

A Progressive View of For-Profit Corporations and Corporate Law
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I. Business Corporations: Why Care?

The business corporation is one of the most important inventions of the twentieth century. Along with fossil fuels and the great public bureaucracies, multi-national business corporations underpin our economy and make modern prosperity possible. At the same time, these great institutions threaten to overpower us, and our ecosphere: the same organizational and legal success that enables them to create unparalleled physical wealth also allows them to impose enormous costs on outsiders and the environment, to evade and undermine essential legal structures, and to accumulate power that, ultimately, threatens the capitalist system. This system of organizing people to act together is critical to most of our jobs, much of our affluence -- and many of the threats to our freedom, happiness and perhaps even survival.

While we often think of our economy as market-driven, in fact most production takes place in bureaucratic organizations – business corporations, not-for-profit corporations, municipal corporations and government agencies – that succeed precisely because they use planning and top-down control to avoid market fluctuations, free-riding and inefficiencies. While we call our political system democratic, in fact corporations, run by committees and hierarchically arranged bureaucrats supervising each other, are one of our most important collective decision-making systems, as important in most parts of our lives as voting, the price system of markets, the technocratic planning of democratically-answerable government bureaucracies, backwards-looking judicial interpretation, or even gerrymandered political boundaries and the indefensible stasis of the Senate. Our daily experience is corporate far more than it is market, democratic or republican.

How should we think about these institutions? First and foremost, as institutions governed by rules – rules that we can change – which allocate power to some people at the expense of others. Corporations exist and operate based on laws enacted, and sometimes changed, by legislatures. Those laws specify their rights and privileges and obligations – exempting them, for example, from otherwise applicable laws barring conspiracies and collective action – and grant and limit power to their leaders (and others) to act on behalf of the corporation – determining who may use corporate assets, and under what conditions, without being arrested for theft or trespass.

Second, as quasi-sovereigns – much like any governmental agency, they exercise collective power over those subject to them. But as currently structured, they are democratic anomalies: that they do not derive their legitimacy from the consent of the governed. They lack basic republican safeguards, such as division of powers or other internal sources of countervailing power to avoid well-understood bureaucratic failures or self-serving power grabs by officeholders. Indeed, we have not even firmly established the basic medieval notion that governance is service, not property – that the institution exists for the benefit of the entire people, not merely its elite.

Because corporations are governance institutions – structures in which some people control the behavior of other people – most of the lessons of political theory apply. At least since the prophet Samuel, political thinkers have pointed out that our security and happiness depend on government protecting us from bullies, powerful wrongdoers, and ultimately Hobbes’s war of all against all. Liberal political theory has warned that we must also worry about the power of the government itself, which can be captured by private power or officials and transformed to their purposes instead of ours. Today, we depend on corporate power as much as official governmental power, and it has the same two-sided aspect: essential yet threatening.

Most of the problems of political theory – how to create a government that is powerful and stable, yet operates in the public interest and not as the property of officeholders – are replicated in corporate law.

However, the usual liberal solutions to state governance are yet to be applied. In the public sector, we’ve largely eliminated kings who claimed property rights to their office and the property and people they control. We have principles of rule of law to require at least formal fairness. We have relatively clear understandings of corruption barring office-holders from using their office for private gain. We have established fundamental rights of citizens that limit the degree to which officials and collective organizations may treat individual citizens (and to a lesser degree, non-citizens) as mere tools to a collective ends. We have rights of debate and dissent, the Fourth Estate, and independent institutions to help limit the degree to which our leaders are trapped in self-affirming echo chambers. We have representative bodies designed to ensure that different views, values and needs are heard even if they aren’t listened to. We expect officials to act in the public interest and not merely that of those who select them. We have principles of rotation in office and division of powers and countervailing powers to limit any particular state office’s power. We use voting and open records to limit officials’ ability to deviate from the views of their constituents.

Few of these ordinary political devices, now commonplace in all decent governments, have close parallels in our business corporations. Progressives, and indeed anyone who believes that democratic republicanism is an advance over feudalism, must ask themselves whether this difference is justified or simply a sign that the great project of the liberal democratic revolutions remains incomplete.

Instead, corporations operate under a norm of duty to profit and efficiency. Corporate managers and directors are expected to treat the various human beings who work for the firm and the people and institutions that invest in it, supply its raw materials and purchase its products and services as inputs. The task is, they are told, to minimize inputs and maximize outputs as measured by money. In effect, we have colonized ourselves. Corporate decision-makers, the dominant ideology contends, ought to treat us – in our roles as neighbors, employees, consumers, producers and even (sometimes) investors – as if the firm were a colonial power, managing the natives with the goal of extracting as much as possible from them with as little effort as possible.

By constantly seeking ways to create more from less, corporations can be engines for increasing productivity and thus social wealth. But our corporate system is not designed to distinguish between increasing productivity – making more with less – and simply redistributing wealth from those with weak bargaining positions to the more powerful. When we place people in positions of power and instruct them to treat those around them as mere tools to an abstract end, we should expect perverse results. And we get them. Colonial rule – even of the enlightened variety – is rarely pleasant for the ruled.

II. Corporate Law: Orientation

A. Corporate law as constitutional law

Corporate law is important first as a branch of constitutional law: it sets out the fundamental rules that determine who gets to run our largest and most important economic institutions, and the small ones that collectively influence so much of our lives. Similarly, it sets out the (minimal) rights the rest of us have against those officials and the limits to their power.

We often think of ourselves as living under democratic rule in a market-based economy, but the corporations for which most of us work and on which we depend for many necessities are enclaves largely exempt from either democratic or market norms. They are, instead, bureaucratic centers of command and control, led by autocrats with few countervailing powers – and pledged not to the public good but largely to private cupidity.

Corporate law is the last major aspect of modern life to escape the democratic republican tide. We have largely overturned the authoritarian monarchies and the dictators of the left and right who sought to succeed them – but the politics of the enlightenment and its commitment to human flourishing has barely reached this major arena of our lives.

B. Corporate law as meta-law

Second, corporate law is important because it determines the effectiveness of (nearly) all our other law.

The oldest and still most basic legal characteristic of corporations – whether they are cities, businesses, charities, large or small, dominated by a single person, anonymous institutions or effectively branches of the government – is that a corporation is recognized by the law as a unified entity separate from the people who make it up, and a legal actor in its own right. It can enter into contracts; buy sell and hold property; commit torts and crimes – and it alone is the responsible party, not the people who control it, depend on it or profit from it. Only the corporation's assets stand behind its contracts or can be seized to pay for the environmental, civil or criminal damages it causes – individual assets are exempt, even if they derive from corporate actions or wrongdoing.

But a legal corporation need not be attached to a sociological organization, and organizations themselves are not necessarily stable. People can create corporations and dissolve them, operate them without assets available for contracting parties or regulators to

seize, or reclassify themselves as a new corporation independent of the old one. Most importantly, corporate organizers are free to structure the legal entities that make up a firm so as to avoid legal liability – placing tort or environmental risk creating activities in one corporation separate from attachable assets, or moving profit-making intellectual property into a corporation “located” in a low tax jurisdiction even while keeping the relevant employees in the real creative centers, or combining pension liabilities with obsolete factories while reinvesting via a different entity.

To the extent that corporate law makes these kinds of games easy – and it is a very great extent indeed – corporate law can subvert all other law.

Law, ultimately, works by threatening force or other sanctions on those who refuse to follow its norms. Corporate law determines if “there is a there there” to sanction. If corporate law allows people to create and dismantle actors at will, it leads directly to the “death of contract,” in Lynn LoPucki’s evocative phrase, since the entity behind the contract will not be there or will have no assets when we come to enforce it. A contract with an entity that can operate with no assets – and therefore can disappear whenever convenient -- is no contract at all.

Voluntarily contracting parties often can protect themselves from this kind of game playing in advance (for example, by demanding security, restricting reorganizations, or requiring guarantees from related corporations). However, too flexible corporate law is likely to undermine long term contracting that requires ongoing trust: it is hard to trust a shapeshifter.

Thus, employees who give up salary now for a promise of a pension in half a century can pretty much assume that by the time comes to collect, managers will have shifted all the assets that could have backed it to a different entity. Indeed, if managers don’t, the market will: a company that actually pays its pension promises will always have higher costs and therefore be at a competitive disadvantage to a newer firm with promises that have not yet matured. If consumer markets are even mildly competitive, corporations will rarely or never fulfill long term contracts where the corporation’s obligation to pay is long after it received its benefits. For the same reason, corporate promises to cover long term “tail risks” – small likelihoods of large damages, such as a nuclear powerplant meltdown, earthquake insurance, mass torts or unusual types of financial crises -- will predictably lead to default. The corporation will always turn out to be undercapitalized.

Worse, many areas of the law do not involve ex ante contractual negotiations. Tort law is meaningless if tortfeasors are permitted to design themselves to be judgment proof. A pollution control regulation that restricts an entity that is solid enough to pollute but too ethereal to sanction is an empty regulation. A residency requirement that can be asserted by anyone who files a piece of paper to create a corporation is no residency requirement at all. Anyone, therefore, who seeks to use law to create incentives for the ordinary, to restrain the powerful or to punish wrongdoers, must concern themselves with corporate law as well.

A market made up of self-interested maximizers that can disappear at will and are therefore completely irresponsible will be taken over by scam artists. The more flexible

corporate law is, the more it invites self-interested managers or investors to use corporations as, in Larry Mitchell's words, "externalization machines," imposing costs on others who cannot protect themselves.

Indeed, at the limit, flexible corporate law would reconstitute corporations as "moments in the market" (Alchian and Demsetz), where all corporate agreements are only as good as the market pressures behind them. Unfortunately, corporations only exist because they are different from markets and often able to outcompete them (Coase); this kind of radically flexible corporate law would destroy the very firm itself. Planning, cooperation and ultimately trust itself will be impossible. Just as the corporations will disappear into markets, the markets themselves will dissolve into anarchy and mistrust (Stiglitz). All that is solid will melt into air; Thatcher's claim that there is no such thing as society will become true as civilization perishes in Hobbes' war of all against all. Believers in the capitalist market system, thus, must ensure that corporate law remains "corporeal": if we allow too much self-interested shape-shifting, our system will self-destruct.

C. Corporate law for sale – a self-defining market?

Third, corporations are not merely the main actors in our economic system. They are also critical players in our political system. Corporations are creatures of law, but the law we have created (and the law that the Supreme Court has imposed on us) also gives them enormous influence on the law. The result is institutions that may evolve and press our other institutions in directions quite different from our values or interests. We grant corporations the right to accumulate vast wealth so that they can plan and manage the large projects on which our affluence depends.

But that wealth also gives them the power to change the very rules that assure that markets serve the public good and not merely private power accumulation. Adam Smith's invisible hand, assuring that private interests serve the public good, is not some immanent property of the world. With the wrong rules, markets will efficiently provide crack, kidnapping and murder-for-hire, while failing to provide jobs, food, transportation, education or other services that make life worth living. Markets function in failed states; they just don't produce decent lives.

Moreover, when the incumbent economic elites can rewrite the rules of the market in their own interest, they are likely – as Smith himself already noted – to do so at the expense of economic growth and, ultimately, prosperity itself (Acemoglu and Robinson). Great accumulations of wealth are dangers to markets and republic alike: if the wealthy can buy political power they can use political power to grant themselves more wealth, in a self-perpetuating spiral heading towards a tiny elite astride an impoverished and enslaved mass (Aristotle, Rousseau, Jefferson, T. Roosevelt, M. Walzer, Acemoglu and Robinson).

D. Rights and duties inside the corporations

More prosaically, most of us spend most of our life under the control of one or more corporations. We work, most of us, for corporations: roughly speaking about 1/3 of employed Americans work for large, publicly-traded business corporations, another third for governmental and non-profit corporations, and virtually all the rest for small, closely held

business corporations. Only relatively small numbers of us work for human beings directly or in partnerships or sell directly to markets without an employer. And we depend on corporate producers and middlemen for most of our necessities. It is relatively easy to escape from the heavy hand of municipal government by moving a few miles; to escape from the clutches of Monsanto, ADP, Time Warner, Google or the little known companies that supply refrigerator motors or automobile brake pads is far harder.

Shortly after the Civil War, the Supreme Court decided that the new constitutional rights of due process, equal protection and the privileges and immunities of citizenship protect us only against state actors – and for-profit business corporations, no matter how regulated, subsidized or dependent on state police power, are not the state. Thus, none of the standard constitutional rights that protect us from over-reaching by government agencies apply to corporations: unlike state agencies, for-profit and not-for-profit corporations have no constitutional obligation to respect freedom of speech or religion, allow dissent, refrain from inappropriate searches and seizures or accord us equal protection, due process of law or the right to remain silent.

Statutory law, of course, does require corporations to obey standard anti-discrimination principles. However, anti-discrimination law remains an exception to a general principle that the state stands behind and enforces corporate power relations. You may be an employee or a shareholder or a creditor of a corporation—even the creator of its product or service – but generally the law demands that you respect the decisions of the person(s) that the law designates as having the right to decide how to use the power of the corporation.

Under standard American corporate, agency, contract and labor law, our corporate employers have enormous power over us. Usually, they can cut us off from our livelihood at will – and with it, salary, medical care, pensions and other necessities – generally without providing any process at all. They own the product of our labor and creativity. They have extraordinary powers to search our private spaces, including computers, email and desks (which the law regards as belonging to the corporation, not us). And they have complete authority, so long as we remain employees, to restrict our speech, suppress dissent, and control our daily activities.

In our role as consumers, corporations exert almost as much authority. We depend on corporations to supply necessities from electricity to housing to email. In most cases, even monopoly providers have the right to refuse to do business with any individual, even if that causes extraordinary harm, without having to justify this exile in any way. Suppliers of internet service arrogate to themselves the right not only to track the contents of our websearches and emails but to sell that information, together with any other private information they can glean about us or trick us into disclosing, to all comers. Credit rating agencies and other private companies adjudicate – as prosecutor, judge and jury, with no appeal and according to rules that they make themselves and do not disclose to anyone – our creditworthiness and even fitness for jobs; a negative report, whether based on fact, fiction, or an accurate or inaccurate model, can make middle-class existence virtually impossible. For-profit medical insurance companies unilaterally (or in negotiations with our employers) decide whether we will have access to medical care and what it will cost us. Monopoly or oligopolistic suppliers of basic

services and products have at least as much power to tax us as government agencies, but with none of the usual safeguards against taxation without representation.

The inherent danger of corporate power to both our individual freedom and our collective self-governance might suggest that we need protections parallel to Magna Carta or the Bill of Rights. That, however, is not the current state of the law. Instead, the general rule remains remarkably similar to the infamous 19th c. doctrine that an employer could not be responsible for injuries to employees, who were said to have voluntarily assumed the risk of injury due to the carelessness of other employees, their own mistakes, or inherent dangers (e.g., *Farwell v. Boston & Worcester R.R. Corp*, 45 Mass. 49 (1842) (fellow servant rule)). Even today, the general rule is that employees and customers alike are deemed to have consented to whatever terms the corporate-powers-that-be set -- a form of tacit consent parallel to Socrates' argument that the Law had the right to murder him or Locke's argument that every landowner has consented to every exaction by King and Parliament simply by not emigrating. Specific exceptions, such as minimum wage laws and safety requirements, are not part of corporate law but enacted piecemeal as substantive regulations, typically applicable to corporate and non-corporate employers alike. The general rule shows up, instead, allowing employers to search employee email, allowing website owner to appropriate their customer's private information, allowing medical professionals to enforce bills for amounts that even the insurance industry classifies as not "reasonable," or permitting mortgage lenders to use MERS and form contracts to evade the public records laws.

In sharp contrast to the general absence of protections for citizen against overweening corporations, the US Supreme Court has erected a panoply of protections for corporations against the citizenry and its representatives. The US Constitution does not mention corporations -- and given how controversial the precursors of modern business corporations were in the early days of the new country, it is hard to imagine that the absence of constitutional protection for what were viewed as monarchist dangers was accidental. Nonetheless, the US Supreme Court has repeatedly granted corporations constitutional rights, even when it had to disregard the explicit words of the document to do so, while refusing to grant us rights against these quasi-governmental institutions. Indeed, in the very first decision involving corporate law that came before it, *Dartmouth College v. Woodward*, the early Court imported into the Contract Clause the medieval doctrine that corporate charters once granted can never be rescinded, as if a charter were a grant of fiefdom (the states effectively overruled this decision). Today, business corporations may sue in the Federal courts as if they were citizens, have most of the privacy and due process rights of citizens (including, often if inconsistently, constitutional rights to avoid the types of prophylactic supervision, open meetings laws, GAOs and ombudsmen that are routine in the public sector), and, most importantly, are largely free to use the accumulated power of their past economic success to subvert our political and economic system. In the *Lochner* era, the Court used its invented corporate constitutional right to due process and equal protection to impose its vision of laissez-faire and overturn ordinary economic regulation. In the last several decades, it has used corporate speech doctrine for the same purpose, holding that various forms of regulation of corporate advertising violate someone's speech rights.

Both democracy and market require that established power not allow incumbents to entrench themselves or preclude upstarts, entrepreneurs, change and progress. Capitalist markets and democratic elections alike have little respect for the past: voters defeat even formerly great politicians when they begin to rest on their laurels, and markets, if they are working properly, should direct capital and competitive success to those who are providing useful goods and services right now, without regard to what they did in the past. But if money can buy power, or even lobbyists and advertising, this core of our system is endangered. If a corporation can use profits from its past success to buy laws that give it special privileges and protections, it can lock itself into continued wealth without doing anything useful. Patents and ever-lengthened copyrights, for example, convert past achievements into legally protected monopolies that simply entrench past success; regulations subsidizing established technologies – oil, coal, roads – or permitting large companies to shift their costs to others – minimum wage law that are so weak that employees are forced to depend on Medicaid, or “too-big-too-fail” risk guarantees -- can do the same.

When money can buy power, economic incumbents use the power of their office to secure themselves in perpetuity. In the political sphere we call this abuse “corruption.” In the corporate sector, it has become business as usual.

E. Corporations and Contract

Corporations exist because contract and markets fail (Coase). Contract attempts to specify deals in advance; in the real world, however, we never know what is going to happen in advance. As a result, as every first year law student learns, most of contract law revolves around courts imagining the contracts parties would have made had they thought of an issue that never occurred to them and reached an agreement in advance, even though they didn’t. This is a clumsy and inconvenient way to do business. Markets have a similar problem: producers will only produce if they expect to have a customer, but customers for anything custom are unlikely to simply appear at the right time and price. It would be hard, if not quite impossible, to produce anything complicated if each piece and process had to be sourced separately at the local bourse.

Corporations replace ex ante contract and market fluctuations with bureaucracy, teamwork and planning. Instead of agreeing in advance on what to do, the parties to a corporation – like the citizens of a state – accept a set of rules of who gets to decide. Instead of relying on guesses about the future state of the market, corporate managers coordinate – deciding in advance what parts and processes will be needed and producing them to order, and readjusting as necessary without the rigidity of contract.

This system depends on trust. (Steiglitz) Employees assume that they will be rewarded later for contributions now, expecting continued employment, raises and pensions that are not legally enforceable and in return placing themselves in positions of dependency by developing firm-specific skills and relationships. Investors assume they will receive dividends to which they have no legal entitlement and that bonds will not suddenly become more risky than expected. Consumers become dependent on products or services assuming that the company will not take advantage of them or disappear. Generally, contracting parties assume that the

corporation on the other side of the contract will stand behind the contract and regulatory authorities assume that corporations will generally obey the law and the normative expectations behind it.

Trust, however, invites abuse. Money can be made by taking advantage of those who have not protected themselves – and many transactions, including many LBO and private equity reorganizations and a great deal of tax “planning,” are designed to do just that. (Lawrence Summers & Andrei Shleifer [Breach of Trust in Hostile Takeovers](#); Coffey, Corporate Web)

We lost something real when young people realized that promises of long term employment on good behavior, or defined-benefit pensions, were not promises that could be relied upon. We will lose more if employees conclude that increases in productivity will benefit only investors, not employees, or if bond and stock investors conclude that they can count on companies treating their interests with the same lack of respect as often seems customary today to treat employees. The corporate system depends on all corporate participants assuming that the corporation takes their claims seriously; if people begin to take seriously the notion that corporations exist only to maximize profit, they will protect themselves in ways that will lead to less prosperity, less growth, and – in the worst case – a Hobbesian collapse.

F. Corporate Purpose

The central problem in a progressive analysis of the modern business corporation could be called self-colonization. Colonial powers treat their colonized subjects as tools to the ends of the colonizer, which governs in its own interest and for its own purposes. The welfare it seeks is its own, not its subjects'. We have taught our corporate executives to treat corporate participants as if they were colonial subjects rather than fellow members of a common enterprise. As discussed below, this is less a matter of formal law than culture and norms. It does, however, set the powerful incentives of the market as we have structured it – the self-interested pursuit of profit – in direct opposition to the weaker forces of governmental regulation seeking to restrain those market incentives when they push in anti-social directions.

Corporate law requires that directors and managers act in the interest of the corporation. However, it does not define what those interests are – a corporation may be formed for “any legal purpose.” Moreover, only shareholders (in for-profit corporations) or the Attorney General (in non-for-profit corporations) may enforce this duty – and their ability to do so is sharply limited. Procedurally, for example, plaintiffs usually cannot even get to discovery without first demanding that the board take over the action and, if it declines to pursue it, overcoming a presumption that the board acted properly.

Substantively, courts are willing to accept almost any definition of the corporation's interests that managers or directors may offer. Review of the directors' duties ordinarily proceeds in a manner reminiscent of “rational basis review” in the heyday of *Carolene Products* Footnote 4. Under the “business judgment rule” board action is almost automatically sustained so long as the board appears to have engaged in any cognitive activity whatsoever (*Francis v. Jersey United Bank*), does not have a conflict of interest, and can offer any justification, no matter how thin, for its actions. (When these requirements are not met, review is stricter but still hardly “fatal in fact” (*Bayer v. Beran*)(upholding nepotism in hiring).)

The proffered justification need not have much, if anything, to do with profit or shareholder interests, for, a corporation has “no obligation to profit maximize in any particular time frame.” In *Time v. Paramount*, for example, Time Magazine’s board contended that their primary concern in determining the future of the company was to preserve what they called “separation of church and state” – the allegedly rigid barrier between the advertising and editorial branches of Time Magazine. The court accepted this goal at face value, despite indications that it may not have been as central as some testimony suggested and despite significant evidence that the Time board’s was in fact preferring the financial interests of top executives to those of shareholders with relatively little concern for the product.

Even when the board presents shareholder value maximization as its primary goal, courts rarely require a tight fit between means and end. For example, in *Kamin v. American Express*, Amex was winding down a failed acquisition. It had two ways to do it. One would make the loss highly visible, but would also allow the company to claim a significant tax subsidy. The other would disclose the loss in a place less likely to be picked up by sloppy analysts, but would preclude claiming the tax benefits. The court upheld the board’s choice of the latter and its justification that the more opaque accounting it preferred might confuse the stock market into placing a higher value on the stock. The board, that is, had walked away from a Federal subsidy in the hope of deceiving the stock market. Clearly, this is not in the interests of the shareholders taken as maximizers: even leaving aside the subsidy, shareholders are not made better off by being deceived. To be sure, assuming that the deception worked, the company’s stock would sell for an elevated price for some period, and shareholders who sold would benefit from that. But the benefit to those jumping ship would come entirely at the expense of the purchasers of their stock. So the company’s ongoing shareholders would clearly lose.

In short, corporate law grants corporate directors and organizers nearly complete autonomy to determine the corporation’s goals and the responsibilities of corporate officials. Corporate law; directors and managers have a legally imposed duty to act in the interests of the corporation, but they need not define those interests in any special way.

Nonetheless, over the last generation, business schools and the business press have reached a near consensus that the proper purpose of a business corporation is to maximize the firm’s profit, even at the expense of the firm’s human participants. Whereas a generation ago, directors might have described their task as creating good jobs or useful products, today they are far more likely to view themselves as aiming to maximize shareholder returns or profits.

To be sure, profit is an inherently ambiguous term and we have little consensus on what it means in any given instance. Moreover, often the pursuit of profit may overlap with our interests, just as France contended that its mission civilatrice improved the lot of its subjects. After all, if you treat your employees or customers badly enough long enough, they are likely to find ways to escape or resist. Ruthless exploitation in the manner of the Belgian Congo often is not profit maximizing. However, neither colonial governments nor profit-driven self-interest come with any guarantee of social utility. When we direct the leaders of our most important economic institutions to pursue profit rather than, say, good jobs, social utility or sustainable production, we have to assume that at least some of the time they will do as they are told at the expense of what we really want.

When managers make profit the corporation's goal, the company's workers, products and services and customers are just tools, means to an end rather than valuable in their own sake. Profit-seeking managers are supposed to minimize costs, the easiest way of which is to give employees – i.e., us – as little as they can relative to what they can get out of us. Thus, in standard accounting and business news reporting alike, a firm that pays its employees more is portrayed as if it is less successful, all other things equal, than one that pays less: accountants, the stock market and those who follow their guidance classify the firm that creates worse jobs as a better firm.

Similarly, a firm that chooses to provide higher quality, or to impose fewer environmental costs on the rest of us, than is required by law or rewarded by the market, is often viewed as doing something wrong. The media, and law and business schools, and sometimes even judges and politicians, act as if it is normal, even admirable, for corporations to take advantage of every possibility in corporate law and other regulations to minimize taxes (the “price of civilization”), or to use undercapitalization to avoid responsibility for injuries it causes to others, or to shift operations to jurisdictions that offer larger subsidies or fewer limits on exploitative behavior such as unsafe working conditions, child labor, environmental destruction or emission of greenhouse gases. Milton Friedman epitomized this view in his epigram, “the business of business is business”: his claim, widely accepted, is that morality and patriotism and loyalty and even common decency are role violations unless they further the end of profit.

What may be less well known is that modern business training extends this instrumental view to all corporate participants.

Managers and directors are fiduciaries; the key role requirement of a fiduciary is that they must set aside their own interests and values to further, instead, those of the organization itself. So, the leaders of the corporation are directed to ignore their own deepest political and moral commitments. But corporations, like any bureaucratic organization, can out-compete markets only by relying on the general willingness of people to cooperate: they succeed by convincing employees to work harder or better than they would on their own. Successful managers, therefore, must inspire team spirit. However, corporate law and ideology alike make clear that the interests of this team are not necessarily the interests of the corporation – and the managers and directors are bound by law to promote the interests of the firm. If the firm's interests conflict with the employees', managers must betray their co-workers without hesitation. Thus, they are expected to be extreme cynics, inspiring their subordinates to loyalty while suppressing the natural human response of offering loyalty back in return.

Bizarrely, at the same time, profit-maximization advocates contend that managers should then take the ill-gotten gains of this cynical violation of the ordinary morals of loyalty – and selflessly turn the resulting profits over to the anonymous investors of the stock market even though the latter have little power to take it. Perhaps unsurprisingly, few managers seem to fully embody this combination of Machiavellian disloyalty and saintly self-effacement.

Indeed, their educators have long since adopted the more consistent position. In the leading academic metaphor, corporations are a “nexus of contracts” in which each corporate

participant is imagined to be in a contractual – that is, self-interested, arms length – with all the others. On this view, corporate managers, representing the entity itself, are obliged to bargain hard with every participant, seeking in each case to follow the contract norm of self-interested maximization. Accordingly, corporate managers ought, mainstream finance teaches, to treat all corporate participants, even investors, as costs to be minimized. The key message of academic corporate finance, taught in the business schools since the late 1950s, has been that a “profit-maximizing” firm ought to have a treasury department devoted to minimizing the cost of investment capital, just as it minimizes the cost of all other inputs.

The bulk of external corporate financing comes from loans and bonds. Bonds and loans alike are arms-length contractual relationships. It has thus been easy for courts to agree with the teachings of “contract” theories of the firm. Corporate managers owe no fiduciary duty to bondholders or lenders. Indeed, at least in the context of sale of the firm, they may be required to entirely disregard lender interests, acting purely in the interest of the firm as borrower (Revlon).

More surprisingly, at least to those familiar with the regular trope of popular and academic commentary that shareholders “own” the firm, standard finance theory urges managers to treat the shareholders in exactly the same way: as costs to be minimized. And the courts, while rarely endorsing this view explicitly, routinely uphold managerial decisions based on it (business judgment rule, *Time v. Paramount*, *American Express*)

The net result then, is that business corporations as we have organized them today, treat every participant – stock and bond investors, other creditors, employees, the countries in which they work and their fiscal systems – as costs to be minimized. They treat the quality and reputation of their product as mere instruments to induce sales, and thus to be sacrificed whenever it seems profitable to do so. They understand their customers as outsiders – to be catered to the extent, and no more, that customers know what they want and make it profitable to give it to them rather than, for example, a cheaper ersatz imitation.

Modern corporate law no longer defines “membership” in the corporation – and our managers are trained to treat every corporate participant as an colonial subject whose good is a cost to the whole, not a benefit. Market pressures will often mean that managers ought to treat them well – it is usually easier to get people to work hard if they feel loyal to the firm, and that usually requires giving them some reason for loyalty. But we train our managers to see this loyalty instrumentally, in the manner of game theory – and in this game of Tit-for-Tat, just like the theoretical ones, the omnipresent specter of end-game betrayal always threatens to destroy cooperation.

The law does not require corporate managers to treat us as foreigners (although in it does occasionally require them to imagine that shareholders are aliens with no interest in the company or the country other than the price of their stock (Revlon)). *Dodge v. Ford*, often cited for the proposition that corporations must profit maximize, is not (and never was) a correct statement of Delaware law.

But markets often encourage this view and corporate law never operates as a countervailing force. We rely, instead, on the weak reeds of substantive regulation and

consumer market competition to direct corporate managers in socially useful directions. Given the often perverse incentives of markets and the decentralized brain power on the corporate side, there is no a priori reason to think that these restraints will consistently guide corporate decisions in a useful direction. In a democratic mixed economy such as ours, we rely on government to guide the markets often quite visible hand – but our corporate law creates entities often able to evade government regulation or even turn it to their own purposes.

III. Corporate Governance

Sociologically, a major corporation appears to be a network of employees structured in a hierarchy and controlling a defined body of assets. The bulk of its resources are generated by selling the products of those employees for more than the firm must pay the employees and other inputs. To the extent that the firm wishes to grow faster than these internally generated funds allow, it may obtain money from outsiders by borrowing (or selling bonds) or by selling equity shares; the investors then have a claim on future income.

Legally, however, the picture is somewhat different.

Federal securities law concerns itself almost solely with investors. It treats investors in publicly traded securities – both bonds and shares – as outsiders, consumers purchasing a corporate product who need to be protected from corporate insiders by an elaborate system of disclosure unparalleled elsewhere in the law. Unlike ordinary consumer protection law, the Federal disclosure system is both proactive and enforceable. The statute and associated regulations require corporations with publicly securities to produce and disclose extensive information. In many instances, disclosure must be pre-approved by the staff of the SEC prior to publication, much as pharmaceuticals must be tested prior to sale – and unlike advertising or labeling of almost any other consumer product. After the fact, investors that invest based on misleading or incomplete disclosure may bring class actions for damages, measured by the profits they might have made had the disclosure been accurate. While such actions have been limited in recent years, they remain far easier to maintain than ordinary tort actions or class actions for discrimination.

A. Entity autonomy and entity liability

Corporate law proper, in contrast, separates the legal entity from the sociological one. A legal corporation is an entity recognized by the law as a legal person – that is, the law in applicable areas (property, tort, criminal, environmental, contract, labor, etc) treats the entity, rather than its participants, as the legal actor. The corporation owns its own property, enters into its own contracts, commits its own torts and crimes, and, at least in the first instance, it alone – not any of its participants – has the rights and responsibilities associated with ownership or actions. Thus, a shareholder of a corporation who enters on corporate property without permission of current management is a trespasser; shareholders do not own corporate property. Similarly, an employee who takes home the product he or she has produced – even a list of contacts – is a thief; employees do not own corporate property even if they made it entirely by themselves. Indeed, under standard American agency and “work-for-hire” law, the

corporate employer – not the creator – ordinarily has a claim to owning even work product that exists only in the employee’s head.

Conversely, if the corporation creates liabilities by contract, tort or otherwise, ordinarily only corporate assets are liable. Corporate participants, even if they have profited from the corporation in the past, have no responsibility whatsoever. Thus, a corporation may profit by selling dangerous instruments or products that may generate contingent liabilities – say, cancer-causing cigarettes, polluting shale oil mines, future pension promises, or debt swaps that could generate large liabilities in unlikely states of the world but have no reserves set aside to guarantee them. Once the corporation properly pays its profits out to participants as salary and bonuses, interest or dividends, claimants against the corporation ordinarily lose all claims against the funds. The doctrine that shareholders have no responsibility for corporate obligations is known (misleadingly) as “limited liability.” The parallel doctrines protecting bondholders, employees and others who profit from the firm are so fundamental that they have no name.

There are exceptions, of course. A corporation is barred from paying out dividends when it is insolvent or if the dividend will make it insolvent. If it does so anyway, creditors may recover (within the confines of a short statute of limitation and narrow definitions of insolvency) from the recipients as a fraudulent conveyance or from the board members who improperly authorized the payment.

More significantly, if shareholders, creditors, managers or directors fail to respect the basic principle of corporate law – that is, that the corporation is separate from its investors and other participants and its assets are separate from theirs – courts will often disregard corporate separation. When shareholders treat corporate assets as their own, by, for example, using corporate assets to pay personal expenses or failing to keep appropriate records to allow an outsider to trace the movement of corporate funds into and out of the firm, the doctrine of “piercing the corporate veil” holds the shareholder liable for an insolvent corporation’s debts. When creditors exert excessive day to day control over the corporation, effectively defeating the right of the board of directors to act on the corporation’s behalf, the doctrine of “lender liability” holds them liable. And when directors or managers treat the firm’s assets as their own by using the powers of their office for personal goals at the expense of corporate ones, they too can be held personally liable, this time under the doctrines of breach of duty of loyalty.

B. Using Entity Liability For Fun and Profit

The principal of entity liability, combined with the enormous flexibility of corporate law, leads to two key aspects of corporate law: corporations as shapeshifters (and therefore liability avoiders or, in Dean Mitchell’s term, “externalization machines”) and corporations as taxpayers.

Since the beginning of the twentieth century, corporate law has had neither minimum nor maximum capital requirements.

1. Minimum capitalization and externalization of costs

The former means that a corporation can be operated knowing that it will be unable to meet large contingent liabilities, so long as it is able to meet its current expenses. For example,

consider a corporation that designs and manufactures a highly profitable product with a short lifespan and a valuable brand name (for example, computer chips), with a relatively young workforce, promises of employment security and a generous pension plan (and lower current salaries to compensate), a highly polluting factory that conforms to current law or that is in violation but current penalties are low, and a remote possibility of creating an enormous tort or contract liability (if, for example, a design error causes the product to be unreasonably susceptible to temperature fluctuations or to catch on fire in airplanes or be insecure).

It is entirely legal to place the valuable brand name in a different corporation from the potentially liability creating factories – and to price transactions between the two corporations so that the factory never accumulates enough assets to pay for potential liabilities. It is perfectly permissible to take the profits from the current generation of chips and reinvest them in designing the next generation – or to pay them out as dividends and cede the next generation to another corporation, even though that means that no business will stand behind the future employment and pension promises.

The law places some limits on transactions designed to avoid current liabilities, especially if they currently render the firm insolvent or nearly so. It places essentially no limits on planning to avoid having assets to meet future contract, tort, or environmental liabilities. Certain contract creditors, of course, can plan around this problem: banks may demand security or charge interest reflecting the risk of non-payment, trade creditors can refuse to extend credit, employees may decline deferred compensation (pensions) or insist on controlling pensions independently of the corporation, using either an independent pension plan (as in the union-based Teamsters' plan) or a defined contribution plan not controlled by the employer (TIAA-CREF).

These work-arounds are likely to impose costs, of course. Secured credit is more expensive to arrange than unsecured credit, and the less trusting the creditor is, the more expensive adequate security becomes. Young people may eventually figure out that future promises are not worth much and demand current compensation instead. But employees who expect to be regularly on the job market will spend more time honing their resume and saleable skills than becoming experts in the needs of their current employers.

Similarly, defined contribution plans are inherently far more expensive than defined benefit plan, for example: Defined contribution plans make each saver responsible for his or her own retirement. That means that we lose the benefits of specialization—each individual must learn to become an investment manager (or to choose investment managers, which is just as difficult), instead of a single plan managing for all. It means that we lose the structural benefits of planning – we know that individuals tend to save too little to fund an adequate retirement. Most significantly, we lose the benefits of diversification and insurance: each individual must plan for a retirement beginning in the bottom of one of the stock market's numerous bubble/crash cycles and then extending into a long life; a defined benefit plan, in contrast, has no life expectancy and can exist through multiple market bubbles and crashes. Accordingly, it can plan on average – not minimum – returns and average – not maximum – life expectancy.

Other participants may not be able to work around corporate liability avoidance at all. Tort victims and the environment have no ability to demand security before being injured.

The most significant cost, however, is the breakdown of trust. If corporations routinely plan to avoid some future liabilities, potential claimants need to spend significant time and money watching for traps. If they conclude that they can't find the trap, they may well conclude that they are better off not transacting at all, leading to the collapse of markets as described by Akerloff (Market for lemons). Moreover, market pressures will force other corporations to adopt similarly sleazy tactics: if your competitor is pricing based on the assumption that it need not set aside reserves for future liabilities, you will be driven out of business if you do not figure out how to do the same. The honest and trusting will lose out to the suspicious and manipulative, and we will all be the poorer for it.

2. Taxing the evanescent entity

Since corporations are separate from the human beings who make them up and ultimately expect to receive the surplus the firm generates, the income tax code has made them taxpayers since its origins. That is, the Code requires that each corporation calculate its income and pay income tax on it. If it then distributes its income to others (e.g., as dividends), those others also pay tax on it. Although this is polemically called "double taxation," there is nothing double about it. It is, instead, the simple and ordinary workings of an income tax system: the corporation pays tax on its income, and its shareholders – who are, by the most fundamental rule of corporate law, separate from it, pay tax on their income. Indeed, anytime an individual earns money and spends it on a non-deductible expense, both the original earner and the second recipient have income and must pay tax on it.

For many years, shareholders of small corporations spent significant money and lawyers' time seeking ways to avoid corporate income taxation. The usual method was to seek to avoid having the corporation recognize any income: corporate surplus would be paid out to the dominant shareholder in deductible forms such as salary, interest or rent (each of which reduce corporate income in both GAAP and IRS accounting) instead of non-deductible dividends. In the mid-1990s, we made this enterprise obsolete by largely abandoning the corporate income tax for corporations with small numbers of shareholders: today, most corporations that do not have publicly traded stock are permitted to elect "pass through" taxation. This means that the Code ignores the separate existence of the corporation and instead imputes all its income and expenses to its shareholders – even while other areas of the law, including tort, contract, property and constitutional law, continue to treat the corporation as separate from its insiders and controlling parties.

The enormous flexibility of corporate law creates serious problems collecting income tax from corporations that are not eligible for pass-through taxation as well.

First, we permit two sets of books -- there is no requirement that corporate profits for tax purposes be the same as corporate profits for securities law purposes (indeed, sometimes they may not be the same). Moreover, the tax returns of corporations, even major publicly traded corporations, are private and confidential as if the firm was an individual with an expectation of privacy. This means that corporations are free to (and routinely do) take

conflicting positions: the public financials, to be disclosed to the SEC, creditors and investors (including shareholders) use the flexibility of GAAP to maximize reported profit at the same time that the latter minimize taxable profit. There is no obvious reason, other than aiding tax avoidance, why corporate tax returns should be private or dual books permitted.

Second, corporate boundaries can be manipulated to reduce income or to place it in low tax jurisdictions. Just as a corporation may evade safety regulations by outsourcing – hiring a Bangladeshi corporation to operate a dangerous (but cheap) factory knowing that it will be unable to pay should employees be injured – so too corporations can change their boundaries to avoid taxes. Apple’s practices, recently in the headlines, provide an example. Apple places its trademarks and patents in a corporation that is legally located in Ireland, which does not tax the corporation’s income. The Irish corporation then licenses this “intellectual property” to the US corporation, charging fees that it sets to ensure that all of Apple’s profits are earned by the Irish corporation rather than the US one. The Irish corporation has a single shareholder (Apple), directors appointed by Apple (who are Apple employees located in the US), is operated entirely by people based in the US, and holds most of its financial assets in US accounts at US financial institutions. (See, e.g., Edward Kleinbard, "Through a Latte, Darkly: Starbucks' Window into Stateless Income Tax Planning", SSRN – arguing that Starbucks’ success in placing its income in low-tax jurisdictions means that any corporation can successfully tax avoid).

Reform is difficult if not impossible. If any of these practices threatened its status as an Irish taxpayer, Apple would change them. For example, should Ireland change its tax law, Apple could simply change its internal pricing, relicensing the patents and copyrights at lower prices so that the profits would show up elsewhere. Conversely, should the US insist on taxing the Irish subsidiary, Apple might well respond by spinning it off – that is, giving its shares to Apple shareholders as a special dividend, or selling them into the market – so that the former subsidiary can more credibly claim to be separate from Apple. From a shareholder perspective, little will change: they will have shares of Apple US (which will have little profit and pay minimal taxes) and Apple Ireland (which will be highly profitable but outsource all its development and production to Apple US) instead of Apple alone, but the two sets of shares will represent the whole old company. Operationally, of course, this may be hard to pull off over the long term: top Apple executives will now be working for a firm that lacks control over its major (IP) assets. However, Apple’s business requires constant innovation, so that the IP held by Apple Ireland rapidly loses its value, which may give Apple US enough market power to control Apple Ireland even without stockholding.

Tax avoidance is a problem beyond corporate law: businesses are often tempted to set up operations in low tax jurisdictions, and jurisdictions often compete by offering lower taxes than their neighbors. Southern New Hampshire and Greenwich Connecticut exist as economic centers only because of this.

However, corporate law makes avoidance far simpler. Usually, there is a cost to moving to avoid taxes. Mississippi has low taxes but also lacks the services that taxes buy and the urban concentration only possible with an active and expensive government. Greenwich is close enough to NYC to free-ride on the City’s high cost, high benefit government and

concentration of skilled employees – but locating there means losing many of the advantages of being in the center, including instant and informal access to others in your business and the surrounding ones. In contrast, creating a corporation in Ireland has virtually no cost at all: the entity can be there while the people remain at Apple headquarters in California taking full advantage of the concentration of expertise and information in Silicon Valley.

In recent years, reform proposals have generally centered on eliminating the corporate income tax entirely. However, corporate income is not the same as shareholder income. Taxing only shareholder returns invites vast accumulations of untaxed wealth at the corporate level, which is not only unfair to persons who do have to pay tax, but creates a powerful tax-exempt aristocracy likely to seek to use its wealth to dominate the political process. In addition, shareholder returns often escape taxation in whole or in part. Under current law, shareholders are not taxed at all on unrealized capital gains even if they borrow against them or use options to construct the economic equivalent of a sale. They and their heirs pay no income tax at all on capital gains realized after death (and substantial sums are exempt from the estate tax). They are taxed only at preferential rates on both realized capital gains and dividends. And, of course, a significant portion of the outstanding publicly traded stock is held by non-taxpayers (endowments, pension funds, etc.) that pay no tax on distributions at all.

A more progressive solution would be to tax the worldwide income of every corporation with a US presence or US income, subject to a credit for income taxes paid to other jurisdictions (much as NY state taxes the worldwide income of NY residents and human non-residents with NY income). That would eliminate the “Irish” income game, since Apple would be required to pay US tax on its “Irish” income except to the extent that Ireland actually taxes it. At the shareholder end, elementary fairness suggests that unearned, passive, income (dividends, interest and capital gains) ought to be taxed at higher -- not lower -- rates than earned income (wages and salary). In a world suffering from demand-shortage recessions and swimming in excess savings, with serious problems of regulatory capture by the wealthy (Acemoglu & Robinson), higher taxes on passive income would almost certainly lead to better incentives and stronger growth. Corporations would have incentives to substitute labor for capital or use capital more effectively. This shift in income downwards would increase equality and, importantly, result in increased consumer demand. Since demand is generally the limiting factor on growth of enterprises and the economy, this would lead to faster – and smarter – overall economic growth. If the government used the taxed income to invest in R&D, education, infrastructure, and enforcement of rules against cheating, fraud, pollution and externalization of costs -- all of which are routinely underfunded by the private sector -- the benefits would be greater still.

3. Maximum capitalization and corruption

The latter rule – no maximum capitalization – means that we no longer use corporate law to attempt to prevent corporations from becoming independent power structures in their own right, large enough to bribe or coerce governments or purchase the loyalty of citizens. These major functions of nineteenth century corporate law are, today, left entirely to anti-monopoly (anti-trust) law. However, US anti-trust law abandoned any concern with the political power of

corporations a generation ago (under the influence of Robert Bork's writings) and today is almost exclusively concerned with monopoly pricing in consumer markets.

From the beginning until the Reagan Revolution, the role of corporations in politics was a major aspect of American politics. Edmund Burke and Adam Smith alike were convinced that corporations were centers of corruption, distorting both sound government and market economy to direct profit into the hands of insiders at the expense of society as a whole. Early Americans fought over the Bank of the United States, arguing about the special privileges of incorporation were legitimate in a republic, whether the institution would become sufficiently powerful to dominate its governmental creator, and whether the benefits of economic growth outweighed the threat of corruption. The same battle was repeated over the railroads and then the trusts, with Teddy Roosevelt leading the charge to limit the political power of these great threats to republicanism. Corporate profits, too often, ended up corrupting legislators. This debate has been quiescent since the post-Watergate election finance reforms, but now seems to be reviving in the aftermath of the Citizens United holding, which overturned Teddy Roosevelt's seminal provision that business corporations may not spend corporate money to influence Federal elections.

C. Entity autonomy and judicial review

Entity autonomy also underpins another fundamental principle of corporate law: judicial deference to the internal decisionmaking procedures of the corporation. Courts grant corporate decisionmakers deference quite similar to the deference they accord to governmental agencies under Chevron or to coordinate sovereigns under comity doctrines, or for that matter to patriarchal families under older "privacy" doctrines. Here, the doctrinal label is the "business judgment rule." The content is similar to other deference doctrines: courts will not interfere with the decisions of the powers that be – the board of directors and its delegates – on behalf of outsiders or participants who lost the internal decisionmaking battle, except in extraordinary circumstances. There is no judicial review for simple error by the board or other corporate fiduciaries.

Instead, ordinarily, corporate participants have only political and economic remedies – that is, they refuse to do business with the corporation, may sell their securities (shares or bonds) to another, or, in the case of shareholders may vote their shares against incumbent directors. Specifically, if shareholders sue directors or managers, they must overcome the Business Judgment Rule's presumptions, which protect corporate decisionmakers from ordinary tort liability for breach of their duty of care -- ordinarily plaintiff shareholders seeking to assert such a claim will be required to allege either gross negligence or a conflict of interest. Moreover, most other corporate participants ordinarily do not even have standing to assert a corporate law claim that corporate decisionmakers have ignored their views or interests or violated their rights as corporate participants. (There is a minor exception for bondholders when the corporation is insolvent or close to insolvency).

D. Corporate Power Structures: Boards

Since the middle of the nineteenth century, American corporate law has placed the board at the apex of every corporation (older law sometimes followed partnership norms, with

a membership meeting as the key decisionmakers). Boards are part-time affairs, typically meeting for a few hours monthly, and most directors are only peripherally involved with the corporation they serve.

The law is that the board, and only the board, acts as the corporation. Any other participant – even a sole shareholder – who purports to act as the corporation risks losing the protection of corporate separation under piercing the veil or parallel doctrines. When the board votes at a duly called meeting, its act is the corporation’s act directly.

On most matters, the board’s decision is final. However, the statutes provide that board decisions on a small number of matters – principally amendments to the Articles of Incorporation (the corporation’s fundamental constitutional organizational document), changes in the voting rights of shares, and sales of the company or the equivalent – are not valid until ratified by a majority vote of the shares.

Other corporate participants, including employees, have no authority whatsoever under US corporate law, although, of course, top executives normally control the board’s agenda and often dominate it, and lower level employees may be able to influence the executives.

Corporate law in countries following the German model grant employees of large companies formal decisionmaking power on issues related to employment (investment, working conditions, plant closings, etc.) through two vehicles: the “works council,” which shares governance at the plant and operational levels, and the “Supervisory Board,” one of two boards of directors, elected in part by employees. There is no US equivalent, although faculty governance in universities bears some resemblance to the works council and on rare occasions unions have won the right to a seat on the board (e.g. United during the period in which the union controlled a majority of shares).

There is no corporate law equivalent to popular initiative: shareholders are barred from directing corporate directors. Shareholder resolution on matters of board responsibility ordinarily are barred unless they are purely “precatory” (i.e., advisory and non-binding). Conversely, it is illegal for directors to abdicate their primary decisionmaking duty to shareholders. Thus, for example, corporate directors may not permit shareholders to vote on a merger proposal unless the board has first determined that the proposal is in the best interests of the corporation, even if the board’s view is that the only relevant issue is the price to be paid for the shareholders’ stock. (*Smith v. Van Gorkum*). Similarly, corporate directors may not pledge to follow shareholder commands or direction in hiring a CEO or any other matter. (McQuade)

Board members (directors in the for-profit sector, often called trustees in not-for-profit corporations) are elected. In the for-profit sector, the voters are shares, usually voting on the anti-democratic basis of one share one vote. Since shares of publicly traded corporations are bought and sold on an anonymous market, the voting electorate constantly changes. Accordingly, corporations set a “record date” and time at which the voting constituency is determined; shares transferred between the record date and the actual election are voted by the record date owner, not the actual owner.

In early corporations, the number of votes a single shareholder could control was often limited, but this is unheard of today. On the other hand, it is not uncommon for founding shareholders to have super-voting shares. For example, Messrs. Brin and Page, the founders of Google, hold Google shares with 10 votes each; so do Schulzberger family members in the New York Times and Dorrance family members in Campbell Soup. Often these super-voting shares lose their supervoting privilege if sold to non-family members, thus allowing the controlling family (or particular members) to sell a significant part of their holdings without losing control of the corporate elections.

Board elections obviously have little in common with political democracy, since votes are per share, not per person. Indeed, most of the people who would have the vote in a democratic corporation are entirely disenfranchised: under US law, the employees have no vote at all. In Germany, in contrast, some directors are elected by employees voting on a democratic basis through the Works Councils, and in Holland, each of the shareholders meeting and Works Councils (employees) have the right to nominate candidates from whom the Supervisory Board selects its members, subject to veto by the nominating bodies. <http://www.ejcl.org/64/art64-10.html> TAN3; Krakman et al Anatomy of Corporate Law).

In any event, most shares are held by institutions and voted by employees or boards of those institutions, so share voting should be understood as a peculiar type of “managers supervising managers,” more similar to the internal hierarchy of corporations, in which managers supervise other managers, than to a political system in which the citizenry has ultimate, even if limited, control over its political leaders. Today, a significant percentage of the voting shares of our publicly traded corporations are held by pension funds, and most of the beneficiaries of such funds are currently employed by such corporations. However, ERISA (which regulates most non-governmental pension funds) bars pension fund fiduciaries from considering the actual interests of the actual beneficiaries of their funds: they are, instead, required to vote the shares as if the sole interest of employees and citizens were, counterfactually, to maximize the size of their pension. Mutual fund and most other professional money managers are under intense market pressure to act in the same way. Accordingly, shares owned indirectly by employees and middle-income citizens, thus, are likely to be voted in the interests of an abstract foreigner with no interest in the company or country other than maximizing share value. Under current law and market mechanisms, it is effectively impossible for share voting to reflect any of the ordinary value conflicts of ordinary politics, such as when we should set aside financial interests for other values or even when we should place the interest of employees or customers ahead of those of the stock market.

Additionally, again contrary to ordinary democratic norms, shares – and their associated votes – are freely saleable. Selling votes, of course, is the most obvious form of corruption in democracies; in corporate law it is routine and expected (indeed, the general view is that incumbent management always wins shareholder votes unless the opposition combines its proposals with purchases, or offers to purchase, votes).

Some cases suggest that votes may not be sold separate from the underlying shares. However, this rule does not prevent a party from buying shares shortly before the record date and selling them afterwards, thus acquiring the vote without any interest in the economic

future of the firm. Moreover, modern finance makes separating the vote from other aspects of shareownership trivial. For example, a party that wishes to have a vote but does not want to share in future economic risk associated with the corporation could buy shares and simultaneously buy put options (which give the option holder the right to sell the shares at a fixed “strike” price) with a strike price just below the purchase price. To pay for the put options, the party can sell call options (allowing the option holder the right to buy the shares) with a strike price just above the purchase price. The net effect is that the shareholder retains the shares – but all future price changes will accrue to someone else.

Relatedly, the current voting system appears to allow some shares to be voted twice. As Professors Black and Hu have pointed out, brokerage firms commonly lend out shares that they hold on behalf of their clients to short sellers. If a short-seller borrows shares and sells them, the buyer (which has no way of knowing it has purchased borrowed shares) will be a record owner – but so will the original owner (which also has no way of knowing its shares were lent out).

Board elections are distinctly different from republican democracy in other ways as well. For example, the incumbent board (or a subcommittee) typically controls nominations, ordinarily nominates only a single candidate for each open position, and ordinarily controls proxy solicitations (shareholders vote in person at a shareholders meeting; since this is impractical, most voting is done by proxy). The courts have clearly held that the corporation – meaning incumbent managers under the supervision of the incumbent board – may spend corporate money to campaign for the board’s nominees (and for the board’s position on other matters on which shareholders have a vote), with only minor and functionally unimportant limitations, and may solicit proxies appointing incumbents to vote on behalf of shareholders. In contrast, opponents of management’s position must finance their own campaign, may face procedural hurdles on access to the list of shareholder-voters, and are limited in their ability to use the proxy machinery the corporation operates. (Pillsbury). The upshot is that corporate elections tend to resemble the plebiscites of authoritarian dictatorships more than democratic contests – it is headline news if the opposition wins 20% of the vote.

Not-for-profit corporations may follow the for-profit norms in selecting their boards (as do many coops, including real estate coops). However, not-for-profit corporations need not have shares (and usually do not, at least when they are barred from declaring dividends). They may give the vote to members (on a democratic basis), as is common in clubs and some churches, to alumni or other affiliates, as some universities do, or instead, create a self-perpetuating board, in which the incumbent board members fill vacancies and elect their own successors. Some corporations also have government officials sit on their boards ex officio; famously, from 1642, the Harvard Board of Overseers included various government officials including the Governor of Massachusetts ex officio. (Mass. Const. of 1780 ChV.1.iii; changed in 1865?)

Given that the incumbent board ordinarily controls the nomination process even in for-profit corporations, the difference between self-perpetuating boards and elected ones is not dramatic. Indeed, it is not hard to design a for-profit corporation to have a self-perpetuating board (e.g., by placing a control block of shares in a trust with a self-perpetuating board, as

Hersheys did). As noted above, Holland (formerly?) requires self-perpetuating boards in most large for-profit corporations.

US corporate law places few constraints on who may serve as a director. However, “good governance” practices are widely agreed upon and usually followed. The top executive and, usually, several of his chief subordinates are typically board members.

In the US for-profit sector, the chief executive officer – that is, the top employee of the company – usually also serves as a director and the chairman of the board. Interestingly, in the UK this sharing of positions is illegal; the CEO will usually be a director but is not permitted to serve as chair. The US non-profit sector follows the UK norm: the chief employee, often called the executive director rather than the CEO, is generally a member of the board (although sometimes only in a non-voting ex officio position), but is almost never its chair.

The overwhelming majority of the directors, however, usually are not employees of the company. In the US for-profit sector, they may include large shareholders, but this is uncommon unless the shareholder controls upwards of 10% of the votes. Until recently it was generally considered better that most directors not have significant shareholdings; it is becoming increasingly common for corporations to issue shares to their directors. In the non-profit sector, institutions that depend on donations often fill a majority of board seats with large donors, although they may look for other connections to the corporate as well.

Not commonly, a large bank creditor may be represented on the board, especially of a smaller corporation. (Until recently, this was nearly universal in Germany and Japan, where even major corporations tended to do most of their borrowing from a single bank, a relationship often consolidated by significant cross-holdings of stock). Other corporate constituencies, including customers, employees, suppliers, and bondholders, are almost never explicitly represented on US boards. Indeed, it is regularly claimed that explicit representation would violate the board member’s duty to act on behalf of the entire corporation (although this is not thought to be a problem with respect to directors chosen to represent shareholders or even a particular shareholder). As mentioned above, in Germany and countries following its model, employees control approximately half the seats of the Supervisory Board of all large corporations.

E. Governance Reform

Governance reform has been a regular topic of debate since the 1980s at least, but the successful proposals have consistently failed to improve matters. This is largely due to a misunderstanding of the problem (although in part is a reflection of the weakness of corporate law relative to other, larger, issues such as macro-economic and trade policies, union density, a well-funded regulatory state, and significant public investment in education, infrastructure and research).

Proposals have generally assumed that the basic problem is a narrow conflict of interest between self-interested management and profit-seeking shareholders, with board members typically considered to be overly close to managers. Most reform, therefore, has emphasized making board members more independent from management or more responsive to stock

market concerns. Thus, for example, the principle reform proposed in light of the 1980s rapid rise of leveraged buyouts, with associated union smashing, betrayal of implicit contracts, mass layoffs, and reduced corporate taxation, was to increase the power of the board to resist hostile takeovers and increase the number of independent (i.e., non-employee) directors. The result was that hostile takeovers were replaced by (otherwise similar) friendly takeovers with a larger percentage of the private gains from reduced wages and tax payment going to insiders. Similarly, the initial reform response to soaring executive compensation was to shift compensation to a committee of “independent” directors (i.e., non-employees of the corporation). The predictable result was that committees hired professional advisors who pointed out that the board has a fiduciary duty to fire any CEO who is below average – and detailed, for the first time, the income of average CEOs. Consequently, CEO turnover increased and average salaries increased exponentially, as boards sought to find superhero CEOs and to pay them commensurately, or at least above average to reflect their above average status.

The reality is that the shareholder/executive conflict is by no means the major corporate governance issue. Even highly overpaid CEOs are no more expensive than the rest of the employees, so executives and shareholders can easily agree to expand their joint share of corporate surplus at the expense of ordinary employees. Both CEOs – especially as their tenure has shortened – and stock market professionals suffer from extreme cases of short-termism, and the market forces that market fundamentalists contend will solve this are imperfect at best. So it is not hard for both executives and the stock market to act (not necessarily consciously) in accord with the Wall Street slogan IBGYBG (I’ll be gone, you’ll be gone).

The more serious problems are the usual internal problems of bureaucracy.

First, we have told the corporate elite that their job is to, as Milton Friedman famously put it, maximize profits within the law. It is therefore not surprising that, in general, they have aimed at maximizing profits, including by lobbying to change laws and regulations that might direct their efforts into more productive areas or require them to internalize costs they impose on others. The easiest routes to profit, especially short term, often involve destructive exploitation of natural resources on the model of the buffalo trade of the late 19th century, reducing wages and employment, selling risk to those who do not understand it, rent seeking and monopolization, and seeking opportunities to exploit ignorance and powerlessness.

The simplest profit source of all often is “regulatory capture:” to fund politicians or opinion makers or offer lucrative career paths to retiring public servants, if they support shifting public enterprises and public resources into private hands at discount prices, creating patent and copyright monopolies to allow firms to convert past work into future returns, inventing guaranteed markets (e.g., in private prisons, military supplies and services, retirement finance, or medical insurance), eliminating regulations necessary for a fair playing field, ending the enforcement that prevents a race to the bottom of non-compliance, socializing downside risk while allowing private actors to seize the upside, or simply using government taxing and spending directly to transfer wealth to the already powerful. To develop a new Mickey Mouse would require skill, funds and luck; to extend the copyright on the old one, it turns out, is quite cheap indeed.

If we, instead, want corporations to pursue creating good jobs for Americans, or sustainably producing useful goods and services, it would probably help if our business schools and business press and courts and public opinion makers urged them to pursue these goals. Successful countries teach their civil servants that they should get their satisfaction from serving the public, not personal gains. We used to have a somewhat similar ethos for corporate officers, now distorted into the claim that executives ought to ruthlessly exploit employees, suppliers and customers regardless of the common good – and then selflessly turn their gains over to the stock market. By inviting corporate officers to pursue their own personal economic interests, we have created the corporate sector equivalent of the mass corruption of the Ottoman Empire, USSR or the License Raj.

Second, corporations are bureaucratic enterprises that suffer from the common ills of all bureaucracies. The people at the top make decisions based on incomplete and distorted information which are then ignored by those in the field (see Tolstoy; Best and Brightest). In a modern version of the Peter Principle, the most successful executives are those who make dramatic changes and then move on before they (or others) learn the consequences. Team work is compromised – after all, each subordinate is fully aware that advancing, and probably even retaining a job, requires pushing out several peers, so trust in your co-workers is dangerous. Top leaders are increasingly isolated by wealth and privilege, and increasingly likely to be the sort of people who excel at competition, rather than true team builders.

To the extent that incentives, rather than, information is the problem, the key issue is that money is a poor motivator – it attracts the wrong people and leads them to do the wrong things, emphasizing short term over long term, appearances over substance, trickery over loyalty, plausibility over honesty and the like. Current executive compensation practices – paying the top executives far more than their subordinates, who are expected to compete fiercely for a chance at the slot – amplify the problem by creating a high stake “tournament” for the top position, destroying the mutual trust that is essential for teamwork, and creating artificial gaps between upper ranks and the ordinary employees.

None of these problems are ameliorated by shifting power to the stock market; on the contrary, the stock market offers profoundly powerful incentives that are often profoundly wrong. Stock market portfolios are diversified – that is, shareholders do not bear the risk of success or failure of a particular enterprise. Stocks are easily traded – stock investors have no commitment to particular places or projects. The market readily converts present cash into future earnings and vice versa, and portfolio investors such as mutual funds or retirement funds have no life cycle: they are simultaneously the longest of long term investors and the shortest of short term ones. Standard portfolio theory teaches that investors ought to diversify, because a diversified investor can aim for the highest average return without worrying about volatility along the way.

But no organization can function in this way. A business must be staffed by people, who, unlike stock portfolios, are inherently committed to particular places and time frames, have life cycles and are never diversified. A business can only prosper if it commits to a particular project and particular people to carry it out – exactly the opposite of the ordinary advice for stock investors. Businesses always must worry about the business cycle and the

prospects of particular projects; if they disregard volatility they will find themselves short of funds and customers at the same time as everyone else, and if they aim for the average they fail at their function.

1. Executive stock and stock options

Paying executives in stock, or worse yet, stock options, merely accentuates these problems. The numbers are too large: why run the company if you can win a king's ransom simply by convincing the compensation committee to give it to you. The easiest way to prosper as a stock investor is to have large, diversified holdings and wait – highly paid executives end up expending energy that ought to go into their jobs into, instead, seeking ever more creative ways to diversify their holdings and separate them from their particular company.

Worse yet, top executives – who invariably have a short expected tenure – may succumb to the temptation to doctor the corporate results. It is always easy to increase current profits at the expense of the future: simply cut research, eliminate quality control, reduce staffing, and pump the stuff out the door. If that doesn't work, standard accounting rules means that a merger nearly always offers an opportunity to push expenses and income into different periods, so that the income is today and the expenses are tomorrow or yesterday. Do enough transactions, as GM or Citibank did, and tomorrow may not come for a long while. These practices are, of course, disastrous for those who depend on the company – its employees, customers and suppliers. But profit-maximizing top executives have a different interest: to keep the numbers up just long enough to retire, leaving the mess for someone else to clean up. And professional stock investors are unlikely to care; they can assume that the inevitable drop in stock price when the brand loses its allure or the accounting games reach their end will be someone else's problem. Even if IBGYBG doesn't apply, there is safety in the herd: as Keynes said, a banker's reputation won't suffer if he is "ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him."

In the end, it defies the basic principles of division of labor to believe that professional stock traders and their bosses will be better supervisors of managers than professional managers. Traders are trained to trade; portfolio managers are trained to consider investments as largely fungible bundles of risk and return; bankers are driven by transactions, with little return to long term investments. These habits of mind are more or less opposite those of a good manager and long term planner.

2. Private Equity and Leverage Buyout Firms

The recently fashionable "private equity" approach to governance problem takes these problems to their logical limit. Private equity firms raise large sums in the public markets by selling debt or private equity interest with even fewer governance rights than shares, charging the passive investors fees of a size dwarfing any previously known to either finance or corporate law. Then they use these funds to purchase all the stock of operating companies, paying themselves handsome fees in the process. They use their role as shareholder – with no fiduciary duties – to cause the company managers to extract the maximum amount from the firm, paying some of this to the passive investors and more to themselves, often with substantial side-payments to the top managers. In short, the private equity principals operate

as a particularly expensive and unanswerable extra layer of managers who perceive their mission as extracting the maximum amount from the firm and, as part-timers who participate in the corporation as representatives of the shareholder, lack any day to day knowledge or contact with the sociological firm. It is not surprising that they simultaneously become very rich and leave the underlying companies in ruins – the technique seems closely related to that of rapacious dictators everywhere.

F. Agents

Boards, by their nature, are not fit to run an organization: they typically meet only once a month or once a quarter and only for a few hours, and under current “good governance” guidelines a majority of the members are otherwise not involved in the corporation. Instead, they delegate their power to the corporation’s agents – the corporate employees.

Unlike board members, employees are agents of the corporation. As agents, they have authority to bind the corporation and act for it in tort, contract and other areas of the law under standard agency law. Usually this means they can act for the corporation whenever the board has actually delegated authority to them (actual authority), whenever a reasonable third party would believe they have actual authority (apparent authority) and for actions – such as torts – that are part and parcel of their actual or apparent authority (inherent authority).

Agency law also provides that employees owe the principal (the corporation) fiduciary duties of care and loyalty – they must act on its behalf, setting aside their own interests, with ordinary care. They must accept control and direction from the principal (the corporation). Their work product belongs to the principal unless explicitly agreed to the contrary. And the relationship can be ended at any time by either party regardless of contractual agreements (so fired employee, even if (unusually) not “at will,” may sue for lost wages but not for reinstatement into the position).

In contract ordinary agency law provides that employees will be able to act for the corporation whenever they appear to be the sort of employee that can make this type of contract. By principles of both agency and corporate law, only the corporation, not the employee is bound by the contract: when a customer hands money to a sales clerk in return for groceries, the contract is between the customer and the corporation, not the sales clerk.

In tort, the usual rule is that an agent committing a tort within the scope of agency binds both the agent and the principal. In other words, the tort victim can sue both the employee and the employer. It is not always obvious, however, whether the tort was within the scope of agency: if the corporate employer (via a supervisor) instructs the employee to be careful, is the employer still responsible if the employee is not? Tort law tends to characterize the issue as one of “vicarious” liability: whether an “innocent” employer is responsible as a matter of policy for torts it did not commit. In corporate law, the issue is more accurately understood as one of the boundaries of the firm: the question is whether the tort was committed by the corporation – meaning, usually, by an employee who was acting as the corporation at the time of the tort – or by a private individual not (at the relevant moment) affiliated with the firm.

Nineteenth century courts often accepted corporate arguments that employee agents could not bind the corporation in tort or criminal law. In negligence, this view has lost much of its power: modern doctrine generally holds a corporation responsible for negligent torts committed by its employees during employment. However, in intentional tort and criminal law it is not uncommon for corporations to contend, and courts to agree, that an employee was acting on his or her own even if the tort or crime would not have taken place but for the agency relationship (e.g., hospital employee using status to sexually assault patient on premises). In criminal law, courts often seem to accept corporate arguments that only the intent and knowledge of high level employees ought to be imputed to the corporation, so that it is not responsible for the actions of lower level employees unless they were under provable and explicit direction from supervisors. Of course, modern businesses work in teams; the most risky situations – both economic and tortious – are more likely to be the result of missing safety planning or similar failures rather than any particular person’s malevolent or even careless actions.

Shareholders (and bondholders and other lenders) are neither agents nor principals of the firm for these purposes. Their actions do not bind the firm: a shareholder (acting as shareholder) cannot contract for the firm and it is not liable for the shareholder’s torts even if they are in furtherance of the corporation’s business. Conversely, they are not bound by corporate actions. This is true even when a single shareholder controls all the votes and thus effectively appoints the board of directors and also serves both on the board and as the chief executive officer. In ordinary speech, we would refer to such a dominant individual as the “principal” of the firm – but agency and corporate law are quite clear to the contrary. Unlike a principal in an agency relationship, this individual has no right to control the corporation and is not bound by its actions.

Thus, even a dominant shareholder may not act for the corporation as shareholder (is not its agent), is not liable for its actions and may not instruct it (is not its principal). As a director, the dominant individual again is neither bound nor able to bind (except as a participant in a vote at a duly called meeting) and is similarly irresponsible. As CEO (and therefore an employee), the individual is the corporation’s agent, not its principal – subject to control of the board of directors, obliged to act in the corporation’s interest, able to bind it, but not liable on the corporation’s contracts or torts.

G. Duties and Obligations: contract v. fiduciary duties

The background law of contract in markets is that of strangers: we owe no duty of care towards others. Instead, contract law permits each participant to act in his, her or its own interest, so long as the actor remains within the law, avoiding fraud, violence or other forbidden forms of illegality.

In effect, economic actors in the market are treated as if they were opposing teams, expected to play as hard as possible without cheating. In this world, every gain that a contracting party makes at the expense of the other side is praiseworthy (so long as it isn’t based on misrepresentation). If I walk into a flea market, spot a painting for sale as junk and realize that it is actually a Rembrandt, I have done something admirable if I purchase it for \$10.

It is this kind of self-interested hard bargaining that is thought to power the strong incentives of the invisible hand. The market, we say, makes all better off by harnessing self-interest for the common good. Since each person seeks to get the most for the least, collectively they press for greater efficiency and shift resources to where they are most valued.

Contract inherently redistributes upward precisely because it assumes that the parties are equal and that their agreements are voluntary. Those who can walk, every business advice book says, will always be in the best position to seize the surplus created by trade. Indeed, as every veteran of unsupervised schoolyards knows, if the disparity is great enough, the stronger party need not limit itself to surplus. In every market bargain, the one with the most to lose will get the least; to those who have, much will be given.

The relationship between corporations and outsiders is governed by these contract norms. Corporations, thus, are expected to bargain with their customers and suppliers from a self-interested perspective, giving as little as they can get away with while seeking as much as they can get in return. The key benefit of the corporate form, from this perspective, is that corporations are exempt from the normal rules restricting conspiracy in restraint of trade: when a corporation bargains with its employees, it automatically represents large numbers of dispersed investors behind a single bargaining position, while the employees are legally permitted to unite only under the extremely restricted rules of the NLRA. This, obviously, gives it enormous bargaining power even beyond the usual advantages capital has over labor. Any employee is replaceable; the corporate employer far less so. Each individual employee must consider his or her family, personal, geographic and economic constraints; the shareholders are united in a mass that has no such limitations.

Corporations may have oligopolistic power over employees, customers and suppliers – middle aged employees, for example, are likely to have few alternative employers that can use their particular skills, especially if they are committed to a particular geographic region. Customers and suppliers, similarly, may have few alternative sources of a corporate product. The unity of the corporation, however, is not a conspiracy even though it controls the market much as a conspiracy of producers would. We have virtually abolished guilds and similar devices by which labor united to create market power and to limit competition; corporations, however, perform exactly the same function for capital.

It might seem that the corporation could then turn around and play the same dominant role in the capital markets. However, corporate law requires corporations treat all shares and bonds of the same class equally, which usually prevents corporations from putting investors into the sharp competition that characterizes labor markets.

Bonds and other debtor-creditor relationships are contractual, which is another way of saying that corporations are expected to give bondholders and other creditors exactly what they bargained for- but no more. If the bond contract doesn't protect bondholders from a proposed corporate transaction that might make outstanding bonds more risky (and thereby less valuable), bondholders have no claim against the corporation. (Reynolds). Still, the norm of equal treatment of bonds of the same issue, along with securities disclosure, restrains intra-

investor competition here as well and, again, prevents corporations from taking full advantage of collective power and contract norms.

Similarly, the relationship of corporation to employee is contractual, at least when the terms of employment are being negotiated. We assume that employment creates social gains – we are all better off if the transaction happens than if it does not. However, the division of the surplus is basically zero sum: the more that the employer gets the less there will be for the employee. Contract norms mean that each party – employer and employee – is entitled to take as much of the surplus as it can. Market reality means that, absent strong unions or normative restraints, corporations should be able to seize virtually all of this surplus. We should not be surprised that employees have not shared in productivity gains since the collapse of the private sector and the New Deal ethos.

In contrast, most relationships inside the corporation are fiduciary, not contractual. Fiduciary relationships are radically different from contract – they follow the ethics of teammates, friends and relationship rather than strangers. Instead of competing with their counterparties, fiduciaries are expected to act in the interests of the other – much as teammates are expected to sacrifice for the team, soldiers for their country, parents for their children and friends for each other. Fiduciaries, unlike contractual strangers, are required to accept their counterparties good as their own. Teammates are supposed to cheer, not groan, when a fellow teammate scores a point. Parents should shep nachus from the achievements of their children, not see them as markers in a Hobbesian, zero-sum, competition for status or physical goods.

Employees – from the lowliest to the CEO -- are agents of the firm, and like all agents they owe fiduciary duties of care and loyalty to their principal (the corporation). As servants, they are expected to subject themselves to the firm's supervision. They are supposed to work for the principal, so their work product automatically belongs to the principal, and even their skills should be dedicated to the principal's benefit. In short, as long as they remain employed, they are expected to abandon the self-interested world of contract and, instead, work for the corporate good.

Agency, unlike contract, is not formally equal. The agent owes the principal loyalty, care and obedience. The principal has no parallel duties to the agent. So, as a matter of basic common law, if an employee screws up, the employer has a cause of action against her for breach of duty of care. Employee negligence is always actionable. If, however, an employer negligently fails to produce a viable product, or even deliberately and intentionally decides not to maintain a line of business, invest in necessary R&D or maintain equipment or skills, the employee has no claim at all. (Since the early twentieth century, employees have been allowed to recover for employer negligence which results in physical injury, usually through the Workers' Compensation system). Absent physical injury, the employee's sole remedy – no matter the degree of economic harm -- is to look for another job. Except not on employer time or using assets the employee produced for the employer, since that would be a breach of duty of loyalty. The employer, in contrast, is perfectly free to plan, during the relationship, to use, exploit or replace the employee and owes no loyalty at all.

Moreover, agency, again unlike contract, exists only so long as both parties will it. Either party may end the relationship at any time for any reason or no reason at all, regardless of prior agreements. (If this violates a contract, the courts will allow money damages for the contract, but will not recreate the agency relationship. A fired CEO may be able to recover his lost salary, but he has no claim to his lost position.) This agency doctrine seems to lie behind the US employment at will presumption -- US courts assume that employees have agreed to be terminated at any time for any reason unless they have a clear contract to the contrary. Only the very highest executives do. Thus, for most US employees below the highest levels, even money damages will not be available for termination without cause.)

Directors are not agents. (Agents serve at will, while directors are elected for a term. Agents must agree to accept the goals of their principal as their own and accept direction at least on major issues; directors are barred from accepting limitations on their business judgment. Agents bind their principals when they act within the scope of their authority; as individuals, directors have no authority to bind anyone and as the board their resolution are the corporation's acts directly, not via agency law). However, directors owe the corporation fiduciary duties of loyalty and care that on their face are similar to those owed by agents to their principals.

On a closer look, however, directors' duties, however, are quite limited, relative to the ordinary fiduciary duties of agents. First, there is the basic procedural problem that their duty is owed to the corporation – and ordinarily, the directors have the right to control the corporation's actions. Clearly, a duty that can be enforced only by the bearer of the duty isn't much of a duty.

The statutes and courts have partially ameliorated this problem by the device of the shareholder's derivative action, which allows minority shareholders, under quite restrictive conditions, to bring a suit on behalf of the corporation to enforce its rights. No one other than shareholders has standing to bring this type of suit, which means that in a closely held corporation (including one controlled by a private equity firm that raises its own funds by selling limited partnership interests), the directors may, or must, follow shareholder will and fiduciary duty is of no importance. The derivative action is further weakened by the demand requirement: shareholder plaintiffs must offer the board the opportunity to take control of the lawsuit, and the board's decision (even if it is to drop the suit) is reviewed under the deferential business judgment rule standard (see below). Additionally, Delaware and many other states allow corporations to amend their articles of incorporation to indemnify directors against most types of breach of duty of care actions or even to eliminate damages in these actions entirely.

Second, in order to protect the directors ability to operate the corporation without judicial second-guessing, the courts are extremely deferential to director decisions. The usual rule (labeled the business judgment rule) is that directors may not be sued for being wrong or losing money for the corporation – they are fiduciaries not insurers. In Delaware the business judgment rule also means that they may not be sued for negligence – at least gross negligence or a breach of the duty of loyalty (sometimes only a conflict of interest) must be shown.

Third, the director's duty is to act in the interests of the corporation, but the directors determine what those interests are. Indeed, the directors have primary responsibility not only for defining corporate means but also the corporate ends – and the time frame in which those means are to connect to the ends. Thus, in *Time v. Paramount*, the Delaware court upheld the Time board's decision to reject a merger offer that was nearly universally preferred by shareholders (because it would have been quite profitable for them) in favor of an alternative that the board defended on the ground that it would make Time Magazine a better journal by preserving the "separation of church and state" (i.e., the division of responsibilities between advertising and editorial staffs). The board, the court stated, has no duty to profit maximize in any particular time frame (and it follows as a matter of logic, no such duty at all).

Moreover, most states permit directors, in exercising their duties, to consider the interests and desires of all corporate constituencies. This means that directors need only find some group or role (other than themselves) that gains from their decisions to protect themselves from a claim of breach of duty; usually that should be trivial. Consequently, claims that the directors have breached their duty in merger contexts ordinarily must overcome a burden similar to "rational basis" in constitutional law. Delaware does not have a constituency statute. However, the case law reaches a similar conclusion, so long as the board has not put the company up for sale. (*Time*). If the board does put the company up for sale, the *Revlon* case holds that the directors have an enforceable duty to maximize the price that the shares receive (even at the expense of other corporate constituencies and without regard to the usual reality that corporate participants may have multiple roles).

Shareholders are not in a contractual relationship with corporations – the rights of shares are determined by corporate law and corporate articles of incorporation, not contractual agreement. Nonetheless, shareholders have the same "stranger" relationship to the corporations they own stock in as contracting parties do: shareholders are expected to, and do, act in their own private interests without regard to the effect on the corporation. This is quite important in the private equity context – a private equity firm that owns all the stock of the corporation is entitled to treat the company as if it were purely private property. That is, so long as it stays within the broad constraints of the law of fraud, it may choose to exploit the corporation's reputation by, for example, reducing spending on quality control or R&D, in order to extract short term "profits" even though this mining of corporate resources will destroy the future expectations of employees, suppliers, customers and community alike. Similarly, it may cause the corporation to borrow large sums in order to finance payments to shareholders (i.e., itself), even if it believes that the firm may suffer from the resulting inflexibility and inability to adjust to changing economic conditions.

H. Leverage and its discontents

Since Michael Milken and the invention of the junk bond, American corporations have become much more leveraged than was customary after the Depression. That is, they raise a greater proportion of their investment capital in the bond market than in the stock market. This is a partial reversion to the nineteenth and early twentieth century norm, in which bonds were viewed as more appropriate to retail investors than stock. The great increase in debt has several important effects.

First, debt is destabilizing. (Minsky, but see Modigliani and Miller). Internally, a heavily indebted company has a large fixed cost that is difficult to renegotiate if the company must shrink or shift. This is not to say that renegotiation is impossible; contracts may be legal obligations, but they are only as obligatory as the law makes them. If the company is unable (or unwilling) to pay its existing debt, the bankruptcy courts provide opportunities to force creditors to the table in order to work out a new deal that fits the company's actual prospects. Default, thus, is always possible. However, bankruptcy court is time consuming and expensive; operating a company under judicial supervision is difficult. Most important, customers, employees and suppliers are likely to respond to signs of financial distress by seeking to protect themselves – which usually means finding alternatives rather than building on the existing relationships.

Externally, one company's debt is another company's asset. When that asset turns out to be worth less than expected, the second company may also be in financial distress. Worse, our system of highly dispersed and readily tradeable debt means that no one knows where the debt actually is. When a large institution defaults, outsiders must guess which other institutions will be affected – and seeking to protect themselves, they may restrict credit to otherwise unaffected creditors. That sudden drying up of credit can make otherwise healthy firms insolvent, much as a bank run can destroy a perfectly safe institution.

In the nineteenth century, we saw these types of rolling credit freezes and panics repeatedly. During the New Deal period, they disappeared. However, since the failure of the Long Term Capital Markets fund and the Asian debt crisis, they seem to have returned as a regular feature of our financial markets, and in the aftermath of Lehman's collapse, the productive economy as well. (Minsky).

On the micro-level, however, debt is prized for its incentive and redistributive characteristics.

First, high leverage allows corporations to reduce income taxes without an act of Congress. The corporate income tax taxes corporate income. The IRC's definition of income, which follows conventional accounting, favors debt: interest reduces the corporation's taxable income while dividends are paid out of after-tax income. So if a firm replaces stock with bonds – paying essentially the same amount to the same investors – its taxable income (and therefore its taxes) drops even though it is the same business creating the same surplus (by paying employees, capital and suppliers less than it charges consumers) and paying it to the same financial markets.

Second, high leverage may give the corporation greater power in negotiations with employees. If a highly profitable firm seeks to shift surplus from employees to investors, employees are likely to react with resentment if not resistance: no one likes to be told that they need to sacrifice so that others can receive unearned income. However, if the same firm, creating the same surplus, first contractually commits to pay the surplus (and then some) as interest, it is in a better position to squeeze employees.

Interest is not commonly understood as a form of profit distribution, and bondholders are not shareholders, even though in reality the same funds are being paid to the same

undifferentiated capital markets. Using conventional accounting, managers can demonstrate to the employees that the company is losing money rather than making money – even though the underlying economics have not changed. Thus, managers can present the issue as an involuntary crisis in which everyone must sacrifice for the good of the whole. Without mutual sacrifice, the firm will end up in bankruptcy (with the implicit threat of dissolution or loss of jobs). Employees are more likely to respond positively – pulling together for the good of all is quite different from being asked to self-exploit. (And, of course, if they do not, the bankruptcy court is empowered to ignore long standing contractual and collective bargaining obligations). The net result, however, is the same: a portion of the corporate surplus that formerly went to employees can now be redirected to investors (and top management). The same company using the same processes and selling at the same price to the same customers will pay less to labor and more to capital.

Third, the process of reorganizing the company creates a moment of instability in which various implicit understandings can be broken, allowing insiders to exploit other corporate participants. In the famous RJR reorganization, for example, preexisting bondholders had charged interest appropriate to a low risk operation; when the company added debt to become risky, they were forced to bear this risk without compensation. This is a straight redistribution from earlier investors to the later ones (junk bond holders, stockholders and executives).

In many companies, the longest term investors are employees who worked at relatively low salaries early on in their careers or invested in firm specific skills rather than more readily marketable general ones. Increasing leverage forces those employees – much like the RJR bondholders to bear uncompensated risk. The benefits go to those who seize the upside while leaving employees to worry about the downside: insiders, top executives, and financial investors.

IV. Corporations and politics (skip A, B, and C)

A. Liberty, Justice and the American Way

The liberal social contract tradition to which we are heir infuses virtually every strand of American political discourse. As summarized in our Declaration of Independence, this tradition asserts that governments are created by people for human purposes – they are not expressions of a natural or heaven-sent hierarchy, but attempts by people to improve their lives. Our governments, unlike those in, for example, the Augustinian tradition, are primarily concerned with this world, not the next: their goal is to keep to peace, the “promote the common Welfare” (in the words of the Constitution’s preamble), and to help us to pursue our individual and collective pursuits of happiness.

In the liberal vision, we need government – and it threatens us. On the one hand, the government protects us from civil war (in its most extreme form, Hobbes’ war of all against all, or the Talmud’s fear that without government men would eat each other alive). Similarly, we need government and the rule of law to protect us from feudal aristocracies and their newer

equivalents, Teddy Roosevelt's malefactors of great wealth -- to restrain the great and powerful, who may seek to purchase the loyalty of minions who will, in turn, help them to impoverish or enslave the rest of us.

At the same time, government itself threatens us. Hobbes' proposal to end civil war by creating an all-powerful state is a cure barely better than the disease. Instead, we want protections and policies to ensure that government works to "guide men in their ways" (Hobbes) without imposing a uniform goal and way of life on each of us. We rejected the European tradition of religious law, long defended on the grounds that no nation could hold together if its members did not worship the same god in the same way or that the highest purpose of government is to ensure that its subjects do not burn in eternal fire. We want a government that – in contrast to the king that Samuel promised the Israelites – will not take our possessions and children, and that – in contrast to the Inquisition – will allow us to find our own ways to express our deepest commitments.

Accordingly, republican government in the American mode is quite limited, especially compared to the classical Greek republics or the modern totalitarian and authoritarian regimes with which we compete. We seek, usually, a government that will help us to live healthy, wealthy, and happy lives without conscripting us into an all-encompassing national project of social or religious redemption or imperial expansion. Instead, we aim to live in peace with those who disagree with us even on fundamental questions of religion and, more generally, the good life. We have decided to sacrifice the pleasures of the conformist mob in order to create spaces for us to live private lives and develop our own commitments, communities, values and projects. (Historically, of course, this tolerance of difference extended even to the intolerable: the American experiment in living with difference began in our great compromise over slavery. The authors of our original Constitution tried, and failed, to found American freedom on toleration of slavery. It took a Civil War to reject that notion and to recognize, instead, that freedom requires fundamental limits on the power any person can have over any other, that equal protection of the laws must extend to all Americans, and that all of us, not just an elite few, are part of our national project of liberty, equality, and pursuit of happiness.)

Governments, first and foremost, must restrain private violence – the violence of anarchy, of feudalism and of slavery. But government is not merely or even primarily negative. Beyond keeping the forces of anarchy – Somalia or Lebanon – at bay, it must provide the rules and structures that let us feed and clothe ourselves, educate our children, create and enjoy our culture, create and work and worship and play. We need schools, roads, electricity, fire protection, pensions, sewers and public health departments, hospitals and transportation. We depend on markets to govern many of our relations between ourselves, but markets exist only where governments are strong and independent: unless governments stop them, too often, the strong will be tempted to take instead of paying, the sly to deceive instead of producing, the quick-witted to steal instead of trading. Prosperity requires rules and norms, and trust and confidence, and institutional and physical structures that allow and encourage people to work in ways that help others as they help themselves: Adam Smith's invisible hand is a creation of politics, not an immanent feature of God's world.

B. The Function of Corporations

Today, nearly all things that are worth doing, or that provide us the necessities of life and the luxuries that make it exciting are too much for a single person to do. Few of us want to become self-sufficient pioneers living in isolation in the wilderness, or would know how to survive if we did.

Moreover, most things worth doing require a level of coordination and planning that demands, in turn, large organizations and bureaucratic enterprises. We would not have cars or computers or carrots in the corner grocery store – or any other accoutrement of modern life -- if, like a medieval town, workmen worked alone or in groups of two or three, coming together only sporadically on market day to sell their products to each other.

Most modern projects are collective, in the sense that they require organized and coordinated efforts of many people, often working without direct contact with each other, over extended periods of time and extended spaces. Even as solitary as act as my writing depends not only on my teachers and the institutions that sheltered them and allowed them to pass on their discoveries, and the students who – quite indirectly and with assistance from great national systems of finance – pay my wages, and the farmers and factory workers who feed and clothe me and the markets and transportation that tie their efforts to my needs, on my computer and its internet connections, on the police and firemen and teachers who ensure peace around me, but on an astonishingly complex system of institutions to bring my peckings to your attention. Most of these organizations – businesses, schools, agencies, churches, associations – are organized as corporations (or legal entities resembling corporations). The markets we are so proud of are merely one of the regulators filling the spaces between these corporate enterprises – and even markets themselves are, quite often, corporations or run by corporations.

Corporations are a major part of how we organize our collective life. Indeed, corporations may be the most distinctive feature of modern capitalist economies. Modern business corporation law is quite new – the basic rules that govern our multinational business corporations were fixed in their modern form only after the First World War, with critical parts even more recent. But the concept of the corporation and many of the basic characteristics are ancient – they appear in recognizable form in Roman law. Since the middle ages, cities have been organized as corporations – that is, as self-governing, somewhat autonomous organizations, entitled to make laws (“by-laws”) for their citizens and subjects, to hold property and enter into contracts, and to deal with the king or other external authorities as a single entity (“legal person”) separate from its officeholders or other people connected with it. Those continue to be the basic rights that corporate law grants all corporations – cities and other governmental agencies, non-profits and churches, and business corporations alike.

We depend on our corporations much as we depend on our other governing agencies – to order our lives, to coordinate different people’s activities, to set the rules that it possible to work together with others, to provide jobs and the goods and services on which we depend.

We also grant them many of the rights of government: corporations can enact rules (we call them “by-laws”) that bind their participants without consent; they can maintain security

with security forces under their own control; they can adjudicate, discipline and punish (most dramatically, by firing employees and cutting them off from income, benefits and community, but also by unilaterally cutting customers off from necessary or convenient services or circulating negative information to others based on the organization's own determination of wrongdoing); they can direct and conscript those within their authority (unilaterally directing employees in doing their jobs, controlling collective funds and determining how to spend them without the consents of employees who made the products or services sold, customers who paid for them, or investors who financed them).

C. Democracy, Markets and Corporate Law.

We use democracy (voting), markets (bidding), bureaucracy (public and private planning) and courts (litigation on the basis of precedent) as our primary decision making systems.

Despite its flaws – voting is a blunt instrument at best – the democratic system must remain supreme, in the sense that the politicians must set the domains for the other systems. Voting, not bidding, must decide what should be for sale and what must be protected from market pressures, when markets are creating social goods and when they are highly efficiently producing externalities or misery. Otherwise, we will all be slaves to the richest.

When we allow backwards looking courts, reasoning from precedent rather than social needs, to determine what change is required, bad results are to be expected. The law protects the status quo, and the Supreme Court most often intervenes to protect economic incumbents or abstract laissez-faire contract law principles that protect the right of the wealthy to convert money into power. Thus, the typical decisions are not *Brown* but *Dred Scott* (protecting slavery and excluding African Americans from privileges of citizenship), *Lochner* (barring workplace safety and maximum hours laws), *Hammer v. Dagenhart* (striking down ban on child labor), *Pollock* (overturning income tax), *Erdman* (finding Yellow Dog contract constitutionally protected), *First National Maintenance Corp v. NLRB* (holding that employers have unilateral right to close plants, thus vitiating protections of unions), *Eldred v. Ashcroft* (upholding quasi-permanent copyright despite Constitutional language), *Buckley v. Valeo* (limiting Congressional ability to prevent purchasing of elections), *Virginia Pharmacy* (finding guild-like professional protections unconstitutional).

D. Limiting Corporate Power: Corporations as Limited Government

The liberal tradition gives us the basic framework we need. Corporations are a form of government and we know how to approximate a decent government.

First, we need to end the concept of ownership. Much as we fought to stop kings from claiming the public treasury as their personal property and auctioning off government offices to the highest bidder, we need to regularize the corporate world. Our largest economic institutions need, of course, to be responsive. But having them for sale to the highest bidder is a foolish form of responsiveness.

Second, we need to create a framework of fundamental rights. Corporations, just like government, can overreach. We, as individuals aligned against aggregated power, need basic rights.

These should include privacy. On the one hand, we need protection against Big Brother against our employers and suppliers, not just the state. When credit agencies can cause us to lose access to essential services or even jobs, or private landlord registries can lead to tenants being blackballed, private power has gone too far. If such information is to be collected and distributed at all, it must be done in accordance with something like the due process rights we'd be entitled to in a democratically responsive government agency.

On the other hand, we need something like property rights in our personal information and privacy against corporations not just the government. Instead of our having to plead with insurance companies or Google to learn what they know about us, they should be required to pay royalties for use of our information. , should be denied the right to appropriate and sell our personal information.

On the third hand, we need basic rights against arbitrary searches and seizures, at work and on our computers. As big data increases, privacy law needs to expand as well.

They should include the right to information that underlies them. Public opinion remains the greatest restraint on arbitrary power and sunshine the best disinfectant.

Major corporate bureaucracies, as power centers with far more potential to do damage than the Highway Toll Authority, should be subject to public disclosure similar to open records laws. In general, we'd all be better off – and markets would be more competitive and more successful – if companies were required to disclose more. The private advantages of secrecy are usually public costs: copying, as a rule, is exactly how progress is made.

Internally, we need to protect dissidents and dissent inside corporate bureaucracy for the same reason we protect them in the public arena: questioning catches error and reduces the dead-weight of group think. Corporations ought to have parallel structures, like an ombudsmen or the GAO, to ensure that employees can step out of the chain of command when the chain is not functioning as it should. And the squeaky wheel needs some protection.

We need to end, or at least limit, exile. Corporations, like states, work best when they must accommodate rather than expel their Socrates. Only if employees have some right to tenure – perhaps less than in the civil service, but more than employment at will – will they be able to challenge the powers that be. Better yet, a national commitment to a tight labor market – unemployment below 4 or 5% -- would give us the benefits of tenure without its formal rigidity.

Third, we need to rethink corporate governance radically. We structure corporations as top down command and control systems, answerable only to a board that, in the for-profit sector is for sale. They need a dose of democracy. Corporate boards, at least in part, should be responsive to the actual human beings who are dependent on them.

Relatedly, we need new systems of accounting. GAAP is intended to determine what part of the corporate surplus shareholders can expect to receive. It works, imperfectly, for that

goal. But we also need a concept of social profit – allowing us to measure whether the firm is producing value or merely redistributing it. We need to be able to distinguish between companies that make profits by leaving their messes for others to clean and those that are actually doing what we intend, which is to make more than we had before. We need to find better ways to measure whether corporations are creating good jobs and useful services and to reward those who do, rather than those that destroy them.

And, perhaps, as we enter the second century of surplus so great that our central social problem is not production of stuff but ensuring that customers exist, perhaps we need to rethink the way that corporations distribute their wealth. Collectively, we have more investment capital than we know what to do with – but less education, fewer trains and other modern forms of transportation, insufficient renewable energy, far too much carbon waste, and more than enough inequality. Can we reconfigure our most successful enterprises for our modern needs?

E. Freeing Corporate Productivity: Restraining Corruption and Elite Capture by Democracy

We depend on the democratic branches of government to structure the market. This can only work if the market does not dominate the government.

Classically, market dominance of government was known as “corruption.” Today, unfortunately, the Supreme Court has given us a narrower meaning of the word, extending only to explicit “quid pro quo” purchase of a vote. That, of course, is not how corruption ordinarily works. The real problem is that politicians and government officials, and corporate officials, place their personal interest in getting rich ahead of the common good.

Unfortunately, corporate influence over government – which Teddy Roosevelt once maligned as “malefactors of great wealth” and saw as the greatest threat to republican government – is today enshrined as Free Speech. Corporate “speech” is not, and cannot be, free in either sense. First, corporations can only “speak” by paying an agent to represent them, so the speech is expensive, not free, an economic rather than a political transaction. First Amendment abstention, in this context, is just another way of saying the richest get to buy what they wish; it is equality of dollars rather than of citizens.

Second, no one in the corporate system is free to say what they believe (unless they conform their beliefs to their legal role). The actual speakers or writers are corporate agents and servants, required by law to set aside their own beliefs and act as they are told by their superiors. So are their superiors, right up the board of directors. The board, of course, takes direction from no one. But directors, too, are required by law and the norms of professionalism to set aside their own beliefs. The law requires them to act in the interests of the organization – even if, as will often be the case, those interests diverge from the wishes, values or interests of the people and the Nation. To the extent that they violate this obligation, which is difficult to enforce, of course, they are simply stealing corporate money for personal purposes. Free

speech rights do not, or should not, include the right to promote your view using money not your own.

Most important, though, corporate money will be spent to manipulate us. This is not the reason we created corporations. Nor is it conducive to economic prosperity or growth. Profit maximizing firms able to use their expertise in advertising and their detailed knowledge of their business context to influence politicians and regulators will inevitably act in anti-social ways. There is nothing more profitable than rules that others must follow but you need not, or than forcing others to pay your costs and assume your risks while you take the benefits and profits.

We need to restrain corporate influence in politics to free democracy. But at the same time, so long as corporate power exists, we need to redirect it internally. We have not abolished the state but tamed it. The next step is to place corporations under democratic and republican control – internally, by creating a broader franchise, and externally, by reasserting the primacy of values over valuation.