Democracy and Delaware: The Puzzle of Corporate Law

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Corporate law does not conform to ordinary democratic norms: unlike human citizens, corporations may choose the law that governs their most fundamental acts of self-governance. Most major American corporations chose the law of Delaware, with the result that the Delaware courts and legislature, under heavy influence of the Delaware and national corporate bar, organized into professional organizations, and of the market pressure of corporate managerial decisions to reincorporate (or threaten to reincorporate), determines much of the corporate law in America. This system seems on its face to violate the most fundamental principle of popular sovereignty -- all non-Delaware citizens of the United States are excluded from even formal participation in the process of determining American corporate law, and even Delaware citizens are reduced to a largely formalistic ratification role of results coerced, to a large extent, by the market for corporate control.

Corporate law scholars have devoted many pages to debating whether the surrender of corporate law to a market for corporate reincorporation generates substantively good or bad results, but there has been virtually no discussion of whether this process can be squared with the American commitment to self-governance. This Article aims to address that latter issue -- with its obvious implications for other areas in which we, consciously or unconsciously, chose to subordinate politics to markets or vice versa.

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I. The Illegitimate Origins Of Corporate Law

Corporate law defies basic democratic principles. While democratic theory insists that the governed should choose their governors, and even more importantly, their system of government, the American system of corporate law removes most important questions of corporate law from the political process. Citizens, acting through the political process as presently constituted, have effectively no say in constituting corporate law. The law, and the corporations formed under it, are rather products of a market that, by historical accident, has freed itself from political control.

Our corporate law is created by lawyers, legislatures and judges unanswerable to the people whose lives are affected by it: Delaware determines the nation's corporate law, and the rest of us are not even "virtually represented." Under the Delaware system, corporate managers are entrusted with stewardship of enormous concentrations of wealth and power — in many instances both larger and more important in our daily lives than most governmental units — with little supervision or answerability to the political process. These autonomous power concentrations, in turn, are granted the strikingly unusual right to choose the law that governs them, thus guaranteeing that corporate law will continue to respect their independence from the will of the people. In short, we have created institutions of major importance and power and then set them on their way to do good or ill with little control or influence by the citizens whom, ultimately, they should serve.

A. What Is At Stake

Corporate law matters. Corporate law structures the ways in which corporations make decisions, respond to the pressures or constraints of markets, constituents and other laws, allocate their surplus and balance conflicting moral or political demands.

Current corporate law directs corporate managers – the proximate decision-makers – to set aside all values other than share value maximization. More importantly, it directs those managers to view all participants in the corporation, with the sole exception of shareholders, as outsiders to be bargained with at arms-length or tools to be exploited (within the limits of the law) rather than, for example, fellow adventurers or partners in a common enterprise. It structures the incentives of managers in a way largely consistent with this narrow understanding of their role, with one large exception: managers have incentives and ability to betray their obligations to shareholders in the cause of pure self-interest.

Our corporate law, then, creates a dichotomy between on the one hand, managers as professionals, who work selflessly for their masters, the shares; and on the other hand, managers as kleptocrats, stealing what is not theirs for their own self aggrandizement. Under current corporate law models, corporate law debates are largely about the extent to which corporate managers are constrained to place share value maximization above manager wealth maximization. Almost no one argues that the latter is a legitimate goal; the debate is rather whether it is a useful means to the primary, share centered, goal, or an unfortunate side effect of market and regulatory failure.

But the dichotomy of current corporate law is deceptive. Public corporations are more than their shares and their managers: they are also our jobs, the architects of our cities, the sources of our pensions, our neighbors, the manufacturers of our consumer goods and the suppliers of our services. Corporations could be run with an eye to many values that drop out of our current system or appear only as external constraints.

Thus, one could imagine a corporate law that directed corporate managers to maximize job creation or wages, or work-place creativity or autonomy, or product quality, or civic responsibility, or environmental quality, or family quality time or enhancement of republican self-definition. In such a firm, share value might be a constraint rather than a goal, much as employee wages are a constraint on the share value maximizing firm: shares would be allocated only so much of the firm's assets as is necessary to attract the minimum necessary amount of capital.

A world in which corporate managers were directed to consider those diverse goals would look quite different from our own. For example, under current corporate law, it is always proper for corporations to cut "costs" at the expense of society as a whole, for example by failing to use the best available environmental protection technology, or at the expense of corporate participants specifically, for example by refusing to honor (legally non-binding) promises of long-term employment on good behavior or generous pension or medical benefits. Corporate law debate, instead, concerns the difficult issue of whether managers are *obligated* to cause their corporations to free ride in this manner whenever it is share value maximizing to do so, and whether (as a matter of corporate law) they may free ride even when they are barred from doing so by (non-corporate) law. At the limit, one could argue that corporate law norms demand that corporations assess all law according to the share value maximization principle: they should violate even the criminal law if it is share-value maximizing to do so.[2]

Were corporate law different, corporate managers would make different decisions. Perhaps if they were told they could consider other values, they would do so more often. If they were told to treat employees (or customers or warm fuzzy animal or pensioners or local governments or creditors) as partners rather than opponents, perhaps they would do so. If they were not invited to externalize costs through liberal limited liability rules,

[2]Compare, Miller v. American Telephone & Telegraph, 507 F.2d 759 (1974) (holding that illegal acts, even though committed to benefit the corporation, may amount to a breach of fiduciary duty) with Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1168 n. 36, 1177 n.57, (1982) ("(M)anagers not only may but also should violate the rules when it is profitable to do so."); EASTERBROOK & FISCHEL,THE ECONOMIC STRUCTURE OF CORPORATE LAW, 37-38 (similar). For further discussion of this issue, see Kent Greenfield, *Ultra Vires Lives*, 87 VA. L. REV. 1279, 1291-5 (2001) (criticizing contractarian view of corporation on ground that it requires managers to violate the law when it is profitable to do so).

perhaps they would do so less often. Asbestos and cigarette companies, nuclear power plant builders and energy traders, accounting firms and the like were and are directed by current corporate law to ignore the possibility of truly massive liability: if it happens, the corporation (as it is understood in the law – the shares) will not bear the bulk of the costs.[3]

Were our markets perfectly efficient, little would be at stake in the wider debate I propose. In a market at full equilibrium, all corporate participants, including shares and managers, are paid only their marginal product, which is equal to their marginal cost. Corporations make no economic profit and are fully constrained in all their actions: were they, for example, to pay shares more than other companies, they would have higher costs and would immediately fail in the product market. Parties that were allocated legal burdens would bargain to shift them to more efficient cost bearers; the law simply wouldn't matter.

But in the real world, markets are never fully at equilibrium and managers never have the information necessary to predict properly the market response to their decisions. Successful corporations do have surpluses to distribute, and our current corporate law directs that those surpluses be given to shareholders while giving top managers, but not other corporate participants, strong mechanisms and incentives to take some for themselves. The predictable result is that top managers and shares have become quite wealthy, while little of the economic growth of the last several decades has reached other corporate participants. Similarly, many corporate participants have no ability to bargain to reallocate the law's burdens – most obviously, retirees and tort victims are just stuck with whatever corporate law allows them to claim against.

Similarly, were corporate managers perfectly self-interested, the political debate I propose would instead be a debate about the limits of regulation. Current law gives managers plenty of room to cheat: to place their own private interests above the ones that, as professionals, they are directed to consider. But if all managers were perfect cheats, the economy would collapse. Under current law, investors buy shares with only weak protections against self-interested managers; they must be assuming that the moral imperative, the law's (often unenforceable) demand that managers set aside their own interests to work for that of the shares, will be enough to cause managers to work for the shares. The necessary implication is that moral imperatives matter. If we told managers to do something else, they would – not in all instances, but in enough to matter.

The issues raised by corporate law are quintessentially political issues. We as a society value wealth maximization, but we also value quality of work, number of jobs, family time, environmental quality, safe products and perhaps even urban architecture. These values necessarily conflict in a disequilibrium market: the more of the corporate

[3]Interestingly, in Europe, where EC directives are less subject to a race to the top/bottom, corporate law includes mandatory protections for employees, creditors and even shareholders absent from U.S. state law or appearing only in the Federal securities regime (which is also not subject to the race). See, e.g., Carney at 320-5.

surplus that is given to shares, the less that is available for other corporate claimants. If corporations are told that it is "cost cutting" to find ways to renege on pension promises, but not "profit maximizing" to reduce dividends, it is predictable that they will do more of the former and less of the latter. (This is why the accounting treatment of stock option grants to top managers matters: if it decision-makers are directed to view options as a "cost", they will give out fewer of them than if they are told they may see them as a pure free will offering costing their fiduciaries nothing).

Political decisions, however, needed to be debated in political fora. Possibly such a debate would ratify the status quo: we might conclude that directing managers to consider one goal and one goal alone of all the possible worthy aims in the world so simplifies their task and the tasks of those who must supervise them that it is worthwhile to pay the cost of ignoring other important needs and desires. But the political debate might go a different direction. We might conclude, for example, that we'd rather have our most important economic actors putting environmental considerations front and center, rather than treating them as constraints on profit maximization. We might conclude that at some point, increased financial wealth is less important than quality of life issues, and we'd like the central decision-makers concerned with those issues on a day to day basis to consider quality of life directly rather than only as it impacts profits. We might conclude that at some point total wealth is less important than distribution: that we'd be happy to have major employers sacrifice some growth in return for job stability or job increases or higher wages.

None of these value conflicts are easy issues and I do not pretend to offer any account of how the political debate about them would or should proceed. The point of this Article is more basic: we have created a process for creating corporate law that cuts off the debate about the goals and purposes of corporate law. The race to the bottom/top, driven by the anomalous right of corporations (meaning corporate managers) to chose their own law, eliminates the forum in which we, as citizens rather than as shareholders, ought to be arguing about when share values ought to be sacrificed for other republican, democratic, or simply civic values.

B. The Metaphors of Corporate Law

Commentators have attempted to legitimize this anomalous system by three related models: first, a contractual model, second, a property model and third an entity theory that confuses the corporation with individual citizens. All three models portray corporations in ways that make them appear private – more like citizens than government – and powerless.

The contractual model contends that corporations are private entities of concern mainly to those who contract with them. Since corporations (on this model) appear purely voluntary, the appropriate role of the state is merely to enforce private agreements. In the most consistent form of the contractual model, the corporation tends to lose its corporeality: it is described as a mere nexus of contracts and dissolves into a moment in the market.

In general, contract law is highly interventionist, and the contracts of most interest to ordinary citizens are highly mediated by substantive law: consumer, loan, insurance and employment contracts are read (to the extent that they are written at all) in light of strong substantive policies developed by both legislatures and courts.[4] In contrast, corporate law is not interventionist at all. The process by which corporate law is made, especially the right of corporations to choose their own law, means that states cannot impose substantive values into corporation law "contracts" to protect weaker contracting parties. Were a state to try to introduce such values into corporate law, the stronger bargaining party would simply cause the corporation to use a different state's law.

Theorists of the contractual model have largely conceded that state corporate law cannot impose protection on parties to the corporate contract. Instead, they have argued that the market participants will insist on law that adequately protects them. The contractual model, then, is not so much a claim that corporate law is like contract law — it clearly is not — as a claim that the market will generate the appropriate legal regulation or guidance by its own processes.

This market/contract model's claim to solve the democratic problem is false. Democracies have long known that markets can be tools for good or ill. That is why we attempt to suppress markets in, for example, protection rackets or cocaine. And markets generally fail to account for important values that are not reflected in price: that is why we have environmental regulations and child labor laws. Markets also tend to contain incentives to self-destruction. That is why successful markets are surrounded by effective disclosure requirements, bars on fraud, and bans on monopoly. To allow a market — or a firm recharacterized as a market — to set its own rules is unlikely to reach results satisfactory to a self-governing people.[5]

The second model uses the metaphor of property: a corporation is conceptualized as an asset — a thing — owned by an individual (or a group of individuals, a difference not seen as meaningful). As a subset of property law, corporation law is seen, then, as largely about agency issues: corporations are property managed by agents and the central issue is only whether the agents are acting in the interests of their principals.

This agency/property concept of the private corporation conflicts with the contractual/market model — agents are fiduciaries, governed by different norms than the ethics of the contractual marketplace[6] — but it shares with it the underlying claim that corporate law does not affect the rest of us. By portraying corporations as property, it suggests that protecting corporations is protecting the property-owners, and thus a system

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[4]See, GRANT GILMORE, DEATH OF CONTRACT (1974).
[5]See, e.g., Daniel Greenwood (iowa and USC)
[6]Salmon v. Meinhard

of law that allows corporations to choose precisely the protection they want is not problematic.

The property/agency model fails, however, to answer the democratic claim for two reasons. First, the "property" in question is fundamentally a set of social relations among people, many of whom are not parties to the alleged agent/principal relationship. And second, the metaphor conflicts with the law: the shareholders, viewed alternately as principals or property owners, lack most of the rights ordinarily associated with either. As a consequence, the corporate agents lack a principal and the corporate property lacks an owner, so that protecting the corporation does not protect the humans associated with it, even those this theory characterizes as "owners."[7]

Third, corporations are often conceptualized as individuals. In one variant, the firm is ignored altogether, reduced to the individuals thought to make it up (usually the shareholders, rather than the people who actually act for it), and it is assumed, without evidence, that the individuals and the entity are the same, or at least share interests. In the other variant, the firm itself is seen as an individual, as if it itself were a citizen to be protected from government and entitled to participate in the governing process, rather than a tool of the citizenry not dissimilar from the government itself. These two models – the aggregate and entity theories of corporate personality – are seen as radically opposed in the academic literature, and for some purposes they are. But in their most common forms, each sees the firm as an "intermediate institution" that must be protected to protect citizens and civil society from the state.[8]

On the aggregative view, protecting the corporation is seen as no more than shorthand for protecting the individual citizens (or shareholders) whom it "really" is. But this theory of corporate personality should be strikingly unpersuasive in a liberal democracy: just as liberal theory attacks the notion that the state can be identified with the citizens who make it up, it should question the naive idea that the corporation and its "citizens" can be conflated.

In contrast, the entity model treats the firm itself as a citizen. Thus, it harks back to the pre-democratic view of the state as composed of estates or corporations each entitled to rights independent of (and often in opposition to) rights of the individuals who compose them. Like a medieval church or university, modern corporations maintain internal disciplinary and justice systems that are largely unreviewed by and independent of the state system. Paradoxically, then, this private model of the corporation claims to justify granting the corporation state-like powers.

A corporation as a state-within-the-state, however, can not be justified under any democratic theory, because this state-like entity defies all democratic norms internally. No

[7]See Daniel Greenwood (USC).

[8]See, ALEXIS DE TOQUEVILLE, DEMOCRACY IN AMERICA

corporation operates by the principal of one person, one vote. All economically significant corporations disenfranchise a substantial portion of the affected populace. Moreover, standard corporate law sharply limits the control that even the "voters" have over "their" entity, in the absence of unanimous consent not only barring them from making fundamental value choices, for example, from balancing the pursuit of profit against other potential corporate goals (such as quality products or interests of non-shareholder participants) but even barring them from electing directors pledged to particular interests.[9] Theorists, therefore, usually resort to market-based explanations of why the corporation is unable to exert any power over its shareholders, employees and other participants.

The entity model must fail for the same reason as the aggregate model: corporations are tools of human beings, not values in themselves. They are, that is, state-like rather than citizen-like. And their lack of internal democracy means that they have only weak claims to be alternative representative institutions in a federal or pluralistic system.

Each of these metaphors takes much of its power from an underlying economic theory combining elements of all of them. In standard micro-economic theory, corporations are sometimes viewed as mere black boxes subject to consumer sovereignty through the product market, and therefore not power loci at all. If a corporation has no choice but to follow the market, the argument runs, then its internal organization is of no importance; corporate economic actors will behave the same as individual ones. In a reasonably competitive market, only the lowest cost producers will survive. Accordingly, corporations will be compelled (if only the state will allow them) to adopt the lowest cost organizational form (including the lowest-cost corporate law).

The "genius" of the American system, then, is that the corporation's right to choose its state of incorporation creates a market for laws: an interstate competition which, in turn, precludes meddlesome reformers from imposing unnecessary costs on corporate organizational form.[10] In this model, then, the corporation is seen as a purely economic actor, important mainly as a producer of consumer goods, and properly subject to purely economic forces. The necessary conclusion is - that corporate law is best which governs least. Corporate law should simply allow the market free rein (or should it be reign?). And, our competitive federalism does just that. To the extent that this model holds, corporate law is largely irrelevant and uninteresting. The only socially important regulation of corporate law will be by the product market itself; the only socially important law will be regulation

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[9]Directors, unlike ordinary politicians, are bound by law to pursue the interests of all (and only) shareholders, and courts will enforce this duty (subject to the often significant limitations of the business judgment rule) at the behest of any shareholder regardless of election results. See Daniel Greenwood (USC).

[10]See ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Bernard Black, Is *Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990).

of the underlying product market, not of corporations.[11] The argument is, in short, that political democracy is unnecessary because market control is sufficient.

But to state the argument in this way is to point to its implausibility: we have long since rejected the notion that unregulated markets can even exist, let alone that they inevitably lead to the best of all possible worlds (or even to a better world than a market limited and guided by politically plausible regulation). More fundamentally, the line between market and democracy is, in a democracy, one for democratic politics to determine, and so the "genius" of a system that lets the market decide when politics should apply is anti-republican and anti-democratic.

Each of these metaphors tends to distract attention from the basic democratic issue: corporations, which are not citizens, choose their own law. In a democracy, however, citizens must govern themselves and that includes controlling their social and economic creations. Americans have abdicated that self-governing function to a legally structured market-for-law.

B. The Value of Democracy

Democracy is not, however, the only value in our politics. There might be good reasons for voters to choose to disenfranchise themselves, choosing the market-evolution model of corporate law over the deliberative-voting model of standard democratic law. For example, sometimes goals are best arrived at indirectly: perhaps there is reason to believe that the non-democratic process of corporate law will produce results that would be more likely to be approved by a democratic process than a direct democratic process will. Or perhaps the non-democratic process is fairer for some reason than a democratic one. Or perhaps it is more likely to fulfill some other goal — such as wealth creation — to such a degree that a democratic decision would decide to restrict democracy.

The peculiar anti-democratic status of corporate law, however, requires a special justification, and in this paper I will explore the available justifications and their limitations.

The paper proceeds as follows: Part II discusses the "Race to the bottom/Race to the top" controversy about Delaware law, focusing on the generally agreed picture: both sides of the debate agree on a basic — and non-democratic — picture of how American corporation law is created. While the debaters disagree on whether the resulting law is good for shareholders or not, they agree that the proximate decisionmaker is largely corporate management, and that other interests and views are reflected only through their influence on managers.

Part III argues that this market-like method of law creation is quite different from democracy, even in its debased interest-group competition form. One result is that Delaware corporate law commands the consent of the governed — if the governed are viewed as the

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[11]Taken seriously, this model would require that corporations be barred from influencing the substantive regulation of the product market. See, Daniel Greenwood (Iowa).

corporations — in a strong sense unattainable in ordinary democratic regimes governing human beings.

The free bargaining aspects of our current system of corporate law creation necessarily mean that the most powerful get the law they want. Indeed, the great race to the top/race to the bottom issue can best be understood as a debate over whether managers or shareholders are more empowered by non-corporate law features of the economic and legal landscape and thus more able to form corporate law in their own interest. In my view, the relative power of shareholders and managers is highly contingent (and greatly influenced by current corporate law). As a result, our current system does not head towards a single inevitable equilibrium, but rather has the potential for radical shifts. Thus, the dramatic shift in the allocation of corporate proceeds that characterized the 1980s is neither an anomaly nor proof of the progressive nature of corporate law: the structured competition of corporate law creation cannot yield a determinate outcome.

Part IV takes the next step. Were corporations citizens, the American corporate law system arguably would avoid some of the most troubling theoretical problems of democratic process, particularly the majoritarian difficulty and the social choice paradoxes. Similarly, it would avoid many of the potential practical problems of democratic action in a world of limited attention and limited citizen interest. Corporate law derives much of its ideological power and persuasiveness, it seems to me, from this picture: the entity, aggregate and property views of the corporation each suggest that corporations can be seen, metaphorically, as citizens. If they were citizens, our corporate law would not merely be democratically acceptable but extraordinarily successful. Corporate law would be our closest approximation to the liberal democratic ideal of a non-coercive state.

But the claim that corporations are citizens is false. Once corporations are understood as power sources, a part of our system of governance rather than an object of it, then the market for law appears radically illegitimate, an example of the powerful seizing the power of the state to increase their own power. Rather than seeing corporations as De Tocquevillian intermediate institutions restraining the state, we should see them as state-like themselves, part of the classic liberal nightmare of a state acting in its own interest, not that of its citizens.

The contract view of the corporation and the micro economic theory of the black box assert that the firm is simply a private transaction, or set of transactions, in the market, to which only restitutive, non-distributive, justice issues apply. For much the same reasons that have led us to reject laissez-faire generally, the claim that the market for corporate law is fair or non-coercive must fail.

Part V completes the picture by arguing that corporate law affects all of us, not just the corporations who are its alleged subjects. In the perfectly competitive equilibrium market of economic theory, all proceeds of corporate activity are imagined to go to consumers, with shareholders, employees and managers understood to be mere factors of production paid their marginal cost. But life is lived at disequilibrium. In disequilibrium markets, successful corporations should generate a surplus above those costs (even assuming that the relevant markets are competitive enough to make the concept of "cost" determinate). In ordinary language, corporations seek to produce a profit and sometimes do. But it is the law that defines what we call a cost and what is a residual profit, or in other words, who is a factor of production and who receives the benefits of corporate cooperation. It is the law that determines that public corporations are their shareholders and possibly their managers and not, for example, their employees, customers, suppliers or neighbors. It is only corporate law that determines that corporate payments to employees are expenses (although partnership payments to partners are profit) while payments to capital held in the form of shares (but not bonds) are profit.

Corporate law determines that employees, suppliers, customers, bondholders and neighbors are all outsiders, with whom the corporation bargains at arms length, following the "morals of the marketplace," and therefore treats as inputs to be exploited to whatever extent possible. For the corporation to voluntarily act in the interest of these factors of production solely because it cares about them would be an egregious breach of legally imposed duty. Corporate law, in turn, determines that other corporate participants – in the ordinary course, just shareholders – are the objects of a fiduciary duty; when the corporation acts in their interests it is acting in its own interests by legal definition.

The distinction between insiders and outsiders is both central, deeply political and legal rather than economic. It is not an artifact of the market but rather defines the structure within which the market will function. In the imperfect markets of reality, that issue is centrally important. A corporation that is directed to maximize shareholder returns will systematically act differently than one that is directed to minimize customer costs, to maximize quality or job satisfaction, or to consider all these goals and to balance them in some political, legal or professional process. The argument that corporations are perfectly private fails, then, because it is the law — a law with no democratic credentials — that determines for whom and for what ends corporations act.

The decision about who is a member of a firm is thus an intensely political one, likely to affect almost every aspect of our collective life. The market generates an answer, or competing answers, under particular conditions. But those answers reflect market power, not justice, efficiency or even political victory. Moreover, the market-based system hinders the political debate that could properly balance the values of economic growth against its costs: increased relative inequality, mobility and change, and most importantly, the devaluing of human effort that comes from being understood as a means rather than an end.

II. Beyond The Race To The Bottom/Top

Scholars and practitioners are largely agreed on the non-democratic process that creates American corporations law.[12] Corporate law, the standard account goes, is created by a process of competition between the states. Each state has a strong incentive to entice out of state corporations to incorporate under its law because it derives tax revenue from the corporation.[13] In the case of corporations with business operations (including employees, customers, suppliers and shareholders) largely located out of state, the state may have no other interest in the firm except as a tax source. Thus, states seek to have out-of-state corporations incorporate locally in order to externalize local costs onto non-citizens. States competing for revenues in this way will seek to offer corporations corporate law that reflects precisely what corporate decision-makers seek – any negative costs of such leniency will in any case be borne by the firm's customers, employees, etc., all of them, by hypothesis, out-of-staters.

One might expect that the corporation's home state — that is, the one where the business and/or shareholders are located – would seek to resist this exploitative behavior, but legal doctrine developed differently.[14] Thus, unlike the practice in some European countries, a corporation incorporated in any American state is presumed to exist in every American state, without any need to create a separate subsidiary or sister corporation in each jurisdiction, or (as some early railroads did) to obtain Federal incorporation. Indeed, states do not require even purely domestic businesses to organize themselves under domestic law: California does not require that California citizens doing business in California apply California law to their businesses.[15]

Given this competition between the states, the conventional account demonstrates, corporate law develops rapidly to meet the perceived needs of corporations. Corporations will re-incorporate in the state that offers them the law they seek; states that attempt to

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[12]The standard accounts setting up the race and the dispute about whether it is to the bottom or the top are, William Cary, Federalism and Corporate Law, 83 Yale L.J. 663 (1974) (race to the bottom) and Ralph Winter, State Law, Shareholder Protection and the Theory of the Corporation, 6 J. Leg. Stud 271 (1977)(race to the top). Dozens of more recent articles include many studies seeking to correlate stock price changes with reincorporation in Delaware. See, e.g., Lucian Bebchuk, *Federalism and the Corporation*, 105 Harv. L. Rev. 1437 (1992) (discussing event studies); Roberta Romano, THE GENIUS OF AMERICAN CORPORATE LAW 21 (1993) (discussing event studies). However, since the decision to reincorporate is, in practice if not in law, under control of incumbent management, it is hard to understand why investors would not price all companies, regardless of where they are currently incorporated, as if they were already incorporated in the most manager-friendly jurisdiction: rational investors should assume that whenever law matters, the firm will be incorporated where managers want it to be. In this market for lemons, any price effects at reincorporation should not be the result of the changes in the applicable law, but rather due to secondary signaling effects, if investors determine that this particular management is more (or less) assiduous in protecting shareholder (or manager) interests than they previously suspected.

[13]Or to protect the interests of the local bar. Jonathan Macey & Geoffrey Miller, Towards an Interest Group Theory of Delaware Corporation Law, 65 Tex. L. Rev. 469 (1987).

[14]The puzzle of *why* states allowed the race to develop and whether there is any doctrinal reason preventing them from simply opting out, I discuss separately.

[15]California comes closer, however, to imposing its own law upon its own citizens than most states. See [Tramp corporation article].

respond to other interests or ideologies in their corporate law will find that their corporations (though not necessarily the associated business) migrate elsewhere.

The story is not simply theoretical; history shows the competition in action. Thus, at the end of the last century, states offered substantially differing models of corporate law. At the turn of the century, New Jersey offered a corporate law designed solely to appeal to corporate management and quickly was able to attract so many incorporators that the associated tax — imposed almost completely on out-of-staters — obviated any need to tax its own citizens.[16]

However, a reform movement in New Jersey under Governor Woodrow Wilson amended the New Jersey corporate law to impose various restrictions that the Progressive movement endorsed but which weren't necessarily attractive to corporations. Shortly thereafter, Delaware, blessed with a small size, central location, and minimal countervailing interests, outdid the original New Jersey law and obtained the distinction of creating American corporate law. Because Delaware is small and not a major industrial state, its local politics are relatively free of the type of reformist politics that did in New Jersey. Delaware corporations are likely to be physically located elsewhere; thus, politicians and citizens have little relationship with the corporations that incorporate there except as legal entities. Moreover, Delaware remains heavily dependent on tax income from incorporations. Accordingly, Delaware is relatively unconstrained in its pursuit of corporate franchise taxes. Together with its sophisticated institutional structures to support its corporate law, this creates a reasonable assurance that Delaware will seek to keep its corporate law attractive to corporations and, indeed, that should any other state find an attractive corporate law innovation, Delaware will match if not better it.[17]

Within the constraints of the principles of free incorporation and the Internal Affairs Doctrine, other states then faced a limited number of possible approaches to corporate law. They could imitate Delaware, in the hope that at least some of their local corporations would find it not worthwhile to reincorporate in Delaware, perhaps with an occasional special twist for a large local company with idiosyncratic needs more difficult for Delaware to fulfill. They could attempt to out-Delaware Delaware -- but that was a difficult prospect once it became clear that the Delaware citizenry was willing to sacrifice its views, if any, on proper corporate law in order to obtain the lower taxation advantages of being the incorporation center of the nation, and that Delaware had created a sophisticated institutions (including special courts, a dedicated bar, and specialized legislative committee mechanisms) to assure that it kept its law the most attractive (to incorporators) in the country. Or they could attempt regulation — and see all significant local business reincorporate in Delaware. Whichever course the states take the result is the same: all important corporate law is made

[16]Hovencamp
[17]Romano, Genius

in Delaware. And regardless of where it is made, corporate law either is directed to the perceived needs of corporate management or it is empty, "vast twisted girders rusted in the wind," because all management need do to avoid it is to reincorporate in Delaware.

A. Gaming the Race to the Bottom/Top.

The general agreement on this story of how corporate law is made is somewhat hidden by a continuing controversy over whether the process is good or bad, reflected in claims that the process should be seen either as a race to the bottom or a race to the top. The argument, in somewhat simplified terms, is one over the appropriate time frame in which to understand managerial strategy.

1. Race to the bottom as a one time game.

Race to the bottom theorists model a simple one time period game. On this view, self-interested managers[18] prefer law which does not restrain them, so that they are free to use their position to appropriate corporate surplus. In particular, race to the bottom theorists assume that management will choose corporate law that allows it to exploit shareholders and other corporate participants. In game theory terminology, managers look for rules that allow them to defect: to enter into mutually advantageous arrangements with shareholders, but then renege on the agreement and take a larger than anticipated share. On this view, Delaware corporate law's radical simplicity and general permissiveness is little more than legalized theft.

In the early liberalization, Delaware eliminated compulsory regulation of minimum capitalization,[19] par value,[20] preemptive rights[21] and ultra vires rules,[22] universalized perpetual existence and limited liability,[23] permitted corporations to hold the stock of other corporations and eliminated other restrictions on corporate behavior common in early codes,[24] and drastically limited the powers of shareholders, placing governance in the board of directors instead.[25] More recently, it has reduced compulsory fiduciary duties almost to

[18]Both race to the top and race to the bottom theorists generally assume that top managers are closely allied with and in the ordinary course control the directors. Accordingly, I refer to managers and management in the following discussion even though Delaware law generally vests authority to make the decisions in question in the board of directors.

[19]Del. Gen'l Corp. Law § 154 (eliminating most capitalization and anti-dilution rules); Del. Gen'l Corp. Law § 162-3 (eliminating most shareholder liability for violation of anti-watered stock rules); Del. Gen'l Corp. Law § 170 (eliminating most limits on declaration of dividends out of capital).

[20]Del. Gen'l Corp. Law § 153 (authorizing no par value stock).

[21]Del. Gen'l Corp. L. § 102 (3) (no preemptive rights unless explicitly granted in corporate charter).

[22]Del Gen. Corp. L §121 (reversing rule that corporation only has powers explicitly granted it); § 124 (eliminating ultra vires action).

[23]Del. Gen'l Corp. L. § 122 (1) (perpetual existence), Del. Gen'l Corp. L. § 102 (6) (limited liability).

[24]Del. Gen'l Corp. L. §122 (4),(10), (11); Del. Gen'l Corp. Law § 160 (permitting corporation to buy and hold its own stock); Del. Gen'l Corp. Law § 251 (permitting mergers).

[25]Del. Gen'l Corp. L. § 141 (business of corporation managed by board, not shareholders). Cf. Del. Gen'l Corp. L. § 228 (allowing corporation to eliminate right of shareholders to act by written consent without a meeting); Del. Gen'l Corp. L. § 211(d) (allowing directors, in bylaws, to determine whether shareholders may call a special meeting).

the vanishing point.[26] The race to the bottom theorists interpret this general reduction in regulation straightforwardly as simple pandering to managers. Similarly, Delaware's general acceptance of limits on hostile takeovers fits nicely into the basic picture: managers get the law they want. Thus, Delaware was quick to correct courts that saw poison pills as violation of its equality of shares principle,[27] and later enacted a statutory pill,[28] both of which have the general effect of requiring target board approval before a tender offer is consummated. In its case law, it has generally upheld the right of management to refuse to put the company up for sale even against strong shareholder opposition and has allowed managers to defend against breach of duty actions by contending that actions seemingly taken without regard for shareholder interests were motivated by concern for other corporate participants.[29]

On this view, it is not accidental that Delaware law (like state corporate law generally) permits management to invoke other interests in defending against takeovers it opposes, but does not require it to consider those interests in connection with ones it supports: the states' law appears to be interested not in regulating takeovers per se, but in restricting hostile takeovers, i.e., takeovers that incumbent management opposes. The law gives managers plenty of tools to resist bust-up, highly leveraged, scorched earth transactions that they oppose; ones that incumbent directors support are scrutinized far less closely.[30]

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[26]Pursuant to Del. Gen'l Corp. Law §102 (7), a corporation may eliminate personal liability of directors for most breaches of the duty of care. Del. Gen'l Corp. Law § 145 generally allows the corporation to indemnify officers and directors against expenses in connection with suits, including for breach of duty to the corporation, so long as the indemnified person acted in good faith and in a manner the person believed not opposed to the best interests of the corporation.

[27] *Compare* Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y 1985) (finding pill to be a violation of the equality of shares) *with* Moran v. Household Int'l., Inc., 500 A.2d 1346 (Del. 1985) (upholding poison pill over opposition by, inter alia, the SEC). Poison pills generally are structured so that they may be put in place (and removed) by directors acting unilaterally without shareholder consent. Unless redeemed by the board (or by order of a court) the pill makes completion of a tender offer financial suicide. The result is that acquisitions by tender offer, like acquisitions by merger or sale of all assets, can not proceed without approval of the target's directors before shareholder action. Of course, if directors are in favor of the transaction, pills are no impediment.

[28]Del. Gen'l Corp. Law §203 (barring most business combinations with interested shareholder unless board approves or a super-majority of the disinterested shareholders approve the transaction).

[29]Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1040 (Del. 1989). Even Delaware has drawn the line at "dead hand boards" (allowing the pre-takeover board to continue in office even after a would-be acquiror has purchased the shares) but this is hardly a significant move towards supporting hostile takeovers. See, ..

[30]Roughly speaking, if an action (or inaction) that directors support does not amount to a sale of the company, shareholders may bring an action contesting the board's decision on grounds of breach of a duty of care to the company, but review will be under the lenient Business Judgment Rule standard, which presumes "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company," Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), and generally precludes complainants from proving negligence. Smith v. Van Gorkum, 488 A.2d 858, 874 (Del. 1985) ((requiring proof of gross negligence). The business judgment rule protects actions the directors take to prevent losing control, such as enacting a pill, so long as they are not done in the context of a particular threat. Kahn v Roberts, 679 A.2d 460 (Del. 1996) (refusing to apply heightened scrutiny to a share repurchase program).

(continued...)

Moreover, as a general rule, no corporate participant other than the fictional shareholder has standing or a cause of action with respect to director decisions. Accordingly, directors are entirely free to ignore all non-shareholder interests except in the most extraordinary circumstances (and would risk suit from shareholders if they were to explicitly consider those other concerns).[31] In the ordinary course, non-share claimants have only contract law to protect them; contract law, however, more often than not instead protects the autonomy of the corporation to defect or not as it pleases. Thus, under the standard analysis of bond contracts, directors and managers are free to take any action not explicitly barred by the contract, even if it radically changes the likelihood that the company will perform its future contractual obligations.[32] Even more dramatically, employment contracts are interpreted against background rules assuming that the employer has the unilateral right to set and control working conditions, including the unfettered discretion to

[30](...continued)
In conflict of interest transactions, the Business Judgment Rule does not apply. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993) (director's material financial interest or evidence of disloyalty lifts the presumptions of the business judgment rule), but review remains quite lenient: directors may defend by demonstrating the "entire fairness" of the transaction, which has generally turned out to be fairly easy.
Where directors are defending against a transaction they oppose, which could be understood as a conflict of interest transaction, the business judgment rule doesn't apply unless the directors demonstrate a threat and that their response was proportionate; this too has not proven an unduly difficulty burden. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (upholding discriminatory treatment of shareholder who sought to make unwanted tender offer); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1040 (Del. 1989) (where directors opposed an all-cash tender offer supported overwhelmingly by shares, court allowed directors to defend their actions as in the interests of non-shareholder constituencies and even a general concept of the corporation's purpose); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995) (when defensive actions are not "coercive or preclusive" review is limited to whether they are within a "range of reasonableness"); Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984, 1010-14 (E.D. Wis.) (upholding "just say no" defense).
However, once the directors decide on a transfer of control, the courts apply a stricter standard of review. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del 1985) (when company is to be sold, directors must maximize price shares will receive). See generally, McMullin v. Beran, 765 A.2d 910 (Del. 2000) (reviewing the multi-tier standards of review).

[31]As noted in the prior footnote, review of shareholder suits is extremely deferential, and outside of the limited "Revlon Mode," the Delaware courts do not seem inclined to **bar** directors from considering non-share interests. Time. Nonetheless, the basic asymmetry seems clear: whenever directors consider non-share interests, a potentially litigiable issue arises. In contrast, only in the most extraordinary circumstances are directors under any judicial pressure, however mild, to consider non-share interests. The one exception is a line of cases holding that when a company is near insolvency, the directors may have some fiduciary duties to protect bondholders. CITES. I know of no cases extending that duty outside the immediate insolvency situation – although, as the bondholders of Reynolds graphically learned, bondholders are injured anytime a company decides to radically increase the risk of insolvency, even if the gamble turns out well. See [Larry Mitchell and Bratton articles]. Nor am I aware of any cases extending fiduciary protection to other corporate claimants who may need it near insolvency even more than bondholders – for example, employees, suppliers or customers with firm-specific investments are less likely to be diversified and (in the case of employees) more likely to be hurt beyond the pocketbook than are bondholders.
[32]See prior fn. Some courts recognize that when the company is close to insolvency, managers may be tempted to gamble with what is effectively bondholders' investment, and therefore impose a fiduciary duty to respect bond interests. However, as Reynolds demonstrates, the temptation to gamble with non-shareholder investments is not limited to near-insolvency circumstances.

organize or reorganize the business in any fashion without consideration of employee interests or desires, that employees have waived any right to process in internal termination proceedings (whether for cause or not), that employee work products (including inter-employee relationships) are the property of the employer to be disposed of as the employer sees fit, and even that (except where ERISA changes state law) pension promises create at most a junior unsecured claim to whatever assets the employer chooses to have available. Contract law, thus, offers cold comfort. Corporate law offers less: deliberately taking maximum advantage of non-shareholder participants in the firm to the fullest extent permitted by other law (and arguably even beyond) violates no corporate law duty whatsoever and, indeed, is liable to be interpreted as a commendable concern for fictional shareholder interests.[33]

In short, takeover law is mostly about supporting managers.

2. Race to the top as a repeating game.

Race to the top theorists, in contrast, contend that managers and shareholders should be seen as playing a repeating game. If shareholders fear that managers will appropriate gains that shareholders anticipated would go to them – that is, if shareholders fear managerial defection in the way that race to the bottom theorists predict – they can easily defend themselves, by charging for the defections ex ante. In other words, if shareholders think managers are going to steal, they will reduce the returns they expect to earn by the amount available to be stolen. If stealing were entirely unrestrained, the result would be that only the naive would invest in the public stock markets: rational investors would not expect any returns except perhaps by accident.

The race to the top point is that in this repeating game, managers have a potential common interest with shareholders. Managers who can convince the financial market that they will work for shareholders, not defect, will be able to obtain investment capital at far lower cost than competitors who do not. This should give them a major advantage in the product market, allowing them to produce products at a lower cost and underbid their competitors. Moreover, if there is an active market for corporate control, managers whom the market perceives are not acting in shareholder interests will quickly find themselves out of a job: if the stock market bids down a company's stock below the company's value if it were run for shareholders, it is an easy takeover target. Shifting corporate surplus to shareholders is not rocket science; it doesn't even require improving the product or production processes. Any manager who makes the shift should be rewarded with an immediate jump in share price; outsiders, even if they are Wall Street generalists with no

[33]Some courts have gone so far as to suggest that corporate law invites corporate decisionmakers to violate other law if they do so in the interests of shareholders. CITES. Others have found at least criminal actions to be barred. But as a matter of corporate law, only shareholders can sue, and as a rule, they will be understood to have no damages and therefore no action if they have not been injured in their role as shareholders. Without some change in the standing and damages rules, corporate law is structurally incapable of protecting non-share interests.

particular knowledge of the industry, should be able to make the changes as well. Moreover, Wall Street should have no trouble understanding the profit potential here, so financing for hostile takeovers should be readily available. Thus, both incumbent management and outsiders have both the means and a powerful incentive to do what the stock market wants. Managers who appear to be running the company for the benefit of shares will be rewarded with a lower cost of capital; those that don't will be penalized and easy targets for takeovers.

Accordingly, the race to the top analysis contends that race to the bottom has it backwards: far from looking for ways to abuse shareholders, managers should be searching for ways to prove that they have only the best interests of shareholders in mind.

3. The end game problem in race to the top.

In an infinitely repeating game, only managers with a reputation for not stealing would be able to sell their services, and those who had a reputation for focusing on shareholder value would obtain the lowest cost capital. Accordingly, managers would seek to obtain such a reputation, as the race to the top contends. But CEOs are typically near retirement age, and a retiring CEO may find it attractive to cash-in on a hard-acquired reputation for honesty: now that he has his hands on the cookie jar, why not just help himself and too bad for the reputation? Even if his company suffers from a sudden jump in its cost of capital, the CEO himself will be both rich and retired.

Generalized, this end game problem presents a very serious problem indeed. If a CEO of a large public company can seize enough corporate assets (via stock option grants, an MBO or golden parachutes) to make future employability or company success an irrelevant consideration, they may do so. But if potential shareholders take this possibility into account ex ante, the market may decide that reputation is not reliable. Kenneth Lay, after all, had a fine reputation until after it was too late. At this point, the situation appears to be a market for lemons: investors should refuse to pay for quality that they can not verify (that is, they should pay top managers on the assumption that they will steal, which would suggest very low pay indeed). Since honest managers are not being paid for their honesty, they will disappear. As in a classic market for lemons, willing buyers of a high quality (or honest) investment product and willing sellers will be unable to make a bargain; all that will be produced is garbage.

But investors are not like car buyers, who simply suffered with poor quality cars until the foreign manufacturers figured out how to escape the lemons trap. Americans can't live without cars, but investors can easily shift out of the stock market. If CEOs can determine unilaterally whether and how much to steal, investors cannot price future returns in any rational way. When the risk is under the control of the insured, insurance companies refuse to sell; the financial markets should act no differently. The implications then are dire: if investors were to conclude that managers are freely able to appropriate corporate assets, the public financial markets might largely close down or, at a minimum, would charge extraordinarily high risk premiums. (How do you price the risk of someone defecting when the defector can change the odds unilaterally?). Presumably, private financing transactions (for example, intra-family financing, where other methods of preventing defection are possible) would pick up some of the slack, but almost certainly we would all suffer from lower economic growth and flexibility.[34]

4. Corporate law as the 'credible commitment.'

What is needed, then, is a way out of the end game problem: some device, more reliable than reputation, that managers can use as a 'credible commitment' that they will not defect. That device is corporate law.

If managers can find law that allows them to prove to investors that they won't defect, some managers should seize on it as a way out of the market for lemons problem, thereby attracting rational investors and enabling them to out-compete those who do not. In short, managerial competition for low cost financing will lead to a beneficial race to the top. Managers, not just shareholders, have an ex ante interest in finding state law that prevents managers from stealing: corporate law can become a 'credible commitment' that managers will live up to their bargain. Thus, race to the top theorists propose that managers acting in their own best interest will choose law that prevents them from defecting.

On this story, managers and shareholders unite in choosing the law that is in their mutual best interests. Since they are the ones most intimately involved in the process, it seems reasonable to assume that they will do a good job of defining those interests and the law that will support them. It follows, then, that corporate law, like contract law, must be about enforcing voluntary agreements.

Oddly, however, Delaware's law doesn't actually look like the law this story would predict. If choice of corporate is law is driven by the need to find a 'credible commitment' that managers will not defect in an ever-imminent end-game, one might expect to see legal regulation obviously preventing defection. The usual story of Delaware law, however, is one of increasing permissiveness, not careful elucidation of minimum standards of behavior.

Race the top theorists, accordingly, have some explaining to do. If they are right, Delaware's permissiveness must have some other rationale than simple pandering. Instead,

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[34]Most investment by major corporations is financed by retained earnings, and most of the rest by debt, so even a total collapse of the public stock markets wouldn't necessarily cripple the economy. Indeed, some modern industrialized countries seem to do reasonably well with far less developed stock markets than our own. However, any loss of finance capital should result in lower growth. Moreover, were investors to withdraw from the stock market due to suspicion of self-dealing managers, it seems somewhat implausible that they would put aside those suspicions in the bond market. Bond markets suffer from their own problems: after Reynolds, bond holders should be quite aware of the possibility that they too may be taking unquantifiable risks of defection. Accordingly, the net result of greater suspicion of the public finance market ought to be lower stock prices and higher interest rates, leading to slower growth (especially of smaller companies less able to generate investment capital internally). Moreover, we would likely see a dramatic increase in influence of banks, large corporations and wealthy families able to escape the market for lemons by personal relationships. In general, investments would be more determined by bureaucratic processes – large firms and banks deciding to support a business plan – and less by markets, presumably with an associated increase in the importance of personal connections, status and background relative to raw market smarts.

it must be a sign that the older regulatory regime imposed costs that were not to the advantage of either shareholders or managers, simple dead weight costs that the efficient processes of competition for law have eliminated. Thus, race to the top suggests that Delaware law ought to be characterized as flexible, rather than permissive. Shareholders, after all, require managers who can freely and quickly adapt to the rapidly changing environment of a capitalist marketplace; the old law must have clogged up the works. Perhaps defection is not as large a problem as the game theory model might suggest. On the race to the top analysis, the law must be mutually beneficial for shareholders and managers, so appearance to the contrary are merely problems to be explained away (or, alternatively, if the appearances reflect reality, race to the top must be wrong).

5. Lifting the race to the top assumptions: the potential for lemons.

Race to top analysis, however, is not pure Dr. Pangloss.[35] There are no guarantees. So long as you can fool some of the people some of the time, some managers will conclude that it is more profitable (for them, if not their companies) to choose law that appears to be shareholder protective, but still allows room to defect. Race to the top theory assumes that these managers will be penalized by a higher cost of capital which will, in turn, penalize them in the product and takeover markets. Plausible as this prediction is, it depends on a number of assumptions that aren't necessarily correct.

First, for the shareholder oriented managers to prevail over those who choose to defect, both the product and the finance market must be thoroughly competitive. Most American companies finance most of their expansion through internally generated funds (retained earnings). Most of the rest is financed through debt. Accordingly, we can not simply assume that companies that suffer in the stock market will quickly be competed into bankruptcy. Similarly, the takeover market is marked by high transaction costs: we can't assume that every company that could be run with shareholder interests more front and center quickly will be. Even if these markets are competitive enough so that they will have their way in the long run, managers may not take a long term perspective: as suggested above, it will often be wealth maximizing for any individual CEO to defect even at the cost of substantial long term damage to the company. If the markets are only imperfectly competitive, the costs are likely not to hit home until after the CEO has retired. (And CEOs being an optimistic group, they may be likely to overestimate the odds that any shenanigans can be put right at the next upturn before ever being found out, or to use the powerful tools of self-deception and cognitive dissonance to convince themselves that what they are doing is good for the company in any event). If CEOs convince themselves that it is in the company's best interest to be in a jurisdiction with rules that give CEOs great discretion, imperfectly competitive markets may not be powerful enough to convince them of their error.

[35] Voltaire, Candide ("All is for the best in this best of all possible worlds").

Second, the race to the top thesis assumes that investors can incorporate their views of different corporate law into share prices. While this seems a plausible assumption, it too is by no means certain. Current corporate law leaves companies entirely free to determine their state of incorporation. As a matter of internal corporate decisionmaking, reincorporation typically requires approval of both the board of directors and the shareholders. The shareholder vote, however, seems to be largely a formality in practice – perhaps because investors take the sensible view that if you can't trust managers, who are the experts in running the company day to day, then you shouldn't be a shareholder in the first place, with the result that the electorate at any given time consists of those who have confidence in management. If the shareholder vote is a formality, however, then managers are largely in control of the re-incorporation decision.

But if managers can change the state of incorporation pretty much at will, we are back in a market for lemons. Rational shareholders will assume that whenever it matters the corporation will be incorporated in the state that is most advantageous to managers. Paradoxically, that could well mean that regardless of where the company is incorporated, the stock market will price it as if it were in the least shareholder-friendly jurisdiction. There isn't much point in paying for protection from rapacious managers if managers can choose to eliminate the protection whenever they please; the commitment simply isn't credible. On this story, the market price for shares would not include any bonus for corporate law protection – and the race to the top mechanism would collapse.

Third, much depends on the interpretation investors place on the situation. Investors are forward looking, valuing investments based on predictions about future returns, not based on sunk costs. Accordingly, past problems are important only if they are predictors of future ones. If investors interpret past defections as the result of a few bad actors, a few arrests may convince them to view the problem as over and done with and not as predicting anything about the future. This understanding would break the link between past bad acts and stock price, thus eliminating both the market for lemons and the pressure towards a race to the top. If investors see the problem as one of a particular technique — the junk bond financed two tier takeover, or improper accounting for off-balance sheet entities, for example — overcoming those particular problems may satisfy them. If problems are isolated and over with, there is no reason to bid down the price of the stock, and (new) managers will not be penalized for the sins of the past or, for that matter, rewarded for choosing law that prevents them from defecting in new and unprecedented ways. The race to the top mechanism, in this instance, would be limited to eliminating specific known and identified problems. But if investors take these views, then so long as managers continue to turn over on a regular basis and can command the services of clever lawyers and bankers to find new (legal) distortions, we can expect to see regular crises, each dismissed by the market as an isolated case.

In contrast, if investors begin to conclude that what they suffer is a pattern, not isolated instances, matters are different. If defection is routine, then perhaps the problem is that the law is not powerful enough to control it; corporate law puts managers in charge of investors' money and leaves it to them to decide whether to keep it or not. On this view, the stock market has a serious moral hazard problem and rational investors should avoid it.

For the race to the top to work, investors must conclude that managerial defection is both predictable, systematically controllable, and differentially affected by different state corporate law. If they view defection as just a problem of isolated bad actors, they will not reward companies that provide systemic safeguards against it; conversely, if they conclude that clever corporate lawyers, bankers and managers will always find a new (and as yet unpreventable) way to defect, so that corporate law will constantly be solving last year's problem, closing barn doors after the horses are gone, they will again not discriminate among companies based on choice of law. Investors who conclude that corporate law can not help them should, in a self-fulfilling prophecy, destroy the very race to the top mechanism that is supposed to save them. In short, if investors do not distinguish carefully between different legal regimes, concluding that some but not all can prevent defection, the incentives of the race to the top fail: investors and honest managers will simply be caught in the low value trap of a market for lemons.

Additionally, "excess volatility" can destroy the race to the top mechanism. Many investors specialize in predicting not future returns but rather investor sentiment regarding future returns. These "momentum" investors should have the effect of amplifying and distorting any changes they discern in underlying views, making the market more herd-like than it might otherwise be. Herds need to be where the grass is, but the safest place to be in the herd at any given time is the center. The latter is an inherently competitive zero -sum game: even if there is enough food to go around, someone has to be on the outer edge of the herd. The difficult to predict movements and sudden changes of direction of stampedes result from this combination of some need to be where food is and a more immediate need not to **be** food. In the market, fundamental value plays the same role as grass: in the long run, fundamental value is the nutrient that keeps investors alive, but in the meantime you can get killed by unexpected movements of the market, changes in liquidity, or simple trampling. A surer way to make money, if you can manage it, is to be in the front of the herd (or at least not at the back), an inherently competitive contest much like the need of each wildebeest to be in the center of its herd. The result ought to be a market characterized by great volatility, lurching from crisis to crisis.[36]

But if market pricing is highly volatile and often based on herd movements rather than fundamental underpinnings, the race to the top mechanism will not work. Any reasonably optimistic and Machiavellian CEO with a short time before retirement should

[36]Shiller, Market Volatility (1989); Shiller, Irrational Exuberence (2000); Soros, On Globalization.

be willing to gamble that the reduction of share value associated with his making himself rich by defection will be lost in the general noise of the market.

Limited rationality could also interfere with the simple race to the top story in another way: investors may not be able to tell the difference between abuse and brilliant management. Indeed, there may not even be a difference. Over the last couple of decades, CEO compensation has increased to a truly extraordinary degree. CEOs are now taking an historically unprecedentedly large share of the corporate pie. But it is not clear, even post-Enron, that shareholders have necessarily suffered: they too seem to have done rather well. High CEO compensation, even if it is not closely tied to company results, likely has the effect of changing CEOs class solidarity: they are now among the ultra-rich, not mere upper middle class working stiffs. This should make it easier for CEOs to identify with shareholders and reduce any tendency to think of the "corporation"as those who work for it. And I need not rehearse the simpler financial incentives of massive stock and, even more so, stock option grants: a shareholding CEO has a powerful incentive to keep the stock price up at least until he can make a graceful exit.

If the stock market believes wealthy CEOs have similar interests to shareholders, then it has no need to demand credible commitments. Rather, shareholders may view their shareholding interests as best served by allowing top managers the maximum freedom of maneuver to work on behalf of themselves and their teammates, the shareholders (much as bondholders before junk bonds assumed that few contractual covenants were necessary: managers were likely to use any discretion in their mutual interest anyway). If the finance market bought this story, it would be likely to see little need for protection from managers and therefore to support managerial flexibility and discretion. Race to the top, then, would mean race to permissive, non-regulatory law.

But the joint interests of managers and shareholders story could very well be generally true and still a gross oversimplification. If the story of beneficent managers working for shareholders has a significant place in the collective Wall Street heart, there should be plenty of room for CEOs to abuse their positions without the market noticing. So long as shareholders were making the extraordinary returns of the 1980s and 1990s, they were unlikely to look too closely at what managers were taking home. Thus, it is at least possible that the stock market could press for deregulation during boom times only to be astonished by the resulting abuses (which will not be highly visible until the next bust), thus accentuating market volatility without approaching any equilibrium level of regulatory restraint. This is particularly true because the end game problem is endemic on Wall Street as well as in the CEO offices: in an industry where most players have very short expected job tenure, many may prefer to overlook known abuses, hoping to make their own pile before the house of cards collapses.[37]

In summary, the race to the bottom and race to the top theories are closely related models of competition between managers and shareholders. Race to the bottom theorists assume that management is relatively free to choose corporate law that allows it to exploit shareholders and other corporate participants. Race to the top theorists contend, in contrast, that the market for shares and/or corporate control is sufficiently competitive to assure that shareholders can force managers to internalize the costs of any possible exploitation of shareholders, thus giving managers an incentive to choose corporate law that bars such exploitation (except, of course, where the benefits to managers outweigh the costs to shareholders). Race to the bottom is easily generated in a one shot game; race to the top in an infinitely repeating one. In the more complicated finite repeated game, however, the models can lead to potential races to the top, races to the bottom, or to market for lemon traps depending on relatively minor changes in the assumptions about market competitiveness and participant motives and rationality. Shareholders may be less rational than race to the top theorists have assumed, unable to see the potential defections in advance and thus regularly surprised when managers find new ways to increase their share of the corporate pie. Or credible commitments may not be available: the very restrictions that would protect shareholders from managers would also make it impossible for managers to manage, so shareholders have no choice. Empirical studies have found little evidence that share prices suffer when companies reincorporate in Delaware, suggesting, perhaps, that Delaware law is no worse for shareholders than any other or, if the decision to reincorporate is largely in the hands of management, that the prospect of future reincorporation is already priced in, leaving little further price change for researchers to find. Finally, the empirical contingency of the assumptions necessary to generate a race to the top suggest little basis for an a priori conclusion that free choice of corporate law will drive the law towards any equilibrium, let alone an optimal one.

B. Situating the Race to the Bottom/Top: conceptual problems.

For purposes of this paper the agreement between the two sides far outweighs any disagreement: it is nearly universally acknowledged, first, that corporate law's evolution is relative free of normal political processes; second, that the ability of corporate management to choose where the corporation will incorporate is virtually without extra-corporate law

[37] As discussed below, section ..., there may also be lock-in effects resulting from the advantages of using Delaware law simply because everyone else uses and understands it. To the extent that corporations are locked in to Delaware, the race to the bottom/top picture is weakened, since Delaware will have greater ability to change its law in directions that might not be attractive to corporate decisionmakers. However, Delaware has little relationship to most of "its" corporations other than as tax sources; accordingly, lock-in, if it exists, seems most likely to produce higher corporate tax rates. It is hard to imagine a Delaware political movement or lobbying group pressuring to move Delaware corporate law in some ideologically motivated direction. On the other hand, lock-in does create room for drift in corporate law based on intellectual fashions or just Brownian movements in the Delaware courts.

consequences; third, that corporate management is the proximate decisionmaker and should be modeled as self-interestedly considering which corporate law will best promote managerial interests narrowly understood;[38] fourth, that states have effectively no ability to regulate management in ways that management perceives not to be in its self-interest; and fifth, that Delaware has created an effective mechanism for giving management what it seeks.

Most importantly for democratic theory, both sides of the race to the bottom/race to the top debate agree that it is effectively impossible for the voters of a particular state — or even every state — to introduce substantive regulation into corporate law, for example, to regulate mergers, to limit limited liability, to make corporate managers politically answerable to line employees or customers, to demand that corporations replace or limit maximization of share value with other possible goals such as maximization of product quality or value, respect for status quo economic relations, improvement of employee quality of life or creditor or environmental protection, to require minimum capitalization, or the like (unless, of course, management finds such regulation attractive for some reason). Only by overcoming the race to the bottom/top, generally by federalizing aspects of corporate law, has such regulation occurred. Thus, for example, ERISA and Superfund each limit limited liability, the Williams Act substantively regulates mergers in ways not always to managerial or shareholder likings, the [Labor] law granted (and in later incarnations took away) substantial employee rights in corporate governance, and so on). Indeed, even basic protection of shares against defecting managers, more often than not, has occurred outside of the race, as the '33 and '34 Acts demonstrate.[39]

The debate is over whether corporate managements determining where to incorporate, seek to maximize the freedom of action corporate law will give them vis-a vis shareholders, or rather seek to publically renounce that freedom in order to avoid having shareholders charge them for it. No doubt, both happen.

In this subsection, I raise three problems with the theory of the race to the bottom/top as a whole. Each addresses, from a different angle, the quasi-empirical claim that the race theorists agree upon: that our law is a product of market-like forces leading to a largely inevitable result (at least so long as the Federal government fails to intervene). Although I will not fully develop any of these objections in this Article, they point the way towards a deeper understanding of the process.

1. The helpless states.

The competition between the states theories agree in portraying the states as largely passive participants in a system that is out of their control. They are price takers in the

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[38]But see Larry Mitchell (contending, in the managerialist tradition, that managers granted sufficient discretion do, or would, consider the interests of the corporation broadly defined and society generally).

[39]Assuming (it does not seem to be controversial) that the securities regulatory regime indeed has succeeded in enhancing the mutual interests of shareholders and managers.

market for law: they simply offer law and then sit back and see whether corporations will accept it or not. But this is deeply implausible: markets exist only within a set of legal rules, and states typically make those rules.

In the standard account, the states are competing for tax revenues. When Delaware wins that competition, it is supporting its internal tax requirements by funds raised from corporations that exist out of state. When a corporation pays taxes, it is not always clear which human beings ultimately bear the bear the burden of those taxes: depending on the relative competitiveness of the various markets in which the corporation is active, the taxes could result in lower dividends, lower wages, higher product prices, or lower payments to lenders or suppliers. What is clear is that in the case of the typical Delaware corporation, few if any of those people will be Delaware citizens. Accordingly, Delaware is exporting its taxes onto non-citizens.

This country fought a revolution on the issue of taxation without representation, so there is something slightly surprising about a model which proclaims that Delaware has the right and ability to tax the rest of us. The issue of whether Delaware has that right I develop elsewhere. In this section, I wish to focus not on the right but the ability.

The race to the bottom/top raises this immediate question: why do the other states put up with it? Why don't they simply opt out of the race by changing the rules? For example, they could take the Civil law approach, deciding that corporations headquartered domestically, or with their principal places of business located in state, will be subject to domestic law. Or they could simply bar foreign corporations from doing business domestically, as current American law apparently permits them to do. Or the states might have stuck to the early American view that a corporation has the citizenship of its shareholders and concluded that it ought to be governed by their law as well. Indeed, several states have refused to grant full recognition to foreign law with respect to corporations composed entirely of domestic citizens but incorporated elsewhere (so-called tramp corporations);[40] the arguments used in those cases could easily be extended to include any instance where the incorporating state has only a minimal connection with the firm.

Moreover, states retain the option to opt out even where they have not done so. The core of the race to the bottom/top is the Internal Affairs Doctrine, which hold that a state will apply the corporations law of the state of incorporation to any corporation, regardless of ordinary choice of law considerations. In general, modern version of the Internal Affairs Doctrine appear near the turn of the 20th century as a matter of case law and were later inserted into statute. Thus, for example, R.M.B.C.A. enacts the Doctrine by defining "corporation" to exclude "foreign corporation"[41] and defining "foreign corporation" to

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[41]R.M.B.C.A. 1.40(4). The R.M.B.C.A. has been enacted more or less verbatim in a number of states and is closely followed in others. See, e.g., Utah Statutes Annotated 16-10a-101 et seq. (Utah Revised Business Corporations Code) (text of Utah (continued...)

mean "a corporation for profit incorporated under a law other than the law of this state."[42] The effect of these definitions is that every corporation incorporated in the enacting state is covered by that state's R.M.B.C.A. regardless of whether it is located or doing business there; conversely, all corporations incorporated elsewhere, regardless of whether they are located or doing business in the enacting state are foreign corporations not subject to the enacting state's R.M.B.C.A. In case the implication were not clear, the statute states it explicitly:

> This chapter does not authorize this state to regulated the organization or internal affairs of a foreign corporation authorized to transact business in this state.[43]

But the very fact that the Internal Affairs Doctrine is a product of statute or judge made common law suggests that any state could reject it by simple legislation. And of course, no state can force another state to allow it to legislate extra-territorially simply by asserting the right in its corporations code. The Doctrine exists, then, only because each state enacts it, by common law or statute, and only so long as the state continues to accept it.

Some states have explicitly restated this limitation on the Doctrine even as they have accepted it. Thus, for example, New York affirmatively asserts the right to legislate with respect to foreign corporations:

> This chapter [i.e., the N.Y.B.C.L.] applies to every domestic corporation and to every foreign corporation which is authorized or does business in this state. [44]

To be sure, having asserted the right to regulate, New York doesn't actually do so: most provisions of the N.Y.B.C.L. apply only to "corporations" defined as corporations organized under the statute. Even where the language could be interpreted otherwise, New York courts consistently refer to the Internal Affairs Doctrine. For example, section 626 of the N.Y.B.C.L. explicitly authorizes derivative actions with respect to foreign corporations, but most New York courts view this as a jurisdictional grant that does not affect the choice of law question.[45]

[41](...continued)
statute closely parallels R.M.B.C.A.). The Uniform Limited Liability Act has almost precisely parallel structure: each LLC is regulated by the law of the state in which its principals choose to organize.

[42]R.M.B.C.A. 1.40(10).

[43]R.M.B.C.A. § 15.05.

[44]McKinney's New York Business Corporation Law §103.

[45]See, e.g., Pessin v. Chris Craft, 586 N.Y.S.2d 584 (1992) (acknowledging the Doctrine while applying New York law to the question of whether shareholders of a Delaware corporation acquired their shares by operation of law in order to allow them to bring a derivative action under N.Y.B.C.L. 626, which explicitly refers to foreign corporations); Miller v. Scheneyer, 606 N.Y.S. 2d 642 (applying Delaware law to determine demand requirements in a derivative action, despite the explicit language of N.Y.B.C.L. 626 authorizing derivative actions with respect to foreign corporations); Hart v. General Motors Corp., 517 N.Y.S.2d 490 (1987) (discussing the "fundamental" principle of the Internal Affairs Doctrine); Tarlow v. Archbell, 47 N.Y.S.2d 3 (N.Y. Sup. 1943) (holding that derivative action claiming that directors breached duty to corporation is not an internal affair and applying New York law to demand requirement); Miller v Quincy, 72 N.E. 116 (N.Y. 1904) (holding that
(continued...)

The point remains: the Internal Affairs Doctrine applies in New York to non-New York corporations only by grace of the New York legislature. There is nothing inevitable about New York's participation in the race to the bottom/top. Even the more restrained language of the R.M.B.C.A. appears to recognize that the Internal Affairs Doctrine is a matter for the host state's legislature: the statement that "this chapter does not authorize the state to regulate the organization or internal affairs of a foreign corporation"[46] clearly acknowledges the possibility that another chapter, or a differing statutory text, might so regulate.

Delaware has asserted that the race to the bottom/top is constitutionally mandated, a necessary consequence of our federal system and the commerce clause's bar on inter-state discrimination.[47] Dicta in some Supreme court decisions suggests the same thing (although the older opinions located the right in a different constitutional clause).[48] I discuss these cases in the companion piece. Here, suffice it to note that the argument requires believing that federalist principles require states to allow Delaware to legislate with regard to matters entirely outside its borders: surely a deeply implausible claim. Indeed, giving constitutional status to the Internal Affairs Doctrine requires believing that this strange understanding of federalism, which defies ordinary notions of sovereignty – even the limited variety we give our states – is so fundamental that it is enshrined in a Constitution that, in all relevant parts, pre-dates the origin of the modern corporation and, of course, is absolutely silent on the subject.

Even in a counterfactual world without the internal affairs doctrine, corporations still would be able to choose their law by changing physical domiciles. But the tradeoff would be quite different. Under current law, a firm can determine its state of incorporation entirely independently of business decisions such as where it should locate its plant or headquarters. High tech firms may need to be in Silicon Valley or publishers in New York, but any corporation can incorporate in Delaware. Where law tied to location, most firms, most of the time, would find that legal regulation was insufficiently salient to determine their location. No doubt, if California law was vastly less attractive than Delaware's, some firms might physically move to Delaware, but in most cases, relocation would simply not be worth the costs.

Moreover, with the development of large firms operating in many different markets and ultimately the creation of a single national American market, firms either would have created independently incorporated subsidiaries in each jurisdiction in which they did

[45](...continued)
a derivative action against directors of a foreign corporation doing business in New York may be maintained in New York, in part out of fear that no other court would have personal jurisdiction over the directors, and rejecting the Internal Affairs Doctrine – understood as a jurisdictional limitation, not a choice of law principle – as to actions that injure a citizen of New York).

[46]R.M.B.C.A. § 15.05.

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business (as banks did as the ban on interstate banking began to break down) or pressured for a Federal incorporation law (as early railroads did and as is the German model, where incorporation is considered a federal rather than a state responsibility).

A fuller account of the race to the bottom/top, then, must explain why states have not fought harder to retain their right to legislate. This Article does not explore that historical question, but it does argue that the time has come for states to reassert the rights they have abandoned. The race is not some inevitable aspect of federalism but rather an accidental byproduct of particular contingent facts. Were the major industrial states to conclude that the race is no longer in their interests or in accord with their political or moral beliefs, they could simply and unilaterally put an end to it.

2. The inevitable internal affairs doctrine.

If the first problem with the race to the bottom/top is that it is hard to understand why states don't simply opt out, the second one is that the doctrinal basis for the race is extremely peculiar. The choice of law rule for corporations – that corporations choose their law by determining where to incorporate – is anomalous.

a. An anomalous choice of law rule

Ordinary choice of law doctrine presumes that the law of the forum state applies unless the weight of interests is clearly elsewhere. In the usual course, courts would consider factors such as where the dispute arose, where the relevant agreements were made or carried out, which state's citizens would be most impacted by the adjudication or rule of law, where the parties are domiciled, and so on. In a case where the corporation's only contact with Delaware is that it is incorporated there (and has the statutorily required registered office and agent), none of these factors points to Delaware.

Under ordinary choice of law principles, if the court understood a corporate law issue to be a dispute between managers and shareholders, it might look first to the location of those human parties. If it understood the issue as over the corporation itself, it might ask as European courts do, where the corporation or its headquarters is physically located. It might explore where the relevant agreements were made or were intended to be performed – where, for example, the relevant by-laws or corporate resolutions were negotiated or enacted. Presumably, it would ask which states' citizens were likely to be affected by the dispute or its resolution.

None of these is necessarily an easy question. In a dispute involving a national corporation, it would not always be clear where the weight of the interests might be, but usually it would be clear that Delaware has no interest at all. Few of the relevant human beings are likely to live in Delaware. When Delaware determines to whom corporate managers have fiduciary duties, or what the scope of Delaware limited liability is, whether shareholders should be imagined to be diversified portfolios as interested in a company's competitors' success as in its own, or whether Delaware corporations may vote their own stock, the humans affected by the decision – shareholders, managers, bondholders, employees, customers, suppliers, competitors, downwinders or economic neighbors affected by the corportation – are almost certain to be located elsewhere.

Under the Internal Affairs Doctrine as currently understood, of course, none of this is relevant. Choice of law is not an issue for courts to determine by comparing the interests of the forum state with that of other possible sovereign claimants. Instead, courts simply defer to the choices made by corporate decisionmakers. Without that deference, the race to the bottom/top would not exist in its current form: states, no longer passive but active participants in a regulatory enterprise, would have to make decisions about which state is entitled to regulate which business enterprises (or, in the case of regional or national ones, which parts of them). Corporations unhappy with the corporate law of their host states would be forced to respond just as ordinary citizens respond to law they are unhappy with: by attempting to mobilize political forces to change the rules, by actually relocating to a different state, or by convincing the federal government to impose a uniform national standard.

b. Defining "internal."

The gap between ordinary choice of law rules – which would not lead to the race – and the Internal Affairs Doctrine means that the race to the bottom/top as we know it in corporate law depends intimately on the line created by the Internal Affairs Doctrine. The boundary between Internal Affairs and ordinary choice of law is the boundary between ordinary politics and the "market for law" that the race to the bottom/top theories see. If the distinction collapses, then either the race must turn into ordinary politics or the reverse.

Legal boundaries are places of conflict and dispute as a rule; maintaining distinctions, tweaking, pushing and destroying them is most of what lawyers do. The Internal Affairs/Conflict of Law distinction is no different than the other famous distinctions around which legal debate centers: it is not only essential but debatable, contestable and ultimately quite fragile.

On the one hand, the race to the bottom/top relies on strong agreement on which matters are "internal" and which are not. Without the internal/external distinction, any state could opt out of the race by declaring a particular regulation "external," or corporations could argue that any regulation was "internal" and ought to be binding only if chosen. In a companion piece, I argue that this doctrinal line is not as clear as race to the bottom/top theory assumes.

There appears to be general agreement on what is covered by the Internal Affairs Doctrine – the sorts of things that appear in the Revised Model Business Corporations Law, matters relating to the internal power relationships between shareholders, directors and managers. The RMBCA, for example, invokes this understanding of the doctrine in its reference to "organization or internal affairs of a foreign corporation." It then effectively defines it as "whatever matters are covered in the RMBCA" [49] by excluding foreign corporations from the scope of its regulation. But there is no principled line that explains what is or is not part of Corporations Law or is or is not internal.

Many issues that seemingly relate to the relationship between shareholders and managers have been taken out of the race to the bottom/top by being declared securities or blue sky regulation. In most countries, securities regulation is considered part of companies law, and of course our Corporations Laws regulate disclosure to some extent. Generally, however, we have removed it from the race to the bottom/top by reclassifying it as something other than corporate law. On the one hand, the federal government, through securities law, regulates not only most issues of disclosure but much of tender offer and proxy solicitation regulation. On the other hand, states simultaneously regulate disclosure and other sale of securities issues without concern for the Internal Affairs rules by declaring Blue Sky law subject to ordinary choice of law doctrine.

Similarly, some states have unilaterally declared particular issues not "internal": California and Wisconsin (?) have mandated (or banned) cumulative voting for directors without closely following the internal affairs doctrine. New York imposes its rules regarding disclosure of the shareholders list on foreign corporations using ordinary choice of law analysis. New Jersey, in a famous case read in many introductory business organizations courses, imposed its own law of fiduciary obligation on a Delaware corporation existing in New Jersey.[50] In the ordinary course, managerial (as opposed to director) duties will be determined at least in part by agency law, following ordinary choice of law rules rather than the Internal Affairs Doctrine.

Conversely, some parts of the RMBCA are "internal" only by the wispiest of legal fictions. The law of limited liability, usually found in business corporations laws, determines whether or to what extent the people associated with a corporation will be responsible for the contracts they enter into or the damages they cause while operating as a firm. In turn, that determines whether other "external" regulatory law has any meaning at all: if a corporation can be set up with no capital and only the corporation is liable for 'its' contracts, torts or environmental disasters, then no one is liable at all. Limited liability, that is, determines if there is a there there, and thus whether the host state (not the incorporating state) will be able to effectively control its economic and other actors. For this reason, no doubt, both ERISA and Superfund ignore the Internal Affairs Doctrine: to be effective, those statutes had to have their own rules of limited liability.[51] California, similarly, for many years refused to recognize full limited liability even when it was granted by the incorporating state. Most states impose minimum capitalization rules on insurance

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[49]See discussion of the way in which the RMBCA enacts the doctrine, supra.
[50]Pritchard v. Jersey Bank
[51]These Federal laws abrogate the Internal Affairs doctrine using Congressional Commerce Clause powers and the Supremacy Clause. States could reach the same end simply by repudiating the Internal Affairs doctrine or limiting its scope: as I demonstrate in the companion piece, the doctrine itself has no history or purpose that gives in Constitutional standing.

companies operating domestically without regard to the Internal Affairs Doctrine (which would leave that decision to the incorporating state); this too is a clear limitation of limited liability.

Similarly, the law of fiduciary obligation (and the rules of voting) determine to whom directors owe loyalty and for whom they manage the corporation. This "internal" rule determines how the corporation relates to its various non-shareholder participants: whether, for example, employees are seen as part of the enterprise or as outsiders to be exploited. Delaware law is quite clear that no non-shareholder has a claim to the loyalty of directors, and that when the company is for sale, shareholders have an enforceable claim to exclusive loyalty.[52] But Federal bankruptcy law ignores the Internal Affairs doctrine and constructs its own, rather different, view of fiduciary obligation, in which bondholders - explicitly excluded from the corporation under *Revlon* - may demand that directors of insolvent or almost insolvent corporations run the firm in their interests. Bankruptcy law thus recognizes, in this limited context, the general truth that everyone, not just shareholders, is affected by how national businesses run their business. Whether or not what is good for General Motors is good for America, it is definitely the case that what General Motors views as good for General Motors will affect every American.

Delaware corporate law instructs managers that their duty is to act in the best interests of the corporation and its shareholders, but offers little guidance as to what interests the corporation might apart from share value maximization (and, in any event, grants no non-shareholder either standing or vote to influence those actions or represent those interests). Under current norms, conscientious managers are likely to see a conflict between their role responsibilities and larger social duties: to be a good professional, one must set aside ones views as a citizen. The role of manager requires professionals to maximize share returns even at the expense of social good (although it probably does not require the manager to adopt any particular view of how best to maximize shareholder value and certainly does not require adopting the false view that share value is always best pursued by disregarding everyone else's interests). Indeed, current norms suggest that managers "ought" to exploit loopholes, evade the law, take advantage of non-shareholder corporate participants and perhaps even violate the law whenever doing so is profit maximizing. Within the professional managerial role, the argument must be about whether criminality or excessive decency is profit maximizing, not over whether Kantian imperatives require one to act morally even if the result is going to hurt the firm. The share profit norm of current corporate law demands that managers cause the corporation to free-ride whenever it is profitable, even if they see and agree that it is wrong to do so. Corporate law, that is, encourages decent managers to act indecently.

One could imagine a state that was serious about its environmental, consumer protection, tort or contract law making those corporate claimants into beneficiaries of a corporate fiduciary duty or voting constituents of a corporate governing board. This would

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dramatically change the decisionmaking process of conscientious professional managers. Fulfilling the spirit, not just staying within the letter, of non-corporate law would now be their duty, rather than an arguable violation of fiduciary responsibilities to fictional shareholders. If the beneficiaries of this new duty had the right enforce it in court, or politically oust directors who ignored it, even non-conscientious managers might find their role demands radically changed. One can not simply exploit a party that has a right to sue for breach of duty or an effective power to remove the exploiter from office. Thus, by opting out of the race to the bottom/top, states could harness the powerful incentives of corporate law to work for, rather than against, other legal norms.

The race to the bottom/top exists only so long as states accept the Internal Affairs Doctrine and give it coherent meaning. But states have a choice about whether to accept the Doctrine in the first place, and having accepted it, they must interpret it. Almost every issue that could be considered "internal" has been declared "external" by some court at some point, for the simple reason that almost any issue involving corporate law impacts large and diverse groups of individuals beyond the ones empowered by corporate law or impacts public policy beyond corporate law itself. Corporate law helps define the job of those who run our economy: how could it be anything other than central to political concerns and public policy?

3. The thinness of the race to the bottom/top analysis.

According to the conventional analysis, states compete in order to maximize tax revenues, but at the same time they voluntarily accept the Internal Affairs Doctrine as binding on themselves even though it allows Delaware to steal their tax revenues. This analysis is problematic. As to Delaware, it make some sense: Delaware has no reason to care about other states's economic enterprises except as sources of tax revenue from non-voters. But as to other states, the race, if it exists, cannot be the simple competition for tax revenues the models postulate. Were the states as mutually exploitative as the model suggests, and were the race in fact about taxes, New York would simply pass a law requiring corporations doing business in New York to incorporate in New York, and that would be the end of Delaware's dominance. Something else is going on here that is not properly modeled in the rational game theory approach.

I do not propose to offer a full alternative motivation for the states' general acquiescence in Delaware's rules of the incorporation game. My best guess is that the states have not resisted the race to the bottom/top more vigorously for reasons that are not entirely rational – a perception that the Internal Affairs Doctrine is more coherent and more fundamental than it is, a failure to think clearly about alternatives – and for reasons that are related to the difficulties American politics often have with controversial issues.

Were states to opt out of the race to the bottom/top, they would have to have controversial debates about the proper content and purpose of corporate law. Why, for example, does our democratic system allow massively important enterprises to operate in an entirely undemocratic way, in which most participants have no vote at all, and the shareholders, who do, vote based not on equality of citizenship but on pure wealth? Why do we tell administrators of major institutions that they are free to seek ways to evade the law – environmental law, tax law, health law, tort law – rather than required to find ways to meet not only its letter but its spirit? There are answers to these questions, and in some cases, the status quo may well be more defensible than any available alternative. But a democratic republic of self-governing citizens will have varying views.

And that is the rub: these are divisive issues. It may well be that state politicians are just as happy to avoid the whole debate by pretending that they have no choice anyway. Alternatively, and more cynically, perhaps the problem is that powerful and wealthy corporations and their lobbyists have every reason to defend the Internal Affairs Doctrine, which places corporate governance beyond the law, while no comparably wealthy and organized group presses the issue on the other side.

In either case, however, the race to the bottom/top, with its image of helpless states unable to do anything but offer corporate managers what they want, is radically incomplete. The states are complicit in this loss of their sovereignty, not just victims. Moreover, even in their abandonment of self-government, they have asserted their right to reclaim it should they choose: As I explore in more detail in the companion piece in fact states have not uniformly accepted Internal Affairs in its full glory. Several states have refused to accept the notion that a corporation composed entirely of domestic citizens (a so-called tramp corporation) is free to incorporate elsewhere. The large commercial states have imposed their own law on foreign corporations in several important instances, including shareholder access to voting lists, shareholder voting rights, and even limiting limited liability. In short, states retain the option to opt out even where they have not done so.

4. Do shareholders hire managers?

The final issue with respect to the race to the top/bottom is the image of the corporation that seems to underpin it.

The race to the bottom/top theories assume a model of the corporation in which shareholders "hire" directors and managers as their agents. On this view, the key problem for the law is whether management is acting as a faithful agent of shareholders: the race is to the "top" when managers work for shareholders and to the "bottom" when they do not. Similarly, the bottom/top debate depends in large part on whether shareholders, as the principals, are effectively able to police managers or whether they need additional legal assistance to do so.

Modern finance theory, however, suggests that there is no particular reason to conceptualize shareholders as hiring managers. One could equally well think of the process as the other way around: managers hiring investors. In a competitive market at equilibrium, the characterization should not matter.

a. The asymmetry of agency.

For lawyers (as opposed to economists), it makes an enormous difference who is hiring whom. Stating that one party hires another invokes a clear set of radically asymmetric default rules. Hiring creates an employer/employee relationship, which is a type of principal/agent relationship. The basic elements of an agency relationship are that the principal has the right to direct the agent; the agent can bind the principal; the agent has a duty to act on behalf of the principal; and the relationship is terminable at will by either party regardless of contractual agreement to the contrary. The first three are each asymmetric in principal; the last is in fact.

An employment relationship will be interpreted to grant the employer/principal the right to control and direct the employee/agent, but not the reverse. The employer/principal will be bound by acts of the employee/agent (contract making and tort-feasing within the scope of the relationship), but not the other way around. The employee/agent will be understood to have assumed the obligation to act on behalf of and in the interests of the employer/principal, and the reverse will not be true. Employers have presumptive rights to retain trade secrets after termination of the relationship; employees do not. The employer will own things the employee makes and have at least a claim to the employee's ideas, thoughts and knowledge; never the reverse. The employer will have the right to inspect the employee's work, read his or her correspondence, snoop in his or her work area, and monitor his or her conversations; the reverse will not be true. In Europe and in the unionized sector of America, even the formal symmetry of agency termination may not extend to employment relations: the employer often will be restricted in its ability to terminate the relationship, but the reverse normally will not be the case. Similarly, civil rights concepts usually will restrict the employer's freedom of action at hiring and firing but not the employee's (there is no civil rights action against an employee who quits out of racial animus).

To be sure, many of these are only default rules, and in theory one could draft a contract that would vary them. But lawyers assume that default rules that go with a status will normally govern large parts of the relationship. Smart lawyers who are unhappy with the results that a set of default rules generate usually will begin by attempting to find an alternative status relationship to enter into, rather than attempting to shift the default rules radically: Courts are likely to read the default rules back into the relationship even when contracts are drafted to keep them out.[53] If you don't like the asymmetry of the employee/employer relationship, ordinarily you are better off thinking about partnership than trying to draft around the default rules.[54] Thus, the claim that shareholders hire managers is for lawyers a claim that unless otherwise agreed, shareholders will have the right to order managers around, that managers have a fiduciary duty to work for shareholders, and so on.

b. Economic symmetry.

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[53] [Duty cases]. Indeed, the power of the default rules is so strong that courts read them back into even statutory attempts at reform: consider, for example, the power of the termination-at-will rule in interpretation of the civil rights statutes. [KE article]
[54] "Ordinarily" and "normally" are strong words here. Highly paid lawyers are highly paid precisely because they spend most of their time in the non-ordinary and non-normal circumstance, where there are other constraints, for example regulatory or tax rules that depend on being in one box rather than another, that make fighting the law's categories fun and profitable.

In contrast, for economists thinking about ideally competitive markets, managers and shareholders are each parties to a "contract" the terms of which are set by market processes. In the frictionless world of equilibrium, all terms are negotiable and both parties must agree to them. Each side is equally free and default rules have no special weight: as Coase demonstrated, they'll simply be changed to put the costs on the party best able to bear them.[55]

Thus, for economists at equilibrium "contracts" are necessarily symmetrical. If investors and managers are negotiating the terms of a relationship, there is no a priori reason to assume that they must agree that investors should control managers rather than the other way around. Since all contract terms are up for grabs, the agreement may well have aspects of both managers hiring capital and the other way around - or it may be simply arbitrary which way we choose to describe it.[56] Indeed, ordinary language is almost as equivocal as the economists' theory: we speak of shareholders "owning" the company, but also of companies "selling" stock – which suggests either that shareholders are mere consumers (and thus outsiders, in an arms length non-fiduciary relationship) buying a corporate product, or that management (on behalf of the corporation) is renting or buying capital for its use. In this view, management can be seen as hiring shareholders.

c. Metaphors and the law: is there any agency here?

Of course, neither shareholders hiring managers nor the reverse image bears much resemblance to actual corporate law. Corporate lawyers speak loosely in metaphors of ownership, agency and trust to discuss the manager/shareholder relationship, but at least with respect to public corporations the relationship has virtually none of the characteristics of ownership, agency or trust. Managers, of course, are agents of the corporation in the full sense of the legal term: they are subject to the corporation's control, they can bind the corporation, they have a duty to act on behalf of the corporation, and they can quit or be terminated at will regardless of contract. But the principal in this agency relationship is the corporation as a legal entity and the only party that can act as the corporation directly (rather than as its agent) is its board of directors.

Shareholders, on the other hand, are not in an agency relationship with either the firm or its directors and managers. First, the relationship lacks the basic agency element of control. It is black letter law in Delaware and elsewhere that the directors have original, undelegated power to run public corporations.[57] Shareholders have no right to direct or control the corporation, its board or its managers: the populist devices of instruction and referendum have no corporate law equivalent. Indeed, even with respect to issues on which shareholders have the collective right to vote, it is a derogation of duty for directors to allow a proposal to go to the shareholders until the board has made an independent, informed

[55] For my complaints about Coase, see [Rutgers].

[56] See e.g., Hansmann (describing why workers might choose to hire a boss rather than self-governing); What Do Bosses Do (similar account characterized as power struggle).

[57]

business judgment that the proposal is in the best interests of the corporation and its shareholders.[58] Conversely, the managers, the directors and the corporation have no right to direct or control shareholders.

Similarly, shareholders have no right to bind the corporation, its directors or its managers. And conversely, the corporation, its directors and its managers have no power to bind shareholders: that is the key point of both legal personality and limited liability. To be sure, the managers, as agents of the corporation, may bind the corporation, and the board of directors may act as the corporation, and if the corporation fails, shareholders will suffer too. But all corporate participants are at risk of losing the investment they have made in the corporation. Bondholders are only quantitatively different from shareholders. Employees and even customers or suppliers are likely to have made specific investments in a given firm that are at risk if the firm fails: an employee will lose the economic value of firm specific skills (understanding the best ways to manage the strengths and weaknesses of particular organizations, for instance), while customers and suppliers may have firm specific investments at risk. If Microsoft were to fail, everyone who depends on Windows and Windows-based programs or on the Seattle real estate market would suffer, not just Microsoft's shareholders. Indeed, given the ease with which shareholders can diversify, it seems likely that other firm participants often will suffer more than shareholders. So long as the corporation is separate from its shareholders, there is no reason to jump from the fact that directors bind the corporation to the unsupportable claim that they bind shareholders.[59]

Third, unlike agents or employees, shareholders have no duty to consider the interests of the corporation, let alone its directors or managers, either in their shareholder role or outside it. Ordinarily, for example, they are perfectly free to compete with the firm. Indeed, a minority shareholder invested in a competitor would breach no duty if it voted in favor of a directorial candidate who promised to destroy the firm (although if elected, the candidate would breach his duty if he kept the promise). Less obviously perhaps, the reverse is also true: the duty of the board and managers to act in the interests of the corporation and its shareholders bears little similarity to the duty they would owe shareholders were they the shareholders's agents. First, the business judgment rule ordinarily precludes judicial investigation of most directorial action. Even beyond the business judgment rule, most courts clearly understand the duty to the "corporation" to be something different from the duty to "shareholders," so that except in the limited sphere of Revlon duties, directors may defend actions that are not in the interest of shares as

[58]Van Gorkum.(holding directors liable for allowing shareholders to vote on proposed fundamental change without first exercising independent judgment); [case barring shareholders agreement]. Closely held corporations operate under a different legal regime in which shareholders have more of the rights of owners and directors are closer to their agents. [Case upholding shareholders agreement in "partnership-like" close corporation].

[59]See, e.g., Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, fn. 101 (1996) (stating that "no court has ever disregarded the entity of a publicly held corporation").

nonetheless in the interests of the corporation.[60] Finally, even in the limited and extraordinary circumstances when courts do require directors to act in "shareholder" interests, they never treat shareholders as principals or even trust beneficiaries: the interests to which they hold managers are pure legal constructs, determined by legally stripping shareholders (or the human beings behind corporate shareholders) of every aspect of their individual personalities, individual interests and individual beliefs, desires and needs, and even of their actual investment portfolios, leaving only undiversified share ownership. That is, the duty is owed to the corporation and its "shares," not its shareholders.[61] It is no defense to a breach of duty claim for managers to establish that their shareholders are, in fact, more heavily invested in the firm as employees so that they would prefer high wages to high dividends, or are so heavily invested in the firm's competitors that running the company into the ground will benefit them.[62]

Finally, the last basic element of agency is missing as well. Neither shareholders nor directors can terminate the relationship at will. Individual shareholders can exit without permission, but only by finding another shareholder to replace them: the share (and the limited duty to it) remains unchanged. Collectively, shareholders cannot exit the firm without a resolution of the directors approving dissolution, merger or reorganization and recapitalization.[63] Similarly, the directors have no right to "terminate" shareholders without their vote: squeeze-outs are frowned upon and never available without approval of the majority of the shares. Thus, the shares can neither exit nor be forced out without consent of both sides. And in the other direction, shareholders have no power to terminate directors except as provided by the articles of incorporation – quite unlike the principal of an agent, who may terminate regardless of any contract to the contrary.[64]

In sum, the board acting collectively, not shareholders, has the sole right to manage the firm and to act for it directly rather than as an agent; managers are hired by and agents of the corporation, not of shareholders; shareholders cannot act for the corporation, dispose of its property in any way, or direct the board to take any action; shareholders do not have any contractual rights against the firm; and the fiduciary duty owed by directors to shareholders bears only the loosest resemblance to that in a trust or agency relationship. The shareholder director relationship has little resemblance to agency, let alone employment, in either direction.

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[60]Revlon; Paramount v Time

[61]See my Iowa, USC.

[62]Indeed, in Revlon itself, the facts suggest that most of the shareholders must also have been bondholders. The case therefore stands for the proposition that directors must work for **share** interests even if **shareholders** might prefer otherwise.

[63]See, e.g., RMBCA

[64]Under the default rules, shareholders may terminate a director without cause at the end of her term, typically one year except where the corporation has a staggered board. But they may do so only at an annual meeting, a special meeting called for that purpose, or by unanimous consent in lieu of meeting, and corporations are authorized to restrict the manners in which shareholders may call for special meetings. RMBCA. All this is quite different from agency law, where the relationship is terminable at will at any time and contractual limitations only create an action for damages.

Under state business organizations laws, shareholders are the electorate in a largely political relationship rather than contracting parties, the principals in an agency relationship, the owners of a property interest, or the beneficiaries of a trust. In contrast, Federal securities law borrows heavily from consumer protection concepts, typically treating shareholders as customers of the firm who have purchased a product (securities) about which they need information.

d. Economic theory vs. legal categories.

Nonetheless, the conceptual heuristic of imagining shareholders and directors as "hiring" each other is useful in pointing out aspects of the relationship that may be harder to see in conventional legal terms.

At equilibrium in a competitive market, each party to a contract is paid its marginal cost, which is also equal to its marginal value. Thus, if shareholders are viewed as hiring managers, they will pay managers a salary equal to both the cost of producing managers and the benefit the managers bring to the company. Were the managerial salaries higher than the cost of production, other managers would bid them down; were salaries lower than the managerial product, shareholders would bid them up.

Conversely, if we view managers as hiring shareholders, shareholders will be paid no more than the marginal cost of the investment capital and risk bearing services the shareholders provide: any investor who attempted to charge more for its services would find itself without customers, and any manager who attempted to pay less would be unable to find financing.

At full equilibrium, there is no difference between these points of view. The corporation, as a nexus of markets, will pay each corporate participant (including shareholders) precisely the marginal cost of producing the supplies or services they sell to the corporation. It will then sell its own product to consumers for, once again, precisely the marginal cost of production, including all the payments it made to corporate participants. Moreover, supply will match demand at the point where these marginal costs are equal to the marginal values produced. Shareholders are no different from anyone else in this model: they will receive the marginal cost of money – normal profit – and not a bit more, and the payment they receive will precisely match the marginal value of the contribution they make to the enterprise. At this imaginary point, there is no difference between shareholders who hire managers and managers who hire shareholders. Indeed, for that matter, we could equally well describe the corporation as employees hiring customers, managers and shareholders. Moreover, at equilibrium, each party is paid precisely what it contributes: if we were to see shareholder earning 18% per annum or managers earning hundreds of times the wages of line workers, it would be because they were contributing that much more as well (and cost that much to produce).

But the interesting problems are all at disequilibrium in non-ideal worlds. In non-equilibrium situations, by definition, someone is receiving more (or less) than his or her marginal product and marginal cost of production. The question is simply who and why.

In the ordinary course, a company could be thought of as an ongoing competitive struggle between participants in different markets: shareholders, managers, employees, consumers, suppliers, lenders, each attempting to charge the others more than their own marginal cost of production. Successful companies will produce a product that has more value than the minimum costs of its components: that is, they will generate an economic profit that cannot exist at equilibrium, a profit above the cost of capital and other factors of production. This producer's surplus is then available to be divided among the various factors of production (at least until a competing company underbids and shifts the surplus to consumers). A priori, there is no reason to simply assume that one party will get it rather than another: that is a question to be negotiated in the various markets in which the corporation participates or legislated by political conflict.

The legal label of who hires whom is a way of signaling the results of the negotiation: at law, the "owner," "principal" or "employer" is presumptively entitled to producer's surplus.[65] Of course, in the corporate context, where the corporation is the employer, that hardly settles the question: the issue is what is going to happen to the corporation's funds. Depending on market power and the legal agreements that result, it could be paid out to shareholders in dividends. But it could also be paid to employees in the form of higher wages, salaries, better working conditions, higher levels of employment (whether featherbedding or executive assistants) or executive stock options. It could go to the general public in the form of charitable contributions, more attractive plant, general research and innovation expenses, unnecessary advertising or improved environmental or safety performance. It could go to bondholders, taxing authorities or landlords in higher payments or less aggressive negotiating tactics. And so on. Only if it remains unclaimed in the corporation's coffers and the firm dissolves do the shareholders have any *legal* claim to it.

Now, the ideological power of the agency theory of the corporation should be clear. Calling the shareholders "owners" or "principals" of the corporation is a (misleading) claim that as a matter of law that the shareholders are entitled to the producer's surplus; that they alone of all the factors of production should be paid more than their marginal cost or marginal product.

In contrast, the economic model re-emphasizes that this is conclusory bosh. Everything is up for negotiation here. The producer's surplus will go to whoever has the negotiating power to take it. Saying that we could think of managers as hiring shareholders or the other way around is a metaphorical gloss on the underlying economic claim: in a free market, no one has an a priori superior claim, morally or legally, to the surplus. Shareholders have no particular claim to the assistance of the law (or the rhetoric of

[65]This is not precise. If other participants succeed in obtaining the surplus – for example, if unionized employees command an above market wage – the law will not call that illegitimate, although politically motivated economists may call it inefficient. (It is inefficient, but no more or less so than if the "owner" seizes the surplus: were the system efficient, there would be no surplus to seize).

"ownership" or "agency" metaphors) in tipping the balance of negotiation in their favor. If the market is truly free, they will be required to negotiate based on the merits or accidents of their position, and it will be difficult to predict the results. If we can think of managers as hiring shareholders, we can contemplate the possibility that the corporate surplus might end up "belonging" to managers rather than the shares. If, following Hansmann, we imagine employers hiring their bosses, then the surplus "should" go to the employees.

e. Shareholders in the economic model.

But we do know one thing: the closer any given market is to the ideal frictionless competitive ideal, the less likely its participants are to be able to negotiate for more than their cost of production. In a competitive market for fungible goods, a producer who attempts to charge more than marginal cost should be underbid immediately.

This, then, is the key economic point: Shareholders are purely fungible providers of a purely fungible commodity - cash - in what is surely our most competitive market.[66] Our capital market, it is widely agreed, is about as close to an ideal competitive market as the real world gets. Accordingly, shareholders should rarely be able to obtain anything more than their marginal cost of production, the normal cost of capital. Rather, economic profit or producer's surplus should go to some more monopolistic or monopsonistic corporate participant who is less fungible, or provides a less fungible service or product, than shareholders. Thus, we should expect to see corporate surplus – what otherwise would be excess corporate profits – going to employees in the form of higher wages or more comfortable working conditions, to managers in the form of stock options and compensation plans that more closely resemble claims on economic profit than payments based on marginal cost or marginal product, or to debt holders and all other fixed claimants (including employees) in the form of retained capital (which reduces the risk borne by non-shareholder firm participants), or to suppliers and customers in the form of higher or lower prices. While lawyers often refer to shareholders metaphorically as "owners," the economic theory emphasizes what careful legal thinkers know: shareholders have no particular claim to corporate assets (except in special circumstances) and are rarely likely to win the competition to control them.

The economic model, then, presents a puzzle. If it were correct, that is, if pricing in markets were determined by cost of production, public shareholders would not earn excess returns even in ordinary, disequilibrium, times. Not only would they not be "owners" in any strict legal sense, they could not be owners in the limited law and economics sense of "residual risk bearers" entitled to the producer's surplus: surplus (which in a competitive

[66]The discussion in the text applies only to publicly traded corporations and their shareholders. In the start-up world, shareholders are not fungible at all: the specific information, relationship or peculiar beliefs about the future state of the world that induce one investor to invest in a firm are unlikely to be easily replaced. Non-fungible venture capitalists should be able to negotiate spectacular deals when there are many more good ideas around than cash to finance them. Conversely, when as in the late 1990s there is more venture capital than there are good investments, the negotiation is between bilateral monopolists and the results are completely open.

market ought to be fairly limited anyway) would always go elsewhere. Shareholders, in short, would be compensated much like bondholders. And, oddly for lawyers used to the metaphors of corporate law, as the most fungible inputs into the corporation, shares and the finance capital they represent would have the weakest claim to being called “owners,” “principals” or beneficiaries of a fiduciary trust. Like the hamburger flippers at a fast food chain, capital is just a fungible, disposable, commodity that, left to the market, will earn little indeed.

On the managerial side, the economic theory is equally implausible. It claims that managers, like shareholders, ought to be paid both their marginal product and their marginal cost. But surely it is unlikely, to say the least, that while in 1960 top managers were 30 times as productive as average workers and cost 30 times as much to produce, over the next generation they suddenly became 500 times more productive and costly in the US (but much less so in apparently equally successful economies elsewhere).

There were moments in the dot.com boom when it truly seemed as though capital was finally receiving the commodity treatment the theory suggests it should. Those who paid phenomenal prices for undefined claims on non-existent earnings of fantasy-based business plans were, indeed, getting what the theory predicts shareholders should get: not much. But rationality seems a poor explanation for the boom: the investors who bought the IPOs and funded the venture capitalists did not act as if they had finally realized that they were in a commodity business and could expect commodity-like returns. Somehow, they seemed to have a different understanding, one better analyzed by theories of irrationality of crowds, herds and bubbles. That is, they signed on for something very different from what the theory suggests they should have known they were going to get.

Leaving aside the dot.com boom, the theory seems to have even more of a disconnect with reality. Unless the 1980s and 1990s bull market ends far more bitterly than is the case as I write, shareholders will have been compensated well beyond any plausible cost of production of passive capital for well over two decades.

Of course, it is possible that the period from the mid-1970s until 2001 will turn out to have been a massive bubble, and that when all is over, shareholders will not have earned any excess returns. Should this happen, it would be support for the economic theory and its critique of shareholder-centeredness (with the caveat that generation-long bubbles suggest that equilibrium modeling should be approached with some scepticism).

If, on the other hand, the last quarter century does not turn out to have been a long bubble, that would be evidence that market pricing doesn’t work the way that the economic model suggests it should. Perhaps the very notion of equilibrium distorts our thinking in some fundamental fashion: if the market does not tend to return to equilibrium, equilibrium based theories (even modified to account for disequilibrium) may be as misleading as they would be if applied to weather prediction. Or perhaps the economic model neglects too much that is too important: the effects of the race to the bottom/top on the law, not only of shareholder protection but of tort and regulatory enforcement or pension provisions; the effects of the destruction of the legal underpinnings of the labor movement and its inability to successfully mobilize for rebuilding; the subsidies for suburbanization with its ambiguous effects on the mobility of labor and capital (does it, for example, change the relative mobility of employees and employers, or particular employees or employers, thus modifying their bargaining power?); the effects of shifting taxation from mobile capital, investments held overwhelmingly by the extremely rich, and corporations to wages and salaries; the effects on labor mobility (and therefore bargaining power) of employer or plant based seniority, pensions and medical insurance; and so on.

Perhaps the most important issue is relative mobility and the power that comes with it. Those who can walk usually win negotiations; nothing is as mobile as capital in the internet age. Some market participants are more mobile than ever before: plants (or easier still, offices) can pick up and move; low capital gains taxes and short depreciation periods help companies learn to think of sunk costs as economists do, as unimportant for future planning; executive suburbs are identical coast to coast, offering instant familiarity for peripatetic employees; managers and information workers have skills applicable to many companies.[67] Others are stuck: unionization is, by law, at the plant level, so that deunionization is as simple as shifting new investment to a new plant; company-based medical care and pensions can tie employees (although this is irrelevant for the large numbers who are either uncovered altogether or in mobile 401k style plans); not every employee is as rootless as our homogeneous suburbs and disposable families suggest. The economic model, of course, can accommodate the friction of immobility – indeed, it is the source of the intuition that the mobile are the winners – but a better theory would accommodate it more centrally.

f. Expanding the legal categories: the implications of economic theory.

We are left then with this unhappy theoretical state of affairs. The empirical predictions of economic modeling seem quite implausible. It is hard to square 25 years of double digit returns in the stock market, or the far larger increases in managerial compensation, with a theory that is based on marginal cost and marginal product.

On the other hand, the theory remains quite useful for the nonchalant way in which it destabilizes ordinary understanding of legal categories: if managers can be thought of as hiring shareholders as easily as the other way around (and if both of them might be hired by the line workers), then the common political acceptance of the notion that extraordinary profits "belong" to shareholders is left floating unsupported in the air. On a market view, shareholders are disposable and should expect to be treated as such.

The first key implication of the economic theory, then, is that as between shareholders and managers, there is little reason to think that shareholders will often win, and no particular reason to suspect some subversion of the market if they do not. The century-old obsession of corporate law with protecting shareholders from rapacious managers seems to be contrary to the injunctions of the free market. On this view,

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[67]Bowling Alone; Winner Take All Society.

shareholder advocates are just rent-seekers. Prophets of double-digit returns to share owners are fools, perhaps even dangerous or fraudulent (if people reasonably rely on them) fools.

The paradoxical consequence is this: to the extent that the economic theory is right, the extraordinary returns to share ownership over the last 25 years must come from something that the economic theory does not explain. That is: shareholder returns must come from law and culture, not the free market.

Similarly with respect to managers. The economic theory has them paid according to marginal cost and marginal product. The cost of a business education has increased in the last generation, no doubt. But surely there are still fine managers who would be willing to run great companies even if they only earned 100 times the nation's median wage: we fill far less pleasant jobs and equally demanding ones with lower wages than that. And it simply makes no sense that Kenneth Lay earned so much because he was so much more productive than his American counterparts of a generation ago or his European ones today.[68] The economic theory strongly suggests that managerial pricing is the result of something not picked up in this theory of the free market.

The second implication, then, is that shareholder and managerial returns alike are a result of non-market processes. The economic model, paradoxically, reemphasizes the power and importance of cultural and legal constraints on the market. Just as we saw that the market metaphor was inadequate to explain the behavior of the states in the race – something other than a drive to profit maximize (or externalize taxes) must be motivating New York's willingness to accept the anomalous Internal Affairs Doctrine – so too something other than marginal cost and marginal product pricing is necessary to explain the joint success of managers and shareholders.

The final implication of the economic model is perhaps the most important for the race to the bottom/top: the number of characters in this story must be increased. Legal thought has concentrated on the relationship between shareholders and managers, often characterized as one of owners and agents. This conceptual box is reinforced by the divisions of the law and the law school curriculum: business organizations laws, like business organizations courses, are centrally about the shareholder/director relationship, with managers appearing both as subordinates to the directors and the puppetmasters pulling their strings.

The economic view, however, removes shareholders and directors from their central place. The business is not just shareholders and directors but all the other participants in the sociological organization and the other parties dependent on it. The conflicts are not just between shareholders and managers but among all the participants in the corporation and no participant has an a priori claim to the proceeds of cooperation. Indeed, assuming that cooperation indeed produces gains, the corporation's gains could end up anywhere: as lower

[68]NY Times Magazine 6/7/02 (describing one CEO's vast pay increases precisely as his company began to stumble).

prices to customers, higher prices to suppliers, higher returns to capital (bonds, banks or brokers), higher wages or salaries, or more expensive buildings.

Moreover, the theory predicts that the gains to cooperation will – if the market has its way – end up in the hands of those with some kind of market power. If this were true, it would suggest that we should not be cheerleading visible success so much as worrying about whether it is an anti-trust violation. If, on the other hand, returns are going to shareholders, who seem unlikely to have monopoly power, we need to think harder about why they are winning, who is losing, and whether this market result is one we find politically attractive.

As we have seen, the theory that shareholders "own" the firm or that they "hire" managers seems to have little connection with law or economic theory. Nonetheless, it remains quite powerful ideologically. Popular discourse appears to accept the notion that shares have a stronger claim to windfall gains than do other corporate participants. It was Michael Milken's downfall that he failed to understand the distinction between owning 1/4 of the company he built (which would have made him a hero and potential presidential candidate) and taking a salary worth 1/4 of the profits of the company he built (which made him an overpaid employee greedy beyond all comprehension -- and also caused him to pay enormous quantities of avoidable income tax).

Although economically income is income, legally and socially salary is very different from profit on shares. Very large salaries are in bad taste. Moreover they are almost automatically somewhat legally suspect: agents and employees are supposed to work for their principals, not themselves. If you pay yourself that much, it seems facially implausible that you have set aside your own interests. In contrast, vast profits on stock ownership look like the rewards to the sort of heroic entrepreneurship that keeps our economy moving. In contrast to the faint reek of high salary, with its hints of breach of duty, high stock profits smell only of roses: owners are supposed to be looking out for themselves.

The rhetorical and political lesson is simple. Managers interested in making lots of money are well advised to do it with modest salaries and large stock grants (even leaving aside the tax implications). Shareholder advocates concerned that managers are taking too big a share of the pie should be working to eliminate the tax subsidization of stock option grants: managers who are paid by salary will be paid far less. And anyone attempting to understand the system should admire the category breaking rhetoric of economics – and approach it with caution. For economists, income is income and shareholders might be hired by employees. At law and in politics, the categories take on a life of their own.

C. Revising the Competition Between the States.

The conventional story of the race to the bottom/top is unsustainable. The states are not passive victims of a system beyond their control, driven by lust for taxes into deregulating corporations for the greater bad or good of society. Were they motivated by taxes alone, it is hard to imagine why they wouldn't have abandoned the Internal Affairs

Doctrine long ago. Accordingly, politics must reenter our explanations: were the political coalitions right, nothing in the nature of the world or our legal system would stand in the way of states reasserting their sovereignty.

If the race is not inevitable, we must confront the political question: is it good? Should individual states opt out? Who benefits when states voluntarily abandon law making to corporations? Is this a fair or a democratic way to decide our corporate law?

Here, the agreement between the race to the bottom and the race to the top analyses is probably more important than the difference. Both sides agree that the proximate decision-maker is management and that management makes the decision in its perceived self-interest. As we have seen, changing the underlying assumptions of the model slightly generates significantly different predictions regarding the degree to which managers will see their self-interest as closely tied to shareholders. But in the final analysis, corporate practice seems to have mooted the race to the top/bottom debate.

The debate assumes that shares and managers are on opposite sides of a conflict. In the world (Enron and the accounting scandals to come notwithstanding), that battle is muted if not over. Both have won.

1. Managerial victory and defection.

In a blow to the race to the top theorists, managers have won many important skirmishes in ways that are hard to rationalize as ultimately gains for the shares. First, managers have tamed the hostile takeover market: since the Poison Pill was upheld and universalized, managers have usually been able to resist unwanted takeovers, at least to the extent that the cheapest strategy for the other side usually is to buy their support. In the end game, successful hostile takeovers nearly all become friendly takeovers and the exiting managers in conceding defeat become even more exceedingly rich.

Second, managers need not wait for takeovers to amass great wealth. Top management has increased its compensation over the past three decades to such a degree as to lead all but the most credulous to suspect that perhaps they haven't entirely set aside their own self-interest. Perhaps top management wasn't fully motivated to work for the shares when it was paid barely more than an ordinarily successful doctor. But somewhere in the last 30 or 40 years, that magic moment must have arrived. Modern CEO salaries can not plausibly be explained as no more than is necessary to extract a full working day out of their recipients and ensure that ambitious youngsters seek to take their place.

Third, accounting conventions continue to be manipulated in ways that are indefensible from a shareholder perspective. Most obviously, perhaps, companies continue to account for stock option grants to managers as if they were cost-free, an accounting convention that from the shareholder perspective would be fraudulent were it not so transparently false. More generally, shares have suffered from defecting managers using faulty or fraudulent accounting, producing accounting profits without actual returns to shareholding.[69]

It is too early to tell what accounting reforms will be adopted in the wake of the 2000-02 market melt-down or how many of them will result from race-to-the-top market like processes. In the abstract, accounting seems to be subject to a relative of Says law or a market for lemons: bad accounting drives out good. Assuming that shareholders are influenced by reported numbers, any firm that does not present its results in the most favorable (even deceptive) way permissible (or acceptable in the market) will be at a disadvantage relative to its peers. In an unregulated market, the standard presumably would steadily march downward, as less aggressive companies feel pressured to adopt the current norm and more aggressive ones push beyond it. Companies that would prefer to use honest accounting have only a limited number of escape routes. In the mode of the race to the top, they could seek a clear signal to the market that they are using better accounting and should be rewarded for it, for example by reincorporating in a state with strict controls. Alternatively, and especially if they are concerned that the market might not give enough credence to such signals, they could try to end the race altogether: they might become a lobby for externally imposed, universally applicable, minimum standards to rein in their less straightforward competitors. At the moment, it seems likely that if accounting reform happens, it will be in the latter form, outside the race to the top: imposed by Congress or the SEC, the stock markets or other centralized institutions rather than voluntarily adopted by corporations reincorporating in order to prove their virtue to the financial markets. The voluntary approach is too easily subverted by defectors, I suspect.

More troubling for the optomistic race to the top theories, it is hard to imagine that the reforms, whatever they ultimately turn out to be, could possibly be enough to eliminate the underlying problem. Managers in an end game, as all managers are, always have an incentive to find a new way to subvert the existing rules, to exploit accounting loopholes and corporate law positioning, while corporate law creates no one with a countervailing incentive and ability to call the abuses until after the bubble bursts. Thus, it seems nearly inevitable that the "race" will force managers to support changes to limit the particular games of the late 1990s – but then invite them to create a new defection as yet unimagined.

2. Share successes.

All these phenomena seem strong evidence that race to the top is not entirely accurate.

Still, this is no race to the bottom. Shares have also done extraordinarily well — share returns have exceeded 15% per year for a quarter century, trough to date, even

[69]Much acquisition activity appears to be motivated by accounting rules that allow acquirors to show increasing profits even though the combined business sells no more at no lower costs than the separated ones. Something is wrong when 1+1 can equal 2.5, providing that stock price, dilution and depreciation of good wills rules allow it.

including the declines of the last two years. That hardly looks like overwhelming empirical support for a race to the bottom.

Instead it seems clear that companies are run in the interests of *both* shareholders and top managers to a degree inconceivable a few decades ago. Indeed, the very distinction between the two roles has shrunk, as managers have become the largest individual shareholders, holding [10%] of the equities of the largest companies — even more than the founding families. Shares have won, even as they lost, because shareholding managers acting in their own interest now necessarily pull the other shares along.

3. The new synthesis.

Here then is a proposed synthesis of the race to the bottom/top. First, strip away the ideological claptrap of inevitability: if we don't like the results of the race, we can change it. Even if we do like the results, we need to consider whether the system of reaching them is defensible: even very bad institutions sometimes reach good results.

Second, the likely results of the race are neither to the top nor to the bottom but somewhat more complicated. So long as the states continue to allow corporations to choose their own law, managers will happily chose state law that is in the interests of shares and managers. It seems safe to assume that corporate managers generally run their corporations in the interests of fictional, undiversified shareholders, if only because they hold a large percentage of their own wealth in the shares of the companies they manage. Direct conflicts between shares and managers should be relatively infrequent, since most of the time managers maximize their own net worth by maximizing share value, both their own and others. On the other hand, when managers and shares unavoidably conflict, as in end games such as hostile takeovers, managers seem to choose law that protects them from shareholders, whether it be state anti-takeover provisions or poison pills, and shareholders rarely succeed in preventing these disempowering moves. Similarly, managers pay themselves increasingly large percentages of the outstanding shares, and the shares have failed to do much about it (or even consistently to view it as negative). Finally, managers seem to participate gleefully in the process of bad accounting chasing out the good, and not only in instances where the bad accounting directly enriches managers.

More important than the remnants of conflict between shares and managers, however, is their united front. Both shares and managers gain when they, collectively (and managers as large shareholders), are able to seize a larger share of the corporate surplus from other corporate participants. Managers should expect no squawks from shareholders when they choose law that is in their collective interest — that is, not only law that frees managers to act in response to changing market conditions, but most importantly law that improves the corporation's bargaining position against its other participants (employees, customers, suppliers, tort and environmental claimants, taxing authorities, neighbors) or frees corporations from social and other obligations.

Race to the top/bottom, in short, is a misnomer. The more critical race is to define the corporation as no more than the pursuit of share value maximization, limited only to the extent that that contradicts the pursuit of managerial return maximization. Under our current system, it is a race that proceeds of its own accord, without regard for any political debate regarding whether this is what our corporations ought to be doing, or, indeed, even whether this is good for the human non-managerial shareholders.

a. What do shareholders want?

The Delaware dominated law created by states accepting the race to the top/bottom furthers the interests of an alliance of shares and managers. I do not mean to belittle the conflicts that remain between those roles, which, as discussed above, remain quite significant. Indeed, for practicing litigators, the conflicts within this coalition are not only significant but of almost exclusive importance: it is those conflicts that generate shareholders litigation and hostile takeover work. For planners and for lawyer citizens, however, the less visible "non-adversarial" aspects of corporate planning may well be more important. When managers work in the interests of shares, the results are quieter but more profound.

In earlier work I have attempted to describe the behavior of a corporation that is run in the interests of its shares. Here, I summarize (but do not defend) that analysis in order to suggest that the race to the bottom/top is politically important: that is, the process generates predictable results that are not necessarily attractive. The choice to allow our corporate law to be created by the race is a choice to avoid explicit discussion of a series of difficult and controversial issues. But it is not a neutral choice: the race generates a determinate, and not necessarily attractive, answer.

1. What a shareholder is.

Shareholders are a legal fiction. That is to say, corporations are not run in the interests of the actual human beings who own shares, or more typically, are the beneficiaries of institutions that own the shares.

Those human beings have many and complicated interests and views, and for most of them, shareholdings are a tiny part of their financial, let alone more general, interests. Most of non-managerial shareholders are ordinary middle class Americans, investing small amounts through pension funds or mutual funds. For nearly all of those investors, roles as consumer and employee are far more important than their shareholder role: even taken in strict economic terms, virtually all shareholders have far more wealth tied up in their jobs than in their stock holdings. Indeed, while stocks are held, directly or indirectly, by close to 3/4 of Americans, barely 5% of the population has a net worth -- in financial and non-financial assets -- larger than their annual income.

But corporate law and the financial markets have no mechanism for passing those multifarious interests and views through to corporate managers. Rather, managers are driven to act as if shareholders were just shares. Sometimes this is legally required: for example, ERISA bars pension managers from considering the actual circumstances of the fund beneficiaries, many of whom would often be, or view themselves as, better off as humans if the pension fund worked to preserve their jobs rather than their pensions.

Sometimes it is an artifact of the combination of a highly competitive financial market and limited human cognitive ability: from the investor perspective, even if I care deeply about corporate behavior with respect to a series of political issue, as a practical matter I have little choice but to focus on expected return in picking investments.

More importantly, however, from the perspective of managers, so long as some significant part of the market focuses only on expected returns (as fiduciaries ordinarily will be required to do), the views of investors who do anything else will all be washed out: prices will be set by arbitraging profit maximizers who will drive the price of all shares to their best estimate of the risk adjusted future returns. Even if, for example, a large part of the investing public boycotted Company X because it engages in widely unpopular activities, so long as some investors are pure profit maximizers, the boycott would have no effect. Were the boycott to reduce the stock price below the risk adjusted present value of expected future returns, the profit maximizers would see it as an opportunity to earn above market returns and would purchase the stock until its price returned to "market" value absent the boycott. Thus, the boycott would have no effect on share price and accordingly send no message to management. In contrast, were managers to pursue a non-profit maximizing course, for example abandoning a profitable but unpopular activity, the same financial arbitrageurs would bid the stock price down to reflect not only reduced profitability but this anti-financial market behavior. Here, in contrast to the political boycott, a clear message is sent: return to share profit maximization (and profit yourself!) or a takeover will force you to do so (and someone else will profit).

Consumer boycotts can send a message to managers: if customers don't buy a product, for whatever reason, fewer will be sold and the company will be forced to adjust. Thus, companies may sell more product if they take political positions that consumers find attractive and vice versa. (It is an empirical question, of course, whether customers actually act in this way except at insignificant margins: cognitive limitations would suggest that few people think hard about General Motors' political interventions even in the broadest sense when choosing what car to buy). But in a reasonably competitive financial market with a significant part of the trading done by politically unconcerned profit maximizers, the political views of shareholders are simply irrelevant: they can not affect the number of shares sold or the price at which they sell.

Thus, for purposes of considering the impact of the shareholder/managerial alliance on American society, we must model shareholders counterfactually: as if the shareholders were no more than shares, profit maximizing rational market participants with no interests, beliefs or views other than discovering the best possible risk adjusted future returns to their shareholdings. This is simplifies theorizing, since we have a well-developed body of literature modeling how such rational investors would act.[70] But it is critical to recall that

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[70]There is a major disconnect between that literature and the world of corporate law, however. Models of rational profit maximizing investors indifferent to all other values assume that, in the absence of inside information, investors should always (continued...)

the shareholders of corporate finance are not human beings or citizens: there is no reason to think that the voters who stand behind the shares would act the way the market and corporate law and managers who seek to pursue shareholder interests construct them as wishing to act.

Were they in a position to trade off their shareholder interests against their non-shareholder interests, an overwhelming majority of shareholders (perhaps even holding a majority of shares) would find their non-shareholder interests weightier. But they are not able to make such trade-offs: ordinary principles of fiduciary law and intense market pressures on institutional investors and corporate managers alike assure that managers will view their role solely as promoting "shareholder" interests, where shareholders are imagined to have no other interests at all. Indeed, in most cases, fictional shareholders will not even be imagined to own other stock; managers do not invest on behalf of diversified portfolios.

2. Understanding the interests of shares: Share interests are not human interests.

According to standard portfolio theory, shares are valued based on the risk adjusted present value of the anticipated returns (dividends and redemptions or final payment upon dissolution) associated with them. It follows that, at an appropriate discount rate, shareholders as a group are time indifferent: the value of the shares at any given time reflects all future returns, short term and long term. The humans behind the shares, of course, may have definite time preferences (for example, human shareholders may be saving for retirement or college, and need returns at a time determined by their life cycles). (Institutional shareholders often not: permanent endowments and pension funds, which hold a large portion of publicly traded stock, are essentially time indifferent and eternal.) But the market makes the preferences of individual shareholders irrelevant: any shareholder in search of an immediate return can sell its stock, at the present discounted value of expected future returns, to another market participant looking for distant returns. Thus, in a variant of Modigliani & Miller's separation theorem, the corporation can treat shareholders as if they were entirely time indifferent - even immortal.

Another way to look at the same phenomenon is this: shareholders do not gain or lose when a company changes the time period in which it earns its gains (again assuming the gains are equal on a properly risk adjusted discounted basis). The present value of the stock already incorporates all anticipated future gains. (Of course, a gain that actually exists is less risky than one that is merely anticipated, so if the market deems an investment more or less risky than managers do, managers may be able to affect stock price by manipulating when gains are realized. In particular, if the market treats future returns as highly risky and

[70](...continued)
diversify. Shareholders, thus, are modeled as portfolios. In contrast, managers must act as if shareholders were undiversified: Delta's managers cannot take into account the fact that many of their shareholders also own Southwest and use that as a reason not to compete.

therefore discounts them at a high rate, it will reward managers who take a very short term approach.)

The time-indifference of shareholders as a group should have strange consequences.[71] People are never time indifferent. Fictional shareholders are odder still, however. They are utterly uncommitted, not only to time but to place, culture, relationships, history and all the other things that make human life worthwhile. Prior commitments, for the financial market, are just sunk costs, largely irrelevant to the important calculation: the risk adjusted present value of future expected returns. If greater profit looms in a new location, shares (though not necessarily the human beings behind them) have no commitment to the status quo.

The result is that the financial market and corporations that cater to it are more revolutionary than the most radical humans of the left or the right. Change, risk and mobility always have costs for humans; for diversified portfolios they are largely irrelevant.

Corporations driven to act in the interests of shares can take account of other values only to the extent that shares do. Thus, they will view compliance with the law as a cost of doing business, not a value in itself. They will treat all participants in the corporation (except top managers) as mere means to the ends of shareholder value maximization: if making customers or employees happy is profit maximizing, wonderful, but if not, that isn't a problem either. Shares do not balance competing values – they just weigh all issues against a single test of profit.

To summarize the key points. Managers, driven by the market in a mechanism not unlike that described by race to the top, will run the corporation in the interests of the financial markets ("shareholders" only in the fictional sense of a profit-maximizing investor

[71] One legal consequence is quite startling. On a first approximation, fully rational and time indifferent shareholders should be largely indifferent to certain kinds of fraud that are viewed as quite serious under the Securities Laws. If a company artificially inflates its reported earnings (and fools the market), the market should respond by adjusting the stock price to heights that would not be warranted by the actual earnings. At some point, usually in the not too long term, however, the company will be forced to bring its stated earnings back to reality. From the perspective of shareholders, the whole exercise is largely a zero-sum game: for every shareholder who gains by selling at the temporarily inflated price, there is another one who loses the same amount by buying at the inflated price. Indeed, for large diversified portfolio shareholders and especially for index investors, the whole thing is largely a matter of indifference: over time they are equally likely to be on the winning or losing side of such transactions.
In fact, however, we see companies that appear to manage their earnings by accelerating income and deferring expenses, thus showing artificially high profits. Then, they may correct the books during a cyclical downturn, showing artificially high losses. Were shareholders entirely rational, this would be a useless exercise (except for managers who were engaging in inside trading or triggering option grants), as would prosecuting its practitioners. However, modern cognitive theory suggests an explanation, by lifting the perfect rationality assumption. If investors are more sensitive to directional changes than to absolute amounts, as cognitive psychology suggests, they may not punish firms' stock prices much more for very bad news than for just ordinary bad news, making lumping bad news an attractive game for managers. If, as the concept of "framing" suggests, investors accept the categories that they are fed, they may treat repeated "one time losses" differently than they would if they were accounted for as ordinary costs, ignoring one time news as unimportant sunk costs rather than a predictor of the future. Similarly, reporting stock option grants in a footnote rather than on the income statement might actually change valuations by less than fully rational investors using shortcuts to calculate valuation.

holding no other investment and with no other interests in the firm or its competitors or neighbors), with the limited exception of when their own interests directly conflict with share interests in an end-game like situation. The financial markets, in turn, act like aliens or a colonial power: they are interested in the human beings who make up the American economy only to the extent that they are profit centers. Rather than treating ourselves as political ends, we have created a system that treats us as no more than means to be exploited. Our corporate law system causes our own corporate managers to use our own pension funds to colonize us.

American corporate law has been a tremendous success. Exploitation can be enlightened: it is often the case that the way to get the most of someone, even if you have no regard for them at all, is to act as if you did. Slavery is not always the most profitable route.[72] And economic growth is an important value, for which we often might be willing to sacrifice others. For the remainder of this paper, I need only to make the non-controversial (I hope) point that share profit maximization can conflict with other values.

If conflicts are possible, we must face the fundamental issue: the race to the bottom/top means that conflicts between share value maximization and other values will be made by managers who are directed to consider the problem as if all other values were important only to the extent that they promote share value maximization. Not only does corporate law teach managers that this is their duty, the right thing to do, but the race to the top assures that (with the possible exception of direct manager/shareholder conflicts) it is in the managers economic interest to think about problems in this way. We have thus aligned two of the most important human motivators in the same direction: role morality and personal financial self-interest teach the same message.

The system that sends this powerful, uninomic, directive to the managers of our most important economic institutions is the race to the bottom/top. Our government, at both the state and federal levels, has decided by means of the Internal Affairs Doctrine to allow corporate managers to determine the law that will regulate the corporations they run. It is time now to consider whether that political decision is compatible with our democratic system, and if it is, whether it is the right decision to make.

III. The Status Of Corporate Law In Democratic Theory: Markets Vs. Voting

Our mixed capitalist system has three broadly different methods of decisionmaking: first, the majoritarian, political, voting mechanisms characteristic of the elective branches of government; second, the supply and demand competition of the market; and third, the

[72] Fogel made a good case that American slavery actually was fairly efficient at extracting labor from its victims. That is why this issue is important. Treating people as exploitable resources would be less problematic if the most profitable way to do so always were to act as if you thought of them as ends.

authoritarian, top down, rule driven, command systems of private and public bureaucratic organization.[73] Each has distinctive benefits and problems and distinctively different claims to legitimacy.

Corporate law claims its legitimacy as a form of majoritarian democracy, but in fact is a market driven process creating and itself legitimizing bureaucratic actors that answer to a norm created by the market itself. Stripped of its ideological and false claims to democratic legitimacy, corporate law should be seen as a norm created by market mechanisms and enforced by bureaucratic processes only as legitimate as the norm they apply. Like other market mechanisms, it requires democratic supervision and limitation to retain its legitimacy — supervision that is not provided in the race to the bottom/top.

A. Markets and Majorities.

Markets and democratic voting procedures each base their claim to legitimacy on their ability to aggregate the views of disparate individuals: they are different expressions of the rule of the people. (In contrast, bureaucratic and rule or law driven enterprises base their legitimacy on the claims of the norm they enforce: courts are legitimate when they obey and express the law, bureaucracies when they enact the mission given them by an external source such as the legislature, a sacred text, or a founder. Bureaucracies, thus, are expressions of rule of norms, rather than of rule of people.)

But markets and democracies aggregate individual views and decisions in radically different ways with radically different strengths and weaknesses.

Political democracies ideally work by extended discussion, followed by a voting procedure that both reflects individual views and encourages them to change in the process of creating a new consensus. In the end, a single decision is reached. Because a conscious decision must be reached, political systems are subject to breakdowns of rationality: even if we all agree on the goal, planning becomes impossible beyond a certain level of complexity. Political processes are a lousy way to choose breakfast cereals.

A second problem goes not to effectiveness but the very heart of legitimacy. Because elections must be decided by majority vote, they suffer from the ever-present danger of minority oppression: that a majority may decide to vote itself more than its fair share of the political benefits to be distributed. This "majoritarian difficulty" stems from the simple fact that a majority vote can't transform unfairness into fairness; winner take all -- if it is taken seriously, and especially if the same people routinely win -- is simply unjust.

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[73] I've discussed this in greater length elsewhere. Daniel Greenwood, *Beyond the Counter-Majoritarian Difficulty*, 53 RUTGERS L. REV. 781 (2001). For present purposes, the judiciary may be seen as a variant on the bureaucratic form — simultaneously more rule driven and more individualistic than most other bureaucracies, but distinctly more similar to that form than the other two in its allegiance to externally created norms that most individual actors believe they lack authority to change. Of course the courts, like all bureaucracies, continually change and create norms as they apply preexisting ones. But judicial and bureacratic actors view themselves as agents acting on behalf of a mission they do not have full autonomy to choose. This gives rise to a bifurcated sense of self — the professional vs. the personal — that is lacking in market and voting mechanisms, where actors typically may legitimately express their own values.

In a functioning democracy, the majoritarian difficulty is mitigated by coalition building politics, open discussion and a shared sense of a common enterprise, that together make it difficult for any particular group to create a stable majority able and willing to blatantly gang up on others. Democratic politics may fail, however, if the sense of common enterprise fails, as when a majority is unwilling to compromise or to acknowledge a minority as full members of the community; when the search for compromisable issues leads to a political discourse so thin or devoid of meaning that the bulk of the population tunes out, or when the necessarily technical aspects of law making are "captured" by well-funded interest groups that are able to mold the law without public discussion or debate.

Our own democratic politics has shown signs of each of these failures as well as more or less successful solutions . Thus, the classic racial politics of the pre-Civil Rights or "silent majority" eras, in which white majorities simply appropriated all the political goods leaving nothing for black minorities, are paradigm instances of majoriarian oppression.[74] The second problem, of thin political discourse, might describe the over-constitutionalization of our politics that results from an aggressive court and the political branches repeatedly ducking difficult issues: while the Congress is happy to divide up pork barrel projects relatively equitably (at least if one doesn't press equity too hard) among its various (salient) constituencies, it stumbles to a halt before issues where proportionality is not possible. How do you give the opponents of legalized abortion the one quarter victory to which their national support entitles them? And the third, capture, seems to describe the failed politics of gun control, S&L deregulation, election reform, large parts of the tax code and much regulatory failure.

Markets, in contrast, have different strengths and weaknesses. Like majoritarian or political decisionmaking, markets aggregate individual decisions. But unlike voting based-system, markets aggregate without a single collective decision: individual decisions are made individually without debate, discussion or consideration of collective effects. Each individual acts in her own perceived best interests (within a given set of circumstances). The collective results are simply the consequences of these individual decisions.

This system has some spectacular advantages over political majoritarianism. First, because there is no collective decisionmaker, standard problems of politics, such as limited rationality, information overload, and corruption are eliminated, lessened or hidden. Markets plan without a planner. Second, because there is no collective decision, there can be no majoritarian difficulty: majorities can't vote to disenfranchise or expropriate minorities. In a market, a minority receives a share proportional to its market demand (the dollars it controls); in a voting system, it receives a share proportional to its coalition power (the votes it controls and their strategic value). Market demand is different from coalition power inter alia in that there is no equivalent to winner take all and the temptation of exclusive racial or partisan politics: in markets, if my group has 51% of the effective market demand, it is likely to get 51% of the goods, not 100%. Markets, thus, are likely to

[74]See, e.g., Gomillion v. Lightfoot, 364 U.S. 339 (1960).

distribute the goods they distribute fairly to the same extent that the underlying distribution of income and wealth is fair. The fairness of voting systems, in contrast, depends not on underlying income and wealth distributions but rather on the structure of issues and coalitions: the more likely it is that a view on one issue is correlated with a view on another issue (whether based on substance or ethnicity, race or religion), the more likely the voting system is to degenerate into majoritarian oppression.

But if markets eliminate the worst problems of the political process, they generate other bizarre and irrational results. Isolated actors in a market must take as given circumstances that the collectivity could change — even to the extent of feeling coerced into taking actions none of them would accept in a collective decision (e.g., a prisoner's dilemma).

Most important for present purposes, markets tend to reflect and accentuate preexisting power relations. The only way market trades will happen is if they are attractive to each counter-party. Given the diminishing marginal utility of wealth and power, this necessarily means that the relatively poor and powerless will always give more than they receive (relatively). Even if absolute wealth increases for all by trade, the relative gap between the wealthy and the impoverished will increase as well.

B. Race to the Bottom/Top as a Market.

The race to the bottom/top operates like a market. Like any market, it operates within a given set of legal parameters: in this case, the decision of the states to accept the Internal Affairs Doctrine and the concomitant ease of reincorporation. Within those boundaries, however, corporate law is not determined by debate and voting but rather "purchased" by "customers" (the corporations) choosing the "product" (state corporate law) they find most attractive from a menu offered by "sellers" (the states).

The market for corporate law means that corporate law is not the result of conscious planning or decisionmaking by a collective body on behalf of the people as a whole, but rather by a process of evolutionary selection, in which individuals operating within narrow role constraints — thinking as professionals rather than as citizens — decide how best to maximize the interests for which they are fiduciaries. Those managers who make choices that help them survive are more likely to survive, and that law that gets chosen more often becomes more influential. The law that results from these individual, constrained, calculations may be quite different from law that would result from deliberative and collective processes, whether ideal or flawed.

1. Pure consent: corporations choose their own law.

At first glance, the market for corporate law appears to eliminate the majoritarian difficulty. There is no way to impose corporate law on a corporation: it must freely agree to it, or it can choose to reincorporate under a law more to its liking, with almost no collateral costs. (I avoid, for the time being, the question of what it means for the "corporation" to agree). Thus, corporations have consented to the law that binds them in a more real way than the "tacit consent" that is sometimes invoked to explain why the losers in a democratic election are nonetheless bound.

If true, this is an extraordinary claim. Consent is the foundation of legitimacy in modern political theory; the search for a political system that can accurately claim to be based in the consent of the governed has been the holy grail of liberal political theory at least since Hobbes. When citizens freely consent, then we need not worry about state oppression – the problem of liberal political theory is solved and we can proceed to other issues.

If corporations choose their own law, corporate law cannot be coercive of corporate decisionmakers. That suggests, of course, not only that the law can't exploit corporate decisionmakers, but also that it cannot restrain them. Corporate law also cannot empower or protect corporate participants except insofar as they could do it (via corporate decisionmakers) without the law's help. Voluntary law is not likely to be reformist law.

a. Consent in a market for law: tacit consent, freedom of choice and external constraints.

The argument that corporate law is consensual depends on the claim that corporations can choose their law relatively freely. Were it the case that reincorporation had significant extra-legal consequences, consent would be purely formal and the law would still have significant coercive potential. Thus, Locke's classic defense of liberalism (following Plato's earlier defense of the rule of law) claims that law is not coercive because citizens have agreed to it by not emigrating. Emigration, however, is quite difficult: emigres have to leave behind their country, their friends and relatives, often their culture and language, jobs or profession. Most people would put up with quite a bit of coercive law to which they would far rather not consent, before making that kind of major change; only a very weak claim can be made that non-emigrants have endorsed (even tacitly) any particular law or even the entire legal system. In contrast, were it possible to change one's citizenship without uprooting other aspects of one's life, Locke's tacit consent would begin to be far closer to a real consent.

The issue, then, is whether corporations have reasons, other than the substance of Delaware law, that might induce them to incorporate in Delaware (or remain incorporated there) even if its substantive law, or some parts of it, were unattractive. Clearly, there are some such reasons; equally clearly, they are far from overwhelmingly strong.[75] {{COMPARE END OF II.A}}

Probably the most important non-substantive reason to incorporate in Delaware is that everyone else does it. This cascade creates significant information benefits. First, because most major corporations use Delaware, there is more litigation in Delaware courts, more discussion of Delaware statutes, and simply more Delaware law. This presumably

[75] Bebchuk (empirical evidence suggests strong incentives to incorporate in Delaware).

makes Delaware law somewhat more predictable, understandable or at least more structured than the less developed law of other states. In Delaware, unlike Utah, it is likely that something resembling your problem has already happened. Second, because Delaware law has the status of national corporate law, corporate attorneys throughout the country are likely to know and understand it, often as the only corporate law they know other than their own local law. Delaware law thus serves as the national "second language", similar to English as the language of international commerce. By adopting it as its first language, a corporation assures that its structure is understandable to everyone.

Delaware incorporation may also have useful signalling effects: it is a way for a firm, particularly one newly entering the capitol market, to signal to investors its commitment to the national market. Like a budding professional seeking experience in the big city, a firm signals that it is prepared to play in the big leagues by incorporating in Delaware.

Finally, inertia may be significantly important. Reincorporation costs money and time and valuable managerial attention that might better be spent on the business; without a quite good reason, firms may simply stay where they are.

None of these non-legal reasons to remain in Delaware seems likely, however, to lead a firm to decide to remain in Delaware despite significant unhappiness with its substantive law. Predictable and understandable law is clearly a benefit, but if the predictable and understandable law were bad law, surely many would decide they'd prefer to take their chances elsewhere. So, it seems safe to assume that the overwhelming choice of national corporations to incorporate in Delaware reflects corporate decisionmakers' genuine choice and consent.

b. Consent in a market for law: limits on consumer sovereignty.

A second possible critique of the notion that corporations freely agree to Delaware law in a way that eliminates the majoritarian problem of more usual democratic forms is quite different. Corporations choose Delaware law in much the same way that consumers choose whether to purchase a product; like consumers in a commercial marketplace, they have no votes but seem to have ultimate control. That is, as suggested above, corporate law is determined by mechanisms that resemble a market more than a political entity.

It follows, then, that the claim that corporations — which do not vote — are nonetheless the ultimate sovereigns controlling corporate law will be subject to the standard critiques of the claim that consumers — who have no political authority over producers in a classic competitive market — are nonetheless sovereign. But most of those criticisms of the notion of consumer sovereignty seem relatively weak in the corporate law context.

First, there seems to be no reason to worry about problems of monopoly in either suppliers or consumers of corporate law. On the contrary, the market for corporate law seems to be characterized by extreme competition. Corporate managers acting on behalf of corporations may choose among 50 state jurisdictions as well as, in most cases, foreign corporate law regimes. It is true that the state incorporation statutes tend to cluster — at any given time, they mostly look alike, and when innovations are introduced, they tend to quickly spread or be eliminated, so that at any given time the range of choice may appear narrow. But this sort of "punctuated equilibrium," in which change spreads rapidly through a population, is characteristic of biological evolution as well as developed markets and not necessarily a sign of lack of competition. Indeed, most competitive markets rapidly settle on a dominant paradigm with competition limited to a few characteristics.

In this case, there is an additional reason not to be concerned about the apparent lack of diversity of offerings in the market: the dominant pattern of corporate law is extraordinarily flexible, allowing corporate decisionmakers an enormous range of choice even within the particular law they choose. Indeed, nearly all corporate law reform in this century has been directed at increasing the range of choice available to corporate planners, who have nearly complete autonomy under most available laws.

Furthermore, the apparent lack of choice in corporate law is largely illusory. Unlike in biological evolution, market competitors are never entirely locked in by their history. A species must adapt to its immediate environment, even if it might be more successful adapting a different one: it can only climb the hill in front of it, not the larger one after the next valley. Firms, in contrast, are led by managers who can consciously decide to change the terms of competition. Accordingly, firms have options that would not be available in a natural selection.

Thus, were it the case that all the corporate law options were unsatisfactory for some reason, managers could also choose alternative organizational forms: public firms can go private or vice versa; for-profits can reorganize in mutual and coop forms, the various forms of trust, partnerships, limited liability companies, even wholly-owned sole proprietorships (incorporated or not).[76] Funding need not be raised in the stock market; functionally similar -- though legally quite different -- options exist using debt financing, by junk bonds, for example.[77] And, of course, it is always possible to redeploy capital and simply leave the dis-favored business.

Similarly, the firm's underlying investors can readily switch their investments to different corporations or, in most cases, to different organizational forms. If the rules regulating stocks are unattractive, functionally similar vehicles may be created using limited

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[76]See, e.g., John Langbein, *The Secret Life of the Trust*, 107 YALE L.J. 165, 167-78 (1997). Trusts, of course, were used for this purpose prior to the great reform of corporate law begun by New Jersey; hence the oddity that our anti-monopoly law is known as the Anti-Trust Act. Today, most REITs and about half the mutual funds use the trust rather than the corporate form, apparently in order to avoid some of the few remaining regulatory requirements of corporate form: the annual meeting, a specified number of shares and the corporate franchise tax. Langbein, id, at 171, 184, 187 & n.133. Langbein suggests that the business trust offers virtually the same limited liability protection as the corporation, without entity taxation, and thus leaves an interesting puzzle, namely why there are any corporations at all.

[77] Thus, for example, Mesa Petroleum reorganized as a publicly traded limited partnership. After tax reform reduced the attractiveness of the LP form, it reverted to corporate form. The great conglomeration and deconglomeration movements of the 1960s and 1980s took many publicly traded companies private (as divisions of public companies) and then later spun them off as free standing public companies again, before taking them private in MBOs. See discussion in ...

partnership interests, high yield bonds, options or hedge fund interests. Few investors are required to remain in any given firm or even in the market for corporate securities itself (and the few that might be, such as mutual funds, have asset bases that could themselves disappear if the underlying human investors became unhappy with corporate investment). Thus, both corporate managers and investors appear to face a wide range of choices that is difficult or perhaps impossible for a state legal regime to restrict.[78]

Similarly, there do not seem to be issues of effective demand or limited bargaining power. Publicly traded corporations are quite large relative to the cost of reincorporation or even lobbying to create an unusual or innovative legal regime. Even for smaller firms, a wide range of "off-the-shelf" solutions is available at relatively low cost, as described above, so effective demand should be present.

Another possible failure in the workings of the market for corporate law seems stronger, but also not decisive. Innovation in corporate law appears to be a public good, and thus might be underproduced, since innovators will be unable to capture the full benefits of their activities.

Thus, for example one might argue that, if a state creates a new and more attractive law, it may have a moment of excess tax revenues as firms reincorporate there. But more likely than not, Delaware will revise its corporate law to respond to the threat before there are any, or any significant, number of defections. Accordingly, the state will be unable to profit from its innovation, and to the extent that states innovate in order to compete for corporation tax revenues, they may well conclude that the game is not worth the candle and not compete at all.

This formal picture, however, seems distinctly unrealistic. Corporate law innovations are more likely to come from corporations seeking a legal mandate for a course of action or attorneys seeking to promote the interests of specific clients or their client base in general, acting through professional associations or semi-academic enterprises, or in rarer circumstances, directly from academics promoting their own views of the best laws. They then may be adopted by state legislatures for a variety of reasons, including intellectual persuasion of influential members, lobbying concerns, seeking to help a locally prominent employer or similar motivations not necessarily reducible to the pursuit of corporation tax maximization.

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[78]See, e.g., Lynn LoPucki, *The Death of Contract*, YALE L.J. (1996). LoPucki argues that the alternative forms are sufficiently fungible that it would be virtually impossible for any state today to significantly restrict limited liability. Since limited liability remains the major attraction of the corporate form, LoPucki's work further suggests that even a concerted effort of the states to impose regulatory content on corporate law would probably fail relatively quickly, as firms abandoned the corporate form for other forms of organization with different ways of limiting their liability. On the other hand, it seems likely that a determined and centralized regulator could impose a mandatory form of organization at least on larger capitalization firms or those employing significant numbers, as we have done in the Civil Rights area and the Germans more generally in employee law.

Again, however, these private actors may lack a full incentive to produce corporate law innovations. If a corporation produces an innovation, it will pay the full cost of its creation — it must hire a team of lawyers to think up the idea and realize it in legal form and perhaps a team of lobbyists to convince a legislature to adopt it. But most of the benefit will go to others: once a beneficial form is adopted by the legislature, it will be available to all firms, not just the one that paid for its creation, and any excess profits related to its introduction will quickly be competed away. Accordingly, private firms, like states, have far less incentive to fund legal innovation than they would if, for example, corporate law innovations could be patented, copyrighted, or otherwise monopolised.

This public good aspect of innovation is a stronger argument for market failure than the ones previously described. Indeed, it may explain why much of the recent innovation in corporate law has been in apparently private law or contractual form: individual lawyers are more able to profit from innovative ideas if they sell them to particular clients rather than having to persuade a client to lobby for it. Thus, for example, both the poison pill and related takeover defensive tactics, and the street sweep, two tiered coercive offer and other offensive tactics to which the pill responded, each of which radically changed the face of corporate law, appeared first not as proposals for legislative action but rather as new transactions within the existing legal framework designed to be formally similar to existing forms.

c. Free consent and the legitimacy issues.

In conclusion, then, it seems fair to describe the consent of corporations to corporate law as "free" in a meaningful sense. Unlike the "tacit consent" of classical liberal political theory or the hypothetical contracting of Rawls' original position, corporations actually choose their law and they do so relatively free of constraints that might be thought of as overpowering their will. The choice to incorporate in a particular state cannot be understood as a choice of among package deals where one aspect (such as the desire not to emigrate) might well overpower many extremely unattractive other aspects. Rather, corporations can pick and choose the aspects of law that they want with very few collateral effects. Second, the basic critiques of consumer sovereignty seem relatively inapplicable: even more so than in real markets for products, corporate consumers are likely to get what they want here.

If corporations chose their law, they are free, in the strong liberal sense that the law does not and cannot coerce them. Were the law coercive, they simply would choose to be governed by different law.{{DOES THIS BELONG IN PART IV}}

2. Non-coercive law and redistribution.

The fundamental difference between free bargaining and majority rule is that the former system makes redistribution from the better off to the worse off nearly impossible. When a bargain must be agreed to by both parties without outside intervention, the one who brings the most to the table also leaves with the most — indeed, often with more.

In a majoritarian system, the majority can do what it thinks is right, even if the minority disagrees.[79] In a bargaining system, in contrast, both parties must be convinced that a deal will leave them better off, or the status quo will prevail. That is, of course, the core claim of the economists for why markets tend to efficient or Pareto superior outcomes: no other result, it appears, is possible, since transactions can't occur unless all bargaining parties are convinced the change will make them better off. Thus, either no change at all will occur, or change will be in an "efficient" direction. More importantly for present purposes, the need for agreement assures that bargaining systems can never redistribute downwards: the rich or powerful need never give up wealth or power without receiving something they value at least equally in return.

But it is equally commonplace that when two parties are bargaining over the surplus that a transaction will create, the one who can walk — the one who needs the transaction less — is likely to receive the most. A starving man will pay any price he can for food; the wealthy one can always buy from someone else. Thus, it is entirely possible, and indeed common, that a bargain may leave the weaker party only marginally better off, while helping the stronger one quite a bit more.

As a necessary result, while it seems unlikely that a competitive market could literally make the rich richer and the poor poorer in the short run, it is highly likely in competitive markets that the rich -- who must be enticed to bargain -- will indeed become richer faster than the poor -- who have less ability to walk away from lousy deals. It follows that to the extent that markets distribute power and similar relational goods — where what is important is not the absolute amount that any individual has, but rather who has more or less than whom — free bargaining will almost inevitably lead to the powerful becoming more powerful and the weak weaker.

Applied to the market for corporate law, this anti-redistribution principle suggests an obvious but important point. Corporate law will not be a vehicle for redistribution from corporations to other parties.

If for example the mobility of investment capital gives it a bargaining advantage over other corporate participants (or conversely, if its fungibility is a disadvantage),

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[79] This is true in the short run. In the medium and long run, majoritarian systems — especially multi-jurisdictional decentralized federal systems such as our own — operate under strong pressure to accommodate minorities (at least organized and relatively powerful minorities). Otherwise the minority is likely to demand (and win) new decision-making rules, often by redefining the voting boundaries or locating the decision in a different level of government in which they may be a local majority or able to form a majority coalition with other minorities. Since majoritarian ideology has no account of the proper boundaries within which the majority should rule, such demands cannot be rejected on principled grounds and, if consensus is not reached, often become long standing sources of conflict.

In the long run, then, majoritarian systems tend to resolve all important issues by something approaching consensus, usually on a "you win some, you lose some" basis, less frequently on a First Amendment style agreement to remove the subject from the sphere of collective decision-making. Bargaining systems, in contrast, simply privilege the status quo: change is impossible unless it is to the advantage of the most powerful.

corporate law produced by the race to the bottom/top is unlikely to weigh in on the side of the weaker party. On the contrary, the party with the stronger initial bargaining position should be able to win not only in the market but also in the contest over corporate choice of law. Race to the bottom/top law, that is, will tend to give extra protection and advantage to those who are already the strongest in the market, thus making them even stronger in the market and giving them more power yet to shift the law in their direction. Over time, the race to the bottom/top should accentuate, not mitigate, the market tendency to give more to those who already have the most.

What may not be as obvious is that "redistribution" here operates from a strange baseline: the market as structured by the law that corporations choose as well as other background rules. When the race to the top logic applies, corporate decisionmakers may choose rules that protect other parties. Thus, if bondholders charge higher interest to corporations that are less likely to repay them, managers might choose law that forces them to repay.

But as to some parties, there is no race to the top logic. Tort victims and environmental complainants, for example, have no ongoing relationship with the corporation. Unlike shareholders and bondholders, they can not incorporate costs they expect to be forced to bear ex post into the price they charge the corporation ex ante: they have no ex ante negotiation. In the market, absent tort law or environmental law, these victims would receive nothing and the corporation would place no weight on their claims. In the market for corporate law the same is true: with respect to these parties, in choosing corporate law, the corporation's sole motivation is to find law that will allow it to impose as many of its costs upon them as possible. The race to the bottom should be complete.

In fact, corporate law reflects this prediction almost precisely. While non-corporate law requires that corporations pay for their torts and environmental liabilities, corporate law subverts these goals to almost the maximum possible extent. As a matter of Delaware law, large scale tort liability is largely voluntary. First, Delaware has no minimum capitalization requirements for corporations. Second, it extends the principle of entity liability to torts. This means that when a corporation commits a tort, only the legal entity is liable, not the human beings or investors who profit from it. Lenders and equity holders alike are free to make a profit without paying the full costs of predictable and avoidable accidents: the corporation may set its capitalization level at any level that works for the voluntary creditors, equity holders and creditors, without regard for the needs of tort victims, environmental claimants or other involuntary creditors.

Employees arguably might some power to impose a race to the top regime on corporations: for example, they could demand higher wages to work for a corporation that is poorly capitalized, highly risky or otherwise less like to meet employee needs. In fact, this doesn't seem to happen, any more than employees seemed to include the predictable costs of accidents in wage demands in the days before workers compensation or the demise of the fellow servant doctrine.[80] Similarly, current corporate law provides no protection for long term employee contracts, whether of the old IBM life-time employment variety or simply pensions.[81] As a matter of corporate law, corporations are free to enter into long term contracts with employees, including for pensions and other post-retirement benefits, without setting aside any assets whatsoever to satisfy those claims. Then, corporations are free to encumber assets or take risks that seriously reduce the present value of these long term claims without even disclosure let alone approval. Again, employees appear unable to resist this process in the market and corporate law simply accentuates the market result. In any event, the corporate law appears to be one of pure race to the bottom here.

A conscious political process might reach the same result. The UCC, for example, which is not obviously subject to a race to the bottom, privileges voluntary creditors (including investors who choose to self-characterizes as creditors) over tort creditors and pensioners in much the same way that corporate law does. American citizens, as commentators at least since Mark Twain have noted,[82] often choose to protect the rights of the rich and powerful even at their own expense. And when the powerful are powerful enough, protecting them often is the only way to help the weaker: trickle down economics had a core of truth amid its layers of greed.

The difference is that when a political process reaches this result, there was a space for opposition and debate, and out of discussion may come greater understanding and sometimes even progress. A political process can enact the sabbatical year's forgiveness of debts and then, on a more sophisticated understanding, or Hillel's prozbul (which abolished forgiveness on the grounds that it hurt the poor). The race just does what the race does, without any understanding at all, and what it does is always tilted towards those who begin with the most wealth and power.

3. Legal change without politics in the market for law.

The second key aspect of the market for corporate law is that law is created without public debate. This is an unsurprising consequence of the market for law. Where consumers are sovereign, the important choice mechanism is purchase, not production. That is, from a social perspective, it is unimportant how producers decide what to produce; what matters is which products consumers decide to buy. We can model the production function as a black box, much as evolutionary theory was able to model evolution even before any understanding of the mechanisms of genetic change: so long as varying phenotypes exist, natural selection states that those better able to produce viable offspring will increase in

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[80]There are several cognitive issues that might explain why employees don't properly price the costs of future accidents or company defaults and defections: over-optimism and cognitive dissonance for example. In order to take a job, one presumably must conclude that the likelihood of accident or defection is fairly low. People often deal with low probabilities of unpleasant events by treating them as zero probability. In any event, pricing the likelihood of corporate defection would be extremely difficult.

[81]Strains in the Corporate Web.

[82]Connecticut Yankee, c. ch XXX (Lynch mob)

number relative to those less able. Corporate law is a process of artificial selection, so we can say a bit more than mere survival of the survivors: regardless of how corporate law is produced, that corporate law that is attractive to corporate decisionmakers (for whatever reason) will be effective and influential. The rest will not.

What is important is how decisionmakers decide – whether the race to the bottom theorists, the race to the top theorists or my race to the shareholder/managerial alliance theory correctly describes corporate decisionmakers. How corporate law comes to take the particular shapes it does is of little significance (except, of course, for the fundamental political decision, to accept the internal affairs doctrine and thereby exclude politics from the corporate law creation process).

The legislatures are so unimportant in corporate law that several of the most important corporate law innovations of recent decades happened without legislative action at all, or with only after the fact ratification. The junk bond financed two tiered offer made hostile takeovers virtually impossible to resist; the poison pill made it virtually impossible to prevail in a hostile takeover without persuading incumbent management. The two combined radically increased the power of both shareholders and upper management, contributing significantly to the major restructuring of the American industrial economy in the last couple of decades. While three decades ago, large industrial corporations were largely managed with an eye to slow and steady growth and internal diversification — an approach that in effect if not intention elevated the interests of debtholders and employees over those of shareholders and customers — today, firms are far more likely to see serving shareholders (and top management) as primary goals, and accordingly to accept a far higher level of risk, specialization and aggressive change than previously.

These radical changes were mediated by corporate law. No doubt, the proximate cause of many of the changes was the increased level of competition in the product market, especially the pressure from less complacent foreign competitors. Nonetheless, it is corporate law that defined and limited the possible corporate responses to the new challenges. It is hard to see how the challenge of responding to Japanese production techniques could be responsible for the shift to shareholder value maximization as the primary goal of US publicly held firms. Rather, it is corporate law that creates management as the primary decision making body in the firm, and corporate law -- in the US far more than in the other leading capitalist countries -- that creates the shareholders as the primary supervisor of management. Hostile takeovers enabled the stock market to force management to refocus their attentions on maximizing, rather than "satisficing," share value. Junk bond financing provided the paradigm break that gave hostile takeovers the impact they did. The defenses to hostile takeover first enacted in the Williams Act and then more effectively embodied in the poison pill, staggered and dead-hand boards and similar legal tactics, freed corporations from abject captivity to the perceived interests, fashions and prisoner's dilemma failures of the stock market. Centralized and unsupervised authority in the board of directors invited payoffs to top managers that ultimately converted hostile takeovers into friendly ones (or convinced managers to make the takeover artists' changes preemptively).

The potential for these payoffs is the carrot that drives the managerial share alliance and broke the old alliances of the defunct slow steady growth model.

But neither the empowerment of shareholders nor the shift of much of that power to managers was ever debated and decided by the state legislatures responsible for creating our corporate law. The innovations were made not by convincing the electorate or lobbying the legislature, but by private lawyers selling to individual clients new financial instruments or planning devices created under the flexible existing rules. Radical shifts in the power structure of the public corporation — from the virtually autonomous salaried management of the New Industrial State to the nearly slavish servant of the shareholder of "Should Takeover Defenses Be Permitted" and then to the super-capitalists of new style managers who pay themselves ten percent of the company and act as owners rather than employees — were each initiated outside of the public sphere. To be sure the legislatures, through the race to the bottom/top, eventually ratified the changes,[83] but the initiative came from elsewhere.

In the process, the surplus of the corporate system, which 40 years ago appears to have largely be divided between production workers and middle-management, has been shifted overwhelmingly to shareholders and upper management, with a not-insignificant increase to information professionals. The income, and even more the wealth, distribution of the country has shifted radically. Shareholders, who received less than bondholders from — to ---, and who clearly were trailing the salary gains of employees from the end of the depression through the Vietnam War, since then have received annual returns of 18% while wages and salaries have been flat. Similarly, upper managers, who in 1950 were paid like doctors — well paid, to be sure, but still dependent on their earned income — today are major owners of our major firms. This entire massive shift — much of it the result of new legal devices that changed the relative power of different participants in the firm — doesn't show up at all in the Delaware statute books.

The private creation of corporate law is entirely predictable as a consequence of the incentive structures of lawyers and corporations with potential innovations. But, understandable or not, it accentuates the general paradox of corporate law: this extraordinarily important aspect of our communal life proceeds without communal discussion. It is a consequence of market-like competition, in which those better placed to compete, or to change the rules of competition, are able to accumulate the power necessary to change the rules of competition in their own favor.

In short, the public good problem of production of corporate law appears to have been solved by creating corporate law as a private good. When a law firm invents the

[83] The "constituency" statutes are sometimes seen as successful attempts by management to use legislative change to seize power they had lost in the market. But in fact, the pill had already accomplished much the same result. Once the poison pill was upheld by Delaware, the curtain was drawing closed for truly hostile takeovers. Management with a pill normally can only be ousted by buying it out: the great shift to a management/shareholder alliance and stock option CEOs followed as the best available deal for shares.

poison pill, or an investment banker the junk bond, or both together with managers discover the wonders of stock options in lieu of salary, the innovators can appropriate enough of the wealth associated with the innovation to amply motivate further innovation. If a firm were to lobby for a legislative ban on hostile takeovers, it would create a pure public good — all other firms would be benefitted, without paying the costs of the lobbying. But when it pays Wachtel Lipton to create a poison pill with the same effect, Wachtel can assure that only those who pay can play -- at least for long enough to make the innovators rich enough to inspire continuing efforts.

Private lawyers and bankers, then, seem to have adequate incentives to innovate. Academics, operating under a sometimes different incentive structure, can also overcome the public good problem: professional rewards for innovation come particularly when the innovator releases the innovation to the public without attempting to profit by monopolizing it. And shareholders and managers each have industry-wide lobbying groups that may be able overcome free-rider problems when legislative change is needed. In any event, we don't see any significant back-log of pro-management or pro-shareholder proposals that haven't been adopted anywhere.

Finally, while it is impossible to measure the innovations that didn't happen because of free-rider or public good problems, we do have some evidence about innovations that have happened. Limited Liability company statutes (and their predecessors the limited partnership statutes), stakeholder statutes, condominium laws and similar organizational innovations have each spread quite rapidly once a critical mass was accumulated; in these cases free rider problems do not seem to have inhibited adoption of innovations. (Other legal innovations haven't spread so quickly, such as the RUPA. But scholars have suggested reasons for the RUPAs apparent failure that do not rely on public good or free rider issues). Other organizational innovations have required no legislative action at all and have spread rapidly as well: consider the history of "going private," now a significant tool in managements' arsenal to resist securities market irrationalities.

C. Summary: from race to the bottom/top to a market for corporate law.

We seen then a different aspect of the race to the bottom/top. This system creates law the way that markets create products, without a collective decision and without the problems of politics. Majoritarian oppression, undue influence of small and well organized groups, and the difficulties of log-rolling principled issues drop out as problems. Moreover, neither monopoly, limited bargaining power, nor public good/free rider concerns seem of major significance in the market for corporate law: corporations seem to choose their law in a relatively free market.

Delaware, then, can be understood as governing with the consent of the governed in a sense quite different from ordinary democracy and quite similar to so-called consumer sovereignty. Rather than the law being determined by the majority, it is chosen by the individual from a fairly broad selection of choices with limited collateral effects or tying arrangements. The decision of the other states to accept the Internal Affairs Doctrine can be viewed as a political choice to restrict the scope of politics. Instead of political debate, corporate lobbying and electoral choice determining corporate law, the states have implicitly decided to step aside.

In the next section, I consider the implications of this choice – the political withdrawal of the state legislatures – for democratic theory. Jewish mystical tradition grappled with the problem of an infinite God by concluding that God had to withdraw and restrict Himself – a process known in the kabala as *tzimtzum* – in order to make room for the world to exist. In our post-Lochner understanding of democracy, majoritarian processes (not to suggest a comparison) occupy all economic regulatory and decisionmaking space until they withdraw and make room for the market, or market-like processes such as the creation of corporate law. Although the withdrawal of God from the world was the great tragedy (in the proper sense of the word) of the kabala, the limitation of politics is by no means so problematic. There is nothing wrong in principle with democracies deciding to decide by non-democratic means; markets are often spectacularly better ways of decisionmaking than the alternatives. The question is, rather, whether this particular restriction of the political sphere, under this particular set of market structuring rules, makes sense: does it produce results that we, the citizens of the political entity, think are likely to be better than the ones we might choose using politics directly.

IV. The Political Critique

Were corporations citizens -- the subjects and objects of a political system -- our system of free choice of law for corporations might be an extraordinarily attractive solution to long standing problems in democratic theory. Corporations, and firms more generally, choose their own law quite free of external pressures and thus under conditions of freedom and non-coercion rarely found among democratic communities. Corporate law could be described as the ultimate liberal solution to the problem of coercion. But corporations are not citizens, and there is no reason in democratic theory, and little reason in any other context, why they should be treated as if they were. Firms are human tools created for human purposes; they ought to be created, regulated or given rights only to the extent that they serve those human purposes.[84]

Our publicly traded corporations are a major locus of power in society today. Measured by the wealth they control, the major firms are far larger than most governmental units. Measured by the degree to which they affect our lives, corporate decisions designing and delivering cars, clothes, word processors, telephone service or electricity have as much

[84] Although this article argues that corporations are not citizens and should not be treated as if they were, the point is not entirely non-controversial. See e.g., Kevin Groves, *No Vote For Corporations in B.C.*, 52 THE MUSE, 3/22/02 (describing attempt to allow corporations to vote in municipal elections); *Good corporate citizens or devil*, STARTUP May 2002 (quoting Jack Peake, Mayor of Lake Cowichan, BC, in connection with his proposal to grant corporations the vote, "It seemed to be reaction by people who see devils in corporations and don't want them to have a person's rights"). [note to editors: these two articles are on the internet; if you can't find them, you could substitute Aurora Inst. *Corporations could get the right to vote in B.C.*, Canada Newswire 3/7/02 (available on Lexis/Nexis), which is less colorful but describes the attempt].

impact as do most local governmental activities. In terms of coercion, it is no more difficult to escape local governmental taxation than to avoid paying fees to Microsoft or AOL Time Warner; hospital bills are likely to be more scary than traffic tickets. Those who work for major corporations are subject to a degree of potential violation of privacy that no governmental unit could contemplate: employers are permitted to monitor mail and phone conversations routinely, employees have no expectation of privacy with respect to their employers in their desks or medical records. For many people, losing a job or their pensions would be more traumatic than any encounter they are likely to have with the government. Even corporate legal decisions – for example, to change seniority rules, switch types of pension plan or deny customers the right to share the software or music they have purchased or to commandeer portions of their hard drives for corporate purposes – can be profoundly determinative of important aspects of our lives. Even on the simplest measure, the ability to wield physical force: private security forces employ more people than public police departments.

Traditional liberal theory teaches that we ought to be suspicious of government even in a democracy: just because the government is responsive to the majority doesn't mean (simple readings of Rousseau notwithstanding) that it will consistently act in our individual or even collective interests. American law has generally regarded corporations as private bulwarks of power protecting us from the government: corporations have constitutional rights to due process, free speech and so on, but we have no constitutional rights against them. Popular culture has not always made such a sharp distinction: big government and big corporations, private and public bureaucracies, Washington and Wall Street have often been seen as indistinguishable enemies by populists of various varieties.

Publicly traded corporations are far more analogous to government than to citizen. Like governments, they are basically bureaucratic enterprises performing a mission that may be given to them in some loose sense by the population as a whole, but which permits plenty of room for independent and potentially heavy handed action.

This is the issue in this section: is protecting corporations, by granting them the right to choose their own law, a way of protecting citizens, as conventional theory often suggests? Or, on the contrary, is allowing corporations to choose their own law closely analogous to allowing governmental units to choose their own law – that is, to escape from democratic control? If the latter, democratic republicans should be quite suspicious of the race to the bottom/top regardless of the efficacy of the particular results it reaches at any given time. Just as enlightened despotism remains despotism and unattractive even if the despot really is enlightened, so to a decision to free a major governmental unit from popular control ought to be scary even if it does not seem to be creating major problems at the moment. Corporate leaders, unlike judges and governmental bureaucrats, are not appointed by elected officials or answerable to them. To the extent that corporate law is determined by the race to the bottom/top, corporate managers do not even nominally follow norms set by the democratic process. They are, rather, analogous to autonomous self perpetuating power structures: a sort of open aristocracy.

A. Corporate Law as Ideal Liberal Freedom: the entity theory

Two senses in which corporate law seems to meet the requirements of liberal theory need to be distinguished.

The first takes the corporation itself as a citizen. Liberalism's ultimate defense of a limited government's right to coerce, since Hobbes, has been based on the claim that there is no "real" coercion, because in a just society, we can see the subject as having chosen, or can say that the subject rationally should have chosen, the law at issue. That is, the subject either has consented in an actual agreement,[85] or would consent in an hypothetical ideal agreement.[86] Of course, no actual government is the product of actual consent or meets the requirements that would be generated by hypothetical consent, if consent is taken even half-seriously. But corporations choose their (constitutive) law more freely and with fewer constraints than any human citizen.

{{COMPARE c. p. 53}}Corporate law itself is unusually flexible: virtually all of its key requirements are merely default rules, waivable at the option of the individual firm or its participants. Thus, one leading explanation of the LBO movement of the 1980s was that the LBO permitted firms to avoid nominally compulsory features of corporate law -- particularly entity-taxation and the separation of investment from management -- even without changing corporate form. Even if corporate law appears to be inflexible, corporations can elect to be governed by corporate law of a different jurisdiction — even of an off-shore island with no interest in the transaction other than satisfying the most particular firms. Thus, corporation law solves the Lockean problem of tacit consent:[87] since corporations have readily available and relatively inexpensive options of emigration, failure to emigrate is reasonably understood as not merely tacit consent but something much

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[85]Nozick

[86]Rawls, TOJ

[87]Locke's solution to the liberal's problem of coercion uses both the techniques described in the text: the hypothetical rational agreement and actual consent. The hypothetical agreement is embodied in his description of the state of nature and the emergence of government from it: governments should limit themselves to matters which rational individuals in the state of nature would have approved. The power of this argument depends, of course, on the persuasiveness of his description of the conditions under which rational individuals would bargain and on the rationality of the bargain they would have made. Locke's actual consent argument is a variant on the position of the Laws of Athens as set out in Plato's Apology: a subject who does not emigrate (and in Locke's version, owns land), has tacitly consented to the laws as they stand.

The problem with Locke's theory of tacit consent is that the agreement it describes looks too coercive, too much like a contract of adhesion. In order to disapprove of an unjust law, the dissenting Socrates or his Lockean equivalent must accept exile. This is so high a price that little moral value can be placed on a subject's failure to pay it. Compare the Sinai midrash of T. B. Shabbat 88a (claiming that God threatened to bury the people under Sinai if they did not accept his terms) (discussed in Daniel Greenwood, Beyond the Counter-Majoritarian Difficulty, 53 Rutgers L. Rev. 781, 792-3 n12): if God threatened the people of Israel with destruction at Sinai, then their consent to his covenant is not legally binding.

In contrast, corporations can reincorporate (accept exile?) without paying any significant price at all: no change in the business is required at all. Since reincorporation requires little more than filing a piece of paper and even reorganization in a different legal form may have relatively limited costs or extra-legal consequences, corporations can be seen as having "consented" to the law under which they are organized in a far stronger sense than Locke's tacit consent. **Move to text?**

stronger. The same can never be true for human citizens, who always have non-legal constraints tying them to a particular citizenship.

Were the emigration option not flexible enough, firms need not elect to be governed by corporate law at all — they can switch to alternative business forms, such as partnerships, limited liability companies, the various forms of cooperatives and not-for-profit corporations, and even debt-financed sole proprietorships, with or without limited liability.

For many years, business planners assumed that there were four or five principal characteristics of corporate form which to a large extent could be achieved only in a package by incorporation: centralized management, eternal life, limited liability, free transferability of economic interests and entity taxation. Much business planning was devoted to the difficult task of obtaining at least some of the former four characteristics without the fifth. But it is now clear that these legal characteristics of the corporation have been entirely deconstructed: any combination of the corporate characteristics is available outside the corporate form. With the advent of the limited liability company, even the IRS has given up and now accepts that entity taxation is entirely voluntary for all firms unless they choose to have their securities publicly listed. With the increasing sophistication of the private placement market, it is no longer — if it ever was — impractical for even quite large firms to remain private. Similarly, as Lynn LoPucki has detailed, it seems clear that limited liability can be achieved through commercial law even without specific statutory authorization via corporate or LLC law.[88]

In short, it appears possible for nearly any firm to pick and choose not only among different corporation statutes but among a far wider full range of business forms: corporate law has no unique benefits to offer and therefore, virtually no coercive power at all.

Since firms have so many alternatives within corporate law and need not subject themselves to corporate law at all, business organizations law meets the liberal demand of non-coercion. In contrast, human citizens have no equivalent options: as the victims of the Second World War and others have learned to their detriment, emigration is of little value if no state is prepared to offer immigration; the stateless, as Hannah Arendt argued, are free of all rights. On this view, then, corporate law appears close to the liberal ideal of an entirely voluntary, non-coercive state.[89]

Attractive as it is, this theory is nonsense. Corporations have no claim to human rights; firms are not repositories of human value. There is no reason why firms should be free of human or political coercion — on the contrary, they are merely tools for the pursuit of human happiness, entitled on liberal grounds to no more or less a priori respect than that other tool of human happiness, the state. That is, an argument is necessary to explain why

[88]Cf. Responses to Hansmann and Krackman.

[89]For modern versions of the liberal theory of non-coercion, see, e.g., Robert Paul Wolff, In Defense of Anarchism; Robert Nozick, ...; John Rawls, Theory of Justice (description of the original position); John Rawls, Political Liberalism.

firms should be regulated, freed from regulation, or even allowed to exist. The value of free choice of law by corporations, if any, is purely derivative of some consequences to humans, and any theoretical defense of granting liberal citizenship to corporations must make that connection.

In the final analysis, then, entity theory is rhetorically powerful because it invites us to imagine corporations in a citizen box: were corporations citizens, granting corporations rights, such as the right to choose their own law, would be the same thing as granting citizens rights. As a trick, this is a quite elegant use of framing, in the sense explained by the cognitive bias theories. But as an argument, it fails. By anthropomorphizing the firm, this firm-as-citizen or corporatist theory ducks the difficult question, which is to determine how best to use corporations to promote human interests.

B. Corporate Law as Ideal Liberal Freedom: consumer sovereignty and the corporation as aggregate.

To avoid the problem of the anthropomorphized corporation, the obvious solution is to break down the firm into its component parts. Standard corporate theory does this by taking the firm to be a coalition of shareholders who have hired a manager/CEO (or, occasionally, the reverse: a CEO who has hired (or sold out to) shareholders). The rights of the corporation, then, are understood as rights of shareholders and/or managers. This second defense of corporate citizenship, then, is the opposite of the one discussed in the previous section: rather than taking the corporation as a citizen in its own right, it takes the corporation to be a proxy for the citizens who compose it.

1. Role morality: why corporations won't act the way the citizens who own shares in them or manage them would.

I have discussed elsewhere the fallacy of assuming that the rights of the human beings behind the firm are protected by granting the firm rights; there is no necessary connection.[90] In the current context, this version of the deconstruction of the firmless firm may be seen as follows:

Two actors, investors and managers, bargain with each other in the shadow of corporate law. But the shadow of corporate law, as opposed for example to ordinary contract or labor law, is extremely dim. For the reasons discussed in the immediately preceding section, managers and investors bargaining together may choose virtually any relationship, and associated law, they like. Managers and investors, then, are in something like the state of nature: they are unconstrained by anything other than their own powers and sense of right and wrong. As argued in the prior section, any agreement they come to and any law they agree to accept will necessarily be non-coercive in the liberal sense.

Not accidentally, this is a picture of a classic free market, and the actors presumably are free in the same sense that market actors in the classical model are free: they may use

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[90] Fictional Shareholders

whatever resources they have in the way that seems best to them under the circumstances. The law, in event, given the extraordinary range of options it presents to negotiating investors and managers, is not an effective restraint.

Unlike the anthropomorphized corporation, this picture of corporate freedom cannot be simply dismissed. Investors and managers are (or may be) citizens in their own rights.

But there is no reason to think that firms will function the same way as their separated component parts would; the aggregation theory fails to reflect sociological reality. As I have argued elsewhere,[91] investors and managers may well not be citizens for all relevant purposes: managers may be tightly constrained by their roles to act in ways that they would not were they thinking as citizens, and in our institutionalized marketplace, investors often are themselves corporations, run by managers in, once again, tightly role-constrained positions. In particular, managers -- both of firms and of institutional investors -- may feel compelled to set aside all values that compete with profit maximization, even in circumstances where, as citizens, they would not do so. For a manager who believes that shareholder value maximization should sometimes give way to other duties -- for example, environmental respect, working conditions suitable for parents, or commitments to or relationships with particular localities, employees or products -- increased corporate freedom may paradoxically reduce managerial and investor freedom.

Consider, for example, tobacco companies. Cigarettes are legal but many people believe they are dangerous and addictive. Managers of an institutional investor, however, should feel obligated as professionals to set aside their personal views on this issue — the ones they would express as citizens in a political forum. Instead, a good professional money manager will focus on whether tobacco companies are good investments. Of course, if other investors avoid them because of political beliefs, the effect will be to drive down the price of tobacco stocks and, accordingly, increase the expected return. A conscientious institutional investor, then, seeking to maximize return for his or her clients, will therefore see this as a strikingly good investment opportunity — even leaving aside the underlying business, which, since it involves the sale of addictive drugs, is likely to be quite profitable. (Of course, any investment manager who cannot accept this internal separation between professional and citizen, and follows his views as a citizen or opts out of the profession entirely, simply increases the rewards for those who respond to the demands of role morality).

Similarly, managers at the tobacco producing firm itself are likely to view the firm as having an obligation to its shareholders to continue in cigarette production so long as it is legal — regardless of any personal views they may hold. As good professionals, it is there job to set aside their own views as citizens and instead work for the interests for which they are fiduciaries – that is, to profit maximize on behalf of shares. Again, those who

[91] Essential Speech: Why Corporate Speech Is Not Free, Iowa L. Rev.

disagree are most likely to quit, leaving the field to those with fewer scruples but not affecting the institutional behavior at all.

In short, the human actors whether shareholders or managers will either put aside their personal views and work for profit maximization, adjust their views to fit their job or find another line of work with less personal conflict. The conflict between role and citizen moralities is utterly impotent. The views of citizens, as citizens, have no effect at all on how the firm is run.

This picture can be generalized to all controversial activities that a firm may engage in. Thus, for example, if discrimination is legal, managers of institutional investors may feel compelled to invest in discriminatory firms, especially if discrimination is profitable (as it will be where, for example, customers prefer to deal with discriminatory firms)[92] and even more so if other investors may avoid discriminatory firms. If pollution, or downsizing, or union-busting (or union-supporting, say in order to regularize employee relations and end wildcat actions), or creating unattractive, unnecessary, unsafe, addictive or immoral products, or gambling (with safety or literally), or weakening traditional families by odd working hours or frequent changes of the workforce -- or any other potentially controversial activity -- is both legal and profitable, firms will do it regardless of the personal and political views of the investor and managerial classes.

Conversely, firms will not engage in arguably socially attractive activities, regardless of the political views of those who run them, unless they are also perceived as profitable. Businesses that close on holy days, offer pay or working conditions better than the market demands, avoid free-riding or externalization of costs, and so on, will be punished by the market; professional managers will avoid taking such actions when they cannot be justified as profit maximizing.[93]

The net effect, however, is that corporate freedom does not increase personal freedom for managers or investors: they are constrained by the market to profit maximize. What is profitable and legal will be done, regardless of how many citizens, acting as managers or investors, might prefer that the another value prevail and that controversy be decided against profit maximization. A fortiori, the firm is not increasing the freedom of other participants who are neither proximate decisionmakers nor beneficiaries of fiduciary duties.

Moreover, law is no different from any other decision the corporation must make. Corporations run by professionals who remain within role morality will typically lobby for regulatory law that enables them to profit maximize. Self interest (except in the race to the

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[92]Bell v. Maryland ("I have nothing against blacks, but I'll lose all my customers if I serve them"). Cf. *Color Code: Black Entrepreneurs Face a Perplexing Issue: How to Pitch to Whites*, WALL ST. J., 1/26/99 at 1 (describing how black entrepreneurs avoid using black employees in visible positions because of fear of racist customers).

[93]Often, of course, markets are imprecise or reward seemingly other-directed actions. Charity that the firm believes is really advertising or above clearance wages that generate loyalty that the firm believes it needs, are profit maximizing and do not create the problem described in the text.

bottom end games discussed above) typically will drive them in the same direction. The occasional citizen who sees a conflict with role morality and chooses to stick with her sense of the right thing for a citizen to do, is likely to be eliminated from the system quickly, out-competed by those with fewer qualms about doing their (narrowly constructed) job.

When it comes to choosing corporate law, this picture applies almost completely: corporate managers will choose corporate law that enables them to strike the best deal with shareholders or other powerful corporate constituents, typically the one that allows them to work for shareholders with the least distraction from other interests. The only important difference, is that managers need not lobby for corporate law. Under the current regime, they have the right and obligation to elect the law that best enables them to shift value to shareholders, taking a part along the way, without regard to any other values, even if as citizens they might act otherwise.

2. Consumer sovereignty: the corporation as market, or are professional managers enabling someone else's freedom?

It is sometimes argued that this constraint on managers and investors is precisely the reason why corporate freedom is human freedom. Corporate investors and managers have no ability to control what the market-place creates: if one individual or institution declines to act as the market demands, it will be driven out of business or, at least, another firm will enter the deserted niche, with no effect on the market as a whole. Thus, despite their apparent control, neither investors nor managers actually have any power at all.[94] In this view the corporation is just a market, reflecting and aggregating the views of market participants without adding anything of its own.

The argument is that, as the race to the top argument contends, when investors and managers bargain and agree upon the legal form that is most advantageous to them, the markets for finance capital will assure that managers work for shareholders and that shareholders — by their ever-restless search for investments on or above the capital investment frontier — will place their capital where it is most productive and thus work for all of us. In turn, the product market, by determining the ultimate profitability of the capital investment, assures that all of us, in our role as consumers, remain in ultimate control (at least to the extent that we are consumers).

This then is the anti-political critique offered by the economists. Politics, it claims, are unnecessary because consumers are sovereign, the only independent actors in the economic system. Accordingly, the only meaningful problems for corporate politics are the market failures — monopoly, free riding and information problems — and egalitarianism.

a. Market failures.

[94] In this strong form, the argument assumes counterfactually something like perfect competition. More realistically, managerial power is limited to the interstices created by market imperfections such as transaction costs and failures of imagination.

As to the former, opinions vary, with some seeing market failure as unusual anomalies probably best ignored and others seeing the market model itself as no more than an heuristic to more easily identify the various pervasive failures. I've discussed these issues elsewhere.[95] For current purposes, it is perhaps enough to say that in the post-Lochner era, our democracy has agreed that markets must be structured and regulated by a political process under the ultimate control of elected officials and the electorates to which they are answerable. Markets generate determinate answers only within a determinate legal and regulatory system; to allow the market to choose its own regulatory system, as the race to the bottom/top does, seems somehow circular and unlikely to solve whatever market failures exist. Rather, to whatever extent there are market problems, the race should simply accentuate them.

b. The egalitarian problem.

The egalitarian problem is not a market failure but rather intrinsic to the market theory: the more perfect the market, the greater the egalitarian problem. Although it is sometimes understood in purely economic terms, the egalitarian problem is fundamentally a political one: markets treat dollars, not citizens, as equal. In a functioning capitalist marketplace, dollars are equal; in sharp contrast to feudal systems (or Soviet communism), the identity and status of buyers and sellers is irrelevant. "My dollars are as good as yours" is, I believe, the leading force behind most economic anti-discrimination law, particularly when it conflicts with pre-market notions of property (property as something to control, rather than something to trade) or privacy (a man's home is his castle, but the market is anonymous). The market's version of the anti-discrimination idea is that the highest bidder ought to win in the market; personal likes and dislikes should not affect the transaction. Indeed, ideally markets function anonymously, like the NYSE, with only dollars representing the individuals behind them.

In contrast, political democracies hold members to be equal; if we are equally members we must have equal votes.[96] While democracies reject status distinctions as

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[95]Most recently in Rutgers.

[96] Since Aristotle, equality has been seen as both fundamental and problematic. Aristotle proclaimed that justice is treating equals equally. POLITICS, Book III, Ch. XII, § 1. ("persons who are equal should have assigned to them equal things."). This Aristotelian Principle seems to me fundamental to any notion of justice or fairness, but is almost purely formal. As Aristotle says: "equals and unequals, yes; but equals and unequals in what?" Id. at III. xii. 2. The Aristotelian Principle seems to require that some justification be offered for treating different people differently (or for treating different people the same.) But it offers no theory of what constitutes equal situations or which differences may be cited to justify unequal treatment. The great puzzle has been in determining what sameness (or difference) of people is relevant. Some theorists have claimed that equal humanity is enough. Isaiah Berlin, *Equality*, 56 PROCEEDINGS OF THE ARISTOTELIAN SOCIETY 301 (1956), thus claims that no special justification is needed if a cake is divided equally. But he is wrong — since different individuals are likely to be quite differently situated with respect to, for example, how much they contributed to making the cake, how much they want or need the cake, whether they are overweight or diabetic, and whether the cake distributor is in love with them, Procrustean equality requires just as much justification as any other division.

In contrast, when membership is the good being distributed, and it is distributed to members alone, equality indeed is the only
(continued...)

vehemently as markets, they are likely also to reject wealth distinctions. And while anonymity sometimes seems a tempting device for avoiding status distinctions (this, I assume, is the power behind "color blindness"), because the central figure of the democracy is the citizen, individuality can never be irrelevant and anonymity never fully possible. To acknowledge our fellow citizens as members of a common enterprise, we must know who they are.

Because consumer sovereignty counts dollars, rather than citizens, as voters, political justice will always seek to restrain it. Consumer sovereignty, then, is based on an understanding of equality — the market's equality of dollars — that is foreign to politics. For this reason as well as the familiar problems of market failure, consumer sovereignty cannot be a solution to the aggregation problem: it cannot transform the powerlessness of corporate managers and shareholders into freedom.

c. Limits to consumer sovereignty in a profit-driven world.

But for present purposes, there is a more fundamental problem with the anti-political claims of consumer sovereignty. Consumer sovereignty, even setting aside the internal problems of market failure and the external problem of egalitarianism, can claim to control only a limited sphere of corporate behavior. Consumers collectively direct the profit motive but cannot restrain it. Even consumers who would prefer that firms limit their pursuit of profit in order to promote some other value have little choice but to buy the products of a profit maximizing firm.

Indeed, given the realities of consumption in a world of information overload and limited time to allocate to shopping, consumers are likely to continue to patronize profit maximizing firms even in the unlikely circumstance that other choices do exist. Regardless of the strengths of ones political opinions or views about when the profit motive should defer to other important values, one is likely to compartmentalize: politics is for debating around the dinner table, not for shopping in the supermarket. Of course, there are occasional exceptions: boycotts of grapes in support of the UFW, or of [Proctor & Gamble] for its supposedly satanic trademark [Disney by Christian groups]. But the limited number of such actions make them just arbitrary bolts of lightening with little impact on politics of the economy as a whole. Most of the time, even consumers who strongly believe that corporate norms have drifted far from their values will buy products based on quality and price — not

[96](...continued)
distribution that requires no justification. Anything else means that some members are "more equal than others", or that some are only second-class members. To be a member of the group is to have the group consider you part of the "we" for whom the group acts. If different members disagree on what the group goal should be, only some form of equality of decision making can fully acknowledge that all the members are indeed members, subjects rather than objects of the group. Most arguments regarding the proper scope of egalitarianism can be understood as disputes over whether a particular good is an attribute of membership. If it is, like voting, it ought to be distributed equally, not based on need, contribution, love, qualifications or ability to use it, or some other basis. (Thus the default voting rule of the UPA). If it isn't, other considerations likely apply. (Partnerships not always being membership groups in the political sense, default rules are only defaults). Compare, MICHAEL WALZER, SPHERES OF JUSTICE. **Move this fn to text??**

on the characteristics of the producer -- if indeed they even know anything about the characteristics of the producer. In the anonymous market, it is the product that is important, not the process by which it was produced or the other actions of the producer.[97]

There is no effective way for consumers to signal when they believe the profit motive has gone far enough. As a result, corporate freedom in the consumer sovereignty model is simply the freedom to profit maximize, regardless of what competing values may be about. Not only investors and managers, then, but consumers as well, may find that granting rights or freedom of action to corporations does not increase their freedom as citizens at all.

We see, then, that the corporation can not be reduced to its components – whether shareholders or customers. It will predictably act differently from and often in opposition to the human beings who make it up, as managers – even if they act entirely in good faith and even leaving aside the obvious problems of corruption and self-interest – find that their role constrains them to ignore the interests and desires of the human beings they are meant to serve.

C. Corporations as Property.

A third justification of treating corporate freedom as human freedom stems from a misuse of fundamental liberal notions of property. Protecting property is an important part of protecting freedom. Corporations are sometimes viewed as a form of property. Ergo, it seems axiomatic that protecting corporations must be protecting freedom.

To fully engage the argument about property and freedom would require a discussion of property that is beyond the scope of this Article: the relationship between property rights and freedom is a good deal more complex than the simple assertion acknowledges. For a start, property rights are the right to demand that the state protect certain power relationships between people and objects or among contesting human claims to objects. The objects of the claims, of course, need not be something physical: one can have property in purely legal inventions, such as cash flows, stock or copyrights. Since all

[97]This is the logic behind Alan Greenspan's opposition to President Clinton's proposal that Social Security invest in the stock market (see NY Times January 23, 1999). Under the Clinton proposal in its original form, Social Security would hold up to 4% of the publicly traded stock. (WJS Jan 25) Greenspan expressed concern that the government might seek to use these holdings politically, for example, in opposition to cigarette smoking. At first glance, Greenspan's criticism is almost incomprehensible: if tobacco production is bad for America, why wouldn't we want the government to use whatever tools are available to limit it, and why would we want Social Security to provide it with investment capital? Within the logic of the anonymous market, however, Greenspan's concern is straightforward: the capital market produces returns on capital, and purchases in that market "should" reflect only returns on capital, not "extraneous" issues like where those returns came from. Greenspan is, in effect, making an anti-discrimination argument: investors should not discriminate against producers whose products or production methods are perceived to be immoral. It is, therefore, a powerful political claim that in the marketplace profit maximization ought always to trump other competing values.
Note also that Greenspan's preferred proposal, individual accounts, does not privatize the values decision but rather assures that profit-maximization will be the only value expressed. There is no practical way for individual investors investing small amounts of money via mutual funds to express any other value. See, Greenwood, Fictional Shareholders.

property involves contested power relationships, invoking property rights can only begin, never finish, a discussion about freedom. Property rights are the ability to say that some things are mine for some purpose, but the more that is mine, the less that is yours, and so my property (and my freedom, in this sense) necessarily conflicts with yours. A persuasive theory of property (and a persuasive theory of liberal freedom) must explain where my property (and freedom) ends and yours begins, not simply assert that property (or freedom) is a good thing.

With respect to corporations, the simple equation of property and freedom suffers from an even simpler flaw. In our legal system, no human holds the basic fee simple property rights in a public corporation. It is fundamental to Delaware corporate law that public shareholders own their shares but not the corporation: they have no right to control the corporation. At the most basic level, so long as the corporation remains public, no participant in it has the right to destroy it. More importantly, as we saw in the previous section, no one has the right to change its basic purpose or adopt a different set of values for it than the one that the law mandates.

For example, were a majority of the shareholders of a public corporation to believe that the public good would be better served if the corporation were to sacrifice some profits for a public purpose – supporting a war effort, protecting the environment, educating the younger generation, building bigger highways, offering above-market employment terms to farmers or other meritorious citizens – they would have no mechanism in current corporate law to cause the corporation to take on this task. First, shareholders have no right to manage the corporation. Second, were they to use their right to elect a board of directors of similar views, the directors would have a fiduciary duty to represent all shareholders and not just those who voted for them, and to take into account the interests of shareholders, not just their views. Were the directors to conclude that they should pursue the platform on which they were elected, they would be subject to personal liability on a breach of duty lawsuit for corporate waste, brought by even a single holder of a single share: and, if the directors were open about their decision to sacrifice shareholder profit for another goal, they would stand a good chance of losing.[98] The directors have a fiduciary duty to act in the interests of the shareholders that is independent of the shareholders' own views as to those interests.[99] Moreover, the fact that a majority of the shares voted had been cast in favor of the project would be largely irrelevant. Indeed, when a corporation's board seeks to take some action that is not within the norms of ordinary share value maximization, courts generally view the existence of a voting majority supporting the directors as an aggravating, not a mitigating, factor. The majority vote demonstrates not electoral legitimacy but majority oppression.

[98]Ordinarily, directors pursuing goals other than immediate share value justify their actions by invoking long term share value. Courts are generally quite deferential to such claims, upholding the directors' actions under the Business Judgment Rule unless there is evidence of self-dealing or the court concludes that the directors' justification is incredible. See, e.g., [Princeton charity case]. In the few cases where directors have openly stated that they were not running the corporation in the interests of fictional shareholders, courts have been far less kind. See e.g., Dodge v. Ford.

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Third, the market will punish such deviance from share value maximization even more harshly than the fiduciary law. Many investors in the public market in fact wish to maximize the value of their shares regardless of other values they may hold; some may not have any conflicting values. Moreover, roughly half of the publicly traded shares are held by institutions that are legally required to pursue share value maximization regardless of the views of the humans who manage them or are their ultimate beneficiaries. Each of these investors will sell or avoid the shares of any company that openly deviates from a share value maximization strategy. That opens an enormous profit opportunity: an arbitrageur who can acquire control at a price reflecting the corporation's public good orientation can make a huge and easy profit by directing the firm to revert to the market's normative amoralism.

In the ordinary course, this market incentive should be enough to force a corporation interested in pursuing any goal other than share value maximization into a limited set of options. It can, of course, go private: a single shareholder has a set of rights much closer to fee simple absolute than do public shareholders, even in the aggregate. With only one shareholder, legal doctrines of fiduciary duty are irrelevant and market pressures are mere opportunity costs (the firm would be worth more in another, more conventional, shareholder's hands, but so long as the private owner is willing to sacrifice the money that could be made by selling out, the market has no power to force change).

Short of ceasing to be a public corporation, however, the corporation that seeks to place a goal above shareholder profit has few options. It can seek to persuade (or fool) the investing public that there is no conflict between its goals, that it can do well by doing good. This was the tactic taken by the numerous corporations that vastly increased managerial pay in the last several decades: they claimed they were doing this not because it was good for managers but because it was good for shareholders, and to a large extent they successfully persuaded the market that indeed there is no conflict between giving managers huge stock option grants and making shareholders (now including managers) rich.[100] If persuasion fails and going private is not an option, it will abandon the other values under pressure of the stick of threatened takeover or the carrot of rich increases in share value for returning to the fictional shareholder's service. The property metaphor, thus, fails to support corporate freedom because publicly held corporations are not property: no human has the legal right to use them for any human purpose other than the one specified by race to the bottom/top law, namely share profit.

In short, none of the metaphors of corporation as citizen, contract or property provides a sufficient justification for freeing corporations from the law. Corporate freedom is not human freedom; we must instead consider when and where corporate law will promote our interests and desires and when it will not.

[100]This is the typical tactic in litigation as well. Cite, eg. Princeton (charitable contribution defended as not really charity but rather advertising); takeover case (managerial payoff defended as shareholder value maximizing).

D. Corporate Law and Value Choices: corporations as voluntary associations or local governments.

The reason that corporations must be taken to be tools of citizens rather than the citizens themselves is central to corporate law's legitimacy and success. Real citizens have multiple and diverse views, reflected in and reflecting their various and conflicting value judgments about many issues important to public life. In a democracy, value issues must be debated and decided in a political process: it is fundamental to the notion of equal citizenship that no democratic citizen has the right to determine value issues by fiat.

Corporate managers are not elected by anything resembling a legitimate democratic political process. Corporate law, and in particular corporate governance advocates, often use the rhetoric of political democracy to explain why shareholders should be given authority within the corporation's internal decision-making processes. But the rhetoric only works because we don't take it seriously.

Were corporations understood to be political organizations run by a democratic process, we would have to reform corporate law in a radical and fundamental fashion: Democracies operate on a principal of one person one vote and corporations do not. The fundamental voting rule of corporate law is that only shareholders vote and they do so on the basis of one share one vote (subject to some flexibility when the corporation elects different voting rules and with the potential disenfranchisement or vote dilution of poison pills and their statutory equivalents). In a democracy, the principle of one dollar one vote would be completely unacceptable.[101]

Corporate "democracy," then, fails the most basic test of democracy: it does not provide for equal citizenship. (Alternatively, one could say that it does provide for equal citizenship, but the citizens are dollar investments, not human beings). Moreover, it does not provide citizenship for the right people: while shareholders have some limited say, proportional to their shareholdings, in running the corporation, many other constituents and affected parties, some of them (unlike most shareholders) even human, have not even a limited right to vote.

Corporate law, however, has not gone the way of other pre-democratic regimes. In part, I believe, this is because the basic understanding of corporate law is not political at all. Corporate law does not imagine directors to play the role of elected representatives of the "people" or even the dollar investments of fictional shareholders, for the simple reason that corporate law does not imagine directors to be making the value choices that are the appropriate realm of elective politics.

Instead, corporate law itself makes the value choice: corporations are an organization created for and dedicated to a limited and specified purpose. As a matter of corporate law, corporations exist to make money for shareholders proportional to their

[101]Cite to case about taxpayer voting in school district.

shareholdings. Directors and their managerial delegates are understood to be professionals who, like other professionals, will work out the implications of this goal. Like other professionals, they have a good deal of discretion in how they pursue the goal. Indeed, they are even entitled to interpret and give meaning to the goal: the business judgment rule is in part a recognition of the need for a large degree of professional autonomy. But like other professionals, they violate their role if they substitute their own values for the goal that is set for them by their client. In this case, the client is corporate law itself, and the goal is profit maximization from a fictional shareholder perspective.

On this view, the purpose of shareholder "democracy" is simply to police the professionals: shareholders vote in order to keep directors within their role requirements, to ensure that they aren't stealing from the corporation or distorting it to some other purpose. Unlike citizens, however, they are not voting in order to determine the fundamental value conflicts that are outside a professional's role: public shareholders (unlike a doctor's client) have no right to pull the plug or (unlike a lawyer's client) to instruct the professionals to take an action just because the client thinks it is right. Those client decisions are made by corporate law. Rather, the shareholder role is to eliminate corruption, self-service and incompetence.

The limited shareholder role is the reason why shareholder votes so often look more like the plebiscites of dictatorial regimes than the tense contests of democratic ones. Where conflicts are over views of the world or balances between powerful but conflicting moral claims, voters normally will disagree, often sharply. It would be quite surprising if a democratic vote produced a 95% majority on abortion rights, for example, or indeed on any issue of importance and interest. In contrast, if the issue is corruption or even competence in pursuing an agreed-upon goal, one would expect a high degree of uniformity: these are largely factual issues more amenable to consensus.

This single and limited goal is the source of much of the success of our corporate sphere. Corporate managers, unlike political leaders, need not concern themselves with the views of their electorates. On the contrary, in the ordinary course they don't even need to know who the electorate is. Instead, they can view themselves as working for a purely imaginary and purely homogeneous fictional shareholder. Basic value conflicts are excluded from their job: it is someone else's responsibility, not the board of directors' or the managers', to decide when profit should give way to other important values.

The issues that are left are by no means simple: managers and directors are charged with finding the cheapest and most efficient ways to turn raw materials, ideas and human labor into saleable products. But those are professional issues, requiring expertise and rationality, not representativeness or value choices; they are issues of applying hypothetical not categorical imperatives. Managers can specialize in that limited set of issues without worrying about the rest of the harder problems of our collective and political life. Presumably, we all win, or at least have a more successful economy, because of this division of labor. (This, no doubt, is also why private industry often is able to provide services more cheaply than government: government officials are almost never permitted to put aside the other considerations that public corporate managers are required to set aside).[102]

But if the limited role of corporate decisionmakers is the source of their success, it is also the reason why corporations are not legitimate participants in the political process. A public corporation is a legally created entity designed to accomplish a specific purpose. The purpose is useful, even noble. But it is only one purpose among many human purposes and it often conflicts with others. A single purpose entity devoted to one value alone is in no position, almost by definition, to know when to stop, when that value must be balanced with others. Corporate values are the product of corporate law, not of the citizens that work for or invest in or purchase from the corporation.

When corporations choose corporate law, the result is not freedom of citizens, but freedom from citizens. An important aspect of our collective governance structure, created to promote one of our values, is now out of our control and out of its proper sphere. Corporations cannot properly balance the claims of employees, bondholders, tort victims, pensioners or environmental claimants against those of shareholders: they have been designed to view the former as strangers to be exploited to the maximum extent practical for the benefit of the latter. Corporations can not balance the claims of conservatism – children who need continuity in school, communities that thrive on commitment and stability, employees whose skills are not readily redeployed – against those of growth and dynamism: they have been designed to exclude the former claims from consideration except to the extent they serve the latter.

Corporate law sets the limits to corporate one-sidedness. It is corporate law that tells corporate managers who they must consider a cost and whose gain is the corporations gain, that increased salaries are bad but increased dividends are good (unless of course the increased salaries or decreased dividends will lead to increased dividends later on). Having constructed contract and tort claimants as outsiders and costs, corporate law then sets the limits to which they may be exploited, by determining, for example, the degree to which corporate managers can move assets out of the reach of those claimants for the benefit of the shareholders for whom directors are meant to work.

The race to the bottom/top distorts the process of countervailing powers that ought to be at work here. Professional managers working within a given framework to maximize a single value must have someone else – the client, the citizenry – to do the job they have given up, namely deciding when it is no longer appropriate to pursue that value. In our corporate law system, no corporate player can do that balancing. But the race to the bottom/top means that corporate players, not the citizenry or their elected representatives, are determining the law that determines where share value maximization will end. That cannot be right: if we allow the one-sided maximizer to set its own limits, there will be no limits set.

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[102]Cite Kelman (?)

V. Taking Corporate Law Public

Corporations are power centers in our society, not citizens that need to be protected from the powerful. Once we de-anthropomorphize them, stepping away from the metaphor of a corporation as a person with an intrinsic value of its own, this seems almost painfully obvious. Corporations are tools that we create for our own purposes, much like governments, and much like governments they can function to make our lives better – or the reverse. "'The question is,' said Humpty Dumpty, `which is to be master -- that's all.'"[103]

{{CUT??}}The internal affairs doctrine and the race to the bottom/top make corporations their own masters: they choose their own law according to the role restraints and incentives of their own decision-makers. Shareholder votes and market constraints, to be sure, limit the freedom of action of corporate decision-makers to a significant degree. But, as we have seen, neither offers a mechanism for importing the full range of important political issues into corporate governance. The mechanisms for shareholder influence, as I've argued at length elsewhere, have the effect of stripping away shareholder humanity, leaving only a legal fiction dedicated to its own self-interested profit maximization. Such a "voter" is an extremely poor proxy for the genuine interests and wishes of real human beings (even leaving aside the fundamental problem that in politics, unlike investment, one dollar one vote is clearly illegitimate). Even setting aside these role problems of the constrained manager, the fictional shareholder and the limited sovereignty of consumers, there is another problem with the standard picture.

Market choice analysis assumes that corporate law is basically private law. Managers and investors, in a situation of relatively equal bargaining power, negotiate a mutually beneficial contract; outsiders have only a relatively minimal interest, primarily in preventing fraud and informational failings or possibly in protecting the weaker party from overreaching.[104] This picture is manifestly false.

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[103]Lewis Carroll, Through the Looking Glass (ch. VI).

[104] The conditions under which apparently voluntary transactions should be viewed as in fact voluntary are controversial. Compare, e.g., ROBERT NOZICK, ANARCHY STATE AND UTOPIA (1974) (listing conditions under which voluntary agreements should be seen as voluntary); Nozick Normative Theory of Individual Choice. Nozick, who views agreements made at the point of a gun as voluntary, takes a rather extreme expansive view of voluntarism. For a contrasting view, see, e.g., GRANT GILMORE, THE DEATH OF CONTRACT (arguing that contract law is largely indistinguishable from tort, because legal and moral analysis is always necessary to determine whether an agreement should be enforced). In Gilmore's analysis, voluntariness is always a matter of degree, and coercion is almost always present to some extent. Cf. Kennedy, Distributive and Paternalist Motives in Contract and Tort Law with Special Reference to Compulsory Terms and Unequal Bargaining Power, 41 Md. L. Rev. 563 (1982).

[Delete this para. Contract law theorists debate whether contracts are binding because they are promises (and promises have intrinsic moral force), see e.g., CHARLES FRIED, CONTRACT AS PROMISE (1981), or rather in order to encourage mutual reliance, see, e.g., Anthony Kronman, *Contract as Promise*, 91 YALE L.J. 404, 411 (1981). Under the former view, the intrinsic moral force surely diminishes as the promise appears more coerced; under the latter view, the social interest in encouraging reliance diminishes as the promise becomes less voluntary. Neither view, however, determines the issue of how to determine when an agreement should be seen as voluntary. See, e.g., Kronman at 414 (Fried rejects consideration doctrine,

(continued...)

Corporate law is public law: the private arrangements of investors and managers in the dim shadow of a nearly voluntary law affect all of us. The law of business organizations determines the effectiveness of other regulatory schemes and sets the framework within which markets function. Thus, as a simple example, it is the law of business organizations that determines who is responsible (and to what degree) for business violations of tort, regulatory or criminal norms. If regulatory schemes seek to make firms internalize costs they would otherwise externalize, but business law allows them to decline the resulting liability, the regulatory scheme fails.

Similarly, it is business law that determines on whose behalf managers work: the market tells firms to profit maximize, but to a large extent it is law that determines where the firm ends and the outside begins. Law, by setting the boundaries of the firm, can help to decide who is an input to be exploited to the maximum degree the market permits and who is the firm, to receive profits to that same degree. Law determines the relative power of the various parties to the market negotiation, for example by solving (or creating) collective action problems. And business law affects the time frame chosen by managers, their responses to taxation, and a myriad of other issues.

A. The Effects of Free Bargaining for Corporate Law.

In the remainder of this section, I summarize some of the areas in which business law affects the citizenry as a whole, creating significant political issues that cannot be debated or decided within a market based framework of consumer sovereignty or free choice of law for business entities.

Market negotiations take place within a given allocation of powers and resources; our business organization law regime empowers certain parties at the expense of others. State corporations law, in its current incarnation, solves many of the negotiation problems fictional shareholders (and the shareholder/managerial alliance) might have, while leaving

[104](...continued)
maintaining that "what ought to matter... is the *freedom* with which a promise is made"); 417-20 (discussing line between permissible and impermissible advantage taking under his and Fried's approaches).]

Since bargaining tends to reproduce or accentuate existing power imbalances — the party that can walk, as every business advice book teaches, wins the deal — the law (and moral theory) tends to devalue agreements when the background conditions are too imbalanced. Thus, if one party holds a gun, the agreement will be viewed as coercive. If one party conceals (too much) relevant information, the agreement may be labeled fraudulent, mistaken, or unconscionable. If one party seems to have too much bargaining power, the law may disregard the agreement under the doctrines of overreaching or duress. See, e.g. (Contract cases on unconscionability — the boat docking in a storm, doctor). Article on the Alaska fisherman case.

Nonetheless, bargaining between upper level managers and investors appears to be quite close to the paradigmatic model of free contract. Investors are both fully fungible and faced with a wide array of (according to modern portfolio theory if not always legal doctrine, see (injunctions)) largely fungible investment options. Managers are not nearly so fungible nor do they face as competitive a market for their services, but at least in the upper levels they seem relatively mobile and quite amply compensated. But see, Strains in the Corporate Web.

other participants in the firm with serious collective action problems. This result is precisely what one might predict from the race to the bottom/top: neither the financial markets nor the proximate decisionmakers have any interest in choosing law that would increase the effective market power of other (non-shareholder or manager) participants in the corporation.

Corporate law overweights the responsiveness of firms to the needs of capital and underweights the response to other claimants. In turn, this empowerment of capital has dramatic effects on our collective life and culture, effects that ought to be highly controversial: capital, after all, is immortal, uncommitted, fully fungible, and mobile, while citizens usually are none of those.

The controversy, however, is suppressed by a legal system that allows voice only to one side. So long as corporate law is chosen by corporate managers accountable only to corporate shareholders, other claimants and potential beneficiaries or victims will not be heard. As a result, we make a critically important political decision about our collective life without either a democratic collective (political) decision or a meaningful aggregation of individual (economic) decisions: not the views of individual citizens but the legal structure of voluntary law determines the collective decision.

The key aspects of the bargaining struggle that are determined by law are: relative mobility, collective action and free-rider issues, governance problems relating to conflicting goals, and ease of externalization.

1. Relative power: mobility, time indifference and unity of capital. {{Combine with c. 45-7}}

Corporate law constructs shareholders as identical and fungible: as a matter of corporate law, the shareholders of a given corporation are assumed to be primarily interested in that corporation maximizing its profits (calculated from a shareholder perspective) and, ultimately, its payout to shareholders. Since the law requires that corporate payouts to shareholders be made pro rata, shareholders ordinarily are imagined to be identically situated with respect to this goal.

This construct is a fiction: in fact, all human shareholders (and all human beneficiaries of corporate shareholders) have other relationships with the firm in other roles. The law treats shareholders as if they were aliens, with no interest in our society other than extracting maximum profit from it. In fact, however, we are also consumers, employees, neighbors and citizens and must care about other issues as well. Even those shareholders who really are aliens encounter firms in other roles: if nothing else, at least as inhabitants of a limited ecosphere.

The fiction, however, assures that the interests of shareholders in share value maximization will be efficiently pursued (even in circumstances where the actual humans might, on reflection or in a system that allowed more room for contrary interests) prefer that other interests be pursued as well or instead. Citizens who disapprove of liquor, cigarettes, daytime television, pollution or whatever will nonetheless find their pension savings efficiently used to promote the production of those "goods"so long as it remains profitable.[105]

Because the law makes shareholders identical, the financial markets can effectively and rapidly move capital to corporations that it believes are profit maximizing.[106] This mobility, in turn, ensures that fictional shareholders (in other words, the interest that real shareholders have, among other interests, in maximizing the value of their shares) will have an enormous bargaining advantage as against employees and other firm participants, who are almost necessarily less mobile. If Wall Street doesn't receive its due, it will simply take its capital elsewhere.

Of course, top managers have place and information advantages relative to shareholders that may be even more important than the fickle mobility of the financial markets. That is the conflict between race to the bottom and race to the top theorists. As between top managers and shareholders, the division of the spoil will depend on whether mobility and fungibility or place and information win out. The results will shift from time to time, depending on the degree to which the financial market anticipates managerial defections ex ante, whether those managers who would prefer to bind themselves not to defect are able to overcome the resistence of those already playing an end game of "apres moi (and my millions) le deluge," and whether the legal system generates solutions to what otherwise may become a market for lemons in which investors, unable to assure themselves that managers will not defect, simply opt out.

However, other corporate participants generally can expect to find a united front of mobile shares and informed managers set against them. In the market competition for division of the corporate pie, capital has a basic advantage: it can walk more easily than can labor. Other corporate participants may be entirely locked in, with commensurately little bargaining power: for example, pensioners, employees with non-transferable seniority, firm specific skills or medical plans, the city in which a plant is located and other economic neighbors, suppliers and consumers of less than completely fungible products, and so on. As against all these, the ease with which the financial markets can cripple the firm should allow shares to extract a large part of the corporate surplus.

Moreover, other corporate participants can expect no assistance or recognition from corporate law. Whatever their differences between themselves, shares and managers alike gain by limiting the responsibilities of the corporation to its other participants. The race to the bottom/top means that corporate law will be chosen by corporate managers answerable primarily to the finance markets: they will not chose law that helps others.

2. Agency and single-mindedness.

As Henry Hansmann has emphasized, governance is extraordinarily expensive. One aspect of the governance problem is that we do not have a successful, mutually

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[105]See Fictional Shareholders.

[106]Sometimes the markets are grossly incorrect in this evaluation as the dot.com craze illustrates.

acceptable way of resolving differences. When there is no consensus and discussion does not create one, all the available solutions are problematic.

We can take a vote, but while majority support offers a basis for making any given decision, it does not create legitimacy where there was none before. No one believes that majority vote can make a wrong into a right: American apartheid was not more justifiable in those states where whites were a majority than in those where they were a minority, nor would Nazi Germany be more attractive if, as --. claims, murderous anti-Semitism was widely popular rather than just the view of a tiny elite gone mad. Most dramatically in our own history, no side to the slavery struggle considered that a majority vote was a proper basis on which to decide the question, unless the forum that was to vote was so constituted as to predetermine the result.

Even where fundamental moral issues are not at stake, on significant issues, the losing side is unlikely to give up, and when the same group perceives itself as losing consistently, it is likely to reject the entire process. While language groups and cultures have decided to assimilate (collectively or individually) for a variety of reasons, I know of no instance in which a minority language or culture has viewed a vote of the larger group as a legitimate basis for the end of collective existence.[107]

Similarly, more individualistic decision making methods — the classic liberal device of collectively deciding only not to decide — will fail to convince those who believe that the very issue is whether such individual decision-making is acceptable. For those who believe that abortion is murder or that blasphemy is an offense against God or that a society should devote a significant part of its collective resources to activities that markets cannot provide (whether they be armies or the arts), a decision to exclude the matter from the political process is a defeat, pure and simple. If abortion is an individual decision, collectively we have decided it is not murder. If armies (or museums, cathedrals, parks, schools, highways, Western water systems or baseball stadiums) must be provided by profit-seeking entrepreneurs or private charity, collectively we have decided that they are not terribly important, at least relative to things that markets provide effectively, like corn flakes, cars and commercial television.

In the firm, these governance issues are resolved by law for capital, because the law creates a uniformity of interest for all investors. Investors, of course, have many and varying interests — different risk tolerances, different time frames and different conflicts between their interest in maximizing financial returns and other goals. But portfolio theory has taught us that managers should (and do) manage without regard for their investors' risk or time preferences; both portfolios and firms (which are themselves portfolios for these purposes) will be invested as if their investors were risk and time indifferent. While people are never risk or time indifferent, the market allows them to invest as if they were, and firms

[107]For a fuller discussion of these problems in democratic theory, see Akhnai. For examples of voluntary abandonment of cultural or linguistic identity, consider the history of almost any American ethnic group; for rejection of majoritarianism as a basis for determining that identity, consider the history of every separationist nationalist movement.

following the market's guidance will be. Thus, these differences between investors drop out, allowing managers to treat them as if they were all the same and eliminating most governance conflicts.

Similarly, since portfolio investors treat firms as cash flows with associated risks, managers will also act as if investors were utterly uncommitted to any given investment, location, or set of human relationships. The human investors aren't, of course: most obviously, a large percentage of publicly traded stock is held by pension funds, the beneficiaries of whom (most of whom are still working) are likely to be anything but indifferent between investments in the firm (or location or industry) where they work and alternatives. But most institutional investors (and corporate managers) are barred by law from considering these differences between investors, and even when the law doesn't, the dynamics of markets operating on limited information will. Firms, then, will again act as if investors were all the same.

These solutions to the governance problems of capital create a seemingly homogeneous capital pool. Firms, then, can be managed by agents on behalf of capital without the agent having to consult the actual investors at all: any competent professional can imagine the goals of a rational investor who is assumed to have no interest other than profit maximization. The result, as Hansmann points out, is that it is easier and cheaper to manage firms on behalf of capital, since there are no disagreements to worry about.

But it is also important to emphasize, as Hansmann does not, that the unity of capital is artifactual. Firms managed on behalf of these fictional shareholders are time indifferent, risk indifferent, free of any commitment to particular products, technologies, employees or location. But that can't be true of the human investors taken individually or collectively. To the extent that the human investors — who are, more or less, the citizenry — have those commitments, the corporate law system assures that firms will undervalue them. We have created a law under which we — even as investors — have no mechanism to say that sometimes profit maximization should give way to other values.

The artificial unity of investors also assures that capital, or fictional shareholders, will have a comparative advantage in negotiations with other corporate participants. Employees have no mechanism to disguise their different risk preferences, time preferences, location preferences and personal commitments. While pension funds are managed on behalf of an ageless beneficiary, always about to retire but never doing so, actual employees must forge difficult to create and maintain coalitions between those who are primarily concerned with the short term — resume building youngsters or about to cash out veterans — and those who are in it for the long term; between the footloose and the rooted; the risk loving (or option holding) and the conservatives (or undiversified); those who are committed to a particular job and those who are not. This fractious coalition will have little chance in a negotiation with a single-minded agent for a fictional unified capital. As a result, the very real interest of capital in profit-maximization will be unduly likely to prevail against any set of competing interests.

Similarly, even in the simplest negotiation of all, the negotiation over the spoils of the corporate system. The corporate law system assures that investors are represented by a single agent with a single voice, while employees (at least in the absence of a strong firm-wide union, an absence guaranteed by US law) will always be divided. In a perfectly competitive market, this difference might not matter. But employees (at least outside of Silicon Valley)[108] always face a partial monopoly in their employer and high transaction costs in re-entering the job market. The constructed unity of the corporation means that many employees face one employer: the employer can generate competition among employees more easily than the reverse. In effect, race to the bottom/top corporate law creates a union – and a closed shop – for capital, while leaving the rest of the corporation unorganized. This, like the mobility of capital, should lead to fictional shareholders obtaining a larger share of the corporate surplus than they would in a more even handed bargain.

Law determines the background rules within which shareholders bargain with other corporate participants; the race to the bottom/top excludes those other participants from the law making process. The predictable result ought to be higher returns to capital than in the absence of the race.

3. Boundary issues: limited liability, externalities, entity taxation and related issues.

Corporate law determines the firmness of firms, whether, when trouble happens, there will be a there there. It is fundamental to Delaware law that the corporation, not those who profit from it, is liable for the corporation's debts, meaning that only corporate assets are available to unsecured corporate creditors. (Secured creditors, of course, may obtain rights to other assets by agreement, and in public corporations it is not uncommon for secured creditors to have claims against various members of a corporate group while unsecured creditors are left to slimmer pickings.)

It is similarly fundamental that the corporation's directors and shareholders have nearly unfettered discretion in determining the scope, financial structure and activities of the corporation. Thus, the directors may choose to put new projects inside or outside the existing corporation. They may take risks or not. They can combine the corporation with others or divide into pieces (some structural changes may require shareholder consent, but rarely will other corporate participants have blocking power). Similarly, the directors have virtually complete control over the degree to which the corporation will have assets

[108]In Silicon Valley, it appears, a largely youthful workforce is strikingly mobile. Because of a high concentration of similar firms in a small geographic area, an extensive professional network that is not firm based, and a lack of firm-specific incentives (such as immobile health insurance or pensions), workers can move from firm to firm with a minimum of disruption to their personal lives, if any. In Silicon Valley, job switching doesn't involve pulling the kids out of school, making new friends or gaps in health coverage. This unusual employee mobility should put employees into a better negotiating position relative to capital and assure that mobile employees receive a larger share of the corporate surplus than is seen in less mobile industries. He who can walk, wins.

available for unsecured creditors including employees, long term unsecured creditors, pensioners, tort claimants or regulators.

By encumbering corporate assets with prior liens, or distributing them to shareholders as dividends, the share/manager alliance can shift risk to current or future unsecured creditors without compensation. Creditors with bargaining power will protect themselves in a race to the top type manner by obtaining security interests in corporate, and if necessary, even extra-corporate assets. But the race to the top is of no avail for corporate claimants who do not engage in ex ante negotiations and cannot force the firm to internalize its future defections: for example, tort victims, the environment and governmental regulators. Less obviously, other claimants that may have ex ante negotiations, such as employees or pensioners, may not be able to predict defections with sufficient clarity. Standard cognitive bias theory suggests that employees should be likely to underestimate the probability of corporate failure and will not adequately charge for it, just as factory workers do not adequately charge for predictable accidents.

The race to the bottom/top assures that state corporate law will never protect these unsecured "outsiders" no matter how deserving they may be. If corporate managers can find a way to extract extra value from pensioners, corporate law encourages them to do so. Similarly, the race to the bottom/top assures that corporate law will be fundamentally antagonistic to tax collection, accident prevention and tort regulation, unionization and employee benefits and so on: the larger the share of the corporate pie these claimants receive, the less there is for those who choose corporate law.

Tort law is a particularly egregious example. State tort law attempts to make businesses internalize the cost of the accidents they predictably create, thus ameliorating a critical market failure that otherwise threatens to destroy the accuracy of the pricing mechanism. Corporate law works in precisely the opposite direction: it invites businesses, by incorporating and limiting the assets they keep available for unsecured creditors, to take risks at the expense of third parties. Whether tort law is properly calibrated is – rightly – a highly controversial topic. There should be nothing controversial, however, about the democratic implications of our current system: so long as the race to the bottom/top exists, the most important part of Texas tort law is that it is in significant part voluntary. Delaware, not Texas, determines the degree to which Texas tort law has any bite.

The same is true of much other law. Remedies against a corporation are meaningful only to the extent that the corporation has a continuing existence: individuals to be enjoined and assets to be seized. The race to the top/bottom assures that corporate managers will be relatively unencumbered in planning corporate structures that allow them (and shares) to profit during the good times and dump costs on outsiders during the bad ones.

4. Who is the firm: portfolio theory and the goals of the public corporation.{{Combine with ~43-49}}

When firms are run in the interests of their shareholders, they are not actually run by the human beings who are the ultimate beneficiary of our institutional shareholders, nor even in their interest. Rather, they are run in the interest of share-value maximization — which may be quite contrary to the interests of the real people who own the shares. Line employees, through their pension plans, now own a significant portion of the American publicly traded stock. But that stock is voted, and managers who act in its interest act, without regard for any interests those employees have other than share value maximization.

The modern system, in which managers have largely abandoned any attempt to run the firm in the interests of anyone other than themselves and these fictional one-sided shareholders, gives the capital market an extraordinary influence over our public corporations.

Following the dictates of corporate finance, share prices will rise when firms take on extra risk. The market pressures firms to act more like itself: since diversified portfolio shareholders can eliminate all firm specific risk, they do not value stability, rootedness, or commitments. Rather, they value firms that, like portfolio investors, see each moment as an opportunity to reevaluate all existing projects.

This tends to be bad for the human beings associated with the firm, since human beings, unlike shares, are always committed, relatively rooted, and never time indifferent.

Not the shareholders but the market calls the shots — and the market, following the dictates of portfolio theory, has a very clear and particular program: firms should pursue the best available investment opportunities, understood as those with the best risk-reward ratio, without regard to overall levels of risk, specifics of cash flow, or any other commitments. Like the market itself, firms should be fully mobile and utterly uncommitted.

This slightly surprising result follows from the nature of the finance markets as currently structured and understood, and stands independent of any political beliefs the ultimate human holders of securities may have: it is a consequence of portfolio theory and rational behavior under the restricted rules of the market, not of conspiracy. Union-owned pension plans will not act any differently in any significant way (for present purposes) than the most class conscious member of the capitalist bourgeoisie.

The key to the portfolio theory dominated market agenda is this: Diversified portfolio investors can eliminate virtually all firm-specific risk themselves. They view firms as largely interchangeable — each one is a predicted cash flow with a degree of probability, and little else. Portfolio theory teaches that the cash flow and risk characteristics of a portfolio are largely independent of the cash flow and risk characteristics of the individual components of the portfolio: thus, in the most famous example, an extremely cautious investor can do better (achieve a higher expected return at any given risk level) by purchasing risky assets than by buying (only) safe ones. Indeed, in the pure theory, all investors, regardless of risk preference, should buy the same portfolio -- a market index of the risky assets and some quantity of T-bills. The only difference between risk loving and risk averse investors would be in the quantity of T-bills they hold: risk averse investors do not hold lower risk stocks than risk loving investors.

Another way to look at the same portfolio theory point is that risk averse portfolio investors will find that they can eliminate firm-specific risk from their portfolios and achieve their preferred level of overall risk almost without cost (by diversification and holding more or less T-bills). Firms, in contrast, can reduce such risk only imperfectly and usually at great cost: most obviously, diversification at the firm level is the same thing as giving up the benefits of specialization. Even risk averse shareholders, thus, should oppose measures to reduce risk at the firm level; they can eliminate it more cheaply "at home".

(In contrast, risk loving shareholders will not necessarily be indifferent to risk at the firm level: they may prefer more risk than they can create outside of the firm. Once a portfolio reaches zero T-bills, portfolio theory counsels that the best way to increase risk further is to borrow money, which may not be possible, or not possible at a rate as low as the firm could achieve. Accordingly, while risk-averse portfolio investors are indifferent as to firm-level risk, seeking only the most favorable risk/reward ratio, risk loving portfolio investors may prefer significantly worse risk/reward ratios at the firm level in order to achieve high overall levels of risk. Shareholders as a group, as a result, will not be risk neutral, but rather risk seeking, even at some cost.)

Similarly, portfolio theory teaches that individual investors should all hold the same portfolio regardless of their time preferences: those who need current income and those who do not will choose the same stock, based solely on its risk/return ratio and not on its dividend policy or the timing of the firms cash flows. Indeed, Wall Street can be thought of as specializing in adjusting firm cash flows to fit the needs of each individual investor, outside of the firm.

Similarly again, the central lesson of portfolio theory is that investors should not be unduly concerned with the particulars of any given company's investments: indeed, the counsel to diversify is precisely the opposite. Rather than being deeply committed to a particular business, product, place, set of people or relationships, portfolio investors diversify to eliminate the effects of those details on their investment returns.

The net result is that portfolio investors act (in their investing) as if they were risk indifferent, time indifferent, place indifferent and free of all commitment to any particularity. This is the source of the well-known paradox that mutual funds and pension funds, which are immortal permanent investors — with the longest possible time-frame of investors in a human community — were (until the recent rise of the Internet day trader) notoriously our shortest term traders. All firms, even or especially for the long term investor, appear as nothing more than a predicted cash flow at a predicted risk. If a better predicted risk/return package is available elsewhere, the investor simply switches.

A shareholder-run firm, then, is likely to be a highly risky firm. Employees, in contrast, are likely to prefer less firm-specific risk, if only because they are less able to diversify to avoid it and because steady firm growth usually provides maximum job security and the least disruptive path to career advancement. Similarly long-term creditors (bond holders) are likely to benefit from steady growth patterns, which in effect increase the security of their loan without lowering the compensation they receive; this effect is lessened to the extent that bondholders are the same diversified portfolios as shareholders.

Furthermore, the finance market being without any long term commitments to businesses, localities, relationships, products or people, shareholder controlled firms are likely to be remade in the market's image. While employee controlled firms (or even ones with powerful unions) are notoriously committed to job stability and to the current employee body, shareholder controlled firms are far more likely to shed and regain employees, products and businesses in the manner of a dieting baby boomer. As different business opportunities appear, each can be judged by the risk adjusted present value of the expected returns; shareholders are less likely to be moved by intangible factors such as morale, firm-specific investments by employees, long standing relationships with particular places, people or products, patriotism or even a quality product. While such traditions or stability may have value to the people involved, the value is unlikely to be reflected in the risk/return calculations of portfolio managers.

B. Conclusion: excess mobility

This brief tour through portfolio theory suggests one of the principal effects of legislation by market: **The stock market has an agenda of its own**, one that emphasizes its own characteristics of time-indifference, space-indifference, mobility, and lack of commitment. The stock market seeks to increase the mobility of capital, across borders and businesses alike, to enable it to pursue the highest possible returns. But people are never so mobile, and high returns to capital, important as they are, are never our only political agenda. People are not time indifferent or place indifferent: while for a shareholder, profit here and now is always fungible with profit somewhere else and sometime later (properly adjusted for the costs of repatriation and the time value of money), for people a job here and now is never the same as one somewhere else or some other time. Capital can shift instantly from Flint to the Philippines and then on to Fresno, or from steel to software; people can't.

When we turn over lawmaking to the market, we lose the ability to trade off market values against non-market values. Corporations, run on behalf of their shareholders, will never chose law that sacrifices shareholder value for human values, even if the shareholders might. Shareholders, after all, are us, and we have many commitments that conflict, at least some of the time, with the needs of the capital market. But those commitments will not be reflected in the process we have created.

In the competition for state law, corporations will choose the law that best suits the needs of the capital market. They will seek maximum flexibility and minimum commitment. They will, for example, oppose any efforts to introduce into corporate law notions of continuing obligations to corporate employees, firm products, firm suppliers or customers, or the localities (or even countries) in which the firm operates. Such rules (which are not uncommon in other advanced democracies that do not have our market driven system of creating corporate law) tend to reduce the share of corporate product that goes to shareholders, and will be rejected by firms seeking to maximize shareholder return.

There is one significant exception to this rule: when shareholder interests conflict with those of upper management, firms may choose law that limits shareholder rights. This is, of course, the race to the bottom thesis; I mean not to rehash it here or even to take sides but only to point out that the race to the top thesis relies on an assumption that shareholders can force managers to internalize the costs of such actions, and that assumption may not always be correct.

Nor is it always the case that managers and shareholders are in conflict primarily with each other. The current state of hostile takeover law is a good example: the combination of the poison pill and the "stakeholder" constituency statutes have essentially eliminated the hostile takeover. But while at first glance this might appear to be a pure vindication of the race to the bottom thesis, the reality is more complex. In fact, the new law has fortified the current alliance of shareholders and top managers against the rest of the corporate employees and furthered, rather than limited, the mobility of capital. Managers no longer oppose the radical restructurings that originally motivated the hostile takeover movement. Instead, they give shareholders more or less what they want, and take 10% as a commission.

Market driven law, in short, will be law in the interests and the image of the capital market — a law of maximum flexibility and minimum tradition, maximum mobility and minimum stability, maximum return to capital and top management and a minimum return to labor. Most importantly, it is simply incapable of sustaining any debate on when, if ever, markets should be restrained. Excess mobility of capital may, as George Soros has claimed, threaten the capital market itself — but that issue cannot be a factor in the creation of our corporate law by the competition between the states. Perhaps even more importantly, market mobility conflicts with our needs as citizens for a certain level of stability in which to raise our families, produce our culture and live our lives.

We, Americans descended from those who fled the stagnation of stability in small towns here and abroad, are unlikely to rush to restrain the markets' mobility in a major way. But the voluntary law of corporations removes the issue from democratic debate altogether.

VI. Conclusion: Who Is A Means And Who An End?

The most important differences between a democracy and the other forms of government are two. First, democracies take their citizens to be the ends of the law: the good of the citizen is the good of the state. In a democracy, the citizens are never only tools to some goal greater than themselves, means simply to be exploited, or strangers to be treated entirely at arms length.

Second, democracies allow the citizens to debate and decide their own good; it is not imposed on them by government or some supra-governmental movement. Democracies do not have established churches, in the broadest sense.[109]

Corporate law is central to a democracy because it determines, for the corporation, who is a citizen and who is a foreigner.

"Foreigners" are outsiders, external to the firm, to be dealt with at arms length. The morality of the marketplace bars the firm from lying to them or stealing from them, but certainly doesn't require empathy with them. If we can get more work out of an outsider for less money, if the outsider doesn't quite understand the full implications of the deal, if a legal loophole allows us to exploit the outsider in some fashion, corporate managers are entitled to do so. Indeed, the profit maximization norm states that they are required to do so. A manager would be at least arguably in breach of duty if she offered to pay employees more than is necessary to maximize their productivity, to lower prices below the profit maximization point, to pay taxes that are not legally mandatory, to voluntarily assume a significant social burden without any public relations value. When a manager decides to end legal (and profitable) discrimination, or to give charity, or to change production methods so as to reduce pollution well below legal requirements, or to increase employee safety beyond profit maximizing levels, his decision is automatically suspect. The business judgment rule, the possibility that apparently expensive ways of doing business may turn out to be profit maximizing and the difficulties of proving motive offer a great deal of protection for socially minded managers, to be sure. Highly paid workers are less likely to quit and more likely to work hard; charity and environmental protection may have public relations value that translates into dollars and cents; low prices may bring higher and more profitable market share. But, the principled issue remains: managers have no right to use corporate funds for non-corporate benefits. It is all very well to give charity, but it is not all very well to give charity with someone else's money.

In short, when a corporation works for outsiders, it is doing something presumptively wrong. We expect an explanation, along the lines of instrumental profit maximization. It may look like we are giving corporate money to the CEO, say directors, but that is just an illusion: really, we are buying greater motivation from him. And so on down the line. Apparent charity, gifts and social responsibility are mere illusions: in reality, they are selfish, brutal manipulations designed to enrich the corporation.

In contrast, when a corporation treats outsiders as mere tools to its ends, no explanation is needed. A corporation that pays its employees the legal minimum wage and not a penny more, that employs hordes of lawyers to find the minimum taxes it can legally pay, that lobbies to modify environmental regulation to allow it to poor more junk into the air, or that charges the highest price the market will bear has done nothing that needs justification. So long as the corporation remains within the law, the managers are entitled,

[109] I've addressed these ideas at greater length in earlier work. See, Rutgers; Response to Walzer; Akhnai.

indeed, expected, to act as if the rest of society were of no interest to them. A corporation treats outsiders as a democracy treats foreigners: with respect, one hopes, but without solidarity.

Shareholders are different. If a corporation gives its shareholders more than the market demands, that is not a suspicious act that needs to be defended in terms of the long run interests of the firm. (It could be, and sometimes is: corporations have been heard to say that a high and steadily increasing dividend makes the financial markets more likely to support the firm, just as a high and steadily increasing wage makes employees more loyal. But no derivative action lies to test whether this explanation is a mere excuse for a give-away of corporate assets). Giving corporate assets to shareholders, in the ordinary course, is not even potentially waste or breach of duty.

The difference is simple: shareholders are "citizens," not "foreigners." Just as a democracy is supposed to work for its citizens, just as benefitting the partners is the same as benefitting a partnership, so too in the ordinary course benefitting the shareholders counts as benefitting the corporation. A benefit to citizens is not a cost but rather a profit: it is a benefit to the institution. The difference between corporate citizens and corporate foreigners, then, is that benefits to the former are viewed as benefits to the corporation while benefits to the latter are costs to it.

Modern corporate accounting (nearly always) and modern Delaware-model corporate law (not quite as consistently) view shareholders as "citizens" and all other corporate participants as "costs". There is nothing inevitable about this division, deep as it is ingrained in our legal culture. Non-profit corporations (especially non-membership firms) have a radically different sense of who their "citizens" are; so do partnerships (which include some employees as "citizens"), cooperatives and other established business forms. Corporate constituency acts in most states recognize the possibility (even if they do not create the actuality) of a broader view of the corporate citizenry. At the edge of insolvency, we admit creditors into the "citizen" group. Some of our most successful institutions have multiple and conflicting "citizen" conceptions: Harvard University's Corporation appears to view its faculty, students, urban neighbors, educational and research missions, buildings and investments as both "citizens" and costs at different times and in different circumstances.

Corporate law decides who is a citizen and who is a cost. If corporate law made the environment an object of the fiduciary duty of corporations, corporate managers would have to lobby for stronger – not weaker – environmental regulation in order to allow them to profit maximize. Only if they were freed to spend more money on reducing pollution, for example by penalizing free-loading competitors, would they be able to fulfill their mission. When environmental expenditures (like dividends) count as profit, responsible managerial maximizers will maximize it. If corporate law made employees citizens, managers might fight to pay shareholders the minimum they could get away, with Wall Street busting replacing union busting as a major and lucrative consulting specialty, as they now fight to pay bank creditors less.

In a perfectly efficient and perfectly competitive friction-free market none of this would matter. In the real world, friction usually determines the answer. Managers directed to work for shareholders will seek to evade the law; managers given a different task would often act differently.

Corporate law, then, is anything but empty. It matters enormously. Our decision to leave corporate law to the corporations is a decision to create self-guided autonomous power centers under the control of no one. A market for law responsive to a financial market structured by law that it itself structures, with little input from citizens except within very narrow role constraints: this is the system we have created. It is one that is unlikely to reflect most human values except by accident.

finis

Deleted (or add some to Part II:) Competition inside the corporation: the struggle over firm surplus.

In the corporate world, relative bargaining power is extremely important. Economic theory teaches that at equilibrium, the price of a firm's product should equal the cost of its inputs, that is, the market value of the products of its various suppliers of goods, services, labor and capital. All the interesting cases, however, are disequilibrium situations, where the firm's output has higher value than its inputs. In these situations, the various participants in the firm compete for shares of the firm surplus.

Conventional legal accounting somewhat conceals this competitive process, so it may be worthwhile to explain precisely what I have in mind. On the surface of the conventional accounting, a corporation pays certain participants — referred to generally as creditors, and including its suppliers of labor (employees), its suppliers of raw materials (suppliers, trade creditors) and some of its suppliers of capital (bank lenders and bondholders) -- the amounts contractually owed. If anything is left over, that remainder, referred to as profit, goes to shareholders, who are therefore sometimes referred to as the owners. Micro-economics teaches us that competition will eliminate this profit (except for the part that is no more than the cost of capital: compensation for the use of shareholder money and any risk-bearing services shareholders may provide), by reducing the sales price of the company's product to its cost of production.

But while any given company may be a price-taker in purchasing most of its inputs, for the economy as a whole (and to a real extent even for individual companies) cost of production is not simply a economic fact, an external and unchangeable reality.

In close corporations, where the top employees, shareholders and debt holders may all be the same human beings, it is widely recognized that the division between costs and profits is entirely artificial. Under the dual taxation regime prior to the effective abolition of the corporate income tax for close corporations by "check the box," close corporations were taxed on their own income, and then their shareholders or other participants were taxed on any corporate proceeds paid to them. As a result, many well advised close corporations never showed any profit (thus avoiding the corporate level income tax) even while making their owners rich: money that could have been profits was passed on to the owner in the form of expenses such as rent, salaries, or interest. Such firms were highly successful in the marketplace — in the strict sense that they were able to sell a product for more than the economic cost of the inputs — but the resulting surplus never appeared as corporate income. Rather, it showed up as above market payments to firm creditors; where these creditors are the same human beings as the shareholders, only tax considerations determine where the above market payment is made.

In public corporations, no one owner controls the firm or can determine alone how it will divide its surplus. Rather, various participants in different markets compete over the firm product. Shareholders, for example, although often called "owners", have few or none of the characteristics of owners of fee simple absolute real property. Rather, they are better understood as fully fungible suppliers of risk capital — a fully fungible commodity. Since the capital market is generally highly competitive, it is a priori difficult to understand why shareholders should ever receive more than the risk adjusted cost of capital: should they demand any higher price, they can easily be replaced at next to no cost with other shareholders who will be satisfied with the going rate. Conversely, the firm ordinarily has little ability to impose below market terms on shareholders: capital is readily mobile and, from the point of view of an investor trained in corporate finance, firms are largely fungible. Thus, any firm that offers less than a market return is likely to see its capital providers rapidly shift elsewhere.

In contrast, other firm participants such as suppliers of raw materials, purchasers of the firm product or bank lenders, may, from time to time, have local monopolies, informational advantages or other sources of market power that they can exploit to obtain better than market terms from the firm. Alternatively, the firm may have such power against them. Producers and suppliers may develop relationships that are not easily replaceable, or products that are specifically designed for this particular pairing in a bi-lateral monopoly, or one may have alternatives at a moment when the other doesn't. Bankers and borrowers may have informational lock-in, where it is cheaper to maintain existing relationships than begin new ones, or, conversely, one side may have alternative customers while the other doesn't. Thus, there may be room for one or more of these participants to demand better than market terms or to be forced to accept less than market.[110]

Employees are in a different situation altogether. Some -- especially lower level or unskilled -- employees may be largely fungible, in the sense that the firm may be able to replace them cheaply and easily at no additional wages and only minimal search and training costs. More commonly, firms will find it somewhat costly to replace even lower level employees, and may find it quite expensive to replace upper level ones. When lower level employees leave, newcomers must be trained in the details of the job and the corporate culture. When top employees leave — especially the CEO — there may be extended periods of drift during extended searches and then afterwards while subordinates concentrate on defending their jobs, lobbying for positions in the new regime and generally on office politics rather than work more likely to enhance the firm's position in competition with other producers of similar goods. Thus, the firm will often find that employees have a significant degree of monopoly power against it: they are not fully replaceable.

At the same time, virtually all employees will view the firm as at least a partial monopolist. Employees can never be fully mobile: leaving a job isn't like selling a stock or

[110]Note that in this market-based account of the firm, customers are as much part of the firm as suppliers, and both as much as employees, shareholders or bondholders. Customers and suppliers alike enter into contractual relations with the firm that are conceptually similar to each other. Shareholders and bondholders are conceptualized as suppliers of capital and risk bearing services, much like suppliers of raw materials. Indeed, suppliers (and customers) may well have closer and longer term relations with the firm than do shareholders, with more likelihood of lock-in or mutual dependency. See Charles Sabel, Columbia L. Rev. (1998). Employees are less usefully understood as having a purely market relationship to the firm — of all the firm participants, they are the least like a spot market — but for present purposes the metaphor will often do. For discussion of the firm as a moment in the market, see ..

purchasing a different product. Changing jobs is typically disruptive, requiring giving up work friends and making new ones, a longer or shorter period of insecurity and possible unemployment, sometimes uprooting oneself and/or family members from non-work relationships in order to move locations and so on. For this reason, employees (outside, perhaps, of Silicon Valley) will nearly always view employers as (at best) imperfectly fungible.

Furthermore, middle-aged long term employees at many levels of many large firms were hired under an implicit — but not legally enforceable — understanding that they would be paid above market wages (or rapid pension accruals) in later stages of their careers, presumably in order to induce loyalty at earlier stages. Similarly, unions have long sought such career ladders in unionized fields, but often no longer have the power to enforce them. These employees cannot replace their current employer in the current market: neither union seniority, seniority weighted pensions, nor even middle managerial salary and perks are transferable across firms. For these unfortunate individuals, their current employer is an effective monopolist. If they were to go on the open market, they would be unemployable at anything resembling their current wages and possibly at all.[111]

Firms and employees, then, generally are likely to be in at least partial bilateral monopoly, and many employees -- including most unionized and non-unionized middle aged employees at larger firms -- will find that the firm can far more easily replace them than they can replace the firm.

CEOs receive a separate discussion. They control the ordinary decisionmaking apparatus of the firm, and in all but the most extraordinary circumstances, control the ultimate decisionmaker (the Board) as well. Even leaving aside informational advantages and the cost of replacing them, CEOs, then, are likely to wield substantial bargaining power over other firm participants.

In short, the various firm participants should be viewed as in ongoing competition for the firm's joint product. Participants in relatively competitive markets are likely to receive a market price for their services or product (or to purchase firm products at a market price). In relatively uncompetitive markets, there may be more room for one side or the other to obtain surplus, and the division of the surplus will be heavily influenced by the ability of each bargainer to walk.

[111]In a society in which wages are a major source of self-esteem, employers are understandably concerned that hiring job candidates at less than their former salary is asking for trouble: the new employees are likely to come in with a chip on their shoulder. All the more so if the individual has been unemployed for a while and may also have lost the habits of the workplace. Why take that risk? Accordingly, individuals who had been earning above market wages may find it extremely difficult to find work at any salary at all, even if they are willing to take a pay cut. It seems clear that many people in this situation simply drop out of the work force altogether, swelling the not altogether voluntary ranks of the early retirees. I take it that this, rather than a sudden reblossoming of the spirit of the hippie movement among 58 year old men, is the main reason for the startling drop in labor participation rates among middle-aged males.

Since trading shares is extremely cheap, stock market investments are largely fungible on the standard corporate finance view and shareholders are likely to have little emotional or other attachment to publicly held firms, shareholders are likely to be the most mobile of all firm participants. While this should give them relatively great bargaining power, that is offset by the fact that for established companies, shareholders are entirely fungible: their contribution to the firm is readily replaceable, either by other shareholders or by other sources of funds (including retained earnings and borrowing) and risk bearing (including insurance and internal diversification).

Managers, in contrast, are far less mobile, but also far less fungible -- making it difficult to ascribe to them more or less bargaining power than shareholders, at least in the abstract. In addition, through their command of the firm's decision making apparatus, they may be in a position to influence both particular decisions and, through their influence on the course of corporate law, the rules of the conflict. Accordingly, particular conflicts between shareholders and managers may go either way.

Of course, to the extent that shareholders can predict that they will receive more proceeds with a given set of managers than another (whether because the former generate a larger pie or whether because they share more of it with shareholders), they will shift away from the latter set, thus tending to equalize shareholder returns at the margin. Conversely, managers may find it more advantageous to devote their energies to find new (and unpredicted) ways of reallocating the existing corporate pie rather than creating a larger one. (Since CEOs normally have relatively short careers at the top, it is unlikely that reputational concerns will limit such one-shot grabs).

In short, managers and shareholders are likely to reach an equilibrium, market price allocation of firm proceeds that will be relatively uniform across firms at any given time (except for innovative managers who succeed in ex poste reallocations). But this equilibrium can be located anywhere between the poles of all surplus to shareholders, to shareholders receiving only marginally more than their risk-adjusted alternative investments.

Four decades ago, the equilibrium appeared to allocate much of the surplus to unionized employees and middle management; top management received only marginally more than those below it, and shareholders had, for two decades, received less than bondholders. Indeed, it seemed fairly clear to most observers that corporations were managed in the interests of employees, bondholders and other creditors, with a strong emphasis on safety and steady growth (rather than the risk-taking aggressive competitiveness that is in the interests of shareholders). In the 1950s, shareholders were often described as largely powerless. Then contemporary management techniques emphasized the importance of delivering steady returns to "satisfy" shareholders. Proxy mechanisms seemed to leave managers firmly in control of their own tenure; shareholders had few other legal or market powers. Indeed, in a world in which firms raised most capital internally and much of the rest in the debt markets, shareholders seemed to have little relevance to the day to day workings of large corporations: they had neither carrots nor sticks with which to influence management.

Rise of a formerly tamed market? Or a shift in power?

Over the course of the last two decades, a new equilibrium seems to have appeared: an alliance of shareholders and top managers against other corporate participants, principally the market-challenged employees. In an increasingly market-driven and competitive struggle over the division of the corporate surplus, the least mobile factor of production — employees — is likely to lose out.

With the invention of the junk bond and the rise of the institutional investors, hostile takeovers became practical and shareholders suddenly obtained a powerful tool for binding managers to the demands of the financial markets. After a brief period of intense struggle that ended rather abruptly with the widespread adoption of the golden parachute, stock option employment contract and poison pill, managers and shareholders settled into a new modus vivendi characterized by mutual assistance rather than battle. Under the new regime, pioneered in the 1980s and now well established, managers received vastly higher pay and grants of significant percentages of their firm's stock. In return, they began to manage firms with far closer attention to the interests of shareholders and less concern for stability, steady growth, internal employment prospects and similar concerns of employees (and creditors generally, to the extent that they are different investment pools than shareholders). The result has been quite extraordinary: average returns of 18% per year for shares since the beginning of the shareholder revolution in about 1980; enormous relative and absolute increases in top managerial salaries and stock option grants; a radical downsizing in the ranks of middle level managers and below; and general stagnation or decline in the earned income of at least the bottom 2/3 of the working population.

The economic picture, then, is relatively clear. Over the last several decades, we have witnessed an immense shift of power and resources from salaries and wages (and salary and wage earners) to shares (and shareholders). Companies today are run in the interests of the shares, not the employees or creditors.

This shift is more important than merely a shift in economic returns, however. Shares are more widely held today then ever before, with almost half the publicly traded shares held by institutions that, in turn, are held by a broad spectrum of the American public. Although the bottom quarter of the American income distribution has unquestionably suffered from the great shift, those in the middle may have had some of their losses as employees offset by gains as shareholders (usually indirect ones) or consumers. Average Americans have lost out in their incomes, but their pensions have gained. On balance, however, given that our wealth distribution is far more unequal than our income distribution, it seems clear that the shift to running corporations on behalf of the shares is financially harmful to far more people than it benefits. **Cut? Iowa/USC?**