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What is Corporate Law's Place in Promoting Societal Welfare?:

An Essay in Honor of Professor William Klein

Randall S. Thomas[†]

Professor William Klein has made many important and long-lasting contributions to the field of corporate law. My debt to him began over ten years ago when I started using his casebook, *Business Associations: Agency, Partnerships, and Corporations*. It shaped my teaching and my thinking in many ways, as I am sure it has done for countless others. Along the way I have read much of Bill's scholarship, and I have always found that it contributed valuable insights to my understanding of the field. Now, once again he has helped me to think about a tremendously valuable project: elaborating a set of criteria for evaluating corporate law. As is apparent from all of the papers in this Symposium, this is a very challenging task.

Bill has provided us with an interesting outline of potential criteria for evaluating what is good corporate law. After mulling over his criteria, I am not sure that any single one completely captures my views. It strikes me that the overall goal of good corporate law should be to assist private parties to create wealth for themselves and the economy in a manner that does not inflict uncompensated negative externalities upon third parties. The rationale for this is not controversial: the state should encourage private businesses that produce goods and services because creating greater wealth is generally beneficial to society. Corporate law can act as a helpful precondition for faster economic growth by protecting private parties' expectations, encouraging savings and investment, reducing transaction costs, minimizing agency costs, and compensating third parties for any harm that they may suffer from this business activity. Let me elaborate briefly on each of these points.

My first principle for good corporate law is that private parties should be able to bargain to maximize their wealth. The protection of private bargains should, therefore, be a bedrock principle of corporate law. This idea rests on the principle of Pareto optimality, that is, that generally the parties would not agree to a bargain that did not make each of them better off. From an *ex ante*

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perspective, adherence to this principle gives each party incentives to bargain for the best deal possible without the threat of having to renegotiate the outcome in the future.

It is important to recognize, though, that people operate subject to bounded rationality, that is, they make decisions based on imperfect information and with limited abilities to process that information. Better information at a lower cost can help rational investors make better investment decisions. This is an important justification for government intervention in creating and distributing information. One can view the federal securities laws, for instance, as a relatively low-cost method of widely disseminating important financial information about publicly held companies, cheaper than the alternative of having each investor spend substantial resources verifying whatever information firms might choose to distribute voluntarily or the alternative of having every analyst incur duplicative search costs to learn the same thing.

Individual cognitive limits on processing and interpreting information may also lead us to consider intervening in the private bargaining process. Unlike the traditional economic assumption of full information and perfect knowledge, bounded rationality recognizes that in certain situations, we may find systematic deficiencies in the ways that investors think and act, which require the state to intervene to protect them. The danger here, of course, is that whenever we regulate the substance of the parties' bargain we undermine the *ex ante* incentives that they had to bargain efficiently.

The problems of close corporations provide many illustrations of the conflict between protecting private bargains and recognizing the principle of bounded rationality. Consider the private company that experiences the unexpected death of its first-generation business founder followed by a distribution of all of the firm's stock among her three children according to the terms of the founder's will. Perhaps due to her untimely death, or perhaps intentionally, the founder put in place no ancillary contracts defining the rights of the future shareholders. Over time, two children become the controlling managers of the business, while the third child is left in the position of a minority shareholder. This child has no employment interest in the firm and wants to be bought out. However, the controlling manager children are happy to keep things the way they are—paying themselves high salaries and enjoying the perks of office, while paying out as little as possible in dividends to their sibling.

How should we resolve this situation? If we enforce the standard corporate law presumption of majority rule, we leave the third child locked into the firm for as long as the controlling shareholders want. In a world of perfect information and complete knowledge, this must have been the bargain that the founding parent intended by dying with a will that provided for pro-rata distribution of her estate and no side agreements, such as buy-sell provisions.

Delaware seems to have accepted this perspective, leaving the minority-shareholder child without much recourse.

However, if we take bounded rationality seriously, then we might ask whether this outcome might not be the result of the founder's imperfect knowledge and limited ability to act before dying. A sympathetic court applying an involuntary dissolution statute could require the controlling shareholders to buy out the third child if it believed that the current arrangement was oppressive. Many states have corporate law statutes that permit courts to take such action.

How much would this type of judicial intervention undermine the parties' *ex ante* incentives? Certainly everything would have been much easier if the founder had acted with perfect knowledge and complete foresight to explicitly address this potential situation. If we solve the lock-in problem using the involuntary dissolution statute in this case, we remove some incentives for other founding families to act with greater foresight in the future, and we may be disrupting the result that the founder intended. Still, I am left with this nagging sense that the founder's bounded rationality is what caused the situation to end up as it did. After all, what parent knowingly inflicts such misery on their children?

There are two other challenges that we must address once we use bounded rationality as a motive for letting government regulators and judges in the door: first, how can we limit government interventions solely to those cases where there are problems truly stemming from bounded rationality? Second, assuming that we can limit intervention to such cases, how do we know that regulators and judges will *ex post* get it right? Answering the first question would take me far afield into debates about bureaucratic empires and questions of regulatory capture, a fruitful trip for sure but far beyond the boundaries of this short Essay. Suffice it to say, there are real concerns that we can draw hard lines that limit government intervention effectively here. On the second question, though, I think there is reason to expect that regulators and judges can *ex post* figure out what the right term(s) should be. In this setting, regulators and judges have the opportunity to gather the requisite information to make informed decisions that will reach an appropriate result.

My second guiding principle is that corporate law should encourage greater savings and investment with well-defined, bright-line rules that aid long-term decision making and institutions that allocate capital to the highest valued usage. Savings and investment are frequently long-term decisions, and people will be more apt to undertake them if they know they will get what they bargained for. Institutions, such as securities markets, that facilitate connecting savers and investors, will benefit society by increasing the depth of financial intermediation in the capital markets. This creates greater growth and faster development in the economy.

A related issue is whether growth will be faster with greater or lesser degrees of income inequality. Economists disagree over whether greater inequality leads to greater growth or vice versa. We know that the wealthy save more than the poor. If their savings is productively invested, grows, and remains in the hands of the few, then society's wealth will increase but become more concentrated over time. Increased concentration of wealth may or may not be a good thing, yet, we know that one feature of every modern capitalist society is some degree of wealth redistribution from their richer to their poorer members. Nevertheless, countries differ over how much redistribution they engage in and the mechanism that they use to accomplish it.

The knottiest corporate law problem this question raises is whether directors should place shareholders' interests at a higher level than other corporate constituencies. If directors were to adopt a more European approach, thereby elevating labor's interests closer to being on par with those of capital, then presumably this would reallocate some wealth away from capital to labor. Certainly, one of the underlying motivations behind union shareholder activism in the United States has been to nudge directors toward more pro-labor economic positions. To the extent this debate is decided politically within the corporation, there is no need for corporate law to intervene. Even within a regime of shareholder primacy, directors have plenty of room to choose whether capital or labor interests need to be better protected to maximize the long-run value of the firm.

For my purposes, the key issue is whether mandatory corporate law should force directors to re-allocate corporate rents to further the goal of income redistribution. If one were to embrace the goal of redistribution, I would think that mandatory corporate law would be a very imprecise method of accomplishing it. Should a board decide to further societal goals by mandating that workers receive increased payments from the firm even if they are not required to do so by contract? If so, should all workers receive the payments, or should the board differentiate between them based on their abilities or incomes? To my mind, tax policy and social welfare programs are better and cleaner mechanisms by which to shift wealth between defined segments of the population.

My next principle is that corporate law should minimize the transaction costs associated with private bargaining. It should do so by offering the parties a set of default rules. To the extent these rules are useful, they cut down on the number of issues that the parties need to bargain over, and they lower the cost of bargaining. The choice of what the right default rules are, though, has efficiency implications because if the parties reject the rule and bargain around it, they incur additional costs. Furthermore, the bounded rationality principle might imply some systematic biases in determining who benefits from certain default rules. For example, in a public company, managers could systematically benefit from strong anti-takeover rules if investors fail to accurately price them due to incomplete information or an inability to process efficiently available information.

The race to the top versus race to the bottom debate provides an illustration of the stakes in the choice of the default rule. Race to the bottom theorists argue in favor of federalizing corporate law, while race to the top theorists have been in favor of the existing system of state corporate law. Under a race to the bottom point of view, if the default rules that Delaware has adopted systematically favor managers over shareholders, then the parties could incur additional transaction costs in bargaining around them or investors could fail to adequately price these rules in deciding to buy shares of Delaware companies. Mandatory federal law rules could be efficiency-enhancing if they provided superior alternative default provisions, or led Delaware to adopt better corporate law. Conversely, state law competition might yield superior default rules if investors would prefer to have a choice of alternative regulatory regimes available to them.

Fourth, corporate law should help minimize agency costs. Here, I think it is important to distinguish between private companies and public companies due to the problems created by the separation of ownership and control. In public companies, where there is a separation of ownership and control, agency costs are a significant issue. Good corporate law should help in the effort to minimize those costs, along with norms, markets and internal and external corporate governance mechanisms.

It is difficult to untangle the various strands of corporate governance to determine which aspects add the most value. Corporate law's main contribution could be its prohibition against self-dealing contained in the duty of loyalty. Should it be a mandatory prohibition as it is for public corporations or should we permit the parties to contract out of it as we do in many of the alphabet entities that are widely used by private companies? The current legal distinction has a lot to recommend it. In the private company context, the parties will generally have better information, be more involved in the business, and better understand the information that they have before them. Allowing investors to contract out of the ban on self-dealing may well be value maximizing in this setting. By contrast, in public companies, most shareholders will not be active in the business, will have access only to public information, and may be broadly diversified investors. Their ability to monitor manager (mis)conduct will be very limited, and the limitations imposed by bounded rationality may lead them to systematically underestimate its adverse impact on the value of their investment. A broad prohibition against self-dealing could be justified on this basis.

Finally, good corporate law should avoid creating negative externalities for third parties, and where they are inevitable, it should create mechanisms to compensate injured parties for the harms suffered. One example of where we do not seem to apply this principle in corporate law today is corporate limited liability. In certain circumstances, a corporation can generate externalities that harm others and then use the shield of limited liability to prevent those tort victims from obtaining compensation from the investors in the firm.

Many authors have argued over the virtues of limited liability. The basic debate revolves around whether it is better to stimulate investment by permitting investors to externalize some corporate liabilities, or whether corporations should be required to fully internalize all costs of their operation so that some tort claimants are not left uncompensated. Under current law, shareholders face joint and several liability for all corporate debts if we pierce the corporate veil. Undoubtedly, public companies would see a much smaller pool of equity capital if courts were willing to freely ignore the protections of limited liability. This would be a very serious problem for large-scale enterprises. If, however, we introduced a pro-rata liability regime for these obligations, then the costs of piercing the corporate veil would be greatly reduced. To me, despite the obvious collection difficulties it raises, this is worth considering as a mechanism to force corporations to internalize more fully their costs of operation.

Professor Klein's list contained quite a few other potential criteria for evaluating corporate law, many of which I could add to my list. But I am going to stop here and reflect on this new lesson that I have learned from Bill in using his criteria and thank him for all he has contributed to me and our profession.