Separation and the Function of Corporation Law

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Preliminary Draft

I am delighted to participate in taking up Bill Klein's suggestion that we could learn something by attempting a functional typology of corporation law. I want to focus my contribution at the macro level – the distinction between the law of public and private corporations. For present purposes, I will not try and define the two beyond distinguishing between those corporations with and without a liquid trading market in their common equity.[1] My proposition is that the presence of markets in the characteristics that determine equity value makes a radical difference in the function played by corporate law. This emphasis on the link between markets, asset pricing and legal institutions has been a familiar theme in my work. For example, I have argued that business lawyers function to make up for market failures in asset pricing.[2] Similarly, Reinier Kraakman and I have stressed that familiar institutions operate to alleviate failures in the information market and thereby operate to support price efficiency.[3]

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[1] Note at the outset that I will not use the term close corporation, which by now carries a good deal of luggage with it.

[2] Ronald J . Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing; Ronald J. Gilson & Robert Mnookin,

[3] Ronald J. Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Re. 549 (1984); Ronald J. Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency Twenty Years later: The Hindsight Bias, 28 J. Corp. Law L. 718 (2003).

Robert Merton has recently generalized this focus on the intersection of institutional structure and imperfect markets in what he styles “a synthesis of function and structure.”[4]

I am convinced that the benefit of working out this interaction between the structure of institutions, including here the structure of corporation law, and how well markets price assets, results in a good deal more than what my friend Bob Mnookin refers to as “cute” theory – that is, theory which appears elegant at first glance, but whose simplicity results not from deep truth but from surface facility.[5] I will argue that recognition of the interaction between the accuracy of market pricing and structure of legal institutions provides a guide to thinking about theoretical and doctrinal issues in both pubic and private corporation law. In the end, this is all a typology can do.

Of course, the account I offer for this occasion is too brief to convince anyone that I am right. My ambition is only to persuade readers that the question is interesting and the answer worth further consideration. So limited an objective opens up the effort to a criticism another former colleague addressed, again documented only in oral tradition, some years ago. In presenting a paper at a Stanford Law School workshop, Bob Gordon anticipated the kind of comment I expect many of us have feared that an audience thought even if they did not actually say it. At the outset of his presentation, Gordon said that he understood that, when they heard his talk, many people in the room would conclude that they could have come up with the same point if they had thought about the problem for three minutes, and acknowledged that the room was full of people who were

[4] Robert Merton & Zvi Bodie, Design of Financial Systems: Toward a synthesis of Function and Structure, (Harvard Business School Working Paper No. 02-074, June 22, 2004), available on SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=313651

[5] This distinction has been the subject of numerous conversations over a period of years. While I do not believe it has been made explicit in any of our writing, it has certainly animated Bob’s scholarship and I hope my own.

clever enough to do just what they claimed. He defended his effort, and so will I defend mine, with the simple point that thinking is hard work and three minutes is a long time.

I. Separation and the Law of Public Corporations

Now think about separation. Where it exists – where capital markets are sufficiently complete that shareholders can fully diversify and whose wealth is therefore affected by corporate decisions only through their impact on stock price -- shareholders will be unanimous about the corporation's objective function. Every shareholder is best served if the corporation acts to increase the value of the corporation's stock without regard to risk. In turn, this unanimity makes the function of public corporation law straightforward: legal rules should function to facilitate shareholder value maximization.[6] Because capital markets are not perfect, organizational structure, like capital structure, matters. Reflecting Harold Demsetz's insight, corporations in different industries and with different business strategies will adopt different structures.[7] Public corporation law should facilitate this market in organizational form.

So what does this get us? I will sketch here a few directions in which one might take the point.

First, this perspective on the function of public corporation law sidetracks claims that a stakeholder-oriented board of directors has anything to do with corporate governance, as opposed to corporate management. The claim is either trivial – how can

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[6] One could well object that I have defined away other goals that Bill Klein has treated as part of corporate law, such as fairness, redistribution, control of political and economic power, issues of antitrust and the like. The criticism is descriptively accurate, but reflects the belief that there is an appropriate distinction between the rules that allow corporations to engage in activities that effectuate their shareholders' goals, and the rules that seek to regulate those activities for other purposes. I am concerned here with the former category because I believe it to be the only distinctive feature of corporate law.

[7] Harold Demsetz, The Structure of Ownership and Control and the Theory of the Firm, 26 J. L. & Econ. 375 (1983); Harold Demsetz & Kenneth Lane, The Structure of Corporate Ownership: Causes and Consequences, 93 J. Pol. Econ, 1155 (1985).

one run a successful business without taking seriously the role of non-shareholders whose contribution is important to the corporation's success? – or is met by the market for organizational form. We observe different roles for stakeholders in different industries. For example, the distribution of stock option grants among employees is vastly different in high technology companies and traditional smoke stack companies. While both the logic of their position and the intensity of their effort remain puzzling, it is no surprise that technology companies led the chorus of concerns about the impact of accounting rules on the efficiency of getting equity into the hands of employees.[8] Similarly, hostile takeovers are extremely rare in industries where the dominant input is human capital – employees figure larger in the management equation.[9] The point is that markets encourage a management and governance structure that fits the corporation's business. Default rules that isolate the corporation from the market by creating barriers to shareholder influence – for example, barriers to shareholders eliminating poison pills or regulation that operates on an "opt-out" rather than an "opt-in" basis – get in the way of the matching of a corporation's governance and its business.

Second, recognition of the role of institutions in responding to market failures speaks to the familiar compliant that a myopic stock market leads managers to prefer short-term over long-term strategies. Merton offers a simple example that illustrates how markets can overcome this kind of a bias.[10] Suppose individuals suffer from a systematic cognitive bias that causes them to underestimate their life expectancies, and

[8] Ronald J. Gilson & David Schizer Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, 116 H. L. Rev. 874 (2003)discuss the importance of equity incentives to entrepreneurial activity and the intuitional structure that developed to support their provision..

[9] The success of the Oracle hostile offer for PeopleSoft may prove that the key is not just the percentage of human capital in the production function that drives the outcome, but also the level of competition in the particular employment market.

[10] Merton, supa note .

therefore be willing to pay too much for life insurance relative to an actuarially fair price. Competition among life insurers, who do know the actuarial cost of the insurance, will drive the price down to the actuarial fair level despite the systematic bias of consumers (and assuming no significant entry barriers). The impact of the bias is corrected by operation of a market that does not suffer from the bias. The solution is not without cost – transactions costs are associated with the operation of the corrective market response – but the larger the market, the lower the unit costs.

The same type of analysis applies to the claim that investor bias in pubic companies leads to short-term management. Assume that stock market investors systematically apply too high a discount rate to expected corporate earnings, and further assume that the optimal planning horizon differs in different industries.[11] Under these assumptions, the stock market will systematically undervalue companies with longer planning horizons relative to companies with shorter time horizons. As with Merton's insurance example, however, an intermediate market can alleviate the bias. The private equity market operates to arbitrage the failure in the market for public corporation equity – competition among investors who do not suffer from a short-term bias will drive stock price toward an unbiased level. The dramatic growth of the private equity market and the expansion in the range of industries in which private equity funds now operate are consistent with this intuition: a corporation's most efficient source of capital is driven by the character of its business and competitive responses to market failures.[12]

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[11] The assumption of systematic bias also assumes the absence of corrective trading by arbitrageurs.
[12] The idea that public and private equity are governance alternatives is at the core of Michael Jensen's famous brief for the role of private equity. See Michael Jensen, The Eclipse of the Public Corporation, Harv. Bus. Rev. 61 (Sept.-Oct. 1989).

Again, the lesson for public corporation law is to get out of the way. When public investors systematically get it wrong, markets will respond. They will do so imperfectly and with significant transaction costs, but the appropriate performance measure is not a perfect market, but the Delaware courts. The same humility that animates the business judgment rule surely teaches that courts will be no better in choosing the right governance structure for a corporation than in choosing a business strategy. The combination of separation and market responses to market failures counsels in favor of public corporation law setting as a default governance structure that opens the corporation to the market and getting out of the way. Where there are claims of market of short-termism, or the need for effective precommitment, markets will do a better job of assessing their validity than will a court.

II. Separation and the Law of Private Corporations

Viewing private corporations through the lens of separation yields quite different implications. Because shareholders in private corporations typically invest their human capital along with their financial capital, they cannot diversify their investment. As a result, we would not expect shareholder unanimity on strategy because corporate decisions will affect the shareholders' wealth other than through stock price. To use a familiar example from the case law, a shareholder's employment relation with the corporation may have a greater impact on her wealth than the corporation's strategic decisions. This opens up a role for corporate law that is not present in public corporations. Individuals may be both opportunistic and biased; unlike in the public corporation setting, no market operates to correct the problem.

So what is the role for law? Part of the answer is familiar. Corporate law imposes a default rule: what rules would parties, who in fact did not choose any to govern the particular dispute, have selected if they made the decision rationally and with complete knowledge?[13] This default rule approach extends to a judicial role in assessing the distributive issues, cast in terms of fiduciary duty, that are central to the private law of corporations precisely because the shareholders cannot diversify. A common formulation of this approach is for the court to apply a judgmental default rule: enforce the parties' "reasonable expectations."[14]

The absence of separation makes it easy to understand why we are so easily persuaded that courts should be involved in private corporation distributional disputes. The litany of cognitive biases that have been catalogued by psychologists provides persuasive evidence that some people may make systematically bad decisions for a variety of different reasons. How many of us have not had the experience of reading the list of entries in a survey of biases and, at least in private, acknowledging with respect to each entry that "I do that"?[15] Because in private corporation distributional issues, unlike in Merten's insurance example and the specter of short-termism in public corporations, no market is available to render these mistakes benign, an institutional role appears for courts: as mediator of distributional conflicts when the parties did not anticipate or systematically misapprehend the problems.

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[13] This formulation is intentionally broad enough to include the concept of default rules operating to force honest negotiating behavior. The nice thing about the conference's requirement of brevity is that the difficult details can be ignored.

[14] For present purposes I will not take up the interesting doctrinal issues that arise when the reasonable expectations standard must be operationalized. Fro example, are the parties reasonable expectations fixed at the time of incorporation, or is the court's role akin to a labor negotiator whose job is to adjust the terms of the arrangement in light of current conditions?

[15] For a recent survey of the biases and the empirical evidence of biases in the context of the capital market, see Nicholas Barberis & Richard Thaler, A Survey of Behavioral Finance, in Handbook of the Economics of Finance (George Constantinides, Milt Harris & Rene Stolz eds., 2003).

But, and here is the insight that I hope warrants three minutes of thought, the same analysis implies significant limits that are not acknowledged by courts that take up the challenge of assessing with hindsight the warring parties' previously unstated reasonable expectations. I will discuss two briefly here, but readers surely will have their own additions to the list. One goes to the imperfect ability of the bias literature to dictate a determinative outcome; the second goes to the real risk of judicial hubris.

The first limit simply reflects the indeterminacy resulting from the sheer range of biases for whose existence the empirical literature provides support. The number of biases, taken together with the general absence of precision about which bias, or combination of biases, are operative in particular circumstances, leaves a decision maker too much freedom in applying the concept to explain the behavior in a particular case[16]. Moreover, with respect to any particular bias, the experimental literature does not demonstrate that everyone suffers from it; in all studies, a significant portion of the sample appears to be immune. Thus, in a specific case, it may be difficult for a court actually to observe whether a particular bias was operative, with the result that the parties' reasonable expectations remain opaque.

Sam Issacheroff and his colleagues have usefully considered the implication of the indeterminacy of the bias literature for its legal application,[17] here the application of this body of social science by courts. They urge its application only in accord with the principle of "asymmetric paternalism." The idea is to rely on the potential for bias only

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[16] "Start with the familiar complaint that the sheer number of biases that have been indentified, together with the absence of precision about which bias, or combination of biases, are operative in particular circumstances, leaves too many degrees of freedom in assigning causation." Gilson & Kraakman, supra note 3, at __.

[17] Colin, Camerer, et. Al., Regulation for Conservative: Behavioral Economics and the Case of Asymmetirc Paternalism, 151 U.Pa. L.Rev. 1211 (2003).

in framing default rules that can be contracted out of by more sophisticated parties. Where the parties do contract out of a default rule, the choice would be respected despite claims that the decision to contract out was itself the product of a bias. In this setting, the court's intervention affects sophisticated and unsophisticated parties differently: the decisions of parties who make an explicit choice are respected, while courts would review the reasonable expectations of those who do not make such a choice.

The second limit generalizes the first point: courts should be hesitant in imposing its after the fact construction of what the parties really had in mind, even in the context of a default rule. In assessing the role of courts in interpreting contracts entered into between firms, Alan Schwartz and Robert Scott recently argued that courts should both limit themselves to strictly textualist interpretation and be parsimonious in their assignment of default rules, in both cases because default rules in the form of standards like reasonable expectations too often lead to bad results.[18] Private corporate law is contract law in positive terms – identifiable individuals elect to go into business with each other on terms specified by agreement or statutory default.[19] Schwartz and Scott assume away most of the power of the cognitive bias evidence by limiting their normative claim to a category of firms where biases are least likely to influence behavior. However, their concerns about the limited capacity of courts to improve outcomes survive even in the face of a more robust role for individual biases.

We are thus left with a tension between the potential for courts to alleviate the distributional inequities that result from individuals contracting under the burden of

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[18] Alan Schwartz & E. Scott, Contract Theory and the Limits of Contract Law, 113 Yale L. J. 541 (2003).
[19] This point raises an interesting issue with respect to the breadth of Bill Klein's ambition for a taxonomy of the functions of corporate law. For this purpose, private corporate law simply may be a subset of contract law rather than a subset of the body of law that also covers public corporations. Framed this way, separation then serves to distinguish between the conceptual domains of corporate and contract law.

cognitive bias and the reality that courts are unlikely to be very good at realizing that potential. Reading the cases with this tension in mind might provide some guidance about where the balance actually comes out.