the corporation perversely fails to accord the shareholder-principals the authority to which principals ordinarily are entitled. You get the same bottom line as with Berle and Means—the corporate law system reverses a natural and appropriate order of things, whether due to capture, corruption, or sheer bad luck due to path dependence. The theoretical burden of proof lies on those who defend the system.

Michael and I took our first crack at these paradigmatic certainties in a paper on Adolf Berle. We there showed that corporate law's collective memory clings to an erroneous reading of its own canonical texts, and, even as Berle did focus on management power, the shareholder interest played no role in his political economy. Today's shareholder empowerment advocates, who want the markets to control management power, invoke a grandfather figure who thought that markets always fail and that the economy should be managed by central planners.

We were right and everybody knew it, but it didn't really matter because it was just history. Hence, this paper, which, rather than seeking to deprive the shareholder proponents of the paradigm they claim as an antecedent, seeks to deprive them of the paradigm on which they draw presently, or least to compromise their position within it.

Shareholder empowerment advocates work within the Jensen and Meckling agency cost paradigm, claiming that management agency costs are excessive, and that shareholder empowerment will reduce them. It follows that corporate law should be reformed to empower the shareholders (or, depending on the particular issue, to disempower the managers), and that the burden of proof falls on those who disagree. Although not everybody subscribes to every item on their law reform agenda, it is as a general proposition reflective of the thinking in our field.

The shareholder proponents have a long reform agenda that's designed to jumpstart shareholder exercise of the corporate franchise. Heretofore, collective action problems have inhibited shareholder use of the power to elect and remove directors. The reformers accordingly would level the playing field between managers and shareholder contestants and subsidize selected shareholder interventions. They also would open doors to direct shareholder intervention into business policy making, albeit on an opt-in basis. In so doing, they would disrupt an allocation of authority that has stood for more than a century.

Even so, to object is to take the minority view, and fight from the rearguard.

Our goal here is to reverse the burden of proof to the normal position where it falls to the side advocating law reform.

The paper pursues five means to the end:

1. Clear the field of the conceptual inheritance of Berle and Means.
2. Make transparent the theoretical and empirical assumptions that motivate the case for shareholder empowerment.
3. Show that management agency costs are not as salient as shareholder advocates claim.

4. Show that shareholder empowerment would implicate significant agency costs of its own.
5. Decouple the financial crisis from the case for the shareholders and couple it with the case against.

1. CLEAR THE FIELD OF THE CONCEPTUAL INHERITANCE  
OF BERLE AND MEANS.

Berle and Means cast the shareholders in the owner role, and if shareholders are in substance the “owners,” then they naturally succeed to the position of principal when corporate legal relationships are restated in terms of the economics of agency. Moreover, if today’s shareholder power advocates legitimately can claim to be Berle’s successors, their theoretical primacy is much bolstered: management power has been corporate law’s unsolved problem for three quarters of a century and they’re the ones who finally are trying to do something about it.

We say, put the rhetoric aside and ask whether the separation of ownership and control in fact is a problem. Our answer is no, by reference to a paper by Eugene Fama and Michael Jensen published in a 1983 issue of the *Journal of Law and Economics* on the occasion of *The Modern Corporation and Private Property*’s fiftieth anniversary. The paper was devoted to the task of rebutting any regulatory policy presumptions deriving from the separation of ownership and control.

Fama and Jensen restated the separation of ownership and control as a rational allocation of management functions. Decision rights go inside the firm. The managers initiate and implement. The board, which must be independent, monitors them, and retains “ultimate control” over them. The shareholders take the residual claim and elect the board but otherwise have no business policy inputs for the simple reason that they lack the qualifications.

For those who insist that the matter be framed in terms of a property allocation, we extrapolate one from Fama and Jensen. In our restatement, ownership and control are no longer separated. Instead, ownership is divided and redistributed across the three groups of actors. This happened as a matter of functional necessity as companies evolved in history.

At this point, the paper has only joined the issue. Putting Berle and Means to one side only returns us to today’s corporate legal theory and the agency model of the firm it poses as a challenge to the prevailing legal model of the corporation.

2. MAKE TRANSPARENT THE THEORETICAL AND EMPIRICAL  
ASSUMPTIONS THAT MOTIVATE THE CASE FOR  
SHAREHOLDER EMPOWERMENT.

Why “make transparent”? If you go out and look for a clear statement of the analytic steps that lead to shareholder empowerment as a policy recommendation, you will be disappointed. We looked, but did not find. If you ask a shareholder empowerment advocate whether managing to the market price is a good thing, I would predict an equivocal answer followed by a change of emphasis: shareholder power, you will be told, reduces agency costs. The paper fills in the missing theoretical background to show the direct connection between the two.

We are told that the shareholder–manager relation should be conceived in agency terms, with ultimate control in the shareholders rather than with the board, as Fama and Jensen had it. Incentives are the reason: where managers are conflicted and self-serving, shareholders come forth with a pure financial incentive to maximize value. It follows that management empowerment implies agency costs, and that agency costs would be reduced if we cleared a way for shareholder inputs.

Well, fine. But what about the fact that dispersed shareholders labor under information asymmetries and lack expertise respecting the production function? This is where the market price comes in to solve all problems. It holds out an objective and accurate measure of the purely motivated shareholder maximand; manage to it and you get a high-quality instruction. There follows a unitary instruction for business policy: manage to maximize the present market price of the stock. We’ve looked closely at focal point presentations of the shareholder primacy position, and we can’t find any other there.

Subpoint: Avoid conflation with other work taking the same policy position.

Here I should note a subsidiary purpose. If this were a room full of corporate law academics I could situate this paper just by saying that we are pursuing the same bottom line as Steve Bainbridge. And I then would have to clear away a lot of theoretical detritus. Bainbridge sees this as a markets and hierarchies question, charging that any departure from what he calls director primacy and we call the prevailing legal model would lead to managerial chaos. As to this point, we agree with the other side. Chaos would not result because management would do everything it could to avert the possibility of interventions by the newly empowered shareholders. Threat diffusion in turn means doing exactly what the shareholder advocates want—managing to the market. The problem would be adverse selection, not incoherence.

### 3. SHOW THAT MANAGEMENT AGENCY COSTS ARE NOT AS SALIENT AS SHAREHOLDER ADVOCATES CLAIM.

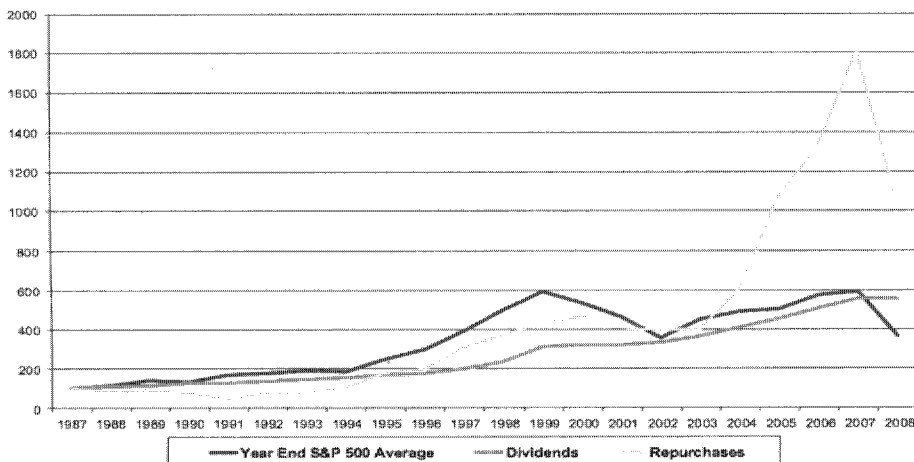
Here we accuse the shareholder side of losing touch with its own paradigmatic roots. It poses an agency cost win-win: empower the shareholders and reduce the costs, with no acknowledgment that so doing might trigger new countervailing costs. The cost picture they pose dates from the 1980s takeover era, and is posed as a static constant. For countervailing authority we go to an unexpected source. The agency cost urtext, Jensen and Meckling, which predicts that actors will address costs as they arise over time, with managers bonding their fidelity to their investors and investors monitoring their investments. And, when agency costs remain unaddressed, it is because their removal is too costly.

We look at the post-takeover history, describing it as a dynamic process of adjustment both inside corporations and outside in the marketplace. We cite a number of factors. Managers emerged from the 1980s sensitized to the benefits of shareholder value maximization. At the same time, the board of directors emerged as a more robust monitoring institution. Together they used equity compensation plans to redirect management incentives. Merger volume reached new records, with friendly rather than hostile deals as the means of moving assets to higher valuing mergers. We can identify regulation that followed from these changes, but cannot find any significant regulatory causes.

Discipline, a factor supposedly lacking in the wake of antitakeover regulation, made a remarkable return to the front lines when the private equity buyout reemerged in the mid-1990s. This is a business model pursuant to which managers looking for big payoffs voluntarily put themselves under the control of penny-pinching market intermediaries.

On the side of the fence, activist hedge funds emerged to show that the shareholder collective action problem is not as preclusive as everyone assumed. The hedge fund activists have brought back hostility, but on a new platform independent of control transfer. Interestingly, they pursue financial items at the top of the shareholder proponents' agency cost agenda—increased leverage, payouts of excess cash, premium asset sales, and cost cutting. They have entered boardrooms in large numbers, all without any change in the prevailing legal model. The difference lies on the shareholder side, in the incentive alignment within which these particular institutions hold their shares.

Finally, just recently, prior to the collapse of 2008, the corporate cash payout pattern underwent a notable shift. As Figure 1 shows, share repurchases, a central shareholder agenda item, took off like a rocket, with total average annual corporate payouts reaching 6.1% of market cap.

**Figure 1: Payouts, 1987–2008**

So where the shareholder advocates depict a governance system that chronically leaves a ton of money on the table, we depict dynamic adaptation toward the end of removing the money. And with Jensen and Meckling, we caution that agency costs should not be expected to be reduced to zero even so. It follows that the fact that an agency can be identified does not by itself justify regulatory intervention. Win-wins should not be assumed. Given a residual agency cost, an independent cost-benefit case must be made for reduction through structural change.

#### 4. SHOW THAT SHAREHOLDER EMPOWERMENT WOULD IMPLICATE SIGNIFICANT AGENCY COSTS OF ITS OWN.

The cost-benefit question presented here does not admit of a definitive empirical answer. But the question can be better framed than it has heretofore. All we have seen are the purported benefits. We counter with some costs.

The agency cost problem arises because managers use their superior information for their own advantage. The shareholders want to address the costs by giving the shareholders sufficient power to impress their preferences, as manifested in market price signals, on the managers. So the question is this: What content does the market price have to teach?

Sketching out an answer requires us to traverse that well-known territory occupied by the efficient capital market hypothesis and the capital asset pricing model. Our sketch makes four points.

First, if markets were strong form efficient, and reflected all information public and private, the shareholders would have a pretty good

case. But the ECMH makes only a more modest prediction that prices will follow a random walk and no trading strategy based on public information can outperform the market. It makes no prediction that the market price will be right even as it implies that insiders with material nonpublic information can make systematic profits trading in their own stock. Its implications for corporate governance are modest accordingly.

Second, the case for shareholder empowerment is stronger or weaker depending on the information on the table. With hostile takeovers, it is quite strong, because takeovers pose a relatively simple governance question in an information enriched environment. But as you move away from an offer on the table for the whole thing to going concern business decisions, the meaning of a market price signal becomes less and less clear and information asymmetries present more of a problem. Prices look less like objective reports on particular value outcomes than inputs for informed interpretation.

Third, information asymmetries are real and are not going to go away. Full disclosure is not cost-beneficial, period. Degrees of information asymmetry vary from company to company and from time to time. We cite a variety of literatures from financial economics that show decisions being skewed as managers seek to take advantage of overvalued stock and sacrifice good projects for fear of undervaluation.

Finally, we assay a line of pricing economics that has come out of the academic woods in the wake of the 1990s tech bubble. This is called heterogeneous expectations and it posits that rational shareholders can bid up a stock above what they see as its fundamental value, to take advantage of an option to sell it to buyers applying a more optimistic valuation. We take some leading models and inquire into their implications for the legal model of the corporation. Two points emerge: First, a duty to maximize the stock price can lead to decisions that sacrifice long-term value. Second, if you want to incent managers to maximize long-term value, you need to lock them into their shareholdings for the long-term. It follows that shareholder governance inputs may not be incentive compatible on a matter like executive compensation.

##### 5. DECOUPLE THE FINANCIAL CRISIS FROM THE CASE FOR THE SHAREHOLDERS AND COUPLE IT WITH THE CASE AGAINST.

The proponents are arguing that shareholder empowerment reforms make sense right now because trust needs to be restored in the wake of the financial crisis. At first glance, this resonates. The managers of a number of large financials got us into a mess as they pursued high-return investment strategies without appreciating concomitant risks. The collapse and bailout amount to a significant externality imposed on the rest of the

economy. If the managers are responsible, then disempowerment initiatives seem to make sense as a regulatory response. Thus have agenda items like say on pay and shareholder board nominations picked up political traction over the last year.

But this is also wrong-headed. The trust talk serves to deflect attention from the shareholder empowerment's economic substance. It's a market control move very much in the deregulatory mainstream of last three decades or so. As such, it makes for an odd response to a market failure. Indeed, once you view the financial companies through the lens of the shareholders, managing to the market emerges to take a place in the chain of causation.

**Figure 2: S&P 500/S&P 500 Banks, 2000–2009**

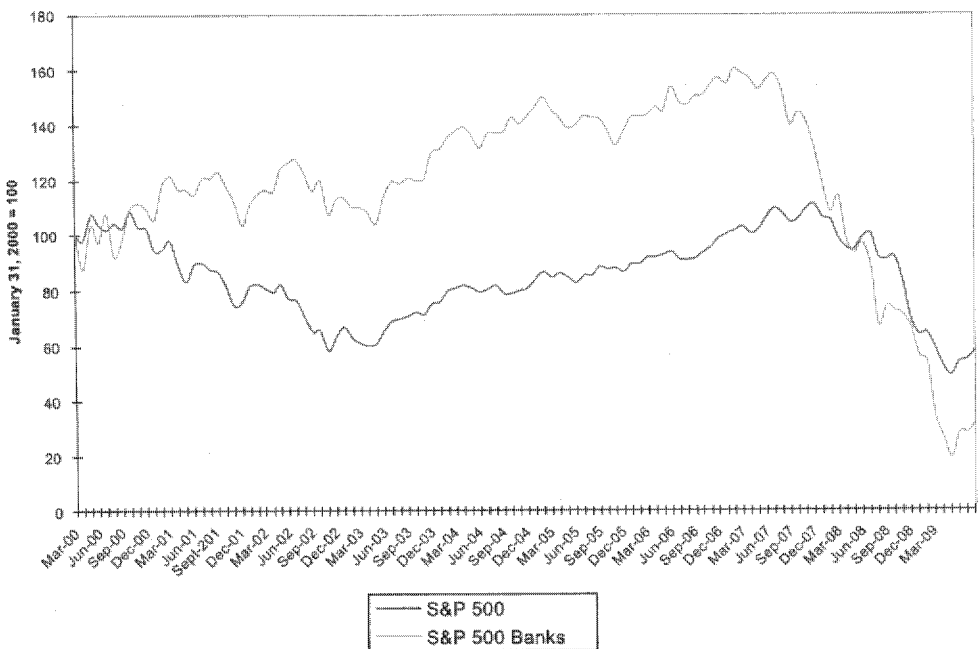


Figure 2 depicts the S&P 500 and the S&P 500 banks from 2000 to 2009. You see quickly that the banks were a segment much favored by the stock market, which loved the spreads yielded by the combination of real estate lending (by no means all of it subprime) funded by short term borrowing in the repo and commercial paper markets.

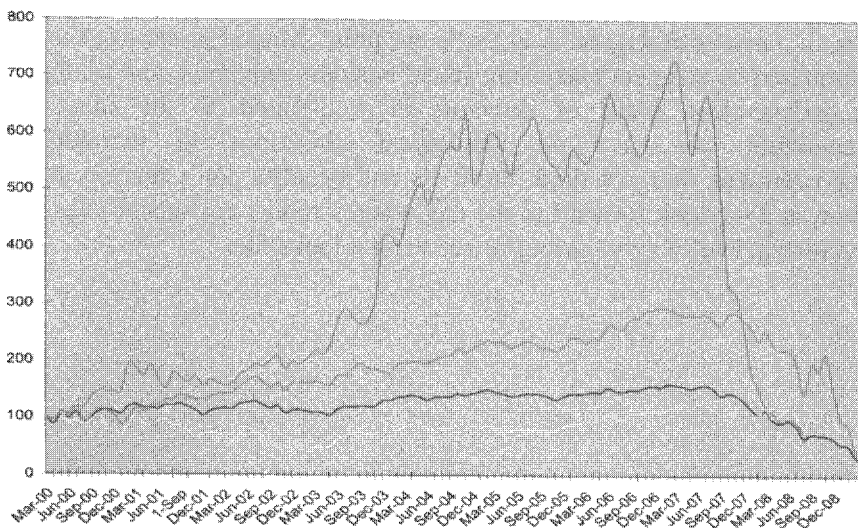
**Figure 3: Sectoral Variation**

Figure 3 depicts Countrywide Financial, Citibank, and JP Morgan Chase, traced against the S&P 500 banks. Countrywide, a pure mortgage and securitization play, is the clear favorite. Morgan Chase, which pursued a more conservative strategy and even stayed out of CMO securitization, is the dog. Yet now it's one of a small number of paragons.

Our point is simple. Just as the managers responsible for the strategies saw the returns but failed to appreciate the risks, so did the market. Here's the question: Would increased shareholder power have moderated the banks' risky practices? The answer is no. It could even have made things worse.

In our view, then, the financial crisis has sharply negative implications for the shareholder agenda, implications manifested in discussions on the flashpoint topic of executive pay. The need to uncouple manager incentives from short term market pressures all of the sudden is a widely held conventional wisdom. When Lucian Bebchuk takes this a step further and puts out a draft that suggests that incentive pay for financial company executives should track a mix of common stock, preferred stock, and bonds, seismic shifts are occurring in thinking about risk, return, and incentives. That purely incented shareholder and its magically curative properties retreats further and further back in the rear-view mirror.

## CONCLUSION

We don't think that market price signals are intrinsically unreliable. It is all a matter of degree. And that's our point. Market prices need to be interpreted by an agent exercising sound business judgment, and we think an independent board of directors is well-suited to the function. Meanwhile, we have no ideological objections to shareholder empowerment. We just think the costs and benefits don't line up in its favor, and we look forward to the day when a robust cost-benefit case is articulated. We're very curious to see what it looks like.

## B. SHAREHOLDERS AND SOCIAL WELFARE

Berle IV, June 15, 2011

Accompanying Article:

William W. Bratton & Michael L. Wachter, *Shareholders and Social Welfare*, 36 SEATTLE U. L. REV. 489 (2013)

## INTRODUCTION

This paper began at Berle III. I got hot and bothered about something somebody said about shareholder democracy and social improvement and so muttered something about shareholders being rich and somebody needing to put that point in a paper. Richard Marins was sitting behind me and shot me a note to the effect that you could find all you needed in the work of Edward N. Wolff of the NYU economics department. I looked up Wolff on the spot and saw that to be the case.

Later I also saw that the data were already out there in places where people in corporate governance ought to be able to find it—Poterba and Samwick in *Brookings* 1995 and Paddy Ireland in *Modern Law Review* 2005. Even so, the point somehow just doesn't seem to sink in. So I decided that it was worth laying out the data one more time, using the 2007 *Federal Reserve Survey of Consumer Finances*, which was the most recent source until last Monday, when the 2010 survey finally was released.

The question was how to contextualize yet another exposition of this data. The answer was to put a series of questions: Do shareholders play a role in social welfare enhancement? If so, how? If not, why not? More generally, when and why do the more particular characteristics of shareholders matter, particularly their socio-economic characteristics, and if they don't matter why not? Once the questions were posed, it was soon apparent that some of the answers lay in work I'd already done with Michael Wachter and that other answers lay in work that Michael and I had talked about but never had gotten around to doing. One thing led to another, and this paper is the result. It collects different answers to the questions and tries to sort them out.

## MANAGERIALISM

For a start point, we go back to what they said about this back in the 1950s and 60s—the golden age of American management. Commentators in those days described a new economy that had evolved past Adam Smith's atomistic free-market strivers so that forward motion came from innovative technocrats in management suites. Management power, which Berle and Means had problematized back in 1932, no longer seemed

anything to worry about. Managers were caught inside a web of countervailing powers and had no way to get out of control. The strands in the web were product market price competition, labor unions, trade associations, public opinion, management's own sense of responsibility, and most importantly, government regulation.

The shareholders sort of dropped out of the picture. Adolf Berle explained why. All they did was passively collect dividends. They as a result played no productive role in the economy. Well, what about stock market controls? No longer important. Corporations are now financed with retained earnings. The function of the stock market was to hold out liquidity for the benefit of the rich, good for nothing grandchildren of the entrepreneurs who had founded the great companies. Monitoring? Government authorities now monitored the markets, thank you. The shareholder voting was a meaningless ritual.

The shareholders only economic function was consumption. They also played a role in social welfare enhancement as providers. They supported their families, they supported social welfare programs as taxpayers, and they supported charities as donors. As such they were entitled to society's thanks, but not its political solicitude. Full justification for the shareholder interest could follow only when shareholder wealth was so widely distributed as to benefit every American family. Only in such a distributive utopia could the shareholder interest serve as a proxy for societal interest and thus hold out political economic salience.

In sum, the socio-economic status of shareholders mattered a lot during the managerialist era. But, as they already were wealthy and their needs were well-satisfied, they had no claim to the attention of a benevolent sovereign preoccupied with maximizing social welfare.

#### SHAREHOLDER PRIMACY

By 1980, managerialism was dead. Jensen and Meckling displaced Berle and Means as academic gods, and the view of shareholders was reversed.

This is a familiar story. So familiar that we decided it was worth retelling from theoretical square one, step by step.

Square one is the first fundamental theorem of welfare economics, which begins with a general equilibrium view of the economy and assumes away externalities to pose that a competitive economy maximizes wealth. The normative kicker is that everything that can be done to make the economy more competitive should be done so that it reaches a pareto optimal production possibility frontier, the point of economic efficiency.

Once we reach the frontier, it's time for the second fundamental theorem, which holds that given an efficient economy, preferences for

redistribution can be dealt with through lump sum taxes and transfers, provided that the transfers do nothing to impair the incentives that got us to the efficient frontier in the first place. We are talking social welfare only at this point.

Of course, it's very likely that taxes and transfers will impair productive incentives, which in turn implies that we never get around to doing any redistributing. At this point, the theory of the second best comes to the rescue, posing that taxes and transfers can make us better off net of their costs by satisfying preferences for social welfare enhancing outcomes, even though production lies short of the efficient frontier.

The next step extends the first fundamental theorem to corporate production. This is surprisingly easy to do: A system of corporate governance is *ex ante* efficient if it generates the highest possible payoff for all the parties involved, shareholders, creditors, employees, clients, tax authorities, and other third parties that may be affected by the corporation's actions.

The extension is completely uncontroversial, even though it holds out cakes and ale for corporate constituents. To get to shareholder primacy, you have to take two further assumption-laden steps.

The first step comes from Jensen and Meckling. They posited that if we model the firm as a nexus of *complete* contracts among all parties involved *except* for the contract between a firm and its shareholders, which we model as *incomplete*, then maximization of shareholder value is tantamount to the economically efficient result. This assertion is literally true—if everybody other than one incomplete contract holder has a complete maximizing contract, then everybody other than the one incomplete contract claimant is already maxed out, and maximizing for the remaining claimant is economically efficient by definition.

Note that the theoretical door remains open to proponents of constituency interests to make efficiency arguments from the point of contractual incompleteness and that this creates a problem for shareholder primacy, whose proponents have to show that other constituent incompleteness does not disable their case. The proponents address the burden with three familiar points: first, relatively speaking, shareholders are more vulnerable; second, decision-making costs should be minimized and a multi-constituent model imports incoherence, adding to decision-making costs; and third, the shareholder interest is the residual interest and thus provides a superior management reference point.

At the bottom line, the shareholders matter and the managerialist result is reversed.

There are three more things to note. First, agency costs are assumed away in this analysis. All it does is insert shareholder value maximization

as the firm's objective function. Second, the reversal of the managerialist result is multi-sided—not only does the shareholder interest now matter for productivity, at the same time the socio-economic status of individual shareholders becomes irrelevant, where before it mattered a lot. Third, all we are talking about here is economic efficiency—reaching the production possibility frontier. Social welfare is not implicated.

How can that be? Social welfare would be implicated if we followed Arrow and Debreu and constructed a general equilibrium model of the economy depicting a Pereto optimal outcome. But, when you are working in partial equilibrium mode, as were Jensen and Meckling, such claims cannot be made.

But can't you say that managing to maximize shareholder value *proxies* for social welfare? Many do. Indeed, many avoid inserting the "proxy" qualification and say that shareholder value maximization and social welfare are same thing. It's theoretically incorrect either way. Why then do people do this? In our view they are jockeying into position for the follow-up discussion about the political economic implications of all of this. The "social welfare" characterization imports legitimacy to deregulatory claims. Indeed, when the economic efficiency as social welfare assertion goes unchallenged, redistributive discussion is pretermitted altogether.

We proceed to Phase II of the shareholder primacy discussion. Recall that the shareholder objective function gets established on the assumption that there are no agency costs.

Relax the no agency cost assumption and you go from shareholder value maximization as a goal to shareholder empowerment as a law reform agenda. At this point in the paper, we repeat points we made in an anti-shareholder empowerment paper we published a couple of years ago.<sup>7</sup> I won't belabor them this morning. Suffice it to say that shareholder empowerment proponents make three moves: first, they assume that agency costs are out of control; second, in their more particular characterization of the shareholder interest, they try very hard to stick with the most purely incented real world shareholders—the fully diversified variety and the market price setters; and, third, even as they talk governance, what people really want to see realized is market control, which in this context comes down to an instruction to manage to maximize the stock price.

We argue that the stock price isn't always reliable due to, *inter alia*, information asymmetries and market dysfunctions. We also argue that it's

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7. William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010).

not at all clear that agency costs are out of control. Jensen and Meckling, the theoretical godfathers of all of this, predict that actors in free markets make adjustments to reduce agency costs, so as to keep them under control. We argue that that's exactly what has happened since the takeover was choked off twenty-five years ago. In today's paper, we make a further observation: three distinct sets of real world shareholders perform a critical function in agency cost reduction: private equity firms, activist hedge funds, and managers themselves. What distinguishes these shareholders is that they actually know something about the business and so are positioned to initiate productivity improvements. None of them have the pure financial incentives idealized in shareholder primacy theory. Put this point together with our reference back to Jensen and Meckling and you learn that agency cost reduction is not a free lunch; you have to pay people to do it.

Finally, neither of social welfare or the socio-economic status of shareholders has any bearing on either shareholder primacy theory or our critique of it. This is strictly an efficiency discussion.

#### THE SHAREHOLDER CLASS

That gets us to the shareholder class, which is the political economic instantiation of the shareholder primate of economic theory. It is claimed that the downward diffusion of shareholding makes the shareholders salient as an interest group. This is presented as a cause for celebration. Why? It's all a little vague, but I take the introduction of the shareholder class as an invitation to refer back to the managerialist era and find that the shareholders' socio-economic status is relevant once again. Of course, it is relevant to the opposite effect. A half century ago, reference to socio-economic status precluded the shareholders from attaining the status of a favored group in public policy; now, with diffusion, socio-economic status is a qualification. Shareholders democratize. Shareholders legitimize. And management is what it always was, a bunch of nasty old oligarchs holding on to privileges illegitimately acquired.

So, what does and does not work here? It is certainly true that the shareholder interest has political resonance in the US where it didn't two decades ago. Sarbanes-Oxley and Dodd-Frank make it clear that the Congress sees shareholders as a species of median voter and happily caters to their interests.

But is it true that shareholding has diffused?

The Investment Company Institute and the Securities Industry Association produced a big study to this effect in 2005. It showed that over one-half of households own stock, up from one-fifth in 1983. It then did its best to put on a populist gloss—a "typical" household owned \$65,000

worth of stock; only 56% of the stockholders had graduated from college, and the age median was only fifty-one years. Unfortunately, three years later in a follow-up effort, they found that stock-owning households had gone down to 45%—the era of 401(k) proliferation was over and people were otherwise exiting the market. According to the 2010 Fed figures, the exit continues.

**Figure 1: Households with Stockholdings, 1989–2007**

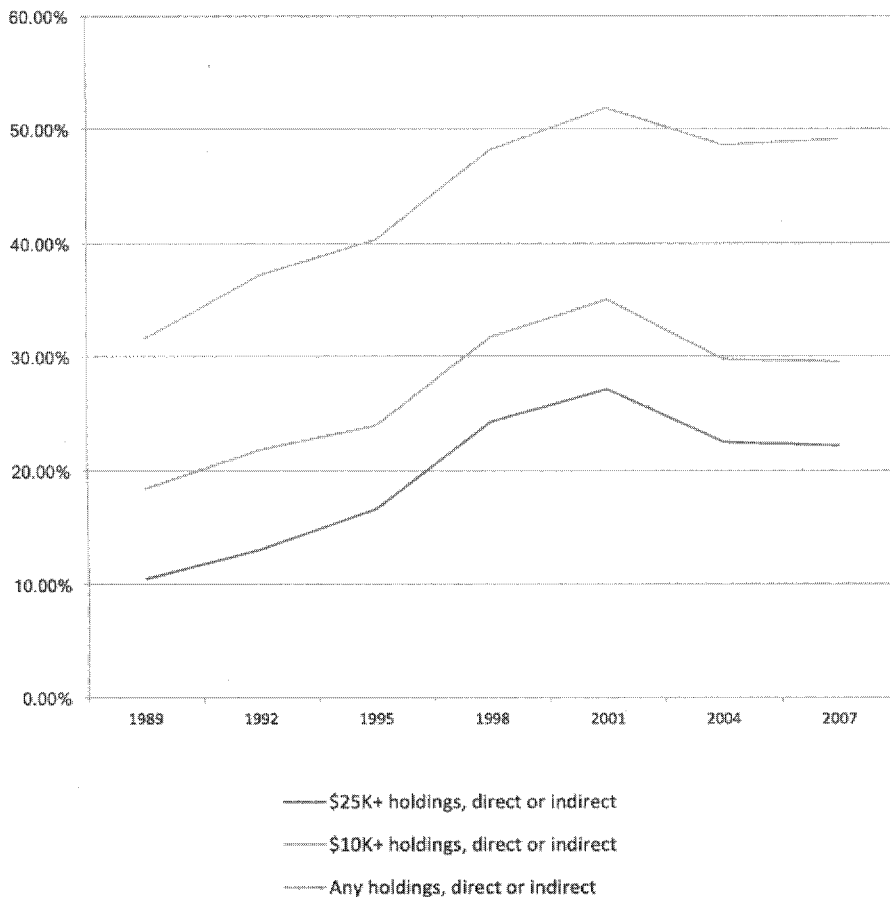
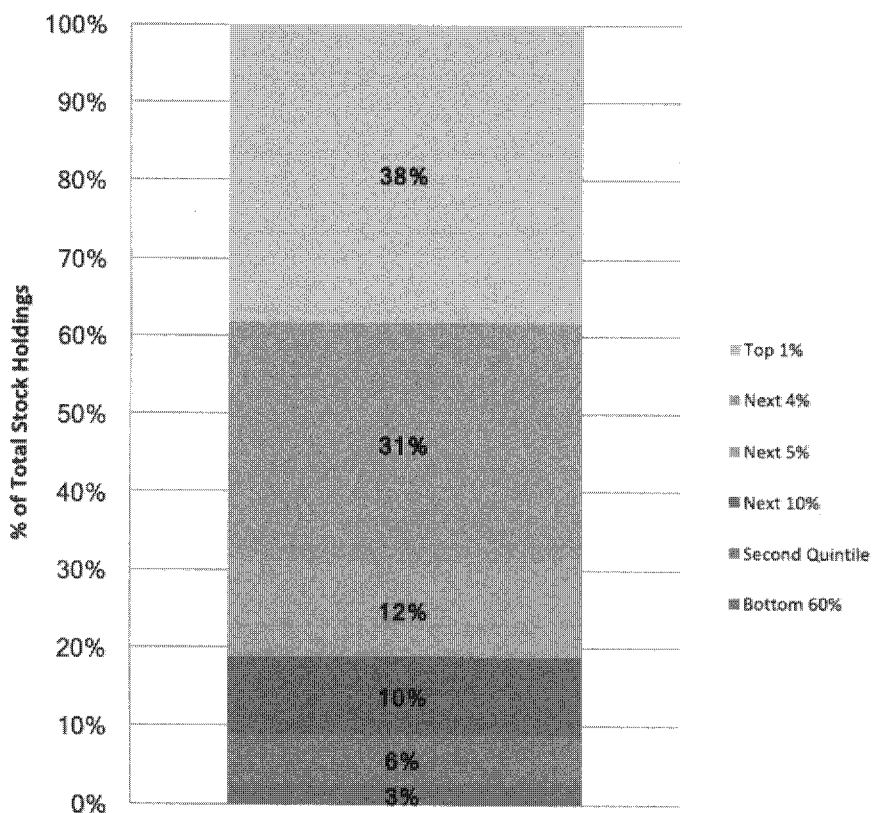
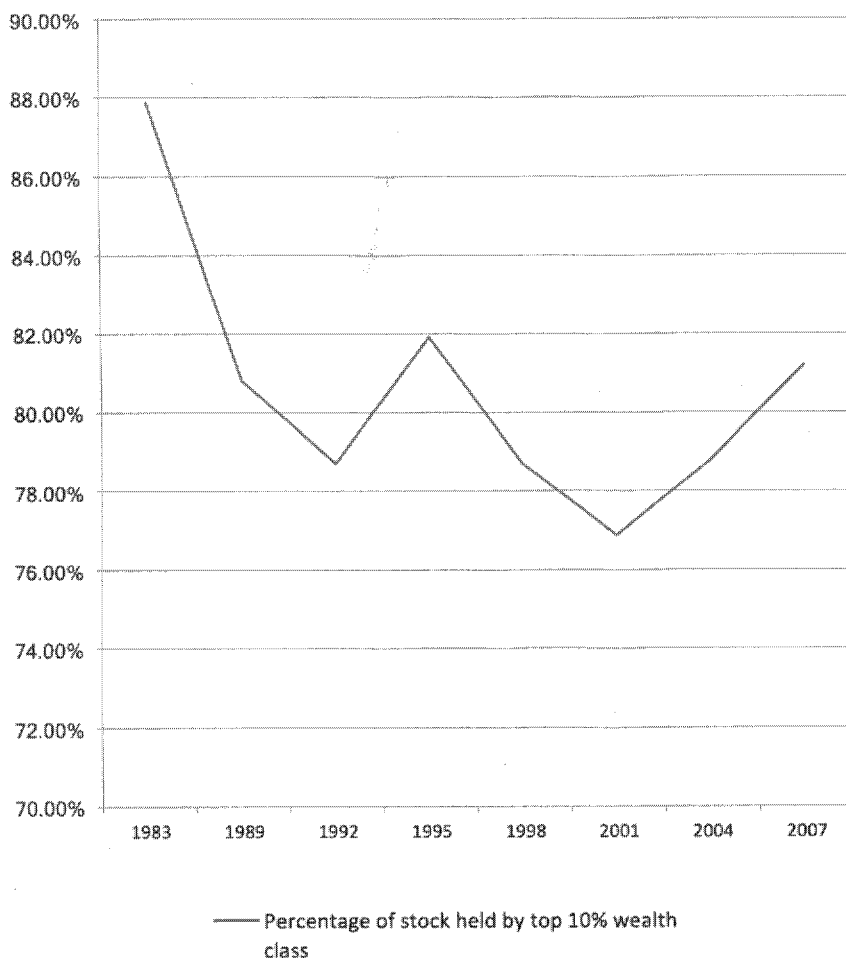


Figure 1 provides a cross-check employing the 2007 Fed numbers, which shows that the industry's household numbers were accurate but could use some unpacking. If you ask for a stake in excess of \$10,000, for example, the household figure drops from 45% to 25% and to 22% if you ask for more than \$25,000. In other words, the industry's \$65,000 typical shareholder is bogus.

**Figure 2: Concentration of Stock Holdings by Wealth Class, 2007**

So who owns the stock? Well, looking at Figure 2, the top 1% by wealth own 38% of it, and the top 5% own 69%. The bottom 80% owns just 9%. Downward diffusion, yes, but limited in depth.

**Figure 3: Stock Ownership of the Top 10%, 1989–2007**

Interestingly, as Figure 3 shows, most of the downward movement occurred during the 1980s, when the share of the top 10% dropped from 89% to 81%. It has been up and down since then, with the top 10% holding the same 81% in 2007 that it held in 1989.

If we stopped here with our survey of US wealth distribution, the profile would be that of a third-world country. Happily, the picture flattens out when we compare assets to income. The top 10% holds 83% of non-home wealth and benefits from a lesser 73% of overall net worth, but draws only 47% of total income. It's an intuitive picture. Outside of the top group, most Americans get by on salary. The home is the primary asset and people borrow to get hold of one.

Figure 4: Wealth Composition by Wealth Class, 2007

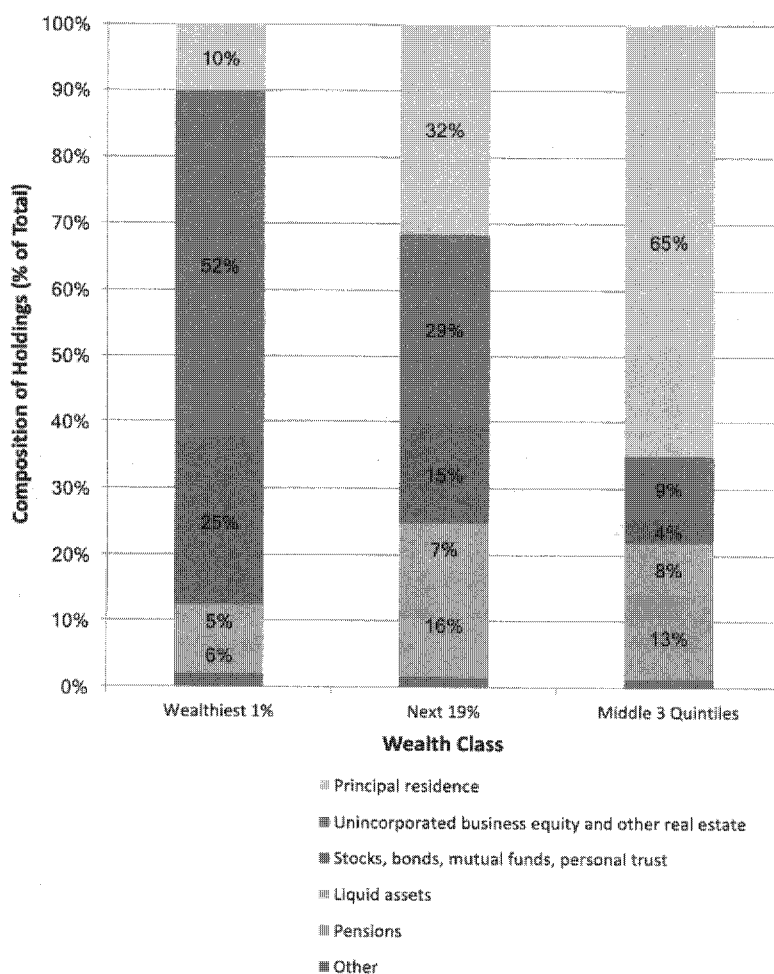
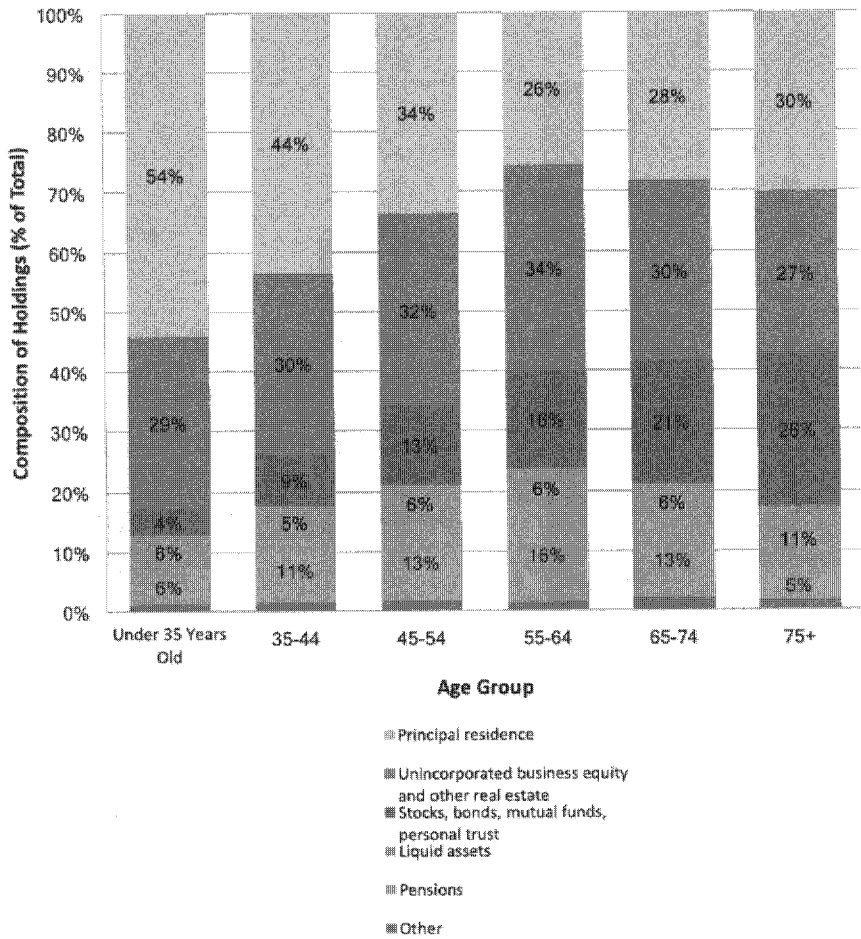


Figure 4 offers another look, breaking out the wealth composition of the top 1%, the next 19%, and following with the next 60%. Stocks and bonds, the dark blue, wane from left to right, while the home, the purple, waxes. The biggest item for the wealthy is own business equity plus other unincorporated business equity, which I assume includes hedge and private equity funds.

Figure 5: Wealth by Type and Age Group, 2007



So, the typical or modal shareholder is rich. Figure 5 shows that the modal shareholder is also old. Stocks and bonds make up 13% of the wealth of the 45- to 54-year age group and 26% of the wealth of the over 75s. Note that of all the asset classes, its only stocks and bonds that loom progressively larger as the years accumulate.

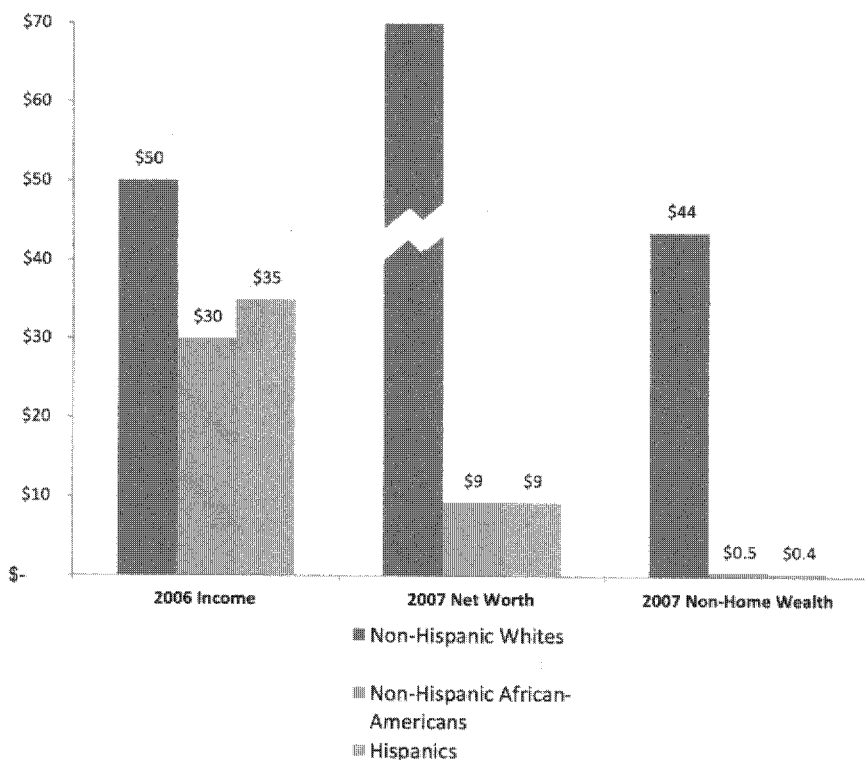
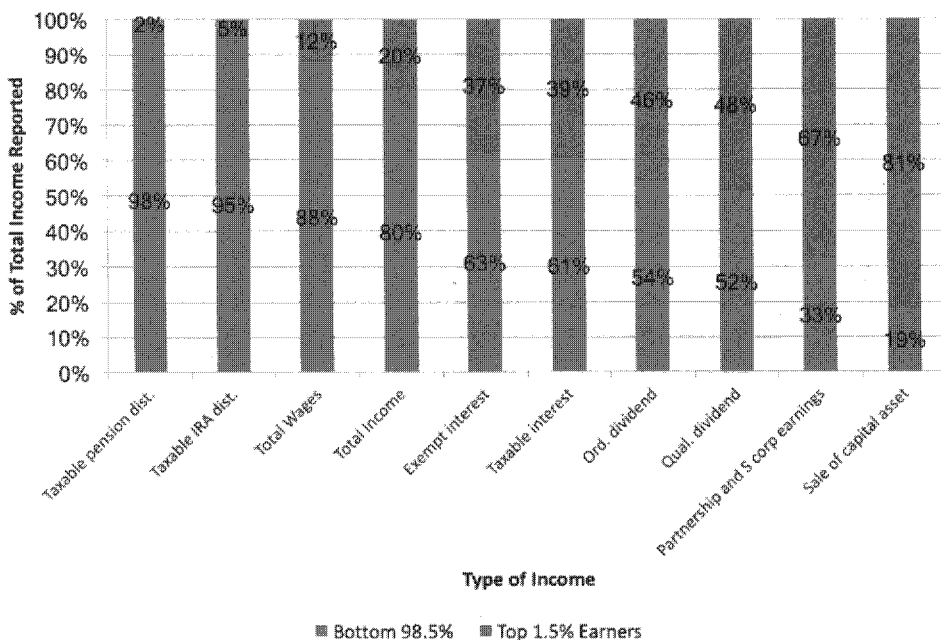
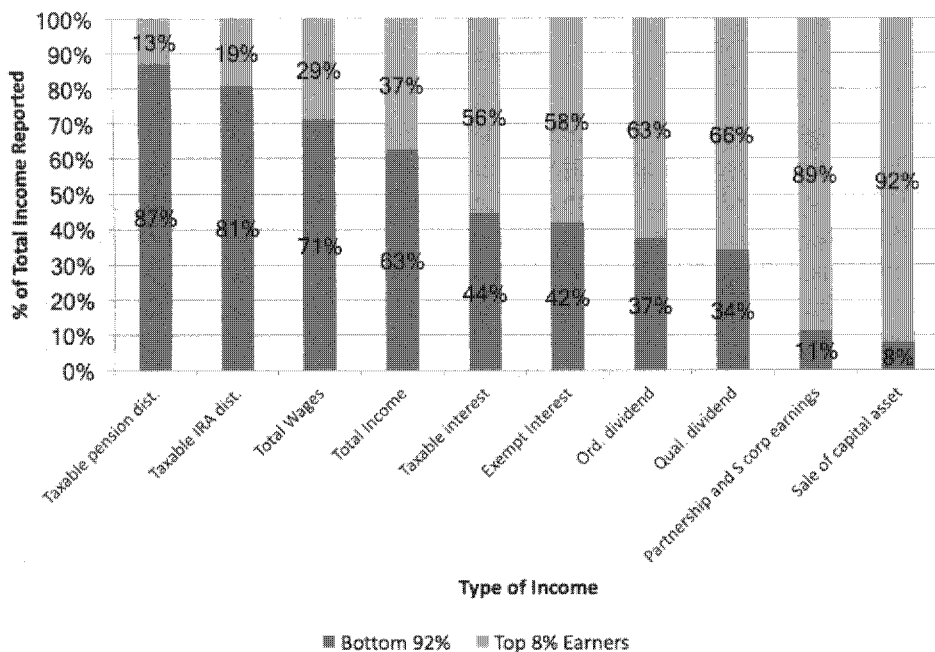
**Figure 6: Median Income and Wealth by Race (\$000s), 2007**

Figure 6 shows that the modal shareholder is also white. This is hardly a surprise, but the degree of the drop off for African Americans and Latinx as regards asset wealth does impart a bit of a jolt. For the minorities, the salary plus home equity pattern is close to an absolute. These are medians, but the means aren't much different.

There's one thing missing from the Fed picture—defined benefit pension plans. There's a reason. The Fed is measuring ownership and pension plan beneficiaries aren't beneficial owners of plan assets. Ironically, it's corporate stockholders (and state and municipal citizens) who take that position. So this source of wealth shows up only as income in the Fed surveys, mixed together with social security checks. We get no sense of the distributive pattern.

**Figure 7: Top 1.5% Earners as a % of Total Income Reported, 2009****Figure 8: Top 8% Earners as a % of Total Income Reported, 2009**

So we turn to IRS data to get a comparative handle on this income—distributions from pensions and IRAs as compared to wage income, dividend and interest income and yields from small business. Figure 7 breaks out this data and it does break the pattern. The top 1.5% of taxpayers by gross income draw only 2% of this income source and the top 8% only 13%. As we move away from retirement income to other sources, the rich take an increasingly large share, peaking at 81% of proceeds from sales of capital assets. But there are limits to wealth diffusion even here. If you slice the tax data using \$100,000 total income as the dividing line between rich and poor, 64% of pension income is above the line and only 36% below.

#### CONCLUSION

We are trying very hard to be fair, but cannot escape the conclusion that shareholders are rich, old, and white. What then is the import of a shareholder class?

The shareholder class is shareholder primacy stepping outside of the box of economic efficiency to look for a favored place in the wider political economy. That the step is being taken at all confirms that Berle's point about the dispersion of shareholdings still has meaning, otherwise the shareholder proponents would not be bothering to rebut it.

Also, given the separation of ownership and control, it remains true that corporate politics involves a many against a few. But the longer you look, the harder it is to see a popular uprising against an oligarchy. This is not have nots against haves. Moreover, the many may not be all that many, once we include shareholding institutions and governance intermediaries in the picture. Do that and corporate politics is a scene of conflict between two rich, self-interested groups, each acting as agents of the same set of rich shareholder principals. As between the two, it is not clear which is the more "oligarchic."

Finally, how does management disempowerment enhance social welfare? There's nothing particularly redistributive about it. So, if we can believe the claims of advocates of shareholder primacy, its impact is only to expand the size of the economic pie. But, so far as we are concerned, that claim is debatable. Is there some other legitimating effect that follows from shareholder control? There's an oft-posed analogy between shareholder voting and voting in a democratic state, but it would have to be a state with property-based weighted voting. So we don't see much there, either.

#### IV. CORPORATE AND SECURITIES LAW

##### A. THE EQUILIBRIUM CONTENT OF CORPORATE FEDERALISM

UCLA-Sloan Research Program on Business Organizations, Conference  
on the Means and Ends of Corporations, January 29, 2005

Accompanying Article:

William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619 (2006) (Annual Symposium), *reprinted in* 48 CORPORATE PRACTICE COMMENTATOR 855 (2007)

#### INTRODUCTION

In this paper, Joe McCahery and I bring five points to the corporate federalism discussion. First, federal intervention into internal affairs is inevitable because Delaware follows an evolutionarily stable strategy that constrains its ability to respond to shocks that create national political demands. Second, national lawmakers pursue a cooperative strategy when intervening, structuring federal corporate law so as to leave the rent-driven state law equilibrium undisturbed. Third, these days the cooperative federal strategy responds to political demands focused on shareholder value. Fourth, although the state equilibrium is second best when evaluated in a microeconomic framework, the negative result has no bearing on the federalism. Fifth, the threat of disabling federal intervention has sunk into the deep constitutional structure, leaving Delaware safe in the present context.

#### THE STATE EQUILIBRIUM

History provides the means to these five ends. More particularly, the paper uses basic concepts of evolutionary game theory to explicate corporate federalism's development over time. Two equilibriums emerge: a rent driven equilibrium in the states complemented by a political equilibrium at the national level.

The state equilibrium originated in 1888 when New Jersey turned corporate lawmaking into a strategic game of rent-seeking from managers looking for a responsive legal framework. Innovating, New Jersey provided an enabling corporate code that vests agenda control over governance matters in management. When New Jersey abandoned its competitive strategy for exogenous political reasons in 1913, Delaware, which already had copied the strategy, captured the rents. Delaware has stuck with the strategy ever since, inviting the designation "evolutionarily

stable.” Delaware’s agents play to protect its rents, approaching the mode of rational maximizers. They update and learn on an ongoing basis, adjusting their lawmaking strategies as they face new situations. But they never stray far from the original formula. So stable is the strategy that corporate law’s basic, enabling outline changed little during the twentieth century.

How legitimate is the system? Well, the possibility of reincorporation out of the state assures a high degree of political accountability. But accountability goes not to voters, but to the firms’ managers and shareholders, who react not as citizens but as economic interest holders. Paradoxically, Delaware corporate law also reflects the preferences of an unusually wide spectrum of voters due to the fiscal impact; any corporate law policy that suits the customers also suits them. This complete concord between Delaware’s firms and its voters cordons off corporate law from conventional political influences and concomitant regulatory volatility. Such a stable political settlement could never be reached at the federal level, where broad political coalitions could contest it.

Many, of course, tell us that the state equilibrium does not measure up as first best when analogized to an efficient product market, instead amounting to a bundle of suboptimal distortions. This second-best description is manifestly accurate. But we don’t see any negative implications for Delaware’s legitimacy. For one thing, it’s not clear to us that a first-best market for law could exist in the first place. Law rarely works as product in the real world because lawmakers lack entrepreneurial incentives. For us this is politics, not economics. It suffices that the system is: (1) consensual, (2) responsive, and (3) monitored at the national level.

#### FEDERAL QUESTIONS

Now to that third factor—national monitoring. The stable state equilibrium holds out a possibility of externalities. The dominant chartering state becomes a national lawmaker, potentially impacting the economic interests of actors nationwide, actors who may be badly represented or entirely unrepresented in its lawmaking process and as to whom it is unaccountable. Such an arrangement is politically tolerable only given the possibility of preemption by the national government. Since the chartering state gets its power to impose its law externally from the federal constitution, it also makes structural sense that disadvantaged groups and broad public interest coalitions get a right to contest the state result by making a political appeal to Congress.

Since 1934, these federal contests over state results have been mediated and channeled by the internal affairs norm. This being only a

coordinating norm, rather than a constitutional mandate, its application is contestable. There follows the central, ongoing issue in corporate federalism: the weight to be accorded the presumption favoring state regulation of internal affairs.

#### THE FEDERAL EQUILIBRIUM

And national lawmakers have progressively, albeit episodically, entered into internal affairs since 1934. These interventions are historically contingent, occurring when political demands are registered nationally. Even so, the federalism has evolved toward an equilibrium balance, because the makers of national corporate law—which include the stock exchanges in addition to Congress, the SEC, and the federal courts—have played an evolutionarily stable strategy of their own. We derive this equilibrium description from a political economy of national incursions into internal affairs since 1934, a discussion that contrasts federal initiatives that failed, federal chartering and federal protection of hostile takeovers, with initiatives that succeeded, like the Williams Act, the Foreign Corrupt Practices Act (FCPA), and the Sarbanes-Oxley Act (SOX).

Where the state equilibrium stems from an exchange of a product for rents, the federal equilibrium is political. Where the state equilibrium is self-enforcing, federal actors have a range of strategies at their disposal and a zone of discretion. They could play uncooperatively, intervening so as to terminate the rents and the state equilibrium. They also could be wholly cooperative, leaving internal affairs to the states. Strategies actually chosen depend on political norms and pressures. Despite this unstable aspect, four patterns can be discerned in the history, patterns suggesting the evolution of a stable, cooperative strategy.

1. The first pattern concerns political substance: Initiatives implicating sharp ideological partisanship do not find their way into federal mandates.

The *failed* initiatives came from proponents of two paradigms who long competed in trying to capture and transform the federalism. First in time came a trust paradigm espoused by progressives who called charter competition a race to the bottom and counseled that no internal affairs presumption should constrain federal intervention. A market paradigm over time emerged in opposition. Its picture of market success reversed the race to the bottom to a race to the top and implied an irrebuttable presumption favoring the states.

Neither paradigm ever motivated (or constrained) national interventions. Federal chartering, at the top of the executive branch's legislative agenda in 1910, gradually sank into political obscurity over the

course of the century. Proponents of the market paradigm similarly lacked necessary political muscle when the time came for federal protection of the hostile takeover in the 1980s. Both paradigms, whatever their substantive merits, have been the projects of narrow networks of academic and policy elites. Neither ever resounded strongly enough, either with the median voter or, with partisan agenda setters, to override interest group opposition and determine results.

But a third policy approach, on the table since the 1930s, does carry descriptive weight. We call it the “governance agenda.” Its proponents seek to reduce agency costs of management for the shareholders’ benefit and avoid mention of unrelated notions of the public interest. Congress and the stock exchange both draw on this agenda when intervening to adjust state equilibrium results.

2. The second pattern concerns political demands and subject matter.

Both the FCPA and SOX responded to broad-based political demands for management accountability, demands so strong as to surmount partisan ideological divisions in Congress. Only rarely does the public make such demands. But well-publicized corruption and noncompliance bring about the exceptional case. Stock market reverses also figure in.

Interventions tend to address topics, legal compliance most prominently, as to which unilateral action by Delaware would be inadequate fully to satisfy the political demands. This follows in part from the federal structure: national demands create a need for parallel action across all fifty states, something the states can’t do quickly. It also follows from the properties of the state equilibrium. The stable state strategy privileges fidelity to the management interest. A shift by Delaware toward hard-wired accountability and enforcement or mandated governance processes would be viewed as defection. Such a shift would disrupt the equilibrium, reducing Delaware’s rents. The equilibrium thus disables Delaware from preemptively anticipating federal interventions.

3. The third pattern concerns the relative influence of shareholders and managers: The shareholder voice tends to register more loudly at the federal level.

We hear the shareholder voice most clearly with the FCPA and SOX, cases where political demands flow against management and the feds respond to avoid finding themselves on the wrong side of median voter preferences. Significantly, with SOX we see that median voter demands have moved away from early- and mid-twentieth century populist concerns like corporate bigness and labor relations. Now, with a rising shareholder class, national political demands tend to be driven by shareholder value. Today’s populist agenda concerns compliance with

laws designed to assure accurate market prices. Delaware's vulnerability to attack diminishes accordingly.

Compare the Williams Act, the National Securities Markets Improvements Act of 1996, and the Securities Litigation Uniform Standards Act of 1998, cases where federal action responds to the same sort of management influence activity that determines results in the states. As in the states, such management political operations tend to succeed against the backdrop of strong stock markets. But then all federal interventions are stock market sensitive.

Here, in contrast with FCPA and SOX, elective politics have no direct bearing. The median voter has no knowledge of the subject matter and hence no opinion. In addition, even as management gets more or less what it wants, the SEC hardwires a shareholder voice into the political process. This skews the federal agenda to weight the shareholder interest more heavily than it is or could be weighted under the stable state equilibrium.

#### 4. The fourth pattern concerns state-federal impact.

Not only have the feds never made full use of their constitutional preemptive authority, they have never disrupted the state equilibrium, which has remained stable even as the feds have crossed the internal affairs line on repeated occasions.

FCPA and SOX traverse internal affairs mostly to strengthen compliance with law, and the law in question is mostly federal. The feds enter state territory to maintain the integrity of their own system, and their system remains directed to the national securities marketplace. Nor does the legislation affect either the state settlement's basic terms or Delaware's rent flows. Viewed from an economic perspective, then, it substantially respects the state system, permitting us to describe the federal strategy as cooperative from Delaware's point of view. SOX targets management, not Delaware; the issue is not federalism, but costs and benefits at the national level.

In our view, non-disruption of the state equilibrium lies at the core of the federalism, a view that contrasts with a prevailing subject matter-based conception.

### DELAWARE

Finally, to Delaware, and the strategy adjustments it made in the wake of the federal incorporation threat of the 1970s and the takeover wars of the 1980s, both of which destabilized the state equilibrium.

The Delaware courts took charge, defusing external threats by taking corporate fiduciary law more seriously, reinventing it so as to make fiduciary review compatible with the management's preference for self-

regulation. To look only at the case holdings is to see an unstable body of law. To look at the cases in the wider equilibrium context is to see a stable strategy. The Delaware courts learned to articulate fiduciary standards with vigor but not to apply them directly, avoiding the levy of substantial money judgments on customers or the permanent injunction of big money deals. I predict that they stick to the strategy.<sup>8</sup>

For Delaware, the market share of which has continued to grow, the only remaining point of disruptive friction lies in the incompatible demands posed by the hostile takeover. But takeovers no longer cause serious instability. Things did seem serious in the 1980s, when Delaware, after due consideration, responded to conflicting demands by sticking with the stable strategy and staring down the federal government. It made the right political choice. The 1980s federal preemptive threat lacked political credibility and would not have disrupted the state equilibrium in any event.

#### CONCLUSION

We emerge with a good cop/bad cop description of the federalism.

Delaware is the good cop. It arbitrates between shareholder and management interests, maintains a dialogue with those it regulates, never chills risk-taking, only polices when forced, and even then puts on the kid gloves. The feds are the bad cop. They mandate to make sure that firms tell the truth about themselves, deploying a significant enforcement apparatus, imposing fines, money judgments, and even sending people to jail.

The good cop/bad cop routine follows from the federal structure. When financial crises and compliance breakdowns coincide, national political demands arise concerning the conduct of corporate business. Charter competition inhibits policing, disabling Delaware from responding. The job of confronting external shocks goes to actors at the national level by default. Although this leaves Delaware structurally vulnerable, federal responses, viewed historically, have been progressively less threatening.

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8. I was wrong about this. Demands stemming from plaintiffs' lawyers caused a shift in the strategy in this century.

## B. BANKERS AND CHANCELLORS

University of Pennsylvania Law School Institute for Law & Economics  
Corporate Roundtable, December 13, 2013

## Accompanying Article:

William W. Bratton & Michael L. Wachter, *Bankers and Chancellors*,  
93 TEX. L. REV. 1 (2014)

## THE CASES

This is a paper about what happens when conflicts of interest on the part of sell-side investment banker-advisors prove salient in the context of *Revlon* review in the Delaware Chancery Court. Four cases are under discussion, cases that, once juxtaposed, yield a prologue, an Act I, an Act II, and an epilogue.

The prologue is *Toys "R" Us*, a garden variety *Revlon* case about a private equity buyout decided in 2005. Then Vice-Chancellor Strine sustained the deal but took the occasion to comment on stapled financing, which is the provision of debt financing to the private equity buyers by the selling board's banker-advisor, here Credit Suisse First Boston. On the facts of the case, the selling board acceded to its banker's participation in the lender group only after the execution and delivery of the merger agreement, so the conflict implicated no *Revlon* violation. But the judge did enter a note of disquiet, a double-sided communication with just a hint of a threat. On the one hand, even as the staple lacked any causal impact on the terms of sale, it created an appearance of impropriety, so maybe it would have been better if the board had refused to accommodate its banker in the first place. On the other hand, said the court, it had no business policing appearances of impropriety lacking an impact on the selling process.

The first act is Vice-Chancellor Laster's 2011 decision in the *Del Monte* case, also about a staple. Here the selling board's banker-advisor, Barclays, got the board to consent to its participation in buy-side financing at a much earlier stage in the buyout process, with the selling board managing the conflict by resorting to the practice palliative that had emerged in the wake of *Toys "R" Us*—engagement of a second, unconflicted banker. But Barclays remained out front during the deal's go shop phase despite the conflict and a bid by a competing bank to replace it. Finally, according to the facts as stated in the opinion, there was a sequence of conflict-related failures by Barclays to disclose acts taken in order to get the sale process going, plus a violation of a no-teaming provision in a confidentiality agreement.

Vice-Chancellor Laster found that a *Revlon* case had a reasonable probability of success. His opinion moved in two directions. First, the banker conflict, taken together with the deception of the board, tainted the sale process. Second, opportunity costs followed. The board, upon permitting a team buyout, might and should have extracted givebacks from the buyers. Likewise, with its banker. Upon permitting the staple, the board should have gotten a *pro* for the *quid* instead of contenting itself with engagement of a second banker at additional cost to the shareholders.

A twenty-day injunction against the shareholder vote followed, but the merger eventually closed at the agreed price, with the litigation thereafter settling for \$89 million.

Act II is Chancellor Strine's 2012 decision of the *El Paso* case. El Paso's board, advised by Goldman Sachs, had been looking into a spinoff of a large division, a process interrupted by a merger proposal from Kinder Morgan, a proposal backed up by a threat of a hostile tender offer. This created a problem for Goldman, which owned 19% of Kinder Morgan and had two representatives on its board. The El Paso board promptly brought in Morgan Stanley to advise on the merger proposal, but left Goldman in place as advisor on the spin off alternative. A no-shop merger agreement with Kinder Morgan eventually followed without solicitation of other bids at any stage.

The court once again found a reasonable probability of success under *Revlon*, even as it refused an injunction against an apparently advantageous deal. The plot gets complicated at this point. The El Paso board had left its CEO, Doug Foshee, out front in the negotiations, and Foshee, as soon as the ink was dry on the merger agreement and without any disclosure to his board, had suggested to Kinder Morgan an *ex post* buyout of an El Paso division by a group led by himself. That by itself might have supported a finding for the plaintiffs.

But Goldman also found its way into the *Revlon* mix. More particularly, before being shunted away from the merger, it had advocated placation of Kinder Morgan, and, as it exited, it had managed to protect its exclusive engagement to advise on the spinoff and to secure a \$20 million consolation prize payout if the board went for the merger. The court thought that this set up skewed incentives in a merger's favor—Morgan Stanley got paid only if the merger closed while Goldman had a payday either way. Meanwhile, Morgan Stanley's engagement being limited to the merger alternative, there was no possibility of Goldman being second guessed on its spinoff valuations, which took a downward trajectory over time. There was also a minor matter of a failure to disclose a holding of \$340,000 worth of Kinder Morgan stock by the Goldman banker advising

on the spinoff. The merger closed and the litigation eventually settled for \$110 million.

As the curtain came down on each of the two acts, there was smattering of applause from the audience in the business press and the blogs. But it was mostly jeers. Bi-polar jeers. For many, the cases amounted to ineffectual slaps on intermediary wrists—shaming where shaming wasn't enough. For others, it was a Chancery Court out of control, catering to plaintiffs' lawyers and interpolating fiduciary principles where they have no place. Since then, *Del Monte* and *El Paso* have come to be seen as game-changers, ushering in a new regime of hypersensitivity to banker conflicts, choking off stapled financing, and contributing to the rise of unconflicted boutique merger advisory firms.

### BACKGROUND

We got a sense of all the brouhaha here at ILE the year before last, when Michael and Chancellor Strine convened a Chancery Court program on banker conflicts. There was more than a *little* tension in the room. One of the panelists was Robert Kindler of Morgan Stanley, who has a line he likes to use when discussing banker conflicts: "We are all totally conflicted—get used to it."

And a great line it is. But Michael and I came away wondering exactly what it's supposed to mean. This paper followed—a sort of investigation of and meditation on Mr. Kindler's assertion. The paper seeks to answer several questions. Do bankers and clients enter into a fiduciary relationship? If they do, why should banker conflicts be tolerated in a world where nobody would proceed with a sale process with the same law firm sitting on both sides of the table? If bankers to are not fiduciaries, why should their conflicts have a disabling effect on good faith, diligent actions taken by independent sell-side directors? Aren't *Del Monte* and *El Paso*, with their taints and appearances of impropriety, imposing an antique norm of fiduciary abnegation—the old punctilio of an honor the most sensitive—in a modern context where it has no place?

We answer that this is, indeed, modern contractual territory. Bankers operate in a vigorous reputational market and contract out of fiduciary duty to the limit of the law with their clients' informed consent. But, at the same time, taking bankers out of the traditional fiduciary frame and remodeling them as arm's length counterparties transforms their posture under *Revlon*, which is more about getting the best deal for the shareholders at arm's length than it is about traditional fiduciary self-abnegation. *Del Monte* and *El Paso* stand for the proposition that selling boards should treat banker conflicts in a contractual rather than a fiduciary framework. The cases take us to a new evolutionary plateau on which it's not enough to consent to

the conflict and then sit back and passively trust that the fiduciary then deals with you in the best of faith. The client board should instead treat its conflicted banker as an arm's length counterparty, assuming self-interested motivation and using contract to protect itself and its shareholders.

#### THE CONFLICTS

Now, back to Robert Kindler and his positive assertion. Are *all* the bankers in fact totally conflicted? Well, no. That's an exaggeration. But conflicts are indeed pervasive and potentially skew the bankers' incentives as they play a critical role in getting the best price for sell-side shareholders. It all depends. Some bankers avoid conflicts. But many do not, and, as we see on the facts of these cases, some even seek them out.

There are three sources of conflict. First, advisors are repeat players and their services have a strong relational aspect. So an advisor, ever thinking about the next deal, could cater to the interests of actors at the seller, actors at the buyer, or, alternatively, a third party like a lender to the buyer.

Second, there's the standard, performance-based fee arrangement, which gives the advisor an all-or-nothing interest in closing any deal, a conflict particularly likely to skew incentives when a risky but more valuable alternative shows up. A fixed fee would eliminate the problem, and a variable contingent fee would ameliorate it. But, for the most part that's not how things are done. And, assuming that the bankers are indifferent to the form of payment so long as the yield over time averages out to the same place, the preference for performance fees would appear to stem from the clients.

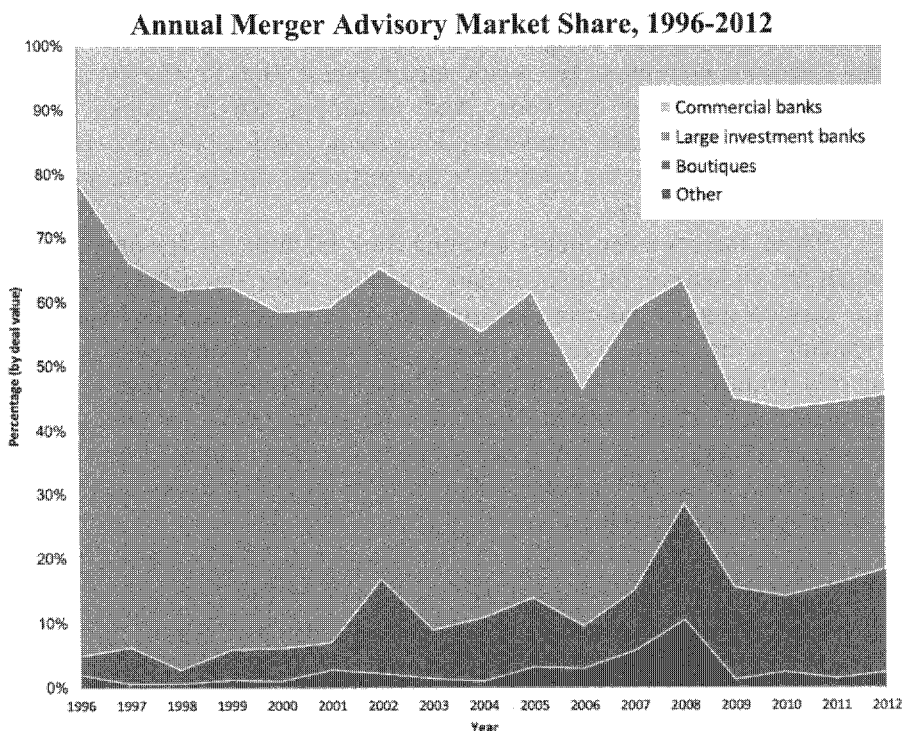
Third, there are conflicts stemming from multiple service provision, which arise whenever an intermediary's maximization through the sale of one service implies subpar performance of a second service. Stapled financing is the prime example: an advisory bank that participates in the buyer's lending group stands to make a bigger fee as a lender than it does as an advisor. Thus situated on both sides of the table, it might, for example, be inclined to favor a buyout over a strategic merger. And, in a bidding war, it might be better off with a lower bid accompanied by a smaller, more valuable loan.

#### ECONOMIC AND LEGAL FRAMEWORKS

Lawyers see red flags on all of these fact patterns. But economists counsel caution. For them, per se avoidance due to the taint of a conflict and an appearance of impropriety presumptively amounts to overkill. After all, rational actors can be expected to deal with conflicts in their

contracts *ex ante*. The services buyer discounts the price until the engagement is an advantageous net of the conflict. The conflicted services seller seeks to build a reputation for effective service provision despite its conflicts, thereby minimizing the pricing discount. So even as the conflict skews incentives, the provider doesn't necessarily give in to temptation. There also will be market pressure to minimize conflicts. But the conflicts do not necessarily reduce to zero even so—to the extent that the conflicts' value exceeds the costs bound up in the price discounting and lost business, the service provider can be expected to continue to seek them out.

Advisory industry structure reflects the predictions implicit in this micro account. To get a picture of it, we took the firms listed in Mergerstat's annual merger advisory top 50 from 1996 to 2012, totaled the deal value for which each firm was annually responsible, and divided the firms into four categories: first, investment bank subsidiaries of commercial banks and other large financials; second, large, full-service independent investment banks (irrespective of their 2008 recategorization as bank holding companies); third, boutique advisory firms; and fourth, advisors not falling into the first three categories, principally private equity and auditing firms.



The exercise yielded a dynamic evolutionary picture. The share of large independent banks declines over time as commercial banks acquire them in a deregulated environment. This enhances the potential for conflicts as it ushers in, *inter alia*, stapled financing. Meanwhile, as if in response, boutique firms, which are less likely to be conflicted due to multiple service provision and aggressively posture themselves as such, steadily gain at the expense of big banks of either category, going from 3% in 1996 to 16% in 2012. The players in this game compete amongst themselves intensely, poaching from one another not only clients but star bankers, and conflict avoidance is also a point of competition.

There is less evidence of competition over the scope of the advisor's duty. But it's certainly a negotiated point. Engagement letters specifically detail the bank's duties, restrict the class of parties to which it owes duties, and indemnify for anything but willful misconduct, gross negligence, or bad faith. Advisory clients, meanwhile, are not exactly unsophisticated players.

Significantly, the basic legal framework easily accommodates this economic picture. The advisory engagement is, of course, an agency, and agents owe fiduciary duties to their principals, including a duty not to act as an adverse party. But the legal bar lifts given principal consent to a conflict on full disclosure, subject to backstop review of the conflicted agent's conduct for good faith and fair dealing. Given contracting out, questions about character of the residuum of fiduciary constraint go to the meaning of "good faith and fair dealing." If the question as to what this means came up in Delaware, we project that the culpability-based corporate law standard would come to bear, leaving us in roughly the same place where we started out with the standard engagement letter's indemnity cut off at willful misconduct, gross negligence, or bad faith.

To complete our picture of effective, arm's length contracting, we compare the lawyers who sit at the same negotiating table. Their rules work similarly, albeit more strictly. A transactional lawyer, like a banker, can be conflicted based on full disclosure and client consent, provided the lawyer can reasonably believe that competent and diligent representation still can be provided. If not, the client's consent is ineffective. Corporate representation is the archetypical case for consensual, conflicted representation. Yet we don't see it in fact because lawyers voluntarily avoid conflicts, constrained not by a legal bar but by a practice norm.

Summing up, the difference between lawyers and bankers lies less in law than in economics—their respective reputational markets vary greatly in sensitivity to conflicts.

Finally, we note that there's a long line of Delaware cases that sanction banker conflicts based on client consent and full disclosure, both to the board and the shareholders in the proxy statement. At the same time, Delaware law holds that the banker owes its duty only to the engaging board, not the shareholders. It can be brought in as a defendant only as an aider and abettor of a board breach.

#### HARD LOOKS

Does it follow from all of this that *Del Monte* and *El Paso* disrupt an established, well-functioning, arm's length equilibrium between bankers and clients by imposing out-of-place fiduciary norms? We don't think so, even as we readily concede that the appearances are otherwise.

The prevailing body of law on banker conflicts has an important limitation. It is almost entirely addressed to banker fairness opinions, and fairness opinions don't matter very much, serving primarily a defensive function. Now, maybe fairness opinions should say more, and therefore matter more, and be subject to a different, more professionalized legal regime. Maybe. But that is not the question here.

Rather, the question is whether banker conflicts can and should have salient status in the context of *Revlon* review, where the stakes implicated by a conflict are much higher than in a fairness opinion case. *Toys "R" Us*, *Del Monte*, and *El Paso* represent a break with the past in confronting this question in a serious way for the first time since *Mills v. MacMillan*. When they answer yes, they apply longstanding principles without altering them in any way. The break with the past lies in the very act of application.

But is that application overly aggressive? Let's take another look. Chancellor Strine's *Toys' "R" Us* dictum castigated for an appearance of impropriety even as it cautioned that appearances are not actionable of themselves. To get a violation, you have to show a negative causal influence on the board's sale process. This requirement accords well with the economic analysis.

The emerging question is whether *Del Monte* and *El Paso* conform to the requirement already laid down in *Toys "R" Us* and ground their *Revlon* violations not on taints but on consequences. If it's taint, then these cases border on best practices rule-making. But we think that there were consequences, albeit of the counterfactual, might-have-been variety.

In *Del Monte*, the banker's concealment disabled the board from getting a clear picture of competitive alternatives, a problem confounded when the conflicted banker was left to run the go-shop. Moreover, the board's apparent interest in maintaining its relationship with the banker disabled it from extracting a giveback in exchange for its consent to a staple.

In our reading, the court here takes the arm's length economic and legal relational framework it has been handed and works out its logical implications in the context of *Revlon* review. If the banker can go into arm's length mode and self-deal, then the sell-side board should be prepared to do likewise when the banker asks for concessions, and not just tack an added transaction cost in the form of a second banker. The message is simple: there should be less trust and reliance and more oversight and protective use of contract in the form of reps and warranties, binding promises, and considerations. An instruction like this isn't necessary in a traditional fiduciary context.

*El Paso* is a bit harder, because there is no significant deception and no clear-cut moment for a banker *quid pro quo* in exchange for a client concession. Indeed, if you look at the sale context and write off the spinoff as a dead letter, it's hard to see any harm at all. On the other hand, this wasn't just a case of a second fee on the lending side. The conflict was razor sharp—we ballpark Goldman's stake in the success of the Kinder Morgan merger at \$200 million. If you then assume that the parties were not just going through the motions on the spinoff and that Goldman's inputs mattered, we think there's an adequate counterfactual basis for ruling the process infirm.

The resulting practice message is still severe. Multiple conflicts have negative synergies. Proactivity plus consent are not necessarily enough. Be trusting and you could stumble into a violation. And, when you take contract seriously, there comes a point when you should stop trusting entirely, cut off the relationship, and walk away.

We think this is quite consistent with the economic analysis of banker-client relationships, particularly given that the immediate objective is short-term shareholder value maximization. But a pushback argument can still be posed: Isn't the Chancery Court here pulverizing arm's length contracts and dismissing the controlling influence of a reputational market? Yes, but to make contract inviolate in this context is to shut down *Revlon* scrutiny altogether, and there's no easy way to cabin off banker-client contracts from the others in the sale cluster. Moreover, fact development in the context of *Revlon* litigation opens up black boxes, enriching the reputation market's informational base. Finally, Delaware incorporation is itself a function of choices made by economic actors. The Delaware Chancery *itself* operates in a market in which it has a reputation to protect.

#### ROBUSTNESS CHECK

We come away with the view that the scrutiny in these cases is structurally inescapable and that the scope for criticism goes only to

matters of degree. The Chancery Court here “gets used” to banker conflicts, albeit not in the accepting way suggested by Robert Kindler.

But we’re still worried about claims of *ex post* uncertainty and calls for guidance. So, just to be safe, we subject our conclusion to a robustness test in the form of a thought experiment posing two alternative, more rules-based regimes.

We first try out per se prohibition of banker conflicts by analogy to the law governing auditor-client relationships. This would elevate boutiques over full service banks, at a potential cost to a client wanting either full service or, in the right case, access to the best-informed banker. A prohibition, carried to a logical conclusion, also would lead to constraints on fee arrangements. Adding up the opportunity costs, we don’t think this makes a whole lot of sense. So we try a narrower per se approach that would target and prohibit staples. This is cleaner and less disruptive, but it’s still very easy to identify opportunity costs. The status quo of leaving the matter to the management of the sell-side board and its capable counsel under an open-ended standard emerges as manifestly more attractive.

We go on to try this from the other side, proposing that full disclosure to the selling board and its shareholders plus engagement of a second banker should merit safe harbor treatment. Here the problem is that the harbor isn’t really very safe, for the *Revlon* door isn’t shut. One is only attempting to close off one line of inquiry within a wider set, and then only after establishing that the disclosure had been full. There also would be questions about the cut-off point. Does one have to inquire into the division of labor between the conflicted banker and the second banker, looking to make sure that any incentive skew is minimized? Presumably yes. And even if one succeeds in cutting off a complaint based on taint alone, what happens with a convincing showing of consequences? We don’t see how a Chancellor could look away.

We close with a question. Why, if the possibility for close scrutiny of banker conflicts lay inherent in the *Revlon* structure all along, did it take so long for intervention to occur? Perhaps the delay was just an accident of history—no case happened to come along. Alternatively, maybe the contracting pattern and relationships changed over time, with cognizable conflicts only showing up recently, amidst the stress of a severe recession. Or maybe the Chancery Court recently became more sensitive to banker incentive problems, perhaps influenced by widespread skepticism about practices at big banks triggered by the financial crisis. Or maybe a bit of all three.

C. THE *SOTHEYBY'S* CASE AND THE FUTURE OF THE POISON PILL

Conference, The Corporate Contract in Changing Times: Is the Law Keeping Up? Berkeley Law School, April 14, 2016

## Accompanying Chapter:

William W. Bratton, *Hedge Fund Activism, Poison Pills, and the Jurisprudence of Threat*, in THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? (William Savitt, Steven Davidoff Solomon & Randall Thomas eds., forthcoming 2019)

## INTRODUCTION

There is but a single high-profile case in which twentieth century antitakeover law has come to bear on a management defense against a twenty-first century activist challenge—the Delaware Court of Chancery’s decision in *Third Point LLC v. Ruprecht*,<sup>9</sup> better known as “the *Sotheby’s* case.” So, when Steve Davidoff told me that Delaware law was on the agenda for this conference collection, I didn’t hesitate to offer a chapter that reflects on *Sotheby’s*. Full disclosure: I worked with some Morris Nichols lawyers during the discovery phase and came away with a sense that there was a problem of fit between *Unocal* jurisprudence and activist fact patterns, in particular with the operative threats.

## THE CASE

Now, quickly, to the facts. The board of directors of a target corporation, *Sotheby’s*, lobbed a poison pill in the path of one of the more aggressive hedge funds, Third Point LLC, and its sharp-elbowed chief, Daniel Loeb. The pill had a “low threshold” feature, capping a hostile challenger’s block at 10% of outstanding shares rather at the traditional 20%. It thereby disabled Third Point from enhancing its vote total in a short-slate proxy contest through additional purchases of target shares. The Chancery Court nonetheless sustained the pill under *Unocal v. Mesa Petroleum Co.*<sup>10</sup> The decision implicated an important policy question: whether a twentieth century doctrine keyed to hostile takeovers and control transfers appropriately can be brought to bear in a twenty-first century governance context in which the challenger eschews control transfer and instead makes aggressive use of the shareholder franchise.

*Sotheby’s* pill had a one-year duration and displayed some careful drafting—the 10% trigger applied only to 13-D filers and there was a built-

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9. No. 9469-VCP, 2014 WL 1922029 (Del. Ch. May 2, 2014).

10. 493 A.2d 946 (Del. 1985).

in waiver for an all cash, all shares offer. The Board's decision to promulgate was tested as at two points in time: first, as of initial adoption pre-proxy contest, and then later in the midst of the campaign, the second look occasioned by Third Point's formal request to the Sotheby's board for a waiver of the pill. The opinion on denial of the requested injunction is a straightforward application of law already on the table. *Moran*, *Stahl*, and *Yucaipa* together had shunted *Blasius* scrutiny off to one side on this fact pattern, remitting the matter to *Unocal*. And, under *Unocal*, preclusion and coercion were already off of the table where, as here, the shareholders were going to get to decide at all events. It came down to a *Unocal* reasonableness inquiry.

The principal justificatory threat is creeping control, which can obtain even in the case of a short-slate challenger asking only for changes in the business plan. Conveniently for defense, the case law facilitates the building of a creeping control profile that can be attached to a hedge fund activist. Given past control acquisitions or past unequal shareholder outcomes, the activist is tainted and the pill passes. Alternatively, any loose talk about a possible sale of the target also suffices. Third Point and Loeb fit the profile to a "T"—Marco Becht et al. identify in their paper the five hedge funds most likely to cause a merger and Third Point is right up there. The Sotheby's board's initial adoption thus turned out to be easily justified.

The case was closer as regarded the mid-contest revocation request—there was deposition evidence from a director who said that all the board had been worrying about at that time was the vote count, and the risk of losing a proxy contest points to a forbidden entrenchment motivation. But VC Parsons sustained by reference to a second, weaker threat—negative control, the power to block. He also mentioned a third, still weaker threat in passing—disproportionate influence, a factor invoked in the cases on a secondary basis.

#### PRIORS

There's the case. I came to it with three priors.

First, activist intervention has arrived and thrived without any facilitating change in state corporate law and without causing the law to change in any significant respect. I think the law's gotten it right. It seems to me that in order to justify a preclusive change, the reform proponent ought to be required to show that activism causes systematic damage, and I have seen no such showing.

Second, with Gillan and Starks, I'd say that activism doesn't implicate control transfer. That historic 20% number was a nice one—a

focal point accepted not only in the law but the economics. Why not just leave it there?

Third, to the extent there's a short-termism problem, it's company specific. We should be wary of generalized characterizations.

#### HOLLOW THREATS

Now to the implications of the case and its trio of *Unocal* threats, creeping control, negative control, and disproportionate influence.

First question: Do activists actually tend to acquire control, creeping or outright?

Answer, no. As to lead activists, here are the figures from the studies. Brav Jiang Partnoy and Thomas find at the 95th percentile an average 19.8% at initial filing and a max of 25%. Gantchev's findings for the 95th are 16% at filing and 18% at the max.

But what about wolf packs? Becht et al, most of whose observations are from the US, find a success rate of 44% for a standalone challenge and 78% for a disclosed wolf pack. But the average wolf isn't all that big at 14% against 8.3% for a standalone. Further, only 11.8% of Becht's targets faced a disclosed wolf pack while 88.2% faced a standalone activist. But what about those invisible wolves who keep their blocks under the 5% reporting threshold? Wong has an interesting study of what I'm calling inferred wolf packs, keyed to an analysis of stock turnover on the day the lead passes the 5% threshold. But her inferred wolf packs have only a 6% higher rate of success.

Conclusion: the wolf pack menace is overdone; they generally don't hold out a control threat.

So let's dial it down a notch and forget about a control threat, and just ask for a campaign that pushes the target into a merger. Here are the figures. They have a way of increasing with the date of the study. The most recent comes from Boyson, Gantchev, and Shivdasani, who cover bids from 2000 to 2012, and come in at 24%, with the activist as the bidder in 3.4% and offering the lowest premium.

Where then is the threat? Technically, creeping control is a threat because the creeper, first, takes control, and then realizes on it either by selling the block at a premium or holding onto it and running the company. That's not what's going on. The company gets sold and everybody shares the premium. And if that 3.4% slice of activist bids is a problem, *Revlon* is there to take care of it. The victims, if any, are those who sell to the activist during the pre-13-D filing blackout period, and they would appear to be noise trading institutions making liquidity trades. Given diversification, what they lose in one campaign on a sell they pick back up in another on a hold.

The second threat is negative control, but that really doesn't fit hedge fund activism either—the activists are in it to introduce affirmative change, and given the ownership numbers, they don't have unilateral blocking power and are helpless without the support of other shareholders.

So we fall back on disproportionate influence, the secondary, backup threat. Here the fit is good. Disproportionate influence is what activism is all about. Let's use it to sustain an extreme 5% trigger pill in the ordinary case. The disproportionate influence serves to bring about mergers, asset sales, borrowing, dividends, buybacks and cost cutting along with an enduring boost in the stock price. To turn this into a threat, we go back to the *Unocal* of the 1980s and the substantive coercion threat—the threat to management's business plan held out by a premium hostile bid. We restate the threat in the present activist context, to wit, the changes brought by the hedge fund may hurt the shareholders by snookering them into taking a present premium rather than the greater long-term value held out by the incumbent's business plan.

This sounds easy, but it implicates a long conceptual extension. *Unocal* evolved on the theory that the bidder stayed by a poison pill backed by a substantive coercion threat could then be remitted to the shareholder franchise. The bidder, rather than closing on the tender offer immediately would have to divert to a proxy context to replace the incumbent target board with nominees who would redeem the pill. The justification for the delay and added expense was process superiority—the annual meeting held out a less coercive venue for group decision-making than did uncoordinated transactions in the market. When we update to today's scenario, we get a difficult result, for now the locus of coercion is not the stock market but that self-same annual meeting. This extension implicitly disavows the soundness of shareholder business judgments registered in connection with director elections.

To make this work, then, we have to spin a theory that casts structural doubt on shareholder votes that directly impact the business plan. Here's my thought as to how to do it. One describes the situation as a majority-minority shareholder conflict of interest. You could run this two ways. First, a long-term shareholder minority is being disadvantaged at the hands of a short-term shareholder majority, which majority, due the parochial, skewed interests of agents of institutional intermediaries, prefers a low-value, short-term revision of the business plan to a superior long-term value strategy. In the alternative, a short-termist minority is exploiting a long-termist majority. You get from here to there by disregarding the activist's shareholdings on the ground of its interest in the outcome of the vote. It all has a pleasing, conventional sound. But it still breaks the

inherited conceptual framework, which allows self-interest to motivate shareholder voting absent board control.

But I think that this or something like it is in the air. Take a look at VC Laster's statement of the conceptual framework in *In re Trados Inc. Shareholder Litigation*,<sup>11</sup> a case that has nothing to do with activism:

A Delaware corporation, by default, has a perpetual existence. Equity capital, by default, is permanent capital. In terms of the standard of conduct, the duty of loyalty therefore mandates that directors maximize the value of the corporation over the long-term for the benefit of the providers of equity capital, as warranted for an entity with perpetual life in which the residual claimants have locked in their investment. When deciding whether to pursue a strategic alternative that would end or fundamentally alter the stockholders ongoing investment in the corporation, the loyalty-based standard of conduct requires that the alternative yield value exceeding what the corporation otherwise would generate for stockholders over the long-term. Value, of course, does not just mean cash. It could mean an ownership interest in an entity, a package of other securities, or some combination, with or without cash, that will deliver greater value over the anticipated investment horizon. The duty to act for the ultimate benefit of stockholders does not require that directors fulfill the wishes of a particular subset of the stockholder base. . . . Stockholders may have idiosyncratic reasons for preferring decisions that misallocate capital. Directors must exercise their independent fiduciary judgment; they need not cater to stockholder whim.<sup>12</sup>

#### TOWARD A USEFUL PILL

Does any of this matter? Standing pills—pills actually in place as opposed to lying inchoate in blank check stock provision—are disappearing. The number is down from 35% of public companies in 2005 to 12.7% in 2015. Given the 10-day filing window for a 13-D report of a 5% stock block accumulation, a hedge fund can get its block in place before target management gets a shot at putting a pill in place, at least so long as the activist keeps his or her mouth shut. And, as Bebchuk, Brav, Jiang, and Jackson point out, given the stock turnover, even with a one-day filing window, most of the damage will have been done already.

So, in order to be hedge fund ready, a potential target needs a standing pill with a 5% trigger, a trigger low enough to invite invalidation for preclusion under *Unocal*. Coffee and Palia have mooted such a pill,

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11. 73 A.3d 17 (Del. Ch. 2013).

12. *Id.* at 37–38.

adding bells and whistles designed to minimize the threat of invalidation—the pill kicks only if the activist fails to file under 13-D in a day of going over 5%, thereby offering a private ordering solution to problem held out by 13-D's ancient 10-day filing window.

Still, if you want the pill to crimp block formation it's going to have to be a standing, plain vanilla, 5% pill. Having gotten to this bottom line, I want to reverse my own prior and suggest that this pill might not be a bad thing. This is simply because in the present context almost no one would dare adopt it. A management putting out such a pill would have a lot of explaining to do. Let's posit an explanation demonstrating the company's unsuitability for activist targeting. That is, assume that management can accurately and persuasively describe an investment policy and relational commitments that would be irrevocably injured by ministrations from the standard activist playbook. A set-to with ISS and Glass Lewis no doubt would follow, however well-put the explanation. I think the resulting dialogue could be beneficial—a learning experience for the institutional investor community. Spinning the scenario out a bit, the pill could emerge as a lever facilitating a productive sorting of companies among those well-suited and ill-suited to activist discipline. It gives activist opponents what they haven't gotten from the SEC—an activist baffler that deters purchases above 5%. And, it would be a superior means to the end because it would be a product of private ordering and would operate company by company.

## D. THE POLITICAL ECONOMY OF FRAUD ON THE MARKET

NYU Penn Conference on Law and Finance, February 25, 2011

## Accompanying Article:

William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69 (2011)

## BACKGROUND

A while back, Michael Wachter and I set to work on a securities fraud project that didn't work out. As we traveled down that road, and after reading papers by Jennifer Arlen, Jill Fisch, Steve Choi, Merritt Fox, Adam Pritchard, and others, we noticed something that grabbed our attention. The fraud on the market subset of 10b-5 actions has slowly but surely been losing its academic backing.

What's the fraud on the market subset? Well, first, put aside insider trading cases, which look toward a disgorgement of ill-gotten gains. Put aside also a new issue case where a company lies about itself when marketing new shares to take advantage of a market price above fundamental value. There are ill-gotten gains to be disgorged here too. This leaves the rest of 10b-5, most of the cases, where a company is charged with telling untruths that cause its stock price to diverge from fundamental value but is not itself trading in the stock. Here the losses lie entirely with the class of holders who, say, bought and paid too much during the period when the stock price was inflated, with the matching gains sitting in the pockets of selling shareholders who got out in time.

## JUSTIFICATIONS AND CRITIQUES

There are two traditional justifications for private lawsuits on this fact pattern. First, by analogy to the common law of fraud, the lawsuit returns out-of-pocket losses to the buyers who paid too much, compensating them. Second, by forcing the damages payment, it deters fraud.

There's a literature that begins with a paper Jennifer and Bill Carney published twenty years ago that takes both theories apart and stomps them into the ground. The key to the critical analysis is enterprise liability. Fraud on the market actions always name as defendant one or more corporate agents responsible for the fraud and then add the corporate issuer itself as a defendant on a principal-agent theory. All but a handful of the cases settle, with the corporation usually picking up the tab for the entire group of defendants. It is the path of least resistance for both sides at the settlement table.

But it also upsets the basic policy calculations. As to compensation, the inflated purchase price goes into the pocket of a selling shareholder who committed no fraud and isn't a defendant. The corporation, derivatively liable for the acts of its agents, pays the settlement.

So wait, who is paying what to whom?

That depends on what kind of shareholder you are. The majority are diversified portfolio investors. For them, what comes in one pocket as out-of-pocket damages over time goes out the other when another portfolio company pays a claim. It's a zero-sum game net until you get to litigation costs, at which point the returns go negative.

If you are a noise trader, you invested based on no information. If you are under diversified, you could have damages. But do you have a policy case for reliance on market price integrity? Arguably not. Now compare a noise investor who gets compensated when the trend turns due to a material misstatement, with a noise investor left to bear her own losses. All other things equal, it's the latter investor who is more likely to get out of noise trading, a desirable result. So it's not clear what function compensation has to play.

If you are an under-diversified long-term investor in the defendant company—you pay, nothing comes back in the other pocket, so you lose.

Fraud on the market litigation turns out to be a defensible positive sum game for only one subset of shareholders—information traders—fundamental value investors who do research and rely on published reports. These folks will have net out-of-pocket losses due to reliance on market integrity. There also may be research costs incurred to avoid victimization—a dead weight loss due to the threat of fraud. So compensation could serve a function. But this is only a subset, and unfortunately, settlement proceeds are shared amongst the shareholders as a group, and on average return less than five cents on the dollar as regards to larger companies. So, if you lost one dollar, the lawsuit returns you three or four cents. This is at best chump change for the one subset that can make a case for compensation.

As to deterrence, fraud on the market does deter fraud to some extent, if only because the suits are expensive, disruptive, and drive down the stock price. But if you are really serious about deterrence, you direct the action against the individual perpetrators. Unfortunately, that doesn't work with the economics of class action litigation because switching from the corporation to the officers removes the deep pocket from the settlement table.

Gradually, just about everyone who does securities has come to accept this critique, even those who take strong pro-enforcement positions.

It is now a conventional wisdom, although that point has only begun to be acknowledged.

The policy discussion emerges in an awkward posture. Ever since the Supreme Court ushered in fraud on the market class actions by sustaining a presumption of reliance on the accuracy of the market price in the 1988 case *Basic v. Levinson*, Congress and the same Supreme Court have labored to contain them. But they remain as economically and institutionally salient as ever. Put that together with a policy conclusion that fraud on the market makes no sense, and then you would think that the next step would be to abolish it—more particularly, to pull the presumption. Doing so would mean inserting an actual reliance requirement. But a small minority are willing to go that far—actually, it's a minority of one made up of Adam Pritchard. The rest stick with fraud on the market on a backstop basis: "Well, it doesn't make any sense, but it's the best enforcement tool we're going to get."

#### OUR INTERVENTION: RELIANCE FOR PRIVATE LITIGANTS AND STEPPED UP SEC ENFORCEMENT

This is our point of intervention. Something has gotten stuck here. We're highlighting the sticking points and mapping what we think is the most plausible route to a better outcome. We think this would be, first, for private litigants, an actual reliance requirement tailored to circumstances of investors who research companies. We look to the SEC, rather than Congress or the courts, to make this change—it is the institution most responsible for the unsatisfactory state of affairs and best equipped to fix things.

Now, because an actual reliance requirement would diminish the flow of private litigation, we also look to a compensating step up in public enforcement capability. The SEC, which also tends to settle with the enterprise, needs enough funding to get out of the enterprise liability trap itself and direct its enforcement actions to culpable, unindemnified individuals.

#### BARRIERS TO REFORM

We address three barriers standing between here and there.

First, there's a new justification of fraud on the market that's gaining currency in the wake of the failure of the original justifications—that fraud on the market litigation enhances the operation of the corporate governance system. Second, we turn to politics and explain why private securities litigation enjoys protection. Third, we inquire into the facts supporting the backstop justification—inadequate public enforcement resources.

First, fraud on the market as corporate governance. Note that the original compensation justification doesn't work because of pocket shifting—shareholders paying shareholders. Shift to governance as a framework and the fact that the shareholders pay is no big deal—the shareholders pay for everything in corporate governance and in theory are happy to do so long as the agency cost reductive effect exceeds the expenditure. So, what's the agency cost reductive effect here? Well, effective shareholder monitoring requires transparency. Fraud on the market litigation is a piece of the larger transparency enforcement apparatus. Therefore, it's justified.

At this point, stop and ask yourself: What informational value-added is occasioned by class action litigation? Not much, in our view.

But that's not the central claim anyway. As we understand it, the governance justification closely ties fraud at the market to the mandatory disclosure system. That is, to get rid of fraud on the market is also to get rid of mandatory disclosure. Do that and you really do have a transparency problem. And there are fraud-on-the-market opponents who advocate relocating disclosure rule-making regime to the private sector. But we see no unbreakable tie between the two—you can have and enforce mandatory disclosure system without private fraud on the market lawsuits.

Once you detach mandatory disclosure from fraud on the market, the governance argument takes you back to the deterrence argument—fraud means opacity and private litigation deters fraud. Unfortunately, viewed as a deterrent, fraud on the market comes up short.

Can the class action be reshaped to have a greater deterrent impact? That would be tricky. To do that, you have to switch to individual fines or some other theory of individually imposed damages. Two potential adverse consequences are projected from such a move. On the one hand, maybe recoveries would be so small that the private plaintiffs would lose their enforcement incentive. On the other hand, you could jack up the fines to keep the private plaintiffs in the game but at the risk of an over-deterrent result—crushing fines might deter executive recruitment and corporate risk-taking.

There are proposals on the table that aim to navigate between the two adverse results. Merritt Fox has one. But we wonder whether, once you get to this point, it might be better to stop trying to tweak the incentives of class action attorneys and rely on a public administrative intelligence to set penalties at the right level.

There's one other line of argument in the fraud on the market as governance category: fraud on the market actions proxy for litigation under the state law duty of care, addressing management defalcations in

the operation of the business, and giving shareholders a platform on which to intervene, bypassing the board of directors.

This doesn't work well either. Fraud on the market doesn't result in managers directly being held accountable for failure. Its consequences do not follow from the judgment of the shareholders as a group, as occurs when the franchise is exercised. It causes the stock price to go down. And those who make the decisions, lawyers, pension funds serving as representative plaintiffs, and federal judges, are, from a corporate governance point of view, largely unaccountable.

There *is* something to the point that fraud on the market overlaps the territory covered by the state law duty of care. But we think the comparison has devastating implications for fraud on the market. The state law care duty became subject to an opt out possibility a quarter century ago, and by now most companies have opted out with their shareholders' approval. Fraud on the market, like the rest of securities law, is mandatory.

#### A NATIONAL REFERENDUM

So we propose an opt out. Not just an exit door to be opened company by company, but a national referendum. The SEC would promulgate a rule pursuant to which the stockholders of every public company would decide whether they do or do not want their company to be subject to fraud on the market litigation under the *Basic v. Levinson* presumption of reliance. The votes would be taken at an annual meeting two years later, so that the institutional investor community would get plenty of time to think over the policy implications. Any company that opted out would be able to opt back in any time, prospectively. I don't know how this would turn out. If the shareholders decided that they want to pay for this litigation, fine; it's their money. I make just one prediction—the more time they get to think about it, the larger the no vote.

#### POLITICS

Now to politics. Political vulnerability does not necessarily follow from the fact that a legal institution makes no policy sense. Indeed, Congress took a look at eliminating fraud on the market in the run up to the 1995 PSLRA and decided to go for smaller scale reforms after Arthur Levitt came over and gave it a lecture. The business lobby has a follow-up list of reforms ready to go in the right political climate. If the past is any guide, the right climate means an expanding economy and a bull market. So fraud on the market is safe for now.

Better than safe, actually. The PSLRA diminished the strike suit problem and brought in institutional investors as lead shareholders, making class actions more respectable. A pay to play problem has resulted,

as plaintiffs' lawyers allegedly donate to politicians in states where they have attachments at the public employee pension fund. But even that doesn't matter very much.

Fraud on the market suits are politically legitimate despite a little corruption around the edges, because managers are empowered actors in the society and the economy and private antifraud litigation holds out a means with which to challenge business decisions gone wrong. It lets social upstarts go after top dogs, and such performances are valued. Its promise to enforce the law against fraudsters strengthens the case, especially if they are avaricious plutocrats.

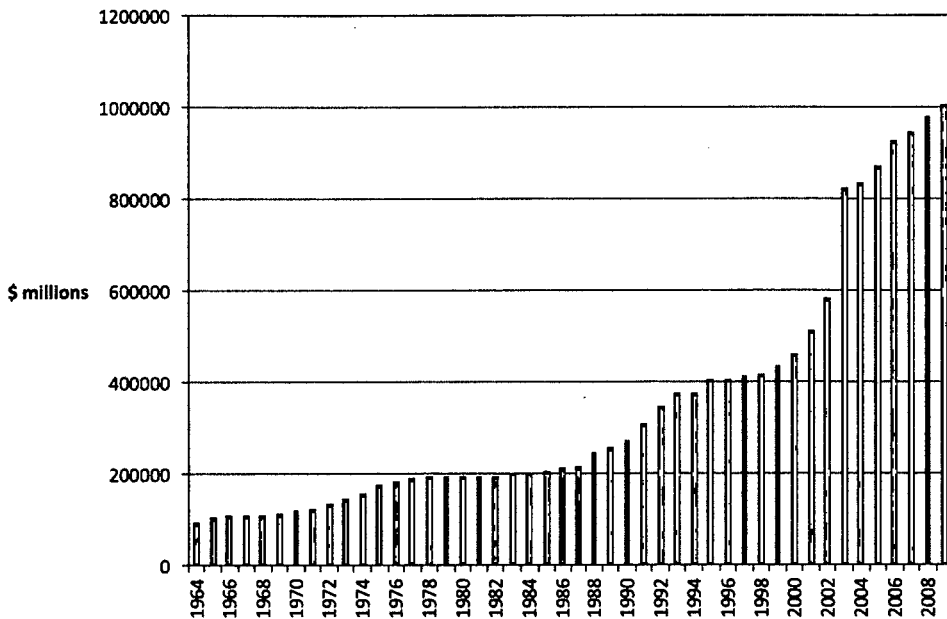
Meanwhile, the shareholders have emerged as a politically salient interest group. Decades ago, no one thought of the shareholder as a proxy for the median voter. Things are different in the ownership society. Invoke the shareholder interest in compensation for out of pocket losses, and you can get results in the right Congress. That a different mode of enforcement might more effectively challenge management decisions, bring fraudsters to account, or protect the shareholder interest, makes fraud on the market contestable (burden of proof on contestant) without denuding it of political legitimacy.

It follows that fraud on the market opponents must surmount a high political barrier. We can only aspire to chip away at it. Our target is the fallback defense of fraud on the market defenders: Even if this tort makes no policy sense, we have to live with it because it has some deterrent value and public enforcement resources are inadequate. That latter point has been repeated over and over like a mantra since the Supreme Court first implied a private right of action under § 14 of the 1934 Act back in 1964.

#### PUBLIC AND PRIVATE ENFORCEMENT RESOURCES

We decided to take a look and see if anything has changed in 45 years, and it has. The agency's budget was \$13.9 million back in 1964. In 2009, it was almost \$1 billion—the increase factor, adjusted for inflation is a multiple of 10.2.

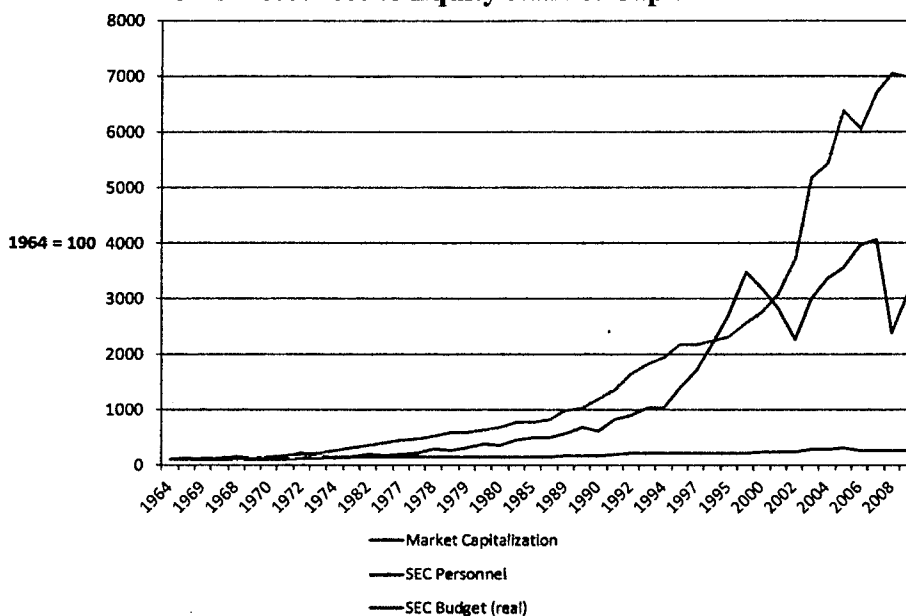
### SEC Budgets Adjusted for Inflation



The slide shows the budgets across time in 2009 dollars. There are three upward bumps: first in the late 1970s after the foreign payments scandal; second in the early 1990s after Drexel and the S&L crisis and some enabling legislation, and third, after Enron. The Enron bump is by far the biggest—the implication is that there’s a break in the historical pattern that justifies a new look at old assumptions. And note another point: fraud on the market defenders assert that public enforcement is politically vulnerable—rely on it and you may wake up with no enforcement at all in a Republican administration. Well, there have been Republican administrations that refused to increase the SEC budget, but none have tried to gut it.

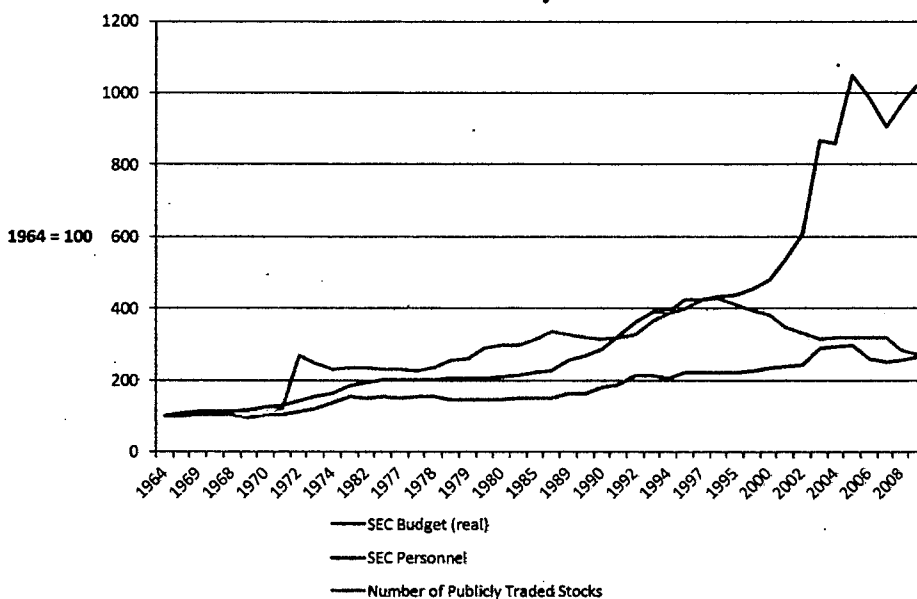
That drama is being reenacted this year. Mary Schapiro wants a 15% post-Dodd-Frank increase, and is having trouble with Congressional Republicans and austerity politics. Barney Frank’s talking as if cuts are on the table, but that’s not the case.

### SEC Resources to Equity Market Capitalization



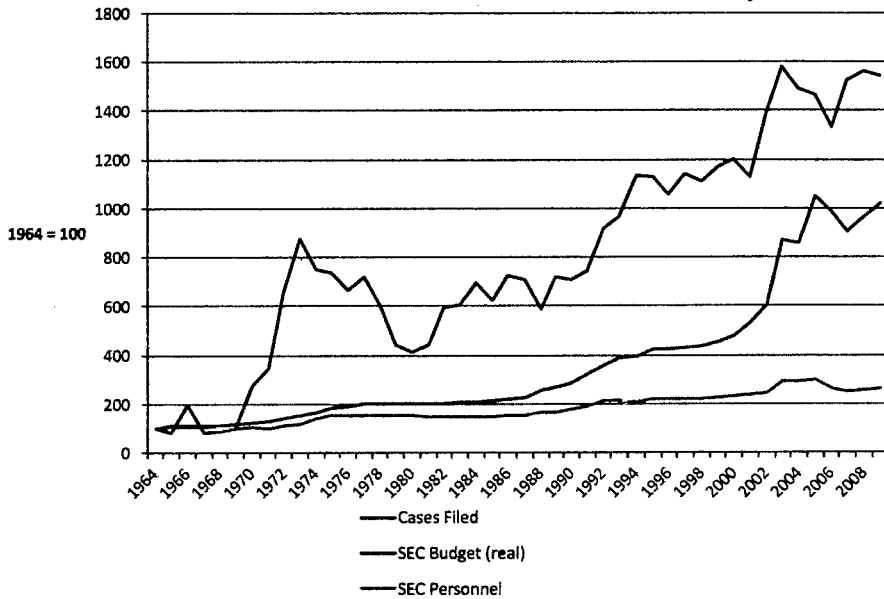
Here's the budget indexed against equity market capitalization, which gives a dramatic picture of the post-Enron bump. But there's also a problem—the personnel line doesn't levitate like the other two. Indeed, personnel numbers have been fingered as the agency's Achilles heel.

### SEC Resources to Publicly Traded Stocks



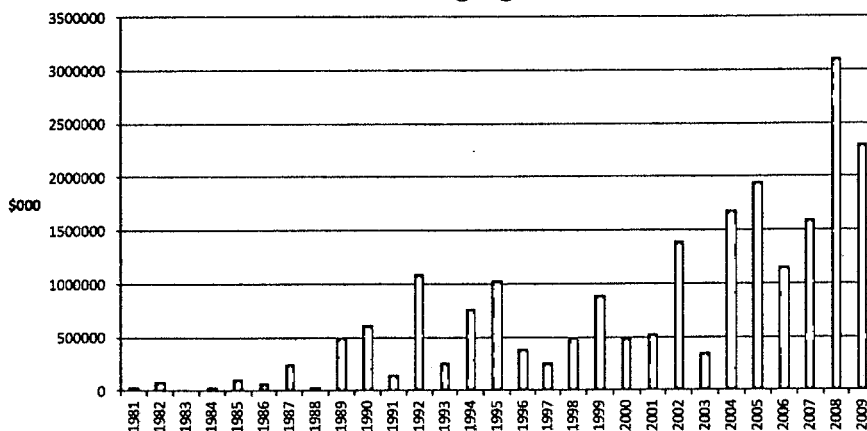
So here's a different picture—the inflation adjusted SEC budget indexed against personnel numbers and numbers of publicly traded stocks. Personnel roughly triple over the decades, with the line of increase roughly tracking the increase in the number of stock issues. The budget outstrips both, but hey, they're presumably paying more to get better people.

### SEC Resources to Enforcement Activity



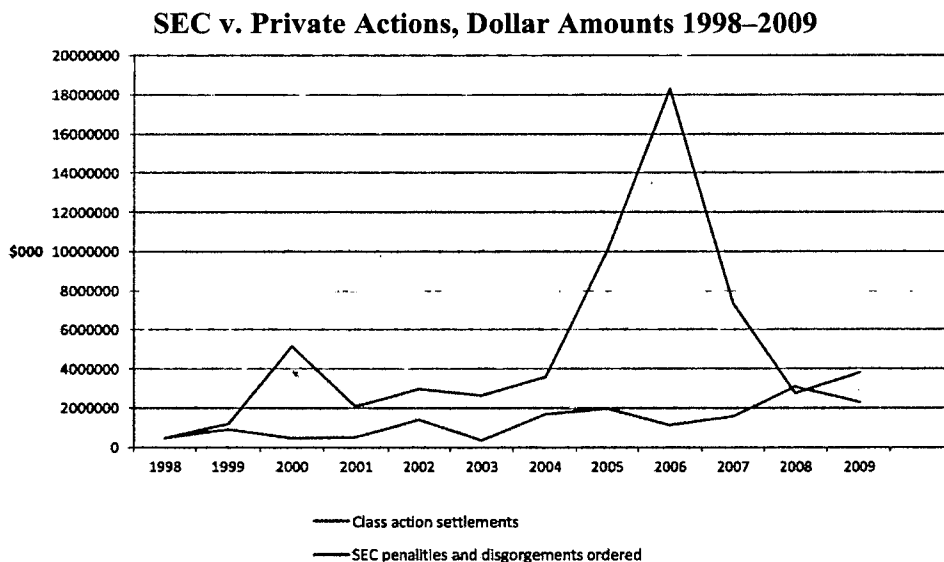
Now for a productivity view, the real budget indexed against the number of enforcement actions filed and numbers of personnel. Here the SEC starts to look good.

### Penalties and Disgorgements Ordered



It also looks good here. This shows amounts of fines and disgorgements ordered in SEC enforcement actions since 1981, when the SEC started reporting these figures. We go from \$30 million in 1981 to \$2.3 billion in 2009. Caveat: prior to 2008, the reported numbers come from judicial orders and are not amounts actually paid. Collection rates are a problem at SEC, stemming largely from the fact that a lot of defendants get into fraud as they grapple with financial distress, emerging as judgment-proof defendants. Private plaintiffs, in contrast, find targets with ability to pay.

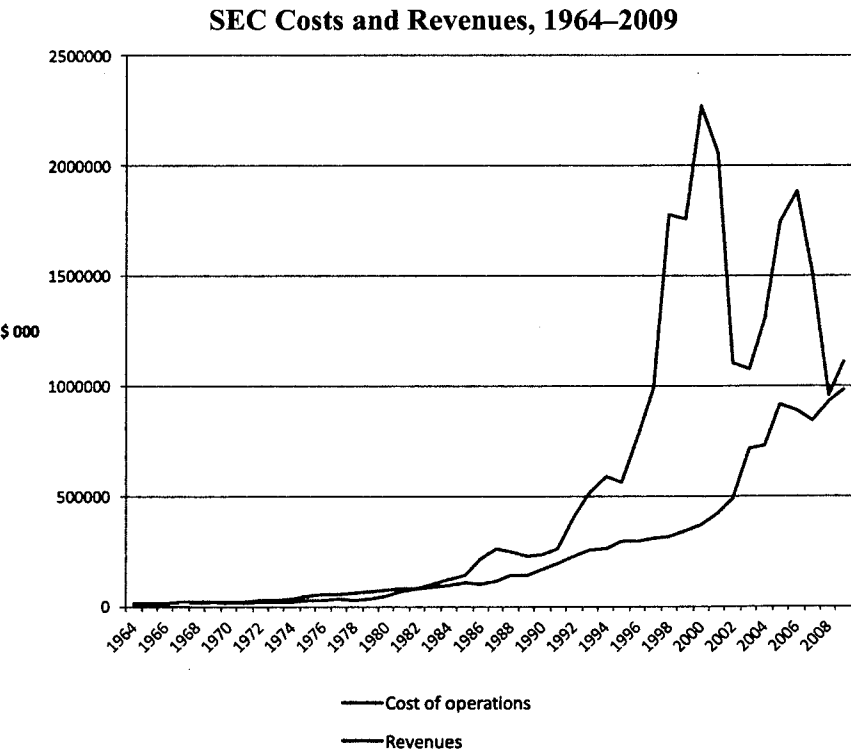
So, overall, today's SEC is real, where it arguably once wasn't.



How does it stack up against the private sector? Here are dollar numbers on litigation proceeds—class action settlements to SEC enforcement proceeds since 1998. The SEC is a lot lower. What should we make of this? My prior was that there would be two lines that never intersected, with the blue, private line always levitating much higher than the red. But the lines intersect at both the start and end dates. The private line levitates spectacularly in 2006, when mega cases like Enron and Worldcom settled. Lop off that outlier and the lines are not far apart. Now consider that private plaintiffs evaluate potential cases based on prospective damage calculations; the SEC presumably looks at the market numbers too, but also at the gravity of the violation. The private sector has financial incentives, the SEC staff's incentives are public service and resume building motivated, but less keenly. The longer I contemplate these numbers, the more plausible I find the SEC.

Here are some roughed out numbers on legal personnel in 2009: Private sector: 753; SEC enforcement: 782. I got the five law firms responsible for 63% of the 2009 settlements, counted the lawyers and grossed up; but the base figure is high—these law firms litigate in other areas. The SEC figure is closer to the truth. Two armies of roughly equal size, subject to a complicating factor. At the SEC, only 20% do trial work. Primary investigation comes first, soaking up 80% of the lawyers—they make up the front line in the war against fraud. The private plaintiffs free ride on their work—one quarter of the private actions are against companies that defended an SEC action, and that quarter shows bigger settlement numbers.

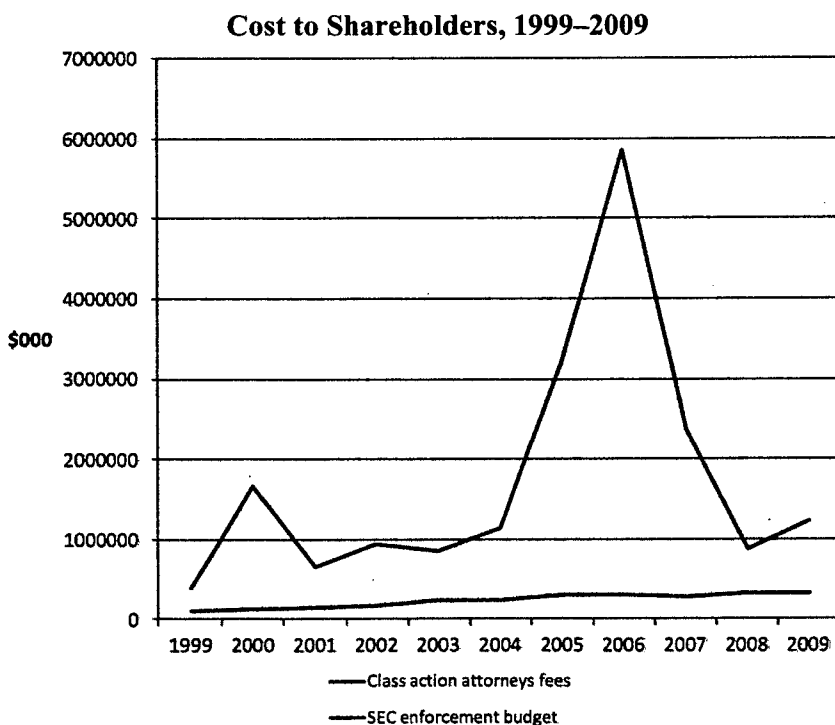
So how does this add up? We are not claiming that today’s SEC makes the private enforcement supplement irrelevant, just that expansion and refocusing at the SEC could more than make up for a reduced deterrent punch in the private sector. So we propose a trade-off; the SEC asks for more money and refocuses, holding out a rulemaking that blocks private actions that use fraud on the market to satisfy the reliance requirement where the issuer is not trading.



One last point. This would not cost the taxpayers a nickel. The shareholders pick up the tab here too. Above are SEC revenues compared to SEC cost of operations since 1964. The revenues come from fees collected when shareholders trade and companies issue new securities. The revenues vastly outstrip the budget for most of recent history, with the excess disappearing into the Treasury. The recent revenue/cost alignment stems from a piece of legislation enacted in 2002, the Fee Relief Act, which was a shareholder protective dictate that lowered the fees to align the inflows and outflows.

For us, the implication is that what has been adjusted down can be adjusted back up. And there's another potential source of enforcement funds—penalty monies. Under Sarbanes-Oxley's "Fair Funds" section, the SEC is to endeavor to return these to shareholders as compensation. And that's what it has been doing. There's an irony here: Congress redirects cash flows into the SEC back out the door to beneficiaries who are indistinguishable from class action plaintiffs. Since most of the fines are paid by companies, this replicates private litigation pocket shifting. The funds, per the consensus view, would be better redirected to focused enforcement.

It's the shareholders' money, one way or the other. Question: where do they get more bang for the buck?



Here is an estimate of the cost to the shareholders of private class actions and SEC enforcement from 1999 to 2009. Class action fees are roughed out at 32% of settlements and SEC enforcement cost at 34% of the budget. The highest multiple is 19 to 1, private to public in 2006, and the lowest 2.8 to 1 in 2008; the average is 7.3 to 1. And there's another way to look at this: The class action attorney's fee numbers imply a damages return of \$2.13 per dollar invested; the SEC enforcement budget returns \$5.80 per dollar invested.

So here's our question: Which makes more sense for the shareholders? Maintain the status quo, or double the SEC enforcement budget and abolish the fraud on the market presumption? I can't offer a definitive answer, but I can say that there's a genuine question, and that up to now, no one's been asking it.

## V. CORPORATE FINANCE

### A. BOND COVENANTS AND CREDITOR PROTECTION: LAW AND ECONOMICS, THEORY AND PRACTICE, SUBSTANCE AND PROCESS

Conference on Efficient Creditor Protection in European Company Law,  
Max Planck Institute for Intellectual Property and Tax Law,  
December 1, 2005

#### Accompanying Article:

William W. Bratton, *Bond Covenants and Creditor Protection: Law and Economics, Theory and Practice, Substance and Process*, 7 EUR. BUS. ORG. L. REV. 39 (2006)

#### INTRODUCTION

I would like to begin by thanking the organizers for asking me to bring a paper about business covenants to this conference. It is an assignment I welcome. There are only three law professors in the US who have demonstrated even the slightest interest in bond contracts—Marcel Kahan, Mitu Gulati, and me. All of us like to write about bonds but we have noted among ourselves that presenting the papers is problematic, because we three are the only ones interested in going to the talk. Writing for this particular conference is doubly nice because one gets this captive, well-informed audience. Anyway, the paper is called *Bond Covenants and Creditor Protection: Law and Economics, Theory and Practice, Substance and Process*, which means that I wasn't really sure on what to focus, so I decided that the safest thing to do was to talk about everything.

#### AGENCY COSTS AND THE FULL SET OF COVENANTS

I will start with the agency costs of debt and the standard full set of covenants.

Lenders take a fixed return, so any action by the borrower that increases the risk of default makes their claims less valuable. Such actions often simultaneously enhance the value of the equity. The incentive to take them increases with leverage and the prospect of financial distress. So, the riskier the debt, the higher the projected agency costs. Lenders in the US protect themselves with covenants phrased in the negative. This drafting practice follows case law providing that a lender who affirmatively controls a borrower has no limited liability from suit by other lenders or equity holders as regards poor business judgments.

We proceed to the categories of agency costs and the standard covenants.

1. *Claim dilution*, defined as any increase in the amount of equal or prior debt claims. For protection, a lender gets, first, a debt covenant, structured around a debt-equity ratio, an interest coverage test, or both. There also will be a lien covenant, which comes either in the form of an outright prohibition subject to negotiated exceptions, or in the form of a negative pledge clause under which the protected loan must be equally secured by any subsequent mortgage or security interest. A sale/leaseback prohibition completes the set. Sale/leasebacks are the unsecured lender's ultimate nightmare—a premises in the borrowing base is sold to a third party with the borrower taking back an operating lease under which it builds up no equity in the property over time even as its business continues to run as if nothing has happened, at least for a while.

Prevention of claim dilution also implies constraints on mergers. If a future acquirer has a more highly levered capital structure, a direct merger implies claim dilution. So a merger will be permitted only if the debt and lien covenants are met as of the closing. Even so, merger covenants never really prevent borrowers from becoming targets. A levered acquirer simply merges the borrower into a clean, shell subsidiary. The covenant is more likely to bite when the borrower is the acquiring firm and its target is highly levered.

2. *Asset withdrawal*. From a lender's point of view, any transfer of capital from the borrower to its equity-holders, whether by dividend, share repurchase, or share redemption, makes the claim less valuable. The standard dividend covenant covers these transactions, limiting payouts from the time of the loan to a set ratio of subsequent earnings, perhaps adding a fixed sum to the permitted pot (referred to as the "DIP") and giving credit for new equity financing.

3. *Underinvestment*. The equity of a levered firm may be viewed as an option to repurchase the firm from the lenders. Under limited liability, the equity has an incentive to invest only to the extent it projects that its option will expire in the money. It follows, on downside scenarios where there is no in-the-money projection, that the firm will pass up positive NPV projects, injuring the lenders and maybe society as a whole.

The problem for the drafter of a covenant concerns investment policy's noncontractible aspect—a firm cannot meaningfully promise to make good investments in the future. Full protection implies control rights, which US lenders cannot reserve. Protection therefore is indirect, with the dividend covenant playing the main role. The borrower with free cash and an incentive to underinvest will want to pay out the cash to its equity, but the dividend covenant blocks the escape. Economists worry that negative net present value (NPV) projects will result from this, but for a lender, there's no problem so long as an investment doesn't result in red ink in the

form of a net cash outflow. In any event, where there's a lender there's always a good use for spare cash—just make a prepayment on the loan.

4. *Asset substitution.* Options become more valuable as the underlying asset becomes more volatile, so the firm, viewed as an option in the equity, has an incentive to discard its present assets and substitute riskier investments, even investments that, viewed as long holdings, have negative NPVs. Investment policy itself being noncontractible, a formal investment covenant serves a limited purpose—it blocks off investment in risky liquid assets like common stocks so as to prevent extreme forms of gambling with the lender's money. Underinvestment is thereby discouraged indirectly. The investment covenant works together with two other covenants to protect against asset substitution—first, a covenant restricting asset sales to a small annual percentage of net assets, and second, a covenant preventing the borrower from changing its line of business. Debt covenants also protect against risky investment by constraining financing.

Note that a sale of all assets is the ultimate asset substitution because the obligor entity emerges owning the consideration for the sale, which could be, say, shares of the acquirer. Protection comes with a covenant that conditions the sale on the acquirer's formal assumption of the debt.

Now, recall that the agency costs of debt are the costs of financial distress. Lenders accordingly may design the covenants to trigger an occasion for renegotiation if the borrower's business starts to deteriorate. Maintenance tests, also called "financial covenants," or "early warning covenants," serve this purpose, establishing minimum levels of net worth, working capital, and interest coverage.

Finally, note that with a full set of covenants and a successful borrower, the covenants, particularly the comfort ratios in the debt and dividend covenants, cause the borrower's equity cushion to grow, making the debt more valuable over time. This reverses the wealth transfer—now the debt benefits at the equity's expense. A borrower thus burdened can be expected to reserve the right to call the loan.

#### EVENT RISK

Event risk is the risk of a wealth transfer from the bondholders to the borrower's equity in connection with a leveraged restructuring. When reviewed historically, it provides an excellent source of instruction about bond contracting practice in the US.

Prior to the 1970s, investment grade bonds contained debt and dividend covenants, along with a negative pledge and a sale/leaseback prohibition—a combination providing minimal but reasonably effective protection. The best-rated borrowers only gave up a debt covenant. Both

the debt and dividend covenants dropped out during the 70s. There were several reasons. More money was chasing top-rated paper, enhancing the borrowers' bargaining power. The give up seemed reasonable, given management's prevailing growth objective and policy of conservative leverage. Bondholding patterns were changing also—as diversified institutions came to dominate the market, exit replaced voice as a protective strategy.

When leveraged restructurings hit in the 1980s, many bonds were defenseless and a lot of value was transferred to exiting stockholders. Almost overnight, event risk sprang up as a new systematic risk of bondholding. The fact pattern, viewed literally, was covered by a good faith duty imposed by contract law. The judiciary nonetheless refused to apply the duty, and not unreasonably. The question was whether bond contracts should be treated as incomplete, and thus open for the implication of terms, or complete, with all risk of opportunism on the bondholder. A normative decision was made to opt for the latter. Eventually, bond contracts were redrafted, not to go back to the standard set of covenants and draft a more elaborate set, but to include a right to put the bonds back to the issuer in the event an actual or threatened control transfer coincided with a rating downgrade. These clauses, called “poison puts,” found their way into 40% of bonds in their early years. But their incidence quickly declined to around 25% as leveraged restructuring activity waned, with most bond buyers opting to take a 25 to 60 basis point reward for taking the risk.

The story presents a nice illustration of the operation of the costly contracting hypothesis of Smith and Warner, which continues to dominate academic thinking about bonds. Under this, an unprotected loan will be priced to compensate the lender for the entire projected agency cost. The borrower accordingly has a high-powered incentive to offer contract protections, trading off its own freedom to borrow, pay dividends, sell assets, and make investments, against its cost of borrowing.

#### INCIDENCE

The costly contracting hypothesis remains robust in the sense that bond contracts trade risk and return, and that the price reflects the trade. But the market does not work quite the way the theory predicts.

**Covenants in bank loans, 1993-2001**  
 (source: Bradley and Roberts (2004) from Dealscan)

<b>Covenant</b>	<b>All Years</b>	<b>1993</b>	<b>2001</b>
<b>Number of early warning covenants</b>	2.52	2.13	2.52
<b>Security</b>	77%	84%	72%
<b>Dividend</b>	85%	82%	81%
<b>Asset sweep</b>	62.5%	32%	94%
<b>Debt sweep</b>	46%	18%	81%
<b>Equity sweep</b>	46%	25%	75%

Above are the Bradley and Roberts figures on a large, recent sample of bank loans with an average duration of 3.5 years. Bank loans, in contrast with bonds, are relational—the lender has a reputational interest in being reasonable about renegotiation. The bank loan market also sweeps in riskier borrowers than does the bond market. It follows that covenant coverage will be relatively thick. Bradley and Roberts confirm this. Substantial protection is the rule, with increasing resort over time to terms called sweeps. With a sweep, a borrowing, asset sale, or new equity offering triggers a duty to prepay a defined percentage of the loan. Even so, contracts lacking in covenant protection do exist in respect of the best credits; 4% of the contracts have none of covered the terms, 8% had only one. Remember, though, that durations are short here.

**Same issuer junk bond and bank loan contracts compared**  
 (source: Gilson and Warner (1998))

	<b>Junk bond</b>	<b>Bank loan</b>
<b>Investment covenant</b>	6%	97%
<b>Asset sale covenant</b>	17%	92%
<b>Debt financing</b> (debt covenant, negative pledge and/or sale/leaseback)	50%	98%
<b>Early warning tests</b>	33%	86%
<b>Dividend covenant</b>	69%	81%

Now let's go to Gilson and Warner and watch a small sample of bank borrowers go to the junk bond market to pay down their loans. One reason they go is to get an easier contract that strips away much of the covenant protection—a much easier contract.

**Public bond issues, 1989 and 1996**  
(source: Nash, Netter, and Poulsen (2003))

	<b>Secured</b>	<b>Junk rating</b>	<b>Senior</b>	<b>Dividend covenant</b>	<b>Debt covenant</b>	
<b>1989</b>	24.1%	40%	66.3%	39.7%	40%	
<b>1996</b>	12.1%	25.4%	86.2%	20.8%	27.4%	

	<b>Negative pledge</b>	<b>Sale/ leaseback</b>	<b>Merger covenant</b>	<b>Poison put</b>	<b>Asset sales</b>
<b>1989</b>	50.1%	11.2%	66.3%	31.6%	12.9%
<b>1996</b>	78.6%	54.8%	89.9%	28.4%	14.3%

Now let's switch over to the bond market and Nash, Netter, and Poulsen's intermediate-sized sample of bonds issued in 1989 and 1996. Dividend and debt covenants tend to appear as a pair in junk rated issues—providing substantial if not full protection, with the much lesser appearance of asset sale clauses signaling that a lot of asset substitution is risk being taken. The negative pledge and sale leaseback clauses tend to appear together in investment grade issues, with the numbers over time signaling movement from bonds without covenants to minimally protected bonds. The increase in the appearance of merger covenants is interesting—here, given the innocuousness of the covenant, the puzzle is why there has not always been something close to 100% coverage.

### Bond issues, 1989-2003

(source: Chava, Kumar, and Warga (2004) from Fixed Income Security Database)

	<b>Dividend covenant</b>	<b>Restricted payments</b>	<b>Debt covenant</b>	<b>Investment covenant</b>	<b>Negative pledge</b>
<b>1980-89</b>	27.2 %	12%	13.4%	5.6%	25.8%
<b>1990-94</b>	19.7%	16.7%	19.1%	5.6%	51.2%
<b>1995-99</b>	4.3%	23.3%	24.4%	2.6%	70.5%
<b>2000-03</b>	1.0%	23.7%	13.9%	1.7%	67.4%

	<b>Sale/lease- back</b>	<b>Merger covenant</b>	<b>Poison put</b>
<b>1980-89</b>	15.4%	67.9%	19.7%
<b>1990-94</b>	32.9%	71.2%	26.1%
<b>1995-99</b>	48.0%	89.7%	46.4%
<b>2000-03</b>	44.7%	91.1%	96.2%

### Dividend covenants by credit rating, 1989-2003

(source: Chava, Kumar, and Warga (2004) from Fixed Income Security Database and Lehman Bros. Bond Database)

	<div style="border: 1px solid black; padding: 2px; display: inline-block;"> <span style="margin-right: 10px;">← Investment grade</span> <span style="margin-left: 10px;">Junk →</span> </div>						
<b>Rating</b>	<b>AAA</b>	<b>AA</b>	<b>A</b>	<b>BAA</b>	<b>BA</b>	<b>B</b>	<b>CAA</b>
<b>Dividend Covenant</b>	5.1%	13.1%	11.7%	9.0%	46.9%	77.7%	80.7%

Here's a comparison set of data from a megasample analyzed by Chava, Kumar, and Warga. It is basically confirmatory of the previous numbers, but the confirmation implies a winding down of the movement toward more protection of investment grade issues. I found two things of interest here: First, note the above breakdown of the appearances of dividend covenants broken down according to credit rating. It is intuitively satisfying in the sense incidence jumps up when you cross the line to junk and rises linearly in junk territory. But questions arise: Why do some investment grade issuers give up the covenant? And why do some junk issuers get away with no covenant?

Now let's go back to the data-in-chief to note an important finding: poison puts are now ubiquitous. This is a big change, a change that seems

to have crept in unnoticed. I infer that the bond market has finally put its foot down, so firmly that marketability is impaired in the covenant's absence. Why the change? The resurgence in going private deals seems an obvious answer. In 1994, private equity buyouts made up 1% of public company acquisitions; by 2003 they made up 27%.

**Covenants in bank loans and issuer characteristics, 1993-2001**  
(source: Bradley and Roberts (2004) from Dealscan)

Number of covenants	Percent of loans in sample	Spread	Market-to-book	Tangible assets	Log (Market cap)	Maturity (months)	Leverage
0	4%	0.43	2.22	36%	45	7.80	24%
1	8%	0.77	1.93	36%	46	6.71	26%
2	13%	1.82	1.83	36%	42	5.36	31%
3	14%	2.10	1.69	33%	44	5.19	36%
4	12%	2.18	1.89	33%	56	5.73	40%
5	19%	2.41	1.69	29%	60	5.36	39%
6	30%	2.69	1.65	30%	63	5.38	42%

Now let's look for a more complete explanation of the overall pattern: Bradley and Roberts, above, test numbers of covenants against a range of variables and get intuitively satisfying results. Log market cap is a firm size proxy, and you get a nice break between big firms with zero or one covenants and the rest of the pack. Spread gives you the interest rate, and it goes up linearly with the number of covenants. Leverage and maturity also go up, less satisfyingly. And tangible assets go down. Generally, the riskier the loan, the more covenants you see. The results on bond market data roughly track these.

This is not quite what the costly contracting hypothesis predicts. Real-world covenants come in predictable clumps as loan risk increases, so that the interest rate goes up rather than down with more covenants. Low-risk borrowers don't seem to surrender covenants in exchange for a rock bottom rate; contrariwise, high-risk borrowers do not seem to get an option to borrow unrestricted in exchange for a higher rate, at least from the banks.

Meanwhile, what most interests the economists in all of this is the underinvestment problem. I think they tend to overdo underinvestment, my sense being that it's an interesting analytical possibility, but that in the real world under separation of ownership and control, management will keep on investing up to the point the firm enters fraudulent conveyance territory. There are in any event two competing predictions: first, growth firms potentially hold out a downside underinvestment problem and so should tend to be made to give up dividend covenants; and second, growth firms will value flexibility highly and thus will resist debt covenants.

**Growth firms**  
**(source, Nash, Netter, and Poulsen (2003))**

	High growth	Low growth
Dividend covenant	11.3%	28.5%
Debt covenant	15.0%	33.3%
Negative pledge	72.5%	62.6%
Sale/leaseback	44.5%	35.7%

Above are the results from Nash, Netter, and Poulsen, who divide their sample into high and low growth segments using market to book as a proxy. The flexibility hypothesis is confirmed; the dividend covenant hypothesis is negated. Bradley and Roberts reach the same result, although they try to squirm out of it, and I hope this is the end of this discussion.

Summing up, the numbers mirror the point that agency costs are the costs of financial distress: covenants linearly follow the probability of distress; good credits preserve their flexibility; bad credits have reduced choices in the matter. At the same time, the market does not hold out a complex menu of risk/return combinations—for example, you can't put together a portfolio of super low-risk, high-grade issues. There are also lots of unexplained anomalies. Why do some investment grade issuers get away with covenant-less bonds and others not? Why do some junk issuers escape a debt or dividend covenant? Why the slow adoption of basic protection against mergers and sales of all assets? Costly contracting may or may not afford answers to these questions.

PROCESS

Some think that bonds should be better protected. I certainly do. But I'm not a bond buyer. And, given price sensitivity, there's no way to pump up my risk-averse reaction to the practice into a full-dress adverse selection argument. Persistent claims of bond contract inefficiency do appear, but they go to process rather than substance. The process problem concerns public bonds only. It has two sides. On the borrower's side lies the cost of getting bondholder consents to waivers and amendments. This has to be done by expensive proxy solicitation. The issuer has to pay for the consents because the bondholders play uncooperatively. This adds to issuer resistance to covenants. On the bondholder's side, there arises the classic collective action problem, much mitigated these days by institutional holdings and the presence of aggressive vulture investors.

Amihud, Garbade, and Kahan suggest that bond contracts be redrafted to invest the trustee with negotiating power over covenant waivers and amendments on the theory that this would ameliorate both problems. The projection is that, given such a super-trustee, the market

would respond with stricter covenants. This is a good idea, but it's not at all clear how large of a zone would be opened up in which issuers trade off lower yields for stricter covenants. Managers may value flexibility more highly than stockholders and forego the opportunity to save the cash; investment bankers aren't incented to negotiate hard terms in the same way as bankers and insurers.

The Amihud, Garbade, and Kahan paper only concerns the waiver and amendment of covenants, avoiding the subject of amendment of payment terms. To go further and ask about payment terms is to step into a decades-long controversy over the drafting of debt contracts, one that flared up in the past couple of years in the sovereign debt area. The controversy concerns the Trust Indenture Act, which mandates unanimous bondholder consent for amendment of payment terms even though it permits covenant amendment by majority vote.

Unanimous consent also has been the universal practice in unregulated debt contracts, so the debate concerns bondholder preferences as well as the statutory mandate. Majoritarians have been arguing for decades that majority-based amendment of payment terms would promote cheaper out-of-bankruptcy restructurings and that the statute is a regrettable piece of New Deal excess. As it happens, the argument to the contrary is one of favorites, so I couldn't resist the temptation to repeat it here.

Unanimous consent provisions prevent amendments because bond issuers never get unanimous consent. There are always hold outs. At the same time, the unanimity requirement can be sidestepped through an exchange offer—a public take-it-or-leave-it offer of new restructured bonds in exchange for the old ones. Hold outs are still a problem—if you keep your old bond when everyone else exchanges theirs, you get 100 cents on the dollar from a healthier, restructured borrower, while everyone else gets less. To contain that problem, the exchange offer sets a supermajority minimum participation. If too many bondholders play chicken and hold out, the offer fails and the borrower slides into bankruptcy, making the whole situation very unstable. With direct amendment by a majority, the whole problem is avoided and we get a composition at lower cost.

I argue that it's not so simple. There's a trade-off here. According to the economists, the more bondholders a borrower has to persuade, the bigger the cut of the surplus it has to offer. So long as holdouts don't kill the deals, and I know of no evidence that they do, the supermajority floor they necessitate benefits bondholders as a group. But I must be getting mellow in old age, because I take the occasion in this paper to suggest that if you extend the super-trustee device to payment modifications and back

it up with majority bondholder ratification, and then amended the Trust Indenture Act to allow this on an opt-in basis, you would get a useful experiment with bondholder preferences respecting the appropriate process for out-of-bankruptcy compositions. Given all of that, I would predict a continuing preference for unanimous consent.

#### CONCLUSION

To conclude. The paper begins by suggesting that covenant practice is worth studying as a way of evaluating positions taken in debates over creditor protection mandates. Unfortunately, the evaluative implications depend on the observer's *ex ante* predilections. If you like contract, you will see a remarkably stable and successful contracting institution—a practice that has suffered only one external shock in a half century (and even then took it in stride), along with the concomitant judicial refusal to intervene to protect the undefended bondholder. The description yields not a single point at which regulatory intervention clearly would improve things—even the process problems are amenable to contractual solution if you just repeal the Trust Indenture Act.

But an observer inclined to be suspicious about the robustness and completeness of contractual creditor protection also will find much of interest. Contract law's assumption of complete contracts is clearly descriptively inaccurate—debt contracts approach completeness only if renegotiation is feasible; the institution of contract works really well here only given small numbers and reputational constraints. That risks and returns are priced out does not mean that substantive allocations are optimal. Agency and transaction costs clearly prevent the evolution of a superior form. Of course, none of this means that regulators should start expanding the Trust Indenture Act.

But there is regulatory implication. When financial markets project high agency costs, they either get contractual protection or they refuse to lend. This implies a function for positive law in contexts less well-suited to high-cost negotiation or to considered rejection of risky borrowers.

## B. THE NEW BOND WORKOUTS

Penn Law Review Symposium, Bankruptcy's New Frontiers,  
October 20, 2017

Accompanying Article:

William W. Bratton & Adam Levitin, *The New Bond Workouts*, 167 U.  
PA. L. REV. 1597 (2018)

COERCIVE AND DISTORTIONARY DEAL-MAKING IN THE ABSENCE OF  
JUDICIAL POLICING

Bond workouts are famously dysfunctional. Exchange offers are the vehicle because direct amendment of payment promises, which in theory holds out a more user-friendly framework, is foreclosed by Trust Indenture Act (TIA) § 316(b). Uncooperative bondholders faced with exchange offers often hold out and attempt to free ride on concessions made by cooperative majorities. Issuers respond in kind with coercive tactics. Exit consents are ubiquitous. Under these, bondholders who accept exchange offers are asked to consent on the way out to amendments that strip the covenants from the indenture, a ploy that attaches a negative consequence to holding out and makes the new bonds on offer more valuable relative to the old bonds. Toward the same end, a second lien can be tacked onto the new bond. And the coercion doesn't stop there. The Williams Act applies only in part to tender offers made by bond issuers. The twenty-day minimum time rule, yes, but neither the all-holders rule nor the highest-consideration rule come with it. There follow consideration differentials, side payments, and vote buying—coercive devices long barred in stockholder tender offers.

Contract law holds out little in the way of tools facilitating judicial policing. There are a couple of reasons for this. First, the territory is sensibly treated as arm's length—neither bondholder holdouts nor coercing issuers labor under a duty of good faith solicitude. Second, even given a fact pattern that begs for policing, there's no conceptual basis to support intervention, because there's no operational principle that separates acceptable from undue coercion or self-interest. Twenty years ago, Zohar Goshen very persuasively set out the incidents of a best available, process context for collective decision-making by investors—a simple majority vote with no side payment or negative ancillary consequences for the voters. But this is an all-or-nothing theoretical construct that offers no help in drawing lines in cases. Meanwhile, we do have a lot of law designed to control coercion against investors, but it tends to be rules-based federal law like the TIA and the Williams Act. In

common law contexts, anti-coercion rules tend to presuppose a fiduciary duty and there is no such duty owed to bondholders, and even then common law constraints are stated in rule-like ways. The one exception is shareholder vote buying, and even that is moving in a narrow, rule-like direction. Judges just don't like intervening here.

As a practical matter, then, there is no judicial policing. Yet fact patterns begging for police presence keep on coming. In 2014, in a case called *Marblegate*, the Southern District of New York intervened on one such fact pattern, invoking a novel interpretation of Trust Indenture Act 316(b). Section 316(b) forbids unconsented impairment of the bondholder's right to payment, as follows: "the right of any holder . . . to receive payment of principal . . . and . . . interest . . . shall not be impaired or affected without the consent of such holder . . . ."

Traditionally, this was read to block unconsented *amendments* of payment terms, preventing indentures subject to the TIA from including collective action clauses or "CACs" that permit payment haircuts by majority vote amendment. Under the traditional reading, the promise to pay in the indenture is the "right," and "impair" or "affect" refer only to amendment or waiver of the promise to pay.

Under the new reading, which was quickly followed in other cases, out-of-court restructurings that detract from a given bond's value can violate the section even though nothing in the bond contract is being amended. That is, "impair" and "affect" can sweep in any unconsented change incident to a restructuring that makes it less likely the bond will be paid. The new reading upended assumptions of bond counsel going back decades—so much so that lawyers from twenty-eight prominent law firms, seeking to facilitate opinion-giving, issued a joint interpretive statement last April.

Under *Marblegate* then, § 316(b) suddenly grew teeth and started biting. In January, a Second Circuit panel reversed, two-to-one, and reinstated the traditional reading in all particulars. Significantly, the Second Circuit opinion looks only to the statutory interpretation question and stays away from the fact patterns, implying no disagreement on the question whether there's a need for policing. As regards the interpretation question, the Second Circuit has much the better of the argument. The Southern District went off one phrase in the 1938 House and Senate reports, concluding that Congress had a one-size-fits-all purpose to force "restructuring" into bankruptcy court. The Second Circuit took a look at the hearings and the massive SEC Report that preceded the TIA's enactment, and found specific backups for the traditional reading—in fact, the drafters intended to cover only the amendment of payment terms.

The Second Circuit's ruling probably ends the matter, putting us back at square one. But the flare up revives an old policy question—whether § 316(b) should be repealed, and if so on what terms.

#### THE POLICY DEBATE OVER § 316(B)

There's a story here. Back in 1987, Mark Roe published a paper advocating repeal, setting out what has ever since been the baseline picture of bond workouts. In this, the TIA's barrier to direct amendment causes instability, for the only way to deal with exchange offer holdouts and calm down the cooperative bondholders is to set the offer up with an ironclad 90% acceptance condition, an overly-high hurdle that dooms many good deals from the start. A bill comes due, said Roe, in the form of unnecessary bankruptcy costs. Meanwhile, the Depression-era concerns that motivated the section's enactment no longer obtained. Finally, because bondholder self-interest and issuer coercion would create problems even in the event of repeal, repeal should be accompanied by an aggressive regime of SEC policing. Victor Brudney responded to Roe back in the early 1990s, arguing that bondholder collective action problems remained salient and contending that the opportunity costs were lower than Roe estimated—many workouts, he said, are bad deals and deserve to fail because the issuer is going into Chapter 11 anyway.

Significantly, both Roe and Brudney worked from the same practice picture, a picture that has been confirmed by a collection of financial economic studies, based, for the most part, on twentieth century data sets. These show that one-half or less of workouts succeed, but also confirm Brudney's skepticism about deal quality, showing that around one-half of the companies that close workouts go on to Chapter 11. In recent years, the theme that workouts are too hard to do got louder when Black and Hu started going on about empty creditors.

When we started up this project, we expected Roe's picture to remain more or less in place. But the more we looked at recent practice, the less prevalent the picture became. The change started with an external shock in 2008, when DIP financing temporarily disappeared, cutting off the path to a quick and smooth Chapter 11 restructuring and refocusing everyone's attention on the out-of-court alternative. Workout activity did not drop back to pre-crisis levels after DIP loans returned, and now accounts for 20% of restructurings today compared with 10% a decade ago. The 20% number is impressive because a workout makes sense only for a subset of distressed companies: a lot of companies have to go straight to 11 because they have tax problems, or need the stay immediately, or they have large numbers of trade creditors, or they need to disaffirm contracts, or they need to give a super-priority lien.

## DEVELOPMENTS IN PRACTICE

We decided to take a closer look and culled data on recent workouts from SEC filings, collecting 46 exchange offers involving haircuts, interest reductions, and/or maturity extensions from 2010 through the middle of 2016. The results stand in contrast with those in the existing studies. We find, depending on how you count, that 82.6% or 87% of the offers closed. Our bankruptcy rate, at 35%, is lower, but still underscores Brudney's point.

Only three of the failed deals meet the classic profile—that is, supermajority support but ultimate failure due to an ironclad 90% subscription threshold erected for the purpose of limiting holdouts. In fact, 90% minimum tender conditions are not even the rule anymore—they showed up in only 40% of the cases. And, issuers waive the high acceptance condition all the time anyway—only 40% of completed offers met the minimum tender. Around a third didn't even state a minimum. Extensions of time occurred in one-half. The picture, then, is loose and flexible and directed toward getting the deal closed.

Our findings break with those of past studies in other respects as well. Exit consents, earlier found to be common, now are ubiquitous—they show up in 82.6% of the deals. In the handful of deals that didn't have them there was either something special about the deal or the deal went on to fail. And issuer pressure doesn't stop there. Coercive upstream second liens were included in 60% of the offers and early tenders got better terms in around half.

Finally, we identified a couple of practice improvements. First, the deals closed quickly—the average duration was .18 of a year, which looks pretty good compared to pre-pac bankruptcy's average duration of .34 of a year. Second, there is tangible evidence of negotiation. 46% of the issuers reported an antecedent support agreement with a bondholder majority. The negotiated proportion of deals probably is higher if you figure that negotiation can occur without resulting in a formal contract. The take-it-or-leave it ad in the paper is gone. Now, it is true that these restructuring support agreements between debtors and groups of creditors have been criticized for failure to synchronize with Chapter 11 policy goals. But in this out-of-court context said to be driven by coordination problems, they seem more like an unalloyed plus.

So, the workout platform is much more robust. This is a big change. We postulate a couple of explanations. First, the shift to secured creditor control inside of Chapter 11 has changed incentives. Managers will be less quick to file and bondholders will be less disposed to hold out and more disposed to cooperate. Second, lawyers now rely on Rule 144A in place of 1933 Act § 3(a)(9) for a registration exemption for the new bonds. This

makes the framework more user-friendly, facilitating the use of banker-advisors as deal makers.

#### RETAIN OR REPEAL?

Add all of this up and go back to the policy case that Roe made thirty years ago, and things look different. While § 316(b) may add some costs, there is no cost emergency. The markets have figured out how to get around it. And, even in the rare case where frictions due to 316(b) cause an otherwise viable workout to fail, the added costs of Chapter 11 have decreased considerably due to prepack bankruptcy practice and creditor control.

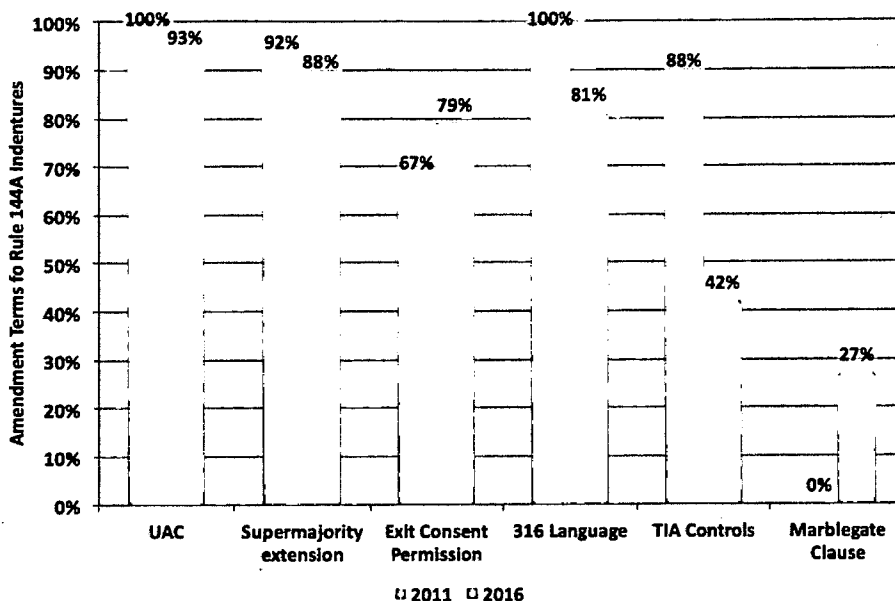
That said, we have a somewhat contradictory follow-up point. Even though § 316(b) no longer creates all that much of a problem, repeal still makes sense. It is hard to see any positive contribution. Brudney's concern with bondholder collective action problems no longer resonates, and there's even been a strange reversal as it regards small investors. Today, given an exchange offer exempted under 144A, non-QIB holders, which means a bond portfolio of less than \$100 million, are entirely excluded from the process—they don't even receive the offer.

The real question is how repeal should be accomplished—whether as Roe suggests, with a heavy continuing SEC policing presence, or as Marcel Kahan has suggested, an outright repeal with future process regulation left to the drafters of trust indentures. The question is whether indenture drafters can be relied upon to provide process rules for the new regime. We think so, but with a caveat, placing ourselves between Roe and Kahan.

We ground our position with an empirical survey of the terms of trust indentures in 144A offerings. We reviewed 49 trust indentures issued in the second quarter of 2011, before *Marblegate*, and 60 from the second quarter of 2016, after the market had a chance to assimilate the decisions' implications. We found the boilerplate doing much more work than we had anticipated.

144A bonds make an interesting test case because they or may not be subject to the TIA. A 144A offering can be made subject to *ex post* registration rights, in which case the indenture needs to be pre-fitted for TIA compliance. If the bond isn't subject to registration, it is 144A for life, and need not be drafted for TIA compatibility. Trading restrictions are becoming less important in the 144A market, and so registration rights are less and less in evidence—67% of our 2011s had them but only 36% of the 2016s.

## 144A Indentures, 2011 and 2016



All of the 2011s, whether or not 144A for life, contained a clause that tracks the language of § 316(b)—which means that the non-TIA bonds were subjected to the individual bondholder consent requirement on a voluntary basis. All of the 2011s also contained belt and suspenders unanimous action voting provisions, which means that if Congress repealed 316(b) tomorrow, thereby pulling the 316(b) language from TIA qualified bonds, nothing would change because all the bonds separately require unanimous action. Any new regime would be entirely prospective and, unless Congress followed Roe’s advice and made repeal contingent on an SEC policing regime, the future would lie in the hands of the drafters.

And, at least in the present context, the drafters like unanimous action. The unanimous voting clauses tend to cover a wider range of subject matter than does 316(b). In 92% of the 2011s and 88% of the 2016s, they go beyond the core payment terms to sweep in guaranties, priority status, conversion rights, even poison puts.

There’s a pattern break with the 2016s. The number of unanimous action indentures drops to 93%, and the number containing a clause that repeats the language of 316(b) drops to 81%. The number containing a clause stating that the TIA controls despite any conflicting term in the indenture drops from 88% to 42%.

Clearly, counsel were drafting out from under *Marblegate* in the 144A for life subset. But only four indentures did this with a CAC. The

rest stuck with unanimous action for core terms but evaded the broad reading by modifying their 316(b) clauses. Instead of the statute's open-ended "right to receive payment shall not be impaired without consent," they substituted "contractual right to sue for payment shall not be amended without consent," or just the "the right to bring suit for payment." One way or another, 23.7% of the 2016 indentures drafted out from under the Southern District.

Finally, a surprise: 67% of the 2011s and 79% of the 2016s also explicitly sanction voting by exit consent, a move nominally at odds with the drafters' preference for unanimous action. We don't think this can be dismissed as issuer-favorable boilerplate. Given pervasive unanimous action clauses, the bondholders quite rationally can prefer simultaneously to leave a door open for coercive exchange offers. And in any event, there's a reason for so doing unrelated to distressed restructuring; most exchange offers are made by healthy issuers as a way of paying down bond issues drafted without an optional prepayment right.

#### BOND CONTRACTING IN THE WAKE OF REPEAL

So what would happen if 316(b) were pulled today? As regards substance, our data provide no basis for making a prediction. Maybe investors just prefer UACs. Or maybe the voluntary UACs are a product of path dependence due to the TIA, and investor preferences would change in an unregulated environment. We have stark evidence of path dependence: 62.5% of the 2011 144A-for-lives and a decreased 18.4% of the 2016 144A-for-lives leave the standard clause stating that the TIA controls even though in fact, the TIA doesn't even apply because the indenture isn't qualified.

Contrariwise, there's no sign of a pent-up demand for CACs, what with only four 2016s indentures going the CAC route despite the *Marblegate* shock. Our projection: were repeal to trigger substantial change in the drafting pattern, the change would occur slowly.

The data do provide a basis for making a more limited prediction. To wit, drafting treatment of process problems in restructuring can be expected to be extensive and responsive to events without being complete.

A drafter in the wake of repeal would have a series of questions to answer. First comes the CAC/UAC choice. Given a CAC, there would be further questions concerning percentages and differentials across subject matters. There also would be a critical question whether to bar exit consents; indeed, whether to bar exchange offers altogether. Arguably, with a 66 2/3% or 75% CAC, exchange offers no longer would serve a legitimate purpose in workout contexts. A prohibition would foreclose a long list of coercive possibilities. There's also a drafting choice to be made

about vote buying, particularly offers of consideration to less than all bondholders. Finally, there are questions concerning bondholder conflicts. Under the present pattern, the contracts repeat the TIA's disqualification of issuer and affiliate votes but go no farther. Going farther, say, to cover empty voting, implicates contractibility problems due to limitations on observability and verification, but there are some strategies available.

All of the questions, except those concerning CAC design, come up in the present context. Yet the indentures address them only intermittently. The most glaring omission concerns selective vote-buying. A lawyer has tipped us off to a provision in circulation that prohibits it, but it didn't show up in our sample. The drafters also could stretch the voting ban on issuer affiliates in 316(a) to cover other taints of self-interest.

And, as we have seen, where there is coverage, it is incomplete across indentures. Why do two-thirds and 80% of the indentures sanction exit consents but not all? Why do only 24% of the indentures explicitly draft out from under *Marblegate*? Why are only 80% of parent guaranties covered by a UAC? Heterogeneous preferences? Or slack? And what do we make of the 39% of the 2016 144A-for-lives that omit the TIA controls clause but include the classic 316 language? Intention to be draft out from under *Marblegate*, or just drafting inattention?

#### CAVEAT

The slack opens up possibilities for abuse. If 316(b) were repealed and the drafters opted for across-the-board CACs without simultaneously barring exit consents, highly coercive exchange offers along the lines of the British *Assenagon* case could and we think *would* follow.

We worry about this, and project that repeal would work best with a change in the background default regime applicable to process matters. For heavy lifting against issuer coercion we would not rely on direct application of contract good faith, which is a dead issue so far as it concerns bond issuers. We instead would proceed by indirection, crossing the aisle to the bondholder side and pre-1939 common law intercreditor duties, a jurisprudence that shriveled after 1939 because its platform disappeared when restructuring activity was diverted into bankruptcy and the fact patterns came to be dealt with under bankruptcy law. The notion is that an actor cannot exercise a power unilaterally to enforce or act in collaboration with the issuer to the detriment of the value of the issue as a whole—it amounts to a situation-specific playing out of something resembling the corporate law majority-minority fiduciary duty. The doctrine has been brought to bear aggressively against highly coercive exit consents in the U.K., and could easily could pick up most of the abuses

showing up in the recent 316(b) cases. But it would just be a default, designed to push issuers and lawyers toward completeness.

## C. A THEORY OF PREFERRED STOCK

Penn Law Institute for Law & Economics Corporate Roundtable,  
December 14, 2012

## Accompanying Article:

William W. Bratton & Michael L. Wachter, *A Theory of Preferred  
Stock*, 161 U. PA. L. REV. 1815 (2013)

## INTRODUCTION

This paper has three motivations. First, its time. The last major paper on preferred *qua* preferred was Dick Buxbaum's synthesis published in the *California Law Review* in 1954. More recent work focuses on venture capital, and as it has accumulated, I've got the sense that someone needs to go back and look at preferred *qua* preferred stock because a lot of problems assayed in the VC literature stem from the *form* of VC participation.

Second, theoretical interest. This is a special case of corporate law's who's in and who's out problem. In the generally-accepted picture, stockholders are in and the rest of the world, including employees, is out. The excluded constituents are treated as contract counterparties and remitted thereto for protective rights. A theoretical story supports the division. The shareholder contract, we are told, is incomplete; shareholders need fiduciary duties to fill the inevitable gaps. Other corporate constituents, we are told, can negotiate into complete contracts. I'll spare you the rest of this familiar account.

Meanwhile, the dividing line between ins and outs is fairly clear until you get to preferred, which is stock with contract rights tacked on. Do we treat it as stock and under corporate law, or as a senior security under contract law? Do we treat it as an incomplete contract filled out by fiduciary duty or as a complete contract with the drafting burden on the party asserting the right? No law review article has ever asked these basic questions.

Maybe that's because people tend to assume one or another answer. Importantly, both assumptions are wrong. Preferred is both—it is both corporate and contractual, neither all one nor all the other. It sits on a fault line between two great private law paradigms and draws on both. The overlap catches up two *grundnorms* and brings them into conflict: (1) managing to the common stock, as residual interest holder, maximizes value, and, (2) holding parties to contractual risk allocations maximizes value. When questions arise concerning the relative rights of preferred and

common, the norms hold out conflicting answers. Decision-makers choose between the two. The law vacillates.

Third, the law of preferred, like a lot else in corporate law, has become more Delaware-centric. Delaware was the venue for 12.7% of reported preferred cases from 1940 to 1950, but since 1980 is the venue for 60% of the cases. And this isn't just a matter of venue. In the olden days, treatments fragmented across the states. In Delaware, since the late 1970s, there has been a growing, self-referential body of precedent that's trying hard to cohere, not just within itself but within Delaware law as a whole. The project of integrating preferred with the rest of Delaware corporate law both inspires innovation and causes stresses and strains.

A trio of recent Delaware cases takes the integration project to new levels of both innovation and stress, and the paper is built around them. There's a merger case, a case about the enforceability of a promise to redeem, and a case where VC preferred in control engineers a sale of the company that wipes out the common. A cross-section of topics.

The cases show two facets of Delaware law coming to bear as the integration proceeds—first, reliance on independent directors for dispute resolution, and, second, the common stock value maximization norm. We think things are going in the wrong direction as a result, making three generalizations. First, the meaning and scope of preferred contract rights should be determined by courts rather than by issuer boards of directors. Second, conflicts between preferred and common should not be decided by reference to a norm of common stock value maximization. Enterprise value should be the referent, more particularly, maximization of the value of the equity as a whole. Third, independent director determinations of conflicts between preferred and common should not be accorded ordinary business judgment review. Instead, a door should be left open for good faith review tailored to the context—a showing of bad faith treatment of the preferred where the integrity of a deal has been undermined, burden of proof on the board.

#### MODULE 1: MERGERS

To create an absolute *contractual* claim against a corporation in exchange for an infusion of \$1 million of capital, all you need to do is to get an authorized officer to take out a piece of paper and write, "The corporation promises to pay you \$1,000,000" and then sign it. There are only two ways to make the claim go away, either get the holder to consent to novation or declare bankruptcy. Preferred works very differently. Its financial rights are embedded in a corporate charter and, during the Depression, the courts decided to allow issuer boards and common stockholders to join together and amend charters to strip preferred contract

rights in cram-down recapitalizations, without the protection of a fairness rule framed in absolute priority terms. This is *corporate* territory, sacrifices are made for the general good, and the ordinary rules of contract consent do not apply.

The charter amendment rights-stripping problem was later ameliorated by statute, but in Delaware persists in mergers. Where a bond stays in a merging company's capital structure untouched by operation of law, preferred can be turned into whatever and how much the negotiating parties determine.

Accordingly, to protect itself in a merger, Delaware preferred needs one of three things in the charter—either a class vote on a merger, a provision deeming a merger to be a liquidation or otherwise fixing a price, or a provision requiring the preferred to be left in place in the issuer's capital structure.

It's not safe to assume that any given issue of preferred has any one of the three. We collected recent certificates of designation from EDGAR. These show that the drafting situation is a lot better than it used to be, but that unprotected preferred still gets issued. The split in public offerings is 50% protected, 50% unprotected; in private placements, the protected portion goes down to 29%.

Assume a class of preferred with a liquidation preference of \$100 and a cash-out merger to a third party. We are on the downside. The preferred's pre-merger going concern value is \$50. The merger involves a premium for the common, which gets \$25, up from \$15 pre-merger.

Let's try three possible outcomes: first, the board is nice and shares the gain with the preferred, paying it \$60; second, the board leaves the preferred where it is and pays it \$50; and third, the board takes the occasion to transfer some wealth to the common and pays the preferred \$40. Let's check in with the paradigmatic alternatives.

The corporate paradigm holds out scrutiny by analogy to majority to minority fiduciary duties to common stockholders. But there are problems. There's no objective calculus that identifies a fair allocation, so the courts scrutinize the *process*. Process scenarios vary depending on number and degree of independent directors, so the standard of review presents a question. And whatever the governance variables, as a process proposition, resolution of a conflict with the preferred is more complicated than resolution of a majority-minority common conflict as regards, say, a parent-sub cash-out merger, because the common-preferred dispute arises even as the issuer simultaneously negotiates with a third party. The usual expedient of an independent director committee doesn't solve the problem—you've already got a committee that's beholden to the common.

So, how about a *second* committee to go in and negotiate for the preferred? Require that and you could mess up the negotiation in chief.

And there's another problem. Look at the case where the preferred comes in and complains that \$60 isn't enough. Nothing in corporate law blocks the claim. But then nothing in corporate law says that preferred has a gain sharing right either, that is, a claim at more than \$50. We conclude that there *shouldn't* be such a right by reference to an upside fact pattern—where the company has done well and the value of the preferred is \$100 or more. Here it gets redeemed out or, if its convertible, its left to convert, and nobody cares if the common takes all the merger gain. It's a senior security and there's a cap, just as there is with a bond.

So, fiduciary review based on an analogy to the common is messy.

Now let's try the contract paradigm. This means modeling the contract as complete and putting the drafting burden on the party asserting the right, including the right to receive the pre-merger \$50. Take the \$40 rip off fact pattern and this leaves a bad taste. But a hands-off approach is still plausible if you add appraisal as a possibility, which gives the preferred a chance to get back to the \$50 it started with. Unfortunately, appraisal doesn't hold out a complete backstop because it's not always available.

To get a better sense of the exploitative possibilities, all you have to do is set up a dummy merger. It's easy and it's fun. There's no third-party acquirer. The preferred issuer drops a wholly owned subsidiary and then merges into it. The surviving company emerges with an all common capital structure. The preferred is converted into common at a ratio set by the issuer. To make the deal particularly nasty, let's do the merger only two weeks after the preferred is originally issued for \$100 and hand it \$50. If the common paid in the merger is publicly traded, the preferred have no appraisal rights and no remedy at all without some kind of fiduciary scrutiny.

You can still argue that the preferred could and should have drafted to prevent this from happening, but it's still complicated.

A preferred class vote requirement solves the problem but runs the risk of a hold up of the common on a downside fact pattern like this one. In our case, the preferred refuses to vote in favor of the merger unless it gets *more* than \$60, more particularly, anything up to the take out of \$100 such that the common still votes to approve the merger. A merger as liquidation provision creates exactly the same problem. A promise to leave the preferred in place also can get in the way of progress—if the acquirer is a bigger company that can get better terms, it will want to take the preferred out. The preferred will say fine, do so, for the \$100 take out price previously agreed on.

Leaving protective terms out, then, gives the issuer board useful elbow room when negotiating downside mergers.

Let's go to Chancellor Strine's opinion in *LC Master Capital Fund v. James*. Facts: Nonvoting convertible preferred, issued at \$25, with conversion value at \$18 at the time of issue. It has no class vote in a merger. The issuer's value deteriorates and it's looking to merge at \$8 for the common. The preferred's conversion value is now \$13. The acquirer refuses to leave the preferred in the capital structure. An independent director committee gets stuck between the preferred and common, all of which is owned by hedge funds or private equity firms. No second special committee is appointed to negotiate for the preferred. The single committee eventually fixes the conversion value of \$13 as the preferred payout. And the preferred sue.

Delaware law holds out a cluster of applicable principles:

1. Fiduciary law may protect preferred in a merger where the preferred is in an exposed and vulnerable position vis-à-vis the board. It is conceivable that the duty implies formation of a special committee to protect the preferred, but there's no per se requirement.

2. Directors owe fiduciary duties to the preferred where the right claimed is not a preference, but a right shared equally with the common. Take a close look at this. It sounds good—a nice corporate/contract split—but what does it mean? If say, in our hypothetical, where the common gets \$25, does the preferred have a claim only if it gets less than \$25, which is arguably the equity core? That's probably not what this principle means, but it doesn't prove very helpful.

3. Generally it is the duty of the board, when discretionary judgment is to be exercised, to prefer the interests of the common. Corollary: it is conceivable that a board of directors could breach a duty to the common by improperly favoring the preferred in making an allocation.

4. There's a preference for preferred to seek appraisal.

5. Preferred should protect itself contractually.

There then are the tools in the doctrinal box. Scan them, and there's internal tension—all of the alternative but contradictory treatments are in there. This is our theory of preferred in action—principles come to bear from both paradigms. If you juxtapose them and ask for ordinary coherence, you will be confused and disappointed. It's a collection of either/or's.

The judge is left to decide whether or not to protect the preferred on the facts. In *James*, Chancellor Strine chose not to do so, on the ground that the charter provided that in the event of a merger the preferred had right to conversion value only, the \$13 that it got. We don't read the charter in question that way, but no matter. The message is clear enough—there's

a preference for contract treatment because corporate treatment implies process overkill.

We ask whether the either/or poses too stark a choice—fairness and overkill versus no scrutiny at all. The paper suggests that the either/or could be patched over by displacing intrinsic fairness with good faith scrutiny, burden of proof on the board. We not only *want* independent directors to do the job here, we want them to know that there's a possibility of judicial second guessing. In addition, common stock value maximization needs to be taken out of this doctrinal toolbox. It is analytically unsuitable. Taken together with the equity core notion, it means paying \$25 in the hypothetical. In any event, the norm can be stated more narrowly: The preferred has no right to share in merger gain.

#### MODULE 2: THE PROMISE TO PAY

Now to the second opinion, from Vice Chancellor Laster in *SV Investment Partners v. ThoughtWorks*. The case is about preferred drafted to work like a bond—an issue with a promise to pay, mandatory dividends, and a set redemption date.

Strange things happen on this fact pattern. The corporate paradigm comes to bear to make the promise to pay intrinsically conditional—payment on the promise may not traverse the legal capital rules, may not amount to a fraudulent conveyance, and may not otherwise impair creditor interests. No lawyer will opine on this promise unless it is qualified by the phrase, “out of funds legally available.” Unfortunately, exactly what that means isn't too clear, and the cases are old. But one point does emerge. You don't see a class of preferred getting a judgment and thereby bootstrapping itself to secured creditor status. The best it gets is a court ordered payment plan.

The preferred in *ThoughtWorks* is held by a venture capitalist trying to secure a large past due redemption payment. Vice-Chancellor Laster takes the occasion to do a top to bottom restatement of the law. “Funds legally available” now works as follows. First, the issuer has to have the ready cash *in the drawer* and no assets may be liquidated to pay off preferred until all of the company's debts have been paid. Second, preferred making a claim that there *is* cash available has to prove that the board is in bad faith; that the calculation of inability to pay is constructive fraud. Restating, so long as the board has any other use for the money, it doesn't have to pay.

We don't like this, but we can't blame the Vice Chancellor for formulating it. The old test tried to finesse the corporate/contract overlap by asking the court to determine whether the issuer had the ability to pay without impairing creditor interests. That's ultimately a business

judgment, and the law-to-fact determination draws a diligent enforcing court deep into the company's finances, potentially on an ongoing basis. Delaware courts don't do that anymore, if they ever did. *ThoughtWorks* avoids this by pushing the payment problem off of the overlap and deep into corporate territory—the question isn't whether they can pay, but whether the board did an adequate job in justifying nonpayment; a restatement of the old test for the modern corporate law context.

The problem is that, read literally, the restatement rubs the promise out of the contract. So we do a thought experiment. If clarity here lies in pushing the promise away from the overlap and into a paradigm, would not the problem be better solved by pushing the promise onto the contract side?

Once you do this, you see that a money judgment doesn't mean dismantling the going concern. The "funds legally available" test predates the Bankruptcy Act of 1938 as well as the modern business judgment rule. Give the preferred a judgment, and the issuer files under Chapter 11 before the preferred levies execution. It follows that the preferred can't bootstrap itself to secured creditor status. And it's entirely possible the preferred doesn't want the issuer in Chapter 11. In that case, either the parties successfully negotiate a for real payment schedule, or there's a control transfer. Nothing messy comes to the door of the Chancery Court.

There's also a policy reason for going in the contract direction—mandatory redemption preferred is integral to the VC business model and in economic models of VC relationships, potential separation of the entrepreneur from the technology is a core efficiency property.

### MODULE 3: VENTURE CAPITAL, PREFERRED IN CONTROL

Now to the last topic, VC preferred in control and Chancellor Chandler's opinion in *In re Trados*, which is finding its way into the casebooks.

Trados is a tech company with five successive rounds of VC financing, with the VC's designees controlling the board in tandem with the CEO and the number 2. Liquidation value is payable to the preferred in event of merger, and it comes to \$57.9 million.

The VCs get antsy and want to liquidate their investments. They turn down a \$40 million offer for the company and bring in a new CEO to clean the company up for sale and set up an incentive plan under which top execs get a slice of merger proceeds. After a year, they sell the company for \$60 million, of which \$7.8 million goes to the execs under the incentive plan. The preferred take the rest, less than liquidation preference, and the common are wiped out.

The common get by motion to dismiss on a simple theory: the merger was approved by a majority of interested directors, therefore intrinsic fairness applies, and the merger was unfair because there might have been some money for the common had the preferred waited longer.

This is the Delaware integration project at work again. Here we have a conflict of interest between a control group and a common stock minority. Historically, such conflicts have been addressed at the shareholder level; the question was whether the majority was self-dealing, and self-dealing meant effecting an unequal outcome to the detriment of the minority. If there was self-dealing, intrinsic fairness scrutiny followed. Now, we skip that and go right into the boardroom, where we expect independent directors to be taking care of things and base a breach of duty on the designees' interestedness.

We think the old approach was more difficult in application but better tailored to the situation. But there's a "who cares" question. Can't the VC in control just incur the expense of a majority independent board so that we safely can assume that all will be well in the next case?

Unfortunately, it's more complicated than that.

*Trados* applies a norm of common stock maximization as it evaluates the board and in so doing chills advantageous deals.

Compare two hypotheticals:

1. Same as the case, except that the VC liquidation preference is \$40,000,000. There's a \$40,000,000 offer. The value of the company is a function of the following projections:

Turnaround \$60 M x .75 = 45

Disaster \$30 M x .25 = 7.5

\$52.5 M = expected value of the company if sale is delayed. Here the VC acts out the classic scenario of a senior securityholder with an incentive impairment. It is fully paid at \$40 million and so has every incentive to sell at a sacrifice of upside value.

2. Now compare a case where the offer is \$60 million and liquidation preference is \$57.9 million. Here is the value breakdown:

Higher offer \$70 M x .25 = 17.5

Turn down \$50 M x .75 = 37.5

\$55 M = expected value given delay.

Here, in a replay of *Credit Lyonnaise*, a board pursuing common stock maximization and refusing the \$60 million sacrifices \$5 million of enterprise value in exchange for a chance for the common to realize \$750,000, net of the incentive payoff to the execs.

*Trados* creates a problem for an independent director in the second hypothetical because it privileges common stock maximization. There follow litigation hold-up opportunities for underwater common,

opportunities which become more salient as the pre-VC angel investment sector gets larger.

To ameliorate the problem, enterprise value needs to be substituted for common stock value as the maximand.

But wait, can't we, the VC, contract out of this in advance? Answer, not after this opinion. Historically, where the VC wants to line up advance common stockholder consent to a merger, the lawyer drafts a shareholders' agreement that binds the common to vote in favor of support the VC's deal. It's called a drag-along. Unfortunately, *Trados* denudes drag-along rights of preclusive effectiveness when it restates what used to be a shareholder-level problem as a director to corporation duty-of-loyalty problem.

Now, back to the first hypothetical, the \$40 million deal. Interestingly, Doug Baird and Todd Henderson, anticipating *Trados*, argued that this deal shouldn't be actionable either, because the common accepted the risk of it when it transferred control to the VC. They argue that a waiver of the fiduciary claim is bound up in the VC financing, or in our paper's terms, that the corporate paradigm should be completely suppressed.

*Trados* cuts off any such waiver by moving the matter to the director level. Putting that to one side, we're in sympathy with Baird and Henderson, but are unable to go along with their per se approach. Waivers should be express not implied, so we want to see the waiver on a piece of paper signed by the given shareholder. If you take out the NVCA standard drag-along form you *can* find a waiver buried in there. Maybe buried a little too deeply, but I'd enjoy arguing the case.

More generally, the fact pattern calls for a considered accommodation between the corporate and contract paradigms. *Trados* shows that foursquare corporate treatment facilitates hold ups by underwater common and destabilizes heavily negotiated transactions. Control having been given up at arm's length, interested director approval should not by itself trigger intrinsic fairness review. At the same time, absent a drag-along, it is not clear that the common in a VC-controlled investee has bargained away its right to complain of a sacrifice of enterprise value.

So we recommend that common stock complaints alleging such sacrifices be entertained, but would substitute good faith for intrinsic fairness as the standard of review, burden of proof on the board, and there's precedent for that in Bill Allen's *Orban v. Field* opinion.

## CONCLUSION

The trio of cases makes promises to preferred harder to enforce, fiduciary protection in situations of vulnerability harder to get, and bargained for control rights less effective. Always plagued by ambiguity, preferred stock emerges more problematic than ever. But then conceptual instability is inevitable given paradigmatic overlap. You can push in one or the other direction but in the long run, preferred stock always reverts to the overlap. It is structurally unavoidable.

The overlap brings two *grundnorms* into conflict—(1) managing to the common stock, as residual interest holder, maximizes value, and (2) holding parties to contractual risk allocations maximizes value. Delaware makes the former a trump, while Baird and Henderson would make the latter a trump. We would do neither, but tend to think the balance presently weighs too heavily in favor of the corporate norm. More generally, we find enterprise value the more reliable maximand because it holds room to accommodate transactional results, and by one or another doctrinal move, would scrutinize minimally, but do so across the board.

D. SPECIAL PURPOSE ENTITIES AND SCANDALS FROM DREXEL TO  
ENRON TO GOLDMAN SACHS

Roundtable, Faculty of Law, London School of Economics,  
February 28, 2013

Accompanying Article:

William W. Bratton & Adam Levitin, *A Transactional Genealogy of  
Scandal from Milken to Enron to Goldman Sachs*, 86 SO. CAL. L. REV.  
783 (2013), reprinted in 56 CORPORATE PRACTICE  
COMMENTATOR 251 (2014)

INTRODUCTION

This paper tells a story, a story that has for me been an exercise in self-education in the telling. Restating, this paper has provided me an excuse and an incentive to figure out highly technical stuff that had always been murky to me. The paper succeeds as a story if the reader comes away feeling that he or she now has a handle on the selfsame highly technical, previously murky stuff. If the reader doesn't come away with that feeling, the paper fails, and is just an excuse to pick up some SSRN downloads with a come-on title.

Here's the story of this backstory. Back in 2009, I read through a stack of books on the financial crisis. One of them was *Fools Gold*, by Gillian Tett, a journalist's account of the creation of the first "Bistro" financing at JP Morgan in 1999. As it turned out, the book really didn't have much to do with the financial crisis. But I was taken with the book because everything in it devolved on a report on the terms of a single deal and when the book got down to explaining that deal, I just couldn't follow it. I read the section multiple times but still didn't understand and came away with the impression that the author didn't quite understand either.

In early 2010, I heard a gripping report on National Public Radio about an outfit called Magnetar, which was allegedly selling securitized paper to suckers and then secretly betting short against them. Then the Goldman Sachs Abacus securitization scandal hit the papers, with the central character, Fabrice "Fab" Tourre, soon testifying under the lights in a Senate committee room.

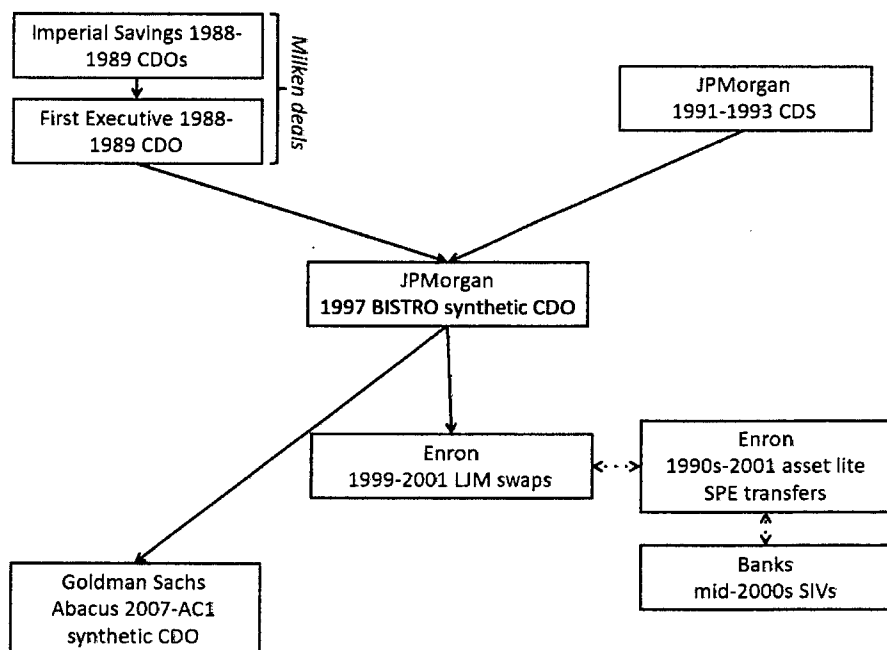
A lightbulb went on at that point. I'd seen the structure they were talking about on NPR and in the press as it reported on Goldman somewhere before. It was the Bistro deal described in the Tett book. I picked up *Fool's Gold* again, and was frustrated to find that I still couldn't quite get the hang of the deal. So I researched the Bistro structure until I finally did. As I went about that exercise another bulb lit—the Bistro

structure was about swapping with your own Special Purpose Entity (SPE), and that was what Enron had done. Bistro was the parent transaction of not only Abacus, but one set of transactions at the heart of Enron's collapse. The other main set of transactions implicated in Enron's downfall turned out to be predecessors to the bank SIVs.

A dotted pattern was emerging. I decided to fill in the dots in a paper. After talking about it with Adam Levitin, I came away persuaded that bank Structured Investment Vehicles (SIVs) also were a part of the pattern. We weren't sure exactly what part was going to be, but certainly were connections to be explored.

I wrote up the Bistro parts of the paper and sent it to Adam to fill in the SIVs. The project grew at that point. Adam decided that he wanted to trace the dodgy SPE transaction structures back to Michael Milken at Drexel Burnham in the late 1980s. The written record was sketchy, so Adam tracked leads and talked to people who were there in the day. The final pattern that emerged is depicted below.

### The Pattern



The story became the long one that's on the table and I'm not sure it quite coheres. But it's my story and I'm sticking with it.

### THREE OBSERVATIONS ABOUT SPECIAL PURPOSE ENTITIES

The tie that binds the variegated topics treated is the Special Purpose Entity—the paradigm smashing shell entity that companies use to get or keep assets and liabilities off of their balance sheets or to arbitrage regulatory capital requirements. SPEs sprang up in practice during the 1980s, descendants of project finance structures invented during the 1960s and 1970s. They proliferated without becoming well-understood. No one outside of banks, big law firms and the higher rungs of the accounting profession had any idea what they were. It took Enron to give them policy salience. I wrote about Enron and monitored the regulatory responses thereto and came away with the notion that some law reform had occurred regarding SPEs. I was not, however, quite sure exactly what the reform said or did. I would find out in 2007 when the bank SIVs became insolvent that the problems had not really been solved. It became clear to me that just as the system had failed so had I: sitting on my legal academic perch I *still* didn't understand how companies had been doing what they were doing with SPEs without somebody in authority having blown the whistle on them. It all remained opaque and confusing. What was needed was a descriptive theory with heuristic value but no one was articulating it.

Toward the end of illuminating this dark corner of corporate finance, we make three broad points about SPEs in this paper.

*First:* SPEs are the apotheosis of the nexus of contracts theory of the firm; they are as such entities that occupy a high evolutionary plateau. This is because they are nexuses of complete contracts that perform all the functions of a firm. With an SPE, every function the firm performs can be determined in *ex ante* documentation; there need be no troublesome contracting gaps that require filling in *ex post* by reference to governance structures or fiduciary law. Indeed, with an SPE the firm doesn't even need agents, just contract counterparties. It follows that SPEs are very complicated contractual nexuses and so lack accessibility: only the most sophisticated actors can get anywhere near them. Finally, and importantly, from the point of view of economic theory, none of this is necessarily a problem. Indeed, because SPEs are entirely contractual, they are presumptively productive when viewed through an economic lens. Nor, from this point of view, does the fact that evasion of existing regulatory constraints figures prominently in the motivational profile of SPEs become problematic, at least prior to 2008.

*Second:* SPEs create regulatory problems because people tend to look at them as a variant on the conventional operating company and as a result

come to misunderstand them. There are a number of basic expectations about firms and how they work—one expects, for example, a capital structure that has debt and equity; that the equity holders are essential governance players on the inside of the firm; that lenders and other contract counterparties are outside of the firm's system of governance rights and duties; and that salient and control relationships and affiliations result from cross-ownership of equity securities. To understand an SPE, you have to drop those basic assumptions and start over when you take out the governing contracts and try to figure out who's in, who's out, and who's responsible and get a handle on the risk-return relationships effected by the contracts. A ground-up rethinking is proceeding, but not in academia or at the Fed or the SEC. The salient intellect is the Financial Accounting Standards Board.

*Third:* SPEs are intrinsically suspicious. The suspicions arise partly from information asymmetries—SPEs are complicated, understood only by a handful of industry insiders. Suspicions also arise from SPEs' motivation—they are used for regulatory arbitrage. There is also a suspicious conflict of interest bound up in SPE transaction structures. An SPE is brought into existence by a "sponsor" to be an arm's length contract counterparty with the sponsor, a contract counterparty the sponsor meaningfully controls by designing the contracts that govern it. This element of control is later disregarded when the entity is organized, deployed as a holder of assets, and treated for legal purposes as a wholly independent entity. The SPE sponsor is treated neither as a parent company, a sibling company, a control party, nor an alter ego. It is a denominated "sponsor" and despite the closeness of its relationship with the entity is treated as an unrelated, arm's length contract counterparty. This is business law's ultimate triumph of form over substance.

The suspicions have been fully justified in history. During the many years in which SPEs were largely unregulated and treated as entities separate from their sponsors, they created occasions for companies to get away with things. Their tendency to show up in the middle of financial scandals is not only unsurprising, it follows from their very nature.

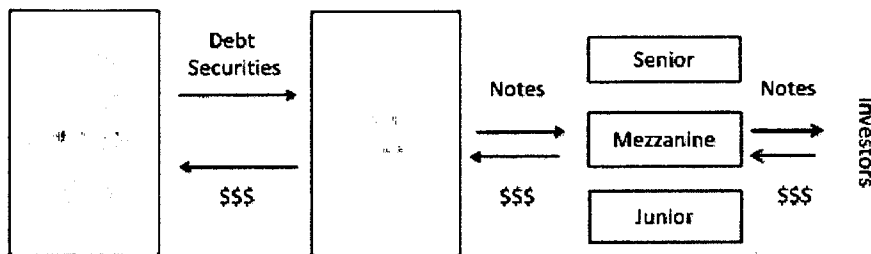
#### MYTHIC ORIGINS

Now to the story.

Return with me now to those heroic days of finance capitalism, the 1980s, when Michael Milken sat at the X-shaped trading desk at the Drexel Burnham office in Beverly Hills and built a junk bond empire. Regulations were inhibiting the junk bond market's growth. Legal investment laws kept pension funds out of the market entirely and restricted the proportions

of junk bonds permissible in savings and loan and insurance company portfolios.

### Basic Securitization



If the debt security is  
 mortgages = CMO  
 bonds = CBO  
 loans = CLO  
 CMOs = CDO  
 We use "CDO" as a generic term

Meanwhile, Fannie Mae and Freddie Mac had learned how to securitize residential mortgages. As I am sure you know, in this sort of transaction, a bank transfers a fistful of mortgages to an SPE which it itself creates, and causes the SPE to raise the money to buy the mortgages by selling notes in the public credit markets. The division of SPE-issued notes into senior and junior tranches vastly elevates the transaction form's utility, because tranching much lowers the cost of money to the SPE. Tranching of SPE-issued notes began in earnest in 1986, when a Revenue Ruling permitted the sponsor to retain a junior tranche amounting to 10% of the notes issued.

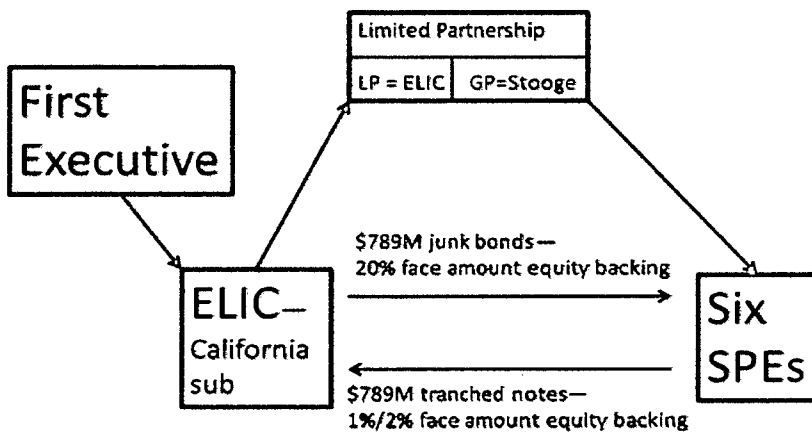
It was a moment begging for financial innovation. Why did the debt securities in the SPE necessarily have to be home mortgages? Couldn't the structure be used to move junk bonds out of the portfolios of Drexel clients, importing added liquidity to the market?

The answer was yes, and one of Drexel's big S&L customers, Imperial Savings, floated the first collateralized debt obligations in 1987 and 1988, the first deal to use tranches to bootstrap the junk bonds' credit ratings. The senior over junior structure of the SPE's notes resulted in an investment grade credit rating for the senior tranche, thus avoiding preclusive application of legal investment laws and expanding the class of potential institutional buyers of junk bonds.

But the handwriting was otherwise on the wall for junk bonds by 1988. The market was softening, poised for complete collapse in mid-1989.

The market's deterioration caused problems for Milken's biggest client, Fred Carr and his First Executive Life Insurance Company. Under the applicable capital rules, junk bonds required the backing of equity capital on the right side of the balance sheet at 20% of face value. With higher ratings, you could get the requirement reduced to 2% or 1%. Carr, with the value of his junk portfolio sinking fast, had to scare up some new equity capital fast, or in the alternative, find some way to get his junk bonds from the 20% category to the 1% category.

### First Executive SPEs



So here's what he did: he set up a limited partnership, taking back the limited partnership interests and putting a trusted stooge in as the general partner. The LP then formed six SPEs. The SPEs took \$789 million of junk bonds out of Carr's portfolio and sent back new notes in the same face amount. What was the point? Well, this positioned First Executive to claim that due to the tranching, the notes coming back in the swap are more creditworthy, lowering the applicable capital requirements.

The Imperial Savings deals had received good press. But this time there was blowback. The California State Insurance commissioner sat on the First Executive deal for a year and finally said no. But it turned out that it didn't matter, for by then first Executive was insolvent anyway.

But what a sham it had been! At no juncture in the above-depicted transaction structure was there the slightest hint of economic substance: create an alter ego, and swap your low-rated debt to it in exchange for

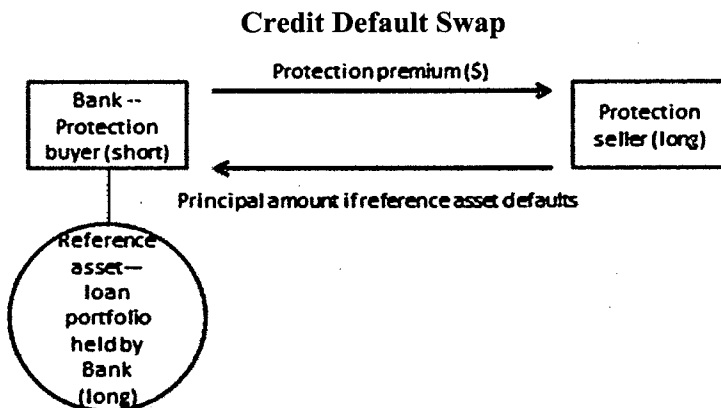
high-rated debt, and presto, your regulatory capital burden decreases by \$100 million.

### THE FULCRUM—BISTRO

Now let's fast forward to 1997, the year JP Morgan created Bistro and managed to succeed where Fred Carr had failed—swapping with its own SPE and getting regulatory capital relief into the bargain.

Hypothesize a big bank in 1997. It's got a large portfolio of corporate loans and has relationships with its corporate borrowers. Under the Basel rules, it must support these loans with equity capital at 8% of principal amount. That's expensive and the bank would like to reduce the burden. But how?

The bank is already securitizing its residential mortgages but that won't work here for two reasons. First, interest rates; the bank can finance its corporate loan portfolio very cheaply with debt of its own, and its corporate borrowers are good credits that pay low rates accordingly. So here, there's no cost of money advantage stemming from an SPE transfer. Second, the powerful people in the corporate loan department warn that the true sale will disrupt confidential relationships with the borrowers, who will have to be notified of the transfer.



Alternatively, the bank could enter into credit default swaps respecting particular loans with financial counterparties. The counterparties promise to pay the principal amount of a loan in the event of a default, in exchange for periodic payments by the bank of what amounts to an insurance premium. This shifts the default risk to the swap counterparty and works better than securitization. There will be no transfer of the loan, which remains on the bank's balance sheet, and the borrower needn't be notified. And, if the bank can find another creditworthy bank

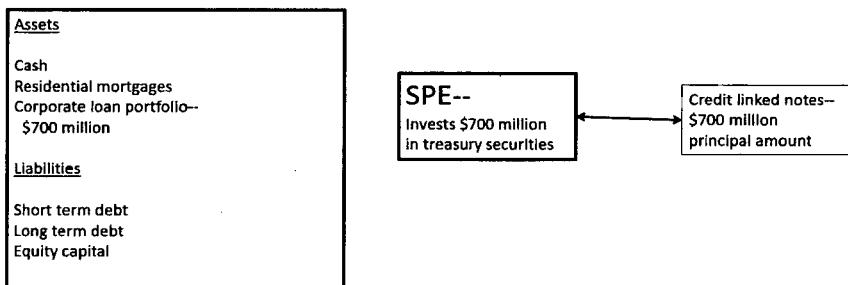
to be the swap counterparty, the Federal Reserve will allow it to reduce the equity capital support level from 8% to 1.6%.

But there are still some sticking points. To swap only with other banks is to limit the set of potential counterparties. Worse, a counterparty taking the risk of a single loan may want to due diligence the borrower, and the bank's confidentiality agreement will get in the way.

So, the bank wants two things. It wants to shift the risk of a whole portfolio of loans all at once, just as it does when it securitizes mortgages, and not go one by one. This lets it take advantage of loan portfolio diversification. But it also wants to do so via a credit default swap that's open to the entire credit market, not just other banks, and get capital relief to boot. But how?

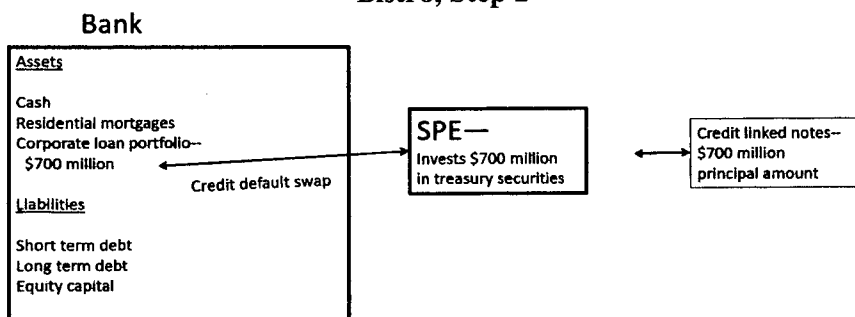
### Broad Index Secured Trust Offering (Bistro), Step 1

#### Bank



Why, with Bistro, a structure that combines the benefits of securitization with those of credit default swaps through the device of something called a "credit linked note."

Let's take a loan portfolio with a principal amount of \$700 million. The bank sets up an SPE. The SPE sells \$700 million of credit linked notes. The proceeds go into the SPE, which invests the \$700 million in treasury securities. Holding the money in the SPE is okay, because this time the SPE isn't going to be buying the loans from the bank.

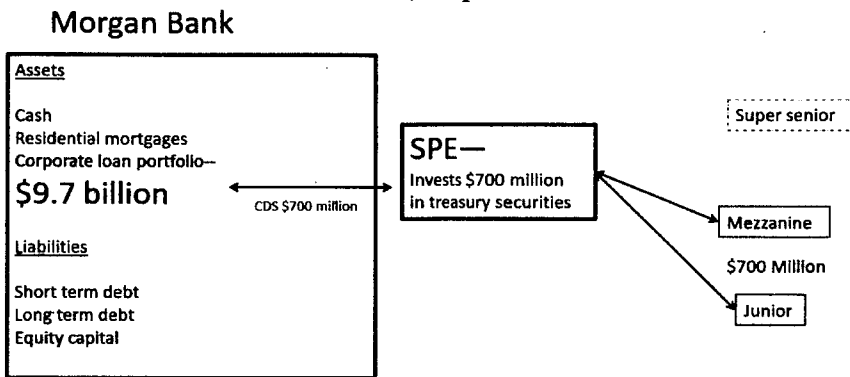
**Bistro, Step 2**

But we haven't gotten very far. At this point, the SPE can only return to the note investors the return on treasuries minus transaction costs, and that's not a competitive return. So let's add a transaction—the SPE enters into a credit default swap with the bank, pursuant to which the SPE accepts the default risk on the loans in exchange for a fee paid by the bank. The premium on the CDS, added to the returns on the treasuries provides a base for a competitive return on the SPE notes.

But, wait, what's the point of swapping with a shell counterparty that's not a real credit? Think about it. It's the same credit play that occurs when you buy a collateralized mortgage obligation—the assets in the SPE provide security for the obligation under the swap, and here the collateral is rock solid treasuries. If there's a default on a portfolio loan, the SPE pays under the swap, drawing on the treasuries; the loss is borne by the SPE noteholder. But that's okay; the noteholder is taking the credit risk on the loan portfolio.

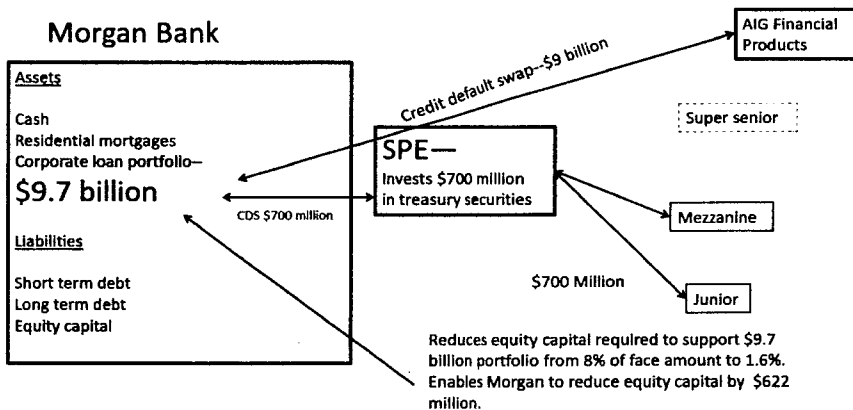
It looks nice and neat. But now let's go to the real world, where, back in 1997, Morgan wants to have this arrangement cover a lot more than a \$700 million dollar loan portfolio. It wants the proceeds of \$700 million of SPE notes to cover the default risk of a portfolio of \$9.7 billion of loans to 301 borrowers, and to get the Federal Reserve to grant it equity capital relief on the whole portfolio!

## Bistro, Step 3



That was the tricky part. Morgan will be dividing the SPE notes into tranches and have the SPE issue \$700 of junior and mezzanine notes. These will take the first default risk on the \$9.7 billion portfolio. But what about the senior tranche—here called the “super senior” tranche? Unfortunately, there was no way to sell the super senior notes for \$9 billion, put the proceeds into treasuries, and tack on a swap so that the resulting note payment stream would be competitive. The return on the senior swap was just too low. So Morgan volunteered to take that tranche itself, constructively—that is, it would retain the risk. It proposed to the Fed it should get equity capital relief for the whole \$9.7 billion portfolio because its quants had produced a risk analysis showing that defaults over \$700 million could not possibly occur. To its credit, the Fed rejected the pitch.

## Bistro, Step 4



So Morgan turned around and entered into a credit default swap with AIG respecting the risk on the unfunded, super senior tranche, paying AIG

two cents per year per dollar of risk taken on residual loan portfolio. This the Fed accepted, AIG having been triple A. Regulatory capital on the entire \$9.7 billion went down to 1.6%, allowing the Morgan bank to leverage itself more steeply and increase its return on assets. Morgan marketed the structure widely, continuing to use AIG to square the circle. Thus did the banks sow seeds of financial disaster in the late 1990s and early 2000s.

To sum up, let's strip Bistro down to its essentials. An originator that seeks to swap away the risk of a portfolio of securities sets up an SPE; the SPE funds itself with borrowed money; the borrowed money supports a swap between the SPE and the originator; and the SPE's noteholders assume the economic risk of a decrease in the value of the originator's portfolio, taking as compensation the swap premium and the proceeds of the SPE's collateral.

#### ENRON

Bistro opened up possibilities. Could the structure be adapted for more highly levered off-balance sheet transfers? Why need the collateral inside the SPE be Treasury securities? Should not any securities with a positive value be fit for the job? And why does the outside investor in the SPE have to be a buyer in the market for long-term securitized paper? Might not another mode of financing do just as well?

Why do I ask? Well, down in Houston, Jeffrey Skilling and Andrew Fastow were watching enviously as the banks raised their return on assets by used securitization structures to go asset lite and thereby jack up their return on assets.

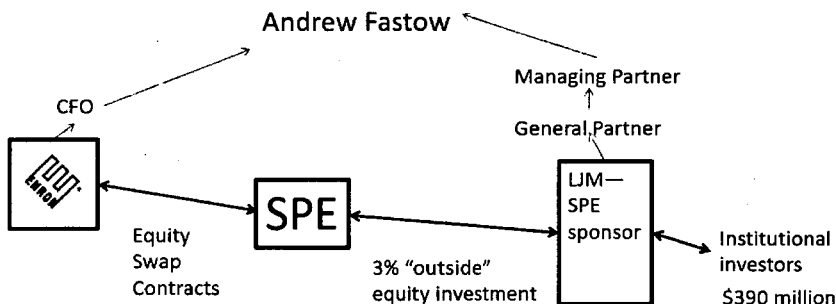
Enron had an investment portfolio stuffed with large block holdings of newly issued tech stocks. Enron's income statement had reflected unrealized gains on the portfolio as the tech bubble rose. A falling market would do the opposite, crushing Enron's earnings figure. Exacerbating the problem, the stock issues were illiquid and thinly traded; hedges were unavailable; there was no counterparty for an equity swap. This left Enron in the position of the Morgan bank: It needed a swap counterparty for a portfolio of illiquid assets. As the market was not bringing forth that counterparty, Enron, like Morgan, needed to create it.

Once again, the counterparty would be an SPE.

Now, Enron already was a heavy user of SPEs. It used them as dumping grounds for junk assets, of which it had a lot. It had run into compliance problems. In those days, when you used an SPE creatively, it fell into a residual accounting category within which it was thought that 3% of the value of the assets in the SPE needed to be funded with equity

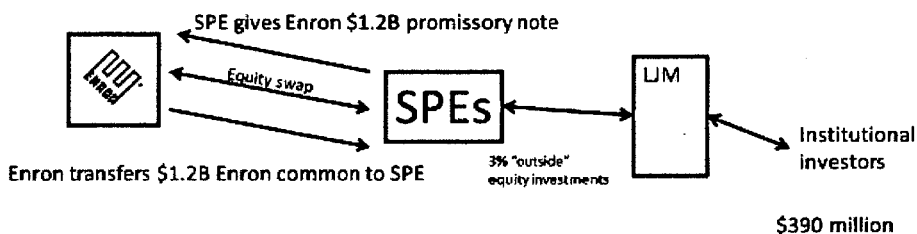
from a third party. It turned out to be hard to find third parties willing to take the downside equity risk in levered SPEs stuffed with junk assets.

### Enron, Fastow, and LJM



So Andy Fastow took a cue from Fred Carr and set up his own limited partnership investment vehicle called LJM, modeling it along the lines of a private equity firm. He was the managing member of the general partner. LJM raised capital from institutional investors. One of its functions was to take the 3% equity interest in Enron SPEs.

### The Enron-LJM Swaps



1. Swaps cover \$1.1 billion of portfolio losses over 5 quarters
2. Enron stock simultaneously drops
3. SPEs become insolvent
4. Enron brings SPEs onto balance sheet and restates earnings
5. Enron goes bankrupt

We are now ready to redo Bistro. Enron, like Morgan, sets up an SPE with which to swap the downside risk on its portfolio, here tech stocks rather than corporate bonds. It gets outside investors—that's what LJM is for. But the outside investors kick in only 3% of the funding for the SPE, and are there only to meet the accountant's outside equity requirement.

But where was Fastow going to get the capital to cover potential losses on the swap—the remaining 97% of the capitalization of the SPE? Such a deal wouldn't make sense to third-party investors and there was a

need for speed at all events. So, he sit down at Enron HQ and had Enron issue \$1.2 billion of common stock to the SPE in exchange for \$1.2 billion of SPE notes. Arm's length sale, or sham transaction? As with Bistro, the SPE is financed with debt—but not from an outside source. Indeed, here no money even crosses the table, just pieces of paper. It was more Fred Carr than it was Morgan Bank. Further, here there was no follow-up investment by the SPE in super safe treasuries. The SPE just sat on the Enron stock.

It all promptly went south. Enron used the swaps to cover a \$1.1 billion loss on the tech stocks, figure that amounted to 72% of its reported net income during the period. Then Enron's own stock started dropping, causing the SPEs to become insolvent. Ultimately, Enron was forced to collapse the SPEs back to its own balance sheet and restate its income, admitting the \$1.1 billion loss. Bankruptcy and scandal followed quickly.

Bistro holds out a comparative tool that helps us appreciate the insidious nature of Enron's transaction structure. Bistro had outside funding in cash. Enron financed with a note for stock swap with itself, which means the risk was never really externalized—if the SPE lost heavily on the swaps but without exhausting the value of the Enron stock with which it was funded, it still would have had no capital left to repay the loan from Enron. The only scenario that avoids the write-off requires an increase in the value of the Enron stock in the SPE by \$1 for every \$1 of loss covered by the swaps.

The structure would have been questionable even if the Enron stock had gone up. Stock goes up because earnings increases are projected. Earnings projections depend on recent earnings results. In this case, Enron was stoking its earnings with a swap contract that derived its economic substance from Enron stock, which in turn derived its economic substance from positive earnings reports, reports that would not be forthcoming absent the swap contract.

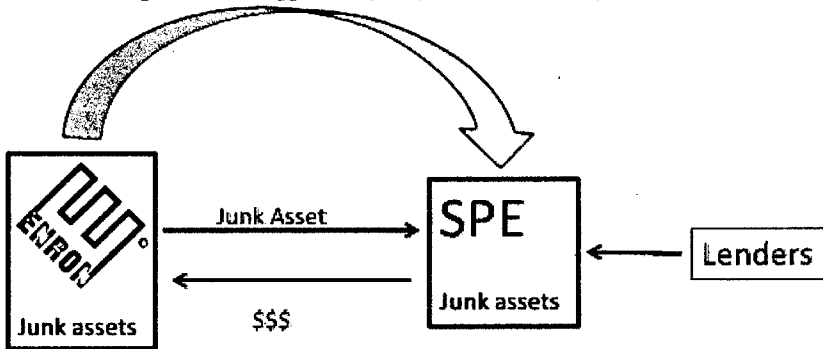
Enron in substance issued its own common stock to cover a loss on its own income statement. This one may not do under the most basic rules of capitalism.

#### STRUCTURED INVESTMENT VEHICLES

I'd like to start my discussion of structured investment vehicles with a look at one last Enron transaction structure.

### Enron Asset SPEs

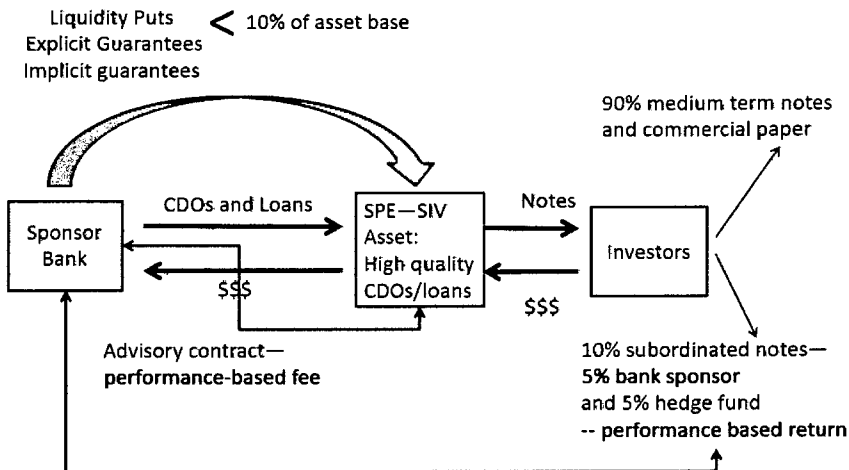
Enron guarantee triggered by drop in Enron stock price



As noted above, Enron also used SPEs as off-balance sheet junkyards, financing the sale of junk assets to the SPE with SPE debt. The arrangements were conditional and put Enron back on the hook for the debt if its stock price fell below stated levels. It received its final kick into bankruptcy when those off-balance sheet obligations came due. They went off like roman candles during its last week of life.

Meanwhile, the banks were doing something structurally similar with SPEs called structured investment vehicles or SIVs. Now, the SIV business model presupposed high quality assets, as opposed to the junk assets involved in the Enron SPEs. The bank SIVs invested in top-rated debt paper that would support the lowest possible borrowing cost when the SIV went into the credit markets for financing. Even so, the SIVs ended up in the same place as did the Enron entities.

### Bank SIVs



The SIVs borrowed partly in the commercial paper market and partly with medium term secured notes. There also was a junior tranche, 10% or so of the capital came through subordinated notes. And there was a nominal equity tranche, fobbed off into a charitable trust. The play was durational—the debt securities in the SIV were all long term; the medium-term notes and commercial paper used to finance them had lower rates because the maturities were shorter; a spread opened up.

The first SIVs had 100% liquidity backing from their bank sponsors—literally a promise to take out the third-party lenders if the SIV couldn't refinance its short-term obligations. But over time, the market stopped requiring 100% coverage and the explicit liquidity put shrank back to less than 10% of the asset base. Even so, it was widely understood that the banks backed their SIVs. This was the so-called "implicit guarantee."

Let's step back and see if this adds up for the bank: you take top-class assets off your balance sheet; you finance for a durational spread; and you make guarantees, explicit and implicit. Question: isn't the bank losing the value of the spread to the charitable trust that has taken the equity sliver?

Of course not. Nothing ever reaches the charity. The bank siphons off the spread in two ways: first, the SIV has an asset manager, and that just happens to be the bank, under a performance-based advisory contract; second, the bank takes half of the subordinated notes that make up 10% of the SIV's financing. Interest on the notes is performance sensitive also. The bigger the spread, the bigger the yield on these contracts.

Interestingly, the FASB had amended the accounting rules to make sure Enron never happened again. Under the new rules, the bank could conceivably be required to consolidate an SPE on the basis of sponsorship, debt investment, and/or contingent guarantees on the ground that the bank bore the entity's downside financial risk. The new rules were drafted in accord with contemporary fashion to be principles as opposed to rules based. The banks gamed them nonetheless and succeeded in keeping the SIVs off-balance sheet.

The SIVs eventually played the role of canary in the coal mine for the financial crisis. They went down in 2007 as a result of market jitters over mortgage-backed debt securities. It was a classic death spiral with short-term lenders refusing to roll over their paper and the SIVs dumping assets to generate liquidity, thereby driving down the values of their own portfolios.

The bank sponsors bailed out the SIVs (and their lenders) doing exactly what Enron had done with the LJM SPEs. The banks yanked SIV assets and liabilities back onto their own balance sheets. They thereby

further softened themselves up for the blows of 2008. And the banks did this despite the fact that any guarantees were implicit only.

We describe this as the scandal that wasn't but should have been, because, well, it was a disgrace. If the assets were coming back onto the banks' balance sheets at the first sign of a downdraft, the SIVs should have been consolidated with the balance sheets all along. If the SIVs really had been independent entities, their creditors should have been stiffed. It should have been one or the other, but not what happened.

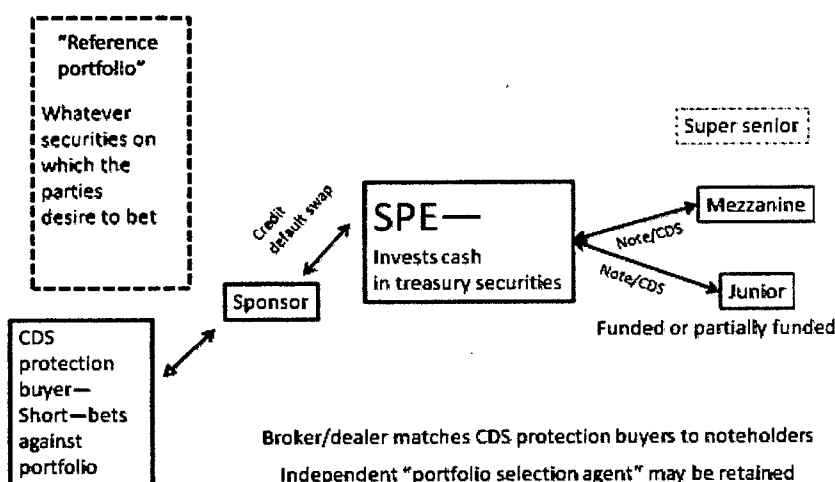
Why then was there no scandal, or at least an immediate regulatory push-back? Sometimes gaming the rules works exactly as intended, so the banks were in formal compliance. Meanwhile, the bank regulators were putting out other fires as 2007 closed and the disaster of 2008 loomed ever larger. The boats were rocking and the regulators were disinclined further to rock them any further.

There nonetheless are multiple parallels to Enron. Surrounding your balance sheet with SPE land mines set to go off due to contingent guarantees? Check. Excess risks run on the assumption that an asset that's good today is good forever? Check. Transfer of nonperforming assets to one's own balance sheet to enhance information asymmetries and reputation simultaneously? Check. The FASB reacting by redrafting and creating new rules designed to make sure this never happened again? Check. Happily, this time the FASB redraft was materially more successful. Now consolidation can follow by virtue of the fact that you are drawing off the profits through an advisory contract, and risk-return analyses have to be updated periodically.

#### GOLDMAN SACHS

Let's go back to Bistro one more time. Morgan there used a credit derivative to *hedge* the risk of a portfolio of debt securities. Credit derivatives also can be used to *speculate*. With speculative usage, the counterparty doesn't own the reference security and uses the swap to make a naked bet against it. If the asset defaults, the speculator gets a windfall payment under the swap.

### Synthetic Securitization



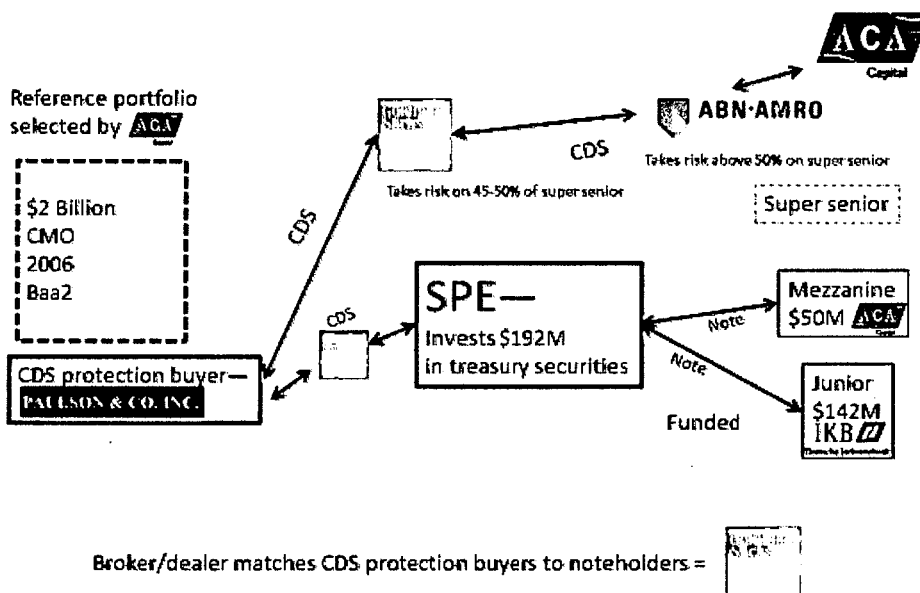
The Bistro structure was quickly adapted to such betting. There's a key, counterintuitive fact in the Bistro pattern: nothing requires the party in the position of the sponsor bank actually to own a loan portfolio and use the structure to hedge it. The deal can be set up by reference to a *hypothetical* portfolio—anything the parties want so long as the securities are out there in the real world and their performance can be tracked. You just have your analyst construct it. That done, the table is open for bets on how the portfolio is going to do. The party in the position of Morgan isn't hedging an asset it owns but pulling parties making bets as to whether assets other people hold will or will not default. Thus situated as an investment bank "sponsor," it that may or may not have exposures in connection with the transaction.

Recall also that in Bistro, there was nobody to take the super senior. Same here. It's just easier now to elide that problem. Since there's no real portfolio—just bets on a hypothetical portfolio—and no one is looking to fulfill the economic function of a complete hedge, you don't need to have a senior tranche or senior protection seller. It even turns out that nothing requires the buyers of the notes fully to fund the SPE; just have them back up the SPE as swap counterparty to the extent positions have been taken and have the quants work out the math. A tranche exists only to the extent there's a party who is willing to place a bet. If there's no one there to place the bet, the tranche is a ghost that exists only in the math. After 1999, most Bistro deals, by then termed "synthetic securitizations," were done this way.

As such, they facilitated risk-taking in debt securities backed by residential real estate mortgages and gave us a leg up disaster. How?

Actual securitization means transferring debt obligations owned by one or more parties into an SPE and using the proceeds of debt securities issued by the SPE to fund the transfer. When it's bets on a hypothetical portfolio, you can package the structure more quickly and cheaply and can tailor notes and swaps to the demands of particular customers. When demand for CDOs is high, as it was from 2004 to 2007, this is the quickest way to get a deal done. And close them they did, magnifying the total amount of risk run on subprime mortgages. If there had to be a scandal about synthetic securitization, that's what it *should* have been about.

### ABACUS 2007 AC-1



Instead, we got Goldman Sachs and Abacus, which was one of many such synthetic financings. Like Abacus, many of them ended up in default—actual and synthetic CDOs were the riskiest debt securities issued during the real estate securitization boom.

In a synthetic securitization, the sponsor is the focal point actor playing its more particular role as a swap dealer. There are two parties to be brought together at the swap desk. First, there must be a party who wants to take a short position on the so-called "reference portfolio." Here that's John Paulson, one of the Big Shorts, looking to short two billion worth of collateralized mortgage obligations. On the other side, you need parties who want to take the credit risk on the portfolio. By the time Abacus was done, the list of clients wanting to go long on these structures was shrinking fast.

But wait, who decides what goes into that hypothetical portfolio? In the Abacus deal, Goldman advertised that an outfit called ACA Management would be the “independent portfolio selection agent.” But Paulson—who was betting against the portfolio, also had a hand in the process. From here later would spring the fraud case, after all of the long securities in the structure had gone into default.

In the newspapers, the alleged fraud lay in the fact that Goldman failed to disclose that fact to the note buyers; and that’s one of the SEC’s allegations. But there were only two note buyers in the deal, one of which was ACA, which in fact knew about the Paulson inputs. The real fraud lay in Fabrice “Fab” Tourre’s statement to ACA that Paulson would be taking the junior equity tranche of SPE notes—a position that amounted to a long bet. In fact, Paulson (a Big Short) was doing no such thing. And thus was ACA lulled into thinking that Paulson was even longer on the portfolio than it was so that it shouldn’t worry about its portfolio selection inputs. (We still have trouble imagining how ACA could have closed this deal under a misapprehension as to Paulson’s role).

Strong case or weak case, this looks to us like a perfectly ordinary fraud case, and not even an interesting one. So why all the brouhaha, at least apart from the fact that the alleged fraudster was a Goldman employee?

The SEC’s enforcement action is seen as a part of a general move to impose customer fiduciary duties on broker-dealers. Goldman defends by claiming that it’s just acting here as a swap dealer, bringing together sophisticated shorts and longs together at arm’s length. If this is a question about the imposition of fiduciary duty and the answer is yes, then Goldman’s defense is countered. But we wonder whether the fiduciary glove fits, and find much less in the fraud case than meets the eye.

Not that we think Goldman shouldn’t take responsibility. We just think outside of the box and view Goldman on this fact pattern as a securities issuer rather than as a swap dealer—we think it should stand in for the issuing SPE as a “firm.” Our reason: when an SPE issues a security, there literally are no issuer agents, just a bunch of contracts. With conventional securities issuance, there is whole firm there to take responsibility for the paper—it’s not just a portfolio of assets, there are actors. We have no trouble merging the sponsor into the issuing firm to yield an amalgam of issuer and underwriter bearing responsibility for the structure. The fiduciary theory of the case is a move in the same direction, a move that stretches existing relational law to a potentially inappropriate place. A bolder approach makes more sense: when there is no there there, it makes sense to put the promoter into the missing issuer’s shoes.

## VI. ACCOUNTING AND THE LAW

### A. RULES, PRINCIPLES AND THE CRISIS IN US ACCOUNTING

Conference, After Enron, Tilburg University Faculty of Law,  
March 28, 2004

Accompanying Article:

William W. Bratton, *Rules, Principles, and the Accounting Crisis in the United States*, 5 EUR. BUS. ORG. L. REV. 7 (2004)

#### INTRODUCTION

The US corporate governance crisis has disrupted many settled views and expectations. Such disruption often results in denial. The denial can be persistent, and distort the articulation of regulatory responses. Accounting reform presents an excellent example of this.

When Enron fell, the accounting profession, led by Arthur Andersen's Joe Berardino, blamed the standard setters, the Financial Accounting Standards Board (FASB) and the SEC. Enron, said Berardino, had only followed the rules. If its financials had been unfairly stated, then the rules needed to be changed. Practitioners needed more specific guidance on treatments for controversial transactions.

Similar defensive-aggressive arguments had worked well for the accounting profession on many past occasions. But this time, the strategy blew up in profession's face. The counter-response came first from the SEC Chairman, Harvey Pitt, and thereafter from just about everybody else. The problem, they said, was that there was too much guidance. Generally accepted accounting principles, or GAAP, had evolved into an exhaustive system of check the box rules. The rules had fostered a culture of regulatory arbitrage in which it paid to invest in gaming the system to get transactions and treatments that, while technically in compliance with the rules, evaded the spirit of the regulation. US accounting needed to look to Europe and transform itself into a principles-based system.

Since then, principles-based accounting has become a focal point in the US governance and reporting reform movement. The Sarbanes Oxley Act ordered the SEC to study its feasibility and the SEC responded with a report ordering FASB to get with the principles-based program as soon as possible. FASB, ever the compliant standard setter, has signaled that it will do so, just as soon as it gets a chance.

I have been watching this discourse with growing alarm and dismay. This is not because I have anything against reference to Europe for regulatory guidance. Quite the contrary. And this is certainly not because

I have anything against principles-based regulation. I was schooled by a generation schooled in turn by Karl Lewellyn and other legal realists, and I still subscribe to their point that a principles-based approach offers the distinct advantages of factual responsiveness and flexibility as to outcome. My dismay stems from the view that principles-based regulation works well only in incentive-compatible institutional frameworks. Unfortunately, the US accounting and auditing environment is not yet incentive compatible and the cleanup process has a long way to go before it will be.

Meanwhile, I suspect that much of the motive force behind the juggernaut for principles in US accounting stems from denial. Joe Berardino and Harvey Pitt's different arguments followed from common presuppositions. First, both assumed that the form the regulations take matters more than the incentives of the actors applying them; second, both assumed that the standard setter was at fault; and third, both assumed that the gravamen of the corporate reporting problem lay with rules-compliant but unfairly stated financial reports. These assumptions neatly shifted the blame from both the managers choosing accounting treatments, the auditors approving their choices, and the federal agency overseeing both, and deflected attention from the seriousness of the incentive problem.

Today's paper attempts to knock some sense into the discussion. It raises eight objections to movement to principles-based accounting in the US at this time.

#### FIRST OBJECTION

US generally accepted accounting principles (GAAP) are not rules-based.

It is true that effective accounting standards need a basis in principles. It just so happens that US GAAP is a system that provides just such a basis. Indeed, unlike any other system of business law with which I am familiar, it makes its own metatheoretical statement—FASB's Concepts Statements. These set out the first principles from which all of GAAP's further instructions are derived. The system is thus explicitly principles-based, even as it contains many elaborate rules, each replete with bright-line tests and multiple exceptions importing internal inconsistencies. With this mix of principles and rules, GAAP resembles not only the UK accounting system and International Accounting Standards, but every other system of business regulation with which I am familiar. I will concede, without having conducted a serious study of the matter, that GAAP contains more rules than either IAS or UK accounting principles.

## SECOND OBJECTION

America's accounting scandals, for the most part, do not stem from manipulation of rules-based GAAP.

GAAP's critics point their fingers at the rules on derivatives and hedging, leasing, real estate transfers, equity compensation, consolidation and off balance sheet treatment of related entity assets and transactions, and pre-2002 M&A. And, to be sure, there's nothing pretty about these labyrinthine bodies of rules.

But what do they have to do with the reporting crisis? At the eye of that storm, we find the 10% of US reporting companies that have been forced to restate past financials in recent years due to GAAP violations. 54% of these restatements concern misapplication of the standards on revenue and expense recognition, which is for the most part principles-based territory within GAAP. Earnings padding at WorldCom is the most famous example: over three years, WorldCom shifted \$8 billion of line costs over to asset accounts and thereby kept the sum from being deducted as expenses on its income statements. This capitalization of what should have been expensed resulted from a bad faith application of a principle. Most remaining restatements, although certainly not all, also implicate principles-based GAAP treatments—stuff like loan write-offs, asset impairment, and inventory valuation. These are matters that require preparers to exercise judgments, and the preparers made their judgments in bad faith.

This stands to reason. GAAP abandons principles and opts for labyrinthine rules in order to provide roadmaps to compliance and to make noncompliance easier to detect. The main problem with these rules is not noncompliance but compliance. The rules tend to lead to reporting results that suit the preferences of complying managers. The critics dislike such compliant reporting treatments. And, where unfair financial statements are the result, the criticism is completely justified. The problem is well-known and antedates the scandals—that's why Pitt was so quick to take up the cudgel for principles after Enron. He was mouthing a standard criticism.

## THIRD OBJECTION

Enron violated GAAP, even as it manipulated rules-based standards.

The critics ascribe the gaming of rules-based treatments a causal rule in the Enron disaster. And it is true that misleading accounting of transactions between Enron and off-balance sheet entities lies at the scandal's core, and that the applicable GAAP is rules-based. It's also true that dissatisfaction with these rules' effects was widespread before Enron—in fact, FASB had been trying to move along a principles-based reform initiative for twenty years only to be stymied by industry

opposition. It's also true that Enron aggressively gamed rules-based GAAP, paying substantial sums to lawyers and accountants who devised elaborate, nominally compliant transaction structures that exploited the rules' structural weaknesses and encased sham transactions.

The problem with the story is that even as Enron aggressively gamed the rules, trying to remain compliant even as it padded its earnings, when it really needed a result it violated any rules and principles that got in its way. The famous LJM structures may have complied with the rules at inception, although I would argue that they did not. But the outcome of that discussion doesn't matter—the transaction structure had intrinsic flaws and quickly went out of compliance. Had Enron followed the rules, it would have had to consolidate the LJM entities' SPEs and would not have been able to cover \$1 billion of income statement losses with sham swaps. The means to the bad end at Enron was old fashioned concealment rather than high tech regulatory arbitrage.

Other standards were ignored from the get go. For example, GAAP's related party transactions rules required footnote disclosure adequate to describe the LJM transactions and show their impact on earnings, even assuming appropriate off-balance sheet status. Had the transactions' dubious substance been put on the table for inspection and criticism, things might have unfolded differently.

The same goes for Enron's \$7 billion of hidden SPE and equity affiliate guarantees, the triggering and revelation of which earned the company its ticket to Chapter 11. Under GAAP's standard on guarantees, there should have been footnote disclosure as to the obligations' nature and amount.

The central problem, then, lay with the corruption of the actors applying the rules, rather than with the rules themselves.

#### FOURTH OBJECTION

GAAP tends toward rules because reporting companies and their auditors demand and procure rules from a responsive standard-setter and nothing in present reforms promises to free FASB from its subordinated political position.

FASB operates at close proximity to the profession it regulates. Its members are selected by an independent not-for-profit corporation, under a process regime apparently designed to prevent capture by the industry. More specifically, FASB has seven seats. Accountants may fill no more than three of them. The remaining four seats go to two corporate executives, one financial analyst, and one academic. This is supposed to prevent the audit industry from dictating to preparers and users. But it does not prevent influence, assuming a community of interest between the

preparers and their auditors. The result is that, even as FASB has performed with admirable independence in recent years, pushing for reforms on topics like derivatives, stock options, and merger accounting in the teeth of corporate and audit firm opposition, it is, on a day-to-day level, highly responsive to requests from audit firms and preparers. They with regularity ask for scope exceptions—rules that exclude stated transactions from treatment regimes—and treatment exceptions—specific rules that take whole industries out of treatment regimes governed by general principles. Once they get these, audit firms and preparers follow up by asking for detailed instructions regarding implementation. FASB hears them sympathetically because it understands the pressures under which they operate and believes guidance to be a good thing. As a result, GAAP more and more has been articulated as rules.

In one sense this presents a paradigm of responsive regulation. But in another sense, it is a classic case of regulatory capture, indeed, a case worse than usual. GAAP rules result from internal conversations between the profession and the firms it regulates. Asymmetries of information and methodological wherewithal retard outside monitoring in the public interest. You have to be a member of the guild in the first place even to know what's going on. And, this is a guild that displays notable solidarity when it comes to public discussion of the merits of GAAP treatments and, even more so, discussion of audit practice. Given public conflict, the accountants close ranks and keep quiet, which is not surprising given a universe of only four to eight firms with the resources to audit public companies, all sharing a common fear of litigation.

The legal profession, with all its faults, behaves very differently. For every lawyer who closes ranks with a corporate client, there's another lawyer looking to bring suit against that client. When a corporation's lawyer goes to Capitol Hill to get the client protective legislation, the trial lawyers already are there, working the other side. When accountants play an advocacy role for their clients, as now happens routinely, no faction within their profession has a financial stake in an adversary position. The entire burden of critique and correction falls on FASB, the SEC accounting office, a handful of academics, and now, the PCAOB.

#### FIFTH OBJECTION

Audit firms demand rules because they are disempowered as professionals; nothing in present reform necessarily alters auditor-client relationships so as to cause the demands to cease.

When an auditor objects to a treatment, its inconvenienced client is likely to respond by saying: Show me where it says I can't do this. With principles-based standards, the auditor then has to say that the client's

treatment traverses the spirit of the regulation, at least in the auditor's professional judgment. Auditors hate being put in this position. Making such negative judgments disrupts their client relations. Better to have a rule to which to point and shift the blame for the naysaying to the standard setter. There results a high demand for rules.

Fear of litigation aggravates this. Principles heighten the possibility of second-guessing *ex post*—the auditor who has passed on a principles-based treatment that later is held to be noncompliant has to verify the good faith judgment that motivated its earlier, erroneous determination. That defensive case turns on uncontrollable inferences from complex facts. Check-the-box rules make the *ex post* defense much easier.

The economics of auditing also fuel the demand for rules. The audit process starts with an appraisal of the risk of compliance failure at the client. The risk appraisal determines the scope of testing conducted during the audit. The greater the risk, the wider the scope of testing, and the higher the fee. Where the financials follow from the client's fact-sensitive applications of principles, the audit is more likely to involve time-consuming hassles, and the cost of these is hard to predict. Check-the-box verifiability gets the job done more quickly and predictably. This eases the pricing process. To the extent the firms compete on price—and some assert that they do—rules are doubly desirable.

So strong is the US auditing profession's desire for check-the-box rules that it invents them where they don't exist. Consider the famous 3% outside equity rule that Enron exploited in setting up the LJM SPEs. It turned out this wasn't a FASB rule, or even a rule. It came from a 1991 SEC opinion concerning the treatment of a lease. That opinion clearly stated that the 3% result followed from the facts of the case—that is, that a principle, not a rule, was implicated. The SEC, in subsequent statements to the profession, repeated the point—the amount of outside equity necessary to support off-balance sheet treatment for an SPE depended on all the circumstances. But the profession paid no attention, applying the opinion as a bright-line rule, and not just at Andersen. The materiality principle is applied the same way—the SEC says noncompliance can be deemed immaterial only in all the circumstances; the profession uses a bright-line 5% test.

In thus demanding rules that ease stress on their professional relationships, accountants only mimic the behavior of US legal professionals. Before saying no to a client, corporate lawyers also like the backing of a precise instruction, always instructing their associates to find a case on all fours to denude their negative responses to clients of any suggestion that the naysaying stems from the lawyer's judgment rather than the terms of the law. Demand for rules is registered across business

law, as lawyers repudiate the legal realists' assertion that fact-specific adjudication under principles makes law more responsive. Just compare the Revised Uniform Partnership Act with the old Uniform Partnership Act. Or track the evolution of the Uniform Commercial Code and the caselaw thereunder for the last two decades. There are, of course, many reasons for this development. I can also cite decreasing confidence in judicial decision-making and a negative reaction to the expanding scope of jury control over mixed law and fact questions. There is also the debatable notion that specific ex-ante instructions import a certainty that enhances economic welfare.

Whatever the complex of motives, the result is clear: US drafters will continue to generate rulebooks until the demand ceases.

#### SIXTH OBJECTION

Rules hold out benefits.

Cost savings is one. GAAP covers homogenous, recurrent situations where actors need ex-ante instructions and have incentives to invest in compliance. On this analysis, an across the board shift to principles only makes sense if the cost of constant rules-revision to keep up with unintended applications due to regulatory arbitrage outweighs the benefits of advance specification. That seems unlikely.

Transparency is another benefit. Precise instructions narrow the room for differences of judgment and thereby make it easier to see what companies are doing, even as they may distort the aggregate story told by the report's bottom line. Rules also ease verification because they import a common basis of assumption and knowledge. They thereby make it more likely that the auditor discovers a noncompliant treatment, even as they put the auditor in a position to say no to the noncompliance once discovered. Since a rule also facilitates ex post scrutiny, it aggravates litigation risk, further strengthening the auditor's resolve.

#### SEVENTH OBJECTION

Lack of transparency makes financial reporting a subject matter unsuited to principles-based regulation.

Principles hold out benefits too. There is no such thing as a complete set of rules that anticipates all future contingencies. Principles allow unanticipated, company-specific information to be brought to bear in the law to fact application, importing flexibility, and, in theory, superior regulatory results.

But there's a problem. To see it, return to the legal realists' case for principles over rules in private law. The case presupposed that law-to-fact applications would be explained in judicial opinions. The idea was that the

reported cases would accumulate in number and give the practitioner an expanding body of fact-sensitive instructions, offering more and more certainty about the principle's meaning over time even as flexibility was maintained. There is much to be said for this, at least so long as litigation, or alternatively, published agency guidance, is not prohibitively expensive.

Decision-making about financial reports doesn't necessarily work this way. Even assuming a long set of footnotes, many of the decisions that result in the reported treatments become merged with the bottom-line numbers, subsumed in a black box. And such decisions are not made by state-empowered adjudicators. They are made by the regulated actors themselves, the preparers, with the auditor standing in for the judge. This is a flawed substitution, given the auditor's much diminished power to say no and financial incentive to say yes.

This gets me to my last objection.

#### EIGHTH OBJECTION

Successful principles-based regulation presupposes unbiased exercises of professional judgment.

Let's go back to the recent spate of reporting failures and restatements, whether these implicate principles or rules-based GAAP, and assuming no negligence or other adverse selection problem, the failures imply opportunism and misaligned incentives. Preparers have been guided by short-term solicitude for their stock prices rather than fidelity to accounting principles, and auditors have not been motivated to stop them. Proponents of principles believe that substituting principles for rules solves the problems. The belief is unfounded.

Sir David Tweedie, in his lectures to the Americans, has stressed that a move to principles means heightened reliance on law-to-fact determinations by regulated actors. The SEC's Sarbanes Oxley report makes for an interesting comparison. The agency parts company with Tweedie and steps back from pure principles, whether out of solicitude for the audit profession or fear of perverse effects. It describes a middle way in which the standard setter backs its principles with extensive implementation guidance. In the SEC's principles-based regime, all scope and treatment exceptions disappear, restoring comparability across companies, even as everybody gets precise instructions and no one relies on professional judgment.

But how does a regulatory regime articulate precise instructions and at the same time avoid ever conceding exceptions to its categories? Line-drawing is exactly what caselaw under principles is supposed to do. However attractive the SEC's vision of a regime of standards all meshing

like part of well-running machine, I suspect that it is unlikely to be realized in practice.

It follows that Tweedie is right—principles-based accounting relies on the judgments of preparers and auditors. Preparer and auditor incentives accordingly matter critically. In the US, it is the job of the PCAOB to realign these incentives. And maybe PCAOB will succeed at this. If it does, principles could become relatively superior to rules. But until it does, if it ever does, US GAAP needs all the rules it can get and the principles-based cure could be worse than the disease.

B. SHAREHOLDER VALUE, FINANCIAL CONSERVATISM, AND  
AUDITOR INDEPENDENCE

Harvard Business School Faculty Workshop, April 1, 2003

Accompanying Article:

William W. Bratton, *Shareholder Value and Auditor Independence*,  
53 DUKE L.J. 439 (2003)

INTRODUCTION

One thing corporate law professors do these days is write papers that start at Enron and goes through to Sarbanes Oxley and then goes back to the late 1990s stock market and maybe even earlier than that, and then give the author's take on what it all means. This one is mine.

It is a reflection on a stock market moment—specifically the drop of January 29, 2002, the day the market finally woke up to Enron's implications for the quality of the numbers on corporate bottom lines more generally. It is also a reflection on a conversation I had that same week, with a fellow teacher of the Accounting for Lawyers course, who reminded me of Arthur Levitt's famous point that auditors need to remember that the firm's managers are not their clients; the audit clients are the shareholders. He and I agreed that Levitt had called it right and that the solution to the crisis of confidence in audits lay in fidelity to the shareholder interest.

Now, at that very time I was asserting in a paper then circulating that Enron's collapse followed from its managers' very adherence to the shareholder value maximization norm. The present paper reflects one question put to me the first time I gave a paper I wrote about Enron: How could I plausibly blame Enron on shareholder value maximization when the sham transactions engineered by its managers had in fact destroyed shareholder value? My questioner had a point. I answered that I was not taking on the norm at a theoretical level, where I had no quarrel, but was addressing the world of practice, where the norm's cheerleaders had to confront a real world, behavioral reproach bound up in Enron. Its managers had internalized the norm and invoked its name even as they brought down their own company. So the norm needed a more careful articulation at the very least.

This paper is my attempt to do a better job of answering that question. My meditation on shareholder value causes me to part company with Arthur Levitt. I no longer think that you adequately can confront the auditor responsibility problem by making the auditor the fiduciary to a shareholder beneficiary. You have to go a step farther and ask about the

operative model of the shareholder and tell a more particular story about the shareholder interest.

Unfortunately, the moment you start unpacking the notion of the shareholder, the incentive picture gets complicated. So complicated that I am sticking my neck out to say that an auditor's professional responsibility can and maybe should be conceived without direct reference to the shareholders' interest.

#### MODELING THE SHAREHOLDER

If you could verify the value of a share on any given day, finance would be a world of technologies and technocrats. But since you can't verify even as all shareholders stake substantial amounts, there is much room for behavioral variation and diversity of approach amongst shareholders. And so the world of finance is every bit as much a world of politics and politicians as it is a world of technologies and technocrats.

Instead of a unitary shareholder, you get a series of binary alternatives:

<u>Left Side</u>	<u>Right Side</u>
Speculation	Investment
Short term	Long term
Noise trading	Fundamental value-investment
Dumb money	Smart money

You can draw from either column in modeling the shareholder beneficiary. But draw too many characteristics from both columns at once and you will not get unitary model from which to deduce governance instructions.

The columns' left-right organization shadows the left-right split of public politics. I've got a label for the right side—"financial conservatism." And, in the interest of full disclosure I should tell you I am a true-blue financial conservative, in my scholarship, my teaching, and the conduct of my personal affairs. Unfortunately, I don't have an omnibus label for the left side.

The first binary, *speculation versus investment*, comes from Graham and Dodd's *Security Analysis*. On the left side are those who play the market looking for quick upsides. On the right side are those who do their homework and look for stable, competitive, well-run companies and patiently invest in the cash flows those companies produce. In the Graham and Dodd picture, the market price is not necessarily the best available shot at the fundamental value on offer. And given a market full of speculators, it certainly won't be.

Next to the *short-term versus the long-term*. People use this distinction today as an omnibus left-right binary that avoids the pejorative implications of Graham and Dodd's label for the left side. If management is supposed to maximize present shareholder value, then a short-term time horizon can't be bad. We only get into problems if the short-term shareholder interest registers demands that constrain and impair investment policy, as with the leveraged restructurings of the 1980s, or otherwise leads management to take ill-advised steps that backfire and depress firm value, as with today's insecurity respecting financial reports.

Next comes the noise trading versus fundamental value distinction drawn in the branch of financial economics that allows itself to be influenced by behavioral psychology. Noise traders trade on information generated in the market. They chase trends. They have marked behavioral biases. When that stock price is trending up, they react too favorably to good news. Once a down trend has asserted itself, they react too unfavorably to bad news. And, at the moment when the trend turns, they can be a little slow to read the handwriting on the wall. And so on.

Fundamental value investors invest in hard cash flows. A longer-term perspective is implied, as is a set of information looking only at facts respecting the investee and the economy, rather than the latest word from the Street. The trends and the noise do not impress them.

Finally, to a related binary: *dumb money versus smart money*. The dumb money is congruent with the noise trader, but could also include a patient fundamental value investor who still has a lot to learn and who, say, does something really stupid like investing based on the recommendation of a stockbroker. The smart money includes a lot of fundamental value investors, but I have a capacious notion that includes other actors as well. Some smart money watches the noise traders and invests on market information. When the noise goes on an upside tear, bidding up stocks in a feedback loop where an uptick is good news that triggers another uptick, smart money certainly can ride along—there is after all money to be made. But the smart money always will be ready to be the first to bail out.

The smart money also is said to be able to take a look at a trend, and see that the fundamental value isn't there, and buck the trend, shorting the stock or the whole market or buying puts. Given a lot of noise, smart money is likely to be contrarian.

I need to mention the efficient market hypothesis (EMH) here because it accepts the presence of dumb money and noise trading even as it asserts that smart money trumps dumb money, keeping stock prices as correctly aligned with fundamentals as they can be. Given all these binaries, I bet you expect me to dismiss it as free market hokum, but I

actually think it's a good story. But right now in the corporate law professoriate, a noise trading description is ascendant, with noisy supply and demand intermixing with fundamental value because there isn't enough smart money to trump the dumb money in the short term. Contrarian investment is just too risky. But in the long-term, fundamental value always prevails.

#### MANAGED EARNINGS AND THE SHAREHOLDER INTEREST

Now, just because the market is noisy, it does not follow that fundamental value information is irrelevant. For all stockholders, left or right side, nothing is more important than news about fundamental value. And of all fundamental value information, earnings information is the most important subset. Given that here everybody more or less agrees, how could we stumble into a crisis about the numbers?

Well, some of the accounting that is now widely condemned was viewed with favor or indifference by left-side actors only a short time ago. The supply-demand dynamic respecting audit services was operating to make auditors sensitive to the left-side shareholder interest. Some of today's condemnation follows from a shift by the left-side to right-side conservative values. The same shift occurred after 1929, with conservatism prevailing for decades thereafter. If a left side demand for aggression returns in the future, and it will at some point, the supply-demand signal respecting audits shifts back. On this analysis, even an absolute prohibition of audit firm consulting does not solve the auditor incentive problem, a problem closely tied to the corporate governance system's evolutionary assimilation of a norm of shareholder responsiveness.

Now, why, prior to 2002, were shareholders impervious to aggressive accounting?

Let's take a benign example of 1990s earnings management: the cookie jar reserve. Here the issuer takes an extraordinary loss in a given quarter respecting an unsuccessful line of business but tops up the loss reserve. In a later quarter when the earnings are coming in a tad less than what was expected for that quarter, management conveniently revisits the loss reserve and reduces it, with the released sum supporting earnings in the later quarter.

Management can offer a couple of justifications for the manipulation. First, shareholders like smoothly increasing sequences of earnings because volatile streams of returns are worth less. Income smoothing reduces volatility without necessarily corrupting the trend.

Alternatively, to take a much-used example from the later 1990s, if the firm misses its expected quarterly earnings number by 1 cent and the

overheated market is going to punish the stock by bidding it down 10%, then a reserve that holds out the missing penny is a very good thing. It allows a management to anticipate and counteract the left side's behavioral shortcomings, protecting the stock price from short-term market mood swings.

How the explanations fly will depend on your politics and the state of the market.

The fundamental value investor will be 100% against this because it wants an unvarnished report. For accurate valuation, the last thing that's needed is management advocacy that results in smoother numbers—you need to see that volatility. In fact, better to do without the reserve—expense the costs as they are incurred, not in advance, giving an unvarnished set of earnings numbers from period to period.

The smart money and long-term investors have slightly different profiles.

The smart money is supposed to be able to see through the ruse to the periodic cash flows, at least so long as the published reports give it an adequate basis for doing so. It will only hurt the cost of the analysis, something it's going to do anyway. With disclosure, the treatment is irrelevant.

The long-term investor, once situated in a stock, isn't going to be destabilized if management is a couple cents short of expectations in the current quarter. At the same time, earnings management, pursued in moderation, isn't going to inflict any significant injury either—for in the long run, the empirical cash flow absolutely controls. The long-run question is whether the company produces competitively, so a long-term investor's confidence is not necessarily destabilized by a little massaging of numbers for the left side.

Now, what about that left side?

If you buy a stock on a trend chasing basis, and the trend is that earnings are up, and your holding period is short or intermediate, so that anything that might be hyped as bad news might destabilize you and cause you to sell, then a little finagling to avoid the firm being short on its earnings projections is not a bad thing. Just by arranging the numbers, management here protects you from yourself and the manic nature of the market.

But, unfortunately, earnings management holds out some problems for the left side, even as it's the nominal beneficiary. It works well only so long as management massages the numbers to protect an upward trend that responds by staying on trajectory. But if management pours balm over bad news as the trend turns down where the unvarnished truth might have prompted the holder to sell, the left side investor management is trying to

protect becomes a victim. But it's hard to see that in a bull market, where earnings management works beautifully and, critically, presently favorable market results have a way of validating business practices. In a bear market, when the noise traders overreact to all the bad news, the left side investors do an about face on the subject, suddenly demanding unvarnished truth.

The paper argues that a similar dynamic obtains respecting the revenue and cost recognition defalcations responsible for most of the recent spate of accounting restatements.

#### THE SHAREHOLDER BENEFICIARY AND THE CHOICE OF TREATMENT

Now, to regulation. Let's hypothesize a firm with a choice of treatments. All are either clearly GAAP or can be defended in good faith as GAAP. Under Number 1, this year's earnings are \$1 billion. Number 2—\$1,050,000,000. Under Number 3—\$950,000,000. Where do you go for a norm that tells you which to choose?

Alternative 1: A norm sitting right there in existing GAAP that tells you to choose Treatment 3. It is an accounting convention termed "conservatism"—the substance is easy: when in doubt, understate. And if you are understating, when in doubt there is no such thing as aggressive accounting.

For a second alternative, you can leave the choice in management's business judgment envelope. But this won't do if you lack confidence in management's incentives and choices—and in 2003, you do lack confidence. So we go a third alternative of revising GAAP so as to narrow the range of choices.

My question is whether there is a fourth alternative of going to the interests of the shareholder beneficiaries for instructions as to the choice.

If you take the fourth alternative, you get different answers depending on how you model the shareholder and the stock price. I see four possibilities.

First, you can look to the EMH, which says that smart money right-side shareholders determine the market price. Here, the choice of treatment is irrelevant so long as enough information is disclosed that the smart money can see how the books have been prepared and translate back to the hard cash truth. Of course, this story becomes less persuasive as you interpolate noise into your picture of the market price. The choice of treatment will start to have market value implications if not necessarily fundamental value implications.

So we fall to a backstop position and admit the noisiness of prices but nonetheless assert that we should structure market regulation *as if* the story told in orthodox financial economics, the EMH especially, was true.

The idea here is that if the regulatory structure treats traders as if they were well-informed rational actors, in the long run they will be pushed toward rationality. Restating, don't regulate even though the markets are like jungles. Paternalism only protects the dumb money unproductively.

If you accept this, Sarbanes Oxley is a bad development and we don't need a Public Oversight Board. But the choice of treatment is still irrelevant given transparency.

Second, we could try to derive a profile of the real-world shareholder, firm by firm, a sociological approach. You do a survey and find out what kind of clientele the firm attracts. A high-water dot com presumably would have a noisy clientele while a solid old economy company would have a more fundamental value-oriented group. But, of course, you have to leave out the outliers, and the clientele could be bipolar, or it could shift in time, if indeed a meaningful clientele could be described in the first place. So I don't think this is going to be helpful.

Things improve if we reverse this and model investors of different types choosing among firms. It follows that each firm should make disclosures about its reporting policies in advance and then stick to them, letting the shareholders sort themselves as they may.

Third, you could drop the shareholder value paradigm and substitute a constituency model with multiple beneficiaries—creditors, other contract counterparties, and employees, as well as shareholders. This is a route to a conservative choice. The creditors, having no upside, do negative analyses looking to default risk. They presumably would want accounting's conservatism convention to be applied firmly. In the standard picture, the employees are similarly risk-averse.

But this isn't politically correct in corporate law, and worse, conservative accounting runs headlong into securities law policy because it insists on verifiability and accordingly rejects fair value treatments.

Fourth, you can model the shareholder *as if* the shareholder was a right-side fundamental value shareholder, taking the paternalistic step of *imposing* right-side values and forgetting about the real-world shareholder. If you look at existing corporate legal theory, there's disagreement about whether to model only on fundamental value or whether also to make reference to a long-term horizon. I'd go long term myself, but I am not prepared to prove one must go long term.

If you take an additional step and model the right-side shareholder as smart, you wind up back at the EMH asking only for transparency as to treatment. That triggers another conflict with securities law policy, which usually wants to protect dumb money. So you end up relaxing your conservatism to address both sides of the smart-dumb binary.

Now, what are the right-side values to be imposed? I personally would do one last thing and read in accounting's conservatism convention. In my view, if you're serious about solving the audit crisis, then conservatism provides the one clear answer. But how many would join me in that? How deep is the support for the approach?

From the right side, there is always support. And right now conservatism looks more than usually welcome to the left side. But how long lasting will be this right-side shift in the shareholder demand respecting audit practice? Left side voices, their protectors in securities regulation, and management can be expected to resist conservatism much of the time.

Or, restating the question more precisely, is there a market for an audit firm with a commitment to conservatism?

At first blush, you would think so. There is a right-side interest out there. There are even right-side managers. By hiring the auditor that always says no to aggression, they can send a credible signal to the markets about the reliability of their bottom lines.

It has been argued that there is a market for such a firm, but that industry concentration precludes its emergence. If we had twelve or fifteen firms with the resources to audit large cap companies, things would be different. Maybe. But I wonder whether the incentive structure works differently.

Let's go back to our differentiated investors. Management today worries a lot about the stock price. This is less because a low stock price means a takeover, than because institutional investors have become empowered actors in corporate politics. Their agents, while sophisticated, worry about quarterly bottom lines and having their portfolios judged against comparable funds. As a result, they have to watch what's moving the market as opposed to watching long-term fundamentals. This puts them in the thick of the noise.

#### CONCLUSION: FIDELITY TO THE SYSTEM

Return now to the three treatments. In an unstable institutional environment, why would management choose an audit firm that has a powerful reputational incentive to refuse to give its opinion unless the lower treatment is chosen? Given shareholder empowerment, management will want an auditor with a reputation for flexibility. Even if conservatism makes sense this year, it may be the last thing you want next year to the extent you make your choice of treatment in response to shareholder demands.

So, to the extent regulators, audit committee members and auditors model the shareholder, I think a fundamental value, long-term perspective

is appropriate, with occasional reference to dumb money needing the protection of a conservative authority figure.

But having gone through this analysis, I end up wondering how often you have to model a shareholder principal at all. GAAP isn't just a bunch of rules. It's a sophisticated set of rules backed by generally stated principles. There's enough there to let us can dispense with the model of the beneficiary and make reference to the system, to GAAP itself, and do so as we articulate the fiduciary duty. The auditor should be faithful not to the shareholders, but to the rulebook and the reporting system it articulates. Any departure from or unprincipled application of the rules in the interest of client advocacy compromises that mission. The CPA represents the system. Its professionalism should come from the system rather than from the client relation.

This plea for positivism in a sense just reinvents the wheel. It's a fancy explanation for the most basic rule in this profession's canon of ethics: The auditor does not hold the client's stock. It's also the idea enshrined in Sarbanes Oxley's § 108(d), which orders up a study of something called principles-based accounting. But, pending the appearance of the study, I read the statute to pitch principles to the wrong place. It addresses its principles prescription to FASB, impliedly accusing it of excess attachment to rules. But I don't buy that diagnosis. This is less a legislative problem concerning the relative merits of rules and standards than a problem of professional practice in a regulatory system made up of both, a system that needs to get back to reporting and away from managing numbers. Firms are managed for their shareholders. Numbers can be reported for their own sakes.

C. PRIVATE STANDARDS, PUBLIC GOVERNANCE: A NEW LOOK AT THE  
FINANCIAL ACCOUNTING STANDARDS BOARD

Boston College Law Review Symposium: Owning Standards,  
March 31, 2006

Accompanying Article:

William W. Bratton, Private Standards, *Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5 (2007)

INTRODUCTION

So why come to this symposium and talk about the history of the Financial Accounting Standards Board (FASB)? Well, I am a member of the law school accounting professoriate. It's a small, exclusive club, and Larry Cunningham, one of this conference's organizers, is its universally acknowledged president. So when he asked me to come here, it meant that for me, the standards under discussion would be generally accepted accounting principles (GAAP) and the standard setter the FASB. As it happened, I had a long-anticipated project on the FASB that I'd never gotten around to undertaking.

The project's origins lie in a wonderful moment that occurred during the Enron winter of 2001–2002, when Harvey Pitt, the soon to be disgraced SEC chairman, went up to Norwalk to lecture the members of the FASB about their responsibility for the mess. Pitt was pitching principles-based standards along with cost-sensitive responsiveness to management demands, a combination I found oxymoronic. But that didn't deter Pitt. You see, FASB-bashing is a reflexive political expedient in a business law crisis.

The truth was that we were in a crisis because management had captured the audit firms, a process Pitt had encouraged. So attention needed to be deflected elsewhere. And here was this underfunded, underappreciated little standard-setter—the one link in the self-regulatory daisy chain that hadn't been captured. The FASB was slowly, doggedly muddling through even as Harvey Pitt and his bar room bullies—big cap management, Silicon Valley, House and Senate Republicans, and the Big Audit firms—blamed it for doing its job.

So I stepped up to the plate and wrote an on the fly symposium piece that defended rules-based accounting. That piece turned out to be problematic. Not because it was wrong—it was right—but because contrary to expectations, people actually read it and it didn't state the case particularly well. So when Larry called me last year, I had an old agenda item—I was looking for an opportunity to write another accounting paper

that would do a better job of stating the case for rules. And there was also a back-burner item. It had always seemed to me that the FASB *should* have been the dirty, the captured lapdog that Harvey Pitt and his thugs always had wanted. Public choice theory, which I often find a source of cogent explanations for the operation of business law institutions, predicts that a standard-setter like the FASB will be captured. So I couldn't help but wonder, how had the FASB escaped?

Hence, this paper. It started out as an exercise in public choice research. If you look at the present FASB, there's an informal arrangement under which three of seven seats go to CPAs and two go to management reps. This suggests that the audit firms and their clients should be running the show with a five to two voting coalition. I figured there had to be a literature on this. And there was. Because B-schools teach a lot of accounting, there's an enormous stable of academics interested in the FASB. It turned out that empirical political scientists and economists had been all over the FASB's case since its 1973 founding. Its proceedings had been put under the academic microscope and the result is clear: there have been no significant voting coalitions. The FASB has been tested for capture, and to the extent that the matter can be determined by the observable data, it has been independent. This was news to me, but I saw at once that it's a basic point in the FASB world.

My project accordingly veered off in an unanticipated direction. I found myself writing an administrative law paper. Now, at Georgetown we don't talk about ad law anymore, we talk about "governance." I figured I would be wrapping the FASB in a sort of Jody Freeman cocoon of public-private cooperation. FASB would turn out to be problematic and conflicted, but striving for independence. But the project ended up with an emphasis on a different variation on the theme of troubled standard-setter, rooted in Richard Stewart's 1975 *Harvard Law Review* excursus on the evolution of thinking about administrative agencies, in particular, his description of the mind set of James M. Landis and the classic New Deal agency model.

In my paper, Landis is the godfather of this particular private setter of public regulatory standards.

#### ORIGINS

The story begins in 1938 when the SEC dumps the standard-setting problem into the lap of the accountants' professional organization, which today calls itself the AICPA. There follow 64 years of chronically underfunded private standard setting, an era that ends in 2002 when the Congress endows the FASB with the proceeds of fees collected from listed companies. Two predecessor standard-setters, both part-time AICPA

committees, fail between 1938 and 1972. In both cases, the standard-setters were too close to the profession and unequipped to perform adequately in an era of increasing demands due to expanding market volume and volatility. The FASB comes into existence in their wake, the result of an ad hoc process led by the AICPA, but with input from heavy hitters from management and Wall Street.

Yes, ladies and gentlemen, it was spontaneous order in the private sector. And it worked because the FASB's founders had a high-powered incentive. They wanted an effective standard setter that would serve their needs without ceding the territory to a federal agency, which they in those days associated with a high risk of domination by progressive, anti-corporate types. But, to make the arrangement stick, important concessions had to be made to public legitimacy.

The new standard setter was as a result formally separated from the profession. The FASB's members are appointed by members of the Financial Accounting Foundation, a not-for-profit, whose members in turn are nominated by a collection of constituent organizations. The third time around we also got a standard-setting institution with full-time players and a staff rather just than a committee. The FASB is independent—its members resign from their posts and separate themselves from their assets, very much like holders of high government office. They set their own agenda. But they at least have to listen to a built-in advisory council made up of representatives of various constituencies, the Financial Accounting Standards Advisory Council (FASAC), also appointed by the FAF.

The FASB's founders, then, wanted the new standard-setter to be independent and public regarding, yet simultaneously responsive to constituent interests, and all the while remaining insulated from political pressure. But their governance design had critics to the right and critics to the left. The classic public choice commentaries denounce the whole thing as a rent-seeking scam. But these had limited political impact. The FASB flunks public choice scrutiny only because it is a cog in the larger machine of the federal mandatory disclosure system. If the SEC were put out of business tomorrow, with the FASB remaining in its present form as a private body generating strictly optional standards and open to competition from rival setters, it would be held out as a public choice exemplar.

The early FASB's problems lay instead with the staffers of democratic Congressmen, who laid down the standard progressive pluralist gauntlet. According to this, choices of accounting principles have significant allocative consequences; accounting standard-setting therefore is a high-stakes game in which the setter has no alternative but to balance interests. Because the setter resolves political rather than technical issues,

its legitimacy depends on political responsiveness. It followed that the FASB's independence was not a virtue but a guarantee of irrelevance, isolation, and unaccountability. The standard-setting authority should instead be an agency directly responsible to the Congress. The FASB was not independent in any event, because it depended on contributions from the preparers and auditors, groups with high stakes in all of its outcomes.

This pluralist shot was fired in the corridors of the Congress in the mid-1970s. The FASB dodged the bullet. But it also got the message, and promptly reorganized itself to strengthen its public bona fides. Most importantly, it distanced itself from the AICPA. It originally had a majority of four CPAs along with a five to two supermajority voting rule inserted to prevent domination by a CPA voting block. The CPAs were reduced to three, and the voting majority reduced to four. Contributions from the Big Audit firms were capped. The AICPA retained a majority on the FAF, but eventually lost that one as well. More recently, in the wake of Sarbanes-Oxley, the AICPA was expelled entirely from a standard setting role respecting GAAP for publicly traded companies.

The FASB also decided to take the K.C. Davis playbook of process legitimacy more seriously. For the sake of independence, it had started out working in secrecy during standards' preparatory stages. Across the board sunshine was substituted.

Summing up, we see that public processes assist in legitimating empowered private actors. But we don't have an explanation for the FASB's survival in the teeth of constant constituent opposition. So far in the story, it has got only one thing going for it politically, the business world's preference for a private rather than a public agency. But that became less and less an imperative once Reagan arrived in 1981 and the threat of progressive capture receded from view.

Yet the FASB held on against constant constituent pushback. From what did it derive this ability to resist?

#### DECISION USEFULNESS

Let's go back to the FASB founders' exercise in agency design.

Standard-setting discretion in an independent body creates a legitimacy problem, whether the body is public or private, and quite apart from any capture allegations. Under the New Deal agency design template, the solution to the discretion problem lies in an explicit statement of the agency's goal. Given that, the regulator's expertise solves discretion problem—as the independent expert applies its knowledge to realize the stated goal, the standards emerge as a function of the expertise and the state of the world, supported by objective bases. One might not approve of the standard, but one cannot dismiss it as arbitrary.

The FASB founders seized on this point. They decided that what the new standard-setter needed was an explicit substantive mandate. They accordingly charged the FASB with the task of creating what came to be called the “Conceptual Framework.” That is, the FASB itself would articulate generally accepted goals that would determine the standards and thus contain its own discretion.

One more structural point needs to be noted. Even as the FASB’s founders outfitted it with a built-in advisory board made up of constituent representatives, they otherwise denied the relevance of the pluralist view that turns rule-making into a legislative and political process of balancing conflicting constituent interests. Under that model, legitimacy comes to depend on the agency’s political responsiveness. Indeed, if we carry the pluralist model to its logical conclusion, the agency merely functions as an aggregator of outside preferences and the independence model is completely negated. The FASB founders’ aversion to pluralism accordingly made good sense in view of their choice to follow the traditional New Deal independence model. The FASB’s pluralist critics would soon offer further confirmation when arguing that an inherently political process like accounting standard-setting should be conducted in the public sector.

The FASB duly promulgated its Conceptual Framework only to be derided by its critics. The Conceptual Framework would never have succeeded in its appointed task of determining the standards set by the Board even if it had gotten positive reviews. It proceeds as much too high a level of generality to yield any outcome-determinative traction.

We are left with a private standard setter that is independent in the sense of being insulated from constituent demands, but whose discretion presents a classic agency accountability problem. It’s at this point that the Conceptual Framework does make a contribution. We take a single unprepossessing sentence in Statement of Financial Accounting Concepts No. 1: “Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.” This is called “decision usefulness” and it seems to state the obvious. But it was radical.

Financial reporting serves two purposes—it imports external transparency and also serves as a part of a rational system of internal management. Three decades ago, the prevailing concept of the purpose of accounting standards, called “stewardship,” encompassed both purposes. That meant that corporate managers had a place at the table along with market actors as important users of the standards. Indeed, they claimed primacy. The FASB departed from this history and elevated the outside interest over the management interest with decision usefulness. It thereby

completed the project of adopting the independent expertise agency model and avoiding the pluralist trap mediating in a world of multiple users with varied and conflicting preferences.

Decision usefulness, however useful as a matter of agency design, would have availed the FASB nothing had it not also imported policy legitimacy. Fortunately for the FASB, it has done exactly that.

It did two more particular things. First, it implied a one-size-fits-all theoretical justification for the enterprise as a whole. Back in the 1970s, management was evoking national competitiveness and public welfare to argue for a cost-benefit burden of proof to be met by every new accounting standard—an argument that later would register in the Congress with respect to public agency rulemaking. The Conceptual Framework's focus on the markets let the FASB come back and argue that information is a public good that will be underprovided absent regulation. Standards directed to user utility reduce the social costs of information asymmetries, which include high transaction costs and thin capital markets with low liquidity.

Second, decision usefulness aligned the FASB's goals with that of its governmental overseer, the SEC and its goal of investor protection. The two agencies maintain a cooperative relationship that works well. The paper accounts for this by drawing on Sid Schapiro's work to note that the SEC has never so much relied on the FASB as to close its own accounting office. This equips it to monitor the FASB intensively, so that it usually gets what it wants in the ordinary course, only rarely resorting to its big stick.

The FASB's problem lies not with the SEC but with corporate management. The FASB sets its agenda independently, again and again pursuing decision usefulness in disregard of management opposition. Management sees this as a betrayal, a classic case of an unresponsive agency promulgating regulations for their own sake. Management uses the FASB's notice and comment and advisory processes to object. But it gets only occasional concessions, as FASB keeps cranking out standards management would just as soon do without. The managers fight back with proposals for a new agenda control mechanism—an oversight board with power to block agenda items and force revision of existing standards. They pitch this as a pluralist case for public accountability. But the initiatives haven't succeeded. The FASB is very good at backing down at the critical moment and throwing bones to attack dogs.

Question: Doesn't this imply a democratic deficit? Answer: No. The managers who prepare financials hardly can be said to lack influence or political access. They have wielded their political muscle to block proposed standards on several occasions. They lobbied for and secured

two of FASB's seven seats, and, at least for a while, procured a supermajority voting regime to go along with them. Meanwhile, the FASB emerges from this four decades back and forth with an enviable reputation for independence and Wall Street's implicit support.

So, the FASB and its founders sought to legitimate private standard setting by adopting the New Deal model of the independent, expert agency. Much like an independent *public* agency, it ran into a range of pluralist, public interest objections to exercises of regulatory discretion. But, in the long run, faithful adherence to the New Deal playbook worked well. This happened in no small measure because the FASB put itself on history's winning side with decision usefulness. It thereby aligned itself not only with the SEC, but the broader economic shift away from managerialism toward capital market governance under the shareholder value norm.

#### RULES AND PRINCIPLES

Now to the standards themselves and the never-ending chorus of complaint. Complaint number one: standards overload. But that's just management's way of complaining that it doesn't have agenda control. Complaint number two: excess complexity. But management never complains about complexity when it likes the bottom-line result. Complaint number three is more serious: the FASB drafts too many rules, seeking to supply a clear answer to every possible situation, pursuing the objective with detailed statements, bright-line tests, and multiple exceptions. This has perverse effects. Internal inconsistency often results. Comparability also suffers: Reporting entities hewing to the same strict standard appear comparable on faces of their financials when their arrangements in fact are dissimilar. Worse, the rules lead to transaction structuring and other strategic behavior that undermines the quality of financial reporting. Financials thus manipulated, while rule compliant, do not truly and fairly state the reporting company's income and financial position. The rules foster a dysfunctional, check-the-box approach to compliance. Preparers and auditors apply them mechanically, ignoring the substance of the transactions being reported.

All of this is true. Actors at the FASB reply that the rules follow from demands generated by management and its auditors, who want treatment and scope exceptions and "roadmaps" that hold out "guidance." It's sorry, but it's just being a responsive regulator. But such responsiveness has a dark side. According to the FASB's public choice critics, the federal securities laws requirement of an independent audit makes the large audit firms providers of a necessary professional service, positioning them to collect rents. Complex, rules-based standards aid and abet the rent seeking.

Complexity by itself generates work, and over time strengthens entry barriers because fewer and fewer firms possess the technical resources necessary for engagements with large clients. Finally, innovation is choked off to the extent that it decreases auditability and exposes the firms to legal risk.

All of this also is true. The paper defends the rules anyway, arguing that the FASB has to take our second-best world as it finds it. And the world is a nasty place where incentive problems impair the auditor-client relationship, auditability does matter, and the standard-setter has to worry about scandal prevention. Rules have advantages in such a place. Although not ideal, they provide a base of common assumptions and knowledge for both preparers and auditors. They decrease differences in measurement; they make noncompliance more evident. And, as room for differences in judgment narrows, transparency is enhanced.

So, intense demand for rules can be expected to persist; and rent-seeking by the audit profession figures into the demand. That said, auditor rents do not necessarily figure into the FASB's pattern of positive response. Rules can be justified independently on a principled basis— they decrease the likelihood of audit failure. So, if audit failure becomes less likely because the PCAOB succeeds in hitting the auditors over the head, I expect the FASB to move to principles over time. Otherwise, I would predict no change.