Criteria for Good Laws of Business Association

William Klein
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INTRODUCTION

Academics debating various aspects of the law of business associations are often like ships passing in the night. One reason for their inability to join issue may be a failure to identify goals or objectives—the failure to weigh proposals against explicitly stated criteria and to engage in effective cost-benefit analysis. This failure to ground proposals or critiques in explicit criteria stands in marked contrast to the customary approach for tax policy analysis by lawyers and economists, who regularly refer to and discuss the criteria for good tax laws.\(^1\)

The “laws of business association” contemplated in this paper consist of the statutes, regulations, judicial interpretations and rules, and commonly used legal forms relating to the organization of business entities; relationships among shareholders, managers, and other stakeholders; and securities market regulation.

Ultimately, the criteria for good laws of business association are derived from and must be grounded in fundamental value systems or political perspectives.\(^2\) The present paper, nonetheless, focuses exclusively on less fundamental, more immediate criteria. In doing so, it attempts to identify all criteria that people with different underlying values and perspectives might find appealing. This means that some of the criteria endorsed by some observers will be rejected by others—which is as it should be when the objective is to

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1. A recent and notable exception to the failure of scholars writing about business associations to identify the appropriate criteria is found in Daniel K. Tarullo, *Neither Order Nor Chaos: The Legal Structure of Sovereign Debt Workouts*, 53 EMORY L.J. 657 (2004). This excellent article identifies goals that are relevant, concretely, to the problems arising in sovereign debt workouts: (1) “minimizing inefficiency in the workout process,” (2) “optimizing external financing for emerging market countries,” (3) “limiting the need for increasing and deploying IMF resources,” etc. These goals are considered in the context of various constraints. The present paper, by contrast, attempts—perhaps unwisely—to identify a more general set of criteria. The choice of approach—concrete or general—is certainly worthy of discussion.

2. See Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 924 (1984) (presenting a “typology of democratic ideals that is of sufficient generality to be helpful in assessing the major policy recommendations of participants in recent debates over corporate law reform”). One might, however, be skeptical of the value of fundamental principles of good and evil in shaping the rules of business-association law. In the tax context, Boris Bittker compared the Comprehensive Tax Base (“CTB”) “concept to the first precept of Aquinas, ‘Do Good and avoid evil.’” Boris I. Bittker, *A Last Word, in Boris I. Bittker et al., A Comprehensive Income Tax Base?: A Debate* 126 (Federal Tax Press 1968). Bittker went on to state that if people who relied upon the CTB “find this bland principle comfortable, I would not want to rob them of it. For myself, I have never been able to extract from the Angelic Doctor’s first principle any guidance to such issues as therapeutic abortion, the gold standard, or student control over the university’s curriculum; and I find equally little help in the CTB formula as a guide to action when I approach questions of income tax policy.” Id. at 126-27. See Psalms 34:14: “Turn away from evil and do good.”
identify and clarify sources of dispute.

It is clear that even among criteria that are consistent with a single underlying set of values or perspectives, conflict is inevitable. For example, administrative feasibility is often likely to conflict with fairness and economic efficiency with redistribution. And it is implicit in the list offered here that a ranking (for example, that fairness is more important than administrative feasibility) would not, in the abstract, be meaningful.

Moreover, one must always bear in mind the question, compared with what? That suggests a general, overriding criterion: the relative advantage or disadvantage of the law of business associations in achieving a goal. For example, redistribution of wealth might be accomplished by rules relating to corporate governance (for example, requiring or encouraging representation of employees on a corporate board of directors), but that goal might be better served in other ways—for example, by protective labor legislation or by the tax system.

For convenience, and for whatever additional insight it may offer, specific criteria are divided into four broad categories: (1) those concerned with fairness (both private and public); (2) those concerned with promoting economic goals; (3) those concerned with controlling political and economic power; and (4) those concerned with administrative costs. This taxonomy, like all taxonomies, is unavoidably arbitrary. There could, among other things, be more or fewer broad categories. Moreover, the specific criteria do not all fit as neatly as one would like into a broader category and some criteria seem to belong in more than one category. Primary attention should be paid not to the four broad categories but rather to the specific criteria identified within each category.

The list presented here is admittedly cursory, even superficial. It is offered only as a starting point. Some of the criteria are abstract and general and may have no useful application to the law of business association. The criteria probably should be viewed less as a set of proposals than as a device designed for a brainstorming session; a list to be culled, modified, and restated. It is not a recipe for resolving conflict but rather a device for forcing people to identify their goals. For example, some people advocating director concern for stakeholders may be doing so in the interests of ex ante economic efficiency, while others may be doing so as part of a strategy of redistribution, helping the poor, or protecting the environment. Identification of the goal may not resolve conflict but might well improve the quality of the discussion.

The list is tentative and is offered with the utmost diffidence. Indeed, it will be useful to question the entire project—to raise the question whether criteria

3. See Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 GEO. L.J. 439, 441 (2001) (suggesting that "the most efficacious mechanisms for protecting the interests of nonshareholder constituencies—or at least all constituencies other than creditors—lie outside of corporate law").
that are implicit and perhaps obvious should not continue to be viewed as sufficient, as at present and in the past.

In fact, while the list that follows is the one presented for the symposium, the other papers submitted for the symposium, and the discussion among the participants, resulted in several revisions of my thinking. First, the papers by Professors Macaulay and Bratton make me aware of the value of shorter lists, and of what Professor Bratton refers to as “binaries.” Following Macaulay, I am impressed by the possibility of a four-cell matrix with one axis divided between rules and discretion and the other between the golden rule and the law of the jungle.  

Second, it may be best to employ criteria that are tailored to the particular project at hand, a point nicely made in Professor Fujita’s paper. In fact, I have used this approach myself in two articles about business organization. The more generic list presented here might nonetheless be useful in fashioning criteria that are particularly relevant to whatever topic is being examined.

Finally, in thinking about criteria it may be useful to distinguish between (a) that part of the law of business associations that is concerned with “deals” and how they are made, especially with small businesses and startups, and (b) the organization and control of public corporations. The criteria presented below seem most relevant to the latter category, while most of my work has related to the former. The former is mostly in the realm of the law of private contracts while the latter has more to do with regulation and with contract as a metaphor.

Finally, I really don’t much care what criteria people adopt and apply, just so they tell me what they are. There may come a time when certain criteria have been applied often enough that restatement is unnecessary. But we are a long way from that time.

4. This does not do justice, however, to Macaulay’s more sophisticated matrix. My colleague Stephen C. Yeazell once offered the thought that at faculty meetings people could be divided into Cold Steelies and Warm Woolies, a dichotomy that might explain much of the controversy in the law of business associations. The Warm Woolies would rely on concepts such as fiduciary obligation, entire fairness, good faith, the golden rule, unconscionability, and implied contract. The Cold Steelies would invoke phrases such as caveat emptor, strict interpretation, the law of the jungle, tough love, and “you made your bed, now you must lie in it.” Compare, e.g., Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842 (1976), with Nixon v. Blackwell, 626 A.2d 1366, 1379-81 (Del. 1993) (en banc). On the other hand, a friend once told me that the world can be divided into two kinds of people: those who divide the world into two kinds of people and those who don’t.

CRITERIA

I. Criteria Concerned with Fairness (Public and Private).

A. Enforcement of private bargains. Wholly apart from economic considerations, there seem to be strong reasons to enforce bargains freely entered into. The idea is that there is a moral basis for enforcement of bargains: good people keep their promises. Their failure to do so is unfair to the other party to the bargain. Our legal system ought therefore to enforce bargains in order to promote this kind of fairness. Thus, for example, if people enter into a partnership for a specified term, it is appropriate that the law provide, as it does, a penalty for early withdrawal. There are, of course, efficiency reasons for reaching the same conclusion, but it is important to keep in mind the fairness reason as well.

B. Avoidance of harshness. There is a limit on enforcement of bargains and rules. Though economic efficiency may point in the opposite direction, forgiveness, compassion, and other such considerations bear on fairness.

C. Fair dealing. By no means is it possible to specify all the terms of business relationships. Participants in a venture or deal are constrained by “bounded rationality.” Accordingly, it is necessary to have general rules of fair dealing and to impose those rules even when they may seem at variance with the express terms of the bargain. It makes sense, for example, to have a strong notion of fiduciary obligation in partnership law and possibly to import similar concepts into corporate law. There is an obvious economic basis for this criterion. It promotes useful exchange by assuring the parties to the exchange that problems that they did not think about will be resolved in a manner that likely would have been satisfactory to them at the outset. But there is also a less tangible, psychic basis: the benefit that derives from a sense that one has been treated fairly.

It seems useful here to reiterate that each criterion may be in conflict with, and may be trumped by, some other criterion. Here, for example, it should be obvious that the “fair dealing” criterion may conflict with the various “criteria concerned with economic goals” and “criteria concerned with costs of administration.”

D. Protection of expectations. This criterion addresses expectations created by governmental (including judicial) actions. When government bestows benefits or creates institutions, people begin to rely on those benefits or institutions. No amount of warning as to the temporary nature of the benefit is likely to prevent such reliance. It is a commonplace observation that people suffer far more from losing what they have than from never having had it in the
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first place. That is why there are "grandfather" clauses. It is fair and just, or at least compassionate, that we have such provisions. (It also makes good sense for other reasons. Often legislation that is wise and beneficial is defeated because of a failure to write in a grandfather clause.)

E. Redistribution. One widely accepted goal of social policy is to reduce the inequality of income and wealth that is associated with a capitalist system. The income tax system is thought by many to embody this goal. Perhaps corporate law is not the best vehicle for achieving redistribution. If so, that will be at least in part because of conflict with some other criterion. Disregarding such conflict, however, redistribution is certainly a relevant criterion, at least for many people. The rules relating to making gifts to charity, proposals for community or public representation on boards of directors, and the rules relating to liability of directors may all reflect the appeal of redistribution. That appeal may be misguided, but if so it is not necessarily because redistribution is an inappropriate criterion but rather because the particular proposal is not an effective device for achieving redistribution. The basis for concluding that it is an ineffective device should be found in one or more of the other criteria. For example, it may be that holding a director liable for approving a sale of the firm without adequate investigation would redistribute wealth from the rich to the less rich. At the same time it seems unfair (not all directors are rich and not all shareholders are poor) and may discourage useful economic activity.

F. Protection of the weak. Protection of the weak is an aspect of fairness that requires special attention because it seems to motivate so many commentators who reject reliance on market mechanisms and on private exchange. (Compare criterion III(F) below, relating to those who take advantage of the weakness of others and who, in doing so, behave arrogantly.) Much of what we find in state and federal securities laws reflects this criterion. Those laws may also promote other goals (for example, promotion of liquidity (criterion II(D)) and at the same time be at odds with still other goals (for example, facilitation of exchange (criterion II(A)) and limiting the cost of governmental enforcement and private compliance (criterion IV)).

G. Allocation of the cost of harmful conduct to the proper person. This aspect of fairness is reflected in our tort and contract law in obvious ways. It is also reflected in less obvious ways in legislation and regulations designed to prevent conduct that may cause harm that cannot effectively be compensated,

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6. For a variation on this criterion, combined with the next one (protection of the weak), see Lewis D. Solomon & Kathleen Collins, Humanistic Economics: A New Model for the Corporate Social Responsibility Debate, 12 J. CORP. L. 331, 337 (1987):

The [authors' proposed] model redirects corporate ends from pure profit maximization—the neoclassical model of competitive markets—to include concern for human beings, primarily employees, who form a constituency of the corporation. The objective of the model is the development of corporate values that promote creation of an economic organization which will further human growth and development as a part of a larger interest in the quality of life.
such as environmental harms. Some commentators have suggested that these kinds of harms can be reduced by changing the structure of the governance of the corporation—for example, by giving directors of corporations greater latitude in sacrificing profit in order to avoid harm to the environment. Similar thinking seems to play some role in the development of the securities laws.

H. Maximization of individual freedom and autonomy. This criterion argues for limitations on the regulation of the rules of business association (for example, for treating codes of corporation or partnership laws as “form contracts” that should be freely subject to modification) and for securities laws whose function is limited to providing a “seal of approval” (that is, an assurance that the rules of the game are fairly enforced). While individual freedom and autonomy can be thought of as aspects of fairness, they might also (or better) be thought of as aspects of economic efficiency, so that this criterion would fit nicely under the next general heading.

I. Evenhandedness and objectivity. The notion that people who are similarly situated should be treated alike—equal treatment of equals—is a fundamental but singularly elusive goal of a good society. The problem is to identify what counts as similarity and what does not—which generally will lead to other criteria. It is difficult, however, to see just what role evenhandedness has to play in corporate law.

Objectivity may be an aspect of evenhandedness. The idea is that the law should prescribe requirements and outcomes rather than leaving these to the discretion of government officials. The relevant aspects of similarity would be specified to lead to uniform treatment of all people with the specified characteristics. At the same time, however, specificity may require omniscience and, in the absence of omniscience, may treat similarly people who are not similar in important respects and thereby oppose the criterion of fundamental evenhandedness.

J. Full Disclosure. In some situations, people who enter into a transaction and later learn of facts, known to the other side, that are inconsistent with their assumptions will feel that they have been treated unfairly. Sometimes this feeling will be reasonable, sometimes not. It is true that the ability to take advantage of information that has been created or ferreted out with some effort, without disclosure to others, can have desirable incentive effects and may be consistent with an intuitive sense of fairness. At the same time, there are situations where nondisclosure will seem unfair. A sense that one will be treated fairly may promote useful exchange and may therefore justify legal requirements of full disclosure—as in the issuance of securities to the public and in the reporting of financial data on a regular basis. Sometimes it may be the law of the jungle that accords with a sense of fairness and with economic efficiency, but other times it may be the golden rule that does so.
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II. Criteria Concerned with Economic Goals.

A. Facilitation of exchange. This criterion reflects the well recognized assumption of most economists in this country that economic well-being is enhanced by exchange and that the more freedom there is to engage in exchange the better off people will be (disregarding conflict with other criteria). Under this criterion one would conclude that there should be maximum freedom to make contracts. The securities laws would be abolished except to the extent that they are necessary to insure that people have enough confidence in the markets to be willing to trade (or able to do so without costs higher than those imposed by government regulation). Corporate codes would be strictly "form contracts." At the same time, since exchange depends on the anticipation that one's property and contract claims will be protected, this criterion tells us that one must enforce bargains. No "hard luck" stories should be accepted.

B. Macro efficiency. A meta-criterion is that rules should maximize "aggregate social welfare." Societal wealth maximization depends in part on exchange and on efficient markets, which provide liquidity and efficient allocation of resources. Or at least so it is thought by those seeking to protect investors and markets through federal and state securities laws.

C. Micro efficiency. Laws should not encourage firms to engage in wasteful or inefficient behavior. For example, the rules relating to director duty of care in takeover situations may encourage directors to waste money on useless fairness opinions. For another example, accounting rules may encourage firms to provide compensation in the form of stock options when other forms of incentive compensation have better incentive effects.

D. Liquidity. The willingness to invest may depend on the ability to sell in the future. Thus, it is desirable to insure that there will be good markets for investment interests. To that end, laws should protect confidence in markets. At the same time, the legal structure should make it easy for people to sell their investments. Barriers to liquidity that are not necessary to the maintenance of the markets should be avoided. The Williams Act seems to violate the latter half of this criterion (barriers), though it may help promote the former half (confidence).

E. Specific goals. As in the tax system, corporate laws can be used to promote objectives that are "extraneous" to the laws of business organization, or at least seem extraneous to many. For example, laws requiring "public" members of the board of directors may be used to enhance environmental protection or to help low-income workers. Much of the debate over such possibilities seems confused because it fails to recognize on the one hand that

7. See Henry Hansmann & Reinier Kraakman, supra note 3, at 441 (claiming that in corporate law there is "a consensus that the best means to this end... is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests").
such goals are in fact extraneous to the laws affecting organization (and that one should therefore be very careful to examine alternative solutions), and on the other hand that the fact that the goal is extraneous is by no means a dispositive basis for rejecting a proposal.

F. Predictability. Rules should be clear enough so that people will not be inhibited by uncertainty from undertaking useful business activity and will not incur needless costs in meeting their obligations. (See the discussion of objectivity above.) In addition, rules should not be changed too often.

G. Caveat emptor. The principle of caveat emptor may encourage self-reliance and self-protection, which may economize on the use of resources for regulation, enforcement, and compliance.

III. Criteria Concerned with Control of Political and Economic Power.

A. General thoughts. Our system creates a problem of legitimacy. By what authority do people not elected to office by the public exercise economic power? By what right do they make important economic decisions? The answer may be that they are entitled to make such decisions because their wealth is at stake. If their wealth is at stake then there are two arguments for their power. First, the money is theirs and they should be free to do with it as they wish, even if they choose to squander it. The interests of others should be protected by contract and if not so protected should be ignored. Second, for the most part, according to Adam Smith and his disciples, owners of wealth, seeking to promote their own self interest, will best serve the interests of all. This is all well and good except for separation of ownership and control. Then the legitimacy of exercise of control fails unless managers are truly agents for the owners. If they are not, then why are they, rather than some government official, allowed to determine, for example, whether a plant will be closed in one town and opened in another? There are two ways of coping with the power issue in the presence of the public corporation. The first is to think of managers as surrogates of the people with their money on the line. The second is simply to ask what better alternative is available. The first focuses on shareholder democracy, takeovers, etc. The latter focuses on the supposed evils of government regulation.

B. Effective shareholder control. Given the above general remarks, the reason for this criterion should be obvious. Examples of its application are also obvious—proxy rules, cumulative voting, an so on. Some of those applications may, of course, be misguided, because of conflict with other criteria.

C. Public involvement. To the extent that one is not convinced of the legitimacy of control even by owners themselves or to the extent that one is concerned with the separation of ownership and control, one may want some form of public involvement in the corporate decision-making process. It is not a sufficient response to this criterion to say that public concerns should be
addressed by laws relating to specific problems. That response assumes the
prima facie legitimacy of the traditional control mechanism. This criterion is a
reflection of an unwillingness to make that assumption.

D. Limitations on specific actions. Suppose that the public, acting through a
legislature responsive to its wishes, decides to impose a specific rule relating to
water pollution. That rule will have a substantive goal. But it may also reflect a
concern with the value of the process. One may want public bodies to make
decisions relating to the environment not because those decisions would be any
better than decisions made by people in industry (responding to tort damages,
among other things), but simply because of doubt about the legitimacy of a
private decision if the people making the decisions are managers who are not
risking their own money and even if they are in fact risking their own money.
(If they are risking their own money then you may still want to impose
limitations on their actions, but for a different reason.)

E. Legitimate the role of management and its exercise of power. For
example, facilitating takeovers may be a good idea because takeovers keep
managers relatively respectful of the public interest and humble. One concern
arising from the separation of ownership and control is that managers will
waste economic resources. If they are going to do that, why not replace them
with government officials? Thus, supporters of free markets are relieved by,
and tend to rely on, Henry Manne’s arguments on takeovers as a disciplinary
mechanism and on the empirical evidence in support of that thesis.

F. Limit the use, and punish the abuse, of power. This may be mostly what
drives Ralph Nader and his followers. Under this criterion, if a rule burdens or
insults management, it is a good rule. If it limits their power at the same time or
causes them financial hardship, all the better.

G. Allocation of power. The power to make and enforce rules should be
assigned to the entity best able to exercise it: to federal, state, or local
government, to agencies, to firms, or to organizations of firms.

IV. Criteria Concerned with Minimizing Costs of Administration and
Compliance

A. Objectivity. Objectivity was previously listed as an aspect of fairness
(see criterion I(I)). Objective rules and regulations also, and more obviously,
reduce the costs of administration and compliance.

B. Self enforcement and private enforcement. Reliance on firms and
industries to police themselves may, on balance, reduce costs, if the costs of
such private policing are less than the costs of governmental enforcement.
Similarly, reliance on the concept of the private attorney general to enforce

rules such as Rule 10b-5 may be more cost effective than allocation of greater resources to regulatory agencies.

C. Limit costs of private compliance. The costs of private compliance can be quite onerous. The costs of operating as a public corporation, for example, increased substantially with the enactment of the Sarbanes-Oxley Act. These costs reduce the liquidity and increase the capital costs of emerging businesses, which certainly counts heavily against such enactments.

D. Old laws are good laws. Learning the rules and how to comply with them is a costly process, as is rewriting them. Again, consider Sarbanes-Oxley. This is not to say that change is bad, only that its costs must be accounted for.