January 2004

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Recommended Citation
Margaret M. Blair, Reforming Corporate Governance: What History Can Teach Us, 1 Berkeley Bus. L.J. 1 (2004).
Available at: http://scholarship.law.berkeley.edu/bblj/vol1/iss1/1

Link to publisher version (DOI)
http://dx.doi.org/https://doi.org/10.15779/Z38S585

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Reforming Corporate Governance: What History Can Teach Us

Margaret M. Blair

INTRODUCTION

For more than two decades, a debate has raged among scholars interested in corporate law, governance, and finance about how control over key corporate decisions should be allocated between shareholders and directors. The debate was incited by the spate of hostile tender offers that took place in the 1980s, spurring academic interest in the legal obligations of directors in response to these kinds of transactions. Over the years since, corporate law scholars have generally divided into two camps, one arguing that corporate directors should not be permitted to engage in defensive actions that pose barriers to shareholders’ acceptance of tender offers, the other arguing that corporate

* Professor of Law, Georgetown University Law Center. I would like to thank the Georgetown-Sloan Project on Business Institutions for research support while I worked on this Article. I would also like to thank KC Goyer and Amir Raz for devoted research assistance, and participants in the symposium on "The Role of Law in Promoting Long-term Value for Public Shareholders," sponsored by the Berkeley Business Law Journal and the Mercatus Center (2003), for helpful comments and feedback. All remaining errors of fact or logic are, of course, my own.


2. See e.g., Lucian Arye Bebchuk, Comment, The Case for Facilitating Tender Offers, 95 HARV. L. REV. 1028 (1982) (arguing that directors should not be allowed to frustrate takeover bids but should advise shareholders as to fairness and seek competing bids); Lucian Arye Bebchuk & Allen Ferrell, A New Approach to Takeover Law and Regulatory Competition, 87 VA. L. REV. 111 (2001) (proposing that shareholders should be entitled to opt into a body of federal takeover law that would require the board to remove a pill if a majority of outstanding shares vote in favor of a takeover bid); John C. Coates, IV & Bradley C. Faris, Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives, 56 BUS. LAW. 1323 (2001) (arguing that even shareholder bylaws cannot effectively eliminate the takeover-chilling effect of poison pills); Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161 (1981) (arguing that the decision about whether to accept a tender offer should rest with the shareholders alone, and that directors should be required to be passive in the face of a takeover bid); Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 STAN. L. REV. 819 (1981) (same); Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 CARDOZO L. REV. 511 (1997) (arguing that shareholders should be able to adopt a bylaw that would allow them to control the use of poison pills in takeover battles); Ronald J. Gilson, Unocal Fifteen Years Later (and What We Can Do About It) (June 2000) (Columbia Law School, The Center for Law and Economics, Working Paper No. 177) (arguing that shareholder bylaws can restore to shareholders decision-making power with respect to tender offers that had been denied them by poison pills); William W. Bratton & Joseph A. McCahery, Regulatory
directors, not shareholders, should decide whether control of a company should be sold, and should have protection under the business judgment rule for whatever decision they make.\(^3\)

In addition to the question of who should decide whether a company should be sold to a hostile bidder, the corporate scandals of the last few years have raised serious questions about the quality and effectiveness of the governance of U.S. corporations and have prompted numerous reform proposals as well as at least one major, new piece of legislation addressing corporate governance arrangements.\(^4\) Again, competing diagnoses of the problem and corresponding reform proposals generally fall into two camps: one set of reforms based on

\(^3\) See, e.g., Leo H. Herzel et al., *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980) (arguing that directors' actions in response to a takeover bid should be protected by the business judgment rule); Martin Lipton, *Takeover Bids in the Boardroom*, 35 BUS. LAW. 101 (1979) (same); Martin Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981) (same); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1991) (showing how constituency statutes bring state laws that constrain management decision-making more in line with case law equating stockholders' interests with the corporation's interests); Steven M. H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991) (arguing that directors' duties are owed to the corporation itself, and not directly to shareholders, and that existing law protects them if they make decisions in the face of hostile takeovers to consider "corporate" interests as well as shareholders' immediate financial interest).

Early opinions of the Delaware courts seemed to support the idea that corporate responses to unwanted takeover bids were a matter of business judgment. See *Unocal v. Mesa Petroleum Corp.*, 493 A.2d 946 (Del. 1985); *Panter v. Marshall Field*, 646 F.2d 271, 293 (7th Cir. 1981) (upholding use of business judgment rule to dismiss plaintiffs' claims against directors for successfully defending against takeovers); *Johnson v. Trueblood*, 629 F.2d 287, 283 (3d Cir. 1980) (holding that the business judgment rule protects majority shareholders' decisions unless control is the sole or primary motive); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 701-02 (2d Cir. 1980) (applying business judgment rules to directors' attempts to defend against takeover). Citing *Unocal*, Robert Thompson notes, "the [initial] response of the Delaware Supreme Court was a resounding affirmation of the board's primary and active role and its 'fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived irrespective of its source.'" Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limitis on the Board's Power to "Just Say No"*, 67 U. CIN. L. REV. 999, 1006 (1999). See also Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002) (defending the key choices of the Delaware Courts since *Unocal* as providing an appropriate balance between director control and accountability).

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idea that shareholders need more direct ways to monitor and influence corporate managers and directors, and another set based on the idea that corporations should be run by managers and directors rather than shareholders, but that directors need to be more independent of managers, better informed, and more conscientious in their duties.

In this Article, I turn to the history of corporate law for insight into the role that the corporate form plays in the organization of business enterprises. I then draw implications from this history for thinking about circumstances and situations in which corporate directors should have unimpeded control over business decisions, versus situations in which shareholders should have more input and control over business decisions. In Part I, I review historical evidence of the rapid growth in demand for the corporate form to organize businesses in the United States during the early nineteenth century. I compare the law that governed corporations at that time to the law that governed partnerships and so-called “joint-stock” companies. This comparison, together with anecdotal evidence from the period, suggests that businesspeople found the corporate form to be a superior mechanism for organizing certain businesses largely because it allowed the entrepreneurs and managers to “lock in” the capital invested in the enterprise, thereby making it possible to invest in long-lived, highly specific assets.5

In Part II, I compare corporate law and the law of partnership and other organizational forms today to see whether these forms provide substantially different default rules. I conclude that the lock-in of assets under corporate law default rules is still one of the most important distinguishing characteristics of this organizational form. In Part III, I argue that the decision of a firm’s organizers to choose one organizational form or another, given the wide array of legal form choices available, should be taken as a signal that the organizers wanted the features of the form they chose. I also argue that the default rules of the chosen organizational form, as well as any special charter provisions that alter those default rules, should be taken as evidence of a pre-commitment by firm organizers to the decision-rules implied by that choice of organizational form. In particular, I argue that, in choosing the corporate form, organizers opt into a set of rules and a body of law (unless otherwise specifically indicated in the charter) that yields important decision rights to corporate directors. Among the most important types of decisions yielded to directors in choosing the corporate form are decisions about the dissolution of the firm, distributions of assets, transactions that would fundamentally alter the business or its organizational form, and sales of securities that would effectively transfer

control of the company. If business organizers wanted to make it easier for investors to withdraw assets from the firm, or to make it easier to transfer control to another set of managers for any reason, they could have organized the business as a general partnership or a limited partnership and made provisions in the partnership agreement to give investors control over these decisions. In recent decades, business organizers have had even more options, given the possibility in most states of organizing as a limited liability partnership (LLP), limited liability limited partnership (LLLP), or as a limited liability company (LLC)—forms that can be thought of as hybrids between corporations and partnerships.

Under default rules of the corporate form, equity investors cannot unilaterally decide to withdraw “their” share of assets. Default rules in all of the other forms, however, give non-passive “members” or investors leeway to withdraw from membership at will, and in many cases withdrawal by a member requires either dissolution of the firm or buyout of their shares by remaining members. Thus, I argue that corporate governance proposals that would make it easier for individual shareholders (or shareholders as a group) to “exit” the firm and withdraw capital contradict one of the purposes of choosing the corporate form over other organizational forms. Because the corporate form is the only form that provides effective lock-in of the capital used in the business, investors would lose the ability to pre-commit their capital if corporate law were changed to give shareholders the right to exit easily. Such a reform would, in effect, reduce the number of distinct organizational options now available to investors, and hence, without substantial proof that the option to lock in capital is harmful, or at least not needed or wanted, the presumption should be against such “reforms.”

On the other hand, reform proposals that enhance shareholder “voice” or strengthen the independence of directors are not inconsistent with the original purpose of the corporate form, and may add value by helping to reduce agency costs.

I. WHY BUSINESS ORGANIZERS WANTED TO USE THE CORPORATE FORM IN THE NINETEENTH CENTURY.

In 1800, there were only 335 chartered business corporations in the United States, and most of these had been chartered after 1790. By 1890, there were nearly 500,000 chartered business corporations in the United States, far more than in any other country. During this same period, the United States was

7. See Dow Votaw, Modern Corporations 24 (1965).
8. See Robert Wright, The Wealth of Nations Rediscovered: Integration and
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transformed from an economically weak and dependent country into a world leader in industrial production. How did this happen? This section argues that as the technical advances of the industrial revolution enabled businesspeople to undertake larger, more complex, and more long-lived business ventures, these businesspeople also sought organizational innovations to take advantage of expanding markets and new mass production technologies. In particular, they began to experiment with new organizational forms that had what we now consider to be corporate-like features, including capital raised from passive investors with tradable shares, centralized management, limited liability, and, as I will argue below, some ability to "lock in" capital contributions.

A. The Industrial Revolution and the Need for Long-Lived Business Institutions

In 1800, most commercial activity consisted of small local transactions between individuals who produced products in their homes and other individuals who wanted to buy and use them, or sometimes between the individual producers and merchants who bought products produced by many households and then transported them to markets where they were sold to households that wanted to buy and use them. Only a few types of commercial activity—trading expeditions, banking and insurance, for example—required a significant amount of capital investment to be tied up over an extended period of time. And even for these activities, the capital commitments usually lasted only a few years. From 1800 to 1860, however, the United States witnessed massive advances in transportation, communications, and manufacturing technology that greatly increased productive capabilities in agriculture, mining, and manufacturing, and massively expanded access to markets.\footnote{With the exception of the U.S. postal system, most of the transportation, communications, and manufacturing infrastructure put in place during the first six decades of the nineteenth century was not financed or managed by federal or state government, but rather was accomplished by private businesspeople. See SIDNEY RATNER ET AL., THE EVOLUTION OF THE AMERICAN ECONOMY, chs. 5, 7 (1979).}

This industrial revolution brought new opportunities to businesspeople to undertake productive ventures, such as building and operating roads, bridges, railroads, or factories, that had the potential to continue in operation for decades. In the early 1800s, a group of businesspeople who wanted to undertake a long-term joint business venture had three choices about how they could organize their enterprise.\footnote{A single individual could operate a business as an individual proprietorship, but for purposes of this Article I will consider only organizational forms that involve more than one person.} They could form a general partnership, in which the participants would jointly own and manage the assets of the business and share responsibility for the liabilities of the business. They could form an unincorporated joint stock company, which was a special type of partnership that used trust law to separate the assets of the enterprise from the personal

EXPANSION IN AMERICAN FINANCIAL MARKETS, 1780-1850, at 159-61 (2002).
assets of the partners (or “members” as they were sometimes called). This made it possible to raise capital from passive partners. Or they could attempt to form a chartered corporation.¹¹ A partnership could be formed by a handshake or by a relatively simple contract binding the partners together for purposes of engaging in the business activity. The formation of a joint stock company required a more complex contract in which a trust was created; the resources contributed by investors were put into the trust; and trustees were assigned to manage the trust for the benefit of the investors. Investors were then given tradable claims on any distributions from the trust. Still, these contracts could be drawn up among private individuals and no involvement of the government was required. To form a corporation, however, businesspeople were required to ask their state legislatures to pass a special act granting the business organizers a charter to create a separate legal entity to hold the assets to be used in the enterprise.

Why were businesspeople willing to go to the trouble and expense of seeking a special act of the legislature if they could easily use the other two organizational forms? Why were organizers of corporations willing to yield property rights over the assets used in production to a separate legal entity, rather than retaining a direct pro-rata claim on the assets, as they would in a partnership or joint-stock company? To understand the answers, it is helpful to think about the contracting problems facing organizers of large complex businesses such as those that entrepreneurs first began assembling and operating in the early- to mid-nineteenth century and that continue to dominate commercial activity today.

In previous work of my own and with Professor Lynn Stout, I have described the problem of assembling and coordinating the use of complex inputs for long-term or continuous production as a “team production” problem.¹² “Team production,” as the phrase is used by economists, refers to production that requires various inputs of differing types from two or more individuals, and for which the output is not easily separable into pieces or portions that are attributable to the various inputs individually.¹³ When inputs

¹¹ A fourth organizational form, often referred to as a “Massachusetts business trust,” was sometimes used. This was an unincorporated organization that was very similar to the unincorporated joint stock company, except that the passive investors had limited liability, and the trust could remain in existence only as long as certain specified members were alive. See Norman D. Lattin et al., Corporations: Cases and Materials 62-65 (1968). I thank Arthur Jacobson for calling my attention to this form. See, e.g., Arthur Jacobson, The Private Use of Public Authority: Sovereignty and Associations in Common Law, 29 Buff. L. Rev. 600 (1980) (describing the development of various forms of Anglo-American business associations, including trusts and joint-stock companies). Because of its similarity to the joint stock company form, and because neither joint stock companies nor business trusts are used much today, I will not include a separate discussion of the Massachusetts business trust in this Article.

¹² See Blair, supra note 5; Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1999).

¹³ Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic
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are complex, difficult to specify in advance, and at least somewhat specific to the enterprise, and when outputs are "nonseparable" and risky, it is virtually impossible to draft complete contracts that will adequately govern the relationships among the participants in the joint production process over an extended period of time. Any contract that specifies the division of output in advance introduces perverse incentives into the relationship.14 Any contract that fails to specify the division of the output, however, is likely to lead to costly "rent-seeking" behavior among the participants over time, as the joint surplus is realized.

The three types of organizational structures mentioned above are all based not on detailed contracts among participants, but rather on agreements among participants about process rules for governing how decisions will be made among the participants over the course of the venture. Under the rules of partnership that applied in the early 1800s, businesspeople could form a partnership simply by agreeing to act as partners in undertaking a certain business activity and to share the profits and liabilities associated with the business.15 Partnership assets were considered to be the joint property of the partners, and contracts entered into by any partner with outside parties in connection with the business were legally binding on all partners. Unless the partnership agreement specified otherwise, the agreement was assumed to be at-will. This meant that any partner could terminate the relationship at any time, and for any reason, thereby forcing the other partners to either liquidate the assets of the business or buy out the share of the departing partner. An exception to this default rule would be made if the partners had explicitly agreed to continue in the relationship for a certain period of time, or until certain conditions were met (such as the completion of a particular discrete project or venture). In such a case, any partner could still exit the partnership at will and force dissolution, but the exiting partner might be required to pay damages. A partnership would automatically be dissolved if a partner died, became insane, or entered into bankruptcy proceedings.16

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15. See 3 JAMES KENT, COMMENTARIES ON AMERICAN LAW 1, at 1-13 (Da Capo Press 1971) (laying out the basic features of partnership law, which, according to Kent, had "attained the precision of a regular branch of science" by the time of the writing of his treatise); Robert W. Hillman, Private Ordering Within Partnerships, 41 U. MIAMI L. REV. 425, 429 (1987) (noting that "partnerships are often informally organized, carelessly managed, less than prosperous, and, when viewed individually, relatively inconsequential."). Simple general partnerships can still be formed on a handshake or oral agreement. See, e.g., Bailey v. Broder, 1998 WL 13827 (S.D.N.Y.) (on whether the oral agreements entered into by plaintiff and defendant constituted a "partnership" under New York Partnership Law). See also ROBERT HAMILTON & JONATHAN MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 154 (8th ed. 2003) (discussing "inadvertent partnerships").
16. 3 KENT, supra note 15, at 28 (noting that partnerships were assumed to be "at will" unless
Each partner in a business venture organized as a partnership, therefore, had tremendous power over the other partners. Any partner could enter into contracts that bound the other partners. That partner could incur debts for which the other partners could be held liable. Or he could threaten to withdraw, forcing dissolution of the business, if he did not get what he wanted out of the partnership. And each time a partner withdrew, or died, or had to exit the partnership for some other reason, the partnership had to be reorganized to keep the business going.\(^\text{17}\)

While partners had considerable power to protect themselves against unfair expropriation of the benefits of team production by other partners, the set of relationships embodied by the partnership were vulnerable to disruption by disputes among partners, as well as the death or even just bad luck of one or more partners. This complicated the relationships not only among the partners, but also between the partnership and its suppliers and customers, who surely understood that the partnership was highly vulnerable to dissolution. Thus, while partnerships provided a potential solution to the "team production" problem, they could be difficult to manage over an extended period of time.\(^\text{18}\) Participants in a large network of business relationships in which mutual success depends on numerous individuals making team-specific investments over a sustained period of time require more assurance of continuity and financial stability.

Understanding the vulnerability of the partnership form, businesspeople began using a variation on the partnership form called a "joint stock company." As early as the seventeenth century, joint stock companies were used in Europe to undertake trade missions.\(^\text{19}\) In the earliest joint stock companies,\(^\text{20}\) a group of merchants would pool their "stocks" (the goods they had for trade) and collectively hire a ship to undertake a trade mission. The charters that these

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\(^\text{17}\) Even in contemporary times, casebook authors Robert W. Hamilton and Jonathan R. Macey note that "a general partnership is . . . fragile." HAMILTON & MACEY, supra note 15, at 11.

\(^\text{18}\) Business historian Alfred Chandler tells us that traditional business partnerships in the early nineteenth century were generally "short-lived." ALFRED CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 8 (1977). Nonetheless, a few major corporations, such as DuPont, Carnegie Steel, and Baldwin Locomotive Works, managed to operate as partnerships over several decades in the nineteenth century, not converting to corporate form until early in the twentieth century. See Blair, supra note 5, at 59-64, for a discussion of why these ventures were able to function effectively as partnerships for so long.


\(^\text{20}\) The British East India Company was chartered in 1600; the Dutch East India Company was chartered in 1602. See Hansmann et al., supra note 19, at 43.
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groups had been granted by their respective kings gave them monopolies over the rights to trade, as well as the rights to establish colonies, in certain parts of the world. The companies' ships embarked on trade missions, and upon their return, the stock of goods acquired in trade would be divided among the merchants and the "company" essentially dissolved, to be reformed under the same charter for the next trade mission. Eventually, some chartered companies decided to stop distributing the proceeds at the end of each trade mission and instead commit their initial capital for an extended period. In 1623, the Dutch East India Co. was granted the right of perpetual existence. Under this new arrangement, the company members were no longer entitled to repayment at the end of each voyage, since some funds or stocks were always retained for the next trade mission. Instead, member merchants could, with the approval of other members, sell their "shares" in the company, much the way members of the New York Stock Exchange today can sell their "seats" or membership in the exchange. In 1654, the British East India Company also adopted a rule of perpetual existence, accompanied by full transferability of shares.

During the late seventeenth and eighteenth centuries in the United States, entrepreneurs pursuing other kinds of business, especially banking and insurance, formed similar organizations. Many of these organizations sought charters from the states to give them special privileges, such as the right to issue currency. By the late eighteenth century, however, entrepreneurs pursuing business ventures that did not require any special monopoly or franchise from the state were increasingly using unchartered joint stock companies for such businesses as land speculation and settlement, harvesting and selling natural resources such as coal, small manufacturing (especially of textiles), and building canals and roads.

Legally, unchartered joint stock companies were partnerships in which partners agreed to place the assets used in the business into a trust controlled by

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21. The charters also gave them extended life; however, they did not legally partition the assets by creating a separate legal entity to own the property. At any point in time, the assets of these companies consisted of the "joint stocks" of the merchants who were members of the company at that time.

22. Hansmann et al., supra note 19, at 44.


24. In an earlier article, I trace the history of the Lehigh Coal Mine Company and the Lehigh Navigation Company in the early nineteenth century. Blair, supra note 5, at 399-404, 416-20. Both were unincorporated joint stock companies. Id. at 399, 416. In the 1820s, the two companies merged and were granted a charter as the Lehigh Coal and Navigation Company by the Pennsylvania legislature. Id. at 420.


26. Hugh L. Sowards & James S. Mofsky, Factors Affecting the Development of Corporation Law, 23 U. MIAMI L. REV. 476 (1969), note that there is no record of how many unchartered joint stock companies may have been formed in the late-eighteenth and early-nineteenth centuries, precisely because such organizations were not granted charters, nor were they otherwise registered.
a group of trustees, in exchange for transferable claims on distributions from that trust. In this way, the promoters were able to achieve some degree of commitment of resources to the business venture (i.e., assets in the trust remained in the trust, even as individual investors sold their "shares" to other investors). This form also made it possible for some investors to be passive, since control rights over the assets were vested in the trustees of the trust. This, to some extent, separated the role of control from the role of investment in the business and made it possible to raise capital from a larger number of investors.

But the commitment of resources was only partial. Because the courts regarded unchartered joint stock companies as a species of partnership, members were regarded as holding pro-rata direct interests in the property of the partnership. Although the organizers of a joint stock company could agree among themselves to commit funds to the partnership trust indefinitely, these agreements apparently were not binding on the members' heirs. So, if a joint stock company member died, the heirs could compel dissolution, just as heirs of partners in an ordinary general partnership could compel dissolution upon the death of the partner.

Moreover, the joint stock company form did not completely separate the role of investing from the role of controlling the company. Because courts at the time regarded joint stock companies as a species of partnership, they generally held that the members selected the trustees and could therefore withdraw authority from the trustees at any time. Hence, members were considered to have legal control over the enterprise, and could therefore be held personally liable for debts of the business just as individual partners could be held personally liable for debts of an ordinary general partnership.

Apparently these problems were not considered trivial. In a pamphlet published in 1823 by seven businesspeople attempting to organize the

27. In England, the Bubble Act of 1720, passed in the wake of a financial collapse and associated market scandals, made it illegal to trade in shares of unchartered joint stock companies. This greatly slowed the development of this organizational form in England for more than a century, until the Bubble Act was repealed in 1825. See Ron Harris, The Bubble Act: Its Passage and Its Effects on Business Organizations, 54 J. ECON. HIST. 610 (1994). During that period, the English Parliament granted charters for joint stock companies very reluctantly, which also slowed the development of the chartered corporate form. England did not clear up the confusion and pass a general incorporation act that clearly permitted businessmen to organize themselves into companies and receive a charter simply by registering until the passage of the English Companies Act of 1844 made incorporation more widely available. See Bishop C. Hunt, The Joint-Stock Company in England, 1830-1844, 43 J. POL. ECON. 331 (1935); Paul G. Mahoney, Contract or Concession? An Essay on the History of Corporate Law, 34 GA. L. REV. 873 (2000).

28. Paddy Ireland, Capitalism without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality, 17 LEGAL HIST. 41, 44 n.13 (1996) (citing WILLIAM WATSON, A TREATISE OF THE LAW OF PARTNERSHIP 3-5 (2d ed. 1807)) traces the history of court cases in England, demonstrating that, prior to about 1837, English courts consistently found that shareholders in joint stock companies, whether incorporated or not, had a direct property interest in the assets of the firm. In the United States, it appears that courts followed this line of reasoning for unincorporated joint stock companies, but not for chartered corporations, which, as I explain in the next section, were always understood under American law to be separate legal entities.
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Schuylkill Coal Company and seeking a charter from the state legislature in Pennsylvania, the organizers listed the following reasons why they needed a charter:

1. To have the real estate of the Company, consisting of the coal lands which they hold, and such limited additional quantity as they may be allowed to acquire, with the necessary and appropriate improvements for the working of the mines, exempted from the laws of succession or inheritance, which govern the cases of natural persons or individuals. 2d. That the Company should be exempted from the ordinary laws of partnership, so far as they subject the estates of the several individuals who compose the Company to all the liabilities of the Association. 3d. To be recognized in law by a corporate name, and to be perpetuated, notwithstanding the demise or change of the members who may at any given time compose the Company.29

The pamphlet goes on to stress the particular problem that would arise if a member of an unincorporated joint stock company were to die:

If one of the partners die, his undivided interest will descend by inheritance, or pass by devise to his heirs, who may consist of numerous children, in infancy, or numerous collateral relations, widely spread, and difficult of recognition. The operations of the Company must, on this event, immediately cease, and the joint estate be sold for division, or be otherwise divided between the survivors and the heirs of the deceased member, according to the decree of a proper legal tribunal, perhaps after a tedious suit, involving intricate questions of partnership claims, accounts, and settlements.30

The promoters of the Schuylkill Coal Company were clearly aware of the possibility of using trust law to try to protect the assets of the enterprise. But they were not confident that organization as an unincorporated joint stock company, or the use of the business trust, would provide adequate protection:

Some of these difficulties may indeed be avoided by complicated trusts, covenants, and stipulations; but these, plain men of business cannot themselves frame, nor without difficulty understand; and when framed under the advice of the best legal abilities, they are subject nevertheless, to various constructions, and end but too frequently in vexatious and injurious controversies, which prudent men will anxiously avoid.31

The organizers of the Schuylkill Coal Company obviously believed, and the legal record supports the idea, that if the enterprise were organized under a corporate charter granted by the legislature, these problems could be solved.

B. How the Corporate Form Helped Lock in the Capital

The earliest incorporated entities in the United States were either chartered trading companies that had received their charter from the English king before the Revolution, or they were eleemosynary institutions, municipalities, towns,

29. MANUEL EYRE ET AL., REMARKS AND OBSERVATIONS SHOWING THE JUSTICE AND POLICY OF INCORPORATING "THE SCHUYLKILL COAL COMPANY" (1823) (pamphlet in the collection of the Hagley Library).
30. Id. at 1.
31. Id. at 2.
settlements, or chartered banks or insurance companies. Occasionally, corporations were chartered to carry out some public works project, such as building a road, bridge, or canal, or providing a supply of water to some municipality. As late as 1826, James Kent, in his Commentaries on American Law, observed that English law recognized two broad classes of corporations: "ecclesiastical" or "lay." Ecclesiastical corporations were religious societies that incorporated in order to provide a mechanism for holding property over time, as individual members came and went. Lay corporations, Kent noted, "are again subdivided into eleemosynary and civil." Eleemosynary institutions included hospitals, colleges and universities, or other institutions organized to provide charitable services to the indigent. Civil corporations, on the other hand, were further parsed into "either public or private." By public corporations, Kent meant entities that exist for "public political purposes such as counties, cities, towns, and villages."

Only the final subdivision of "private" corporations included business corporations. Of Kent's categories, private corporations were the only ones that might engage in strictly commercial activity, although in the late eighteenth century even corporations in this category were expected to provide some needed service. Clearly, in all of these categories, the primary reason why the state provided a charter incorporating the entity was to create a mechanism of holding property for some public, charitable, educational, or religious use, so that such property would not be owned by the individuals who at any point in time might be managing the organization or charged with making decisions about the use of the property. Since the property held by an incorporated entity was not owned by individual persons, it could not be passed to the heirs of such persons, but continued to be the property of the institution, even as its "managers" (mayors, bishops, or presidents, for example) came and went. The concept of separate legal personhood was developed with respect to these non-business types of corporations, and it is from this legal development that the law governing business corporations in the United States apparently evolved.

After the American Revolution, the new American states began, tentatively at first, granting corporate charters to business promoters, to establish banks, to

32. See LIVERMORE, supra note 23, at 9-36 (describing "precedent forms of association"); see also VOTAW, supra note 7, at 19 (noting that "the concept of persona ficta did not begin with commercial associations but with religious, educational, and municipal associations").
33. 2 KENT, supra note 15, at p. 221-22.
34. Id. at 222.
35. Id.
36. State courts apparently regarded it as an inappropriate use of legislative power for the legislature to grant corporate status for purposes that were not regarded as in the public interest. See, e.g., Curries Admin. v. Mutual Assurance Soc'y, 14 Va. (4 Hen. & M.) 315, 347-48 (1809) (arguing that "it may often be convenient for a set of associated individuals to have the privileges of a corporation bestowed upon them; but if their object is merely private or selfish; if it is detrimental to, or not promotive of, the public good, they have no adequate claim upon the legislature for privilege").
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build turnpikes, or to provide other needed services. Due to the special public purpose of the businesses that were granted corporate status, it was important that the business property be held separately from the personal property of the individual business promoters, and that it not be subject to being subdivided or otherwise broken up. Ronald Seavoy, for example, notes that "the new classes of incorporated businesses were usually fairly large-scale and they often had a high risk factor."37 Incorporating a business, he added, "helped protect the collective ownership of real property [and] facilitated the mobilization of capital."38

Although state courts would later struggle with the implications of entity status for business corporations in certain situations, and waver back and forth about the extent to which business corporations should be understood as being like partnerships or different from partnerships, the separateness of the incorporated entity from its members or participants was rarely at issue. The whole point of the charter was separateness. In fact, courts eventually took the position that they might "pierce the veil" of the separate entity in order to reach through to the individual persons associated together in the entity only if "the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime."39

I regard legal separateness as the singular accomplishment of corporate law, the characteristic that provided the benefit business organizers so eagerly sought. In prior work with Professor Stout, I have argued that an important feature of the corporate form that helps to solve the "team production" problem is that control rights are delegated to a board of directors.40 Delegation of control helps ensure that none of the participants in the enterprise can exercise too much control over factors that affect the outcome for the other participants. This makes it easier for all of the participants in the enterprise to make credible commitments to cooperate with each other. In a recent, separate article, I argue that another critical feature of the corporate form that made it the preferred way of organizing large, complex businesses in the nineteenth century was that a corporation was regarded as a separate legal entity with potentially perpetual life, and was considered the legal owner of the assets used in the business.41 Holding the property in corporate form, rather than in a partnership or a joint stock company, made it easier to commit resources to long-lived, specialized business enterprises.42

38. Id.
40. Blair & Stout, supra note 12.
41. Blair, supra note 5, at 390-91.
42. Id. at 393.
In connection with the separate legal status of corporations, early corporate charters and general incorporation statutes made several provisions that facilitated the locking-in of capital committed to the corporate enterprise. First, as already noted, neither shareholders nor their heirs could compel dissolution of the enterprise. Second, early corporate charters provided that organizers designate a "par value" for each share of stock issued. The initial shares in the company might be issued to subscribers for a fraction of par value, and the corporation would begin its business with the money raised from these initial installments. But when this approach was used, charters always provided that the corporation could return to the subscribers at any time in the future and require them to pay the rest of the promised commitment.\(^4\) Thus, from the time of the earliest corporations, financial investors who wanted to participate in a business organized as a corporation were required to make substantial financial commitments, and these commitments were considered to be part of the corporation's permanent capital.

Once committed, the capital paid into a corporation by its initial investors could be very difficult to recover. Early charters and statutes typically specified that shareholders or "members" could not withdraw their capital unless the enterprise were to be formally dissolved.

Charters often provided that investors could receive dividends out of operating profits, but not out of the permanent capital of the corporation.\(^4\) Moreover, shareholders did not have a legal right to receive any dividend at all unless such a dividend was declared by directors. Also, early case law emphasized that the resources that had been invested in corporations no longer belonged to the shareholders, but rather remained the property of the corporation unless and until paid out in the form of dividends.\(^5\)

The final feature of corporate law in the nineteenth century that supports

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4. See EDWIN M. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860: WITH SPECIAL REFERENCE TO MASSACHUSETTS 74 (1954). In fact, prior to the nineteenth century, corporate charters commonly did not specify a par value for their shares, and in such cases there was no legal limit to the assessments that could be made against shareholders. See Oscar Handlin & Mary F. Handlin, Origins of the American Business Corporation, 5 J. ECON. HIST. 1, 13 (1945) ("As first organized, therefore, corporations could replenish their coffers by drawing without limit on the resources of all their members."). Thus, the idea of corporations as separate legal persons for purposes of holding property preceded the idea of limited liability. Limited liability began to be a characteristic of some corporate charters in the 1810s, but the state of California did not provide for limited liability for business corporations until well into the twentieth century. See LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 191 (1985) (noting that limited liability was not universally available in the nineteenth century); Mark Weinstein, Share Price Changes and the Arrival of Limited Liability in California, 32 J. LEG. STUD. 1, 2 (2003) ("[T]he last major jurisdiction to adopt limited liability [was] California which did not adopt limited liability for corporations until 1931.").


45. See, e.g., Brightwell v. Mallory, 18 Tenn. (1 Yer.) 196, 197-98 (1836) (noting that "the money in the [corporation] is the property of the institution, and to the ownership of which the stockholder has no more claim than a person has who is not at all connected with the [corporation]").
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the idea that the corporate form facilitated the lock-in of capital investments is the "trust fund" doctrine. The modern trust fund doctrine holds that, in an insolvent corporation, the directors have fiduciary duties running to creditors because corporate assets are held in trust to satisfy creditors first. This doctrine was articulated clearly in an 1824 case,\(^46\) in which Justice Story wrote:

> It appears to me very clear upon general principles, as well as the legislative intention that the capital stock . . . is to be deemed a pledge or trust fund for the payment of the debts contracted by [the corporation]. The public, as well as the legislature, have always supposed this to be a fund appropriated for such a purpose. The individual stockholders are not liable for the debts of the [corporation] in their private capacities. The charter relieves them from personal responsibility, and substitutes the capital stock in its stead. Credit is universally given to this fund by the public, and as the only means of repayment. During the existence of the corporation it is the sole property of the corporation, and can be applied only according to its charter, that is, as a fund for the payment of its debts. . . . If the stock may, the next day after it is paid in, be withdrawn by the stockholders without payment of the debts of the corporation, why is its amount so studiously provided for, and its payment by the stockholders so diligently required?\(^47\)

Thus, the corporate form made it possible for investors in shares, as well as creditors, employees, and suppliers, to enter into long-term relationships with a firm with a greater assurance that the pool of assets would remain in the business to keep the business going forward.

C. Why I.M. Singer & Co. Decided to Incorporate

The story of the rise of the Singer Manufacturing Company provides an example in which the corporate form was used not to raise financial capital, nor to achieve the benefits of limited liability, but rather to lock in existing capital and to provide a mechanism for settling any subsequent disputes among the leading participants in the firm, thereby supporting the development of an extensive marketing organization.

The Singer Manufacturing Company had its start in 1851, when Isaac Merritt Singer got a patent on a machine that would make a continuous series of stitches. Singer had formed partnerships with a number of different people who provided workshop space, equipment, and financial capital while he worked on his machine design. But once he had his patent, he got out of those various partnerships and formed a new partnership with Edward Clark, a lawyer who had pushed through Singer's patent application.\(^48\)

During the next ten years, the market for sewing machines grew, slowly at

\(^{46}\) Wood v. Dummer, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944). This case concerns a bank, but its reasoning has been widely applied to business corporations of all types.

\(^{47}\) \textit{Id.} at 436.

\(^{48}\) RUTH BRANDON, A CAPITALIST ROMANCE: SINGER AND THE SEWING MACHINE 82 (1977). Much of the details about Singer, his business, and his relationship with Clark are taken from Brandon's account.
first, as Singer and several other sewing machine manufacturing firms tried to convince the male breadwinners of households that it was worth spending what amounted to a very substantial amount of money relative to typical household net worth on a device that, from their point of view, had no purpose other than to make women's work easier and faster. Moreover, the various sewing machine manufacturers were continually suing each other over patent infringement claims. Indeed, Singer's design, while containing novel components, was based partly on a prior machine patented by Elias Howe in 1846. The patent wars among Howe, Singer, and the other manufacturers absorbed most of the partnership profits, and virtually all of Clark's time and energy, during the years from 1851 to 1856.49 In the fall of that year, the three leading manufacturers, together with Elias Howe, who among them held dozens of patents on sewing machines and their various improvements—including all of the most important patents—agreed to form the first "patent pool." The parties contributed all of their relevant patents to a single pool, and agreed that, for a fee of $20 per sewing machine sold, they could all use each others' patents.50

With the patent wars settled, I.M. Singer & Co. manufactured and sold 2,564 machines in 1856, and by 1860 production and sales reached 13,000 machines. Singer and Clark were rapidly becoming very wealthy people, and, although still organized as a conventional general partnership, were beginning to build a substantial manufacturing, distribution, and sales organization. They had established sales offices in many major U.S. cities, as well as in Paris, Glasgow, and Rio de Janeiro, and were thinking about establishing manufacturing operations overseas as well. Singer and Clark, despite not particularly liking or trusting each other, had managed to establish a reasonably successful working relationship and had begun building substantial intangible assets in their brand and unique marketing organization.

Meanwhile, however, Singer was thoroughly enjoying his new wealth, and was living an unusually flamboyant life. In 1860, a series of incidents brought public attention to the fact that Singer had domestic relationships with, and numerous children by, at least four different women, only one of whom was legally his wife. To escape the wrath of the woman with whom he had been living the longest and most openly, who called herself Mrs. Isaac Singer (although he and she had never legally married), and with whom he had

49. *Id.* at 89 (describing reports that newspapers of the era carried about the latest developments in the "Sewing Machine Wars"). This example of a partnership deciding to incorporate was previously developed in Blair, *supra* note 5.
50. *Id.* at 98. The first $5 of this fee was to go to Howe, who held a key early patent and had won a series of court battles defending his claim. Another part of this fee was set aside for fighting future patent infringement battles against any other manufacturers who might attempt to use the devices covered by patents in the pool, and the rest would be divided among the three manufacturing firms in the pool.
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fathered eight children, Singer fled to England.\textsuperscript{51}

Apart from the unseemliness and notoriety of this lifestyle (which might have had a negative impact on the ability of the firm to market Singer machines to “respectable” households), why did this matter to Clark? The problem, Clark could easily foresee, was that if the firm were still organized as a partnership at the point at which Singer died, the valuable business which the two of them had built over the previous years would be destroyed in the legal battles over claims to Singer’s estate. Singer’s heirs, however many of them there might be, would undoubtedly all attempt to claim some share of the business, and it would probably require years of court battles to establish who was to get what. Clark feared that without liquidating much of the firm, he would not be able to come up with enough cash to prevent catastrophe by buying out Singer’s share from the heirs.

The solution to this problem, Clark also realized, was to incorporate the business, and Clark hoped as part of the bargain to ease Singer out of active management. By 1860, most states had passed generalized incorporation statutes, and the corporate form was being used widely enough that Clark would have been aware of its advantages. Once incorporated, the business assets would no longer be the joint property of Clark and Singer, but would belong to the corporation. Equity shares would be issued to Clark and Singer, each of which would provide a pro-rata claim on any distributions from the business. But any such distribution would be at the discretion of the board of directors of the company, and could not be compelled by either former partner, nor by the executor of the estate, nor would it likely be compelled by any court of law handling the proceedings. Heirs could be given equity shares in the business out of Singer’s estate, and they could thereby become passive investors in the business. All this could happen without disturbing or breaking up the assets and governance structure of the business.

The company by this time had no need to raise additional capital (it was generating cash faster than it could reinvest it), nor were there any particular concerns about limiting the liability of shareholders: the firm had little or no debt (except perhaps small amounts of trade credit from materials suppliers), and class-action lawsuits for fingers injured by sewing machine thread guides and pressure feet had not yet been invented. The most important function that incorporation served was to ensure that the substantial organizational capital that had been accumulated by the firm could not be torn apart, nor could the firm’s reputation be easily destroyed, as a result of the messy personal affairs of one of the partners.

\textsuperscript{51} This woman was Mary Ann Sponsler, who had been Singer’s most frequent and public companion for nearly twenty years, despite the fact that Singer had never been legally divorced from Catherine Haley Singer, with whom he had fathered two children. \textit{Id.} at 162-63.
According to Singer's biographer, it took more than three years for Clark to get Singer to agree to incorporation of the business. But in August of 1863, I.M. Singer & Co. was dissolved, and the business was reorganized as the Singer Manufacturing Company. The firm by then had twenty-two patents and capital assets of $550,000. Within four years after incorporation, it had established manufacturing and sales operations overseas, becoming the first American firm to produce and market extensively in Europe.\(^\text{52}\) According to Chandler,\(^\text{53}\) Singer was also the first manufacturing company to establish a sales force of its own salaried employees, rather than rely on sales agents. The Singer organization that developed in the 1860s and 1870s included retail branches in virtually every community in the United States with a population of at least 5,000 (as well as in many communities in Europe and South America). Each branch office included, at a minimum, a general salesman, an instructor (often a female employee hired to teach other women how to use the machines), a mechanic (to assure customers that machines could be promptly repaired if they broke down), and a bookkeeper.\(^\text{54}\)

One other detail of the transition of I.M. Singer & Co. to the Singer Manufacturing Company, provided by Singer's biographer Ruth Brandon, suggests that the governance structure established in the newly organized corporation was designed to serve a mediating function, as the team production theory suggests, rather than to establish agents to act on behalf of shareholders, as the standard principal-agent theory of the corporation argues. Brandon says that:

Singer had only agreed to the end of the partnership [in which he knew he would lose his ability to make extraordinary demands on the other participants] under certain conditions, the principal one being that neither of the partners would be president of the new company while the other was alive, and that both would 'retire from active participation in the management of the business.' In other words... if Singer was to become a non-executive director, then so must Clark. If he [Clark] was so determined to dissociate Singer from the business, this was the price he had to pay.\(^\text{55}\)

The agreement they ultimately reached was that Singer and Clark would each take 40 percent of the shares of the new company in exchange for their interests in the partnership, with the rest to be subscribed to by four senior officers of the firm (who were each required to buy 175 shares at $200 per share), and twelve other employees of the company who were offered the opportunity to buy shares. A young manager, Mr. Inslee Hopper, was named president. The initial board of trustees would include Singer, Clark, Hopper,


\(^{53}\) CHANDLER, supra note 18, at 403.

\(^{54}\) Id.

\(^{55}\) BRANDON, supra note 48, at 179.
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George Ross McKenzie (who had been a trusted agent of the firm for a number of years), William F. Proctor, and Alexander F. Sterling.

While Singer did retire from active involvement in the company after that, Clark did not, and after Singer died in 1875,\(^5\) Clark became president in 1876.\(^6\) Chandler credits Clark and McKenzie with building an integrated organizational structure that became a model for many other large manufacturing and distribution companies in the late nineteenth and early twentieth centuries.

II. IS INCORPORATION STILL ABOUT LOCKING IN CAPITAL?

Contemporary businesspeople have a much broader array of organizational forms to choose from than Clark and Singer had. In addition to general partnerships and corporations,\(^58\) entrepreneurs today can organize their business affairs through limited partnerships (LPs), limited liability partnerships (LLPs), limited liability limited partnerships (LLLPs), and limited liability companies (LLCs). They can choose between closely held corporations and widely held corporations whose shares trade on public markets. And they can also choose more complex structures such as joint ventures or organizations in which one or more members or shareholders are other organizations. Within each of these categories, the laws governing their use are generally "enabling," meaning that the organizers can use the standard form provided by the law, or customize their form by writing specific provisions into the partnership agreement, limited partnership certificate, articles of organization, operating agreements, corporate charter, or bylaws (depending on the basic form they choose).

A. General Partnerships

Under the terms of the Uniform Partnership Act (1914) ("UPA"), on which many state laws are based, a partnership is "an association of two or more persons to carry on as co-owners of a business for profit."\(^59\) Under the Revised Uniform Partnership Act (1997) ("RUPA"), a partnership is "an association of two or more persons to carry on as co-owners a business for profit formed under Section 202, predecessor law, or comparable law of another jurisdiction."\(^60\) In states that have adopted this more recent version of partnership law, a partnership is legally an entity separate from any of its

\(^5\) Id. at 193.
\(^6\) CHANDLER, supra note 18, at 403.
\(^58\) The use of joint stock companies died out as the corporate form became readily available to business organizers.
\(^59\) Uniform Partnership Act (1914) [hereinafter UPA] § 6(1).
members, which implies, among other things, that the partnership may continue as the same entity even if some partners dissociate or new partners join. This, in turn, means that property can be held and contracts entered into in the name of the partnership, and that these arrangements do not have to be revised every time a new member joins or an existing member departs. Nonetheless, partners in a general partnership still bear full joint and several liability for partnership obligations.

Under either UPA or RUPA, it is still true today that partnership relationships are assumed to be “at will” unless otherwise specified in the partnership agreement. The effect of this default rule is that a general partner can choose to “dissociate” from a partnership at any time, merely by announcing his or her decision to stop conducting business as a partner with the other partners in the firm. Under UPA, if one partner dissociates, the partnership must formally be dissolved. The remaining partners may continue the business of the firm if they buy out the interest of the dissociating partner, but the continuing business is organized legally as a new and distinct partnership. Under RUPA, a partner’s departure does not necessarily compel the remaining partners to reorganize as a new partnership in order to continue the business.

If the partnership agreement includes a provision that the partners agree to continue in partnership for a specific period of time, or until the completion of some specific venture, or if such a commitment is implied by other agreements the partners entered into (such as a lease agreement with a specified term), then the decision of a partner to dissociate can be construed as a breach of contract, or “wrongful dissociation.” In such a case, the partner may still dissociate, and courts will not compel a dissociating partner to continue in the partnership. Moreover, continuing partners may still be required to buy out the share of the departing partner. But the dissociating partner may be compelled to pay damages for any harm caused to the partnership by her dissociation. Such damages will be subtracted from (and may even exceed) the value of the partner’s share of partnership assets owed to the departing partner. Thus, it is

61. RUPA § 201(a). UPA was ambiguous about whether partnerships created under the act were separate legal entities. Being a separate “entity” means that a partnership formed under RUPA may continue to exist even as individual partners come and go; it also ensures “affirmative asset partitioning” (to use the phrase chosen by Hansmann et al., supra note 19), meaning that the assets of the partnership are protected from creditors and heirs of the partners.

62. A majority of states have adopted some variation on RUPA, which provides in § 601(1) that “[a] partner is dissociated from a partnership upon the occurrence of any of the following events: (1) the partnership’s having notice of the partner’s express will to withdraw as a partner [upon the date of notice] or on a later date specified by the partner.”

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almost as difficult today as it was in the nineteenth century to lock invested capital into a general partnership.

Businesspeople acting together in a general partnership carry the burden of full, joint and several liability for debts incurred by the partnership for partnership business as well as tort claims against the partnership.

B. Limited Partnerships

The limited partnership (LP) form was developed in France in the early nineteenth century, but was not widely adopted in U.S. states until the late nineteenth century. Unlike general partnerships, limited partnerships may only be formed by filing a certificate of limited partnership with the relevant state authorities. Under the limited partnership form, partners are divided into two classes: general partners and limited partners. General partners contribute assets and have general management responsibilities for the enterprise, just as partners in a general partnership do. General partners also have full, joint and several liability for partnership debts and tort claims against the partnership. Limited partners, however, may invest assets in the partnership but not participate in the management of the enterprise. If they do not participate in management, limited partners will enjoy “limited liability,” meaning that they may not be held accountable for partnership debts or tort claims beyond the amount that they contributed in acquiring their limited partnership shares.

64. RULPA (1976/1985) § 201(a); ULPA (2001) § 201(a). Robert Hamilton observes that “the idea that some persons should be able to contribute capital to an enterprise and share in its profits but not be responsible for its debts or losses developed comparatively recently. ... there is no general common law of limited partnerships as there is a common law of general partnerships, and limited partnerships are not a default form of business.” ROBERT W. HAMILTON, BUSINESS ORGANIZATIONS: UNINCORPORATED BUSINESSES AND CLOSELY HELD CORPORATIONS 102 (1997).

65. RULPA provides:

Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he [or she] is also a general partner or, in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] participates in the control of the business. However, if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.

RULPA § 303 (a).

§ 303 (d) provides that “[a] limited partner who knowingly permits his [or her] name to be used in the name of the limited partnership [except under few specified circumstances] is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.” RULPA also provides that:

An obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

RULPA § 303.

The Comment to § 303 of the 2001 ULPA observes that “[I]n a world with LLPs, LLCs, and, most importantly, LLLPs, the control rule [articulated in § 303(a) of RULPA ] has become an anachronism.”
Limited partnership shares are sometimes tradable. Like shareholders in a corporation, limited partners may not withdraw their investments in the venture at will, but must generally wait until the time specified in the partnership agreement for the dissolution and winding up of the partnership. If the limited partner does not want to wait that long, however, under the Revised Uniform Limited Partnership Act ("RULPA") (1976/1985), Sec. 603, the limited partner may withdraw "upon not less than six months' prior written notice to each general partner...." General partners, under RULPA, Sec. 602, however, may withdraw from a limited partnership "at any time by giving written notice to the other partners," but if the withdrawal violates a specific term of the partnership agreement, the partnership may recover damages from the departing partner. In other words, the law has taken the position that for limited partners to have the protection of limited liability, as well as the benefits of liquidity that come from having the shares be tradable, they must accept some restrictions relative to general partners on their ability to withdraw their share of assets from the firm.

Under the Uniform Limited Partnership Act ("ULPA") (2001) (which has not yet been widely adopted), partners (limited or general) may dissociate at will by giving notice to the partnership. However, Sec. 505 of ULPA provides that "a person does not have a right to receive a distribution on account of dissociation" from a limited partnership. So the law of limited partnerships has always made it somewhat easier, relative to other partnership forms, for business organizers to lock in the capital initially contributed to the enterprise by the limited partners. If and when states adopt ULPA, the law of limited partnership will move further in the direction of locking in of capital contributions to a degree comparable to the corporate form.

C. Limited Liability Partnerships and Limited Liability Limited Partnerships

During the last decade of the twentieth century, a number of states passed discuss LLPs, LLCs, and LLLPs infra Parts II.C and II.D.

66. The default rule under both RULPA and ULPA is that a partnership interest in a Limited Partnership is transferable or assignable, although unless the partnership agreement provides otherwise, the assignable interests include only the financial interests and not any governance or management participation rights. See RULPA § 702; ULPA § 702. If the partnership agreement so provides, limited partnership interests may sometimes even trade widely, on exchanges, so long as the appropriate securities regulations are met to make financial information about the securities available to the trading public. See, e.g., ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP (1988) §§ 2.13(e), 12.14 (discussing application of securities laws to partnerships). This arrangement is common with limited partnerships that have a corporation as the sole general partner—an organizational form that became popular in the 1970s as a tax shelter vehicle. See Robert W. Hamilton, Corporate General Partners of Limited Partnerships, 1 J. SMALL & EMERGING BUS. L. 73, 78-87 (1997). Large limited partnerships with a corporate general partner and widely traded limited partnership interests are called "master limited partnerships." See Donna D. Adler, Master Limited Partnerships, 40 U. FLA. L. REV. 755 (1988).

67. See ULPA § 601(b)(1) (dissociation as a limited partner); ULPA § 603(1) (dissociation as a general partner).
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some form of LLP statute. These statutes make it possible for members of businesses ventures that are otherwise equivalent to general partnerships to be protected from personal liability for obligations of the firm that exceed the assets of the firm, simply by filing a set of forms with the appropriate state regulatory authorities.\(^6\) Partners in LLPs, however, are still liable for claims arising from their own misconduct.\(^9\) The LLP form of organization has become particularly popular among professional partnerships, but so far, the extent and protection provided by the liability shield has not been tested.\(^7\)

Since LLPs are otherwise like general partnerships, the same rules apply to LLPs as apply to general partnerships regarding the ability of partners in an LLP to dissociate and withdraw their capital contribution. Most large professional partnerships today establish a fund to be used to buy out retiring or otherwise departing partners. Thus, these organizations provide almost no lock-in of capital.

According to Susan Fortney,\(^71\) the LLP form may, in fact, encourage not only capital flight, but also human resource flight. Fortney explains:

The exodus of Andersen partners and practice groups [in the wake of Arthur Andersen's exposure to liability for their role in the collapse of Enron] is another negative consequence of the LLP structure. Andersen's U.S. payroll has dwindled from 28,000 to 1,000 and its worldwide staff of approximately 85,000 has been similarly decimated\(^72\). Rather than jumping ship, Andersen partners might have been more committed to rebuild the firm had they believed they were personally on the hook for Enron. Why remain with a crippled firm and have your future accounts tapped when you have no personal responsibility?\(^73\)

Just as LLPs are otherwise identical to general partnerships except for the liability shield, LLLPs are limited partnerships that have adopted a liability shield for their general partners by filing appropriate documents with relevant state authorities. Hence, just as limited partnerships provide for at least some temporary lock-in of capital contributed by limited partners,\(^74\) LLLPs also provide some degree of lock-in. And, as noted, ULPA would provide more complete lock-in than the previous law because limited partners may not withdraw their contributions until the date set in the partnership agreement for

68. RUPA § 1001.
70. Id. Hamilton and Macey note that the litigation underway against Arthur Andersen LLP arising from the auditing work it did for Enron may set precedents for the degree of protection provided to partners not involved in any wrongdoing or malpractice. See also Jonathan D. Glater, Suits Against Andersen May Test Partners' Risks, N Y TIMES, Feb. 12, 2002 (late ed.); Susan Saab Fortney, High Drama and Hindsight: The LLP Shield, Post-Andersen, 12 BUS. L. TODAY 47 (2003) (discussing the benefits and problems associated with the use of the LLP form by professional firms).
71. Fortney, supra note 70, at 47.
72. Id. at 48 (citing Lee Hackstader, Andersen Hit with Maximum Penalty; Judge Fines Firm $500,000, Puis It on Probation, WASH. POST, Oct. 17, 2002).
73. Fortney, supra note 70, at 49.
74. Capital contributed by general partners is locked in only in states that have adopted ULPA (2001).
termination or some earlier date determined by the general partners.\textsuperscript{75}

As a general rule, the limited partnership form, or the LLLP form today, is used only for ventures that are expected to have a termination date, as opposed to long-term ongoing ventures with an indefinite life. Hamilton & Macey note that in contemporary times, only three types of business ventures commonly use the limited partnership form. These are leveraged buyout firms, venture capital firms, and family limited partnerships.\textsuperscript{76} Family limited partnerships are tax shelter vehicles in which the choice of organizational form is driven solely by tax rules. Leveraged buyout firms and venture capital firms are typically organized as LLPs or LLCs (see \textit{infra} Part II.D) which, in turn, operate as the general partners in a series of limited partnerships. The organizing firm raises money from limited partners in tranches, with each tranche committed for a certain period of time and organized as a separate LP (or LLLP). So investors enter the partnership knowing that, as of a certain future date, the venture will be terminated, and whatever assets remain in the LP at termination date will be distributed.

\section*{D. Limited Liability Companies}

LLCs are a late-twentieth-century innovation, developed primarily to take advantage of the differential tax treatment between partnerships and corporations. The first limited liability company statute was passed in Wyoming in 1977.\textsuperscript{77} The statute permitted businesspeople to organize themselves into an entity that had some features of partnership status and some features of corporate status. In particular, all members had limited liability (like corporate equity holders), but the entity was otherwise organized like a partnership. In 1988, the promoters of this organizational form won a favorable ruling from the Internal Revenue Service, allowing for partnership taxation for LLCs.\textsuperscript{78} Responding, then, to widespread demand from businesspeople to use such a form, other states quickly adopted similar statutes, so that since 1995, all fifty states have had LLC statutes.\textsuperscript{79}

These statutes vary in certain significant details, however, because states did not want to wait until a uniform LLC statute was drafted. Although most of the statutes provide wide latitude for organizers to adopt whatever financing and organizational structure they want, the IRS initially insisted that the

\begin{itemize}
  \item\textsuperscript{75} ULPA § 601(a) ("A person does not have a right to dissociate as a limited partner before the termination of the limited partnership."); ULPA § 504 ("A partner does not have a right to any distribution before the dissolution and winding up of the limited partnership unless the limited partnership decides to make an interim distribution.").
  \item\textsuperscript{76} HAMILTON & MACEY, \textit{supra} note 15, at 191.
  \item\textsuperscript{77} \textit{Id.} at 199 (citing Susan Pace Hamill, \textit{The Origins Behind the Limited Liability Company}, 59 \textit{Ohio St. L. J.} 1459, 1563-64 (1998)).
  \item\textsuperscript{78} See HAMILTON & MACEY, \textit{supra} note 15, at 199.
  \item\textsuperscript{79} \textit{Id.}
\end{itemize}
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resulting entities not incorporate more than two of the features that the IRS regards as “corporate” characteristics if they were to qualify for “pass-through” partnership taxation. These characteristics are: (1) continuity of life; (2) free transferability of interests; (3) centralization of management; and (4) limited liability. Since an important object of LLCs was limited liability, and organizers generally wanted to centralize management, in practice this meant that LLCs could not have continuity of life or free transferability of interests. In 1997, however, the IRS adopted new rules that allow organizers of business entities such as LLCs, LLLPs, and S-Corporations simply to “check the box” to choose whether to be taxed as partnerships (in which income is attributed to members on a pro-rata basis each year, and taxed at the member’s tax rates) or as entities (entity profits are taxed at the corporate tax rate before being distributed to members, and then taxed again as income to the members when paid out). Since the IRS adopted “check-the-box” tax treatment, it became immaterial for tax purposes what organizational form and structure these business ventures adopted.

In 1996, the National Conference of Commissioners on Uniform State Laws promulgated a Uniform Limited Liability Company Act (“ULLCA”), but to date, LLC statutes still vary considerably from one state to another. Hence, it is hard to generalize completely about the ability of business organizers to lock in capital contributions using the LLC form. ULLCA, however, provides that members who initially contribute less than the stated contribution required for each unit of membership are liable for the full amount, and that distributions from the LLC are limited by solvency constraints on the entity, similar to the constraints on distributions in many corporate statutes. It also

80. Id. at 202.
81. Early adopting states, including Colorado, Virginia, and Nevada, required that LLCs lack continuity of life. Id.
82. ULLCA § 402.
83. The ULLCA provides:
A distribution may not be made if: (1) the limited liability company would not be able to pay its debts as they become due in the ordinary course of business; or (2) the company’s total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the company were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of members whose preferential rights are superior to those receiving the distribution.
ULLCA § 406(a). The RMBCA provides that no distribution may be made to shareholders if:
after giving it effect: (1) the corporation would not be able to pay its debts as they become due in the usual course of business; or (2) the corporation’s total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.
RMBCA Subch. D § 640(c). By contrast, the DGCL provides that dividends can only be paid out of capital “surplus” as determined by the board of directors under the terms of DGCL §154, or DGCL § 244 (which provide alternative ways directors may determine the capital stock of the company and the surplus). DGCL § 170 (a).
provides as a default rule, however, that LLC members may dissociate from the LLC at will. As in the default rules for general partnerships under the RUPA, ULLCA provides that the firm may continue to conduct business as the same entity despite the dissociation of one or several members so long as a specified percentage of the remaining members agree to continue the business of the company. If the LLC is not dissolved as a result of the dissociation of one or several members, then the LLC must buy out the interests of the dissociating members. If the dissociation by the members violates a term of the operating agreement or is otherwise considered wrongful, the continuing firm must still buy out the dissociating members’ interests, but the dissociating members must pay any damages resulting from their premature or wrongful dissociation.

Hence, it appears that the default rules for LLCs provide about the same potential for locking in capital as is provided in the default rules for general partnerships and LLPs—that is, not much.

E. Corporations

As the IRS has observed, the distinguishing characteristics of the corporate form have historically included continuity of life, free transferability of interests, centralization of management, and limited liability. Now that limited liability and centralized management can easily be achieved through a wide range of organizational forms, the IRS’s list of unique features of the corporate form is reduced to continuity of life and free transferability of shares (and even these features can be arranged contractually in partnership-type firms). I would add to this list the fact that equity investors in corporations generally have no power, on their own initiative, to insist that the corporation buy back their shares or distribute corporate assets to shareholders. The only other organizational form that possesses this characteristic is the limited partnership (and its limited liability counterpart), in which the limited partners

84. See ULLCA § 601(1).
85. ULLCA § 801(b)(3).
86. ULLCA § 701.
87. ULLCA § 602.
89. Under case law dating back to 1868, shareholders have not had the legal right to receive any dividend at all unless it was declared by directors. See, e.g., Minot v. Mallory, 99 Mass. 101, 111 (Mass. 1868) (“The money in the hands of directors may be income to the corporation; but it is not so to a stockholder till a dividend is made . . .”). Delaware law requires corporate directors to determine what proportion of receipts from stock issuances or other assets represents “paid-in capital” and what proportion is “surplus” (DGCL § 154; DGCL § 244). Dividends may only be paid out of surplus, or if there is no surplus, out of net profits for the most recent two fiscal years, but any decision to pay dividends is solely the prerogative of directors (DGCL § 170). And, according to MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 375 (1987), U.S. courts have never in the last century ordered a management-controlled, publicly-traded corporation to increase its dividends. Corporations may, of course, issue redeemable shares, but common stock is generally not redeemable at the option of the shareholder.
may be subject to fairly strict limits on their ability to compel the firm to buy out their interests. But limited partnerships are typically established for some term, at the end of which limited partners will be bought out, or the firm wound up and dissolved.\footnote{Limited partnerships were commonly used in the 1970s as a vehicle for holding oil and gas producing properties because the profits from producing and selling the oil and gas—a depleting resource—could be paid out directly to the partners without being taxed first as corporate income. Mesa Petroleum Co., for example, pioneered the use of limited partnerships in this way, setting up limited partnerships to hold the depleting assets, and spinning off limited partnership interests to its shareholders as dividends. It did this because it did not believe that it could reinvest cash flows from oil and gas production profitably. Thus, as the oil and gas deposits in the properties held by the LP were played out, the LP would eventually be wound up and dissolved. See, e.g., Laurie P. Cohen, Mesa Petroleum Plans a Switch to Partnership, \textit{Wall St. J.} (West Coast Edition), Aug. 27, 1985, at 3.}

Corporations are generally not subject to any given term, so shareholders may never have their interest in the firm bought out or retired by the corporation. Moreover, any decision to pay dividends is solely the prerogative of a board of directors\footnote{DGCL § 170; RMBCA § 6.40. See, e.g., Berwald v. Mission Development Co., 185 A.2d 480 (Del. 1962) (finding that a decision to pay a dividend was protected by the business judgment rule unless it was designed to serve the selfish interests of a controlling party).} (subject to certain legal constraints designed to protect corporate creditors) whose members need not, necessarily, be shareholders.\footnote{DGCL § 151(a); RMBCA § 6.01(c). In such a case, holders of the “preferred” shares can insist, according to rights granted them in the stock certificate or articles of incorporation, that prescribed dividends be paid to preferred shareholders before dividends are paid to common shareholders. DGCL § 151(c). But the distribution of dividends to preferred shares remains optional, and ordinary common shares generally cannot command any dividends.}

Thus, the corporate form of organization, more than any other form, facilitates the locking-in of invested capital for an extended—even indefinite—period of time. It also places control rights over the assets of the firm in the hands of a board of directors.\footnote{In Blair, \textit{supra} note 5, I argue that the ability to lock in capital was one of the important features of the corporate form that made it attractive to business organizers in the nineteenth century. I further argue that investors were willing, in fact eager, to invest via this form despite their loss of control rights because they apparently believed that, over time, they could achieve a higher rate of return by investing in a vehicle that was more financially stable, and could provide security to other corporate participants. In Blair & Stout, \textit{supra} note 12, we argue that shareholders are willing to yield control rights over the assets they contribute to corporate enterprises because yielding control to boards of directors apparently produces attractive (risk-adjusted) returns over time, relative to investing in enterprises in which they could maintain more control.}

Although in principle, directors are elected by shareholders (hence a majority of shareholders acting together might be able to elect a slate of directors who promise to pay certain dividends or buy back shares, or even to dissolve the company), in practice it is difficult and costly for shareholders to elect directors other than those nominated by existing directors. As a result, boards of directors tend to be self-perpetuating bodies. This ability to lock in capital can contribute to or exacerbate the so-called “oppression” of minority shareholders in closely-held corporations.\footnote{To address this problem, most states have enacted so-called “close corporation” statutes (such as DGCL Subchapter XIV, which permits shareholders to form agreements that restrict the discretion of directors (DGCL § 350), or eliminate the need for directors altogether (DGCL §351; RMBCA § 7.32),} But in corporations where
common shares are widely held and traded on exchanges or over the counter, any shareholder who wants to withdraw from the corporation may do so by selling his or her shares to some other shareholder. The investor may withdraw, even while the invested capital stays locked into the enterprise.

F. Implications of the Choice of Organizational Form

Until the last decade of the twentieth century, entrepreneurs and business organizers who wanted the protection of limited liability had very few choices about how to organize their businesses, since only the corporate form provided limited liability for the managers and active investors of a firm. But use of the corporate form required investors to yield control over the assets they contribute to the corporation's board of directors.95 Organizers could contract around this requirement, to some extent, by using charter provisions or bylaws that gave shareholders the right to vote on or even propose a broader range of actions than the statutes provide. But unless they met the strict requirements for a close corporation96 equity investors in corporations were, and still are, basically restricted from initiating or compelling actions to pay dividends or make other distributions.97

In the year 2004, however, with the ready availability of the LLC, LLP, and LLLP forms in virtually every state, entrepreneurs and business organizers can have the benefits of limited liability without the constraints of corporate status. Meanwhile, the corporate form and, to a lesser extent, the limited partnership form, are the only forms through which organizers can effectively lock in the and gives shareholders control over decisions to dissolve the corporation (DGCL Subch. XIV § 355).

95. See RMBCA § 8.01(b) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitations set forth in the articles of incorporation."); DGCL § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors.").

96. Under DGCL Subch. XIV§ 342(1), close corporations may have no more than 30 stockholders, under § 342(2) the transferability of shares is restricted, and under § 342(3) the firm may not make any public offerings of securities. Under RMBCA § 7.32, corporations may be governed by shareholders (under a shareholders agreement) and the board of directors either eliminated or greatly restricted in its powers if the corporation does not have securities traded on an exchange or over the counter, and if the shares of the corporation provide adequate notice of the existence of the shareholders' agreement. Shareholder agreements are valid for no longer than 10 years unless the agreement specifically provides otherwise.

97. Under RMBCA § 6.40, directors are authorized to make distributions to shareholders subject to constraints designed to protect creditors. § 12.02(b) provides that any sale or distribution of assets that requires shareholder approval must be initiated by directors. Under § 12.01, many sales or distributions can be carried out by directors without shareholder approval. Under § 14.02(b)(1), directors must initiate and recommend to shareholders for their approval any dissolution, unless directors have a conflict of interest with respect to such transaction. Delaware law is similar. DGCL § 170 provides that directors may declare and pay dividends subject to certain solvency tests. Under DGCL § 271, directors have initiation rights for sales of assets, and under § 275, directors must initiate any dissolution. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919), is the classic case in which a shareholder successfully sued to compel a corporation to pay dividends, but Ford Motor Company was closely held at the time.
capital contributions of equity investors for indefinite periods of time. And even in businesses organized as limited partnerships, organizers may, in the partnership agreement, give limited partners the right to dissociate at will and be paid their share of the assets, or propose and vote on dissolution or sales of assets or other payouts to partners. In corporations whose shares trade widely, however, default rules provide that shareholders may vote on dissolutions or sales of assets, but they may not propose such actions. Statutory and case law makes it clear, also, that directors control any decision to pay dividends.

While these provisions of corporate law make it possible to lock in capital, and may occasionally lead to abuses by directors and managers, they do not lock in particular investors, since individual investors can sell their shares to

98. Such a right is implied by RULPA § 303(b)(6) (clarifying that a limited partner does not become liable for partnership liabilities by taking certain enumerated governance-related actions). Such actions include:

- proposing, approving, or disapproving, by voting or otherwise, one or more of the following matters: (i) the dissolution and winding up of the limited partnership; (ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership; (v) the admission or removal of a general partner.

Id. Under ULPA § 7, limited partners are broadly protected from liability regardless of governance activities they may engage in, presumably including the acts of proposing or approving dissolutions, and sales of substantially all the assets.

99. Throughout much of the twentieth century, it was very clear that corporate law required that directors be decision makers for corporations, and that shareholders were not permitted to establish voting agreements that had the effect of "sterilizing the board." See, e.g., McQuade v. Stoneham, 263 N.Y. 323, 328 (1934) ("[s]tockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office . . ."); Manson v. Curtis, 223 N.Y. 313, 322-23 (1918) ("All powers directly conferred by statute, or impliedly granted, of necessity, must be exercised by the directors who are constituted by the law as the agency for the doing of corporate acts. In the management of the affairs of the corporation, they are dependent solely upon their own knowledge of its business and their own judgment as to what its interests require."); Continental Securities Co. v. Belmont, 206 N.Y. 7 (1912) ("As a general rule, shareholders cannot act in relation to the ordinary business of a corporation . . . They are not by statute in any state given general power of initiative in corporate affairs.") But exceptions were carved out for close corporations. See, e.g., Clark v. Dodge, 269 N.Y. 410, 416 (1936) ("[W]here the questioned agreements were entered into by all the stockholders of small corporations about to be organized, the fact that the agreements conflicted to some extent with the statutory duty of the directors to manage the corporate affairs was thought not to render the agreement illegal . . .") (citing Lorillard v. Clyde, 86 N.Y. 384 (1881); Drucklieb v. Sam H. Harris, 209 N.Y. 211 (1913)). In the late in the twentieth century, a number of close corporation statutes were added to state corporate statutes. See, e.g., MBCA § 7.32 (authorizing shareholders to eliminate the board of directors and directly run corporations that qualify as "close corporations"); DGCL § 341 (defining a subset of Delaware corporate law applicable to close corporations); DGCL § 342 (defining close corporations); DGCL § 350 (allowing shareholder agreements that restrict the discretion of directors in close corporations); DGCL § 351 (providing that the board of directors may be eliminated in a close corporation, and the affairs of the firm run directly by shareholders). See also Ribstein, supra note 67, at 14 (observing that "though corporate statutes provide that management by the board can be qualified to some extent by contrary provisions in the articles of incorporation, such provisions do not clarify how far such restrictions may go. The existence of some limitation is supported by the fact that corporate statutes explicitly permit reduction or elimination of board functions only in special provisions applying to closely held corporations." [footnotes omitted]).

100. RMBCA § 640(a); DGCL § 170(a); see also Knapp v. Bankers Securities Corp., 230 F.2d 717, 720 (3d Cir. 1956) (noting that "[i]t is an elementary principle of corporation law that the declaration of dividends out of net profits rests in the discretion of the board of directors" except in situations in which directors act fraudulently or arbitrarily in refusing to declare a dividend out of surpluses).
other investors. Apparently, the benefits of this "lock-in" feature of corporate law are perceived as outweighing the problems, because, if the lock-in feature of the corporate form were regarded as oppressive or problematic to investors, investors could choose to invest in other organizational forms. Since we continue to see widespread use of the publicly traded corporate form by business organizers, and eager investment in businesses organized in this form by sophisticated investors, it seems reasonable to assume that the benefits outweigh the disadvantages. Furthermore, in light of the easy availability of alternatives that provide centralized control, tradable claims, and limited liability, it seems appropriate to regard the choice by business organizers to use the publicly-traded corporate form as a clear and unequivocal choice to use an organizational form that locks in capital, and restricts the rights of equity investors to exercise control over how the capital is used and when or whether equity holders are paid back any of the funds invested in the corporation. The choice of corporate form, in other words, should be regarded as a choice by organizers to "pre-commit" to locking in their capital investment and yield control to directors. Professor Stout and I have argued elsewhere that it might be advantageous to shareholders in the long run to pre-commit to yielding power to directors. Here, I argue further that to have teeth, the yielding of decision rights about the use of corporate assets must be accompanied by a yielding of the right to decide whether and when assets will be distributed back out to shareholders.

III. THE LOCK-IN CHOICE AND ITS IMPLICATIONS FOR CORPORATE GOVERNANCE REFORM

In the debates about various corporate governance reforms over the years, the idea that shareholders should be given more power and control rights relative to directors and management is based on the premise that the principal-agent problem is the most important governance problem to be addressed in contemporary corporations. This premise has been widely accepted by

101. In a forthcoming article, Larry E. Ribstein argues that the corporate form is inflexible and not efficient, but continues to be used because "corporate inflexibility and the concession theory serve both politicians' interests by making it easier to regulate business, and managers' interests by protecting their power." Larry E. Ribstein, Why Corporations?, 2004 BERKELEY BUS. L.J. (forthcoming fall issue) (copy of July 2003 draft on file with author).

102. Kahan and Rock similarly argue that corporate charter provisions together with statutory requirements of corporate law that give corporate directors substantial control over decisions about whether and how to sell a company can be understood as a "pre-commitment whereby shareholders, by binding themselves ex ante, may be able to improve their collective position ex post." Kahan & Rock, supra note 1, at 2.

103. Blair & Stout (1999), supra note 12, at 305.

104. In a recent article, Lucian Bebchuk argues for greater shareholder powers to initiate and approve major corporate transactions, simply asserting as a matter of fact that "granting such power would address important agency problems that have long afflicted publicly traded companies, considerably improving corporate governance." Bebchuk, supra note 2, at 1. For at least two decades,
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corporate legal scholars, and is often assumed, almost without discussion, in the debate about takeover policy.105

Without denying that there are agency problems in the management and governance of large corporations, Professor Stout and I have argued that the widely-traded corporate form (in which the role of contributing financing is separated structurally and legally from the role of controlling the business, and with the latter role vested in a board of directors) may serve as a solution to a more fundamental organizational problem: the problem of contracting in team production contexts.106 The argument, in short, is that the participants in a corporate "team" can more easily commit to cooperate with each other and work together toward mutually beneficial goals that enhance the productivity of the enterprise if they yield ownership and control rights over inputs to, and outputs from, the corporate enterprise. Ownership of corporate assets and outputs goes to the separate legal entity created by corporate law. Control belongs to a board of directors that is legally independent of shareholders, managers, employees, and all other corporate participants. To the extent that the corporate form serves this function, reform proposals that are designed to address agency problems by enhancing shareholder monitoring or control over management must be tempered by the need to protect the integrity of the basic structural solution to the team production problem provided by the corporate form.

Bebchuk has advocated the idea that corporate boards and management (he typically treats boards and managers as if they were the same) need to be reined in by the "market for corporate control." See, e.g., Lucian A. Bebchuk, The Case for Facilitating Competing Tender Offers, 95 HARV. L. REV. 1028 (1982). The work of a team of researchers at Harvard Business School and the Wharton School at the University of Pennsylvania is indicative of just how deeply this mentality has permeated corporate scholarship. Paul Gompers, Joy Ishii, and Andrew Metrick have collected data on corporate governance arrangements in hundreds of companies, categorizing each arrangement by whether it tends to enhance "shareholder democracy" or lead to management "dictatorship." See Paul A. Gompers et al., Corporate Governance and Equity Prices, 118 Q. J. ECON. 107 (2003). It is interesting to note how few of the scholars who have engaged in the debate about corporate governance have chosen to use rhetorically neutral language in their scholarship rather than conclusory language and labels, such as calling proposals to enhance shareholder power "efficient," "better," "democratic," or "corporate governance improvements," while labeling director strengthening proposals as "entrenching" or "dictatorial.

105. See, e.g., Frank Easterbrook & Daniel Fischel, The Proper Role of A Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161 (1981) (same); Ronald J. Gilson, The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept, 34 STAN. L. REV. 775 (1982) (arguing that shark repellent amendments should be held invalid even if they are approved by a vote of shareholders); Ronald Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 STAN. L. REV. 819 (1981) (assuming that takeovers are about reducing agency costs and improving corporate performance, and arguing that directors should be passive in response to a takeover offer). Cf. Barry D. Baysinger & Henry N. Butler, Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation, 71 VA. L. REV. 8, 1257 (1985) (accepting that agency costs are a significant potential problem, but arguing that existing law and governance arrangements "emerged in a market environment that permitted free contracting among interested parties" and that therefore it is safe to assume that these arrangements do an adequate job of reining in agency costs); Roberta Romano, The Political Economy of Takeover Statutes, 73 VA. L. REV. 111 (1987) (accepting the agency problem premise and endorsing antitakeover charter amendments if they are approved by shareholders, but opposing statutory antitakeover rules).

106. Blair & Stout, supra note 12.
In this Part, I propose in particular that corporate governance reform proposals be distinguished according to whether their purpose and effect is to strengthen the independence and information available to boards, to enhance shareholder "voice," or to make it easier for shareholders as a group to "exit." If the purpose and effect of a corporate governance reform proposal is to make it easier for shareholders to "exit," by, say, requiring boards to submit takeover offers to a shareholder vote, or permitting shareholders to propose and mandate (by election) distributions, dissolution or asset sales, I argue in this Article that such a proposal is at odds with the "lock-in" function of corporate law. Since business organizers would find it difficult to achieve effective lock-in using other currently available organizational forms, to eliminate or weaken the lock-in potential of the corporate law choice by statutorily requiring corporations to give shareholders such powers would take away an important organizational option that business organizers and investors currently have. This option has been eagerly sought out and used by business organizers in the United States for more than 150 years and, superficially at least, appears to be associated with substantial economic innovation and growth. Thus, it seems unwise to change the law in ways that would eliminate this option.

On the other hand, if the purpose and effect of a corporate governance reform proposal is to enhance the monitoring capabilities of corporate boards, or to facilitate shareholder "voice," such proposals are not obviously at odds with the lock-in function of the corporate form, and may well reduce agency costs without unduly subverting the role the corporate form serves in addressing the team production problem. In the next Part, I review various corporate governance proposals, categorized by whether they make exit easier for shareholders, facilitate shareholder voice, or strengthen boards of directors. Then, in the final Part, I speculate about the implications of my arguments for the process of finding the right balance between director control and accountability.

IV. BRIEF REVIEW OF CORPORATE GOVERNANCE REFORM PROPOSALS

Corporate governance questions moved into the public policy spotlight during the early 1980s, when the corporate sector suddenly faced a wave of hostile tender offers. Takeover offers often triggered controversial defensive responses by corporate managers and directors, and the resulting debate

107. The concepts of "exit" and "voice" as responses to problems in organizations are borrowed from ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1972).

108. THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE (Margaret M. Blair ed., Brookings 1993) provides an analysis of some of the policy issues at stake in the takeover debates.

109. Corporate managers and boards, together with their legal advisors, have developed and
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produced a wave of legal scholarship on the questions of whether takeovers were good or bad for the economy, whether directors and officers should be allowed to resist a hostile offer, and if they do, what tactics were legitimate, both legally and from the perspective of public policy. Some businesspeople and a few legal practitioners and management professors protested that the sudden and pervasive threat of hostile takeover was contributing to unhealthy pressures on businesses from the financial markets to focus on short-term performance at the expense of long-term performance. But the legal and finance faculties of leading universities largely accepted the premise that hostile takeovers were the market’s way of correcting bad management—the fulfillment of Henry Manne’s argument that the “market for corporate control” would prevent managers from straying too far from their job of maximizing value for shareholders.

A. Some Prominent Proposals Designed to Weaken Takeover Protection

The dominant academic response to the takeover wars of the 1980s, then, attempted to use a wide variety of tactics for warding off or preventing takeovers. In 1985, for example, Mesa Petroleum launched an attempt to take over Unocal Corp., offering $54 per share for the first 50 percent of outstanding shares, and announcing that once it held a controlling interest, it would buy out the remaining shares with “highly subordinated securities,” nominally worth $54 per share, but whose market value was much less. Unocal responded by making a discriminatory exchange offer, providing that, if Mesa succeeded in buying the 64,000,000 shares it sought, “the remaining Unocal shareholders could exchange all of their remaining shares for debt securities worth $72 per share that would be senior to Mesa’s junk bond financing.” See Hamilton & Macey, supra note 15, at 1228. Unocal’s tactic was deemed legitimate by the Delaware Supreme Court in light of the coercive threat represented by the Mesa offer in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). Other firms adopted so-called “staggered boards,” in which directors serve three-year terms, with only one third of directors standing for re-election at each annual meeting, and the so-called “poison pill” or “shareholder rights plan,” by which shareholders are given rights to buy new securities issued at dilutive prices if a hostile bidder acquires more than some triggering percentage (such as 20 percent) of outstanding shares. The rights could be redeemed for a nominal amount by the target’s board of directors if directors were satisfied with the bid. Rights plans were approved as a legitimate takeover defense in Moran v. Household Int’l., Inc., 500 A.2d 1346 (Del. 1985).

110. Lipton, supra note 3, at 1037-39, provides a chronology of the main arguments in favor of takeovers and of limiting director discretion to resist them. Lipton is generally credited with inventing the “poison pill” defense.

111. See, e.g., Robert H. Hayes & William J. Abernathy, Managing Our Way to Economic Decline, 58 HARV. BUS. REV. 67 (1980) (arguing that U.S. corporations suffered from “competitive myopia” which they blamed on a tendency for managers to rely too heavily on “short-term financial measurements like return on investment for evaluating performance.”). See generally MADE IN AMERICA: REGAINING THE PRODUCTIVE EDGE (Michael L. Dertouzos et al. eds., 1989) (noting that business executives describe their own behavior in response to financial market pressures as attempting to “maximiz[e] their short-term profit in the belief that the market would penalize them for taking the long view.”); TWENTIETH CENTURY FUND, REPORT OF THE TASK FORCE ON MARKET SPECULATION AND CORPORATE GOVERNANCE (1992) (characterizing financial markets as prone to “high-volume, speculative trading and short-lived bubbles and crashes,” which the report asserted were “the essence of ‘short-termism.’”); Lipton, supra note 3 (defending efforts by corporate managers and directors to fight off takeovers that, in the opinion of directors, would impair the ability of the corporation to perform well in the long run).

has been a continuing stream of reform proposals that would encourage takeovers and weaken the ability of corporate officers and directors to fight off unwanted takeovers. The following is not a comprehensive list, but a sampling of prominent proposals to weaken the ability of corporate directors to resist takeovers:

* Corporate managers should be required to remain passive in the face of a takeover bid, and the decision about whether to accept the tender offer should rest with the shareholders alone.\(^\text{113}\)

* Directors should not be allowed to frustrate takeover bids but should advise shareholders as to the fairness of the bid, and seek competing bids.\(^\text{114}\)

* Shareholders should be able to adopt bylaws that would allow them to control the use of poison pills in takeover battles.\(^\text{115}\)

* Shareholders should be entitled to opt into a body of federal takeover law that would require the board to remove a pill if a majority of outstanding shares vote in favor of a takeover bid.\(^\text{116}\)

One puzzle about the intensity and ongoing nature of the debate over takeovers and their defenses is that the underlying premise, that takeovers are the financial market's way of correcting poor management, is rarely challenged. In the early 1980s, scholars produced a large body of evidence that target company share prices rise when a tender offer is announced.\(^\text{117}\) To finance scholars, steeped in the belief in efficient capital markets, a rise in the price of the target company stock that is not offset by a decline in the price of some other asset could only be interpreted to mean that the proposed takeover must enhance productivity.\(^\text{118}\) But this price-increasing effect could alternatively be explained by the fact that tender offers are nearly always made at a price that represents a substantial premium over the previous price of the stock in order to get existing shareholders to sell. It should hardly be surprising, then, that the trading price of the target stock rises as the market incorporates some estimated probability that the bidder will eventually pay the higher

\(^{113}\) Easterbrook & Fischel, supra note 2.

\(^{114}\) Gilson, supra note 105; Bebchuk, supra note 2.


\(^{116}\) Bebchuk & Ferrel, supra note 2.


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offered price.119 Furthermore, the fact that the acquiring company's shares do not all immediately fall by an amount sufficient to offset the gains to the target shareholders can be explained by the fact that the market may not be able to tell initially whether the acquiring company will be able to improve the performance of the target company.120

The real test comes in the months and years after a takeover, and there is substantial evidence indicating that acquiring companies typically lose money on corporate acquisitions.121 Meanwhile, there is little or no evidence that takeover targets are poorly performing companies,122 or that their performance improves after the takeover.123 Moreover, there is no robust evidence that takeover defenses, such as staggered boards and poison pills, actually impair the performance of companies that have them,124 nor that they are effective at

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120. Bouwman, Fuller, and Nain find substantial evidence that the market's initial judgment about whether an acquisition will add value to the firm over time are systematically wrong. Christa Bouwman et al., The Performance of Stock-Price Driven Acquisitions (May 2, 2002) (working paper) (on file with author). See also Ming Dong et al., Does Investor Misvaluation Drive the Takeover Market? (Sept. 27, 2003) (unpublished manuscript, on file with author) (finding that misvaluation of bidders and targets influences the means of payment chosen, the mode of acquisition, the premiums paid, target hostility to the offer, the likelihood of offer success, and bidder and target announcement period returns).


122. Anup Agrawal & Jeffrey F. Jaffe, Do Takeover Targets Under-Perform? Evidence from Operating and Stock Returns, 38 J. FIN. QUANT. ANAL. 721 (2003) (finding little evidence that target firms were performing poorly before acquisition, using either operating or stock returns, and concluding that the conventional view that targets perform poorly is not supported by the data).

123. See Scherer, supra note 121.

124. Bebchuk, Coates, and Subramanian find that corporations with "effective staggered boards" (ESBs) were more likely to remain independent if they became a target of a hostile takeover, and that, as a result, shareholder returns were 8 to 10 percent lower for target companies that had an ESB. Bebchuk et al., infra note 127. But see Lynn A. Stout, Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem, 55 STAN. L. REV. 845 (2002) (noting that the Bebchuk, Coates, and Subramanian study does not take into account the potentially greater value that corporations might have been able to create by having an ESB before they became targets). See also John Coates IV, Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence, 79 TEX. L. REV. 2 (2002) (finding that "two decades of research on poison pills and other takeover defenses does not support the belief—common among legal academics—that defenses reduce firm value"). A body of research by Gompers, Ishii, and Metrick, however, suggests that corporate governance arrangements may come in clusters and that when firms are ranked according to a "governance index" that scores firms on how many of twenty-four different governance arrangements the firms have in place, the highest ranking firms (those with the weakest shareholder rights) performed significantly less well during the 1990s than those with the lowest ranking (strongest shareholder rights). Notably, the authors do not find a negative coefficient on their governance index in regression results. Rather, they compare the performance of firms in one tail of the distribution of firms ranked by the index to firms in the other tail of the distribution. Results based on comparisons of outliers are inherently less likely to be robust. The governance arrangements scored by this data cannot be easily categorized by whether they enhance (or weaken) shareholder voice, or shareholder exit, or support (or undermine) director independence and
One possible explanation for the absence of clear empirical support for the efficacy of takeovers is that the threat of takeovers actually has a mixed effect on corporate performance. On one hand, takeovers may in some cases discourage wasteful managerial empire-building, but on the other hand, the vulnerability of companies to unwanted takeovers may make it more difficult for corporate managers to foster long-term cooperation and commitment to the corporate enterprise by "team members" other than shareholders.

Nonetheless, the debate goes on, and takeover advocates continue to generate reform proposals that would weaken the power of directors to fight off takeover offers that, in the directors' judgment, would not be in the long-run best interest of the target company.

B. Proposals That Would Enhance Shareholders' Exit Options or Give Them More Direct Control over Corporate Assets

One of the most relentless proponents of the view that agency costs are a severe problem for the corporate sector, and that takeover defenses increase agency costs by entrenching managers, has recently proposed a very aggressive set of corporate governance reforms that would greatly strengthen shareholders' control over corporate assets, even beyond the takeover context. Bebchuk classifies his proposals into three categories, according to how they influence one of three kinds of decisions made within corporations: "(i) 'rules-of-the-game' decisions to amend the corporate charter or change the company's state of incorporation; (ii) 'game-ending' decisions to merge, sell all assets, or dissolve; and (iii) 'scaling-down' decisions to contract the size of the

access to information.


127. This may explain why young companies that are just going into the publicly-traded financial markets for equity capital often have both staggered boards and poison pills, the takeover protection combination that Bebchuk, Coates, and Subramanian claim is the most effective at preventing an unwanted takeover. See Lucian Bebchuk et al., The Anti-Takeover Power of Classified Boards: Theory, Evidence and Policy, 54 STAN. L. REV. 887 (2002). See also Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Anti-takeover Protections in IPOs, 17 J. L. ECON. & ORG. 82 (2001) (finding that a majority of firms that go public through IPOs have adopted both staggered boards and poison pills); Laura Casares Field & Jonathan M. Karpoff, Takeover Defenses of IPO Firms, 57 J. FIN. 1857 (Oct. 2002) (same); Stout, supra note 124 (arguing that available studies of anti-takeover protections generally focus on their impact on firm valuation after a takeover offer has been made, but fail to measure how they affect firm value prior to the takeover bid).

company’s assets by ordering a cash or in-kind distribution.”

I regard his “rules-of-the-game” proposals as proposals that give shareholders a more effective voice, so I consider them in the next section, and here consider only his “game-ending” and “scaling-down” proposals:

1) Scaling-down proposals:

* Shareholders should have the power to initiate and approve distributions, in cash or in other corporate assets.

* Shareholders should have the power to order the distribution of new debt securities to shareholders, compelling management to liquidate assets in order to satisfy the claims of the new securities.

2) Game-ending proposals:

* Shareholders should have the power to initiate mergers and/or consolidations with other companies.

* Shareholders should have the power to initiate a sale of all the assets of a company to a certain buyer (or even to auction the assets to the highest bidder).

* Shareholders should have the power to initiate the dissolution of the company.

Bebchuk’s case for these proposals is based on an argument that apparently assumes that whatever is better for shareholders at any point in time is “better” in some larger social sense. Or he may believe that giving shareholders more power is “better” because it is more consistent with his apparent view of shareholders as “owners” of corporations, and, therefore, serving their

129. Id. at 1.

130. Bebchuk himself implicitly concedes that these are the most radical of his governance reform proposals, observing that his “proposed [shareholder] intervention power wins support most easily when applied to rule-of-the-game decisions and meets most resistance when applied to scaling-down decisions.” See Bebchuk, supra note 2, at 4.

131. Id. at 36.

132. Id. at 36.

133. Id. at 37.

134. Id. at 31.

135. Id.

136. Id.

137. Id. at 33.

138. Id. at 31.

139. Bebchuk continually argues that focusing on shareholders' interests represents an “improvement” over current arrangements, without being explicit about the standard by which he measures the quality or effect of such arrangements. See, e.g., id. (noting with respect to giving shareholders the right to initiate reincorporation in other states that the result would be that “states will have incentives to focus on shareholders’ interests. The resulting improvement in the quality of state corporate law rules will considerably improve the arrangements governing publicly traded companies” (emphasis added)).

140. Bebchuk carefully avoids explicitly referring to shareholders as the “owners” of corporations, a view which has long been rejected by contractarian legal scholars. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 37 (1991) (“Notice that a contractual approach [to corporate law] does not draw a sharp line between employees and contributors
interests honors their property rights.\textsuperscript{141}

Perhaps Bebchuk would not claim that shareholders are the "owners" of corporations, but he nonetheless considers their situation to be analogous to that of partners in a partnership, except that shareholders lack the degree of influence and control rights over corporations that partners have in partnerships. But if this is Bebchuk's analogy, this line of reasoning suggests its own response: If equity investors in corporations had wanted the same rights of control over corporate assets as partners in a partnership have over partnership assets, then they should have invested in partnership-type organizations rather than in corporations.\textsuperscript{142}

As discussed above, unlike shareholders, partners are considered "co-owners" with direct interests in partnership assets, and as such have considerable leeway to influence the use of partnership assets, to withdraw their share of the partnership assets, and to compel dissolution of the partnership. Since those options are available to investors through the partnership organizational form (and can be modified to the precise specifications of any given group of investors through the details of the partnership agreement), then restructuring corporate law so that shareholders have similar options by legislative requirement would effectively deny investors the opportunity to commit their assets to ventures that they think might be more effective if capital is locked in. Bebchuk's proposals would reduce the range of investment opportunities now available to investors by eliminating one of the most important factors that distinguishes corporations from partnerships.

\textsuperscript{141} Bebchuk does not explicate a theory of property rights in corporations that explains why all the benefits of corporate activity should flow to shareholders.

\textsuperscript{142} Ribstein, supra note 66, proposes exactly this: that investors should consider reorganizing firms using partnership law rather than corporation law, on the grounds that investors would then have more control over the use of firm assets, and the firm would be less subject to government regulation. But, of course, passive investors in limited partnerships may have even less ability to withdraw their contribution or influence management to make distributions than shareholders have, especially if the limited partnership shares are publicly traded. Perhaps Bebchuk just believes, for aesthetic or distributional reasons, that shareholders should have the benefits of direct ownership of corporate assets (control rights and claims on economic value created using the assets), but none of the responsibilities of direct ownership of corporate assets (liability and lack of liquidity). As an economist, I find the incentives implied by such an allocation of rights and responsibilities to be a bit troubling.
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C. Proposals That Give Shareholders More Information and More Effective Voice

The corporate scandals of the last few years have made it clear that agency problems in corporations can be severe, but even granting that agency costs can be a problem, it is hard to see how Bebchuk's "scaling-down" proposals or "game-ending" proposals would have helped to prevent the frauds that happened at Enron or WorldCom, or the insider dealing at Tyco, or even the errors in business judgment that might have been behind Time Warner's merger with AOL. The financial markets appeared to love all of those companies right up until their problems were revealed, and by then it was too late to prevent them.

Financial investors, however, may not be able to make optimal investment decisions because they are likely to suffer from limited and/or distorted information about the performance of companies in their portfolios. Presumably it was bad information and distorted perceptions, rather than stupidity, that led financial investors to invest so much cash in internet and telecom companies in the late 1990s, resulting in the financial market boom of that period, and the subsequent bust since 2000. Hence, corporate governance proposals that are aimed at enhancing investor information, and even giving investors more effective voice, might "improve" corporate governance (in the sense of increasing the wealth-creating potential of corporations) by reducing agency costs and facilitating the allocation of capital toward truly promising investments, while not undermining the features of corporate governance that help to solve the team production problem. A sampling of the reforms that have been proposed (or enacted) are:

1) Enhancing the quality of information:

* Enhance oversight of the accounting profession through a new, publicly-chartered oversight board.

* Enhance the rules for auditor independence.

* Require CEOs and CFOs to take personal responsibility for the accuracy of reports filed with the Securities and Exchange Commission.

143. All the more reason that they should not have scaling-down, or game-ending authority.

144. See ROBERT SHILLER, IRRATIONAL EXUBERANCE (2000) (reviewing evidence that financial markets often overreact to new information).

145. Sarbanes-Oxley Act § 101(d) (providing for the establishment of the Public Company Accounting Standards Board).

146. Id. § 201(a) (prohibiting auditor provision of certain non-audit services to audit clients; § 202 (requiring audit committee pre-approval of audit and permissible non-audit services); § 203 (requiring audit partner rotation); § 204 (requiring auditor to report to audit committee regarding critical accounting practices and other matters); § 206 (providing for the SEC to develop rules regarding auditor conflicts of interest).

147. Id. § 302(a) (requiring CEOs and CFOs to certify disclosures in quarterly and annual reports; § 906 (requiring CEO and CFO certification of disclosures in periodic reports containing financial information).
* Enhance disclosure requirements regarding off-balance sheet arrangements and contractual obligations. \(^{148}\)

* Reduce the time allowed for companies to report insider transactions. \(^{149}\)

These reforms have, of course, all been made law by the enactment of the Sarbanes-Oxley Act of 2002. Without analyzing the merits of these reforms (which would be beyond the scope of this Article), we can safely assume that all of them are intended to improve the quality and reliability of information that shareholders have about the corporations in which they are investing. Better information will help shareholders decide whether to buy or sell shares, causing the market price to more accurately reflect the true underlying value of the shares. But better information does not affect the degree of control that corporate directors have over corporate decisions or allocation of corporate assets. Hence, these are the kinds of reforms that could reduce agency costs in ways that are consistent with the “team production” and “locking-in of capital” functions of corporate law.

2) “Rules-of-the-game” proposals:

* Shareholders should have the right to vote on all equity-based compensation plans. \(^{150}\)

* Shareholders should have the right to nominate directors. \(^{151}\)

* Shareholders should have the power to initiate charter amendments as well as bylaw amendments. \(^{152}\)

* Shareholders should have the power to initiate actions to reincorporate in another state under different statutory rules. \(^{153}\)

These proposals all clearly shift power and influence away from directors and toward shareholders, and so I regard them with caution. But they do so in ways that are not necessarily inconsistent with the ability of directors to retain

\(^{148}\) Sabanes-Oxley Act § 401(a) (requiring disclosure of off-balance sheet arrangements and contractual obligations).

\(^{149}\) Id. § 403 (requiring accelerated reporting, electronic filing and website posting of information on insider transactions).


\(^{152}\) Bebchuk, supra note 2, at 4.

\(^{153}\) Bebchuk, supra note 2, at 30-31.
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ultimate control over "scaling-down" and "game-ending" decisions, which are the types of decisions that, if left to shareholders, would have the greatest potential for undermining the team-production-fostering role of the corporate form. If shareholders were permitted to nominate directors, propose charter amendments, and initiate reincorporations in other states, it would be interesting to see whether they would use these rights to improve their access to information and ability to monitor performance, or whether they would use these additional powers to attempt to extract immediate benefits for shareholders at the expense of other stakeholders or at the expense of the long-run wealth-creating potential of the corporation.

The funds managers at large institutional investors may understand that, to a great degree, the performance of their portfolios is ultimately tied to the performance of the economy as a whole. Although it might benefit individual shareholders from time to time to engage in scaling-down or game-ending strategies that extract wealth at the expense of the long-run performance of a particular firm, it does not serve the interests of shareholders as a class to have weak directors and managers who are unable to elicit the enthusiastic cooperation of other corporate stakeholders in the wealth-creating enterprise of the firm. Thus, to the extent that the large-block shareholders in U.S. companies are widely diversified institutional investors, they might use these new powers in moderation, and would not undermine the strength of boards or compel the premature distribution of corporate assets.

This line of argument does not apply to the game-ending and scaling-down decisions, because the short-term benefits that are available from extracting assets from a corporation can sometimes be attractive enough to motivate individual investors to acquire concentrated holdings and form coalitions with other undiversified and short-term-oriented investors to strip assets out of a corporation. This could occur despite the fact that a widely-diversified institutional investor, with a very long time horizon (such as an indexed

154 For example, in April 1995, investors led by Kirk Kerkorian formed an alliance with former Chrysler Corp. chairman Lee Iacocca to make a bid to acquire Chrysler Corp. Kerkorian claimed that his intention was to get Chrysler to use its cash surplus to pay out dividends and buy back stock to increase the share price. Iacocca disavowed any interest in running the company, and Kerkorian explained that Iacocca was involved because he knew a great deal about the auto industry and because he recognized the opportunity to pull assets out of Chrysler in a way that they thought would increase the value captured by shareholders. Kerkorian publicly praised the Chrysler management team and promised that he had no intention of replacing them. Kerkorian and Iacocca did not win the support of enough institutional investors to allow their bid to succeed, however. See, e.g., Charles Stein, Investor Seeks $22B Takeover of Chrysler, BOSTON GLOBE, Apr.13, 1995, § 1, at 1; Bill Barnhart, Chrysler Bid Pairs Two Old Allies, CHICAGO TRIBUNE, Apr. 13, 1995, § 3, at 1. See also Shinichi Hirota & Kohei Kawamura, What Makes Autonomous Management Do Well? Corporate Governance Without External Controls (ECGI—Finance Working Paper No. 10/2003) (finding that it is optimal for shareholders to be passive and leave the firm to management control in situations where workers are employed on a long-term basis and the effort of young workers depends on managerial decision-making; employees in such situations will keep the pressure on managers to perform, providing a substitute for shareholder control), available at http://papers.ssm.com/paper.taf?abstract_id=379100.
pension fund) would not find that the advantage to be gained from pulling assets out of one corporation outweighed the costs in lost credibility of the capital lock-in bargain that would affect its whole portfolio of investments.

D. Proposals That Strengthen the Role and Effectiveness of Boards

The team production approach to understanding corporate law emphasizes the role of strong independent boards of directors in maintaining the right balance among the competing claims and interests in corporations. By contrast, the principal-agent approach to understanding corporate law often conflates the roles of directors and managers. In Bebchuk's article on empowering shareholders, for example, he never even acknowledges that boards of directors might be distinct from managers institutionally, legally, and in terms of the personalities involved. Hence, he acknowledges no role for boards of directors to help address the principal-agent problem by monitoring managers to be sure that they are not self-dealing, and that their actions are directed toward long-run wealth creation by the corporation rather than get-rich-quick schemes by management itself. If the role of boards of directors is properly understood, then it seems clear that any reforms that enhance the independence of boards, that provide them with better information, or that help them to work better and smarter, are likely to enhance both the team production-fostering and the agency cost-reducing functions. A sampling of proposals that I believe have the potential to generate this effect include:

* Boards of directors should consist of a majority of independent directors. 155

* Boards should have audit, nominating, and governance committees consisting entirely of independent directors. 156

* Directors and committee members should be required to meet without management, 157 and their responsibilities should be enhanced to include reviewing more closely the goals, objectives, and performance of management, and evaluating compensation in light of these. 158

Although reforms such as these are not inconsistent with the role of boards in addressing the team production problem, they would not necessarily improve the performance of boards, nor of companies, by themselves. What is also

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155. NYSE Proposed Rule Change, supra note 150, at 6; see also NASDAQ, supra note 150, at 1 (proposing that NASDAQ listing rules should require a majority of independent directors on boards).

156. NYSE Proposed Rule Change, supra note 150, at 9-11; see also NASDAQ, supra note 150, at 2-3 (proposing that audit committee members be independent, and approval be by independent directors of nominations and executive compensation).

157. NYSE Proposed Rule Change, supra note 150, at 10; see also NASDAQ, supra note 150, at 2 (proposing that executive sessions of independent directors must be convened regularly).

158. NYSE Proposed Rule Change, supra note 150, at 8. NASDAQ proposals suggest independent compensation committees but do not specify duties in the same way that NYSE proposed rule changes do.

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needed is education and acculturation of directors so that they better understand, buy into, and have the tools they need to fulfill their roles.

V. FINDING THE RIGHT BALANCE BETWEEN REDUCING AGENCY COSTS AND FOSTERING TEAM PRODUCTION

The problem of choosing appropriate organizational forms and rules arises whenever people agree to work together to accomplish complex and long-term goals. If people could foresee all contingencies, and if they were all completely cooperative and trustworthy, almost any organizational form would work, because no one would try to take advantage of private information or unforeseen events. But, as Oliver Williamson noted long ago, people are "boundedly rational" and behave opportunistically.\(^{159}\) Thus, productive activity that involves many people is susceptible to being co-opted or diverted to serve the interests of one or more participants at the expense of the others. It is therefore impossible to write complete contracts that will elicit best efforts and cooperation by all participants in the enterprise. Productive organizations, or firms, provide an alternative solution to this problem by establishing a set of gap-filling rules about who gets to decide what as the enterprise proceeds. Corporations in particular come with a set of default rules that, under U.S. law in the twenty-first century, differ from the rules of legal organizational forms based on partnership in four principal ways: They provide continuity and possibly perpetuity of existence; they provide for control by a board of directors; they provide free transferability of interests; and they provide a mechanism for locking in the capital used in the enterprise without locking in the investors. Although the default rules for partnership do not provide these features, it is possible to structure partnership forms contractually to provide the first three of these features too. Conversely, it is possible to include charter provisions in corporate charters that eliminate or restrict these features. But the basic corporate form provides for all four features, and using the basic form is the simplest way to create a business organization that has these features.

Hence, under current corporate law, it is possible for investors to form an organization, invest capital in that organization, turn control over to an independent board of directors, and pre-commit not to withdraw their invested capital prematurely, or capriciously, or in ways that harm other participants in the enterprise. Such a pre-commitment may be important in order for a corporation to attract complex, intangible, and firm-specific inputs from other participants in the enterprise, such as managers and skilled employees. If corporate law were "reformed" in ways that conferred upon shareholders in corporations the rights to compel directors to pay out dividends, make other

distributions, sell assets, or liquidate and dissolve the company, such "reforms" would eliminate investors' ability to choose a form that essentially prevents them from taking advantage of the other participants—or at least, makes it more difficult for them to do so. By reducing options currently available to business organizers, such a "reform" would probably reduce overall welfare. In light of more than 150 years' worth of experience with wealth creation through the corporate form, it seems to me that the burden of proof is on those who would propose such changes in corporate law to show that the economic welfare is reduced, and society is harmed by the fact that business organizers have the ability to choose an organizational form that locks in capital and yields control rights to directors.
A Framework for the Regulation of Securities Market Intermediaries

Stephen J. Choi*

INTRODUCTION

This Essay examines the role of private institutions in promoting strong securities markets. Recent scandals in the United States highlight both the importance and the fallibility of the securities market intermediary institutions to which investors typically turn for protection, such as auditors, analysts, and proxy advisory firms. From the perspective of investor welfare, this Essay discusses the various forms of institution failure and the efficacy of recently promulgated reforms.

A securities investment returns value only through intangible rights associated with the securities.¹ The value of these intangible rights depends on information related to the company, including information relating to earnings and strategic business plans, among others. Not all investors are on an equal informational footing. Insiders, for example, systematically enjoy an information advantage over outside investors. Even among outside investors disparities exist. Large institutional investors, including mutual funds and public and private pension funds, often expend significant resources on researching securities. Individual investors typically lack the ability to engage in the same level of research.

Collective action problems stand in the way of investors as a group coordinating researching and overcoming informational asymmetries. This lack of coordination leads to at least three problems. First, individual investors who systematically engage in trades opposite to insiders and other informed investors face reduced returns. Second, confronting the possibility of information disparities, institutional investors may expend costly resources to gain a trading advantage over each other (or, alternatively, to avoid being at an information disadvantage). While privately beneficial, often such duplicative

* Roger J. Traynor Professor of Law, University of California, Berkeley (Boalt Hall). Special thanks to Un Kyung Park. Thanks to the participants of the East-West Center and KDI Conference on Corporate Efficiency in Korea (2003) and the symposium on "The Role of Law in Promoting Long-term Value for Shareholders," sponsored by the Berkeley Business Law Journal and the Mercatus Center (2003) for helpful comments and suggestions.

¹ Common stock, for example, typically gives investors the right to share pro rata in dividends and the right to elect directors to a corporation's board of directors.
expenditures are socially wasteful.\textsuperscript{2} Third, when outside investors lack information on corporate activities, managers and insiders enjoy greater leeway to expropriate private benefits of control.\textsuperscript{3} Through the expenditure of costly resources, any single investor may monitor and work to discipline underperforming managers. To the extent the benefit from monitoring and disciplining managers accrues to all investors, however, no single investor will have full incentives to engage in such activities.\textsuperscript{4}

Solutions exist to information problems in the capital markets. La Porta, Lopez-De-Silanes, Shleifer, and Vishny (LLSV) provide cross-country comparison evidence across a series of papers demonstrating a statistically significant correlation between strong legal protections for minority shareholders (as well as a common law legal tradition) and various measures of financial development.\textsuperscript{5} The evidence that laws matter, however, leaves open the question of exactly what laws are important and how laws interact with norms and institutions.\textsuperscript{6} Standing alone, for example, a legal requirement of mandatory disclosure may not provide much benefit for individual investors. Even with disclosure, individual investors face the daunting task of interpreting the information, determining its credibility, and collectively pursuing their shareholder rights.\textsuperscript{7}

Crucial to the operation of legal protections for investors is the presence of securities market intermediary institutions, such as institutional investors, auditors, and analysts among others. Intermediary institutions play a key role in

\begin{itemize}
\item \textsuperscript{2} See Jack Hirshleifer, \textit{The Private and Social Value of Information and Reward to Inventive Activity}, 61 AM. ECON. REV. 561, 562–66 (1971) (providing a model where information research works only to accelerate the disclosure of information in a pure exchange economy and, therefore, generates no net social value).
\item \textsuperscript{4} Even well-informed public shareholders have few levers available to them—outside of a fiduciary duty lawsuit—to stop controlling shareholders from shifting value to the controlling shareholders. Importantly, the presence of a controlling shareholder is endogenous. The inability of firms to sell large amounts of securities to the public (leading to a concentrated control group) may be precisely due to the lack of institutions able to provide credible information as well as to assist in collectivizing the actions of shareholders in disciplining underperforming managers.
\item \textsuperscript{5} See Rafael La Porta et al., \textit{Law and Finance}, 106 J. POL. ECON. 1113, 1116 (1998); Rafael La Porta et al., \textit{Corporate Ownership Around the World}, 65 J. FIN. 471 (1999); Rafael La Porta et al., \textit{Legal Determinants of External Finance}, 52 J. FIN. 1131 (1997); Rafael La Porta et al., \textit{Agency Problems and Dividend Policies around the World}, 55 J. FIN. 1 (2000); Rafael La Porta et al., \textit{Investor Protection and Corporate Valuation}, 58 J. FIN. ECON. 3, 4-6 (2000). Correlation, of course, does not necessarily mean causation. Questions remain as to the exact causal relationship between protections for minority shareholders and measures of financial development.
\item \textsuperscript{6} See also John C. Coffee, Jr., \textit{The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control}, 111 YALE L.J. 1, 4 n.6 (2001) (“By no means is it here implied that [LLSV’s measured] rights are unimportant, but they seem to supply only partial and sometimes easily outflanked safeguards, which have little to do with the projection of control and the entitlement to a control premium.”).
\item \textsuperscript{7} Of course, small, individual investors may look to the market price for securities that trade on an efficient market. Not all companies, however, trade on an efficient market. See infra notes 37-39 and accompanying text.
\end{itemize}
A Framework for the Regulation of Securities Market Intermediaries

interpreting disclosed information, assessing the value of companies, and
collectivizing the actions of shareholders, thereby increasing investor welfare.
Institutional investors, including mutual funds, help to aggregate the interests of
a large number of smaller, individual investors. Auditors provide certification
and verification of a company’s financial statements. Analysts give the
investing public information on the value of particular investments. Proxy
advisors, such as Institutional Shareholder Services (ISS), give primarily
institutional investors information on how to vote their proxies. Underwriters
in a public offering work, at least in part, to certify the quality of the offering.
Mutual funds help collectivize investment research (and decisionmaking) for
investors, among other services.

Despite the importance of institutions, examples of institutional failure
exist, as exemplified recently within the United States. Arthur Andersen, for
instance, failed to catch and report the off-balance sheet financial schemes in
Enron. Merrill Lynch and other Wall Street firms allegedly put forth overly
optimistic reports on particular companies that provided investment banking
revenues for the firms. The response on the part of regulators in the United
States has been one of regulation in the form of Regulation FD, the Sarbanes-
Oxley Act of 2002 and the recent settlement between Wall Street brokerage
firms and the SEC together with Eliott Spitzer, the New York State Attorney
General (the “Spitzer-SEC Settlement”).

This Essay provides two contributions. First, the Essay provides a
taxonomy of the various forms of securities market intermediary institution
failure. More than one reason exists for why private market intermediaries fail
in their function to protect the interests of investors. Understanding these
separate reasons is important in assessing the present regulatory response as
well as considering possible reform. Second, the Essay compares the failings of
the market against the fallibility of regulators. Not all regulations are the
same—a series of possible interventions into the securities market exists

8. For information on ISS’s services, see http://www.issproxy.com (last visited Feb. 4, 2004).
9. A hierarchy of prestige exists among underwriters, with higher quality offerings typically
associated with higher prestige underwriters. For a study examining the prestige hierarchy among
underwriters, see Richard B. Carter & Steven Manaster, Initial Public Offerings and Underwriter
Reputation, 45 J. FIN. 1045, 1056-66 (1990); Richard B. Carter et al., Underwriter Reputation, Initial
10. Mutual funds may also obtain large scale economics in securities transactions unavailable to
most individual investors.
11. For a discussion of the Enron scandal, see William W. Bratton, Enron and the Dark Side of
Shareholder Value, 76 TUL. L. REV. 1275 (2002); John C. Coffee Jr., Understanding Enron: It’s the
Gatekeepers, Stupid, 57 BUS. LAW. 1403 (2002); Jeffrey N. Gordon, What Enron Means for the
Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U. CHI. L.
REV. 1233 (2002); Larry E. Ribstein, Market Versus Regulatory Responses to Corporate Fraud: A
12. See Charles Gasparino, Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts, WALL
ST. J., May 22, 2002, at A1 (noting that “[i]n one e-mail, a Merrill analyst referred to an Internet stock
the firm was touting as a ‘piece of s—’”).

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ranging from merit regulation at one extreme to the provision of optional investor education materials at the other. Some forms of market failures require less intervention (with a corresponding reduced cost of regulatory error and capture). Lawmakers often regulate first and ask questions later, ignoring both the potential downsides of regulation as well as the possibility of market-based alternative solutions to market failures. The presence of market-based solutions allows regulators to intervene less stringently into markets, leaving the market with some degree of choice in how to address particular intermediary defects.

Part I provides the taxonomy of institutional failure. Part II surveys the laws in the United States which directly affect the role of institutions in overcoming information asymmetries in the capital markets. The Part also discusses the impact of the recent regulatory reforms. Part III sets forth a framework to consider the optimal form of regulatory intervention to correct for defects in the intermediary market. The Part proposes that regulatory reforms should instead follow a more market-assisting rather than supplanting approach when possible.

I. TAXONOMY OF INSTITUTIONAL FAILURE

The Essay focuses on securities market intermediary institutions that supply collectivizing services for investors, including the provisions of information and advice to investors (as well as verification and certification of information) and services designed to reduce the cost of collective action. Intermediary institutions, in theory, profit from protecting investors. Intermediaries, including independent analysts, may sell services directly to investors. Even intermediaries paid directly by the issuer gain when they protect investors. Investors, for example, will increase their willingness to pay for securities of an issuer associated with particular intermediaries, such as high-reputation auditors, who work in the best interests of investors. Issuers will then pay a correspondingly higher fee to such intermediaries.

Investors, nonetheless, confront the risk that an intermediary institution


Djankov et al. posit that regulatory intervention balances two concerns. On one hand, private ordering alone may lead to excessive disorder (particularly where property rights and contracts are not respected). On the other hand, too stringent government intrusion in the economy opens up the risk of governmental expropriation of value (leading people to spend more time hiding their wealth as opposed to accumulating new wealth). They argue that varying forms of regulation strike different balances between disorder and order. Moreover, what is optimal for a particular country may differ from other countries (and be dependent on the history and cultural background of the country). In the context of the securities markets, Djankov et al.’s analysis requires more nuance. Within the United States, property rights and contracts are well respected. Instead, a variety of failures affect the market, as discussed in this article, that individually may require a different balance between allowing private ordering versus regulatory intervention.
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may fail to protect them. This Part examines various causes for failure in the securities markets including (A) financing problems of intermediaries; (B) conflicts of interests plaguing some intermediaries; (C) agency problems among individual members of a securities intermediary; and (D) unsophisticated investors in the market.

A. Financing Problems

Overcoming information asymmetries is costly. Investors attempting to research a company’s securities encounter well-known collective action problems. These problems can lead to both too great and too little incentives on the part of dispersed investors to expend resources in researching the companies in which they invest. Where investors research information to obtain a trading advantage, they may have too great incentives to become the very first with such an advantage (and thereby enjoy a trading profit) from the perspective of social welfare. Conversely, where investors must vote as a group to ratify various corporate transactions or elect directors, individual shareholders may lack the incentive to invest in determining how to vote (or in convincing others how to vote). While an individual shareholder bears all the costs of such activities, they benefit only pro rata with other shareholders to the extent the vote increases overall corporate welfare.

Intermediary institutions help reduce such collective action problems. However, collectivizing activities are not cost free. Both sell-side analysts working for brokerage firms as well as buy-side analysts in the employ of institutional investors must invest in researching information on the covered issuers. Analysts then synthesize such information, drawing upon their experience and expertise, in coming up with a recommendation for investors. Auditors must expend large resources in going through a company’s books, assessing the company’s system of internal controls, and spot-checking to ensure financial accuracy. Proxy insurgents, similarly, bear large costs. Not only must they distribute a formal SEC proxy filing to the SEC as well as to all solicited investors, but the insurgent must often expend resources directly communicating with (and often entertaining) a company’s largest shareholders.

Many intermediaries turn directly to investors for financing. Several independent analysts, including Value Line and gimmecredit.com, obtain funds

14. For a discussion of the various positive and negative societal impacts from securities research, see Ian Ayres & Stephen Choi, Internalizing Outsider Trading, 101 MICH. L. REV. 313, 328-35 (2003). Alternatively, to the extent information research results in a more accurate securities price (benefiting not only investors but also society), dispersed investors may have too few incentives to engage in research. Nonetheless, for many types of information about to be released soon to the market in any case (such as information internal to a company relating to earnings and other matters), the benefit from accelerating disclosure is likely small. See id. at 363-64.
directly from investors.\textsuperscript{15} Buy-side analysts working for institutional investors, as well, receive funding from investors (indirectly through mutual fund fees).

Significantly, because information is a public good, many institutions may fail to obtain funding from dispersed investors commensurate to the benefit they provide to the group of all investors.\textsuperscript{16} Without some ability to finance their activities, intermediaries will at best provide less (if any) of the service. Sell-side (as well as purely independent) analysts, for example, may not provide the level of research and breadth of distribution that maximizes societal welfare. Simultaneous and broad distribution of research increases price accuracy while reducing the incentive of dispersed investors to engage in their own duplicative (and therefore wasteful) research.\textsuperscript{17} Analysts seeking to sell their information, however, will not want to distribute the information at once to all investors (doing so eliminates the trading advantage). Without a trading advantage, the broad and simultaneous distribution of information results in valueless information to investors, who will then pay a correspondingly reduced (zero) amount to analysts.\textsuperscript{18}

\textbf{B. Conflicts of Interests and Intermediary Corruption}

As a solution to the financing problem, some intermediaries seek financing directly from publicly-traded firms. Auditors receive financing directly from issuers. Many sell-side analysts obtain funding through cross subsidies from the investment banking business within the same brokerage firm.\textsuperscript{19} Cross subsidies, in turn, are made possible from elevated investment banking fees charged to publicly-traded firms (and therefore indirectly to the shareholders of the firms).\textsuperscript{20}

\textsuperscript{15} Investors may purchase a one-year online subscription to the Value Line Investment Survey for $598. \textit{See Valueline.com Homepage, at http://www.valueline.com (last visited Jan. 28, 2004).} The gimmecredit.com analyst firm provides bond research to institutional investors at a price of $18,000 per year. \textit{See Gimmecredit.com Homepage, at http://www.gimmecredit.com (last visited Jan. 28, 2004).}

\textsuperscript{16} A lack of financing may result in intermediaries seeking goals other than purely investor welfare. Proxy insurgents, for example, have a difficult time recouping their expenses, typically getting reimbursed only if they win (and only to the extent the shareholders vote to make such a reimbursement). \textit{See Edward Robinson, Sam Wyly, Cowboy Investor, BLOOMBERG MKTS. MAGAZINE, Sept. 2001} (noting that “companies generally pay all the expenses for the reelection campaign of incumbents, but reimburse challengers only if they gain control over the board of directors”), available at http://www.bloomberg.com/marketsmagazine/ft3_0109.html (last visited Dec. 23, 2002). As a result, some proxy insurgents able to bear the expense of such a contest may do so not to maximize overall shareholder value but to obtain private benefits of control for themselves.


\textsuperscript{18} For example, an investor may learn that Apple is about to enter into a contract with Sony Music to distribute music online. However, if everyone else simultaneously learns of the same information, the investor will not have a trading advantage over others.

\textsuperscript{19} \textit{See also Jill E. Fisch \& Hillary A. Sale, The Securities Analyst as Agent: Rethinking the Regulation of Analysts, 88 IOWA L. REV. 1035, 1045-54 (2003) (describing cross subsidies for sell-side analysts).}

\textsuperscript{20} Indeed, without such cross subsidies, analysts may choose not to cover certain firms. After
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The funding connection between publicly-traded firms and institutional intermediaries in the securities markets has provided corporate managers with an avenue to influence the information provided through the intermediaries to the market. At worst, managers may threaten to withhold investment banking business to obtain more favorable analyst ratings for their firms than warranted. Managers may also threaten to terminate non-audit-related consulting business with auditors to influence an audit. Auditors, analysts, and other intermediaries receiving funding either directly or indirectly from a corporation may therefore choose to sacrifice the quality of their information services to please corporate managers. Over the 1990s, in particular, the problem of manager-directed corruption of intermediaries increased rapidly, culminating in Enron and other scandals.21

Certainly, conflicts of interest pose an identifiable problem within the securities intermediary market. Understanding the conflicts of interest problem in the context of the overall financing problem, however, leads to a policy dilemma.22 Simply prohibiting conflicts of interest alone does not address the underlying financing problem. Indeed, the financing problem is made worse to the extent intermediaries lose the ability to seek funds from publicly-traded firms due to conflict of interest prohibitions. Regulators that attempt to separate analysts completely from investment banking may very well reduce conflicts of interests facing analysts. However, such a separation may also result in a drop in the available financing for analysts, thereby reducing the amount of sell-side analyst research provided into the capital markets.23

The market already provides one solution to the possibility of intermediary corruption. Intermediaries may seek to develop a reputation for providing high quality services for investors. Auditors with high reputations among investors are more valuable to public companies than auditors with poor reputations. Auditor certification helps assure investors that the financials of a public firm are credible, leading investors to pay a higher price for the firm’s stock. From


21. Jack Coffee has argued that the incentive of managers to corrupt intermediaries to obtain even a short-term boost in share price rose over the 1990s due to the increased use of stock options. See Coffee, supra note 11, at 1413-14. Managers holding large numbers of options profited greatly from exercising their options at times when their stock price was even temporarily elevated. See also Gordon, supra note 11, at 1245-47 (noting that managers compensated with a large amount of options “have incentives to increase the riskiness of the firm, including projects that offer lower expected returns but higher variance”).


23. Intermediaries, of course, may become corrupt even without inducements from corporate managers. As discussed later, individual agents working at an intermediary may sacrifice the best interests of both investors and the intermediary itself for the agents’ own personal self-interest.
this reputation, an intermediary is able to charge a higher fee for its services. Intermediaries that earn super-competitive profits (from the elevated fees) will lose a great deal, to the extent investors sour on the particular intermediaries. The prospective flow of super-competitive profits then bonds the high reputation intermediaries to remain credible in the information they provide.

Even when reputation works perfectly to ensure that an intermediary will not sacrifice the best interests of investors (and, as discussed below, perfection is hard to obtain), the reliance on reputation is not cost free. In equilibrium, fewer competitors will operate in the market for intermediary services where reputation is used as a bonding mechanism leading to higher profitability. Higher profitability imposes a greater penalty on those intermediaries which choose to sacrifice their reputation. Less competition, however, means a lower incentive on the part of intermediaries to innovate in ways to protect investors. Furthermore, investors indirectly pay more for investor protections derived from such intermediaries.

C. Agency Problems

Not all those associated with an intermediary work in the best interests of the intermediary. An agent of the intermediary may only partially consider the best interests of the intermediary, taking into account the agent's own self-interest in making decisions. An intermediary’s high reputation, moreover, is not a remedy for agency problems. Arthur Anderson’s relatively high reputation pre-Enron resulted in the auditor obtaining large rents, as issuers sought to obtain an audit from Arthur Anderson to boost their own credibility. Nonetheless, individual audit partners within Arthur Anderson did not internalize the full value of Arthur Anderson’s reputation. John Coffee and Jeffrey Gordon have separately argued that David Duncan, the Houston partner of Arthur Anderson, reduced the standards of the audit in an effort to increase his own revenues at the expense of Arthur Anderson’s overall reputation. Indeed, when a high-reputation institution helps to assist fraud, investors are harmed to a much greater extent than when the investors are already on guard.

Setting aside self-interest, agents within securities market institutions may

24. See Coffee, supra note 11, at 1415-16 (describing the possibility that audit partners and consultants both were aligned in keeping "their mutual client satisfied, and together they would form a coalition potentially able to override the protests of their firm's internal audit unit (if it felt that an overly aggressive policy was being followed)"); Gordon, supra note 11, at 1239 (noting that "Enron might have been a relatively small client for Andersen, the firm, but it was the largest client for its Houston office, and, for the Enron relationship partners, perhaps their only significant client").

25. The fact that investors missed obvious (at least using hindsight) warning signs related to Enron supports the notion that investors may be more at risk when dealing with supposedly high-reputation institutions. See Gordon, supra note 11, at 1240 ("The only compelling reason not to assume the worst about Enron's deliberately obscure financial statements was because of Andersen's certification, yet the market 'knew' that the certification had little value.").
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also suffer from a variety of behavioral biases that may lead to institution failure. Overconfidence, for example, may cause some audit partners to believe that they can get away with less-than-complete audits while still protecting investor interests. Similarly, analysts and money managers may become overoptimistic about the stock market. Alternatively, analysts and money managers may come under an availability bias, focusing too closely on more recent information. Short-term upswings in the stock market and in corporate earnings may lead analysts to overstate the value of stocks.

The agency problem facing intermediary institutions interacts with the need of institutions to develop a reputation for credibility. To the extent that institutions must maintain a large market share (thereby generating super-competitive profits) to bond themselves to remain credible, organizational problems will increase within the institution. As client-firms grow multinational, the need for an international presence also exacerbates the organizational problem facing intermediary institutions. For example, as auditors grow international in size and scope, the possibility of a single auditing partner located in a specific geographical region putting his own self-interest above those of his other partners, thereby sacrificing the reputation of the entire international entity, becomes more acute.

D. Uninformed and Irrational Investors

In theory, rational and fully-informed investors should provide a natural disciplining influence on poorly-performing intermediaries. Intermediaries earn a return directly based on their reputation. An analyst with a poor reputation among investors, for instance, will not find a large audience for its research. Similarly, publicly-traded firms that hire auditors with a poor reputation send a negative signal to the market and thus will face a reduced share price. Firms

26. Experts, such as auditors and analysts, are not immune to overconfidence or overoptimism. See Dale Griffin & Amos Tversky, The Weighing of Evidence and the Determinants of Confidence, 24 COGNITIVE PSYCHOL. 411 (1992). Compare John Jacob et al., Expertise in Forecasting Performance of Security Analysts, 28 J. ACCT. & ECON. 51 (1999) (providing evidence that analyst forecast accuracy does not increase with experience) with Michael B. Mikhail et al., The Development of Expertise: Do Security Analysts Improve their Performance with Experience?, 1 J. ACCT. RES. 131 (1997) (finding a statistically significant decline in analyst forecast errors as their firm-specific experience increases).

27. Many other behavioral biases have been documented. For example, under the confirmation bias, people tend to confirm prior decisions regardless of whether the decisions were correct at the time they were made. See, e.g., R. Forsythe et al., Anatomy of an Experimental Political Stock Market, 82 AM. ECON. REV. 1142 (1992); Charles G. Lord et al., Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence, 37 J. PERSONALITY & SOC. PSYCHOL. 2098 (1979).

28. Social norms may also affect the magnitude of agency costs in different countries. In a country where the norm is for agents to adhere faithfully to the interests of principals and those found deviating from the norm are shamed in their communities, agents may be much less likely to engage in self-interested behavior. On the other hand, in countries where agents routinely sacrifice their principal's best interest (by taking bribes, for example) and people commonly treat such practices as part of the business culture, agents are far more likely to act with self-interest.
trading in markets with pervasive information asymmetries and collective action problems will experience a large discount in their share price. Companies, therefore, may internalize the cost of being unable to reduce the risk facing investors when they seek to raise capital in the market.29

Not all investors, however, are rational and fully informed. Particularly smaller, individual investors may lack the information and expertise to assess the credibility of specific intermediaries. Bernard Black, for example, has made the argument that some intermediaries may free ride on the reputation of other intermediaries.30 Where investors generally are not able (or find it prohibitively costly) to distinguish precisely among different intermediaries, a high-quality intermediary may find that other, more low-quality intermediaries benefit from the high-quality intermediary’s investment in reputation. Consequently, intermediaries face a reduced incentive to invest in building their reputation.

A related observability problem exists. Audits sometimes turn out inaccurate, and analysts occasionally (in recent memory, often) are wrong in their recommendations. Institutional investors may make poor investment choices. Whether such unfortunate events are due to unforeseeable circumstances or, instead, are due to failure on the part of the intermediaries to take actions in the best interests of investors is sometimes unclear to the market. Where the market believes, for instance, that a positive probability exists that a bad event is not due to intermediary failure, intermediaries that fail investors will not suffer the full hit to their reputations.31 On the other hand, intermediaries that perform up to their ability in protecting investors but simply get unlucky will get penalized to the extent the market is unable to distinguish them from poor quality intermediaries.

Some investors may suffer from a variety of behavioral biases, in addition to informational problems. Individuals, for example, may act with overconfidence in their ability to pick investment “winners.”32 Individuals may also make decisions subject to framing effects. For instance, they may purposefully avoid selling losing stocks longer than warranted to avoid realizing a loss on their investment (loss aversion).33 Conversely, investors may treat gains as “house money,” making overly risky investment decisions with

31. See Coffee, supra note 11, at 1415.
33. See Hersh Shefrin & Meir Statman, The Disposition To Sell Winners Too Early and Ride Losers Too Long: Theory And Evidence, 40 FIN. 777, 788 (1985) (reporting evidence that investors sell stocks with gains too quickly and hold on to stock with losses too long, thereby suffering from a higher tax liability than necessary).
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the gains. Investors suffering from behavioral biases (or otherwise irrational decision-making) may not properly account for the risks of relying on particular intermediaries. Overconfident investors, for example, may simply follow the buy recommendations of analysts, regardless of the possible conflict of interest risk.34

Social norms may interact with investor behavioral biases. Where a deeply-rooted active investor norm arises, more investors may become pulled into engaging in active investment (often to their detriment). For instance, in the United States during the internet boom, discussions of investments became popularized in web sites such as those hosted by The Motley Fool.35 While perhaps only a correlation, large numbers of investors also took up day trading during the same time period.36

Firms whose securities trade in an efficient market provide some amount of protection for the unsophisticated and behaviorally challenged. To the extent larger, more sophisticated investors price the value of particular securities, even those investors lacking information or operating under a behavioral bias may pay a price commensurate with the value of the securities which they purchase. Not all securities, however, trade in an efficient market.37 Securities of smaller firms or firms which trade in less-developed markets may lack an efficient market. Even for firms whose securities do trade in larger, well-developed markets, herding and other forces may cause market prices to move away from the efficient price point.38 Case in point, if large numbers of investors exhibit overconfidence in their trades and are unaware of possible conflicts of interest of the part of analysts, sophisticated investors may find it more profitable to follow an upward trend in price (due to the analysts' positive recommendations) than to arbitrage against that trend.39

In sum, the starting point in determining failures on the part of intermediary institutions to protect investors is financing. Intermediaries may react to inadequate financing with less than desirable amounts of information services

35. The Motley Fool maintains several discussion boards devoted to investing, at http://boards.fool.com (last visited Feb. 4, 2004). Investors can find discussion devoted to retirement investing, day trading, and other topics. See id.
36. Since the end of the latest bull market, the number of day traders has diminished. See Aaron Elstein, Yes, Day Traders Still Exist, They Just Keep a Lower Profile, WALL ST. J., Oct. 17, 2002, at D4 (reporting a fall in the number of full-time day traders from 20,000 to 7,500).
37. Indeed, Gordon uses the collapse of Enron (and the market's inability to foresee many of the failures leading to the collapse) as evidence of a lack of efficiency in the market. See Gordon, supra note 11, at 1235-40.
38. See J. Bradford De Long et al., Noise Trader Risk in Financial Markets, 98 J. POL. ECON. 703, 703 (1990) ("The unpredictability of noise traders' beliefs creates a risk in the price of the asset that deters rational arbitrageurs from aggressively betting against them.").
(from the perspective of investor and social welfare). For intermediaries that receive financing directly or indirectly from a publicly-traded firm, a different sort of problem arises: managers may use their power to direct funds as a means to corrupt the intermediaries. Reputation provides one solution to the problem of corruption. Nonetheless, relying on reputation results in more concentrated intermediary services markets (with correspondingly higher fees). Moreover, reputation may fail due to both individual agency problems within an intermediary and an inability on the part of investors to distinguish among intermediaries.

II. INSTITUTION-FOCUSED REGULATION IN THE UNITED STATES

Institutions within the United States do not operate in a completely free market. Instead, securities market intermediaries are regulated pursuant to the federal securities laws, among other regimes. In theory, regulation may provide a more effective means of addressing the various forms of securities intermediary failure than the market. The government enjoys a monopoly on certain forms of sanctions, including criminal penalties. Furthermore, the government, as a centralized actor, may have economies of scale in monitoring the securities market as well as disseminating information to investors.

A vast array of U.S. regulations deal with securities intermediary institutions. John Coffee has observed that various regulations dealing with the securities fraud liability of intermediaries (including in particular auditors) have moved toward reduced liability over the 1990s. This Part discusses three recent regulatory reforms in the United States aimed at shoring up the role of securities market intermediary institutions in protecting investors: (A) Regulation FD, (B) the Sarbanes-Oxley Act, and (C) the Spitzer-SEC Wall Street Settlement.

A. Regulation FD

Selective disclosures occur when managers of a firm distribute material, non-public inside information to a select group of favored outside investors and analysts. For many years, the SEC attempted to classify selective disclosures as impermissible “tips” under the insider trading laws. The Supreme Court in Dirks v. SEC, however, held that tippees violate the insider trading laws only when they receive information from a tipper in a situation where the tipper violates his fiduciary duty and the tippee knew (or should have known) of the breach. Importantly, the Court required that the fiduciary breach result in a

40. See Coffee, supra note 11, at 1409-12. Coffee theorizes that the rise in intermediary failures is due, in part, to the reduction in antifraud incentives. See id. But see Ribstein, supra note 11, at 33-34 (questioning the impact of the reduction in antifraud liability over the 1990s).

41. The Court stated:
personal benefit from the tipper.\textsuperscript{42} In doing so, the Court was particularly concerned with giving corporate officers the ability to pass inside information freely to analysts.\textsuperscript{43} While the SEC has attempted to characterize selective disclosures to analysts within the confines of the \textit{Dirks} definition of insider trading,\textsuperscript{44} in 2000 the SEC utilized its rulemaking authority to promulgate Regulation FD, constraining further the ability of corporate officers to provide information selectively to outside analysts among others.\textsuperscript{45}

Regulation FD is limited in application to only Exchange Act reporting U.S. companies\textsuperscript{46} and those working on behalf of Exchange Act reporting companies.\textsuperscript{47} Regulation FD, moreover, does not restrict selective disclosure to all possible recipients; instead, it prohibits selective disclosure of non-public material information to broker-dealers, investment advisors, investment companies, and any investor that is reasonably expected to trade on the information must also disclose the information to the market at large.\textsuperscript{48} Foreign

\begin{flushright}
[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.


\textsuperscript{42. See id. at 662 ("[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders."). See also id. at 664 ("The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.").}

\textsuperscript{43. See id. at 659 n.17 (discussing the concern that too broad a reach for insider trading liability may have an "inhibiting influence on the role of market analysts").}

\textsuperscript{44. The SEC in \textit{SEC v. Stevens} attempted to characterize a tip from a corporate CEO to an analyst as involving personal benefit, because the officer enhanced his reputation from the tip. See \textit{SEC v. Phillip J. Stevens}, Litigation Release No. 12813, 1991 SEC LEXIS 451, at *2 (Mar. 19, 1991). The CEO settled with the SEC, however, and the case never reached court. Commentators, however, have criticized the SEC's position. See John C. Coffee, Jr., \textit{Is Selective Disclosure Now Lawful?}, N.Y. L.J., Jul. 31, 1997 at 5. See Fisch & Sale, \textit{supra} note 19, at 1061 (noting that after \textit{Stevens} the SEC "stopped bringing selective disclosure actions based on section 10(b)").}


\textsuperscript{46. The Exchange Act imposes periodic information reporting requirements (including annual Form 10-K and quarterly Form 10-Q filings) for certain issuers, commonly known as "Exchange Act reporting companies." See 15 U.S.C. \S\S 78a-mm (2003) [hereinafter Exchange Act]. Companies listed on a national securities exchange must register and comply with the SEC's periodic information disclosure requirements. See Exchange Act \S\S 13(a), 12(b); \textit{see also} Exchange Act \S 13(a)(1) (defining "exchange" for the purposes of the Exchange Act). Additionally, companies whose total assets exceed $10 million and have a class of equity security (other than an exempted security) held of record by more than 500 shareholders must register the securities under the Exchange Act and thereby come under the periodic reporting requirements of Section 13(a). See Exchange Act \S\S 13, 12(g); \textit{see also} Rule 12g-1 (raising the asset requirement to $10 million). Companies which recently filed a registration statement that has become effective under the Securities Act must also comply with the periodic reporting requirements. See Exchange Act \S 15(d)).}

\textsuperscript{47. See Rule 101(b), Regulation FD (defining "issuer" to encompass primarily Exchange Act reporting companies).}

\textsuperscript{48. See Rule 100(b)(1), Regulation FD.}
issuers are exempt from the coverage of Regulation FD.49

Unlike many other provisions of the U.S. securities laws, private antifraud liability does not follow from a violation of Regulation FD.50 Violators face only SEC enforcement. Intentional selective disclosure requires the issuer to disclose the same information simultaneously to the public.51 In cases of unintentional selective disclosures, Regulation FD requires the issuer to disclose the information publicly within twenty-four hours or by the time trading commences in the NYSE (whichever is sooner).52 Moreover, violation of Regulation FD does not affect the ability of issuers to employ Forms S-2 or S-3 for a public offering, as well as investors to use Rule 144 of the Securities Act to sell restricted securities.53

Removing the ability of firms to make selective disclosures works to level the playing field for analysts and outside investors. The playing field, of course, is still not completely level. Analysts and certain outside investors may expend (often considerable) resources in securities research to obtain an information advantage. Nonetheless, information advantages obtained at relatively low cost from corporate managers is curtailed under Regulation FD. At first glance, removing such advantages may strike some as intuitively fair.54 Taking into account the various categories of institutional related problems, however, gives a more mixed picture on the value of Regulation FD in protecting investors.

From a financing perspective, the prohibition on selective disclosure removes a mechanism for firms to subsidize analysts. Selective disclosures help finance favored analysts to the extent the analyst is either able to trade based on the information or sell the information to its clients.55 Particularly smaller firms without a large following of analysts may face a need to subsidize an analyst to initiate coverage on the firm. Analysts earn a return based on the ability to sell information to investors. For smaller firms in less-traded markets, fewer investors may actively follow such companies—giving analysts reduced


50. See Rule 102, Regulation FD.

51. See Rule 100(a)(1), Regulation FD (requiring simultaneous disclosure in the case of intentional selective disclosure).

52. See Rule 100(a)(2), Regulation FD (requiring disclosure "promptly" in the case of unintentional selective disclosures); Rule 101(d), Regulation FD (defining "promptly").

53. See Rule 103, Regulation FD.

54. For example, the SEC has explained that:

[i]t believes that the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security's price change dramatically and only later are given access to information responsible for that move rightly question whether they are on a level playing field with market insiders.

SEC Promulgating Release, supra note 45, at *2.

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profitability. Without the ability to give selective disclosures, therefore, an issuer may find itself with reduced analyst coverage.\(^5\)\(^6\)

The ability of issuers to use selective disclosures to finance analysts, however, comes with the risk of corruption. The SEC feared that managers were using selective disclosures to pressure analysts into giving better-than-warranted recommendations.\(^5\)\(^7\) Regulation FD, therefore, highlights the tension between financing and conflicts of interest. To reduce analyst corruption, the SEC cut off an avenue of funding for many analysts. What is uncertain is whether this tradeoff results in an overall increase or decrease in investor welfare.

Regulation FD also has an ambiguous impact on the problem of unsophisticated and uninformed investors. On the one hand, firms may react to the prohibition on selective disclosures through greater disclosures to the marketplace.\(^5\)\(^8\) In such a case, more information is revealed to investors, leading to more accurate prices and lower research costs generally on the part of dispersed investors. Another possibility exists, however. Firms may react to Regulation FD through a reduction in the overall amount of information they provide to the market.\(^5\)\(^9\) Analysts may then face more obstacles in ferreting out potential fraud within companies.\(^6\) Some outside investors and analysts may also expend greater (and duplicative) resources in determining the content of information that otherwise might have been disclosed by the company prior to

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\(^6\) See Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 (proposed Dec. 20, 1999) (to be codified at 17 C.F.R. parts 230, 240, 243, 249), 1999 WL 1217849, at *4 ("[A]nalysts are likely to feel pressured to report favorably about particular issues to avoid being ‘cut... off from access to the flow of non-public information through future analyst conference phone calls’ or other means of selective disclosure.").

\(^7\) Evidence exists that the information environment post-promulgation of Regulation FD has not been negatively affected. See Frank Heflin et al., *Regulation FD and the Financial Information Environment* (undated manuscript) (focusing on the information environment prior to an earnings disclosure and reporting no evidence that Regulation FD resulted in a reduction in the quality of this information environment), available at http://ssrn.com/abstract=276768 (last visited Jan. 28, 2004).

\(^8\) See Cheryl Winokur Munk, *SEC Disclosure Rule Dims Appeal of Conferences*, WALL ST. J., Feb. 27, 2001, at C16 (reporting that Regulation FD “has made companies less likely to share juicy tidbits in breakout sessions and in general presentations at these conferences” and thereby resulting in drop in attendance at investor conferences).

the promulgation of Regulation FD.

B. Sarbanes-Oxley Act of 2002

In the wake of scandals at Enron, WorldCom, Tyco, Global Crossing, and other corporations, Congress enacted the Sarbanes-Oxley Act of 2002, a series of somewhat disjointed reforms targeting securities market intermediary institutions. Sarbanes-Oxley first established a new Public Company Accounting Oversight Board (the "Oversight Board") to oversee the auditing profession. Under the Act, the Oversight Board consists of five members, two of whom must be (or have been) certified public accountants, while the remaining three must not be CPAs. Following the tactics taken in other areas of securities regulation, Congress established the Oversight Board as a self-regulatory organization—relying on the expertise of industry members to guide the regulation of auditors. As with other SROs, the SEC has oversight responsibility over the Oversight Board. The Act also provides for a greater direct role for the SEC in monitoring public company filings (with a corresponding increase in the SEC's budget).

Despite the willingness of Congress to leave much of the regulation of auditors and corporate financial statements to the new Oversight Board and the SEC, Congress did make a number of targeted substantive interventions dealing in particular with the provision of non-audit related consulting services. The Sarbanes-Oxley Act prohibits an auditor from providing a delineated list of non-audit services contemporaneous with an audit. The prohibited services include financial information systems design, management services, and legal services, but, significantly, do not include tax consulting. Auditors, after pre-approval on the part of the issuer's audit committee, may continue to provide non-audit related tax consulting.

63. Among other things, the Public Company Accounting Oversight Board must:
   (2) establish, or adopt, by rule, "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;"
   (3) conduct inspections of accounting firms;
   (4) conduct investigations and disciplinary proceedings, and impose appropriate sanctions. . . .
Sarbanes-Oxley Act § 103.
64. See Sarbanes-Oxley Act § 107.
65. See Sarbanes-Oxley Act §§ 408, 601.
66. Congress also provided for specific reporting requirements for off-balance sheet transactions in Section 401(a) of the Sarbanes-Oxley Act. The Act also provides for more rapid reporting of corporate filing information. See Sarbanes-Oxley Act § 409.
67. See Sarbanes-Oxley Act § 201.
68. See id
69. See id. Sarbanes-Oxley follows up on the SEC's earlier efforts in 2000 that, among other things, required companies in their proxy disclosures to report aggregate audit and non-audit related fees. See
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To reduce the possibility of individual conflicts of interest, Sarbanes-Oxley requires the lead partner and reviewing partner of the auditor to rotate at least once every five years.\(^{70}\) Similarly, the Act mandates that several top officers of the issuer (including the CEO, Controller, CFO, and Chief Accounting Officer) not be employed by the issuer’s auditor within the one year period preceding the audit.\(^{71}\)

Sarbanes-Oxley also focuses on the composition of the audit committee of a corporation’s board of directors. The Act requires the SEC to prohibit the securities exchanges and Nasdaq from listing companies without a separate audit committee on the board of directors.\(^{72}\) The Act requires that each member of the audit committee be “independent,” defined as “not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof.”\(^{73}\) The Act also makes clear that the audit committee has responsibility for the selection, compensation, and oversight of the public accounting firm for the issuer.\(^{74}\)

To bolster further the credibility of corporate reporting, Sarbanes-Oxley imposes on the CEO and CFO a duty to certify personally the audit report.\(^{75}\) The Act also requires those officers to certify all financial statements filed with the SEC as well as the company’s system of internal controls.\(^{76}\) The certification of financial statements must state that the disclosures fully comply with the Exchange Act reporting requirements and that the “information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.”\(^{77}\) Knowing and willful violation of the CEO and CFO financial statement certification requirement results in a fine of up to $5 million and imprisonment of up to

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70. See Sarbanes-Oxley Act § 203.
71. See Sarbanes-Oxley Act § 206.
72. See Sarbanes-Oxley Act § 301.
73. See id.
74. See id.
75. See Sarbanes-Oxley Act § 302. The CEO and CFO, in particular, must attest to the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." Id. Section 408 of the Sarbanes-Oxley Act also provides for increased SEC review of corporate filings. See Sarbanes-Oxley Act § 408. A related measure in the Sarbanes-Oxley Act focuses on the corporate ethics code (if any) of public corporations. Section 406 of the Act requires Exchange Act reporting companies to disclose whether they have a corporate ethics code for senior financial officers and also to disclose any changes or waivers in the code for such officers. See Sarbanes-Oxley Act § 406.
76. See Sarbanes-Oxley Act § 302
77. See Sarbanes-Oxley Act § 906(a), Tit. IX (codified in 18 USC § 1350).
twenty years. Sarbanes-Oxley makes explicit that: "It shall be unlawful . . . for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading." The Act also provides penalties requiring that the CEO and CFO must "reimburse the issuer for any bonus or other incentive-based or equity-based compensation received" during the twelve month period after the issuance or filing of the materially non-compliant document and "any profits realized from the sale of securities of the issuer" during that period.

While Sarbanes-Oxley has a wealth of provisions targeting auditors and financial reporting more generally, the Act says relatively little about securities analysts. Section 501 of the Act simply leaves it to the SEC to adopt conflict of interest rules governing analysts recommending equity securities. The Act, instead, directs more attention toward attorneys, imposing an affirmative duty on attorneys to disclose corporate fraud. In a similar vein, the Act provides more stringent protections for whistleblowers.

Sarbanes-Oxley finally provides a number of provisions aimed at enforcement. The Act first makes it a felony for someone who "knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct or influence" any federal investigation. Sarbanes-Oxley provides for a number of penalty enhancements for white collar crime and reduces the standard which the SEC must meet to ban corporate officers and directors from serving in publicly-traded companies. The Act also extends the statute of

78. See id.
79. Sarbanes-Oxley Act § 303.
80. Sarbanes-Oxley Act § 304. On a related note, the Act also prohibits the issuer from making personal loans to the directors and executive officers. See Sarbanes-Oxley Act § 402(a).
81. See Sarbanes-Oxley Act § 501. Among other things, Sarbanes-Oxley requires that the SEC adopt rules which restrict the "prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities . . . ." Id. at § 501(a). The SEC adopted Regulation AC in February 2003, which requires analysts to disclose their compensation related to their recommendations and to certify the accuracy of the opinions in their research reports. See Regulation Analyst Certification, Sec. Act. Rel. No. 33-8193 (Feb. 20, 2003), available at http://www.sec.gov/rules/final/33-8193.htm (last visited Aug. 5, 2003).
82. See Sarbanes-Oxley Act § 307 (requiring the SEC to implement rules mandating that attorneys representing issuers "report evidence of a material breach of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof.").
83. See Sarbanes-Oxley Act § 806.
84. Sarbanes-Oxley Act, Tit. VII. The Act also extends the statute of limitations for securities fraud and makes a new crime for securities fraud with up to a ten-year imprisonment. See id.
85. See Sarbanes-Oxley Act Tit. IX. Among other things, the maximum criminal penalty for mail and wire fraud was increased from 5 to 20 years. See id.
86. See Sarbanes-Oxley Act § 1105 (giving the SEC power to bar a person from serving as a corporate officer or director of an Exchange Act reporting company "if the conduct of that person demonstrates unfitness to serve as an officer or director of any issuer").
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limitations for fraud claims.  

As with Regulation FD, Sarbanes-Oxley does not address all of the problems facing intermediary institutions equally well. Sarbanes-Oxley exhibits the tension between financing and conflicts of interest. Congress, in writing the Act, focused primarily on the more visible conflicts of interest problem. While prohibiting auditors from providing a large number of non-audit related consulting services contemporaneously to audit clients reduces the possibility of conflicts, it also lessens the ability of auditors to obtain profits from their audit relationship.

A question exists why auditors require compensation through non-audit related services to help finance a quality audit. John Coffee and Jeff Gordon separately have made the argument that managers aiming to corrupt auditors have purposefully structured relationships with auditors to include highly profitable non-audit consulting services as a means of increasing the ability of managers to reward (and punish) auditors. U.S. securities regulation requires firms to disclose when they terminate a firm’s auditor in a Form 8-K filing. Managers seeking to discipline auditors that go against management’s wishes through the outright termination of the auditor send a large negative signal to the public marketplace. Termination of an auditor’s non-consulting services, on the other hand, is relatively non-transparent to the investing public. Managers can thus punish auditors that fail to follow the managers’ wishes through a reduction in the non-audit related consulting services.

Of course, the question remains why auditors that value their reputation would allow themselves to get pushed into a position where managers are able to discipline the auditors through low-visibility sanctions, such as the termination of non-audit related consulting services. One possible answer is that self-interested audit partners may have intentionally made the provision of audit services a loss leader, given that individual partners typically receive compensation from non-audit consulting revenues. Another answer is that the lack of competition in the audit business overall has generated complacency. At the very least, firms that do not guard jealously their audit reputation are not punished to the extent they would be if there were numerous competitors waiting to take audit business away from incumbent firms.

The Sarbanes-Oxley Act’s express prohibition on a wide variety of non-

87. Sarbanes-Oxley Act § 804 (extending the statute of limitations for private fraud claims to the earlier of “2 years after the discovery of facts constituting the violation . . . [or] five years after the violation.”).
88. See Coffee, supra note 11, at 1411-12; Gordon, supra note 11, at 1237-38.
89. See Item 4, Form 8-K.
90. Both Coffee and Gordon separately refer to termination of non-audit consulting services as a “low-visibility” means of sanctioning auditors. See Coffee, supra note 11, at 1411-12; Gordon, supra note 11, at 1237-38.
91. See Coffee, supra note 11, at 1414-15.
audit related services thus provides a means of blocking low visibility methods of auditor corruption. Nonetheless, the prohibition is not cost-free. Auditors may enjoy scale economies in providing certain forms of consulting services (including, for example, information systems design). Blocking auditors from providing such services may simply increase costs for issuers.  

The solution that the Sarbanes-Oxley Act provides with respect to agency problems within auditors is also unclear in its effect on overall investor welfare. The requirement that auditing partners and reviewing partners must rotate once every five years helps limit agency problems. Without the ability to enjoy the profits from a long-term relationship with the grateful management of a client, an auditing partner may think twice about subverting an audit in order to benefit management. On the other hand, mandatory rotation may reduce the ability of auditors to develop an in-depth knowledge of their client’s financial situation through long experience. Without such knowledge, audits may become both more costly and less effective.

Sarbanes-Oxley’s focus on independent audit committees is similarly ambiguous in its value for investors.  

Of course, if boards (and committees of the board) are somehow energized to work diligently in the best interests of shareholders, then investor welfare will increase. However, even independent board members will face substantial time pressures from their full-time day jobs. Increased barriers against providing directors incentive-based stock option compensation may also leave directors more indifferent to the overall value of the company. Simply removing the corrupting influence of managers thus will not affirmatively give directors the incentive to protect investor welfare.

Likewise, pre-Enron CEOs and CFOs already had incentives—protection of their personal reputation and pre-existing requirements that they must sign the annual 10-K filings (exposing them to potential securities antifraud

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92. See also Ribstein, supra note 11, at 40-41 (noting that “prohibiting some links between monitors and firms, such as the performance of nonaudit services, may block ‘knowledge spillovers’ that give monitors access to valuable information”).

93. Jeff Gordon has made a related suggestion of creating “trustee” directors who would receive only flat, non-stock based compensation, be self-nominated by other trustee directors, and come with stringent prohibitions on side payments from management. See Gordon, supra note 11, at 1243-45.


95. Ribstein makes the related argument that truly independent directors may lack the requisite experience and sophistication to monitor the company’s management adequately. He claims: In order to avoid suspect relationships and connections, corporations may have to appoint more directors from outside the business community. Board members such as law professors with little hands-on business experience and no formal connections with a company may not be sophisticated enough to spot problems or be able or willing to stand up to a powerful executive. Ribstein, supra note 11, at 27-28.

96. See Exchange Act § 13(a); Exchange Act, Form 10-K. CFOs must also sign the quarterly 10-Q filings. See Exchange Act, Form 10-Q.
liability)—to ensure that disclosed financial information was accurate. Requiring explicit certification, while dramatic, may not add much in the way of added deterrence. And even if deterrence is enhanced, to the extent they are personally liable, CEOs and CFOs may expend overly large amounts of effort verifying corporate disclosures, taking them away from focusing on generating new business and increasing the profitability of their companies.

Perhaps the most long-lasting effect of Sarbanes-Oxley is its provision of alternative mechanisms to help auditors bond themselves to remaining credible. In theory, the Oversight Board provides a lower cost mechanism for auditors to bond themselves to providing high quality audits. Rather than rely on reputation and the prospect of losing out on super-competitive profits, audit firms may point to possible investigation and sanction from the Oversight Board as a mechanism to bond the auditor's credibility. To the extent the Oversight Board provides a low-cost means for auditors to bond their credibility, the Oversight Board makes new entry more possible into the auditing business and, as a result, may foster greater competition. What is uncertain, however, is how effective an institution the Oversight Board will become. Plagued with controversy in the selection of its chairman from the start, the Oversight Board may come under the influence of the auditing industry, reducing its effectiveness Conversely, the Board may become detached from the needs of both auditors and investors and impose non cost-effective restrictions on auditors. Because the oversight role of the Oversight Board is mandatory, auditors unhappy with the cost-benefit of using the Oversight Board for bonding purposes will not have the ability to escape to any alternative.

Even less likely to succeed is the Act's attempt to turn attorneys into gatekeepers to protect investors through the requirement that attorneys must disclose corporate fraud. Unlike auditors—who play a natural gatekeeping role in protecting investors—attorneys function more like transaction cost

97. See Ribstein, *supra* note 11, at 35.
98. Ribstein notes that the CEO and CFO certification requirements enhance deterrence in at least two aspects. First, the certification covers the system of internal controls. Second, Section 304 of the Sarbanes-Oxley Act requires the reimbursement of certain types of executive compensation after an accounting restatement. *See id.*
99. *See also id.* at 37-39 (noting that executives may "reduce the variance in its expected returns, thereby reducing the chance of an earnings 'surprise' that could trigger massive liability" and that "executives may under-report earnings on the theory that they are less likely to be held liable for overly conservative than for exaggerated earnings reports").
engineers, assisting corporate clients in structuring transactions to maximize their legal value. As transaction cost engineers, attorneys receive little compensation (and build only a negligible reputation) for their ability to protect investors. Because revealing corporate fraud is against the attorney’s financial interest (and does not directly enhance the attorney’s reputation as a transaction cost engineer), simply imposing a disclosure duty may result in less than full compliance. Moreover, corporations and their managers may react to the duty on the part of attorneys to disclose simply by cutting off disclosure of sensitive information. Because attorneys do not provide the public with any certification of information from the firm, cutting off disclosure of information to attorneys—unlike a similar shutdown of information to auditors—does not result in any penalty for the firm.

C. Spitzer Settlement

Parallel with recent reform efforts targeting auditors, regulators have focused separately on abuses within the analyst industry itself. In early 2002, Eliot Spitzer, the New York State Attorney General, uncovered evidence in a series of emails from Merrill Lynch that called into question the objectivity of analyst recommendations. Spitzer’s investigation eventually culminated in a settlement with many large Wall Street brokerage firms.

Towards the end of 2002, Spitzer announced a joint settlement between the New York State Attorney General’s office, the SEC, the NASD, and ten Wall Street brokerage firms. Under the Spitzer-SEC settlement, Goldman Sachs, Merrill Lynch, and other Wall Street firms agreed to pay a total of $1.4 billion. Under the terms of the settlement, $432.5 million is earmarked for independent securities analyst research. Each settling Wall Street firm is required for a period of five years to contract with at least three independent research firms to provide securities research to customers of that firm. The Wall Street firms are required to give an “independent consultant” the final say

103. See Coffee, supra note 11, at 1417 (noting that “differences exist because lawyers specialize in designing transactions to avoid regulatory, legal, and other costly hurdles, but seldom provide meaningful certifications to investors”).
104. See Ribstein, supra note 11, at 32 (“Those involved in a fraudulent scheme are unlikely to discuss it with nonparticipants. The new rules may inhibit even innocuous conversations that might have helped indirectly in uncovering frauds by making them fodder for federal litigation and investigations.”).
107. See id.
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in choosing the independent research firms. Another $387.5 million is allocated for investor restitution. The settlement specifies that a distribution fund administrator be appointed (subject to court approval) to apportion the restitution monies. Most of the remainder is given to the states in the form of fines (often not directed back toward investors) as well as funding for investor education efforts.

The Spitzer-SEC settlement also includes a number of internal reforms within the Wall Street firms designed to separate analysts from investment banking. Among other reforms, the settlement requires that research analysts are separated from the investment banking business "including prohibiting analysts from receiving compensation for investment banking activities and prohibiting analysts' involvement in investment banking 'pitches' and 'roadshows.'" While the Wall Street firms participating in the settlement are allowed to retain analyst departments, they are required to keep such departments separate from investment banking (including preventing the flow of information). Furthermore, the research department's budget as well as the compensation for analysts must be determined without regard to revenues obtained from investment banking.

As with Regulation FD and the Sarbanes-Oxley Act, the Spitzer-SEC settlement focuses much of its force on obvious conflicts of interest with the securities analyst profession. Stopping short of completely separating analysts from the investment banking business, the settlement imposes a number of artificial walls within the Wall Street firms. Despite the continued indirect reliance of analysts on revenues brought in through investment banking, the settlement at least reduces more obvious conflicts. With a reduction in

108. See id.
110. See id.
113. See id.
114. See id. The settlement goes on to provide that "[r]esearch management will make all company-specific decisions to terminate coverage, and investment bankers will have no role in company-specific coverage decisions." Id. The settlement also provides that "the ten firms have collectively entered in to a voluntary agreement restricting allocations of securities in hot IPOs—offerings that begin trading in the aftermarket at a premium—to certain company executive officers and directors, a practice known as 'spinning.'" Id.
conflicts, however, comes the possibility that analysts—now more tenuously connected with financing sources—may become underfunded within brokerage firms. Why would a brokerage firm pour money into sell-side analyst reports (intended to be distributed for free or at low cost) if now such reports do not help win investment banking business?  

Unlike Regulation FD and Sarbanes-Oxley, the Spitzer-SEC settlement not only works to limit conflicts but also proposes an alternative financing scheme in support of independent securities analyst research. The total amount of the subsidy, however, represents only a fraction of the total pre-tax profits of the securities industry. While the settlement calls for a $432.5 million subsidy over five years for independent research, in 2000, the pre-tax profits of the securities industry totaled to $21 billion. As well, it is unclear why Wall Street firms should have to pay for analyst research. In theory, analyst research goes to benefit investors; any financing solution, therefore, should work to collectivize the interests of investors in providing funds for value-increasing analyst research. A large question also exists as to how such funds will be allocated. To the extent securities firms are able to pick the “independent” research firm themselves (even with the final say of a consultant), the research firms may fall under the influence of such firms. At the very least, independent research firms desiring selection in future years may lean toward favoring the position of the securities firms.

Also different from Regulation FD and Sarbanes-Oxley is the Spitzer-SEC settlement’s explicit focus on the problems facing the more unsophisticated investors in the marketplace. While the settlement’s allocation of $80 million for investor education arguably may help raise awareness among investors of the risks they face, it is uncertain how effective investor education will be in changing the securities market environment. Much of the trading volume in the markets is not due to small individual investors, but rather to large, sophisticated institutional investors. Greater investor education will not have much impact on the larger sophisticated investors. Even for small, individual investors, whether education will matter turns on the problem facing such investors. Deeply-rooted behavioral biases may be resistant to education efforts. Moreover, if the problem is a failure on the part of intermediary

115. Higher brokerage commissions provide one possible answer. However, the end of fixed rate commissions in the 1970s and competition from discount brokerage firms have reduced the ability of analysts to turn to brokerage commissions for their source of funding. See Fisch & Sale, supra note 19, at 1046 (describing use of fixed commissions to subsidize analyst research).


117. See, e.g., Choi & Fisch, supra note 22, at 342.

118. Earlier, Spitzer had proposed utilizing a quasi-regulatory analyst oversight board to select twenty independent analyst firms to provide investors with subsidized research. See Charles Gasparino & Randall Smith, New Plan: Stock-Research Cops, WALL ST. J., Oct. 25, 2002, at C1. For a more in-depth discussion of the Spitzer-SEC settlement, see Choi & Fisch, supra note 22, at 341-44.

119. On the other hand, it is possible for education to reduce some biases. See Gregory Mitchell,
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institutions to protect investors, education will accomplish little, unless targeted toward informing investors of such failures.

III. A FRAMEWORK FOR REGULATORY INTERVENTION

Despite the varying promise of Regulation FD, the Sarbanes-Oxley Act, and the Spitzer-SEC settlement, legal intervention inherently carries risks. First, it is difficult to know exactly how legal intervention will impact the markets. As discussed above in Part II, the recent legal reforms all work, to some extent, to prohibit possible conflicts of interest between securities market intermediaries and corporate managers providing financing. Simply eliminating such conflicts, however, would also work to reduce financing for intermediaries. Whether investors overall are benefited or not, therefore, is unclear. In the worst case scenario, securities intermediaries—unable to find alternative financing—may simply close up shop.¹²⁰

Second, legal intervention often displaces market-based investor protections. Installing the Public Company Accounting Oversight Board over the accounting profession may very well increase auditing standards. On the other hand, the Oversight Board represents a new layer of regulation, which may in fact chill private attempts to develop new accounting standards and practices. To the extent the Oversight Board may override private innovations at any time, private actors will have less incentive to invest in such efforts.

Third, once legal interventions take hold, they often take on a life of their own. The market and investors operate endogenously with the regulatory climate. Investors that come to believe they are protected through regulation may choose (either rationally or perhaps overoptimistically) to take greater risks with their investment dollars and take fewer precautions. As a result, regulatory protections for such investors become self-justifying. Once market-based institutions are displaced, they may have a difficult time regenerating. In the absence of market-based institutions, staying with status quo regulation may then maximize investor welfare (even if the initial displacement of the market did not). Once given more authority, regulators (as well as newly appointed members of the Oversight Board among others) may resist relinquishing this authority, especially where it results in greater prestige and compensation.

¹²⁰ Likewise, Sarbanes-Oxley provides for more rapid disclosure of corporate information to the market. See Sarbanes-Oxley Act § 409. It is unclear how much extra information the markets obtain from such increased disclosure. Moreover, disclosure is not without cost. Imposing a rapid disclosure requirement may impose high costs on firms attempting to gather corporate information to meet reporting deadlines.

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Markets, of course, may also experience failure. Market participants, nonetheless, have a strong market incentive to correct failures; regulators ensconced with monopoly power lack any such incentive.\textsuperscript{121} Worse still, when regulators and politicians do focus on the securities markets, this focus is often episodic and prone to overreaction. In the wake of a scandal, politicians in particular may feel large pressure to be seen as “fixing the problem,” regardless of whether investors in fact are benefited in the long term.\textsuperscript{122} The Sarbanes-Oxley Act itself was passed hurriedly by Congress in response to Enron and other instances of corporate fraud. Behavioral biases on the part of regulators (such as overconfidence) may exacerbate this tendency to regulate first and ask questions later.\textsuperscript{123}

In weighing the relative merits of regulation compared with the market, regulators face a range of options with varying tradeoffs between the costs of regulation and the failings of the market.\textsuperscript{124} Consider the setting of market standards of behavior (e.g., the requirement of mandatory disclosure, restricting certain investors from participating in a private placement, prohibiting certain conflicts of interest, and so on).\textsuperscript{125} At one extreme, regulators could simply engage in merit regulation, completely supplanting the market in selecting only “good” securities for investors. Merit regulation has the greatest impact on investors and also the greatest risk of regulatory error (as well as the possibility of regulatory capture). At the other extreme is purely private ordering: regulators could simply leave investors to contract for desired protections from issuers. Private ordering provides the lowest possibility for regulatory mistake or abuse; on the other hand, investors are left without any alternative means of protection other than contractual damages. Between these two extremes is a range of alternatives striking different balances between regulatory intervention (and the risks of regulation) against private ordering (and the failures of the market).

An alternative that is less intrusive than merit regulation, for instance, involves mandatory prohibitions on various marketplace activities (stopping

\begin{itemize}
  \item \textsuperscript{121} See, e.g., Choi \& Pritchard, supra note 34, at 42-43.
  \item \textsuperscript{122} See generally Stuart Banner, What Causes New Securities Regulation?: 300 Years of Evidence, 75 WASH U. L.Q. 849, 850 (1997) (putting forth evidence that significant legal changes frequently occur after major scandals in the securities markets).
  \item \textsuperscript{123} See Choi \& Pritchard, supra note 34, at 20-36 (discussing the behavioral biases within the SEC).
  \item \textsuperscript{124} Djankov et al. provide a similar framework to examine the desirability of more (or less) stringent government intervention to control disorder in the economy. See Djankov et al., The New Comparative Economics, supra note 13 (arguing that the different levels of government intervention in the economy result in a tradeoff between disorder in the absence of government intervention, at one extreme, and the risk of government expropriation of wealth, at the other extreme, which involves stringent intervention in the market).
  \item \textsuperscript{125} In addition to substantive standards, a range of enforcement possibilities also exists, spanning from public enforcement and monitoring of the market to greater reliance on private litigation (including possibly class actions).
\end{itemize}
short, however, of prohibiting investors from particular investments). The bar on many non-audit consulting activities placed on auditors under Sarbanes-Oxley provides an example of this form of mandatory prohibition. Moving closer toward private ordering are regulations that force market participants (such as issuers) to provide information to investors (including mandatory disclosure requirements and antifraud rules, among others). This option is similar to many provisions under the current U.S. regime. With less control comes a decreased ability on the part of regulators to protect investors; nevertheless, the chance of mistake and regulatory malfeasance is lessened. An even less intrusive approach would require judges on a case-by-case basis to determine aspects of the securities laws (such as the definition of materiality). Judges may lack expertise, and deciding issues on a case-by-case basis may result in slow, uncoordinated changes to the securities regime. At the same time, judges may lack the same incentive as bureaucrats to expand their powerbase, thereby reducing public choice concerns. At the end of the spectrum closest to purely private ordering, regulators may simply attempt to influence the market through the provision of investor educational materials.

How should we balance the shortcomings of both markets and regulation and determine exactly the proper amount of regulatory intervention? The answer depends on the precise type of market failure that initiates the need for regulation. Regulators may use the range of available regulatory options as a framework to consider the optimal response given the presence (or absence) of market-based incentives to address a defect affecting securities market intermediaries. Where the market has an incentive to correct for any failings, less interventionist regulation is required. On the other hand, where the market failure is deeply-rooted, more interventionist regulation may be justified. To simplify, this Essay divides intermediary market failures into those (A) where participants in the market have an incentive to find a solution to the market failure and those (B) where individual participants have less of an incentive to solve a particular failure.

A. Intervention in the Presence of Market Alternatives

Where market failures exist alongside incentives among individual market participants to ameliorate those failures, regulators may benefit investors more by assisting the market with minimal intervention. Rather than displacing the market, regulators, for example, may choose a less intrusive approach designed to assist market-based solutions. Market-based solutions provide greater flexibility than mandatory regulatory intervention. Particularly given the wide

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126. See supra notes 66-68 and accompanying text.

127. See Basic v. Levinson, 485 U.S. 224, 238-39 (1988) (providing that materiality of a contingent event depends on the probability times the magnitude of the event).
range of problems facing intermediary institutions, flexibility is valuable in
crafting a series of solutions over time. Market-based solutions also help ensure
actual benefits for investors. When regulators work to assist market solutions
rather than intervene directly, the danger of regulators becoming attached to a
certain level of regulatory authority (and thus resistant to unwinding regulation,
if necessary) is lessened.

Conflicts of interest and agency cost problems within securities
intermediaries are examples of problems with potential market-based solutions.
To the extent institutions are able to solve their conflict of interest and agency
problems credibly, they will profit through higher fees (whether directly or
indirectly from investors). Institutions, therefore, internalize the benefit of
addressing conflict of interest and agency cost problems. Nonetheless, the
range of present market-based solutions through private ordering may be
limited. Institutions may use both private contract and market-based reputation
as mechanisms to bond their fidelity to investors. Neither mechanism, however,
is perfect. Relying solely on reputation, for example, is costly and often works
only imperfectly to bond a firm’s credibility.

Regulators may assist intermediaries in bonding their credibility in at least
two ways. First, representing a level of intervention one step above purely
private ordering, regulators may reduce the cost to investors of discerning the
precise reputations of specific intermediaries. The SEC, for example, could
maintain a centralized database of intermediaries and include disciplinary
histories (or track record of complaints much like the Better Business
Bureau). The NASD already provides such a database of brokers. Within the
NASD’s CRD database, investors may look up the disciplinary history of a
specific broker. Greater information (at a lower cost) will allow investors to
distinguish more accurately high performing intermediaries and provide a
corresponding higher price of issuers associating with such intermediaries.

Second, regulators may increase the penalty to intermediaries that breach
the trust of investors. Stronger penalties reduce the importance of market-based
reputation bonding. Indeed, regulators may enjoy a comparative advantage in
imposing penalties. Regulators have economies of scale in monitoring markets
for intermediary failures. They also enjoy scale economies in maintaining an
ability to enforce penalties across a wide variety of intermediaries. Regulators
also may use penalties which intermediaries are unable to implement through
private contract, such as imposing criminal penalties. Lastly, regulators are able
to bind intermediaries to parties not in privity of contract with the intermediary.

The fact that regulators enjoy a comparative advantage in bonding

128. For more information on the Better Business Bureau, see BBB Homepage, at
129. Investors, for instance, may search for information on brokers at the NASD’s public disclosure
intermediaries to protect investor welfare, however, does not mean that the bond must be made mandatory. Regulatory interventions incorporating aspects of private ordering are possible. The market may have a better sense than regulators of precisely the best combination of sanctions to impose on particular intermediaries that fail to protect investors. Mandatory solutions, in comparison, may lack comprehensiveness and flexibility. For example, while the Public Company Accounting Oversight Board provides an alternative bonding mechanism for auditors, it is limited in at least two respects. First, it covers only auditors. Second, as a quasi-regulatory entity, the Oversight Board may make mistakes or, worse still, come under the influence of management and auditors who profit from duping investors.

Regulators may improve on investor welfare by giving intermediary institutions the ability to pick and choose from various regulator-supplied bonding devices (termed "self-tailored regulation"). To the extent such choices are transparent to investors in the market, intermediaries that select value-increasing bonding mechanisms will experience an increase in their value to investors (and thus to issuers in the market). Importantly, self-tailored regulation allows intermediaries to adopt limits unavailable or ineffective through private contract, and to make the adoption both credible and transparent for investors. For example, intermediaries may self-tailor the level of government monitoring, enforcement, as well as the magnitude of penalties facing them for breaching their duty to investors (while possibly paying a fee to cover the regulator's additional costs). Upstart competitors may use self-tailored regulation to provide a credible means of bonding themselves to protecting investors, even without a large market share (and corresponding super-competitive profits). Self-tailored regulation, therefore, may act as a mechanism to reduce the anti-competitive effect that relying on reputation alone has on the intermediary market.

Intermediaries may also undo non-cost-effective prohibitions through a self-tailored regulatory system. While the Sarbanes-Oxley Act arguably moves in the right direction with its ban on auditing partners and review partners serving the same audit client for more than five years, such a flat ban may not maximize investor welfare across all types of intermediaries. Some audits may improve in quality when conducted under the supervision of an audit partner

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130. Coffee notes that one of the costs of having little competition among intermediary gatekeepers is a lack of upstart competitors willing to push investor protection as a means of gaining business. See Coffee, supra note 11, at 1414-15. Coffee further writes:

"If each of the Big Five were to prefer a strategy under which it acquiesced to clients at the cost of an occasional litigation loss and some public humiliation, it could more easily observe this policy if it knew that it would not be attacked by a holier-than-thou rival stressing its greater reputation for integrity as a competitive strategy."

Id. at 1414. Self-tailored regulation overcomes one market barrier—the need to bond one’s fidelity to investor protection—to the entry of new competitors.
with more than five years of experience at a particular client. Allowing intermediaries to self-select into different forms of limits placed on agents gives intermediaries the ability to pick those prohibitions which maximize the joint value of the intermediaries and investors.

Of course, investors may fail to appreciate fully the selections on the part of intermediaries under a self-tailored regulatory system. Regulators may assist investors through disclosure of the self-tailored regime selected by each individual intermediary. Regulators may also constrain self-tailored regulatory choices to only increases in liability and monitoring above the present regime. Thus, if a specific intermediary desires more SEC monitoring and higher legal liability, regulators should provide a low-cost means for the intermediary to obtain such assurances for investors. That sort of one-way, ratchet-upward approach to self-tailored regulation avoids the danger of intermediaries abusing choice to lower investor protections, while giving intermediaries that desire a low-cost means of bonding themselves the ability to do so.

Regulators may also go one step further and constrain the choices available to intermediaries to one of several well-defined options. Investors then will have an easy-to-follow range of possibilities (rather than the more open-ended nature of allowing intermediaries full freedom of choice in their regulatory regime). Moreover, regulators may harness the power of regulatory competition to determine this limited range. One possibility, for example, would be to give the securities exchanges and the NASD full freedom to determine their own individual rules for associated securities market intermediaries (allowing the exchanges and the NASD to utilize SEC enforcement resources as well as the full range of civil and criminal penalties).\(^{131}\) Investors, issuers, and intermediaries could then select among the different regulatory regimes based on the maximization of their joint welfare, rewarding the exchange (or the NASD) with higher listing fees. To the extent a race-to-the-bottom is a concern, regulators could set a floor on the level of intermediary regulation, allowing the exchanges and the NASD to raise the level of regulation above the floor.\(^ {132}\) Notably, Sarbanes-Oxley moves in a different direction. Regardless of the specific merits of Sarbanes-Oxley, the Act is important for its federalization of many aspects of corporate governance.\(^ {133}\) To the extent Congress made the

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131. Under the current self-regulatory organization (SRO) system, neither the exchanges nor the NASD enjoy full freedom. Instead, the SEC must approve new SRO regulations, and the SEC retains the power to unilaterally change SRO regulations. See Securities Exchange Act § 19. The SEC may approve, disapprove, or modify SRO rules as it "deems necessary or appropriate to insure the fair administration of the self-regulatory organization" and among other things. See 15 U.S.C. § 78s(c) (2003).


133. Ribstein addresses this importance in noting how the Sarbanes-Oxley Act's focus on: the composition of board audit committees, the activities of corporate counsel, protecting
A Framework for the Regulation of Securities Market Intermediaries

wrong cost-benefit analysis with the Act, federalization makes it difficult for the market to escape such provisions.

B. Intervention in the Absence of Market Alternatives

Where market failures are diffuse through the market and no one individual party has full incentives to find a solution, greater forms of regulatory intervention may be warranted. At least two forms of securities market failures may fit into this category: (1) the financing problem facing intermediaries, and (2) the lack of sophistication among certain groups of investors. Even in such cases, however, the risk of regulatory error (or capture) may caution against moving too far along the spectrum toward more stringent regulatory approaches.

1. Financing Solutions

Because of the public goods nature of information, intermediaries looking directly to investors for funding often encounter free riders and are often unable to obtain full payment for the value of the services which they provide. Intermediaries, on the other hand, that turn to publicly-traded firms for financing may come under pressure from firm management to bias the information they provide investors in favor of management. Solving only the conflicts of interest problem without also addressing the financing problem runs the risk of simply drying up the market for intermediary services for investors.

No easy solutions exist, however, to the financing problem. Even issuers seeking to increase investor welfare may fail to provide adequate intermediary funding. To the extent some of the benefits from intermediary services accrue to large numbers of investors across different firms, no single issuer will have full incentives to provide funding.\textsuperscript{134} Analysts covering a particular industry, for example, provide information on all companies in the industry. Proxy insurgents searching for poorly performing managers against which to launch a control contest provide a deterrent effect on managers at all firms. Furthermore, not all managers of issuers will seek to advance the interests of investors at the expense of the managers’ own private benefits of control (particularly to the extent the firm is not about to raise capital in the markets). Even without free riding on intermediary funding, such managers will not choose to fund whistleblowers, regulating loans to officers, requiring reimbursement of bonuses and stock profits, mandating disclosures regarding particular types of transactions and of the issuer’s code of ethics for senior financial officers, fixing responsibility on officers for corporate disclosures, and increasing the SEC’s power to bar people from serving as officers and directors, all involve insertions of federal regulators in corporate governance.

Ribstein, \textit{supra} note 11, at 57-58.

intermediaries that increase investor welfare.

Absent a voluntary solution on the part of issuers, regulatory intervention may be needed to impose a mandatory financing solution. Regulators may impose a levy on issuers and then reallocate the money to intermediary institutions, in a manner similar to that of the Spitzer-SEC settlement. Mandatory financing, nonetheless, leaves at least two possible areas for regulatory error. First, regulators may incorrectly set the size of the subsidy. Second, even if the size of the subsidy is correct, regulators may err in allocating the subsidies to different intermediaries. Due to the risk of regulatory error, not surprisingly, most mandatory subsidies found today in U.S. securities law exist in areas where the value of the subsidy is unambiguous and relatively uniform. For example, one justification for requiring a mandatory audit of public firms is that almost all public investors value such an audit. Moreover, the uniformity of investors' desire for an auditor makes it easy, from a regulatory viewpoint, simply to impose a single audit requirement on all publicly traded firms. Regulators need not decide precisely what kind of audit is required, to the extent a one-size-fits-all approach is sufficient to protect investors.

Most intermediary services, however, are not one-size-fits-all with respect to investor welfare. Government provision of subsidies to intermediaries is problematic and rarely occurs, despite the financing problem. Consider analyst subsidies. How are regulators to know which analysts to subsidize and by how much? What if the need to subsidize analyst research in particular industries varies over time?

The presence of even pervasive market failures, therefore, does not necessarily justify stringent intervention (including, at the extreme, merit regulation). Instead, regulators may move along the spectrum of regulatory possibilities toward greater levels of intervention, while taking advantage of extant market-based incentives. Put another way, the presence of some market-based incentives to correct for failures allows regulators to intervene with a less stringent form of regulation than in the situation where no market incentives exist at all.

Although obtaining subsidy dollars for intermediary services requires mandatory intervention, possible market-based solutions may exist at least for the problem of how to allocate subsidy dollars in situations where the optimal amount of the subsidy from the perspective of investors may vary across intermediaries (and across firms and time). Jill Fisch and I propose such a market-based allocation mechanism.135 Under our proposal, regulators still face the challenge of determining the total size of intermediary subsidies (and how to levy firms to raise this subsidy amount). While difficult, regulators have

135. See id. at 314-41.
levied firms for collectivizing services in other areas (including, most recently, to fund the Oversight Board under Sarbanes-Oxley). Regulators, for example, may attempt to estimate the total amount spent on analyst research, proxy advisory services, and other intermediary services (although we exclude auditors from our proposal) as a starting point in determining a total levy amount for firms.

We propose to give dispersed shareholders the ability—through vouchers—to self-direct subsidies to intermediaries, once funds are raised. Shareholders would have the ability to redirect vouchers received from several firms to their highest value use. For example, shareholders holding diversified portfolios may assign all their vouchers to independent analysts covering the high technology industry. Alternatively, shareholders may save their vouchers and in a later year direct them to a proxy insurgent targeting a specific underperforming management team. Shareholder voucher allocation of subsidy dollars has the potential of flexibly and automatically redirecting dollars to their highest value use. Relying on shareholders to distribute vouchers also provides a feedback mechanism to assist regulators in setting the amount to levy issuers in funding the vouchers. Regulators, for example, may gauge the demand for intermediary services based on the total number of vouchers actually distributed, adjusting future voucher funding levels accordingly.

Problems, of course, exist with relying on vouchers and shareholders to allocate funding. Shareholders may lack full information on the value of different intermediaries and may also fail to coordinate in the distribution of vouchers. Solutions, nonetheless, exist for such problems. Institutional investors may come to coordinate over voucher allocation decisions. Specialized intermediaries may arise to assist investors in how to allocate their vouchers (taking their fee as a percentage of vouchers received from investors). Importantly, the Choi-Fisch proposal would allow investors to give their vouchers to such specialized intermediaries who would then have the ability to redirect these vouchers to their highest value use (or alternatively save

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136. Securities exchanges already impose listing fees on listed firms. The NYSE, for instance, charges a maximum original listing fee of $250,000 and a maximum continuing annual fee of $500,000. See NYSE LISTED COMPANY MANUAL § 902.02 (2002). To fund the new Public Company Accounting Oversight Board, the Sarbanes-Oxley Act imposes fees on public companies in proportion to their market capitalization. To fund the new Public Company Accounting Oversight Board, the Sarbanes-Oxley Act imposes fees on public companies in proportion to their market capitalization. The Act establishes that:

The rules of the Board under paragraph (1) shall provide for the equitable allocation, assessment, and collection by the Board (or an agent appointed by the Board) of the fee established under paragraph (1), among issuers, in accordance with subsection (g), allowing for differentiation among classes of issuers, as appropriate.

Sarbanes-Oxley Act § 109(d)(2). See also Sarbanes-Oxley Act § 109(g) (allocating support fees according to relative market capitalization).

137. See Fisch & Choi, supra note 22, at 314-41.

138. See id.
them for another year). The government may also reduce information costs for investors through the provision of information on intermediaries (including their disciplinary track record and use of voucher funds). Once the decision is made at a regulatory level to subsidize intermediaries, voucher financing represents a superior alternative, compared with error-prone mandatory regulation.  

2. Market Partitioning

Relying on the market to protect investors imposes added risks on unsophisticated (and uninformed) investors. Relatively small, unsophisticated investors may ignore the consequence of different self-tailored regulatory choices on the part of institutions (including choices to reduce liability), leaving the investors more exposed than under a purely mandatory regulatory regime. For example, to the extent an auditor that selects a regime of no public enforcement and no private liability is not punished by the market, the auditor may very well make such choices at the expense of the unsophisticated investors who continue to rely on the auditor.

While more minimal intervention is possible to address unsophisticated investors (such as the SEC-Spitzer settlement's provision of investor education funds), it is unclear whether simply providing educational material to investors will improve their sophistication. Instead, a more interventionist approach involving the mandatory partitioning of investors based on sophistication may be necessary.

Partitioning the market based on the types of firms or investors may help reduce the informational complexity of relying on market choices for investors interpreting such choices. To the extent certain investors are better equipped to assess investment risks and utilize the services of intermediaries, restricting investments in a certain company's securities to such investors may allow

139. Simpler allocation methods exist. Regulators could pit certain classes of intermediaries against one another in a tournament. All analysts, for example, could form one group of competing intermediaries. Regulators could base the tournament on observable objective factors, such as how accurate the analyst's recommendations were during the past year. Regulators could then award a fixed percentage of the subsidy dollars to the top winners of the tournament (providing an ex ante subsidy to all participants of the tournament). In an unrelated area, Mitu Gulati and I have proposed installing a tournament of federal circuit court judges with elevation to the Supreme Court as the prize. See Stephen Choi & Mitu Gulati, A Tournament of Judges?, 92 CAL. L. REV. 299 (2004).

regulators to reduce more stringent regulatory protections. Similarly, to the extent investors are more sophisticated in such markets, giving institutions that service such investors the ability to tailor their own regulatory regime allows for the most cost-effective bonding of the institutions' credibility. Regulators may then focus their attention on companies that cater more generally to the broader segment of unsophisticated investors.

Partition of the market based on investor sophistication already occurs, in part, under the present U.S. securities regime. On the one hand are the general public capital markets. Firms that wish to sell securities in the public capital markets generally must engage in a registered public offering. The registered public offering process puts companies through a tightly controlled series of steps under which a company generates a mandatory disclosure document (the registration statement) and distributes a part of this document known as the prospectus to the public. Stringent private antifraud liability attaches to material misleading statements (as well as certain omissions) in the registration statement and prospectus. Almost any investor (except for control persons of the issuer) may freely trade securities which have gone through the public offering process.

In contrast, securities in a non-registered offering in the U.S are generally restricted in the types of investors to whom securities may be offered and sold. Issuers have several different avenues to sell securities outside of the public offering process. One of the most common is through a private placement to a relatively small number of more sophisticated investors. Under Rule 506 of the Securities Act of 1933, for example, issuers may sell an unlimited amount of securities to an unlimited number of "accredited" investors as well as up to thirty-five sophisticated (either individually or with a representative) purchasers. Initial purchasers then face resale restrictions for a period of up to at least one year. During this restricted period, a parallel resale market consisting of qualified institutional buyers may exist for some securities pursuant to Rule 144A of the Securities Act. Thus, more sophisticated investors are able to both initially purchase as well as trade in securities of issuers which choose not to endure the public offering process. Note, however, that the partitioning in the U.S. markets is not permanent. After the first year, most restricted securities are allowed to be freely resold (and thereby enter into the general public market).

142. See Securities Act §§ 11, 12(a)(2).
143. See Securities Act, Rule 506.
144. See Securities Act, Rule 144A.
145. Resales after one year for most outside investors may take place pursuant to Rule 144 of the Securities Act. See id.
C. Comparison with the Present Reform Approach

The present approach toward reform takes almost exactly the opposite approach from this Essay. In areas where regulators could simply assist the market with more minimal intrusion, such as for conflicts of interests, regulators have moved immediately to implement a wide variety of mandatory prohibitions. The Sarbanes-Oxley Act forbids auditors from providing many forms of non-audit consulting services to their audit clients. Regulation FD curtails relationships between issuers and analysts based previously on selective disclosures. While such measures may work to bolster the credibility of intermediaries, they may fail as well. Given the possibility of less intrusive regulation designed to enhance already existing market-based incentives to reduce conflicts, the question exists why we had to march down the road toward mandatory reform in the first place.

Conversely, in areas where the market is less likely to provide solutions—including the financing of intermediaries and the presence of less sophisticated investors—reform efforts have been largely absent. Aside from the SEC-Spitzer settlement’s provision for subsidies for independent analyst research and investor education efforts, the reforms over the past several years have simply ignored the financing needs of intermediaries, as well as the problem posed by less sophisticated investors. In part, the lack of reform effort may have public choice roots. Where dispersed investors suffer harm with no visible “bad guy” (as with the lack of intermediary financing), regulators may be slow to address the problem due to a lack of any concentrated political pressure. Nevertheless, where a small group of investors suffers a very visible and concentrated harm caused by, for example, a conflict of interest or a breach of trust on the part of a market intermediary (giving the public an identifiable “bad guy,” such as Arthur Andersen), public demand for a stringent regulatory solution will not be far behind.146

CONCLUSION

Regulators attempting to develop strong securities markets face a difficult task. Academic studies have demonstrated a correlation between strong investor protections and the size of a country’s capital markets and economic

146. An extensive literature exists on the public choice implications on how concentrated versus dispersed parties interact with the regulatory state. See Paul G. Mahoney, The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses, 46 J.L. & ECON. 229 (noting with respect to the specific type of blue-sky legislation adopted in various states that “more dispersed interests such as farmers and progressives might have paid little attention to the details of the legislation compared to directly affected and concentrated interests such as banks and brokers”); Richard L. Revesz, Federalism and Environmental Regulation: A Public Choice Analysis, 115 HARR. L. REV. 553, 567 (2001) (stating that “additional resources... make it possible for concentrated industry interests to participate in more proceedings than do dispersed consumer and environmental interests”).
Questions remain, however, as to the causal relationship between strong legal protections and economic growth, as well as the exact legal protections which are important. Regulators, moreover, only have a limited set of policy options available to them. While they may change the laws on the books, changing the norms among investors and managers as well as the operation of private securities market institutions within a country is neither quick nor easy.

Because of the difficulties facing regulators, the possibility of mistake is high. The chance of mistake is heightened by the tendency of regulators often to take a narrow approach to perceived problems. In the U.S., for example, regulators and the financial press have focused a large amount of attention on conflicts of interest problems plaguing analyst and auditors, but pay far less attention to the financing problem facing intermediaries. Unsurprisingly, much of the reforms—including Regulation FD and the Sarbanes-Oxley Act—primarily have addressed conflicts of interest without finding a replacement source of financing for intermediaries. While the Spitzer-SEC settlement does provide limited support for “independent” research, it does so in a manner unlikely to generate truly objective research.

First, this Essay has argued that regulators must consider the underlying problems facing securities market intermediaries. Securities market intermediaries lie at the heart of generating a strong investor protection culture within a country’s capital markets. These intermediaries, however, face separate financing, conflicts of interest, and agency control problems. Any attempt on the part of regulators to shore up the role of intermediaries in protecting investors must take into account these various problems concurrently.

Second, regulators should consider the entire range of available regulatory options. Too often, after the decision to regulate is made, regulators move immediately toward heavy-handed mandatory requirements and prohibitions, such as those contained in the Sarbanes-Oxley Act aimed at auditor conflicts of interests. Regulators, however, have a number of less intrusive forms of regulation designed to take advantage of existing market incentives to address various market failures. Where purely private ordering may fail to solve a market defect, investors with the assistance of regulators (whether through centralized information dissemination or self-tailored regulation) may generate value-increasing solutions to defects affecting intermediaries. The use of these less intrusive mechanisms provides the market more flexibility while avoiding many of the pitfalls of more mandatory regulation, including mistake and regulatory capture.

147. See supra note 5 (citing the LLSV studies).
Tender Offers by Controlling Shareholders:
The Specter of Coercion and Fair Price

A.C. Pritchard*

INTRODUCTION

Taking your company private has never been so appealing. The collapse of the tech bubble has left many companies whose stock prices bordered on the stratospheric now trading at small fractions of their historical highs. The spate of accounting scandals that followed the bursting of the bubble has taken some of the shine off the aura of being a public company—the glare of the spotlight from stock analysts and the business press looks much less inviting, notwithstanding the monitoring benefits that the spotlight purports to confer. Moreover, the regulatory backlash against those accounting scandals has made the costs of being a public company higher than ever. The passage of the Sarbanes-Oxley Act of 20021 has brought a host of costly new requirements for public companies affecting both disclosure and corporate governance.2 Securities fraud class actions are booming,3 and rates for D&O insurance are correspondingly skyrocketing.4 Auditors’ fees have also spiked, reflecting the greater expectations imposed on accountants to ferret out corporate wrongdoing, and the commensurately greater risk of liability.5 Who needs it?

As it happens, Delaware has a fire sale on going private for one group that might be particularly interested—controlling shareholders. In addition to the risks enumerated above, corporations with controlling stakes in subsidiaries

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2. Andrew Countryman, Law’s Effects Pile up on Firms: Sarbanes-Oxley’s Internal Controls Rules Prove Costly, CHICAGO TRIBUNE, July 20, 2003, at C1 (reporting increased compliance costs due to law).
4. Theo Francis, It Still Costs Big to Insure Against a Boardroom Scandal, WALL ST. J., July 31, 2003, at C1 (reporting annual increases in the 25 percent to 30 percent range after premiums doubled or tripled post-Enron).
5. OBSERVER COLUMN, FINANCIAL TIMES, July 17, 2003, at 12 (“Companies expect audit fees to rise by a third ... according to a survey by Financial Executives International.”).
have to worry about the risk of derivative litigation on behalf of minority shareholders. This risk arises from the fact that all of the controlling shareholder’s transactions with their controlled subsidiary are potentially subject to the “entire fairness” standard, the most demanding regime in corporate law.\(^6\) That same standard makes it difficult for controlling shareholders to escape the risks of derivative lawsuits (and other costs of holding a control bloc in a public subsidiary) because Delaware courts impose the entire fairness standard on mergers between parent corporations and their subsidiaries.\(^7\) The result is that, until recently, freeze-out mergers to eliminate minority shareholders have been procedurally complicated, expensive and a target for litigation.

A recent series of cases from the Delaware courts, however, has blazed a path for controlling shareholders to freeze out minority shareholders with minimal procedural hurdles and commensurately minimal litigation risk. By combining a tender offer to minority shareholders with a follow-up “short-form” merger under Section 253 of the Delaware General Corporate Law, controlling shareholders can eliminate minorities while avoiding the demanding requirements of “entire fairness”.\(^8\) The attraction for controlling shareholders is obvious, but is the tender offer/short-form alternative a good thing or a bad thing for investors? The commentators to date have generally concluded that minority shareholders are likely to be harmed. Alternatively, they claim that this development undermines the doctrinal consistency of Delaware corporate law by their inability to extract a greater premium from the controlling shareholder.\(^9\)

This Article dissents from that consensus: my bottom line is that the streamlined regime is likely to be positive for shareholders and that doctrinal purity is not worth worrying about. To be sure, minority shareholders would always prefer more to less in exchange for their shares, and the entire fairness regime—and the elaborate procedural apparatus that it has spawned—might generate more generous offers from controlling shareholders. But wealth transfers between shareholders of subsidiary corporations and shareholders of parent corporations are largely a social wash—one group’s increased wealth exactly offsets the other’s diminished wealth. The risk of misappropriation will be factored into the amount that investors will be willing to pay for a minority stake, or into the premium necessary to obtain control. Requiring a second control premium serves little useful purpose. Moreover, the most egregious

\(^6\) See Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).
\(^7\) See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (en banc).
\(^8\) See infra Part I.
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over-reaching will be deterred by the need to encourage minority shareholders to tender. On balance, less law is likely to produce more value for shareholders in this context.

Of equal importance, from an institutional perspective, this streamlined procedure is not a judicial innovation, but instead, well grounded in the overall structure of Delaware corporate law. The entire fairness mandate is a reasonable (if not inescapable) interpretation of the obligations imposed on corporate boards by §251. There is no similar statutory mandate under §253, nor is there any role prescribed for boards in connection with tender offers. Consequently, the end run around the entire fairness regime threatens no new incursion into the authority of corporate boards, the importance of which is recognized by the business judgment rule. Moreover, the streamlined procedure developed by the Delaware courts respects the careful balance between the paramount role of the Delaware General Corporate Law and the interstitial role of courts in spelling out the common law of fiduciary obligation. Fiduciary obligation fills in the gaps of the corporate code—it is not intended to supplant statutory law, or transform it into an “ideal” corporate law.

The Article proceeds as follows: Part I sketches the “entire fairness” regime, Part II traces the development of the tender offer/short-form alternative and Part III addresses objections to that alternative. I summarize the main points in a brief conclusion.

I. ENTIRE FAIRNESS

A. Application to Mergers

1. Weinberger

The general rule, long established in Delaware and elsewhere, is that controlling shareholders owe a fiduciary duty to the corporation and minority shareholders. This obligation requires that a parent company, when it engages in “self-dealing” with its controlled subsidiary, demonstrate that the terms of the transaction are entirely fair to the subsidiary.10 Not surprisingly, the Delaware Supreme Court included mergers between the parent and subsidiary in the category of “self-dealing” transactions when the issue arose in Weinberger v. UOP, Inc.11 Although the defendant, Signal Companies, attempted to shift the burden on the issue of entire fairness by making the merger subject to approval by a majority of the minority shareholders, its attempt failed because of its failure to disclose all material information to the

minority. Specifically, it failed to disclose a study by two UOP directors (Arledge and Chitiea, who were also Signal directors) on the feasibility of a buyout of UOP's minority shareholders. "Using UOP data, it described the advantages to Signal of ousting the minority at a price range of $21 to $24 a share." Given that the price offered in the merger was $21, the court concluded that Signal's willingness to pay $24 would have been important information for the minority shareholders confronted with the choice of either voting for the merger or dissenting and seeking appraisal. Obviously, this was material to the minority shareholders, but the duty question was harder. Did controlling shareholders have to reveal their reservation prices in all circumstances? Did fairness require self-sacrifice by the majority shareholder? Weinberger was ambiguous with respect to these questions.

Perhaps more significant than the court's holding, however, was a footnote suggesting an alternative procedure:

Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.

This footnote was a strong hint to transactional planners about the court's preferred method for determining price in a freeze-out merger: arm's length bargaining. Left unanswered, however, was a fundamental procedural question: How strong would evidence of an arm's length bargain be in establishing fairness? Would it be enough to secure the protections of the business judgment rule?

2. *Rosenblatt*

The answer to the first question soon followed. Just two years later, in *Rosenblatt v. Getty Oil Co.*, the court held that a majority shareholder need not disclose its reservation price to establish the fairness of a squeezeout:

While it has been suggested that Weinberger stands for the proposition that a majority must under all circumstances disclose its top bid to the minority, that clearly is a misconception of what we said there. The sole basis for our conclusions in Weinberger regarding the non-disclosure of the Arledge-Chitiea report was because Signal appointed directors on UOP's board, who thus stood on both sides of the transaction, violated their undiminished duty of loyalty to UOP. It had

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12. Id. at 712.
13. Id. at 708.
14. Id. at 712.
15. Id. at 709 n.7.
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nothing to with Signal’s duty, as the majority stockholder, to the other shareholders of UOP.\(^{16}\)

As clarified by Rosenblatt, the entire fairness regime established for mergers in Weinberger stands for two rather unremarkable propositions. First, directors of a subsidiary owe that firm a duty of undivided loyalty; allegiance to the parent firm cannot dilute that bedrock duty. Second, the parent corporation cannot expropriate assets from the subsidiary, such as the non-public information contained in the Alredge-Chitiea report. It does not stand for the proposition that all of the gains from the transaction must go to the minority.

3. McMullin

The importance of property and statutory rights in the entire fairness analysis is reinforced by McMullin v. Beran.\(^{17}\) McMullin arose out of Atlantic Richfield Company’s (“ARCO”) efforts to sell its 80 percent-owned subsidiary, ARCO Chemical (“Chemical”).\(^{18}\) ARCO was anxious to sell its stake in Chemical to pay down debt accrued in financing the acquisition of another subsidiary.\(^{19}\) Chemical’s board, recognizing that ARCO’s 80 percent stake gave it veto power over any transaction involving Chemical, delegated its authority to negotiate the sale of the company to ARCO.\(^{20}\) ARCO negotiated a deal with Lyondell Petrochemical for a tender offer for Chemical shares at $57.75 per share, to be followed by a second-step merger at the same price.\(^{21}\) ARCO committed to tendering its 80 percent stake into the tender offer, thus making the deal, as it was presented to the Chemical board, essentially a fait accompli.\(^{22}\) The Chemical board could withhold its consent, but Lyondell could override that refusal after it acquired ARCO’s stake by replacing the Chemical board.

Notwithstanding the reality of ARCO’s voting power over Chemical, the Delaware Supreme Court concluded that the Chemical board had breached its fiduciary duty to the minority by failing “to make an informed and independent decision on whether to recommend approval of the third-party transaction with Lyondell to the minority shareholders.”\(^{23}\) This fiduciary duty arose out of the “statutory duty imposed under 8 Del. C. § 251 ‘to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders.’”\(^{24}\)

17. 765 A.2d 910 (Del. 2000).
18. Id. at 914.
19. Id. at 921.
20. Id. at 915.
21. Id. at 916.
22. Id.
23. Id. at 924.
24. Id. at 917 (quoting Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985)).
Form matters here. ARCO clearly could have sold its 80 percent stake—for whatever price it could negotiate—without any involvement from the Chemical board. The Chemical board would have had no role to play in those negotiations. By instead negotiating an acquisition agreement that required the Chemical board’s assent under § 251 because of the agreed-upon follow-up merger, ARCO implicated the Chemical board’s duty to recommend only value-maximizing offers to the Chemical shareholders.\(^{25}\)

One caveat is worth noting here: if ARCO had required concessions from its subsidiary, the Chemical board’s fiduciary duties might have been implicated in connection with the sale of only its stock. For example, in *In re Digex, Inc. Shareholders Litigation*,\(^{26}\) the board of the subsidiary breached its fiduciary duties by agreeing to waive the protections of § 203 in connection with the merger of its parent corporation. *Digex* follows closely from *Weinberger* (and for that matter, *Sinclair*): rights held by the subsidiary corporation (whether conferred by common law or statute) are to be exercised for the benefit of the subsidiary, not the parent. The subsidiary must receive fair consideration for waiving those rights.

**B. Procedures**

1. **Kahn**

The answer to the procedural question left open in *Weinberger* took longer to resolve. In *Kahn v. Lynch Communication Systems*, the Delaware Supreme Court held that “approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder plaintiff.”\(^{27}\) The court also held, however, that whatever the procedures adopted to protect the minority, the business judgment rule standard would not apply to a merger with a controlling shareholder; rather, the standard would remain entire fairness.\(^{28}\) The court justified its refusal to confer business judgment protection because of the perceived risk of potential retaliation by the majority:

Even where no coercion is intended, shareholders voting on a parent subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder. For example, the controlling stockholder might decide to stop dividend payments or to effect a subsequent cash out merger at a less...

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25. *Id.* at 920 (noting that sale of entire company, “rather than selling only its own 80 percent interest,” implicated *Revlon* duties).
27. 638 A.2d 1110, 1117 (Del. 1994).
28. *But see* Model Bus. Corp. Act § 8.61(b)(1)-(2) (altering standard to business judgment when merger is negotiated by an independent special committee or ratified by an informed minority).
Tender Offers by Controlling Shareholders

favorable price, for which the remedy would be time consuming and costly litigation.\textsuperscript{29} The refusal to shift the standard from entire fairness to business judgment was significant because of the incentives it gave to the plaintiffs' bar. Not only did the court refuse business judgment protection for the work of special committees, but it also mandated "careful judicial scrutiny of a special committee's real bargaining power before shifting the burden of proof on the issue of entire fairness."\textsuperscript{30} Consequentially, application of the entire fairness standard, even if the controlling shareholder was likely to eventually prevail, "normally will preclude dismissal of a complaint on a Rule 12(b)(6) motion to dismiss."\textsuperscript{31} A claim that can withstand a motion to dismiss may have settlement value, if only to avoid the expense of discovery. After Kahn, it would be the rare freezeout that would not generate a lawsuit, no matter how scrupulously negotiated. The controlling shareholder might prevail, even if less than scrupulous (as the defendant eventually did in Kahn),\textsuperscript{32} but not without the risk of delay and uncertainty.\textsuperscript{33}

II. TENDER OFFER/SHORT-FORM MERGER

A. The Supreme Court Shows the Shortcut to Squeezeout

Transactional planners were quick to exploit an alternative freeze-out path by combining the holdings of two more recent Delaware Supreme Court decisions: Solomon v. Pathe Communications Corp.\textsuperscript{34} and Glassman v. Unocal Exploration Corp.\textsuperscript{35} To many observers, the combined import of these two holdings threatened to vitiate the protections of the entire fairness standard as applied in Weinberger.

1. Solomon

Solomon involved an unusual takeover, in that Credit Lyonnais Banque Nederland N.V. ("the bank") was poised to gain its controlling interest not through the purchase of shares, but rather through foreclosure on an 89.5

\textsuperscript{30} Id. at 1117.
\textsuperscript{31} Orman v. Cullman, 794 A.2d 5, 20 n.36 (Del. Ch. 2002).
\textsuperscript{32} Kahn, 669 A.2d 79 (Del. 1995) (affirming chancery court's conclusion that merger was entirely fair to the minority despite "coercive" threats made by majority shareholder to special committee).
\textsuperscript{33} See William T. Allen et al, Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 26 DEL. J. CORP. L. 859, 880-81 (2001) (criticizing failure to give business judgment protection to transactions approved by a majority of the minority).
\textsuperscript{34} 672 A.2d 35 (Del. 1996).
\textsuperscript{35} 777 A.2d 242 (Del. 2001).
percent block of Pathe shares in which it held a security interest.\textsuperscript{36} In conjunction with this foreclosure, however, the bank proposed a tender offer for the 10.5 percent of the shares held by the public.\textsuperscript{37} Plaintiff-shareholders sought to enjoin the tender offer as both unfair and coercive.\textsuperscript{38}

The Delaware Supreme Court made short work of both claims. As to the claims of unfair price, the court curtly replied that “in the absence of coercion or disclosure violations, the adequacy of price in a voluntary tender offer cannot be an issue.”\textsuperscript{39} The court also discerned no factual basis in the complaint for the allegation of coercion.\textsuperscript{40} Accordingly, it affirmed the Chancery Court’s dismissal of the complaint on a 12(b)(6) motion.

2. Glassman

Glassman raised an entire fairness challenge to a merger by a controlling shareholder. It differed in one crucial respect, however, from the mergers subjected to the entire fairness standard in Weinberger, Rosenblatt, and Kahn. Unlike those cases, which involved mergers under Delaware’s section 251, the merger in Glassman was to proceed under § 253 of that code, the “short-form” merger provision.\textsuperscript{41} Unlike § 251, which requires the approval of both the board and shareholders of the subsidiary, a merger pursuant to § 253 can be implemented unilaterally by the board of the parent company if it owns at least 90 percent of the subsidiary’s shares.\textsuperscript{42} It does, however, allow minority shareholders to seek appraisal under all circumstances (unlike mergers under § 251, which are subject to § 262’s complicated “market out” provision).\textsuperscript{43}

The Glassman court found that the differences between § 251 and § 253 were fatal to the plaintiffs’ entire fairness claim:

If a corporate fiduciary follows the truncated process authorized by § 253, it will not be able to establish the fair dealing prong of entire fairness. If, instead, the corporate fiduciary sets up a negotiating committee, hires independent financial and

\begin{itemize}
\item\textsuperscript{36} Solomon, 672 A.2d at 37.
\item\textsuperscript{37} Id.
\item\textsuperscript{38} Id.
\item\textsuperscript{39} Id. at 40. The chancery court had reached a similar conclusion previously in In re Ocean Drilling & Exploration Company Shareholders Litigation, 1991 WL 70028, at *3 (1991) (concluding that “as a general principle our law holds that a controlling shareholder extending an offer for minority-held shares in the controlled corporation is under no obligation, absent evidence that material information about the offer has been withheld or misrepresented or that the offer is coercive in some significant way, to offer any particular price for the minority-held stock.”) and in Joseph v. Shell Oil Co., 482 A.2d 335, 343 (1984) (distinguishing Weinberger as involving a merger rather than a tender offer).
\item\textsuperscript{40} Id. at 40
\item\textsuperscript{41} Glassman, 777 A.2d at 243.
\item\textsuperscript{42} Del. Code. Ann. Tit. 8, § 253.
\item\textsuperscript{43} Compare tit. 8, § 253(d) (providing that “the stockholders of the subsidiary Delaware corporation party to the merger shall have appraisal rights as set forth in Section 262”) with Del. C. § 262(b) (providing various exceptions to right to appraisal for mergers under § 251).
\end{itemize}
Tender Offers by Controlling Shareholders

legal experts, etc., then it will have lost the very benefit provided by the statute—a simple, fast and inexpensive process for accomplishing a merger. We resolve this conflict by giving effect to the intent of the General Assembly. In order to serve its purpose, § 253 must be construed to obviate the requirement to establish entire fairness.44 The court qualified its holding by noting that the determination of fair value which would be available in an appraisal proceeding would incorporate many of the issues that would be raised in an entire fairness proceeding seeking equitable relief.45 It also noted that the controlling shareholder’s duty of full disclosure carried over to the short-form merger context, mandating that minority shareholders “be given all the factual information that is material to that decision.”46 Nonetheless, the procedural burdens imposed by Kahn were cast aside for controlling shareholders who held at least 90 percent of the subsidiary’s stock. The only requirement was full disclosure.

B. Combining Tender Offers and Short-Form Mergers

Transactional planners were quick to recognize that combining the tender offer used in Solomon with the short-form merger used in Glassman could effect a squeezeout of minority shareholders with no entire fairness review. A trio of decisions from the Chancery Court (decided by three different vice-chancellors) have blessed the two-step path to a freezeout, although they have varied in their enthusiasm.

1. Siliconix

The first case in this trilogy, In re Siliconix Inc. Shareholders Litigation,47 arose out of a tender offer by Vishay Intertechnology for the 19.6 percent of the Siliconix shares that it did not already own. At the time that it announced its tender offer, Vishay also disclosed that it would “consider” a follow-on short-form merger at the same price if it acquired over 90 percent of Siliconix stock.48 The Siliconix board responded to the tender offer by appointing a special committee (of dubious independence) to evaluate the offer of $28.82 cash per share.49 The special committee advised Vishay that it considered the offer inadequate.50 After some effort at negotiating a possible merger with the special committee, Vishay dropped its cash offer and substituted an exchange

44. Glassman, 777 A.2d at 247-48 (footnotes omitted).
45. Id. at 248.
46. Id.
47. 2001 WL 716787, at *1 (Del. Ch. 2001). Vishay had acquired its 80.4 percent stake from Daimler-Benz in 1998. Id.
48. Id. at *2.
49. The court noted that “Both members of the Special Committee had done extensive work with Vishay,” one as its attorney and the other as its banker. Id.
50. Id. at *3.
offer of one and a half shares of Vishay stock for each share of Siliconix. This exchange offer, unlike the previous cash offer, included no premium over the market price for Siliconix shares. Despite the somewhat niggardly price, the exchange offer did contain "a non-waivable 'majority of the minority' provision providing that Vishay would not proceed with its tender offer unless a majority of those shareholders not affiliated with Vishay tendered their shares." Vishay’s exchange offer (like the earlier cash offer) did not, however, include a commitment to a follow-on short-form merger.

Not surprisingly, the offer provoked one of the minority shareholders to file a lawsuit seeking to enjoin the transaction. In addition to a litany of alleged disclosure violations, the plaintiff alleged that the exchange ratio did not reflect a fair price for the Siliconix shares. Following the holding in Solomon, Vice-Chancellor Noble concluded that:

Vishay was under no duty to offer any particular price, or a "fair" price, to the minority shareholders of Siliconix unless actual coercion or disclosure violations are shown by [the plaintiff]. In short, as long as the tender offer is pursued properly, the free choice of the minority shareholders to reject the tender offer provides sufficient protection.

The court acknowledged the incongruity of allowing Vishay to proceed with the tender offer/short-form merger combination with minimal judicial scrutiny while a one-step freeze-out merger under § 251 would be subjected to entire fairness review, given that both paths would lead to the same result. The vice-chancellor offered two justifications for the differences in judicial scrutiny. First, the shareholder who rejects the tender offer would still hold his shares, even though they might be taken in the subsequent short-form merger. Second, the tender offer spurred no "corporate decision" as a merger would have "because the actual target of a tender is not the corporation (or its directors), but, instead, is its shareholders." The bottom line is that Vishay stood on the opposite side of the transaction from the Siliconix shareholders, not the Siliconix corporation. Vishay had no control over those shareholders, who had the power to thwart the transaction by refusing to tender, so entire fairness was not triggered. Vishay’s only affirmative obligation as a controlling shareholder (in addition to its passive duty to avoid coercive

51. Id. at *4.
52. Id.
53. Id.
54. Id.
55. Id. at *6.
56. Id. at *7.
57. Id.
58. Id.
59. Id. at *8 (rejecting entire fairness review because "[h]ere, the Siliconix minority shareholders have the power to thwart the tender offer because it will go forward only if a majority of the minority shares are tendered").
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threats) was a duty of full disclosure of all material facts to the minority. The court followed precedent without additional discussion of rejecting the claim that Vishay's failure to commit to a short-form merger was actionable coercion.

The fact that the shareholders, rather than the target corporation, were called upon to make a decision also had important implications for the duties of the Siliconix board. Responding to the plaintiff's argument that the Siliconix board had a duty under *McMullin* to advise the minority shareholders on whether they should tender their shares, the vice-chancellor emphasized the lack of a statutory role for the board in tender offers which contrasted with the mandate imposed on the board under § 251 to make a recommendation to shareholders. The minority shareholders were left to their own devices in responding to Vishay's tender offer.

2. *Aquila*

In *re Aquila, Inc. Shareholders Litigation*, like *Siliconix*, involved a tender offer by an 80 percent shareholder (in this case UtiliCorp) for the shares of the minority. Unlike *Siliconix*, however, UtiliCorp committed to doing a short-form merger if its tender offer resulted in it obtaining 90 percent of Aquila's shares. This left the plaintiffs without a claim that the offer was coercive. Undeterred, the plaintiffs argued that they were deprived of the procedural protection of a recommendation on the tender offer by an independent board. Aquila had failed to honor its commitment made at the time of its IPO to appoint two independent directors to its five-member board. Consequently, the conflicted members of the Aquila board declined to make a recommendation on UtiliCorp's offer. Instead, they solicited an analysis of the offer by an independent investment bank, which was provided to the Aquila minority. The board did not, however, request a fairness opinion from the investment bank. Following the ruling in *Siliconix*, the court concluded that the Aquila board had no obligation to provide an evaluation of the fairness of the transaction. There was little evidence that the views of independent directors would make a difference to the minority shareholders. The court

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60. *Id.* at *9.
61. *Id.* at *16.
62. *Id.* at *8.
63. 805 A.2d 184, 186 (Del. Ch. 2002).
64. *Id.* at 188.
65. *Id.* This commitment was required by the listing rules of the NYSE, where Aquila stock traded, and was reflected in Aquila's certificate of incorporation. *Id.* at 188 n.1 (citing N.Y.S.E. Listed Co. Manual § 303.02(I)).
66. *Id.* at 189.
67. *Id.*
68. *Id.* at 191.
explained:
The offer being made by UtiliCorp is structured in a non-coercive way and the stockholders of Aquila appear to have adequate information and time to make an informed and reasoned decision whether or not to tender. While the presence of a functioning audit committee of independent directors might add some measure of protection for the Aquila stockholders, I cannot conclude that its absence is clear and convincing evidence of an injustice... even if those two new directors were to conclude that the UtiliCorp offer is unfairly priced, they could do little more than communicate their conclusion to the stockholders in the Schedule 14D-9 and recommend that they not tender. In the end, those stockholders would still have to decide for themselves whether to tender or not and would still have the collective power to reject the offer.69

Aquila, therefore, reaffirms Siliconix's faith in the ability of shareholders to fend for themselves.

3. Pure Resources

The smooth sailing to squeeze out validated in Siliconix and Aquila ran into rougher weather in In re Pure Resources Inc. Shareholders Litigation.70 Unlike Siliconix and Aquila, in which the courts were content to allow the tender offers to proceed with minimal scrutiny, Vice-Chancellor Leo Strine held forth at length on a variety of topics in Delaware corporate law that he considered relevant to the legality of tender offers by controlling shareholders. In the end, however, he somewhat grudgingly allowed the offer to proceed subject to only minor modifications.

The offer under review was Unocal's exchange offer for the 35 percent of Pure Resources' shares that it did not already own.71 Like the Siliconix and Aquila offers, Unocal conditioned its offer on approval by a majority of the minority.72 And like the offer in Aquila, Unocal committed itself to a short-form merger at the same price if it obtained 90 percent of Pure Resources' shares.73 The facts alleged in Pure Resources differed from Siliconix and Aquila in two important aspects: (1) the Pure Resources management was generally hostile to Unocal's bid; and (2) the Pure Resources board appointed an energetic special committee that gave Unocal's offer a very hard look.

Pure Resources had been formed as the result of the combination of Unocal's oil and gas operations in the Permian Basin (located in western Texas and southeastern New Mexico) with Titan Exploration, an independent oil and gas company operating in the same area.74 Titan's managers stayed on to run

69. Id. at 194.
70. 808 A.2d 421 (Del. Ch. 2002).
71. Id. at 425.
72. Id. at 430.
73. Id.
74. Id. at 425.
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Pure Resources, but the relationship between Unocal and Pure Resources’ management proved to be prickly. More importantly, in the context of Unocal’s tender offer, management held a quarter of the Pure Resources’ shares not owned by Unocal. Consequently, Unocal’s tender offer faced tough sledding if it did not appeal to this bloc. Moreover, it is difficult to imagine that Unocal had any informational advantage over Pure Resources’ management in pricing Pure Resources’ stock—a recurring worry in tender offers by controlling shareholders. Therefore, the presence of a hostile management bloc made Pure Resources an unlikely case for raising concerns about a “coerced” minority.

Minority shareholders could take further comfort from the fact that the special committee appointed by Pure Resources was not content to merely roll over in the face of Unocal’s offer. Instead, the special committee sought “the full authority of the board under Delaware law to respond to the offer.” Such authority would have provided the committee not only the power to negotiate, but also would have added teeth to its negotiating position: the full authority of the board would presumably include the ability to adopt a poison pill and to thwart Unocal’s offer. The full board (including the Unocal designees on the board) rebuffed this request by the special committee. Despite this limitation on the authority, the special committee attempted to extract a higher price from Unocal, but to no avail. In the face of Unocal’s recalcitrance, the special committee voted to recommend against Unocal’s offer; this recommendation was conveyed to Pure Resources’ shareholders in the company’s Schedule 14D-9.

The special committee’s recommendation against tendering into the offer did not satisfy the plaintiff-minority shareholder, who sought to enjoin the tender offer from proceeding. Given the factual similarities to Siliconix and Aquila, those precedents would have provided a relatively straightforward basis for refusing the injunction. Vice-Chancellor Strine, however, seized the opportunity provided by the proceeding to hold forth on a wide-ranging series of issues in Delaware takeover law. The duty of judges, as the vice-chancellor saw it, was to craft “equitable principles sufficient to protect against abuse and unfairness, but not so rigid as to stifle useful transactions that could increase the shareholder and societal wealth generated by the corporate form.” A lofty

75. Id. at 427.
76. Id. at 425.
77. At the time of the lawsuit, management had announced that it did not intend to tender its shares. Id. at 452.
78. Id. at 430.
79. Id.
80. Id. at 432.
81. Id.
82. Id. at 434.
goal, indeed.

Strine was troubled by the "possible incoherence" in treating "economically similar transactions as categorically different simply because the method by which controlling stockholder proceeds varies."³⁸³ Minority shareholders were just as squeezed out after tender offers followed by short-form mergers under § 253 as they were after mergers between subsidiaries and controlling shareholders under § 251. So why treat the transactions differently? Worse yet, the judge felt the threat to minority shareholders was arguably greater in the tender offer/short form merger transaction. The vice-chancellor remarked:

In a merger vote, stockholders can vote no and still receive the transactional consideration if the merger prevails. In a tender offer, however, a non-tendering shareholder individually faces an uncertain fate. That stockholder could be one of the few who holds out, leaving herself in an even more thinly traded stock with little hope of liquidity and subject to a § 253 merger at a lower price, or at the same price but at a later (and, given the time value of money, a less valuable) time. The 14D-9 warned Pure's minority shareholders of just this possibility. For these reasons, some view tender offers as creating a prisoner's dilemma – distorting choice and creating incentives for stockholders to tender into offers that they believe are inadequate in order to avoid a worse fate.³⁸⁴ Thus, the specter of coercion made the shareholders' decision to tender their shares suspect as an indicia of the fairness of the offer.

Strine was also troubled by another disparity in Delaware's corporate law: tender offers by controlling shareholders were subject to relatively hands-off treatment, while tender offers by third parties justified the invocation by target boards of the full gamut of corporate defenses.³⁸⁵ This issue had heightened salience in Pure Resources in light of the special committee's rebuffed efforts to be delegated authority to adopt a poison pill. Despite the lack of a statutory role for boards of directors in responding to tender offers, the Delaware Supreme Court had recognized an "affirmative duty" for directors of companies confronted with tender offers.³⁸⁶ Strine focused on this language from that court's seminal decision validating defensive measures against hostile takeovers, Unocal Corp. v. Mesa Petroleum Co.:

[T]he board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source. Thus, we are satisfied that in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality.³⁸⁷

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³⁸³ Id. at 435.
³⁸⁴ Id. at 441-42.
³⁸⁵ Id. at 444 ("As a general matter, Delaware law permits directors substantial leeway to block the access of stockholders to receive substantial premium tender offers made by third-parties by use of the poison pill but provides relatively free access to minority stockholders to accept buy-out offers from controlling stockholders.").
³⁸⁶ Id. at 440.
³⁸⁷ Id. (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)) (emphasis Strine's).
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Why then, should the board of a controlled subsidiary be a "passive instrumentality" when confronted by a tender offer from the controlling shareholder, the position seemingly endorsed by Siliconix and Aquila? Did the undiluted fiduciary duty of a subsidiary's board require the directors to adopt a poison pill to give minority shareholders' bargaining leverage in the face of a tender offer by a controlling shareholder? On the one hand, such a mandate would have given minority shareholders the ability to extract higher prices in freezeouts. On the other, it would have gutted the advantages of the tender offer/short-form merger path to squeeze out for controlling shareholders. Controlling shareholders might hesitate to make such offers as a consequence, and ex ante, reluctant to become controlling shareholders at all.

The plaintiffs squarely put this issue to the court. They argued that the Pure Resources board's rejection of the special committee's request for the authority to adopt a poison pill was subject to the entire fairness standard because Unocal controlled the board. The court declined the plaintiffs' invitation, despite what it termed the "analytical and normative appeal, embodying as it does the rough fairness of the goose and gander rule." The court's rationale, however, was somewhat tenuous: it was "reluctant . . . to burden the common law of corporations with a new rule that would tend to compel the use of a device that our statutory law only obliquely sanctions and that in other contexts is subject to misuse, especially when used to block a high value bid that is not structurally coercive." The court's reluctance stemmed from the "awkwardness of a legal rule requiring a board to take aggressive action against a structurally non-coercive offer by the controlling stockholder that elects it."

"Awkwardness" is less than compelling as a justification for avoiding the protections of entire fairness. Moreover, it is difficult to characterize the Delaware Supreme Court's treatment of defensive measures as only obliquely sanctioning them, though the attitudes of some members of the court of chancery may be less favorable. The vice-chancellor's distinction of Digex, in which the subsidiary board was held to have breached its fiduciary duty by waiving the anti-takeover protections of § 203, is similarly shaky. According

88. Id. at 443 (noting "an . . . obvious concern is that subsidiary directors might use the absence of a statutory role for them in the tender offer process to be less than aggressive in protecting minority interests, to wit, the edifying examples of subsidiary directors courageously taking no position on the merits of offers by a controlling stockholder").
89. Cf. Weinberger v. UOP, Inc. 457 A.2d 717, 710 (Del. 1983) ("There is no dilution [of the obligation of fiduciary duty] where one holds dual or multiple directorships, as in a parent-subsidiary context. Thus, individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations . . . ").
91. Id.
92. Id.
93. Id.
to the court, in *Digex* "the controlling stockholder forced the subsidiary board to take action only beneficial to it, whereas here the Pure board simply did not interpose itself between Unocal’s offer and the Pure minority."95 This rationale rings a bit hollow in light of the fact that the special committee had attempted to interpose itself, but was rebuffed by the Unocal-dominated board. Was not the refusal of the Pure Resources board to give the special committee authority to adopt the poison pill "action only beneficial to" Unocal? Overall, the court’s rejection of the entire fairness argument put forth by the plaintiffs is a bit thin.

Perhaps a more candid (but no more intellectually satisfying) response to the plaintiffs’ argument would have been the constraint on a lower court of the combined import of the Delaware Supreme Court’s decisions in *Solomon* and *Glassman*. While those cases are not squarely controlling on this point, a lower court could be forgiven for reading the direction that the wind was blowing in the court above. The “just say no” authority to thwart the advances of a controlling shareholder sought by the special committee in *Pure Resources* is the benchmark of fair dealing under *Kahn*,96 and *Solomon* and *Glassman* are clearly a turn away from that regime.

Rather than risk reversal, the *Pure Resources* court endeavored to satisfy its concerns within the “non-coercive” doctrinal framework established by *Solomon*. Vice-Chancellor Strine imposed three requirements intended to ensure that the tender offer was non-coercive:

1) a non-waivable majority of the minority tender condition;
2) the controlling stockholder promises to consummate a prompt § 253 merger at the same price if it obtains more than 90 percent of the shares; and
3) the controlling stockholder has made no retributive threats.

Applying these principles to the case at hand, the court found that Unocal had failed the first prong by failing to exclude Pure Resources’ management from the definition of the minority and enjoined the offer until it was revised.98

4. The Definition of Non-Coercion

The last of the *Pure Resources* requirements is an uncontroversial criterion for non-coercion, but the first two are less obvious. The first objection to them is obvious: both of these protections could be provided contractually, so should judges supply them when parties do not?

A contractarian answer has appeal in this setting. Consider how minority shareholders got to be minority shareholders. There are two primary avenues.

95. *Pure Resources*, 808 A.2d at 446 n.49 (citing *Digex*, 789 A.2d 1176 (Del. Ch. 2000)).
96. Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110, 1119-20 (Del. 1994) (emphasizing that special committee negotiating a merger with a controlling shareholder must have “power to say no”).
97. *Pure Resources*, 808 A.2d at 445.
98. Id. at 446-47.
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The first is a public offering by a parent company doing an equity carveout of a subsidiary. It does not take a zealous faith in the efficient capital market hypothesis to see that the risks of appropriation by the controlling shareholder will lead investors to discount the value of shares in a company that has a dominant shareholder. This discount, of course, comes out of the pocket of the controlling shareholder, who will receive less for the shares that it sells in the public offering. If the discount is too great, the controlling shareholder will take steps to reduce discounting by ensuring minority shareholders receive adequate protection in the event of a subsequent freezeout. Such a risk is surely obvious enough that investors will take it into account in valuing the securities.

The second principal path to becoming a minority shareholder is as a result of a third-party tender offer for a majority, but less than all, of the shares. The target board, armed with the bargaining leverage of the poison pill, surely has a role to play in securing protections for shareholders whose stock will not be taken up in the tender offer. Extracting procedural protections for those soon-to-be minority shareholders is entirely consistent with the target board’s Revlon duties. In the post-Solomon/Glassman world, directors of target boards would do well to take such concerns into account when negotiating with potential acquirors. Alternatively, the board can insist on a higher premium from acquirers seeking less than any and all shares. All of the shareholders would be entitled to share in that initial premium on a pro rata basis.

Even if one thinks that judges should play a more active role in protecting shareholders who (or whose bargaining agents) have neglected to protect themselves, the Pure Resources non-coercive criteria seem less than compelling. The requirement of a majority of the minority seems largely superfluous—why would a controlling shareholder offer an amount less than what it would expect to produce a majority of the minority’s shares? The tender offer itself is not free, and simply increasing its percentage ownership of the company offers few benefits to a controlling shareholder. Only if it reaches the magic number of 90 percent will there be a concrete benefit, i.e., the ability to do a short-form merger and take the company private, which should generate cost savings. The controlling shareholders in Siliconix and Aquila each owned 80 percent of the shares—they needed a majority of the minority to get the 90 percent needed to do the short-form merger. A majority of the minority would have done little for Unocal—it needed slightly more than 71 percent of the 35 percent of the Pure Resources stock that it did not already own to reach the crucial 90 percent threshold.

99. See Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1994) (suggesting that a poison pill could be used to extract protections for soon-to-be minority shareholders).
100. It is possible, one supposes, to acquire a controlling bloc through open-market transactions. The poison pill, however, would appear an insuperable barrier to this takeover strategy.
101. See Donald J. Wolfe, Jr., The Odd Couple: Majority of Minority Approval and the Tender
As a strategic matter, any offer that does not include a condition that the offeror obtain 90 percent of the shares sends a strong signal that the offeror believes that there is a good chance that it will be rebuffed, i.e., it is a low-ball offer. An investor does not need to be an investment professional to recognize that an offer lacking such a condition should be rejected. To be sure, some firms will hold closer to 90 percent and may be able to proceed with less than a majority of the minority; but those firms are likely to find it cheaper to buy what they need in open-market transactions, so even the Pure Resources criteria would be inapplicable.

This line of analysis also suggests that the requirement of a commitment to do a § 253 merger is also redundant. Moreover, other courts have not seen that as necessary to ensure non-coercion. Recall that the controlling shareholder did not commit to a § 253 merger in Siliconix, but the court there did not conclude that made the offer coercive. For that matter, the controlling shareholder did not commit to a follow-on merger in Solomon, although the issue is not discussed by the court. The shares of the subsidiary left outstanding were subsequently delisted by the NYSE. The failure to follow up the tender offer with a merger will undoubtedly cause the shares to lose value (particularly if they are delisted), but it does not follow that it makes the tender offer coercive. Will the diminution be sufficient to cause a shareholder to tender into an undervalued offer? They will, after all, continue to hold their shares and have a pro rata claim on any earnings distribution. Is that claim worth more or less than a low-ball offer by the controlling shareholder? These are, however, largely quibbles. Controlling shareholders will not be burdened unduly by the Pure Resources criteria in most cases. The bottom line for transactional planners is that the tender offer/short-form merger combination provides a ready means for evading the entire fairness regime imposed on controlling shareholders doing mergers under § 251.

III. OBJECTIONS

The Solomon/Glassman circumvention of the entire fairness standard has obvious procedural benefits and cost savings, but it has, nonetheless, provoked the usual outpouring of complaints about the potential for its abuse. Those

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complaints fit generally into two categories echoing the concerns expressed by Vice-Chancellor Strine in Pure Resources: coercion and fair price. I deal with each of these objections in turn.

A. Coercion

The most frequent complaint about Solomon/Glassman and their progeny is that the standards set forth by the Delaware courts for tender offers for controlling shareholders will not protect investors from coercion. This specter of coercion, it is said, removes any assurance that the acceptance by minority shareholders of the tender offer reliably indicates that they consider the price to be reasonable. Shareholders will tender even at lowball prices, the argument goes, rather than face an uncertain future as a minority shareholder of a still smaller minority, facing possible delisting with its attendant loss of liquidity. Even if the controlling shareholder proceeds with a § 253 merger, it will come at later time and, potentially, a lower price. For those declining the merger price, opting for appraisal ensures even more uncertainty and delay. Some commentators go further, claiming that all tender offers are coercive.

The claim that even a fully-informed minority can be coerced into accepting offers by controlling shareholders certainly has a theoretical appeal to those inclined to find oppression at every turn. Unfortunately, it runs afoul of empirical reality: minority shareholders are not readily buffaled into accepting a lowball offer. Consider the tender offers in the cases discussed above. Vishay won its battle in court, but lost the war when less than a majority of the Siliconix minority shareholders tendered their shares. Siliconix continues as a public company today. Unocal succeeded with its tender offer for Pure Resources, but only after offering a more generous exchange ratio to the Pure Resources minority, which induced the Pure Resources board (and management) to recommend the offer.

At the time Unocal raised its offer, only 450,404 shares had been tendered, representing 2.6 percent of the shares.

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104. See, e.g., Kimble C. Cannon, Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers after Siliconix, Aquila and Pure Resources, 2003 COLUM. BUS. L. REV. 191, 196-7 (“[T]he line of Delaware cases permitting director inaction in connection with unilateral tender offers also legitimizes as non-coercive a class of tender offer transaction that leaves shareholders no practical choice but to accept an offer’s terms.”).
105. Id. at 242.
110. Pure Resources Decides to Accept Final Amended Buyout Offer from Unocal, PETROLEUM FIN. WEEK, October 14, 2002; Unocal Increases Exchange Ratio of Exchange Offer for Pure Resources Shares, PR NEWSWIRE, Oct. 2, 2002.
held by the minority.\textsuperscript{111} Apparently the 97.4 percent that held out for a better offer did not understand that they had no choice but to tender. Only in the third case of the trilogy—\textit{Aquila}—did the controlling shareholder succeed with its tender offer without raising its bid.\textsuperscript{112} Other controlling shareholders have faced similar resistance.\textsuperscript{113} In the choices that we commonly think of as coercive—"Your money or your life"—a considerably lower percentage dare to risk the imposition of the coercive sanction.

What do these investors know that lawyers and law professors do not? Perhaps it is that the "coercive" threat posed by controlling shareholder tender offers is not much of a threat. To begin, the threat of being left behind as a member of a smaller minority is largely illusory—Utilicorp and Unocal announced short-form mergers immediately upon acquiring 90 percent of Aquila and Pure Resources.\textsuperscript{114} As noted above,\textsuperscript{115} increasing your controlling stake above 90 percent only makes sense if you plan to proceed promptly with the squeezeout. Otherwise you are giving up a relatively cheap source of capital and increasing risk for a very limited return. Moreover, the Delaware appraisal statute gives a strong incentive to complete the merger promptly. Under \textit{Cede & Co. v. Technicolor, Inc.},\textsuperscript{116} minority shareholders are entitled to any post-tender offer increases in the value of the company. Controlling shareholders who delay a short-form merger will be required to share the value of any changes they make in the subsidiary's operations. Furthermore, only controlling shareholders who believe that the subsidiary's value will increase have an incentive to make an offer at all. Thus, waiting to complete the short-form merger will increase the prospect that the minority shareholders will seek appraisal. The controlling shareholder would prefer to avoid having any shareholders seek that remedy because of the expense and distraction of having to defend in the appraisal proceeding. It is the litigation costs, rather than the risk of a higher payout to a small minority, that provide appraisal with its real deterrent value—and give corresponding credibility to the threat of minority shareholders not tendering.

This line of reasoning also suggests why a lower offer in the short-form

\textsuperscript{113.} See, e.g., Tyson Freeman, \textit{Son of Siliconix}, CORP. CONTROL ALERT, Oct. 23, 2002, (reporting that Network Associates tender offer for McAfee yielded only 4 percent of outstanding shares after Network Associates had raised bid five times; sixth bid resulted in endorsement by McAfee independent directors and success of tender offer); Reuters, \textit{Motorola increases its bid for Next Level; Companies agree on $1.18 per share}, CHICAGO TRIBUNE, Mar. 25, 2003, at C3, (reporting that Motorola was forced to increase its bid after tenders under original offer did not meet minimum condition).
\textsuperscript{115.} See supra Part II.B.4.
\textsuperscript{116.} 684 A.2d 289 (Del. 1996).
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merger following the tender offer is exceedingly unlikely. What could be more of a red flag to a minority shareholder considering his or her appraisal option?

Apart from these rather tenuous implicit threats, if the controlling shareholder makes an actual threat to induce the minority to tender, or a structurally coercive offer, those threats are actionable coercion under Solomon.\(^\text{117}\) And virtually all such threats will be litigated because they are necessarily conspicuous—the threat is ineffective if the public shareholders are not made aware of it. In sum, the specter of coercion is just that, a specter.

\section*{B. Fair Price}

Commentators have also complained that the Solomon/Glassman regime deprives minority shareholders of the bargaining leverage afforded by the entire fairness regime.\(^\text{118}\) Only a special committee of independent directors with the power to “say no” will ensure that minority shareholders get the best price for their shares.\(^\text{119}\)

One would question, however, whether the best price is the fair price for minority shareholders. Wealth transfers in this essentially self-contained, multi-period bilateral negotiation between majority and minority hardly present a compelling case for legal intervention. As noted above,\(^\text{120}\) minority shareholders generally did not acquire their minority status by accident. They invested in a public offering by a controlling shareholder, in which case the risk of “unfair” expropriation was incorporated into the price that they paid for their shares. Alternatively, they had the opportunity to sell their shares \textit{pro rata} into a tender offer by which the controlling shareholder obtained control, in which case they shared in the control premium paid by the controlling shareholder. Should the controlling shareholder have to pay a second control premium, in this case a “complete control” premium?

Such a regime would reduce the number of transactions seeking control, a result unlikely to benefit investors \textit{ex ante}. Remember that minority shareholders are not discrete and insular minorities: the minority shareholder of the subsidiary may well be part of a diffuse public majority of the parent corporation. Certainly, if they hold a diversified portfolio, they can expect to be

\begin{itemize}
\item \textit{117.} See Jon E. Abramczyk et al., \textit{Going-Private “Dilemma”?—Not in Delaware}, 58 BUS. LAW. 1351, 1363 (2003) ("[T]he court’s insistence that there be no threat of retribution reaffirms the long-standing practice of Delaware courts to scrutinize carefully whether there is any actionable coercion in tender offers made by controlling stockholders.").
\item \textit{119.} See Resnick, supra note 118 at 261 (arguing that “adequate procedures are important to ensuring that minority shareholders get the best price, not just a fair price").
\item \textit{120.} See supra Part II.
\end{itemize}
on the parent side as often as the subsidiary side. If this is the case, requiring subsidiary boards to extract the largest possible premium would simply create greater transaction costs, with minimal benefits for public shareholders.\textsuperscript{121}

This argument, however, may prove too much—investors are just as likely to be shareholders in acquiring corporations as they are target corporations, but that has not kept the Delaware Supreme Court from approving a regime of defensive measures that allows target company boards to extract all of the available rents from hostile acquirers. The court has specifically rejected a model of director passivity in response to outside tender offers.\textsuperscript{122} Indeed, \textit{Revlon} essentially mandates that a target board which has made the decision to sell must extract every last dollar for \textit{its} shareholders.\textsuperscript{123} Why not expect as much from the boards of controlled corporations?

The analogy to Delaware’s regime for third-party tender offers is central to Ron Gilson and Jeff Gordon’s criticism of the \textit{Solomon/Glassman} regime. Like Vice-Chancellor Strine, they seize upon the language in \textit{Unocal} suggesting that target directors have “both the power \textit{and duty} to oppose a bid it perceived to be harmful to the corporate enterprise.”\textsuperscript{124} This “power and duty” subsequently was held to include the power to adopt a poison pill in \textit{Moran v. Household International}.\textsuperscript{125} In Gilson and Gordon’s view, the target board passivity approved in \textit{Siliconix}, \textit{Aquila}, and \textit{Pure Resources} raises a “troubling inconsistency in Delaware law: that minority shareholders of a controlled company receive less protection when faced with a hostile ‘internal’ tender offer than shareholders faced with a hostile ‘external’ tender offer.”\textsuperscript{126} Gilson and Gordon claim that if target directors “have the right to prevent the shareholders from choosing to accept a hostile tender offer by declining to redeem a pill, there is no coherent case for not demanding that target directors confronting a freeze-out tender offer have available the same power.”\textsuperscript{127}

Gilson and Gordon’s claim turns on whether the \textit{duty} to rebuff hostile tender offers recognized in \textit{Unocal} sweeps as broadly as the \textit{power} also recognized there and expanded in subsequent cases. I have my doubts. Recall that the offer rebuffed in \textit{Unocal} involved two-tiered consideration, with cash

\textsuperscript{121} See \textit{FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW} 209 (1991) (“Courts shape the corporate contract, and legal rules influence the wealth of \textit{inversors} who may hold stock in bidders, targets, bystanders, or (most likely) all three groups. Robbing Peter to pay Paul is poor use of corporate law, especially when Peter is just Paul’s nom de plume.”).

\textsuperscript{122} \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d 946, 955 n.10 (Del. 1985) (observing that Easterbrook and Fischel’s argument for passivity “clearly is not the law of Delaware”).


\textsuperscript{124} Gilson & Gordon, \textit{supra} note 118, at 38 (quoting \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d 946, 949 (Del. 1985) (emphasis supplied by Gilson & Gordon)).

\textsuperscript{125} 500 A.2d 1346 (Del. 1985).

\textsuperscript{126} Gilson & Gordon, \textit{supra} note 118, at 55.

\textsuperscript{127} Id. at 59.
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at the front end and highly subordinated securities at the back end.\textsuperscript{128} The coercion in such an offer is apparent: tender and get the cash, or refuse, and risk getting the junk bonds instead. As such, it was what the Delaware Supreme Court would later come to term "structurally coercive."\textsuperscript{129}

The modifier "structurally" was necessary to distinguish a second category of threat that the target board had the power to defend against: "substantive coercion." Substantive coercion describes "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management’s representations of intrinsic value."\textsuperscript{130} Although the coercion in "structural coercion" is fairly clear (making the case for judicial intervention correspondingly straightforward), the use of the word coercion in connection with the price offered in a voluntary tender offer for shares is at least odd, and, some might say, an abuse of the English language. Most observers would agree that the risk of erroneous shareholder tendering is slight, particularly if the target directors are afforded an opportunity to explain why the unwelcome offer does not reflect the target's intrinsic value.\textsuperscript{131} Investors, particularly the institutional investors who are likely to hold the balance of power in most takeover battles, are not in the business of throwing money away. Greed is a powerful incentive to see things clearly. There may be a threat here, but it scarcely rises to the level of coercion—perhaps "confusion," at most.

Surely, the members of the Delaware Supreme Court know this, despite the rhetoric of "substantive coercion." Gilson and Gordon are correct that there appears to be a "sharp disconnect" between Solomon’s affirmation of the shareholders’ right to consider tender offers by controlling shareholders, as long as they are not infected by "actionable coercion" and the rhetoric of "substantive coercion" employed in the court’s review of anti-takeover

\textsuperscript{128} Unocal, 493 A.2d 946, 949. The court also cited the risk of two-tier tender offers when it subsequently approved the use of poison pills as a defensive measure. See Moran v. Household International, Inc., 500 A.2d 1346, 1356 (Del. 1985) ("Household has adequately demonstrated, as explained above, that the adoption of the Rights Plan was in reaction to what it perceived to be the threat in the market place of coercive two-tier tender offers.").

\textsuperscript{129} Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1153 n.17 (Del. 1990).

\textsuperscript{130} Id.

\textsuperscript{131} A Delaware chancellor, for example, stated:

[O]ne of corporate management’s functions is to ensure that the market recognizes the value of the company and that the stockholders are apprised of relevant information about the company. This informational responsibility would include, one would think, the duty to communicate the company's strategic plans and prospects to stockholders as clearly and understandably as possible. If management claims that its communication efforts have been unsuccessful, shouldn't it have to show that its efforts were adequate before using the risk of confusion as a reason to deny its stockholders access to a bid offering a substantial premium to the company’s market price?

However, the Delaware Supreme Court may treat these seemingly similarly situated shareholders differently because the two contexts raise distinct policy concerns. Perhaps the threat of "substantive coercion" is not really a threat to shareholders, but instead, to another constituency entirely.

To see what might be at work, we need to look past the rhetoric of the court’s anti takeover jurisprudence to the substance of the rules that it actually applies. Specifically, what are the limits of the board’s power to hide behind a poison pill and thereby preclude shareholder consideration of a third-party tender offer? After wading through a lot of cases, we find two situations in which the pill must be redeemed: 1) when the company has put itself up for sale, thereby invoking Revlon duties, and 2) when an insurgent has prevailed in a proxy battle to replace the incumbent board that has been resisting. Outside these two areas, the target board’s power to resist an offer is subject only to Unocal’s proportionality review, which is to say, essentially unconstrained. The board can “just say no” to an unwanted takeover. Looking at these rules as applied, rather than taking judicial rhetoric at face value, may give us a better sense of the actual policy concerns in play.

Recognizing when a board has put a company up for sale, and thus subjected the directors’ conduct to the exacting scrutiny of the Revlon standard, is not simple. Is a company for sale when it agrees to merge with another company? The answer to this question, we found out in Time-Warner, is generally no. The triggering event for the Revlon duty to maximize value for shareholders became clear in QVC: a change in control of the corporation. Why is control the central focus?

When a majority of a corporation’s voting shares are acquired by a single person or entity, or by a cohesive group acting together, there is a significant diminution in the voting power of those who thereby become minority shareholders... In the absence of devices protecting the minority stockholders, stockholder votes are likely to become mere formalities where there is a majority stockholder. For example, minority stockholders can be deprived of a continuing equity interest in their corporation by means of a cash-out merger. Absent effective protective provisions, minority stockholders must rely for protection solely on the fiduciary duties owed to them by the directors and the majority stockholder, since the minority stockholders have lost the power to influence corporate direction through the ballot. The acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price. That price is usually a

133. See Robert H. Thompson & D. Gordon Smith, Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers, 80 Tex. L. Rev. 261, 284 (2001) (arguing that Unocal is “incapable of policing management entrenchment”). Unocal review may have some bite where the board agrees to an offer and the agreement entirely precludes the shareholder’s consideration of an alternative offer. See Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003) (enjoining merger agreement for which shareholder vote was a “fait accompli”).
134. Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1152 (Del. 1990) (rejecting argument that Time had put itself up for sale by agreeing to combination with Warner).
control premium which recognizes not only the value of a control block of shares, but also compensates the minority stockholders for their resulting loss of voting power. 136

Control can be sold, but a price must be paid to compensate the shareholders for the voting authority that they are yielding when they consent to the transaction. The transfer of control—and the fiduciary obligations that accompany it—is tied to the power conferred by the shareholder vote.

Less obvious, but of equal importance, the question of control is inextricably intertwined with the protections of the business judgment rule for directors. If control is to change hands, the target company directors' business judgment is entitled to considerably less deference. The QVC court explained: "Irrespective of the present Paramount Board's visions of a long-term strategic alliance with Viacom, the proposed sale of control would provide the new controlling stockholder with the power to alter that vision." 137 The business judgment rule preserves the discretion of the directors to take risks in making business decisions against the threat of second guessing by judges. Defenses against takeover are tools to protect the business judgment of the directors from second guessing by market participants. When the board has ceded the authority to implement its judgment, however, it loses the protection of the business judgment rule. 138 Once the board has conceded that it is no longer the best custodian of the corporation's assets, the board has a duty to extract the best price for the public shareholders who will be giving up control.

The other takeover context in which the board can also lose the protection of the business judgment rule is when its defense against a takeover conflicts with the shareholders' exercise of their franchise. Under the Blasius standard, the business judgment rule gives way when board discretion conflicts with the shareholder's vote because "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests." 139 By contrast, defensive measures adopted with shareholder approval are not subjected to any form of enhanced scrutiny, even the toothless Unocal variety. 140

These rules are not purely the product of common-law evolution; statutory rules are fundamental here. Director primacy over the corporation's direction is

136. Id. at 42.
137. Id. at 43.
138. From this perspective, the QVC rule has a similar import to the rule of Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), which denied the protections of the business judgment rule to directors who had made an uninformed judgment.
140. Williams v. Geier, 671 A.2d 1368, 1377 (Del. 1996) ("A Unocal analysis should be used only when a board unilaterally (i.e., without stockholder approval) adopts a defensive measure in reaction to a perceived threat.").
mandated by § 141(a), which directs that the corporation's business and affairs "shall be managed by or under the direction of a board of directors." That power, however, is subject to the shareholder's overarching authority to replace the board through the electoral process, as recognized in § 141(k).

This quick overview hardly does justice to the nuances of Delaware's antitakeover jurisprudence, but for the purposes of this Article, it is the broad principles that count. As a descriptive matter, the interrelated pieces of the Delaware Supreme Court's antitakeover jurisprudence can perhaps best be seen as maintaining director supremacy over the business and affairs of the corporation. Directors call the shots, limited only by the shareholders' ability to select who the directors will be: if the shareholders are unhappy with the job that the directors are doing, they can throw the bums out, but only through the electoral process. One can quarrel with the wisdom of this policy choice favoring proxy fights over tender offers (perhaps one should put more faith in the ability of investors to balance short-term gains against long-term ones), but director supremacy constrained by electoral accountability seems to reflect the actual practice of the Delaware Supreme Court in deciding cases. Furthermore, one cannot dismiss the theory underlying this director supremacy model as simply foolish. For better or worse, the Delaware Supreme Court's Unocal doctrine allows directors to protect themselves against second-guessing of their business judgment by the marketplace.

141. Del. Code Ann. tit. 8, § 141(a). See also Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 Del. C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.").

142. Del. Code Ann. tit. 8, § 141(k) ("Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors.").


144. One Delaware court elaborated:

Maintaining proper balance in the allocation of power between the stockholders' right to elect directors and the board of directors' right to manage the corporation is dependent upon the stockholders' unimpeded right to vote effectively in an election of directors. This Court has repeatedly stated that, if the stockholders are not satisfied with the management or actions of their elected representatives on the board of directors, the power of corporate democracy is available to the stockholders to replace the incumbent directors when they stand for re-election.


145. See, e.g., Lucian A. Bebchuk, The Case Against Board Veto in Corporate Takeovers, 69 U. Chi. L. Rev. 975, 977-81 (2002) (arguing that boards should not be permitted to block noncoercive offers); Ronald J. Gilson, Unocal Fifteen Years Later (And What We Can Do About It), 26 Del. J. Corp. L. 491, 507-09 (2001) (arguing that the shareholders should decide whether to accept or reject a bid for control).

146. See Marcel Kahan & Edward B. Rock, How I Learned to Stop Worrying and Love the Pill: Adaptive Response to Takeover Law, 69 U. Chi. L. Rev. 871 (2002); Martin Lipton, Pills, Polls, and Professors Redux, 69 U. Chi. L. Rev. 1037, 1064-66 (2002) (arguing that the decision whether to accept or reject an acquisition offer was primarily for the board of directors).
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How do these broad principles apply to tender offers by controlling shareholders? Can one reconcile the seeming conflict between the passive role for the board endorsed in *Solomon* and the active auctioneering role mandated by *Revlon* (as more fully explicated by *QVC*)? The focus on control provides the key. Control will not shift as a result of a tender offer by the controlling shareholder; the controlling shareholder will enjoy the same level of authority over the corporate enterprise whether the offer succeeds or fails. Consequently, there is no threat to the business judgment of the board—the board’s business judgment is already subject to the overarching authority of the controlling shareholder. The board has no duty to extract a premium because control has already shifted (through the earlier tender offer by which the controlling shareholder gained control) or was never yielded (because it was retained at the IPO stage). In addition, interference with the shareholder franchise is not implicated because the power reflected by that franchise is held—quite lawfully—by the controlling shareholder. The board of the controlled subsidiary has no duty to adopt a poison pill because there is no threat to the control of the subsidiary.

Gordon and Gilson counter by asking “why should the board’s duty to protect shareholders be lower when the threat is the misuse of control than when the threat is an unfavorable transfer of control?” Characterizing the controlling shareholder’s efforts to freeze out the minority as “misuse,” however, begs the question. Simply put, controlling shareholders have rights too. Controlling shareholders owe the corporation a fiduciary duty, but that duty does not require self-sacrifice. Anyone can make an offer for the shares held by the minority, so why should a controlling shareholder be disabled from doing the same? The corporate machinery is not implicated. More to the point, if the shareholders of a company that is owned by a diffuse public majority have the power to replace the board of directors with one that will redeem the pill, why should a controlling shareholder be disabled from doing the same?

The board has limited authority to interfere with the prerogatives of a controlling shareholder. According to Chancellor Allen:

The board’s fiduciary obligation to the corporation and its shareholders, in this setting, requires it to be a protective guardian of the rightful interest of the public shareholders. But while obligation may authorize the board to take extraordinary steps to protect the minority from plain overreaching, it does not authorize the board to deploy corporate power against the majority stockholders, in the absence of a threatened serious breach of fiduciary duty by the controlling stockholder.

147. Gilson & Gordon, supra note 118, at 39 n.80.
148. Mendel v. Carroll, 651 A.2d 297, 307 (Del. Ch. 1994) (stating that issue of option that would have diluted majority stockholder’s interest would have breached board’s fiduciary duty to controlling stockholder).
150. Mendel, 651 A.2d at 306. See also Freedman v. Restaurant Associates Industries, 1987 WL 14323, at *9 (Del. Ch. 1987) (“I take it to be established in our law that it would ordinarily be found to
The controlling shareholder is within its rights in vetoing the sale of the subsidiary to a third party, and no one thinks that this veto is subject to entire fairness review. The tender offer does not require the minority shareholders to give up any entitlement (they are free to—and they do—decline to tender). The possibility of a follow-on short-form merger is explicitly authorized by statute. Consequently, it would be odd to characterize either step of the transaction as misuse, much less the "serious breach of fiduciary duty by the controlling stockholder required to justify action against the controlling shareholder." Thus, the only apparent "threat" here is that the minority shareholders will be unable to extract a second control premium from the controlling shareholder. That is hardly a cognizable threat, however, in light of the fact that control already stands with the controlling shareholder, rendering a duty to auction under Revlon clearly inapplicable. Consequently, "substantive" coercion drops out of the picture, leaving only "structural" coercion, which is termed "actionable" coercion in the Solomon progeny. Competently advised controlling shareholders will rarely make the mistake of threats that rise to the level of "structural" or "actionable" coercion because they know that courts will step in to protect minority shareholders.

CONCLUSION

The structure of corporate law, as developed by the Delaware legislature and courts, places only limited duties on the boards of subsidiaries when confronted with a tender offer from the controlling shareholder. It is sufficient for the board of the controlled company to protect the property and statutory rights of the subsidiary and provide minority shareholders with information to make an intelligent choice on whether to tender. The board has a role to play, as part of its duty of candor, to keep the minority informed, especially if a merger is to follow, so that the shareholders can evaluate their appraisal option. It is not unreasonable to ask that those directors serve as information agents for the diffuse public minority, a role that will help the shareholders make their

constitute an abuse of power for a board of directors to issue stock, not for the principal purpose of raising necessary or desirable capital, but for the sole or primary purpose of diluting the voting power of an existing block of stock."); Canada Southern Oils, Ltd. v. Manabi Exploration Co., 96 A.2d 810, 814 (Del. Ch. 1953) ("[M]ajority voting control is a right which a court of equity will protect."); Condec Corp. v. Lunkenheimer Co., 230 A.2d 769, 775 (Del. Ch. 1967) ("It is a breach of [fiduciary] duty, wholly apart from any consideration of pre-emptive rights, for directors to make use of the issuance of shares to accomplish an improper purpose, such as to enable a particular person or group to maintain or obtain voting control, against the objections of shareholders from whom control is thereby wrested.").

153. Mendel, 651 A.2d at 306.
A broader role for the subsidiary board, however, is not justified under Delaware corporate law. Controlling shareholders have already paid their control premium once, either explicitly in the form of a premium by which they obtained their control bloc, or implicitly in the form of a discount in an equity carveout. Control premia are not an end in themselves; they are a price to be paid for second-guessing the business judgment of an incumbent board and nullifying the voting authority of minority shareholders. Controlling shareholders are second-guessing only themselves, and the minority shareholders have either long since lost, or never had, effective voting power.

Tender offers by controlling shareholders pose an inevitable policy tradeoff: additional protection to minority shareholders (beyond their ability to refuse to tender) against the costs imposed by more lawsuits. Courts have a role to play in policing against structurally coercive offers and retributive threats. But judicial intervention beyond that narrow scope is less clearly desirable. Whereas the Weinberger/Kahn regime strikes a balance on the side of shareholder protection, the Solomon/Glassman regime strikes a balance in favor of minimizing transaction and litigation costs. The real costs, if any, of that streamlined procedure come in the form of diminished willingness of investors to participate in partial equity carveouts, or greater concerns for target boards in responding to offers for a controlling bloc, but not all, of the company’s shares. If this happens, investment bankers can no doubt devise appropriate protections for minority shareholders against expropriation by freeze-out. The bankers can even duplicate the procedural hurdles of the entire fairness regime, if anyone wants that. The costs of the entire fairness regime, by contrast, are unavoidable, with lots of money going to lawyers and investment bankers for their services in ensuring the “fairness” of freeze-out transactions, with more money going to lawyers to prosecute and defend the inevitable class actions to challenge the “fairness” of those transactions. It would be a mistake to bring those costs back to freeze-out transactions in the name of doctrinal purity. The Delaware courts have a long history of working their way around cumbersome procedures and the Solomon/Glassman alternative squeeze-out procedure simply adds another chapter to that story.

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Measuring Share Price Accuracy

Merritt B. Fox*

This Article concerns how to measure share price accuracy. It is prompted by the fact that many scholars believe that the prices established in the stock market affect the efficiency of the real economy.¹ In their view, more accurate prices increase the amount of value added by capital-utilizing enterprises as these enterprises use society's scarce resources for the production of goods and services. More accurate share prices help improve both the quality of choice among new proposed investment projects in the economy and the operation of existing real assets currently in corporate hands.²

The proposition that more accurate share prices improve the efficiency of the real economy implies that promoting share price accuracy is a worthy goal of public policy. It would therefore be helpful to be able to measure whether the policies adopted in fact accomplish this aim. A wide variety of policy

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2 Improved price accuracy in the primary market for shares produces these social benefits directly. Greater share price accuracy at a time when an issuer contemplates implementing a new project by means of a new share offering will bring the issuer's cost of capital more in line with the social cost of investing society's scarce savings in the contemplated project. As a result, these savings are allocated more efficiently, going more to the most promising proposed projects in the economy. Improved price accuracy in the secondary market creates social benefits as well, though less directly. More accurate secondary market share prices enhance the effectiveness of the social devices that limit the extent to which managers of public corporations place their own interests above those of their shareholders (the agency costs of management). By signaling when there are problems, more accurate prices assist in both the effective exercise of the shareholder franchise and shareholder enforcement of management's fiduciary duties. They also increase the threat of hostile takeover when managers engage in non-share-value-maximizing behavior, not only by pointing out when incumbent management is failing but also by reducing the chance that a value-enhancing acquisition will be deterred by the target having an inaccurately high share price.
measures are implicated here. Does issuer disclosure increase share price accuracy? What is the effect of various restrictions on insider trading and tipping? What is the effect of selective disclosure by issuers to institutional investors or analysts? Should analysts be regulated in some fashion? All of these questions are subjects of unresolved theoretical debates. Good empirical input could be of great value.

Developing a practical measure of share price accuracy, however, is tricky. As will be discussed below, a share price is more accurate if it is a better predictor of a firm’s dividends and other distributions to its shareholders over the rest of the life of the firm. How well a firm’s share price scores in this regard cannot be determined definitively until the firm’s life ends and it liquidates. To be useful for policy making, a measure of share price accuracy must be able to be made earlier, while firms are still operating. Thus, scholars have looked for proxies for the definitive measure that can only be made after liquidation.

Traditionally share price variance over time has been used as such a proxy. A smaller variance has been interpreted as suggesting a more accurate price. More recently, some scholars have adopted a different measure, called $R^2$, which reflects the extent to which a firm’s share price moves with the prices of all the other firms in the economy. A lower $R^2$, meaning less co-movement, is taken by these scholars to mean a more accurate price. I will argue here, through a combination of theoretical and empirical analyses, that $R^2$ is in fact a better proxy for share price accuracy than share price variance.

I. SHARE PRICE ACCURACY

The first step in considering how best to measure share price accuracy is to discuss with greater precision exactly what it means to say that prices are more accurate. The concept of share price accuracy used here relates to how good a share’s price is as a predictor of the future cash flows (dividends and any other distributions) that will be received by whoever holds the share over the rest of the life of the issuing firm. This approach to share price accuracy is functional because the roles that share prices can play in the functioning of the real economy relate to their capacity to signal which firms’ proposed new real investment projects promise the highest returns and which firms’ managers are doing a good job at operating existing facilities. The better share prices can predict future firm cash flows to shareholders, the better they can perform these roles.


4. See infra Part III.
Measuring Share Price Accuracy

A. Precise Definitions of "Actual Value" and "Share Price Accuracy"

The first step in understanding share price accuracy is to define a share's "actual value," which at any point in time is the aggregate future stream of income—dividends and other distributions—paid out from then on to whoever holds the share over the lifetime of the firm (discounted to present value). This definition of actual value requires an ex post view to be operative. The actual value of a share at $t_0$, a point during the ongoing life of the firm, cannot be determined until the moment of the firm's liquidation, $t_{liq}$. The moment of liquidation is the end of the firm's life, by which time the issuer has paid out its last distribution. Only then can it be determined definitively how close the share price at $t_0$ was to the share's actual value. Until $t_{liq}$, the amounts, if any, of the remaining distribution or distributions are uncertain. Thus, at $t_0$, which is prior to $t_{liq}$, even the best-informed real-world investor can only make an estimate of the share's actual value.

What can one say about the relationship at $t_0$ between the market price of a publicly traded share and its actual value? The efficient market hypothesis (EMH) suggests that the market price of a share at $t_0$ is an unbiased estimate of the share's actual value at $t_0$.\(^5\) In other words, as best anyone can tell who knows all information publicly available at the time, the price at $t_0$ is, ultimately, equally likely to turn out to be below the share's actual value at $t_0$ as above it. By itself, however, the conclusion that a share price is unbiased says nothing about how close the price is likely to be—one way or the other—to actual value. Share price is relatively "accurate" if it is likely to be relatively close, whether above or below, to the share's actual value. When a price has a high expected accuracy, the deviation of the price from actual value is on average relatively small.\(^6\)

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\(^5\) There is a large body of financial economics literature evaluating the market reaction to the affirmative public announcement of various kinds of events affecting particular issuers. For a classic review, see Kenneth Garbade, Securities Markets 249-59 (1982). An event study involves a large number of issuers, each of which has experienced at one point of time or another the announcement of a particular kind of event, for example a stock split. The typical study shows that the shares of the affected firms as a group experience statistically significant abnormal returns at the time of the announcement and, starting almost immediately thereafter, normal returns for the duration of the study, which is sometimes as long as several years. Thus, while some issuers' share prices go up in the periods following the immediate reaction to the announcement and others go down (each compared to the market as a whole), the average change is near zero. Assuming that longer term prices are themselves unbiased measures of actual value, the results of the studies are thus consistent with the concept that the market's evaluation of the significance of the event for the actual value of each issuer's shares, while it may have sometimes been too high and sometimes too low, was unbiased.

\(^6\) Put in statistical terms, price can be considered a random variable generated by a distribution function that, because price is unbiased, has a mean equal to the share's actual value and a variance that can be considered a measure of the expected accuracy of the price. Throughout this Article, when I refer to price accuracy, I am referring to this concept of expected price accuracy.
B. The Core Determinants of Share Price Accuracy: The Existence of Information and Its Reflection in Price

Share price accuracy is a function of two core determinants. One is the amount of information concerning a firm's future distributions that exists in the hands of one or more persons in the world relative to what would need to be known to predict these distributions with perfect accuracy. The other is the extent to which price reflects this information. A number of considerations influence these two core determinants of share price accuracy.

1. Length of Time before Distributions

Consider first a firm that makes no distributions to its shareholders prior to its liquidation. The closer in time an issuer is to its liquidation, the more accurate, everything else being equal, is its share price. This proposition becomes obvious by looking at an issuer's share price when the issuer is taking its last breaths immediately prior to liquidation (i.e., when $t_0$ is at a moment immediately prior to $t_{ilq}$). The market price is likely to be very close to the amount of the liquidating distribution paid to the holder of each of its shares, whether zero or some positive amount. This is because of the way both determinants of share price accuracy work at this point. As for the amount of information, it is relatively easy for at least some people to be highly informed concerning the size of the final distribution. This information is then very likely to become fully, or nearly fully, reflected in price, either through public disclosure of what the liquidating distribution will be or, unless prevented by effective rules imposed by the legal system or norm structure applicable to the holders of the information, through trading by insiders or others informed via tipping or selective disclosure.  

Now consider a company that makes one or more distributions prior to its final liquidating distribution, for example in the form of a dividend. Each distribution can be viewed as a partial liquidation of the firm. At any point in time, the discounted present value of each distribution contributes its portion to the total actual value of a share of the firm. In accord with the foregoing analysis, the closer that point in time is to the time of any given distribution, the more accurate is the portion of the market price that corresponds to the portion of actual value relating to this distribution. The same is true for each other distribution of the firm, including its final liquidating distribution, if any. Thus, with multiple distributions, the conclusion continues to hold that the closer in time to a firm's moment of liquidation, the more accurate is the price. Another

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7. Because the information provides a near certain prediction of the amount of the distribution, the economic risk associated with trading on the information is very low. Absent effective legal or normative restraints on such trading, the volume of trades by insiders, tipees and selective disclosure recipients is therefore likely to be high.
Measuring Share Price Accuracy

implication of this analysis is that a firm that has a policy of paying out a larger portion of its earnings in dividends is likely, ceteris paribus, to have a more accurate share price.

2. Economic and Legal Incentives to Gather, Share, and Trade on Information and Their Interaction

When a possible cash distribution by an issuer to its shareholders is further in the future, share price accuracy is affected by the fact that, inherently, it becomes increasingly difficult for persons to gather and analyze information about the factors determining the amount of the distribution. How much information is in fact gathered and analyzed by anyone depends on the economic incentives to do so. It also depends on laws, to the extent they exist, that effectively require such collection and analysis (such as a rule requiring a public company to undergo an audit by an independent accountant). The extent to which such information is then reflected in price depends on the economic and legal incentives, both positive and negative, for persons who have gathered and analyzed such information to disclose it to others (publicly or selectively). It also depends on the economic and legal incentives, both positive and negative, of anyone possessing such information—whether a generator or a receiver—to trade on it.

Assessing the effect of existing economic and legal incentives on price accuracy is made more complex by the fact that there is an interaction between the considerations determining how much information is gathered and analyzed, and the considerations determining how much of what is gathered and analyzed gets reflected in price. On one hand, the opportunity to trade on information that is not required to be disclosed to others creates incentives to gather and analyze such information. On the other hand, the more widely held information is by persons who can trade on it, the more likely it is to be reflected in price. Moreover, when someone receives, whether by selective or

8. See Ronald Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 568-69 (1984); Eugene F. Fama, Random Walks in Stock Market Prices, 21 FIN. ANALYSTS J. 55 (1965) (describing how information is incorporated into price). The simplest models of price formation suggest that price is the product of the weighted average of expectations of all investors. See, e.g., John Lintner, The Aggregation of Investors’ Diverse Judgments and Preferences in a Purely Competitive Economy, 4 J. FIN. & QUANTITATIVE ANALYSIS 347. This would mean that the trading of a small number of arbitrageurs acting on a piece of information could not by itself move price sufficiently to reflect fully the import of the piece. Indeed, contrary to the EMH, in such a model, the price would not fully reflect the information until all active investors knew the information. See Merritt B. Fox, Finance and Industrial Performance, in A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY 36-43 (Eli Noam ed., 1987) [hereinafter Industrial Performance] (demonstrating the inadequacy of arbitrage to correct prices fully due to the risk that arbitrage adds to an arbitrageur’s portfolio because of the dediversification it involves). More sophisticated models recognize that investors are aware that price may reflect information known by other investors. Hence, price is not just a constraint, it can affect investor demand for securities and as a result information known by only some traders can influence price as if more investors knew it. Sanford J. Grossman, On the Efficiency of Competitive Stock Markets Where Investors Have Diverse Information, 31 J. FIN. 573 (1976). This is not a complete substitute for
public disclosure, information gathered by someone else, the recipient may find it more worthwhile herself to gather and analyze yet additional information on her own. This is because the information that is received may constitute a valuable input to the process of further discovery. Thus, for example, it may be more worthwhile for an investor to gather and analyze information (not yet gathered and analyzed by others) concerning the market for the product of an issuer that has disclosed basic financial information about itself, than to gather and analyze information concerning the market for the product of a firm that has not engaged in such disclosure. In addition, when a small number of people are able to trade regularly on relatively precise material information in advance of others, it becomes less profitable for persons outside that circle to gather and analyze information for trading purposes. The complexities of these interactions is what makes it difficult to determine at a theoretical level whether share price accuracy is enhanced or diminished by any of the standard tools of securities regulation, such as: mandatory disclosure, insider trading regulation, the regulation of selective disclosure, broker-dealer regulation, or regulation of analysts.

9. There are good theoretical reasons for thinking this to be true. The discovery of information not yet discovered by others and hence not reflected in market price is more likely to hold the promise of greater arbitrage profits in the case of a firm that has disclosed basic financial information about itself than in one that has not. The firm that has not disclosed the basic financial information is likely to have, for the relevant time period, more risk associated with it than would the firm that has disclosed this information. The risk is firm specific, though, and so it will not affect the riskiness of a fully diversified portfolio. Each purchase, based on the difference between current price and what is indicated by the newly discovered information, is an inherently diversifying transaction, however. Taking on an additional share of the firm that has not disclosed will add more to the riskiness of the investor's portfolio than taking on an additional share of the issuer that has disclosed. Thus, compared to the firm that has disclosed, fewer shares of the firm that has not disclosed will be added to the investor's portfolio before the additional arbitrage gain from purchasing an additional share is not worth the added risk. See Industrial Performance, supra note 8, at 36-43. This prospect of smaller arbitrage profits will reduce the incentive to gather and analyze information about the firm that does not disclose. More generally, John Coffee has made the argument that mandatory disclosure constitutes a subsidy to the investment analyst industry that increases that amount of analyst activity. John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717, 728-29 (1984). Coffee's point is consistent with the theoretical point by Grossman and Stiglitz that if the cost of gathering and analyzing private information is lower (which it would be with more free publicly available information to use as feedstock for research) there will be a higher intensity of trading by the smart money speculators, which will lead to "more informative pricing." Grossman & Stiglitz, supra note 8, at 405. There is some empirical support for the theory that more disclosure leads to more gathering and analysis of yet additional information. Lang and Lundholm find that a firm that discloses more is followed by more analysts and that the analysts' forecasts are more accurate. Mark Lang & Russell Lundholm, Cross Sectional Determinants of Analyst Ratings of Corporate Disclosure, 31 J. ACCT. RES. 246 (1993).

Measuring Share Price Accuracy

C. "Speculative Noise" versus "Fundamental Information"

Share price accuracy will be diminished if the price is affected by what financial economists refer to as speculative noise. The model of share pricing described so far excludes speculative noise. It assumes that whatever information share prices do reflect, it is of a kind that will help in predicting future distributions more precisely (i.e., it is "fundamental information"). Thus, the model implicitly assumes that smart money speculators focus exclusively on future distributions and that their arbitrage activities fully counteract any trading by naive speculators, whose trading is activated by fads, fashions, or irrational psychological predispositions toward behaviors such as chasing trends. Many financial economists believe, however, that the arbitrage activities of the smart money speculators, even if they focus exclusively on future distributions, do not always fully counteract the actions of these naive speculators. As a result, share prices will be further from actual value than they would have been absent the trading by the naive speculators, the difference being speculative noise. The more speculative noise in the market, the less accurate are share prices.

Moreover, there are reasons to believe that, at least in some part, if less fundamental information is gathered and reflected in share price, the smart money speculators will not focus exclusively on future distributions and their attention will turn in part to the direction of speculative noise. If, relative to fundamental information, this noise plays a larger role in determining future

11. See, e.g., Fisher Black, Noise, 41 J. FIN. 529 (1986). In the view of these economists, speculative noise can occur even if there are smart money speculators in the market who trade knowing a stock's fundamental value (the price that would prevail if the market consisted entirely of rational investors who possessed all available information—i.e., the price that would prevail in a truly efficient market). The smart money speculators are limited in their ability to arbitrage away the difference between what the share's market price would be, based on the trades of the noise traders and the share's fundamental value. To start, unless the smart money speculators have an infinite time horizon, the uncertainty created by the possibility of continued noise trading makes taking such a position inherently risky even if the smart money speculators know for certain a stock's actual value. This is because they know at the time they are contemplating a purchase that because of noise, price at the end of their time horizon may still deviate from actual value. See J. Bradford De Long et al., Noise Trader Risk in Financial Markets, 98 J. POL. ECON. 703 (1990). Furthermore, smart money speculators in fact do not know a stock's actual value with certainty; rather, they only know its fundamental value, which is the value implied by the available fundamental information. Thus, fundamental value is just a more accurate guess concerning actual value than is the noise trade influenced market price. This uncertainty as to the stock's actual value adds to the smart money speculators' risk of arbitrage. See Andrei Schleifer & Lawrence Summers, The Noise Trader Approach to Finance, 4 J. ECON. PERSPECTIVES 19 (1990); Industrial Performance, supra note 8, at 36-43, 55-59. It should also be noted that the very fact that gathering and analyzing information privately is costly means that despite the existence of smart money speculative traders, space exists for noise trading to occur. This is because of the "efficient market paradox" noted by Grossman and Stiglitz, who observe that "because [acquiring private] information is costly, prices cannot perfectly reflect the information which is available, since if it did, those who spent resources to obtain it would receive no compensation." Grossman & Stiglitz, supra note 8, at 405. An excellent survey in the legal literature of the work of the noise theorists, together with an analysis of its legal implications, is found in Donald Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. PA. L. REV. 851 (1992).
share prices, speculators will get more reward for trying to figure out future noise and less reward for trying to figure out future cash distributions to shareholders. This reward structure makes the effort to design social institutions that encourage the gathering and analyzing of fundamental information and its reflection in price doubly important in terms of share price accuracy. It thus makes more critical the determination of the effectiveness of mandatory disclosure, for example.

II. SHARE PRICE INFORMEDNESS

A. The Concept

Share price informedness is a concept closely related to share price accuracy. A share price is more informed at a given time if it reflects a larger portion of all the fundamental information known, or, through sufficient effort, knowable, by one or more persons in the world. Thus, a fully informed price would reflect all information that is knowable at the time. Any fact that is at a given time unknowable will by definition have an unpredictable (i.e., random) effect on future shareholder distributions. Because of this, a fully informed price, while not perfectly accurate, would be both unbiased and the most accurate price possible at the time. Therefore, all of the factors discussed above that make a share price more accurate make it more informed as well.

Share price accuracy and informedness can be pictured as follows. Consider an analogy between the process by which bits of information are incorporated into share price and sampling from a large urn containing 1000 balls. Assume that somewhere between zero and 1000 of the balls are red and the rest are green. Prior to any sampling of the urn, nothing is known about the ratio of red to green balls in the urn. A share’s actual value is analogous to the actual ratio of the green to red balls. A random sample of the urn’s balls is equivalent to the bits of information that are incorporated in price. Even a small sample of balls provides an unbiased estimate of the actual ratio of red to green balls. Similarly, in an efficient market, share price is an unbiased estimate of a share’s actual value even if there is not a great deal of information available. The impact on the estimate of drawing another ball from the urn is unknowable—it could increase or decrease the estimate of the actual ratio—but the greater the number of balls that are drawn from the urn (i.e., the larger the sample)—the greater the expected accuracy of the estimate. Similarly, the impact of a new bit

12. JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 157 (1936). Grossman and Stiglitz make the inverse of this point, suggesting that if the cost of gathering and analyzing private information is lower, there will be a higher intensity of trading by the smart money speculators, which will lead to “more informative pricing.” Grossman & Stiglitz, supra note 8, at 404.
of information on share price is unknowable prior to its availability—it could increase or decrease price—but its incorporation in price will increase the price's expected accuracy as an estimate of the share's actual value. The ratio of green to red balls in the largest sample possible at any point in time will provide the most accurate possible estimate of the actual ratio in the urn. Similarly, a fully informed price at a given point in time is the most accurate estimate possible at that time of the actual value of the share.

While the concept of share price accuracy allows a simpler, more direct story concerning the relationship between share prices and the real economy, the concept of share price informedness serves two useful functions in fully understanding this relationship. First, it avoids the discomfort that some may feel about the deterministic nature of the model behind the concept of share price accuracy. More importantly, as will become clear when I discuss immediately below the use of the R\textsuperscript{2} methodology to measure share price accuracy, the concept of price informedness highlights the fact that price movement can be a sign of share price accuracy rather than inaccuracy. This is because price movement may indicate, at least in part, an ongoing process by which new fundamental information is being reflected in price.

**B. Relationship of Share Price Accuracy to Price Movement**

In essence, there are two countervailing considerations at work in terms of the relationship between price accuracy and price movement. The first force relates to the expectation discussed above that the deviation between the portion of an issuer's share's actual value derived from the discounted present value of any given expected future distribution, and the corresponding portion of the share's price, will tend to decrease as the length of time before the distribution decreases.\textsuperscript{13} Taking account of just this first consideration, at any given point in time, the more accurate the price is, the less share price movement one would expect to see thereafter as price eventually approaches actual value. Thus, if only this consideration were at work, where one observes over a period of time relatively little movement in the price of an issuer's shares, one would assume that on average its share price was more accurate than the share price of an issuer displaying more movement.

The second consideration is the amount of new information relevant to an issuer's future cash distributions that on an ongoing basis is being gathered, analyzed, and reflected in price. This second consideration can potentially work in the other direction. Just taking account of the second consideration, more movement may suggest greater accuracy. Consider firms A and B. Assume that A and B will each make a single distribution of the same amount, at liquidation, on the same date at some time in the future. Thus, at any point in time, the shares

\textsuperscript{13} See supra Part I.B.1.
of the two firms have the same actual value. To control for the first consideration, assume that at the beginning of the period of observation, A’s and B’s prices are equally distant from the respective shares’ actual values. After this, substantial amounts of new information about firm A is, on an ongoing basis, being gathered, analyzed and reflected in its share price. Less of this updating is occurring with respect to B.

Each newly arriving bit of information will on average move price closer to actual value but will, as appears to be the case in the real world, include a significant amount of random noise. The random noise I refer to here is not the speculative noise discussed earlier. It simply reflects the idea that any new piece of information is not perfect. While, on an expected basis, each bit of information moves price toward actual value, it contains a random element that in any given case may move price in the opposite direction. In terms of the analogy above comparing the incorporation of information into securities prices with sampling from an urn containing 1000 red and green balls in an undetermined proportion, the new bit of information is like a collection of balls, some of which are from the urn and the rest of which are randomly added from a side collection that is half red balls and half green balls. The person doing the sampling knows the average number of balls drawn from the side collection but no more. Each sample adds to the accuracy of the estimate of the ratio of red to green balls in the urn despite the noise from the balls drawn from the side collection.

Information bit by information bit, price may move one way or the other, but the total effect of the cumulating bits will on average be moving price closer and closer toward actual value. One would expect firm A to have, during the period of observation, a more informed, and hence more accurate, price than firm B because the updating information is on average moving its share price closer to actual value. If the random noise element of each bit is sufficiently large, however, A’s share price will display more price movement on average than B’s, given that new bits of information arrive more frequently and with the arrival of each bit comes random noise that can shift price.

Consider the following example to demonstrate the plausibility of the proposition that firm A, whose price is more frequently updated by new information than that of firm B, will have on average a more accurate price, but will have price changes displaying a greater variance than will firm B’s price changes. Suppose that firms A and B will each pay out a single shareholder distribution, which will occur at liquidation. Each will liquidate at $t_5$.

14. See supra Part I.C.

15. This model, in which new information, on the one hand, helps to bring price toward actual value but, on the other hand, is less than perfect, follows in the tradition of R.W. Holthausen & R.E. Verrecchia, The Effect of Sequential Information Releases on the Variance of Price Changes in an Intertemporal Multi-Asset Market, 26 J. ACCT. RES. 82 (1988); and K.R. Subramanyam, Uncertain Precision and Price Reactions to Information, 71 ACCT. REV. 207 (1996).
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pay out $10 per share at that time, its only shareholder distribution. Assuming for simplicity a zero discount rate (i.e., pricing is in accordance with CAPM and there is no time value of money or systematic risk), each firm’s shares will have an actual value of $10 throughout the life of the firm. Suppose also that at \( t_0 \) each firm has a price of $15 and so each starts out with an equally inaccurate price.

Firm A’s price is updated in each of the five periods by a new bit of information. The bit of new information in each of periods \( t_1, t_2, t_3, \) and \( t_4 \) contains two elements. One element is like an accurate missing piece in the puzzle and moves the price $1 closer toward actual value. The other element is noise: it is random and has an expected value of zero. Investors can only observe the aggregate implications of the two elements combined. Thus, on an expected basis, A’s price becomes more accurate after the receipt of each bit of information, but the observable aggregate implication of the bit involves variation around what would be implied by the accurate-piece-of-the-puzzle element alone. The bit of new information at \( t_5 \) is the announcement of the liquidating distribution. The price at \( t_5 \) is therefore $10 and is perfectly accurate. Firm B’s price is not updated at all until \( t_5 \), but, for it too, the bit of information at \( t_5 \) is the announcement of the liquidating distribution. Its price at \( t_5 \) is therefore also a perfectly accurate $10.

The following prices provide an example consistent with this story. Firm A has a price at \( t_0 \) of $15. At \( t_1 \), the price is $12.50 (the result of a noise element of -$1.50, which when combined with the accurate-piece-of-the-picture element, moves the price in aggregate down by 2.50). At \( t_2 \), the price is $14.50 (the result of a noise element of +$3.00, which when combined with the accurate-piece-of-the-picture element, moves the price in aggregate up by $2.00). At \( t_3 \), the price is $10.50 (the result of a noise element of -$3.00, which when combined with the accurate-piece-of-the-picture element, moves the price in aggregate down by $4.00). At \( t_4 \), the price is $11.00 (the result of a noise element of +$1.50, which when combined with accurate piece of the picture element, moves the price in aggregate up by $.50). At \( t_5 \), the price equals the share’s actual value of $10 (the result of the noiseless announcement of the liquidating distribution, providing the last missing piece of the picture). Thus the noise element in this example has a mean of zero and a standard deviation of 2.37. Firm B’s price stays at $15 for periods \( t_1, t_2, t_3, \) and \( t_4 \) and drops to $10 in period \( t_5 \), when the liquidating dividend is announced. The paths of the share prices of A and B are depicted in Figures 1 and 2 below.
As shown in Table I below, firm A’s price changes display a greater variance than firm B’s (5.5 versus 5.0) even though firm A’s share price is on average closer to its actual value of $10 (i.e., more accurate) than firm B’s share price. This greater accuracy can be observed simply from looking at Figures 1 and 2. A more precise measure of average share price accuracy would be the average of the squared deviations of share price from actual value in periods $t_1$, $t_2$, $t_3$, $t_4$, and $t_5$ (the smaller the figure, the more accurate the price). As shown in Table I below, the average of these squared deviations for firm A is 5.55 and for firm B is 20.
## Measuring Share Price Accuracy

### TABLE I

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This example is generalizable to ongoing firms not facing immediate liquidation. Specifically, the result that firm A will have on average a more accurate share price and will display a higher price variance is replicable under the following changed assumptions. Imagine a five-period cycle in which, once every fifth time period, the prices of firm A and B are equally accurate. Firm A is updated every period. Firm B is updated only every fifth period, but with a bigger piece of information so that, after the updating, its price is for the moment as accurate as firm A's. The example above now illustrates one such cycle with each firm starting at an equally accurate $15 at \( t_0 \) and each ending up at an equally more accurate $10 in \( t_5 \), but with firm A making adjustments along the way. The same calculations as in the example above show that in this case also firm A has on average greater share price accuracy and greater price variance.

I am not claiming that more frequent updating inevitably results in the combination of greater share price variance and greater share price accuracy. Whether or not it does depends on the amount of noise in the updating bits of information. The example only illustrates that greater share price accuracy can plausibly be accompanied by greater share price variance. There are other possibilities as well. If the random noise element is sufficiently small, firm A, compared to firm B, could have a combination of smaller price variance and greater share price accuracy. If the random noise element is sufficiently large, firm A, compared to firm B, could have a combination of larger price variance and less share price accuracy. Where the amount of random noise element to new information is between these two extremes, however taking account of just this second consideration—more frequent updating—, the more accurate the share price is at a given time, the more share price movement one would expect to see.

In the real world, both countervailing considerations are at work. The first consideration, relating to time to liquidation, is working so that greater price movement suggests less share price accuracy and the second is working so that, at least if information bits contain an amount of noise in the middle range, greater price movement suggests greater share price accuracy. One can say as a theoretical matter that the second consideration would be more important relative to the first in the case of relatively short term (e.g., day-to-day or week-to-week) price changes compared to longer term (quarter-to-quarter, year-to-year, or decade-to-decade) price changes, because with the longer term price changes the noise elements of the day to day updates tend to cancel each other out. For any given term's price changes, however, this observation does not tell us which consideration predominates. Whether greater price movement indicates greater or lesser price accuracy is ultimately an empirical question. I will discuss immediately below strong empirical support for the conclusion that, in the case of relatively short term price changes, more movement
Measuring Share Price Accuracy

indicates greater share price accuracy.

This discussion of price informedness suggests that price variance over time may not be a good inverse proxy for share price accuracy. As a theoretical matter, greater variance may be associated with more share price accuracy rather than less, especially if the time intervals are short between the points at which the price changes are measured.

III. THE R^2 METHODOLOGY

A new measure for the informedness of share prices and hence their accuracy involves a measure, \( R^2 \), which is related to the extent to which share prices of an economy's issuers move together.\(^{16}\) For the reasons discussed below, \( R^2 \) appears to be a better inverse proxy than share price variance for how much fundamental information concerning future shareholder distributions is impounded in share prices: the lower is \( R^2 \), the more accurate are prices.

A. Preliminary Theoretical Considerations

There are good preliminary theoretical reasons for believing that higher co-movement of stocks in an economy indicates less informed prices of the shares of individual firms. These reasons follow from an explanation offered by Laura Veldkamp concerning why share prices appear as a general matter to co-vary more than would be called for by measures of their fundamental value.\(^{17}\) Veldkamp suggests this pattern results from the facts that information is costly and that information about the future distributions of one issuer has some predictive value concerning the future distributions of other issuers as well. As a result, investors may economize in their expenditures for acquisition of information. They may collect information about one issuer and also use it to predict the future distributions of other issuers even where they could make better predictions about the future distributions of the others if the collected information specifically about each of these other issues as well. The price of the shares of the other issuers would therefore co-vary with that of the issuer about which the information is collected more than would be called for by their respective fundamentals. In a richer information environment where collecting information about each individual issuer is less expensive, less of this reliance

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16. The \( R^2 \) measure for an individual country is computed as follows. For each individual issuer \( j \) in the country, run a regression using time-series data on the issuer's share rate of return whereby
\[ r_{j,t} = \beta_{j,0} + \beta_{j,m} r_{m,t} + \beta_{j,i} r_{i,t} + \epsilon_{j,t}, \]
with \( r_{m,t} \) = market return and \( r_{i,t} \) = industry return. Then decompose the total variance of the issuer's return as follows:
\[ \sigma^2 = \sigma^2_m + \sigma^2_i. \]
\( R^2 \) for firm \( j \) is then defined as
\[ R^2 = \frac{\sigma^2}{\sigma^2_m + \sigma^2_i}. \]
\( R^2 \) for the country is an average of the \( R^2 \)'s for its individual issuers, weighted by the total variation of each stock's return. From this formula, one can see that there is more firm-specific variation when \( R^2 \) is low. \( R^2 \) is low.


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on information about one issuer to predict the future returns of another would occur and the amount of co-variance would be lower. In such a world, individual share prices would be more accurate. Thus lower co-variance would be an indicator of greater share price accuracy.

B. Indirect Evidence That \( R^2 \) Is a Good Inverse Proxy for Share Price Accuracy

The idea that \( R^2 \) is a good inverse proxy for share price accuracy initially arose from the observation by Morck, Yeung, and Yu ("MYY") that countries vary a great deal in the extent to which share prices of their firms tend to move together, the phenomenon measured by \( R^2 \). This difference among countries is shown dramatically in Figure 3, on the next page. For example, for most weeks during the first half of 1995, in each of China, Malaysia, and Poland, over 80 percent of stocks moved in the same direction; for the same period in each of Denmark, Ireland, and the United States, there was not a single week in which as many as 58 percent of firms moved in the same direction (despite, in the case of the United States, the then-ongoing bull market). These startling differences cry out for explanation.

1. The Link between \( R^2 \), Poor Quality Government, and Risk Arbitrage

MYY try to explain these national differences by exploring the factors that seem to be associated with low and high \( R^2 \) scores. They observe, as illustrated in Figure 3, that developed countries, ones with high per-capita GDP, tend to have low \( R^2 \)'s and emerging countries, ones with low per-capita GDP, tend to have high \( R^2 \)'s. There is no obvious reason why low per-capita GDP would lead directly to a greater tendency for share prices to move together. More likely, MYY reason, low per-capita GDP is associated with other national characteristics that lead to this result. MYY try to identify what these other characteristics might be and in the process find evidence that \( R^2 \) is a good inverse proxy of how much fundamental information is impounded in share prices.

MYY first consider a number of obvious structural characteristics of a country that a priori would appear likely to affect its \( R^2 \). One factor is country size. Firms in a small country might be more uniformly subject to environmental influences such as bad weather or nearby geopolitical instability. Small countries also tend to have more uniform factor endowments, making

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19. Id. Data from other periods in the 1990s behave similarly. Id.
20. Id. at 227-28.
21. Id. at 230-41.
their overall economies more sensitive to changes in relative factor prices such as the price of oil. A second structural characteristic is the extent of diversity of a country's firms across industries: the less the diverse the industries, the more likely the fortunes of all firms will move together. A third structural characteristic, which serves as a kind of catchall, is the extent to which the earnings of a country's firms tend to move together.

**Figure 3**

![Bar chart showing average fraction of firm-level return variation by market indexes for various countries.]
MYY run a regression with a log transformation of country $R^2$'s as the dependent variable (the variable to be explained) and with per-capita GDP and measures of each of these three structural characteristics as the independent variables (the variables that potentially explain the dependent variable). The coefficient for per-capita GDP remains statistically significant. Continuing with the proposition that there is no reason why low per-capita GDP would lead directly to share prices moving together, the continued significance of the per-capita GDP coefficient suggests it is a proxy for yet additional country characteristics, institutional rather than structural, that help explain the variation in $R^2$ across countries.\(^{22}\) MYY add to the regression one additional independent variable, a measure for "good government." This measure consists of the sum of the scores for each country on indexes created by La Porta et al.\(^{23}\) relating to government corruption, risk of government expropriation, and risk of governmental contract repudiation. With the addition of this factor, the coefficient for per-capita GDP becomes insignificant. In sum, countries vary in their $R^2$'s not just because of differences in their structural characteristics, such as country size and diversity of industry. An institutional factor—the quality of government—appears to play an important role as well.

MYY's discovery that governmental quality plays an important role in explaining differences among countries in their $R^2$'s leads them to hypothesize that $R^2$ might be a good inverse proxy for price informedness.\(^{24}\) I believe this is a plausible hypothesis. My reasoning, building upon MYY, begins with the observation that the predictability of future cash distributions to a firm's outside shareholders depends on two factors. One is the predictability of the level of the firm's underlying cash flows. The second is the predictability of the division of these underlying cash flows between the outside shareholders, on one hand, and inside shareholders and other firm stakeholders, on the other.

In countries with low good government scores, extra-legal governmental influence will play a larger role in determining both the level of firm cash flows and the division of these cash flows. In low good-government-score countries, a firm's profitability can be dramatically affected by whether or not it has close relationships with governmental officials, the persons who grant government contracts, issue licenses, and determine when to enforce regulations. Also in such countries, the division of a firm's cash flows will deviate from the standard corporate law model of pro-rata distribution among all shareholders. Instead, inside shareholders receive, in one form or another, more than a pro-rata share of the wealth generated by a firm's activities, and other stakeholders receive more than a market return for their contributions to the firm.\(^{25}\) These

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22. Id. at 241-51.
24. Morck et al., Information Content, supra note 18, at 242-43.
25. Russia provides an excellent case study of this problem. See Bernard Black et al., Russian
deviations come at the expense of outside shareholders. The closer a firm’s inside shareholders and other stakeholders are to governmental officials, the greater are the governmental tolerance of such deviations.

This larger extra-legal governmental influence on the amount of distributions ultimately reaching outside shareholders makes these distributions harder to predict. To start, in low score countries, the cash flow levels of firms themselves are harder to predict. This is because the impact of this extra-legal governmental influence on cash flows from one firm to the next is harder to predict than the purely market factors that would determine firm cash flows in the absence of such influence. The problem of predicting the impact of such influence on the cash flows of any one particular firm is aggravated by the opaque, erratic nature of political regimes prevalent in many emerging countries. In addition, the proportion of this cash flow that will ultimately be paid out to outside shareholders of a firm in a low score country is itself less predictable. In such a country, outside shareholders are, as noted, relatively unprotected legally. The total amount of distributions that they receive over the life of the firm is arbitrary. Outsiders receive what is left over, if anything, after the inside shareholders and other stakeholders have taken what their positions of political power allow them to get, plus, perhaps, the occasional distribution to outsiders made for some strategic reason.

The last step in our reasoning concerns the effect of these less predictable distributions to outside shareholders on the process of share pricing. When future distributions to outside shareholders are harder to predict, naive speculators—the “noise traders”—are more likely to become confused, which adds to the riskiness undertaken by rational smart money speculators—the risk arbitrageurs—who bet against them. This added riskiness makes it less attractive to be a risk arbitrageur, which means less such activity occurs in the economy. Less information about fundamentals (both firm specific and market wide) is incorporated in price because fewer risk arbitraguers find it worthwhile to gather, analyze, and act on such information. As a result, there is more effect on price from the trading of the naïve speculators (“noise trading”) and share prices will less accurately reflect what the distributions to outside shareholders ultimately turn out to be. This problem of a low level of risk arbitrage in countries with low good government measures may be accentuated by the fact


26. Morck et al., Information Content, supra note 18, at 242-44. The idea that there will be more noise trading when future distributions to outside shareholders are less predictable is consistent with the idea that when less information is publicly available, less trading based on privately acquired and analyzed information will occur. See supra notes 9-12 and accompanying text.

27. J. Bradford De Long et al., Noise Trader Risk in Financial Markets, 98 J. POL. ECON. 703, 733. See also supra Part I.C.

28. Morck et al., Information Content, supra note 18, at 244-47.
that in such countries, risk arbitragers may be less confident that they will be able to keep free from confiscation of the profits that they do manage to make. This lower level of risk arbitrage, with its resulting lower level of price informedness and hence price accuracy and higher level of noise trading, can be expected to be accompanied by the higher R\(^2\)s that one observes with the low good government score countries. This is because the fads and fashions that motivate naïve speculative traders tend to have an impact across the market.

In sum, the link between high R\(^2\)s and low price informedness is established as follows. High R\(^2\)s are observed to be associated with low good government scores. Low good government scores suggest that extra-legal governmental influence will play a larger role in determining future distributions to outside shareholders. The impact of this kind of influence is harder to predict than the market forces that would otherwise determine the level of such distributions, thereby making the distributions themselves less predictable. This unpredictability confuses naïve speculative traders, which causes them to act in ways that add to the risk of smart money speculation. This added risk depresses the level of risk arbitrage activity, which has two consequences. One is that less information is impounded in prices. The other is that the naïve speculative traders have a larger role in setting prices. The fads and fashions that motivate the naïve speculative traders tend to have impact across the market, and hence their larger role in the market results in prices of different firms tending to move together more. As a consequence, country R\(^2\) will be higher. Thus, everything else being equal, a high R\(^2\) is indicative of a low level of risk arbitrage, which will result in a low level of price informedness.

2. Further Implications of the Link between R\(^2\) and Poor Quality Government

The implications for share price informedness of our analysis go even deeper than this, however. While the mechanisms of real economic efficiency promoted by share price accuracy still work to some extent even when prices are relatively less accurate, the greater extra-legal governmental influence that drives up R\(^2\) not only leads to a lower level of share price accuracy, it makes this lower level of price accuracy even less effective than it would otherwise be in promoting the functioning of these mechanisms of real economic efficiency. To see why, recall that a share price is less accurate when it is less likely to be close to the share's actual value, which is the discounted present value of what the future distributions to outside shareholders ultimately turn out to be. In low good government score countries, a significant factor in this lower level of share price accuracy is the underlying unpredictability concerning the

29. *Id.* at 243.
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proportion of a firm’s underlying overall cash flow that will ultimately reach outside shareholders. Thus, share price is doubly less informed in terms of being an estimate of the firm’s underlying overall cash flows. This result is critical because the theory suggesting that accurate share prices enhance real economic efficiency assumes that accurate share prices are good estimates of future underlying overall firm cash flow. A firm’s residuals are, under in this theory, assumed reliably to go largely to its shareholders and every shareholder, whether inside or outside, is assumed to receive a pro-rata distribution of these residuals. In short, share prices in a country with a low quality government are doubly disabled in their capacity to promote efficiency in the real economy. First, because there is less risk arbitrage, share prices are poorer predictors of future distributions to outside shareholders. Second, future distributions to outside shareholders are themselves less reliable indicators of a firm’s underlying cash flow. It is the accuracy of prices as predictors of firm cash flows that promotes the effectiveness of the mechanisms of efficiency in the real economy.

3. Other Indirect Evidence That $R^2$ Is a Good Inverse Proxy for Price Informedness

Two other pieces of indirect evidence help support the hypothesis that $R^2$ is an inverse proxy for price informedness. First, the average $R^2$ for U.S. firms has decreased significantly over the twentieth century, particularly since World War II. This corresponds to a period in which, for both technological and institutional reasons, more information has become available for risk arbitraguers to use, even putting aside mandatory disclosure, which was originally adopted in the 1930s and has since been significantly enhanced.

Second, MYY examined a subsample consisting of $R^2$s of all the developed countries in their study. In the regressions they ran to try to explain the differences in $R^2$s among these countries, they included, as an additional independent variable, another La Porta et al. index, one purporting to measure the protection of outside shareholders through rights that help them control directors. They find that the coefficient for this index was negative and statistically significant, thus suggesting an inverse relationship between the level of such protections and country $R^2$.

MYY’s explanation for this result starts with the assumption that in a country with weak protection for outside shareholders, managers will find it easier to divert a larger portion of the firm’s cash flow to themselves. These

30. See supra Part II.B.
31. Morck et al., Information Content, supra note 18, at 220-22.
32. La Porta et al., supra note 23.
33. Morck et al., Information Content, supra note 18, at 255.
managers are more likely to divert extra cash flow generated by favorable firm-specific developments than extra cash flow generated by favorable developments in the economy as a whole. This is because a diversion of the firm-specific, development-generated income is less likely to be detected, since outsiders know more about changes in economy-wide factors than about changes in firm-specific factors. Thus, changes in firm cash flow due to changes in economy-wide factors are more likely to be passed on to outside shareholders. As a consequence, these changes in economy-wide factors are likely to affect distributions to outside shareholders more than they affect the underlying cash flow of the firm. The result will be the higher $R^2$s that are observed in the data for countries with a lower level of protection for outside shareholders. This effect will be accentuated by the fact that, relative to countries with more protection, risk arbitrageurs in low protection countries will rationally devote more of their attention to predicting economy-wide factors and less to predicting firm specific factors, because these economy-wide factors play a larger role in determining distributions to outside shareholders.\(^3\)

In conclusion, while the higher $R^2$s in such countries do not necessarily indicate that share prices are less accurate predictors of future distributions to outside shareholders, they will be less accurate predictors of underlying firm cash flows and thus again will not perform as well their real-economy, efficiency-enhancing functions.\(^3\)

C. Direct Test of $R^2$ as a Proxy for Share Price Accuracy

Durnev, Morck, Yeung, and Zarowin ("DMYZ") examine more directly the usefulness of $R^2$ as an inverse proxy for share price accuracy by examining the relationship between a firm's $R^2$ and the extent to which its share price reflects future versus current earnings.\(^3\) For a set of U.S. publicly traded firms, DMYZ go back in time and regress each firm's then current stock price on its then current and future earnings. They find that future earnings explain more of the share prices of low $R^2$ firms than with high $R^2$ firms. In other words, share prices of lower $R^2$ firms are better predictors of their future earnings than share prices of high $R^2$ firms.

This finding is much more direct evidence that low $R^2$ firms have more accurate share prices. Remember that a more accurate share price is one that better predicts future shareholder distributions. Future distributions can only come from presently known existing assets or future cash flows, and future earnings are on average a reasonably good proxy for future cash flows.

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34. Id. at 254.
35. See supra Part I.B.
Measuring Share Price Accuracy

CONCLUSION

Theory suggests that regulatory policies relating to a wide range of activities—issuer disclosure, insider trading and tipping, selective disclosure to institutions and analysts, and analyst recommendations—may possibly affect share price accuracy. With respect to each of these activities, however, there is heated debate concerning whether in fact the activity has such an effect and if so in which direction. The widespread belief that the level of share price accuracy affects the efficiency of the real economy suggests the importance of resolving these debates. Assuming this belief is correct, it is obvious that regulatory policy could be improved if there were more empirical evidence addressing these questions.

This Article has addressed the problem of developing a practical empirical measure of share price accuracy. It has argued that share price variance, the traditional measure, is ambiguous in its actual implications. Under at least some circumstances, greater share price movement indicates greater, not less, share price accuracy. A new measure, $R^2$, which reflects the extent to which a firm’s share price moves with the prices of all the other firms in the economy, appears to be a more reliable proxy. While further testing is required, there are good theoretical and empirical reasons for believing that a lower $R^2$ (i.e., less co-movement) means a more accurate price.
Economic Organization in the Construction Industry: A Case Study of Collaborative Production under High Uncertainty

William A. Klein and Mitu Gulati*

INTRODUCTION

This Article presents a case study focusing on part of the planning phase of a major construction project at Saint John's Hospital Center (SJHC) in Santa Monica, California. Santa Monica is a city of about 84,000 residents, bordered on the west by the Pacific Ocean and on the other sides by various parts of the City of Los Angeles. SJHC is a major nonprofit community hospital serving Santa Monica and the west side of Los Angeles.  

* Respectively, Maxwell Professor of Law Emeritus, UCLA School of Law, and Professor of Law, Georgetown University Law Center. The authors are grateful to Robert O. Klein for allowing William Klein (no relation) to observe the planning process at Saint John's Health Center described in this Article. Robert Klein also generously provided information and ideas, as did other SJHC representatives, especially A. Redmond Doms and Michael P. Russell. Also generous with their time and valuable for their ideas were the various members of the Master Site Planning Team (identified in this Article), especially Paul Danna and Dana Taylor. In various conversations over the years, Joseph J. Scarano provided many important insights into the construction industry in general. Other valued sources of information and ideas were David Forbes Hibbert and Joan Ling. Among our colleagues at UCLA, Stephen M. Bainbridge was, as always, an invaluable listener, critic, and supporter, as was Lynn Stout. For their insights into motion picture production we are grateful to David R. Ginsburg and Kenneth Ziffren and for their insights into law firms we are grateful to Joel Rabinovitz and Stephen C. Yeazell. For comments and conversations about prior drafts we are grateful to Scott Baker, John Borchenheimer, George Dent, Tom Geu, Lynn LoPucki, Gail Pesyna, Larry Ribstein, Steve Salop, and participants in the symposium on “The Role of Law in Promoting Long-term Value for Public Shareholders,” sponsored by the Berkeley Business Law Journal and the Mercatus Center (2003), and at a workshop at UCLA.

Note on the Interviews and Project Documents: At various points in this Article, we refer to interviews and documents relating to the construction project that is the subject of this case study. In order to ensure verifiability for later researchers, we have disclosed the names of the interviewees and the documents in question. The specific documents and interview notes are on file with the authors.

1. The general planning process of which this planning project is a part has been a long-term effort involving many people, yet the planning that is the focus of the present study is itself a substantial project, with a budget of about $1 million.

2. The population declined from 88,314 in 1980 to 84,084 in 2000. See City of Santa Monica, Demographic & Economic Profile: Population and Race/Ethnicity (relying on the 2000 Census), at http://pen.ci.santa-monica.ca.us/resource_mgmt/demographics/pop_race2.htm (last visited Dec. 2, 2002). In 2000 the Santa Monica population was 72 percent white, 13 percent Latino, 7 percent Asian/Pacific, and 4 percent African American. SJHC, with 1,755 employees, was the second largest employer in the City, close to the City’s 1,892 employees. Id. There were 6,028 firms, which provided 74,077 jobs; this helps explain the traffic problems that were a significant issue for SJHC in seeking approval of its development plans. Id.

3. According to a SJHC planning document, the SJHC “primary service area is marked by a relatively affluent, aging population, with no expectation of significant population growth.” SJHC
The goal of this study is to gain insight into some of the key attributes of the microsystem that assembles inputs and organizes large-scale, complex production without central planning.

I. BACKGROUND: WHY CONSTRUCTION PROVIDES VALUABLE INSIGHTS

Legal and economic scholars have devoted little attention to an industry—construction—that seems to offer valuable lessons about the organization of economic activity. Major construction projects are generally initiated, and proceed, without governmental central planning, without organized, formal markets for the exchange of services, and without hierarchical top-down control within a single firm. Many of the characteristics that have long been associated with the construction industry are now increasingly observed in outsourcing by traditional firms and, by the extension of that process, in the virtual firm. Construction projects reflect a system of economic organization involving a high degree of contracting, both formal and informal, rather than formal integration. This contracting may take place under conditions of high uncertainty; conditions may be constantly changing and ex ante specification of rights and obligations is often difficult at best. Construction projects also

Strategic Vision Statement (undated) (on file with authors). At the same time, according to a presentation by one of the feasibility consultants (The Camden Group), that W. Klein attended, national health care spending was expected to increase by about 50 percent from 2001 to 2007.


5. Not all of these characteristics apply to all construction projects. In fact, it is somewhat misleading to refer generically to a construction industry, since there is wide variation in types of projects, including highway construction, single-family residential tract development, apartment building construction, etc. Each has its own particular organizational structure and modes of operation. In highway construction, for example, traffic disruption is a major problem and specialized types of contract provisions have been developed to provide appropriate incentives to minimize the disruption. See Zohar J. Herbsman et al., Time Is Money: Innovative Contracting Methods in Highway Construction, 121 J. CONSTRUCTION ENGINEERING & MGMT. 273 (1995). Moreover, it is often said that "all construction is local," and there are important regional differences—for example, differences in the role of trade unions. The segment of the industry that is the focus of the present study is the development of large commercial and multi-use projects in Southern California. It does seem, however, that many, perhaps most, of the observations and insights offered here are applicable to other types of construction in other parts of the country, and, in any event, are instructive for the case-study's basic inquiry into the nature of economic organization.

Economic Organization in the Construction Industry

provide insights into the role of teams of individuals from different firms; into the networks of relationships that produce such teams; into a "culture of collaboration"7 that seems vital to successful teamwork; into trust, reputation, and other such informal, nonlegal mechanisms that affect collaboration; and, in a minor way in this study, into the role of written contracts.

It seems useful to expand briefly on these ideas.

As has just been suggested, the types of major construction projects of which the SJHC project is a good example are accomplished by the creation of a team of legally independent individuals or firms. The construction team8 has been described as a "quasi-firm,"9 which means that it (and its counterpart, the virtual firm) is not a firm at all. Rather, it is a network of relationships and contracts.10 Most notably, it lacks the characteristic of hierarchical control. The

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7. The importance of collaboration was first brought to co-author Klein's attention by Joseph Scarano, an architect who specializes in construction management, as director of the Los Angeles office of 3D/International. See 3D/I website, at http://www.3DI.com (last visited Mar. 1, 2004). Its importance has been uniformly confirmed in conversations with other people involved in construction. The culture of collaboration may be contrasted with the culture of command associated with the strongly hierarchical organization that characterizes large-scale, vertically and horizontally integrated industrial production. However, "[i]n the late twentieth century, the face of manufacturing is changing," with a great deal more flexibility. Paul Milgrom & John Roberts, The Economics of Modern Manufacturing: Technology, Strategy, and Organization, 80 AM. ECON. REV. 511 (1990). This leads, on one hand, to integration and, on the other hand, to "an extensive use of independently owned suppliers linked with the buying firm by close communication and joint planning." Id. at 526.

8. There is substantial scholarly literature on teams and teamwork. Its focus is mostly on teamwork as a way of increasing productivity and efficiency within an existing, larger organization. See, e.g., Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 NW. U. L. REV. 594-96 (2003). In the present study, the team is the organization. That is, teamwork not only enhances productivity but also provides the organizational structure. In any event, the literature on teams and teamwork, while obviously relevant to the present study, does not seem to bear directly on the issues that are the principal focus of this study. For a study of the types of teams that are more similar to those in construction (e.g., TV programs and theater productions), though shorter term and smaller in scope, see Debra Myerson et al., Swift Trust and Temporary Groups, in TRUST IN ORGANIZATIONS, supra note 6, at 166. The following statement from that study seems relevant to this one: "[A]s the size of the pool from which members are selected gets smaller, talent becomes thinner, and information about performance diffuses more effectively, then reputations become vulnerable." Id. at 171. The vulnerability of reputations is then said to lead to the development of trust. Id. at 181.


10. See ANNA DUBOIS, ORGANIZING INDUSTRIAL ACTIVITIES ACROSS FIRM BOUNDARIES (1998). The point is that it is neither the firm nor a system of markets that is the proper focus, but rather networks of dyadic relationships. "Interdependence... blurs the firm boundaries and thus makes individual make-or-buy situations difficult to delimit." Id. at 2. "The dichotomy between firm and market, between directed and spontaneous co-ordination, is misleading; it ignores the institutional fact of co-operation and assumes away the distinct method of co-ordination that this can provide." Id. at 14 (quoting G.B. Richardson, The Organization of Industry, THE ECOn. J., 883, 895 (1972)). The present study adds the additional reality that the network of relationships is primarily among individual members of firms and only secondarily among the firms of which they are members. See infra Part VII.B.

A prime example of extensive outsourcing and the collaboration that it requires among independent contractors is found in the Japanese automobile industry, in which a company such as Toyota is essentially an assembler, working cooperatively with the suppliers of virtually all of its components. DUBOIS at 7. See also DUNCAN J. WATTS, SIX DEGREES: THE SCIENCE OF A CONNECTED AGE 254-60 (2003) (describing the cooperation among Toyota's many independent suppliers to fill a supply gap, with almost unbelievable speed, when the factory of the single supplier of a vital component was
architects, engineers, consultants (e.g., acoustical, landscape, roofing, interiors, structural), general contractors, trade contractors (e.g., electrical, plumbing, specialty concrete, drywall), and suppliers (e.g., air conditioning unit, elevators, steel, windows) are all legally independent contractors, not employees. They do not work exclusively for the owner/client and are not, legally, people "whose physical conduct in the performance of the service is controlled or is subject to the right of control by the [owner/client]." At the same time, the legal and practical independence of the participants in construction projects elevates the importance of collaboration.

The focus of much of legal and economic scholarship is on dyadic relationships and bilateral contracts. Construction projects draw attention to the mosaic of which dyadic relationships are a part. From an economic or practical perspective, no contract stands alone, and the terms of each contract must take account, at least implicitly and in a general way, of the terms of others, because the work efforts of the various contractors are interdependent.

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Consider also the examination of the make-or-buy decision (another way of stating firm versus market or in-house production versus outsourcing), in the aerospace industry, in Scott E. Masten, The Organization of Production: Evidence from the Aerospace Industry, 27 J. LAW & ECON. 403 (1984).

See also George W. Dent, Jr., Gap Fillers and Fiduciary Duties in Strategic Alliances, 57, 58 THE BUS. LAWYER 55 (2001) ("Strategic alliances pose a paradox: under classic financial theory they should not exist. In theory, business is transacted either in markets or in firms; a firm chooses to 'make-or-buy' each input it needs. Strategic alliances fit neither category.").
multilateral nature of relationships is important to bear in mind because it affects and limits incentives and the allocation of control.\textsuperscript{13}

But there is something far more fundamental than this at work—a phenomenon that may be referred to, as previously suggested, by the phrase "culture of collaboration." A construction project requires teamwork and a willingness and ability to adjust to changing needs and circumstances without hierarchical control.\textsuperscript{14} Construction plans can never specify all details or anticipate all contingencies. Even after the architects and engineers and their consultants have completed their construction drawings and specifications and the contract for construction has been signed, the general contractor and subcontractors will need to provide "shop drawings: the final fabrication drawings for building systems."\textsuperscript{15} And even then, it is likely that unanticipated problems will arise and the team members (including the architect, engineer, general contractor, subcontractors, and suppliers of components) will need to work together to devise the solutions.\textsuperscript{16} A change agreed upon by the general
contractor and, say, the plumbing contractor, or a delay in performance by that contractor, may require adjustment by various other subcontractors either as to what they do or when they do it or both. This phenomenon of collaboration seems to trivialize (at least in this context) the distinction between firms and markets and between separable and nonseparable tasks. It is true, to be sure, that in the end there is one person or entity that has the legal, and perhaps even the practical, right to exercise control—to decide by fiat. But the premise of this study is that there is much to be learned from a focus on complexity, on networks, and on collaboration, as contrasted with hierarchy and fiat, and that this focus may provide useful insights into the distinction between firms and markets. The focus on complexity, networks, and collaboration need not deny that there is a nexus for the relationships. Nor need it, or does it, deny that there is a set of bilateral contracts, between or among several key participants—generally, contracts with the client or the general contractor. Moreover, in the project examined in this study, the client’s representatives are actively involved in the project on a day-to-day basis, and there is no doubt about who is ultimately calling the shots. But the existence of a nexus and of dyadic relationships (between the client and the various contractors) is not what makes the construction industry especially interesting.

Construction projects may seem to have unique characteristics that limit their relevance to other economic activities. To be sure, in the construction industry the principal organizing devices are contract (outsourcing) and

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On any sizable project, there is likely to be a regularly scheduled weekly meeting of representatives of the design team (the architect, the structural engineer, and the mechanical engineer), the general contractor, the construction manager, and the major subcontractors, to iron out problems. Cf. Stewart Macaulay, Non-Contractual Relations in Business: A Preliminary Study, 28 AM. SOC. REV. 55 (1963). The distinction between our focus and Macaulay's in his outstanding article is that his focus was on the dyadic relationships alone and not on the network of such relationships. Given a network of contractual relationships, participants need to take account of how accommodation of one participant may require the cooperation of others. This in turn draws attention to the importance of teamwork and collaboration. What matters to both Macaulay and to the present inquiry is the significance of informal mechanisms for enhancing cooperation and accommodation. See DUBOIS, supra note 10, at 16.

17. The same process in connection with the manufacture of trucks by the Swedish company, SweWork, is described in detail in DUBOIS, supra note 10, at 37-91. See also supra note 10 (describing the Japanese automobile industry).

18. Note, however, that within a project team there may be two or more people from a single firm; these individuals have a firm-sourced relationship as well as a team relationship. Moreover, the contributions of the individual members from, say, a firm of architects may be less separable than the contributions of the architects and the general contractor.

19. Construction has been treated as an example of "temporary systems. . . defined as a set of diversely skilled people working jointly on a task of some complexity over a limited time period." RICHARD ALAN GOODMAN, TEMPORARY SYSTEMS: PROFESSIONAL DEVELOPMENT, MANPOWER UTILIZATION, TASK EFFECTIVENESS, AND INNOVATION 2 (1981). Goodman claims that "[t]he most prominent [temporary system] in the modern era is the research and development project," but also includes "presidential commissions and senate select committees" as well as "theatre, construction, auditing teams, architectural groups, negotiating teams, juries, election campaign organizations, etc." Id. at 4. As previously suggested (see supra notes 9-10), however, such systems have much in common with the phenomenon known as outsourcing and, even more clearly, with the virtual firm, which is simply an extreme form of outsourcing.

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collaboration rather than the hierarchy and command that characterize much of large-scale industrial production and many segments of the service industries, but contract and collaboration are important in aspects of all economic organization and increasingly so in recent times. Additionally, the notion of control that is so vital to the concept of the firm is far more slippery than discussions of firms generally recognized. In a firm such as General Motors, for example, there is important hierarchical organization, but control of workers is constrained by, among other considerations, union power, while control over executives is constrained by their opportunities to move to other firms. Moreover, General Motors must contract and collaborate with its many suppliers, as well as with its dealers. Construction may seem unique in that projects are finite and are characterized by a high degree of uncertainty. But the same characteristics are found in the entertainment industry, in the delivery of legal services, and in most other industries, such as automobile production, though perhaps less dramatically so. Furthermore, in construction, though the identity of the participants will generally change from project to project, the industry persists and the participants are in for the long haul, which, of course, affects how people behave on any particular project. Once one adopts an industry-wide perspective, one can recognize the importance of the continuing nature of interaction.

II. THE SAINT JOHN’S HEALTH CENTER PROJECT

A. The Hospital: History, Needs, and Plans

Saint John’s Health Center (SJHC), as previously noted, is a major community hospital. In 2002 the AARP ranked SJHC twelfth among the top fifty hospitals in the country. It is affiliated with the renowned John Wayne Cancer Institute, which is located next to the SJHC hospital complex.

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20. Rock and Wachter claim that reference to general contractors as examples of nexus of contract as that term is used in corporate-law theory is “misleading . . . about firms in general.” Edward B. Rock & Michael L. Wachter, Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation, 149 U. PA. L. REV. 1619, 1628, n.12 (2001). This claim (a minor observation in an otherwise insightful and valuable article) is typical of much writing about firms in that it assumes what is at issue—that the word “firm” has a well-defined and useful meaning. That assumption must depend in turn on the assumption—questionable at best—that in general, in business organizations, there is a common and identifiable model of hierarchical control, with dominating employers and compliant employees. If the firm is defined in terms of a residual right of control, as under the property-rights theory of the firm (see id. at 1634), then it would seem that a construction project is a firm, with the owner/client as quasi-employer and all others as quasi-employees. But then the concept of a firm becomes all-inclusive, so as to be almost useless.


22. See AARP Magazine On-line, at http://www.modernmaturity.org/departments/2002/health/chart.html (last visited Dec. 19, 2002). SJHC’s two major competitors were ranked second (Cedars-Sinai Medical Center) and ninth (UCLA Medical Center).

SJHC was founded in 1942 by the Sisters of Charity of Leavenworth (SCL). The SCL have their headquarters in Leavenworth, Kansas and, through a corporation entitled Sisters of Charity of Leavenworth Health Systems (SCLHS), control a total of nine hospitals and four stand-alone clinics in four western states, California, Colorado, Kansas, and Montana. SJHC is the most successful of the hospitals. While SJHC has considerable autonomy, its major decisions are subject to the veto power of the board of SCLHS.

In January 1994 a major earthquake severely damaged the main hospital building of SJHC, forcing closure of that building for about eight months. Repairs were made that allowed the hospital to resume operations on an interim basis, but bringing the fifty-year-old building into compliance with current earthquake standards was another matter. Moreover, new facilities were thought to be necessary to deal with changes in health care technology and systems of delivery and to provide "extended services which focus on outpatient care, prevention and community health education." A decision was arrived at, therefore, that it would be best to replace the existing building with a new one. Thus began an extensive planning process that went beyond simply replacing the existing facilities and sought to imagine and provide for ancillary needs in the immediate and the more distant future. Some or all of the ancillary needs—including a large parking structure and a medical office building—may be essential to the continued success of the core hospital operation. The resulting project's complexity and cost were increased substantially by staging problems—that is, by the need to construct large new buildings on much the same site occupied by the existing buildings. The focus of this study is on the planning for the ancillary needs and the integration of the ancillary facilities with the core hospital facilities in an enlarged and visually attractive campus extending beyond the boundaries of the original campus.

The overall planning process had led, in 1998, to a development agreement with the City of Santa Monica. This was a lengthy, detailed agreement that was

25. What is perhaps even more important in the present context is that SJHC not only requires approval from SCLHS for major projects but also must rely on SCLHS for a large amount of the funding for its major capital investments, at least in the short run (that is, at least for interim financing).
26. This was the so-called Northridge earthquake. Its epicenter was about twenty miles north of SJHC, but because of the peculiarities of the earthquake and of the soil conditions in Santa Monica, it inflicted substantial damage in Santa Monica, while sparing much of the intermediate and surrounding areas. The same earthquake also damaged the UCLA hospital (about ten miles to the northwest of SJHC) and led to a decision to replace that hospital's main structure. For both hospitals, much of the money needed for the new construction has come from the Federal Emergency Management Agency (FEMA).
27. It was necessary, however, to demolish part of the hospital facilities (the North Wing).
28. The new state-mandated earthquake standards reflected the special need, following any future earthquake, for hospitals that would be able to provide emergency care.
29. Project Development Agreement at 7 (on file with authors) [hereinafter Development Agreement].
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effective until 2008. The main function of such an agreement is to provide the developer of a major, long-term, multi-stage project with a commitment by the City to allow construction of the structures described in the agreement—that is, a commitment not to change the rules, while at the same time "preserv[ing] substantial City discretion in reviewing subsequent developments." The individual structures would still require approval for compliance with various engineering, architectural, safety, and other provisions. The development agreement divided the plans into two phases. Phase I covered primarily the core hospital buildings (with patient beds, operating rooms, laboratories, etc.) in a three-square-block area north of a major east-west artery, Santa Monica Boulevard—the area called the "north campus." This location lies within a built-up section of the city that includes both commercial and residential properties. The development agreement for Phase I reflects the City's concerns with a variety of issues, not the least of which is traffic and parking. At the time the present study was initiated, the construction on Phase I was well underway, though still (at the end of 2002) a long way from completion.

Phase II is the object of the current study. It contemplates some significant changes on the north campus, but is concerned largely with development of the "south campus"—a three-square-block area south of Santa Monica Boulevard, where SJHC owns several parcels of property and was considering acquisition.

30. California law declares that:
Assurance to the applicant for a development project that upon approval of the project, the applicant may proceed with the project in accordance with existing policies, rules and regulations, and subject to conditions of approval, will strengthen the public planning process, encourage private participation in comprehensive planning, and reduce the economic costs of development.
CAL. GOV'T. CODE § 65864(b). Section 65865.2 provides:
A development agreement shall specify the duration of the agreement, the permitted uses of the property, the density or intensity of use, the maximum height and size of proposed buildings, and provisions for reservation or dedication of land for public purposes. The development agreement may include conditions, terms, restrictions, and requirements for subsequent discretionary actions, provided that such conditions, terms, restrictions, and requirements for subsequent discretionary actions shall not prevent development of the land for the uses and to the density or intensity of development set forth in the agreement. The agreement may provide that construction shall be commenced within a specified time and that the project or any phase thereof be completed within a specified time.

The agreement may also include terms and conditions relating to applicant financing of necessary public facilities and subsequent reimbursement over time.


32. The development agreement covers such obvious matters as total permissible square footage, as well as items such as landscaping, drainage, etc. The main new structures on the north campus were to be for "Inpatient Suites," a "Diagnostic and Treatment Center," and a "New Central Plant." Development Agreement at 44. The development agreement also provides for a "plaza area [to] serve as the principal vehicular and pedestrian entrance and exit," for subterranean parking (id.) and for a "North Lawn" of 41,300 square feet, "to provide a serene outdoor location for recuperating patients," but open to the public (id.). To preserve the serenity, however, there are restrictions on types of public use, including a prohibition on "cooking, dispensing or preparing food, ... sleeping camping, or staying overnight," a nontrivial restriction given Santa Monica's welcoming, or at least tolerant, treatment of homeless people. Id. at 44, 58-61.
of additional parcels. Currently, the John Wayne Cancer Institute is located on the south campus. One part of the Phase II project is a new location or set of locations for that Institute (which needs space both for patient care and for research laboratories). Other possible buildings on the south campus would include a medical office building, a health and fitness center, residential housing with some units for nurses and doctors, assisted-living housing, an education and conference center, and, possibly, some town houses, a restaurant, and a small retail space. All of this would require substantial additional parking in above- and below-ground structures—which turned out to be a first priority, especially because there is an existing parking deficit on the north campus. More vitally, all of it was subject to uncertainty because of questions of market demand and availability of financing. Further difficulty arose from the need to move quickly. To be successful, hospitals need patients, and patients are brought in by doctors. Consequently, SJHC must keep the doctors happy, and this requires good hospital facilities (operating rooms, diagnostic laboratory services, hospital beds, and outpatient and ambulatory amenities), and good nearby office space. There was a serious concern that if SJHC did not move quickly to fill, or at least demonstrate its commitment to fill, these needs, the needs would be filled by other area hospitals or by new, private-sector offerings (such as office buildings with outpatient operating facilities.) There was also one other important objective: to provide visual improvements (landscaping, walkways, etc.) that would integrate the north and south campuses and enhance the appeal of the entire campus. With all this in mind, SJHC obtained U.S. $1 million to engage in planning for Phase II (but coordinated with Phase I).
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B. Organizational Structure of SJHC

The key figure at SJHC in planning for Phase II is Robert O. ("Bob") Klein, a vice-president of SJHC who was appointed director of that project. Another key figure is A. Redmond ("Rusty") Doms, who served without pay as President of the SJHC Foundation (principally responsible for fundraising and finance) and played an active role in the planning process.

The SJHC CEO is Bruce Lamoureux, a highly regarded hospital executive, who was always well informed of what was happening in the planning process, but was not an active participant. SJHC has a thirteen-member board of directors, which includes doctors, a hospital administrator, and several successful real estate developers. The SJHC staff and its board of directors have considerable autonomy, but at the top of the formal decision-making chain is the Board of Directors of SCLHS, which, among other powers, appoints the CEO of SJHC.

Perhaps of most relevance for the purposes of this study is that Klein and Doms were able to draw on the input of knowledgeable and experienced people in the community, particularly people on the Foundation's seventy-five-person board of trustees and on the SJHC board of directors. Klein and Doms also established an advisory Master Site Planning Committee of fifteen people, including several prominent and successful real estate developers, the chief of the SJHC medical staff, and certain key SJHC executives.

C. The City of Santa Monica

Until the mid 1970s, Santa Monica's City Council was largely controlled by conservative local business owners, landlords, and small-time developers, along with some community activists and long-time residents. At that time, however, housing prices, and rents, began to rise. A substantial majority of the population of Santa Monica lived in rental units (still true). The renters supported a renter's rights organization, which took control of the City Council. As a result, Santa Monica became one of those communities sometimes referred to as "the people's republic . . . ." Rent control was imposed.
to the point for present purposes, the City adopted various provisions that have made development difficult and costly. Among many other requirements, the City boasts of "a set of guidelines to facilitate development of 'green' buildings" and of having two building code ordinances that, "aim at higher environmental and resource performance of buildings than state or federal requirements." Builders must, as in most other cities, comply with myriad building-code, zoning, and other requirements and satisfy an array of City bureaucracies. Beyond that, they must take account of the positions of various special- or public-interest groups that may be able to convince the City Council to kill, or impose additional requirements on, a project. Moreover, while there are many individuals and groups within the community who support affordable housing, there is also strong anti-growth and anti-development sentiment, to which members of the Council must respond. This being so, an important criterion for selection of consultants and contractors for the SJHC master site plan was knowledge of how to comply with the rules and get things done in Santa Monica. In a sense, the administrators, politicians, and citizens of Santa Monica were silent but influential members of the planning team.

III. THE MASTER SITE PLANNING TEAM AND ITS MISSION

The major focus of this study is on the process of creating a master site plan. The observations reported here begin with the initial formation of a Master Site Planning Team (MSPT), which is distinguished from the Master business people—wouldn't be at all surprised." Anne-Marie O'Connor, Sea Change in Santa Monica, L.A. TIMES, Oct. 16, 2002, at A1. The article notes a change in the politics as the population became wealthier. "Nowadays, Santa Monica seems more like Beverly Hills run by the Green Party." Id.

44. See Santa Monica Green Building Program Website, at http://greenbuildings.santa-monica.org (last visited Mar. 1, 2004). The ordinances include detailed recommendations (ignored at one's peril) for landscaping, with the objective of reducing energy and water use, as well as the use of fertilizers, pesticides, and herbicides.

45. A building project like that of SJHC requires the approval of City offices responsible for planning, building and safety, traffic, zoning, transportation management, fire, trees and landscaping, environmental matters, etc.—all of which are subsidiary to the Planning and Community Development Department, whose recommendation is reviewed by the Planning Commission and is also subject to review by the Architectural Review Board and the Landmarks Commission. Approval of any major project by the Planning Commission is difficult, at best, to achieve. The Planning Commission decision can be appealed to the City Council, which is highly sensitive to political issues raised by development projects. The entire process is likely to take at least twelve months and generally will take eighteen months or longer.

46. Moreover, according to Mike Russell, it is not unusual for a developer, after eighteen months or more of costly planning, and gaining approvals from overlapping jurisdictions (federal, state, local, and regional), to find its project held up by a lawsuit that anyone can file for $200.

47. SJHC is a valuable community resource, supported in large part by substantial donations. Moreover, it has long provided public services, including support for the Venice Clinic (in a part of Los Angeles contiguous with Santa Monica) and operation of a highly praised Child and Family Center. Nonetheless, as a condition for receiving the right to build the new hospital (costing over $100 million for the first building alone), it was required to provide free services to the community for the benefit of school children, and for "the indigent; uninsured and under-insured, seniors and persons with disabilities; women; and the homeless." Development Agreement at 20-21. These services must have an annual value of at least $732,000, rising by 1.5 percent per year, for fifty years. Id. at 25.
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Site Planning Committee, described earlier. Long before the MSPT was formed, considerable thought and study had been devoted to developing a broad vision for what might be built. Much of this vision was reflected in the previously described 1998 development agreement with the City of Santa Monica. This agreement, which will be effective until 2008, provides in some detail for the various Phase I projects on the north campus. The development agreement also provided, though in a far less detail, for Phase II. As previously indicated, Phase II presents a complex and difficult planning challenge because of the nature of the property; SJHC owns some, but by no means all, of the parcels in the relevant three-square-block area and might or might not be able to acquire the additional parcels in which it has an interest. Adding to the complexity is the number of separate but related objectives, the uncertainty as to the availability of financing, the staging problems, financing issues, serious traffic problems, the need to comply with the stringent rules of the City of Santa Monica and to satisfy the interests represented by the City, and the need for approval from Leavenworth. And as if that were not enough, the planners needed to project needs and trends in the distant future in a field in which there is rapid and dramatic change—which, among other things, argues for maximum feasible flexibility.

The job of the MSPT was to figure out what should be built, where each element should go, what the entire campus should look like, when each element should be built, and how various problems should be solved. The planning task was to be completed in four months beginning in mid-August 2002. As already suggested, the SJHC objectives were based on a general notion that in order to remain competitive and serve the future needs of the community—in order to fulfill its mission—it needed to create an effective and attractive hospital environment, not limited strictly to hospital needs. A guiding principle was that it would be necessary to generate revenues from some profitable activities in order to support other activities. Another guiding thought was that SJHC was located in an area with an aging population that will “age in place” rather than moving off to retirement communities. This led in turn to the idea that the objective should be not just to heal the sick but to promote wellness and fitness and “healthy aging.” More specifically, the following building and other projects had been identified:

A. Parking

It was plain at the outset that there was a need for parking and, as the planning proceeded, it became clear that the first priority would have to be a 3,500-car parking structure (four levels below grade and three levels above), partly to meet the needs of projected uses on the south campus and partly to meet a parking deficit on the north campus.
B. A Medical Office Building

There are a number of medical office buildings presently located in the immediate area, more or less contiguous to the hospital, but more space was needed. A medical office building would be a revenue generator in two ways. First, there would be the rental payments.\textsuperscript{48} Second, the office space would accommodate doctors, who would bring to the hospital patients for its beds, for its operating rooms, and for its ambulatory, diagnostic, and other services. “Build it and they will come” was not considered a viable strategy for the core hospital structure.\textsuperscript{49}

C. A New Building for the John Wayne Cancer Institute

However, it was recognized during the planning process that research/laboratory facilities could be separated from the patient-care facilities. Only the latter needed to be centrally located.

D. Health and Wellness Center and Conference Center

These were somewhat more questionable, but they are important parts of the big vision.

E. Housing

At the periphery of the south campus there was room for buildings for apartments, townhouses, and assisted-living units.

F. Landscaping

An essential element of the plan was the development of an attractive and inviting environment, with landscaping and other features designed to enhance the public perception of SJHC, facilitate pedestrian and vehicular traffic, and integrate the north and south campuses.

G. Traffic

In order to make the hospital attractive to patients, and to satisfy concerns of the City of Santa Monica and its residents, it would be necessary to solve some serious traffic problems.

\textsuperscript{48} SJHC already owned land on which a medical office building could be built. SJHC could build the building itself (if it could find the money) or it could lease the land to a developer who would commit to building an acceptable medical office building. The latter course would generate revenue that could be used to finance other projects or to support money-losing operations.

\textsuperscript{49} There were, to be sure, some people who, at least initially, favored limiting development to the core functions.
The first step in the planning process was to select two teams, one for design (the Master Site Planning Team) and one to study feasibility (market demand). A key move initially was to hire an experienced person to work with Klein in selecting the team members, communicating the SJHC objectives, and coordinating and directing the planning work. The selection of this person involved reliance largely on an informal network and on reputation conveyed by word of mouth. Klein and Doms were the right kind of people to proceed in this way. They are both experienced and smart. According to Doms, Klein "knows everyone" in the community, particularly in real estate, and is "very good at building consensus." Much the same could be said for Doms.

The person selected was Michael P. Russell, who had an impressive record in real estate development and had recently completed a sixteen-month job overseeing planning for a 260-acre mixed-use redevelopment project for a Boeing aircraft manufacturing facility in Long Beach, California. Russell was plainly well qualified, and he was available. More to the point, he and Klein knew each other and had previously had informal conversations about the SJHC project. Doms also knew Russell and had a favorable impression of his professional reputation. Beyond that, Klein and Doms were both part of an informal business and social network heavily populated with successful real estate developers, contractors, and investors (some of them on the board of SJHC or its Foundation), who were able to corroborate Klein’s and Doms’s impressions.

With all this in mind, it is not difficult to understand why Russell was hired on the basis of his record, his reputation, and interviews but without a formal search or competition. Russell was hired as a nonemployee consultant for a period of nine months at a fixed monthly fee, with the title “Senior Development Advisor.”

50. Klein was born and raised and still lives in Pacific Palisades, which is a part of Los Angeles contiguous to Santa Monica. He was a star football player (tight end) at the University of Southern California and later with the Los Angeles Rams and the San Diego Chargers. He is personable and outgoing, and is highly respected. While still playing professional football he pursued a career in commercial real estate. He began working for SJHC in 1992 and before that had been a member of the SJHC Foundation Board of Trustees and an active volunteer fundraiser (as well as a frequent surgical patient during his long career as a football player). He is a lifelong member of the Corpus Christi Catholic church in Pacific Palisades, which is an important link in his connections to knowledgeable people in the community served by SJHC.

51. This observation by Mike Russell (see infra note 52) is confirmed by co-author W. Klein’s own observations.

52. Before retiring (to a virtually full-time volunteer role at SJHC), Doms had been a member of a firm that invested in real estate on behalf of large pension funds. While he was not directly involved in real estate development, he came in contact with many who were.

53. They were students at the University of Southern California at the same time; both had lived in Pacific Palisades; and their children went to the same schools.

54. One of those conversations occurred when Russell’s son was undergoing surgery at SJHC and Klein and Russell happened to encounter one another there.
Once Russell came on board, he played a leading role, along with Klein and Doms, in selecting the other members of the teams. Most of the other consultants were, like Russell, selected on the basis of reputation (in many cases being people with whom Russell had worked on projects in the past). One notable exception was the group of four architects who were the central figures on the Master Site Planning team, who were selected as the result of proposals made by groups from five different firms.

V. THE MASTER SITE PLANNING TEAM: MEMBERSHIP AND SELECTION

The people most actively involved in the four-month planning gathered at the hospital in Santa Monica for a three-hour meeting once each week (with some exceptions) and communicated with one another regularly. Except for the client representatives, all of the team members were hired as consultants for a fixed fee (plus expenses, with a maximum amount). The organization of the team is shown in Figure 1, on the following page.

A. The Client Representatives

The MSPT included the three SJHC representatives previously described—Klein, Doms, and Russell—plus, somewhat less actively, Michael Monaldo, an architect by training and SJHC’s director of the Phase I construction. These client representatives played an active role in the planning process.

B. The General Architects

There were four architects who were responsible for design of the plan and for coordination of the work of the other members of the team: Three of them—Paul Danna, Jose Palacios, and Dana Taylor—had worked together for many years, first at a major architectural firm (Skidmore, Owings & Merrill), then in their own firm, and for the past eight years at DMJMHN, a large firm itself and a subsidiary of an even larger firm, AECOM. Their work spaces were contiguous to one another and they tended to operate as a team within the architecture division of DMJMHN. The fourth DMJMHN architect, Alton Chow, was a junior participant for the SJHC project.

The DMJMHN team was selected after a competition in which proposals were presented by five different teams. The DMJMHN team devoted considerable time and expense to preparing and presenting its proposal—an investment for which there would have been no return if another team had been

56. It had about sixty architects plus engineers, landscape architects, and interior designers. Id.
58. He had, however, worked for DMJMHN for five years.
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selected. It was the team of Danna, Palacios, and Taylor (later joined by Chow) that won the contract, not the firm of DMJMH+N, an observation that is explored more fully below.

59. A more extreme form of this sort of investment of time with no assurance of compensation is found with investment bankers, who provide advice without charge in the hope of a large fee when a transaction is accomplished. See ROBERT C. ECCLES & DWIGHT B. CRANE, DOING DEALS: INVESTMENT BANKS AT WORK 39 (1988).

60. The contract was between SJHC and DMJMH+N, with Klein signing for SJHC and Taylor signing for DMJMH+N. The contract amount kept the project within limits that allowed Taylor to sign for DMJMH+N without approval from anyone else in the firm.
C. The Landscape Architects

As part of their proposal to SJHC, the DMJM+H team—Dana, Palacios, and Taylor—represented that it had an agreement with Bob Hale and Mark Tessier of Rios Associates to provide landscape services. In other words, Rios was to be a subcontractor of DMJM+H. Hale and Tessier took part in the presentation to SJHC that resulted in the award of the contract to DMJM+H. They had recently worked successfully on the design of various parks in the City of Santa Monica. Because the SJHC people were concerned about the commonly perceived difficulty in satisfying the City and complying with its rules, this was a significant benefit. In addition, Rios Associates had recently served as landscape architect for a master plan for a major hospital in the West Los Angeles area (Cedars-Sinai Medical Center). Moreover, Hale had an excellent reputation and was known to and had worked on projects with Russell.

DMJM+H had its own landscape architects, who could have provided the landscape-design services. The choice by Danna, Palacios, and Taylor of the Rios architects created some tension within DMJM+H, but Danna, Palacios, and Taylor believed that SJHC probably would not award the contract to them without Rios—a surmise later confirmed by Klein.

D. Residential Architect

DMJM+H also subcontracted for residential architecture, with Ron Nestor of the firm of Nestor and Gaffney. Again, the services could have been provided by architects within DMJM+H, but it was thought that bringing in Nestor was important in winning the contract.

E. Civil Engineer

SJHC hired the civil engineer, Nicole Kerry of Kimley-Horn and Associates, Inc. Kerry had worked previously with Russell and he held her in very high regard. Klein explained that he and Russell wanted to pick the civil engineer who had knowledge of the City's rules regarding tree removal and replacement. Klein also noted that Russell had worked with Nicole Kerry on previous projects.

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61. The City has rules covering, among other things, what trees could be removed and what types of new trees could be planted. Part of what Hale and Tessier brought to the project was their knowledge of these rules.

62. At the time of this project, Hale was president of the Los Angeles branch of the American Institute of Architects. See AIA Los Angeles Website, at http://www.aialosangeles.org (last visited Nov. 19, 2001) (listing Hale as President at that time).

63. The civil engineer is responsible for locating utilities, helping in planning to accommodate to their existence, planning for the delivery of utilities to new structures, planning for drainage, etc. Generally, the civil engineer is responsible for planning the delivery of utilities to within five feet of the envelope of a building, where the building engineers take over. The architects need to know, for example, where underground utilities are located before they can decide where to place underground structures such as subterranean parking. Utilities can be relocated, but that can be costly.

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engineer, rather than leaving that choice to the DMJMH+N team, because the job had a vital bearing on the entire hospital operation.

F. Traffic and Parking Specialists

Because of substantial increases in office development in the area near SJHC, traffic problems had arisen and traffic and parking had become a serious concern for the City. To deal with the traffic and parking, SJHC hired Sam Ross, president of Crain & Associates, a firm of about thirty professionals specializing in traffic engineering and transportation planning. Another member of the firm, Diana Skidmore (the only member of the firm who is an architect), also attended some MSPT meetings, generally when Ross was not in attendance. As with the civil engineer, Russell and Klein considered it important for them, rather than the design architect, to select the traffic engineer. Ross was hired without competitive bidding. Klein and Russell feared that if they had had a competition there was a risk that they were unwilling to take that they might not get the qualities they wanted. Russell had worked before with Ross and had confidence in him.

G. Construction Specialist

Near the end of the planning process, SJHC brought in John R. Gavan, managing principal of KPFF (consulting engineers). Gavan’s role was to advise on construction requirements that might affect design. For example, when the design reached a point of focusing on a parking garage with three or four levels below ground and three above, with the possibility of a building on top of that, he advised on the necessary size of the columns needed in the lower levels of the parking garage, to support the upper levels. The size of the columns would obviously affect the design of the garage and the number of parking spaces, which was important to Ross, the traffic and parking consultant, as well as to the design architects.

H. Silent but Powerful Members: The City of Santa Monica and Its Citizens

While the City of Santa Monica was not involved in the phase of the project that is the direct focus of this study, throughout the planning process all members of the planning team were consciously aware of and expressly and openly deferential to the formal and informal requirements and potential objections of the City and of individuals (e.g., neighbors) and nongovernmental organizations. It was always an implicit, and often an explicit, assumption that the City (both the agencies and the more politically oriented City Council) retained substantial discretion over approval or disapproval of various aspects.

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VI. THE FEASIBILITY TEAM

SJHC also hired a number of “feasibility” consultants—people who estimated demand. These included people from (strategic planning and market assessment for ambulatory care and for the medical office building); The Camden Group (demand analysis in general and for research zone); Cornerstone Decision Support (demand analysis for fitness and wellness center); Economic Research Associates (feasibility of educational conference center); RCL & Co. (feasibility of employee and market rate housing); Gerontological Services, Inc. (feasibility of assisted living housing and lifestyle center); Robert Charles Lesser & Co. (residential feasibility); and Webcor (construction analysis).

Klein, Russell, and Doms met with these feasibility consultants and then communicated the results to the MSPT. There was some collaboration among the feasibility consultants, but their efforts were not observed as part of this study.

VII. OBSERVATIONS, THEORIES, INFERENCEs, AND QUESTIONS

A. The Culture of Collaboration

The work of the professionals involved in the SJHC Phase II master site planning project is a small-scale example of an important aspect of construction projects—namely, the culture of collaboration. Collaboration means not just an ability to work together—not just doing one’s part in a joint project—but adaptability and responsiveness to the needs of other members of the team. As such, it illustrates an aspect not only of the construction industry, and other

68. For a reference to the source of this phrase, see supra note 7 (referring to the 3D/I website). A more extreme, and to some degree unique, example of collaboration arose in the reconstruction of the portion of the Pentagon destroyed on September 11, 2001. The key people responsible for that job adopted the seemingly impossible goal of reopening within one year—and succeeded. “Rebuilding the Pentagon took teamwork, creativity, and some ingenuity. The workers also shared a tremendous amount of patriotism, personal pride and emotion—not to mention 20-hour days, six or seven days a week.” Sherie Winston, Pentagon’s Construction Team Beats the Odds on One-Year Rebuild: Motivation and teamwork shave three years from schedule, 249 ENGINEERING NEWS-RECORD 6 (Sept. 2, 2002). The government’s representative “made it clear that ‘we operate as a partnership.’” Id. The contractor’s lead on-site executive noted that no one had a written contract and that “Everyone left their egos in the [Pentagon’s] south parking lot.” Id. For a soul-stirring, and more detailed, story of the rebuilding, see Steve Vogel, From Ruins, Pentagon Rises Renewed: Determined Crews Keep Their Promise to Return Workers, WASH. POST, Sept. 8, 2002, at A1.
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project-based industries such as motion picture production, but also of other economic activities characterized by cooperation in a nonhierarchical setting. More broadly, by inference, it is at least suggestive as to other nonhierarchical economic relationships, particularly those that are multilateral. Collaboration in turn involves trust and reputation. It is of some relevance that the pool of professionals from whom the MSPT members were selected was of the type that reliable reputational information was available to the SJHC executives and their advisors without excessive effort. This final point is one to which we will return.

Thus, in the case of the SJHC project, a prime criterion for initial selection was reputation for being a "team player." Once the team began work, it was plain to the observer's eye that the members of the team expected to and did rely on and cooperate with one another. They had frequent meetings, telephone

69. See Laubacher et al., supra note 6, at 8 ("On large projects in the film industry today, hundreds or even thousands of individuals and small entities contribute their part to the completion of a multi-million dollar production."). The article refers to other firms that rely heavily on outsourcing, including Nike (athletic shoes) and the personal computer display division of Nokia, which "accounted for sales of over $150 million in 1995 and has only five employees." Id. at 9.

70. For authorities cited, see Dubois, supra note 10.

71. The trust observed in this study seems to be mostly of the type that has been called "knowledge-based trust," derived from adequate information, and "identification-based trust," based on "empathy with the other party's desires and intentions," and not much of the "deterrence-based" type, based on punishment. See Roy J. Lewicki & Barbara Benedict Bunker, Developing and Maintaining Trust in Work Relationships, in Trust in Organizations, supra note 6, at 118-19.

72. See infra notes 90-95 and accompanying text.

73. Mike Russell analogized the project to a basketball team on defense, where, in a fast-changing situation, each player should know what the other is going to do and should be able to rely on being backed up as needed.

74. Co-author William Klein sat in on all but one of the weekly MSPT meetings and interviewed most of the participants, asking them in particular about teamwork and collaboration.
conversations, and exchanges of documents, drawings, and plans (largely by electronic means), and operated in a collegial, mutually respectful manner.

An important generalization, then, seems to be that coordination does not require a firm or the power of fiat—and may even be more effective without firm or fiat.

B. Firms and Markets

In the traditional and still-dominant economic models of economic organization, transactions are divided between those within firms and those across markets.\(^7\) Oversimplifying, firms are deemed to house the “black box” of production and the goods that they produce are then traded among firms and individuals on markets. In law, the analogous dichotomy is between contract law, on the one hand, and the law of agency and of business organization on the other hand.\(^6\) The present study shows that for some significant set of economic activity, that dichotomy simply does not work.\(^7\) Because the dichotomy does

\(75\). See OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975). But see OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 6-7 (1985) (offering discussion that is devoted mainly to the firm-versus-market distinction but that offers the observation (with an attribution to Ronald Coase) that “the study of internal organization and market organization are not disjoint but rather are usefully joined within a common transaction cost economizing framework”). Even if economizing on transaction costs is the unifying theme, however, the focus on those costs stems from the initial inquiry into why transactions are sometimes organized within firms and sometimes across markets, with an assumption of the explanatory virtue of the firm-versus-market dichotomy. Moreover, the transaction-cost explanation of the boundaries of the firm has now been joined by other explanations. See Holmstrom & Roberts, supra note 10, at 74-75; Steven Tadelis, Complexity, Flexibility, and the Make-or-Buy Decision, 92 AM. ECON. REV. PAPERS & PROCEEDINGS 433 (2002); see also Harold Demsetz, The Theory of the Firm Revisited, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION AND DEVELOPMENT 159, 167 (Oliver E. Williamson & Sidney G. Winter, eds., 1991) (objecting to the focus on transaction-cost and monitoring explanations for the existence of firms and disregarding or downplaying the role of “moral hazard analysis, shirking, and opportunism—the problems of incentive compatibility”).

Oliver Hart and John Moore offer this theory:

We argue that the crucial difference for party 1 between owning a firm (integration) and contracting for a service from another party 2 who owns this firm (non-integration) is that, under integration, party 1 can selectively fire the workers of the firm (including party 2), whereas under non-integration he can “fire” (i.e., stop dealing with) only the entire firm: the combination of party 2, the workers, and the firm’s assets.

Oliver Hart & John Moore, Property Rights and the Nature of the Firm, 98 J. POL. ECON. 1119 (1990). This statement seems to tell us little, if anything, of interest about SJHC and the team it engaged for its master site planning project.

76. The present study may reflect the fact that its authors specialize in the law of business organization (including agency) rather than in the law of contracts, and may have paid too little attention to the literature on relational contracts. See Robert E. Scott, A Theory of Self-Enforcing Indefinite Agreements, 103 COLUM. L. REV. 1641, 1644-45 (2003) (presenting a theory that “predicts that self-enforcement of deliberately incomplete agreements between strangers is more efficient than the alternative of more complete, legally enforceable contracts”).

77. Cf. Dent, Jr., supra note 10, at 71 (“In theory, business is transacted either in markets or in firms; a firm chooses to ‘make-or-buy’ each input it needs. Strategic alliances fit neither category.”) (citations omitted). For more on strategic alliances, see Robert M. Grant & Charles Baden-Fuller, Knowledge and Economic Organization: An Application to the Analysis of Interfirm Collaboration, in KNOWLEDGE CREATION: A SOURCE OF VALUE, supra note 10, at 113-50. It is relevant that Scott takes as given that where, in repeat dealings, reputation is at stake, contracts tend to be self-enforcing. The
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not work, extrapolating from it to account for "hybrids"\textsuperscript{78} at best distorts an economic phenomenon that stands on its own.\textsuperscript{79} The collaborative team described in the present study has a number of defining characteristics.

First, the professionals within the team were from different firms. Production took place outside their firms (or, at best, at the periphery of the firms). There were firms in the picture and they were in some sense involved—they "supplied" the team members. But the transactions among the firms, and among the members of the team, were not transactions across markets as such transactions are usually conceived.\textsuperscript{80}

Second, within the production team, there was no hierarchy and no power of fiat of the sort one expects in a traditional firm.\textsuperscript{81} The members of the DMJMH+N team provided leadership and coordination, but they did not issue orders. They did not exercise the control over others that plays such an

cited paper extends the theory to one-shot deals.

\textsuperscript{78} See Oliver E. Williamson, Comparative Economic Organization: The Analysis of Discrete Structural Alternatives, 36 ADMIN. SCI. Q. 269, 280 (1991) ("Markets and hierarchies are polar modes. . . . [H]owever, a major purpose of this paper is to locate hybrid modes—various forms of long-term contracting, reciprocal trading, regulation, franchising, and the like—in relation to these modes.").

\textsuperscript{79} See Walter W. Powell, Neither Market Nor Hierarchy: Network Forms of Organization, 12 RES. ORG. BEHAV. 295, 299 (1990):

The idea that economic exchanges can be usefully arrayed along a continuum is thus too quiescent and mechanical. The continuum view also misconstrues patterns of economic development and blinds us to the role played by reciprocity and collaboration as alternative governance mechanisms. By sticking to the twin pillars of markets and hierarchies, our attention is deflected from a diversity of organizational designs that are neither fish nor fowl, nor some mongrel hybrid, but a distinctly different form.

Powell goes on to state that a "hierarchical structure . . . is particularly well-suited for mass production and distribution," while "[n]etworks are particularly apt for circumstances in which there is a need for efficient, reliable information." \textit{Id.} at 303-04. What Powell seems to have mostly in mind, however, are semi-permanent network alliances ("durable relationships," \textit{id.} at 306), or so-called strategic alliances, though he does refer, among his examples, to construction (\textit{id.} at 306) and the "film and recording industries" (\textit{id.} at 308).


\textsuperscript{80} Each of the firms did have a contractual (market) relationship with SJHC, but those contractual relationships were used to create a production team, not to exchange goods or services directly.

\textsuperscript{81} In modern firms, the traditional theoretical distinction between firms and markets is increasingly undercut by the substitution of team production for hierarchy. \textit{See} Watts, \textit{supra} note 10.

Watts explains:

\textit{W}hen a firm embarks on a major new project, \textit{the people involved don't actually know how they are going to do it.} In fast-moving industries from software to automobiles, designs are rarely final before production itself has commenced, and performance benchmarks evolve along with the project. Furthermore, no one person's role in the overall scheme is ever precisely specified in advance. Rather, each person starts with a general notion of what is required of him or her, and refines that notion only by interacting with other problem solvers (who, of course, are doing the same).

\textit{Id.} at 268 (italics in original). Watts goes on to state, "The result, in a successful firm, is a continual swirl of problem-solving activity . . . ." \textit{Id.} at 269. Earlier in the book, Watts had offered the important related observation that often, in problem-solving networks (not necessarily in firms), there is not only an absence of hierarchical control but there is no "center" or there are many centers, and "innovations originate not in the core of the network but in its peripheries." \textit{Id.} at 52.
important role in legal doctrine and theory and in the traditional economic theory of the firm. Thus, the present study suggests that perhaps the distinction between control over employees and control over independent contractors, and the corresponding distinction between firms and markets, is less clear-cut, and less significant, than legal doctrine and legal and economic theory presume.82

Third, SJHC did not, except in a narrow legal sense, hire the firms of which the MSPT members were principals or employees. The hiring process may have been influenced to some degree by the reputations and the capital of the firms, but that process focused more on the individuals who would perform the services. For example, the people making the decision at SJHC would not have been willing to hire DMJMH+N and allow DMJMH+N freedom to select the individuals within the firm who would perform the services.83 In fact, while DMJMH+N had an excellent general reputation, the SJHC people considered its conservative style to be a negative attribute, a deficiency that the DMJMH+N team remedied by taking on Hale, Tessier, and Nestor as subcontractors. On the other hand, it may be that the backing of a major firm did add a comfort factor for SJHC that supported the Danna-Palacios-Taylor

82. This point was made long ago by Alchian and Demsetz. Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777 (1972). In the literature on firms and markets, however, it is sometimes noted and then generally ignored. In legal theory, a plumbing contractor can tell its employees how to do their job; it has the power of fiat. A general contractor, by contrast, lacks this legal power over the plumbing contractor. So what? If the general contractor, for some good reason, directs the plumbing contractor to do something unanticipated or unusual, the plumbing contractor is unlikely to object (though some financial adjustment may be required). Likewise, if the plumbing contractor directs its employee to do something reasonable, though perhaps unusual and unanticipated, the employee is unlikely to object. For a somewhat different and more generalized version of the argument, see Mark Granovetter, Economic Action and Social Structure: The Problem of Embeddedness, 91 AM. J. SOC. 481, 499-502 (1985) (citing empirical studies calling into question the idea that hierarchically organized firms have effective power of fiat).

The idea originated by Alchian and Demsetz is echoed in WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 14-19 (8th ed. 2002), which focuses on control. In both law and economics, control is the critical element in distinguishing between employment (firm) and contract. See id. at 19-21, suggesting that that there is a continuum between firms and markets, with varying degrees of "firmishness," depending on a variety of bargain elements. See also G. Mitu Gulati et al., Connected Contracts, 47 UCLA L. REV. 887 (2000) (reiterating the point about degrees of firmishness).

83. The same focus on the individual rather than the firm was even clearer with respect to the other members of the MSP team, who were hired without any formal competition. For example, Mike Russell spoke about why he and Bob Klein hired Nicole Kerry, the civil engineer, without saying anything about the firm of which she was a member. It may be, of course, that her affiliation with a firm of good reputation was an implicit condition of her selection. It may also be true that she could not have been fully effective without the support of others within the firm. Yet the fact remains that the relationship between Kerry and her firm (Kimley-Horn), and the relationship between her, her firm and SJHC does not fit easily in the traditional model of firms and markets.

At a meeting of the Master Site Planning Committee in January 2003, attended by, among other committee members, three successful real estate developers, the prospect was raised of hiring legal services for acquiring the legal entitlement to take Phase II to the next stage. When ideas were informally solicited about whom to hire, there were eight or ten quick suggestions—all of them names of individual lawyers. In some, but not all, cases the names of the firms were appended to the names of individuals, but no one offered the name of a firm alone. A draft memorandum for seeking proposals from law firms for various legal work included the statement, "We want to know the partners and any associates who will be working with us on this assignment."
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proposal. This raises the question, when a client hires a professional who is a member of a firm, what does the client expect of its relationship with the individual professional and of its relationship with the firm? The same question can be posed for law firms, and the answer may vary with the client, the type of matter, and the size, traditions, and organizational structure of the firm. The point is, once more, that the concept of a “firm” is a simplification.84 A central feature of the notion of a firm in economics and of an employer in agency law is control by the firm or employer over its employees. The present study suggests that in some (many?) situations the notion of control that defines firms and employment fails to mesh with (indeed, falsifies) reality—as does the notion of markets, bargains, and contracts.85

Fourth, the individual MSPT members had considerable autonomy within their firms. They were much more like partners in a law firm than like executives in a major manufacturing corporation. While for many purposes it may be useful to refer to both law firms and manufacturing corporations as “firms,” it is also clear that that lumping-together obscures important aspects of reality. To put that idea in other terms, Paul Danna is an “employee” of DMJMHN and Bob Klein is an “employee” of SJHC, but their connections to their employers are significantly dissimilar. Danna’s human capital—his skill, reputation, etc.—is readily transferable to other firms; his human capital is not “firm specific.” Klein’s skills at management are more generic perhaps—there are more types of jobs for which he would be qualified—but at the same time much of his value is tied to SJHC. The legal concept of an employee—a “servant-type agent”86 in the language of agency law—ignores this important distinction, as does the distinction in economic theory between firms and markets. To put this idea in still other terms, it may be that we should think not of a firm like DMJMHN hiring architects, or of a large law firm taking in partners and hiring associates, but rather of the individual architects or lawyers

84. Compare Equal Employment Opportunity Commission v. Sidley Austin Brown & Wood, 315 F.3d 696 (7th Cir. 2002) (addressing the question whether certain “partners” of a law firm were “employees” for purposes of the federal prohibition on age discrimination). Sidley Austin Brown & Wood was controlled by a self-perpetuating executive committee, which delegated authority to other committees, which remained subject to its ultimate control. In a concurring opinion, Judge Easterbrook speculated:

perhaps each practice group at a large law firm is best viewed as a distinct venture, and the umbrella organization (run by the Executive and Management Committees at Sidley) as a partnership of partnerships. The top committees can make all decisions, but much power is bound to be delegated, just as departments at a university make their own hiring and salary decisions even though a self-perpetuating board of trustees holds all the legal authority.

Id. at 710.

Even within each “practice group,” one can easily imagine that there were individual partners with substantial autonomy derived from, among other things, their productivity and their relationships with clients, other members of the firm, and associates.

85. In many types of construction projects, moreover, the contractors do not select their employees. A contractor may have a small permanent staff of crew chiefs, while the rest of the workers for any particular project are assigned by a union from its hiring hall.

86. See Restatement (Second) of Agency § 2 (1958).
engaging certain specified management, accounting, monitoring, and marketing
services, and taking advantage of networks of relationships.

Finally, as previously noted, Danna, Palacios, and Taylor chose landscape
architects and a residential architect from outside of DMJMHN, despite the
fact that this created some tension within the firm.

All this raises the question, why did the architects join a large firm? In fact,
Danna, Palacios, and Taylor had, early in their careers, worked at Skidmore,
Owings & Merrill, LLP. In 1990 they left that firm and went out on their own.
Four years later, their small firm had grown to one with about sixty architects,
and then was acquired by DMJMHN. Paul Danna offered two main reasons
for his support of this latter move. One reason was that the firm provided its
members with security, tiding them over in the lean times. His second reason
was that working with a large firm gave him the opportunity to work on larger-
scale projects than would otherwise have been available to him, an opportunity
that appealed to him for largely nonpecuniary reasons. It is conceivable that he
could have worked as an independent contractor on larger projects or that he
could have (with Dana Taylor and Jose Palacios) put together ad hoc teams for
such projects. But that seems impractical. Presumably, the firm could more
efficiently provide marketing capabilities and an array of services to clients
reluctant to seek out specialists (or to allow their prime lawyer to do so),
financial weight; monitoring of the performance of its architects; access to
networks; and reputational capital. And bear in mind, Danna, Palacios, and
Taylor retained considerable autonomy.

87. Similarly, one could, with some stretch, think of the Japanese automobile parts suppliers hiring,
say, Toyota for coordination, design, marketing and other services, rather than Toyota hiring the
suppliers. See supra note 10. The point is not that either perspective is right but rather that neither is
wrong and each may be useful—or that both are myopic and what we need is a fresh perspective.

88. See Randall S. Thomas et al., Megafirms, 80 N.C. L. Rev. 115 (2001) (explaining the rise of
large firms in response to, among other factors, the desire of clients for "one-stop shopping" for large,
complex matters).

89. Clients of law firms are, like clients of architectural firms, likely to select the individual
members of the firm with whom they intend to do business. It may be, as suggested above, that law
firms are most fundamentally a combination of (a) guilds, (b) marketing cooperatives, (c) mutual
insurance societies, and (d) screening, certification, and monitoring agencies. If you strip away those
functions, what is left? (It is easy enough to imagine outsourcing the accounting and property-
management functions.) For other suggestions as to the role of firms more generally, see Richard A.
www.ssrn.com/abstract=378740. The firm is still a valuable and important reality. The point is that the
productive work for clients is done not so much within the firm, as in the manufacture of pins, but rather
independently of the firm. Cf. Stephen C. Yeazell, Re-Financing Civil Litigation, 51 DePaul L. Rev. 183,
199-200 (2001). Yeazell points out that lawyers in firms, compared with solo practitioners, can
more easily specialize and acquire expertise, which yields returns to scale and marketing advantages.
Moreover, he adds, the firm, with its indefinite duration, enhances the feasibility of amassing firm-
specific capital, including both physical assets such as a library and intangible assets such as reputation.
A firm also allows lawyers to "hedge their bets" by taking on a variety of high-risk and low-risk work.
However, Yeazell later points out that "[t]he plaintiffs [personal injury] bar has used inter-firm referral
and fee splitting to achieve a network of expertise that replicates many of the advantages of larger
firms." Id. at 203.
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C. Networks and Relationships

The hiring of the various consultants who formed the planning team was largely the product of an informal network\[^{90}\] of relationships that supplied information about reputation for quality of work and for being a team player.\[^{91}\] The set of professionals from which the MSPT members were selected, and the set of real estate investors and developers with knowledge of their reputations, was small enough and socially homogeneous enough to make this method of selection feasible and effective.\[^{92}\] That said, this network of individuals in the Los Angeles construction industry was a far cry from the small, closed, often ethnically homogenous, communities (communities whose members have "strong ties" to one another), where reputational and social sanctions serve as a substitute for law.\[^{93}\] Here, the community was relatively large and ethnically diverse and the ties, while present, were much weaker than those in the classic studies of either the ranchers in Shasta County or the orthodox Jewish diamond merchants in New York.\[^{94}\] The relatively weaker ties were seemingly unavoidable, given the scope of the project and the corresponding need to assemble a broad and diverse group of specialists. The nature of the network, however, was such that these relatively loose and weak ties seemed nevertheless to cohere into an effective mechanism for non-legal sanctioning.\[^{95}\]

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\[^{90}\] We use the word "network" here to refer not to a formal set of business relationships, but rather to the informal set of social and business connections that people in various business activities rely upon, to varying degrees, to share information, particularly about the skill and trustworthiness of potential business associates, employees, and professionals.

\[^{91}\] See supra Part IV. A similar observation could be made for many other economic activities. For example, Frank R. Kline, a partner in a leading venture capital firm, Kline Hawkes & Co., stated, "The venture business is truly a relationship business." Interview with Frank R. Kline, Partner, Kline Hawkes & Co, Los Angeles (Jan. 15, 2003). Kline elaborated that almost all of the many deals in which his firm, or the firm in which he had previously worked, invested came from people he knew—lawyers, investment bankers, people involved in other deals in which he had participated, other venture capitalists, etc. Id. For more information about this firm, see Klein Hawkes & Co Website, at http://www.klinehawkes.com (last visited Mar. 27, 2003).


\[^{93}\] See, e.g., Eric Posner, *A Theory of Contract Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 755 (stating that the standard view is that non-legal sanctions are effective primarily in "small and homogenous" communities).


\[^{95}\] That there could be strength in weak ties was recognized in Mark Granovetter's classic article,
D. Contracts, Specification, and Trust

The contracts reflect the problem of "bounded rationality" or "incompleteness"—that is, the difficulty of specifying what each consultant was expected to do. Consider the contract with DMJM+H+N. It was drafted by SJHC's lawyer and contained provisions for the fee and the term, plus a number of standard provisions for books and records, warranties, confidentiality, ownership of documents, etc. The key provision was the "specification of services." This was three and a half pages long and included a detailed schedule of activity and coverage, as well as lists of "deliverables" including the "Overall Development Site Plan," the "Landscape Schematic Plan, Specimen List & Plant Photographs," the "Pedestrian Circulations Plan," the "Conceptual Site/Building Sections," etc., as well as drawings (renderings) and models. All of this would, of course, require some minimum amount of effort. But it would not provide the basis for a viable legal claim for failure to deliver a high level of skill and effort. In other words, a range of effort was legally permissible, so there must be some mechanism, other than legal sanctions, to give the client reasonable assurance of best efforts. Our impression was that the primary mechanism here was trust and that reputational

96. For a good brief discussion of bounded rationality and its consequences, see PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION & MANAGEMENT 129-40 (1992). "Because real people are boundedly rational, complete contracts that specify what they will do in every conceivable circumstance are impossible to negotiate and write." Id. at 160. And, of course, some contractual rights and obligations are more difficult to specify than others.

97. The contract is relatively brief and skillfully drafted. The same form was used for all the contracts other than Russell's, which he and Klein developed from a form that Russell had previously used. There are myriad form contracts available in the construction industry. For a sample, see Sweet, supra note 4, at A-1 to I-48. See also infra note 109 (describing the basic types of contracts used and their underlying rationales).

98. The "Description of Services" in the contract with the civil engineering firm (Kimley-Horn) provided for a base map with site constraints, a grading plan, a storm drainage plan, a sanitary sewer plan, and a water plan, and required appropriate coordination with the architects or owner or other engineers. It also specified attendance at four-hour weekly meetings for four months. Similar specificity was provided in the contracts with other consultants.
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sanctions were important but at best served to reinforce trust.99 This trust-based explanation is relevant because of another, related explanation (other than high uncertainty) for the failure of the parties to attempt to cover more contingencies in the contracts—namely, that an effort by the client to specify, in detail, a minimum level of performance might be interpreted, or misinterpreted, as a signal of a lack of trust or confidence, and that might sour the relationship.

Interestingly, the contract between SJHC and DMJMH+N had not been signed by the time the services that it covered had been completed. The two parties had been unable to reach agreement on warranty and indemnification provisions that were favorable to SJHC and unacceptable to Taylor of DMJMH+N. These provisions had little if any significance for the task for which DMJMH+N was initially hired, but more significance for later phases of the project, for which DMJMH+N was ultimately engaged.100 At the outset of the initial effort, Taylor had been unwilling to accept the disputed provisions because he was concerned, presciently as it turned out, about setting an unacceptable precedent for contracts for future efforts.101

The difficulty of specification of contract obligations is even more starkly present in film production, which is similar to construction projects in using temporary, ad hoc teams for finite, relatively short-term efforts. When a studio agrees with a producer to finance the production of a feature film, it will almost

99. See supra note 71. Compare the following excerpt from Steven Kelman, writing about U.S. government procurement of computer systems:

How can the government predict from a written proposal the zeal a vendor will display in solving an unexpected problem? How can the government tell from a written proposal how successfully a vendor weeds out incompetent repair people and motivates the others to fix things efficiently and properly? How can the government determine from a written proposal whether the vendor plans to assign nine lawyers to comb the contract in search of ambiguities to exploit after the contract is signed?

What normal people in their everyday lives do when faced with such a situation is to rely on the main source of available information besides search—namely, experience.


100. Among other issues arising at a later contracting phase, SJHC wanted DMJMH+N to guarantee a maximum price for the construction project that it was to design, a guarantee that Taylor found excessively onerous.

101. Taylor made the interesting observation that a client who is “unyielding” on contract provisions is the kind of client who is likely to “come after you” later—in which case the provisions could turn out to be important. Thus, Taylor pays attention both to the substantive effect of contract terms and to the signals the other side sends in negotiation. Compare Dent, Jr., supra note 10, at 69 (“When cooperation falters, partners dust off and read their contract. . . .”).

Even without a signed agreement, and even with an impasse over certain terms, the parties did have an oral contract; they had agreed on basic terms. Cf. Stewart Macaulay, supra note 16, at 60 (“Even when a purchase order and acknowledgement have conflicting provisions printed on the back, almost always the buyer and seller will be in agreement on what is to be sold and how much is to be paid for it.”). Similarly, it is commonplace in film production that the lawyers will bargain hard over terms and then the parties will not sign the final product. This leaves room for later haggling and even for failing to abide by agreed-upon terms, but there remain basic terms that cannot be ignored without a serious blow to reputation, in an industry in which reputation as to such matters is of vital importance. Macaulay puts it this way: “Although the parties fail to cover all foreseeable contingencies, they will exercise care to see that both understand the primary obligation on each side.” Id. at 62. Macaulay later describes the non-legal sanctions, of which “the most obvious” is concern for “general business reputation.” Id. at 63.
invariably condition its obligation on its approval of (a) the script, (b) the
director, (c) the principal cast, and (d) the budget and shooting schedule.\footnote{102}
From the very start, however, all the elements are interrelated and changeable.
The director may want changes in the script. Political events may occur that
necessitate a change in the script or in locations. The lead actor may object to
aspects of the script or the choice of other actors. Changes in the script, both
before and after shooting begins, may require changes in the schedule or the
budget or both. All these types of changes, and more, are not only possible but
likely. Thus, a completely specified contract between the studio and the
producer is literally impossible. Even though the lawyers for the producer and
the studio often spend endless hours bargaining over the terms of a contract,
often it is not signed by the parties,\footnote{103} and even if it is, often it is ignored—
though with two general exceptions. First, generally the studio will not renege
on the terms relating to the money it is required to pay to the producer and
certain other participants. Second, the studio is likely to respect agreements as
to entitlement to credits (which are of far more importance to the participants
than those outside the industry might imagine).

Thus, both in construction and in film production trust or good faith,
backed by reputational concerns, is essential.\footnote{104} Trust reduces the importance of
specification. At the same time, the lack of specification in these settings
should not be overemphasized. Efforts to specify obligations reduce the

\footnote{102} Interview with Kenneth Ziffren, Ziffren, Brittenham, Branca, Fischer-Lurie & Stiffelman,
LLP, in Beverly Hills, Cal. (Jan. 18, 2003). Mr. Ziffren has long been widely recognized as one of the
leading specialists in entertainment law.

\footnote{103} There are, however, certain documents that must be signed: (a) those that must be signed by
the writer, and probably also the director and the producer, giving the studio a valid copyright; and (b)
documents required for bank loans; and (c) an agreement on the budget for the benefit of the completion
guarantor.

By way of contrast, in the production of movies for television, there is far less uncertainty. This
observation was offered to co-author W. Klein by David R. Ginsburg, a long-time, successful producer
of such movies (and earlier a practicing lawyer in the entertainment industry) during an interview in
Santa Monica, on January 23, 2003. Ginsburg noted that contractual relations for producing TV movies
are different from contracting relationships for feature films because TV movies are produced more
quickly and on much lower budgets. With TV movies it is the firm expectation that the budget agreed
upon (along with the writer, major cast, etc.) by an independent producer, on one side, and the network
buyer and the distributor, on the other side, will not be exceeded. It is the responsibility of the producer
to ensure that the budget is not exceeded. The producer bears the cost when the budget is exceeded and
rarely will there be any additional payment for unforeseen budget excess—though if the producer fails
to deliver a finished product after having received advances, and the production firm becomes bankrupt,
the network and the distributor will bear the loss. Directors of TV movies who cannot be relied upon to
respect the budget will not find work. For feature films, the directors are often more powerful and are
given much more freedom to make changes that result in breaking the budget. Thus, contractual
obligations, both explicit and implicit, are clearer and are perhaps more important to the parties for TV
movies than for feature films.

\footnote{104} Compare this statement in the government’s request for proposals for reconstruction of the
Pentagon: “Trust that each partner [the government and the contractor] will act in accordance with
[previously stated general] expectations is essential to maintaining the relationship that will enable this
contract to succeed.” Public Release Version of the Pentagon Renovation Wedges 2-5 Request for
pressure on trust by reducing the chances of misunderstanding. Indeed, even when there is full recognition that circumstances will likely change in unanticipated ways and there is no expectation that the contracts will be signed, there may be lengthy discussions about the obligations on either side, often resulting in detailed documents. For example, in film production, there is a budget that serves, at the very least, as a guidepost for what the studio is entitled to expect and what the producer can be expected to deliver, as well as specification of payments to be made that is highly likely to be respected. Similarly, even though it was impractical to specify level of effort, skill, and creativity, and even though the contract was not signed, SJHC and DMJMH+N did have a clear understanding of the deliverables that SJHC was entitled to expect.

E. Contracts, Fees, and Incentives

All the consultants were hired for fixed fees. One question that this raises is, why were the consultants not hired at an hourly rate, the method of compensation most common for legal services? Since it was difficult to specify the quality of the services expected, and the time to be devoted to the project, an hourly rate might seem, superficially at least, to be a sensible approach (especially in a setting characterized by high levels of trust and effective reputational sanctions).

In our case, SJHC had a limited budget. The problem thereby presented could have been solved by using an hourly rate with a maximum amount (a "cap"), but the general perception seems to be that the maximum will then turn out to be the contract amount. Moreover, it was possible within reasonable

105. Put another way, people can do business on the basis of trusted relationships or on the basis of enforceable agreements, or, as in construction, on the basis of some combination of the two, with each supporting the other. Compare Lucie Cheng & Arthur Rosett, Contract with a Chinese Face: Socially Embedded Factors in the Transformation from Hierarchy to Market, 1978-1989, 5 J. CHINESE L. 143, 188 (Fall 1991): ("Contract suggests a safer way to do business with strangers [compared with doing business with family, clans members, etc.], who, lacking authority or relational sanctions for performance and security, depend heavily on the legal sanctions provided by contract law.") Cheng and Rosett later observe: "The heartland of Contract is the band of transactions that are made between near-strangers." Id. at 154. While the introduction of enforceable contracts has been important to economic development in China, the introduction of the idea of trustworthy relationships is important to understanding economic transactions and organization in America. See Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. PA. L. REV. 1735, 1806 (2001) (participants in closely held corporations may avoid specification for fear of undercutting mutual trust, but specification "may avoid the sort of nasty surprises that undermine trust in a long-running relationship"). For discussion on the role of trust, and its relationship to specifications, in strategic alliances, see George Dent, Lawyers and Trust in Business Alliances, 58 THE BUS. LAWYER 45 (2002); George Dent, The Role of Lawyers in Strategic Alliances, 53 CASE W. RES. L. REV. 953 (2003).

106. The legal services, however, were billed on an hourly rate. Klein anticipated that legal work on the legal "entitlement" from the City might be done for a fixed fee. It may be that Klein assumed it would be easier to estimate the amount of time that such work would be likely to take than to estimate the amount of time to negotiate and draft the development agreement.
tolerances for the architects to estimate how much time they would need.  
There had been a competition for the job, and Mike Russell, representing SJHC, had enough experience to know whether the contract amount was reasonable. Though all the consultants (including the feasibility consultants) worked for fixed fees, there may have been particularly strong reasons for a fixed fee for the architects. According to Taylor, architects are never content to treat a design as finished; they can always imagine another approach or another improvement. It is in their nature. The fixed fee, along with their need to make a living, forces finality.

There was always the possibility of additional fees for services not initially contemplated and described in the contract. Such additional fees would,
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however, be unusual. Paul Danna, of DMJMHN, noted that clients hate requests for additional fees. He added that his firm, unlike some other firms, had a reputation (which he valued) for rarely requesting such fees. On the other hand, Rusty Doms said that if more time and effort were needed than was expected, and the contractor asked for money, he would want to “sit down and talk about it.” His view, which seems to be common among people in business, is that a “contract has to be fair to both sides.”

contingencies is likely to result in loss of the contract. For the low bidder, the profit will generally have to come from change orders. With a cost-plus contract the financial incentive for the contractor to hold down costs is weak, but commitment to fairness and quality of performance, plus a concern for reputation may protect the owner/client.

In recent years, intermediate forms of contracting—mostly variations of the so-called design-build contract—have been developed in an attempt to preserve incentives for cost saving (and design improvement) while at the same time reducing haggling and other “transaction” costs. Under such contracts construction can begin before the design is completed, which obviously speeds up the process. Moreover, contractors can lend their expertise to the design effort. For example, the architect/engineer might specify the delivery of a certain volume of air to an area and leave it to the contractor to determine the size of the ducts. “One of the main advantages of the design-build process is the single-point responsibility of the design-builder for both design and construction problems.” Adrian L. Bastianelli, III, Notes from the Editor: Design-Build, 21 CONSTRUCTION LAW. 3 (Winter 2001). For good brief descriptions of various forms of contracting, see Christopher M. Gordon, Choosing Appropriate Construction Contracting Method, 120 J. CONSTRUCTION ENGINEERING AND MGMT. 196 (1994); 3D/International, Project Delivery Strategy, (unpublished essays), available at http://www.3di.com (only available on Internet Explorer, not on Netscape) (last visited Jan. 14, 2003); Philip L. Bruner, Design-Build: Viewed from the Surety’s Perspective, 20 CONSTRUCTION LAW. 17 (July 2000); Mark C. Friedlander, Designer-Led Design-Build: Why It Works for Contractors, 21 CONSTRUCTION LAW. 29 (January 2000); Christopher L. Noble, The Design-Builder-A/E Contract: A Comparison of Standard Forms, 21 CONSTRUCTION LAW. 5 (Winter 2001). A similar process to design-build has arisen in manufacturing. See Michael Hammer, The Superefficient Company, HARVARD BUS. REV., Sept. 2001, at 88. For discussion regarding incentive provisions in contracts for highway construction, see David Arditti et al., Incentive/Disincentive Provisions in Highway Contracts, 123 J. CONSTRUCTION ENGINEERING & MGMT. 302 (1997) (payments per day of completion ahead of schedule); David Arditti & Firuzan Yasamis, Incentive/Disincentive Contracts: Perceptions of Owners and Contractors, 124 J. CONSTRUCTION ENGINEERING AND MGMT. 361 (1998).

Another interesting variation is the Award Fee Plan used in contracting for renovation of the Pentagon, under which the contractor on a cost reimbursement contract was guaranteed neither fee nor profit. Instead, fees were to be awarded based on a complex spreadsheet analysis applying a detailed set of performance criteria and a plan for administration of the award process. See Public Release Version of the Pentagon Renovation Wedges 2-5 Request for Proposal 3 and § C at 59-61 (2001) (on file with authors). The contract states that “if the Government is greatly pleased with the Contractor’s performance the Contractor will be greatly pleased with the Government’s reward. The converse is obviously true as well.”

Perhaps the most interesting variation is the Award Fee Plan used in contracting for renovation of the Pentagon, under which the contractor on a cost reimbursement contract was guaranteed neither fee nor profit. Instead, fees were to be awarded based on a complex spreadsheet analysis applying a detailed set of performance criteria and a plan for administration of the award process. See Public Release Version of the Pentagon Renovation Wedges 2-5 Request for Proposal 3 and § C at 59-61 (2001) (on file with authors). The contract states that “if the Government is greatly pleased with the Contractor’s performance the Contractor will be greatly pleased with the Government’s reward. The converse is obviously true as well.”

110. Similarly, in construction, some general contractors have a (bad) reputation for bidding low and making their profit on change orders. See supra note 109 (discussing lowest bid). In the presence of this phenomenon, reputation is important, and one architect (not involved in the SJHC project) said that his firm advised clients never to contract with the lowest bidder. Or, as stated by Joseph Scarano, “the worst form of contract[ing] is the low bid.” There is, nonetheless, an inevitable correlation between the fixed-fee contract and the need for change orders.

111. In deciding whether additional compensation might be fair, Doms would want to know why the extra effort was unexpected, why it is needed, etc. The outcome would also, he said, depend on
To many observers, including the authors of this study, the fixed-fee contracts seem to present a problem of incentives. Given that quality was not subject to specification and that better quality would mean more work, what incentive was there to do more than a bare minimum? When the team members were asked about this issue, however, their reaction for the most part was what might best be described as puzzlement, as if it simply had not occurred to them that they might fail to deliver high-quality services. When pressed, they talked about the effect of performance on reputation and on future work, but at the same time made clear that they took pride in their work and were personally committed to doing as good a job as they could. This reaction could, of course, be attributed to concern for reputation and its effects on future earnings. On further pursuit of the issue, the team members expressed their recognition that this was important. Yet they also conveyed the impression that there was more to it than simply a concern for reputation, that their performance was a matter of personal pride and commitment.

An hourly rate would, of course, present a different incentive problem—namely, a lack of incentive to limit the number of hours and to work efficiently. In construction, in the actual building phase, the counterpart to the hourly rate is the cost-plus contract—that is, a contract in which the supplier of the services is compensated for all costs and receives a percentage of the costs as its fees. As one might imagine, this gives rise to the risk of inefficient performance.
SJHC hired the DMJM+H architects, who in turn brought in the landscape architects and the residential architect—who were by no means minor players. But SJHC hired the civil engineer and the traffic consultant. It was not content to allow the DMJM+H team to do this. Part of the reason is simply that the key people at SJHC (Klein, Russell, and Doms) had the ability to choose—they were able to identify the people they wanted and had confidence in them, based on reputation and past experience. Another reason is that civil engineering and traffic issues affected the entire SJHC development, both Phase I and Phase II, and were vital to overall, long-term success.

This may be comparable to recent developments in law practice, with the general counsel of the client corporations selecting different lawyers (and their law firms) for different functions, even for a single project, but with the lawyers then putting together their teams.

By way of comparison, the selection of production teams in the motion picture industry follows a similar pattern that may be more obvious and easier to understand. Imagine an independent producer who has developed an idea for a film and has a first-draft script. He or she approaches a studio, seeking financing. Suppose the studio likes the producer’s script and agrees to provide financing. Typically, the producer will want to choose the screenwriter, the director, and the principal cast, and will be principally, or at least initially, responsible for doing so. As previously noted, however, the studio will almost invariably insist that his selections be subject to its approval. The studio will also insist on the right to approve, or disapprove, the final script and the budget and shooting schedule. Its money is at risk, and with risk goes control. Thus, the producer and the studio executives will engage in a joint decision-making process for selection of the participants, changes in the script, and setting the budget and shooting schedule. Its money is at risk, and with risk goes control. Thus, the producer and the studio executives will engage in a joint decision-making process for selection of the participants, changes in the script, and setting the budget and shooting schedule. The principal cast members, the writer, and the director may also have suggestions, or demands, that become part of the selection, budget-setting, and scheduling process. Once the principal participants are selected, they select other participants. For example, the director is likely to have a crew of assistants with whom he or she likes to work, and a camera person. The producer will be consulted but is likely to accept the director’s recommendations for these additional participants, subject to budget constraints (which may bring the studio back into the selection process). There may be further delegation of selection of the members of the production team. For example, the camera person will select his or her assistants and crew. There are, however, two members of the production team who are important to the protection of the studio’s interests and who will be hired by the studio. The first is the production auditor. The second is the unit production manager, or UPM. The UPM chooses and supervises the carpenters and set builders, negotiates for locations, etc. The UPM thus protects the studio
from waste, excessive cost, skimming, and padding.\footnote{115}

\textbf{G. The Role of Law, Lawyers, and Legal Educators}

Experienced practitioners are sensitive to the risk that focusing excessively on difficult organizational issues and engaging in hard bargaining on behalf of clients may undermine trust and cooperation and spoil a deal.\footnote{116} Moreover, as observed in the present study, clients may, quite rationally and sensibly, be willing to do business without signing a contract, though with mutual understanding about basic obligations. These types of considerations receive scant attention in the basic law curriculum, which may train students to be far more aggressively adversarial than is consistent with good transactional lawyering.\footnote{117}

The present study also suggests that the default rules provided by formal organizational law (e.g., the law of corporations or partnerships) may fit awkwardly with the reasonable expectations of the parties. Partnership law, for example, imposes strong fiduciary obligations on partners, while the good-faith

\footnote{115. This account is based on the interview with Kenneth Ziffren, referred to in \textit{supra} note 102.}
\footnote{116. The same point has been made with respect to the lawyer's role in big-time strategic alliances. \textit{See generally}, Symposium, \textit{The Role of Lawyers in Strategic Alliances}, 53 CASE W. L. REV. 857-976 (2003). At an earlier symposium, Lee Buchheit offered a similar observation with respect to transactional lawyering at big Wall Street firms, stating:

You hire a corporate lawyer to negotiate a transaction for you; that is almost by definition the beginning of a business relationship between the two principals. Litigation, however, is the end of a business relationship. A corporate lawyer's behavior, in the context of the negotiation, reflects upon his or her client. And if the corporate lawyer comes across as grasping, gratuitously aggressive, or uncreative or unreasonable, all of that can poison the business relationship that their client and the other party are about to enter into. Sometimes you walk out of a negotiating room and your client says, "When this transaction ends I don't ever want to ever see these people again." If that disappointment is caused by the behavior of the other side's lawyer during the negotiations, has that lawyer really helped his client? On the other hand, if you’re at the litigation stage, you’re probably not looking forward to a bright future with the other side. For that reason, you’re prepared to tolerate a little more of the gladiatorial instinct in your counsel.

Symposium, \textit{Theory Informs Business Practice}, 77 CHI-KENT L. REV. 121, 140 (2001). \textit{See also} Claire A. Hill, \textit{A Comment on Language and Norms in Complex Business Contracting}, 77 CHI-KENT L. REV. 29 (2001) (observing that contracts in complex business transactions perform a "stage setting" role for the relationship, where "accommodation is more the rule than the exception").

In an interview over lunch when we were in the early stages of this project, Ken Ziffren made the same point about effective transactional lawyering in the entertainment industry. (Interview at the UCLA Faculty club, Feb. 22, 2001).


And what happens when students arrive at law school? Almost all first year courses are litigation oriented. And even to the extent that one encounters transactional courses in law school, there is still a tendency to be suspicious and say: "Watch out. The other side is probably trying to take advantage of you, so be careful. And, of course, bargain hard for your client, get the best possible deal you can." So, it is not surprising that when students emerge from law school and go into practice, they are bewildered by a client who says, "We are trying to cultivate a relationship of trust and confidence here, and everything you are doing is destroying that."

\textit{Id. at 962.} }
obligations of parties to a contract are far weaker. Yet relationships of trust were a crucial element of the teams in our study, even though there was not even a contractual relationship, much less a partnership, among the team members. At the same time, it is easy enough to think of law firms, organized as partnerships, in which there is a significantly lesser sense of mutual obligation.

These observations raise a number of questions that we do not pursue. One such question is whether the marginality of law is a general phenomenon in transactional lawyering or the result of idiosyncratic characteristics of the construction industry, with its high levels of uncertainty and the relatively short duration of projects. Another such question is, to what extent is the role of trust dependent on a strong set of rules and enforcement mechanisms that are taken for granted?

**H. Duration, Specification, and Control**

SJHC hired DMJMHN for a limited project, but there was the possibility that DMJMHN would later be hired for subsequent phases—which is what eventuated. The short initial term gave SJHC more control and provided a strong incentive to DMJMHN. Moreover, the relatively short term reduced problem of specifying the task, pending the development of more information.

Duration, therefore, can operate as both a substitute for the control that one would obtain in a traditional hierarchical firm and as a solution to the problem of specification.

**CONCLUSION: STEPPING BACK**

The question of why certain productive activity occurs inside firms and other activity occurs across markets has been the subject of extensive inquiry in law and economics. The standard explanation that derives from the work of stalwarts such as Coase and Williamson has to do with transactions costs. The firm, with its hierarchical structure and power of fiat, serves to solve problems of, among other things, opportunism, hold ups, team production, and specialization. Underlying these ideas is the problem of uncertainty or, put differently, the difficulty of specifying contacts that cover every important

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118. The fiduciary obligations of partners supposedly enhance and protect the pre-existing relationships of trust that exist among partners. The classic case on the subject is Meinhard v. Salmon, 249 N.Y. 458 (1928). For an argument that fiduciary duties operate to make trust "rational," see Lawrence E. Mitchell, The Importance of Being Trusted, 81 B.U. L. REV. 591, 614-16 (2001). But see Ribstein, supra note 71, at 556 (arguing that "law cannot produce trust").


contingency. Whatever the theory, the central theme is that the firm houses and controls production.

Contrary to the standard story, in construction (and elsewhere to varying degrees) production takes place outside the firms with which the production team members were affiliated. This did not mean that firms did not exist in a meaningful way. They did, but instead of housing production, they housed functions such as monitoring, networking, marketing, accounting, and insurance. Given the standard story about uncertainty, one might have expected that the tasks to be performed in construction are characterized by low uncertainty and an ease of specification—for example, that the plans for a building could fully specify what needs to be done to meet the client’s expectations. In fact, construction planning prior to groundbreaking is characterized by considerable difficulty of specification.

Of far more salience are attributes of construction that one might expect to find in many other settings—namely, valuable relational/informational networks, a mosaic of contractual relationships, and a culture of collaboration that depends on trust, commitment, and reputation.

121. In recent years, given the high levels of outsourcing in industries such as high tech, a number of scholars (including us) have questioned the continued value of the traditional concept of the firm (and related constructs of hierarchy and a nexus). See, e.g., Gulati et al., supra note 82, at 887; Douglas G. Baird, In Coase’s Footsteps 14 (January 2003) (Olin Law & Economics Working paper No. 175), available at ssrn.com/abstract_id=368400. Others, such as our colleague Steve Bainbridge, have vigorously argued the continued importance of these concepts. Stephen M. Bainbridge, The Board of Directors as a Nexus of Contracts, 88 IOWA L. REV. 1 (2002). The discussion in the text perhaps suggests the need for a different focus—that is, on the question: What do firms do these days? This latter question is the focus of the recent article by Baird and Rasmussen, where they ask whether firms, given what they do these days, need to be preserved as going concerns. Douglas G. Baird & Robert Rasmussen, The End of Bankruptcy, 53 STAN. L. REV. 751 (2003). Lynn LoPucki vigorously challenges the factual premises on which Baird and Rasmussen base their conclusions about the role of the law of insolvency reorganization. Lynn LoPucki, The Bankruptcy Boom: A Challenge to Baird and Rasmussen’s The End of Bankruptcy (2003) (unpublished manuscript, on file with author W. Klein).
Observers of the corporate world were surprised and bewildered by the demise of Enron in late 2001. It was hard to comprehend how Enron, seventh on the Fortune 500, with a market capitalization of almost $100 billion, could fall apart in such a stunning manner in such a short period of time (p. 93). Today, in the aftermath of Enron and other commercial disasters, questions remain: What really went wrong? Although fingers have pointed to abusive accounting and disclosure policies, could there be deeper, underlying causes? Are these recent corporate collapses emblematic of widespread corruption in the market, or should these corporate implosions be viewed as anomalies in an otherwise healthy market? Perhaps most importantly, how can we prevent these corporate catastrophes from happening again in the future?

Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and Other Major Corporations makes a timely entrance and addresses these difficult issues with a careful and scrutinizing eye. Editors Christopher L. Culp and William A. Niskanen assembled a broad and impressively comprehensive mix of essays written by expert scholars who attempt to clarify the underlying dynamics behind Enron's operation, implosion, and effects upon the market.

I. ORGANIZATION

The book is organized into five parts: the first delves into the intricate relationship between corporate innovation and governance; the next four analyze, in turn, energy and derivatives markets, structured finance, credit risk mitigation, and the regulation of corporate innovation. These parts are further subdivided into fourteen chapters, each of which explores a particular facet of one of these major areas. A sample listing of discussed topics illustrates the breadth of this book’s undertaking:

- How Enron’s role as an innovator positively contributed to the development of energy and derivatives markets, and how Enron’s failure might impact their future operation and regulation (pp. 91–149);
- How the widespread proliferation of financial contracts and techniques designed to help firms manage their credit exposure to ailing counterparties affected the impact of Enron’s failure, and consequently, the lessons we can learn from Enron about credit risk management practices and products prospectively (pp. 211–62); and
- How structured finance can be beneficial and how to mitigate the potential for abuse of structured finance activities in the future (pp. 151–208).

Each chapter begins with a fundamental overview of the particular subject area being addressed. Assuming that their readers will have various degrees of background knowledge, the contributors present this foundational information in a relatively straightforward manner. While some chapters, given their subject matter, are substantially more technical than others, these introductory sections add much to the quality of the work by laying out a short and concise overview in an understandable way before launching into detailed topic applications.

II. POLICY BATTLES

Corporate Aftershock has an underlying message and purpose, articulated from the outset by Editor Culp: the reader should step back and consider the potentially deleterious effects of hastily implementing legislation in an attempt to “fix” the modern corporation and prevent future Enron-style disasters (p. xvii). The thrust of this argument is that the reader should resist the swift and expected political reaction to the chain of corporate implosions, since calls for increased regulation of the markets, which continue to echo across the landscape,¹ may create greater problems down the road (p. xvii).

In his chapter, Fred L. Smith, Jr. “provides a comprehensive framework in which to view the Enron saga and, in particular, the calls for greater regulation that Enron’s failure has engendered” (p. xxi). He identifies two conflicting regulatory approaches that exist to handle corporate reform: the political and

¹. See, e.g., Elizabeth Bumiller & Jeff Gerth, The Blackout: Legislation, N.Y. TIMES, Aug. 19, 2003, at A 16 (discussing the need to re-regulate the energy transmission system after the August 2003 blackout).
the competitive (p. 266). Both approaches stem from the overarching question of how corporations should be governed and by whom. The political regulatory scheme relies on legislation to set restrictive boundaries and centralized agencies to monitor and regulate corporations and their activities (pp. 270–71). The public’s knee-jerk reaction to the Enron debacle is to push for and, to a certain extent, expect the federal government to follow this type of approach by “coming in and straightening things out” via regulations requiring corporations to correct corporate abusive practices (p. 286).

The second approach, competitive (or private) regulation, is decentralized in nature and relies on the free market to keep businesses in check. Smith maintains that “the Enron crisis has blinded us to the value of competitive regulation—to the idea that the best way to discipline the financial investment sector is to encourage the evolution of institutions that would profit by discovering and profiting from uncovering inept corporate management” (p. 291). This argument could, according to Smith, support utilizing external private risk managers to help monitor the corporation (p. 295).

Contributor Barbara T. Kavanagh’s chapter mirrors these overarching arguments, as applied to the realm of structured commodity finance. Kavanagh delineates the evolution of structured finance, its uses and abuses, and its “economic benefits to corporations, investors, consumers, and the economy” (p. 154). She then exposes the potential harm incurred by increased regulation of structured finance activities (id.). The following passage, which channels the volume’s continuous theme, succinctly summarizes Kavanagh’s sharp and insightful analysis:

Structured finance generally has its own inherent checks and balances protecting the interest of all parties involved, from seller to investor. In the Enron case, however, a group of senior executives seems to have successfully bastardized the process in pursuit of personal wealth and power. Current efforts to revamp materially fundamental aspects of structured finance, especially through new political restrictions on these activities, are, however, tantamount to “shooting the messenger.” Fraud can, has, and will be perpetrated by insiders through any means at their disposal if insiders decide the criminal path is the one they want to take. Draconian constraints we might arbitrarily place on certain asset or income categories will not change that. (p. 171).

As a collection, Corporate Aftershock contends that political regulation may very well be the wrong path to take. Given the assumptions of the political regulatory scheme, such an approach seems counterintuitive. Under the political regulatory framework, it seems perfectly plausible that a federal agency, with its broad oversight powers and backed by muscular legislation, could effectively protect the interests of the company’s investors and make sure that corporations are playing by the rules.

At the same time, Corporate Aftershock eloquently outlines the dangers inherent in the political regulatory approach. For instance, contributor Smith
demonstrates how political regulation hinders market innovation, as financially
innovative corporations on the frontier that could revolutionize the market
would face severely limiting regulatory roadblocks (p. 295). Restricting
corporate innovation in this way, Smith argues, could lead to increased risk of
market stagnation (pp. 266, 286–88). A better solution, according to Smith, lies
in the competitive regulatory domain: “A vigorous market for corporate control
is a powerful disciplining agent on companies that deviate from acceptable
business conduct” (p. 296). This point highlights the book’s bias—while the
editors blithely accept Smith’s claim that Enron contributed positively to the
development of energy and derivative market, this issue is bitterly debated by
economists, politicians, and representatives of the investing public. It is
important, therefore, to take this argument with a grain of salt.

The book’s arguments carry much weight—each chapter issues a powerful
examination of a financial market or instrument relevant to Enron, coupled with
well-reasoned public policy analyses. The breadth of topics—from the pitfalls
of conventional accounting to the drawbacks of the consensus model of
 corporate governance—is commendable. However, most readers will notice the
imbalance in perspectives and dearth of positions that adequately investigate
any potential benefits that may arise from, say, increased legislation or some
other application of the political regulatory approach. While the book serves as
an excellent statement against rushing to implement legislation post-Enron, it
falls short of fully exploring the benefits of this process, if undertaken in a
more prudential manner.

III. CONCLUSION

*Corporate Aftershock* sets out to describe the public policy lessons that can
be gleaned from the demise of Enron and other corporations, and it succeeds to
a great extent. Editors Culp and Niskanen collect a set of powerful analyses of
the relationship between policy initiatives and the market economy, as well as
superb insight into the reasons behind these collapses with a focus on the
characteristics of the markets Enron participated in and the financial devices
Enron employed in its pursuits. The reader would gain a great deal, though, by
reading this as a one-sided, anti-regulatory treatment that might underplay the
strengths of the political regulatory model. With this caveat, Culp and Niskanen
have assembled an effective and educational overview that is likely to assist
anyone involved in the creation, interpretation, or implementation of
corporation policy initiatives.
A Familiar Manifesto

Wall Street on Trial: A Corrupted State?

By Justin O’Brien


Reviewed by Kenneth K. Hsu

In Wall Street on Trial Justin O’Brien attempts to expose the institutional and systematic corruption that plagues American political and financial institutions. He tries to dissect the actions of the network of actors that he claims have greedily robbed honest investors and the public of their money and trust. The book, however, is filled with familiar rhetoric of moral high ground and overtones of self-righteous indignation. Thus, the narrator not only fluctuates between the perspectives of an investigative journalist and an interdisciplinary academic, but also seems to take on a role of moral police, seemingly wanting to shame the relevant actors into behaving better.

Essentially, Wall Street on Trial is a book without a hero, and this quality makes the book unreadable. Throughout the work, O’Brien unabashedly bombards his readers with unapologetic doses of cynicism about the state of the American political and financial affairs. He leaves no stone unturned, in directing his insults at US institutions: Republicans, Democrats, accountants, bankers, lawyers, journalists, mayors, bureaucrats, soldiers, and defendants charged with corporate frauds, prosecutors who levied charges, voters, and regular investors each receive their respective share of heavy-handed critiques. In O’Brien’s worldview, all such actors are responsible for a morally bankrupt system that is too weak to regulate itself, but too potent and protected by political powers to be overhauled.

The book becomes a series of lectures aimed at proving the greed and moral ineptitude of American businesspersons, politicians, and other relevant actors. In the post-Enron world, however, O’Brien’s tremendous research and analytical efforts prove points already too familiar to public discourse. In the end, O’Brien’s sound and fury against the structural corporate greed leaves the

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readers without a clear picture of the root of the American problem or any viable solutions that would have prevented the scandals of the late 1990s. Instead, the reader is left perplexed, as to the British scholar's motivation for deconstructing the American political and financial institutions in such a brazen and accusatory manner.

O'Brien is a former investigative journalist for the BBC and a current research fellow at the Institute of Governance, Public Policy and Social Research, at Queen's University, Belfast. True to the Institute's interdisciplinary approach to the study of public policy, O'Brien's methodology involves a beat writer's fast-paced narrative accounts of corrupt dealings intertwined with a broader analysis drawn from the field of cultural studies. O'Brien attacks the issues with an aggressive style of an independent weekly. At the same time, his analysis lacks academic rigor, drawing sources outside of traditional political, economic, and legal frameworks without proper scholarly integration.

O'Brien's bias is evidenced by the parallels he draws between the methods of Wall Street's corporate and political actors and the methods of "the Mafia" and historical urban political machine politics (pp. vii, 129–30, 138, 149–50). The author lumps together all of these figures as one group of the hopelessly corrupt, purposefully criminal, and morally bankrupt (pp. vii, 141). In fact, O'Brien goes so far as to advocate using the Racketeering and Corrupt Organization Act—historically used to prosecute criminal organizations—to prosecute corporate entities (id.). While these comparisons contribute to O'Brien's overall case that the corporate and governing structure has serious systematic and moral flaws, the use of these comparisons and metaphors ultimately undermine the author's credibility as a scholar. Instead of providing deeper insights and details of potential solutions to the problems that have created the current crisis in corporate governance, O'Brien presents an unforgiving and oversimplified series of truisms that leaves the reader unfulfilled.

Further illustrating the poor focus of the book, O'Brien attacks the Bush Administration's unilateral decision to enter Iraq, throughout his analysis of corporate misconduct. O'Brien simplistically boils down all of the complicated issues of the war to two theses. First, the journalist argues that Bush and Karl Rove's Iraq Doctrine was developed to mask the Administration's unwillingness to solve the crisis of corporate governance (pp. 22–24). This unwillingness, O'Brien maintains, stems from the flow of too much money and favors between the White House and Wall Street for the administration to step in (id.). Second, the academic claims that Rove has manipulated the crisis in Iraq so as to "ensure maximum political advantage" for Bush to win the 2004 election (pp. 23–24). Together, these theses turn O'Brien-the-journalist-and-academic into O'Brien-the-conspiracy-theorist. In effect, the book indicts Rove
A Familiar Manifesto

for orchestrating a grand conspiracy, along the lines of the apocryphal tale of political maneuvering found in the movie *Wag the Dog.*

O’Brien’s analysis, while presented with all the stern seriousness of an academic, strays far afield from the purported heart of the discussion—the flaws of the corporate and financial structures. Given this shortcoming, the narrator’s humorless attitude and academic postures are decisively unconvincing to the reader. *Wall Street on Trial* becomes a free space for O’Brien-the-moral-crusader to roam cynically about American institutions without providing enough of a precise academic understanding of the subject to convince anyone but those who might already be hostile to American ways.

In *Wall Street on Trial*, even the “good guys” get their doses of unsophisticated critiques from the author. After praising Eliot Spitzer, the New York State Attorney General who gained unprecedented success prosecuting investment bankers and analysts involved in corporate fraud, for attacking the structural issues behind the corporate governance crisis, O’Brien proceeds to undermine Spitzer’s character (pp. 143, 173, 175–76). The narrator paints a negative portrait of Spitzer as an ambitious political climber and outsider. The narrator seems to suggest that Spitzer’s success had more to do with his aggressive style and ambitious politicking than a true commitment to creating shareholder-beneficial public policy. As a final jibe, O’Brien wrote extensively on politicians with similar pedigree and in the same position of power and influence that become inclined to adjust their goals vis-à-vis the financial community as they require more and more money from donors on they climb up the political ladder (pp. 218–46). This characterization supports O’Brien’s argument that the task of cleaning up Wall Street has become the province of ambitious prosecutor-politicians. Instead, O’Brien argues, this public policy must be actuated by a legislature, which has both the legitimacy and the institutional duty to make new laws to regulate the financial industry.

O’Brien’s cynical prose accuses many and implicates all. As a result, his style and manifesto lose the nuance necessary to analyze a financial crisis in which many victims, including the average investor, were involved. O’Brien wrote a book with no hero, and he wrote for no audience except those like himself who have already put the entire United States on trial and convicted her for eternal damnation. Toward the end of his book, O’Brien unmask his biased view of American legal institutions, noting that “[i]n Britain when you had mad cow disease, you killed the cows. In the United States our response would be to regulate the cows. It is a quintessentially American thing to do” (p. 272).

*Wall Street on Trial* is a British political journalist’s attempt to attack the legitimacy of American institutions. While this goal may be appropriate to
some extent, given the institutional maladies in the American financial community, O'Brien employs an improper forum, if not the wrong profession, to express that point of view. His sound and fury would signify something in an independent weekly, where repeated and familiar political manifestos and rhetoric are read and welcomed. As an academic attempt to shed light on the corruption of Wall Street and its Washington counterparts, however, the book fails.