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Robert B. Thompson†

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The most dramatic change in law teaching over the last generation has been the growth of interdisciplinary scholarship. The long dominant pattern of scholars working in silos, oblivious to adjacent disciplines, has given way to recurring examples of information arbitrage, and learning generated at the intersection of law and other bodies of knowledge. Professor William Klein was on the leading edge of this movement. His book, *Business Organization and Finance*, pioneered the integration of finance and legal principles, and led a host of such approaches. The topic of this Symposium, Criteria for Good Corporate Law, illustrates that we do not have to venture even to an adjacent discipline for a stimulus to prod us beyond our traditional blinders. Bill Klein's work in tax law has led him to push corporate scholars about the absence of criteria for good corporate law, and to suggest a thoughtful metric by which we might evaluate our ongoing discussions about the content of corporate law.

I. CRITERIA CONCERNED WITH THE RELATIVE ROLE OF LAW AND PRIVATE ORDERING

My focus is to suggest a category to supplement the four initially provided by Professor Klein. In the lexicon of the original four, I would label this new category "Criteria Concerned with the Relative Role of Law and Private Ordering." In addition to criteria concerned with fairness, promoting economic goals, controlling political and economic power, and administrative costs, this fifth category seeks to highlight what should be a guiding force for any law: an awareness of the alternative constraints on human behavior from private ordering, and a recognition of the areas in which law has a relative advantage (or does not, as the case may be). This broad category in turn suggests six more specific criteria for law: (1) private ordering as the first mover, (2) preserving law's humility, (3) preventing externalization, (4) reducing transaction costs/creating wealth, (5) filling gaps in bounded rationality, and (6) getting the preferred balance in our federal system. Following a discussion of these criteria, I address briefly how this category might shift the analysis of corporate issues, and I then suggest the concept of piercing the corporate veil as a case study to test the use of such criteria.

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1. Constraining Human Behavior: Private Ordering as the First Mover

Corporate law, more than most legal subject matter areas, illustrates how law is but one constraint on human behavior. In the transactional and collective action settings that are central to corporate law, the non-legal methods of controlling behavior become immediately obvious. Markets (e.g. products, capital, executive services, and takeovers) regularly upstage the law as the primary determinant of behavior. Alternatively, private ordering, particularly in the form of various contracts providing incentives and arrangements to monitor behavior, does the work that might be done by law. Indeed, private ordering precedes law; law is often a response to the deficiencies in private ordering such as the externalization, bounded rationality, and transaction cost issues that are included in Klein's original list. Sometimes such deficiencies can justify public control (Klein's Criteria IV(D) and (E) suggest such an argument). But a core criterion for good law should be to recognize the availability of alternative constraints on human behavior that precede the making of law. Klein's Criteria I(A), II(A) and IV(A) reflect the relative advantage, even the primacy, of private ordering in key categories. My additional category emphasizes the relationship of these regulators of human behavior.

2. Recognizing Law's Humility

Corporate law, at first glance, may appear as a plenary governor of collective business behavior. Corporations statutes appear to provide rules for the entirety of an entity's life from birth to death and everything in between. But the law's impact on organizational behavior is surprisingly lumpy. Executive compensation is lightly regulated, even after the crises of the last few years. In contrast, conflict of interest situations are subject to intense legal scrutiny. Director conduct is at the heart of corporate law; officer conduct, at least until the recent wave of post-Enron reforms, is left to other devices. Consider that officers are hardly mentioned in most corporations codes. And even more telling, corporate codes themselves mention only three participants in corporate governance: directors, officers, and shareholders. There are, of course, other participants in the corporate enterprise who have a real interest in its progress, for example, employees, creditors, suppliers, and the community.

2. This relationship has been written about often. My suggested treatment derives from Robert B. Thompson, The Law's Limits on Contract in the Corporation, 15 J. CORP. L. 377 (1990).
3. A general incorporation statute often contains nothing about executive compensation. See, e.g., DEL. CODE ANN. tit. 8, § 142 (2005). Case law in this area has traditionally provided only a light review of director decisions regarding executive compensation. See, e.g., Heller v. Boylan, 29 N.Y.S.2d 653, 679-90 (Sup. Ct. 1941), aff'd mem., 32 N.Y.S.2d 131 (App. Div. 1941) (“Courts are ill-equipped to solve or even grapple with these entangled economic problems.”).
5. The Model Business Corporations Act § 8.42 is a recent addition that is more extensive than most state statutes.
where it operates, but these actors dare not look to corporate law to work out their relationship to the entity. The appropriate conclusion is not that the relationships left out of the corporations codes are unimportant, but rather that law defers to other regulators of human behavior when those alternative regulators have a relative advantage.

Given the alternative constraints on human behavior, an important criterion for developing good corporate law would be to ask if law has a relative advantage in regulating the conduct in question, or whether markets or some other type of private ordering might work as well. Law is humble. If another constraint has a relative advantage in addressing a particular human behavior, law will not provide costly redundant constraints.6

3. Preventing Externalization of Behavior

The option to choose from a menu containing both law and private ordering as a means to address various human behaviors in corporations suggests that a different emphasis would emerge if, in addition to the original four categories, the criteria for good corporate law included my suggested category. Private ordering is least likely to be effective when the private actors do not bear the costs of their own acts. Law has a particular function to serve in protecting those outside of the organization from the perhaps selfish decisions of those within the organization. Environmental law is one example of this, where the government forces polluters to internalize the costs of their use of resources. There are a host of others, including antitrust laws. (See Klein's Criteria I(G) and II(C).) This protection of outsiders is found in the consumer relations aspects of our securities laws, in takeovers laws, in laws relating to dividends and minimum corporate capitalizations, and in agency laws regarding who can speak for the corporation.

4. Filling Gaps in Bounded Rationality

The previous section addresses the invocation of law to protect outsiders to the corporation, that is, parties other than those groups named in the corporation statute who may be interacting with the corporation on a one-time basis, or who may be unable to meaningfully negotiate terms in contracts with the corporation. But law also has a role to play among parties who are repeat players in dealing with each other, and who are insiders to the corporation. Law facilitates these relationships by filling gaps, for example, as to topics for which

6. Professor Gilson has developed this point very effectively. See Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 STAN. L. REV. 819 (1981) ("Where incentive mechanisms created by one part of the corporate structure—the various markets in which the corporation and its managers function—constrain managerial discretion to perform inefficiently, one would not expect a different part of the structure to provide redundant controls. As we have seen, the legal elements of corporate structure are consistent with this conclusion.").
the parties would have difficulty planning in advance. Bounded rationality, as covered in Klein's Criterion I(C), illustrates this. Fiduciary duty is the most recurring example of this in corporate law, but there are others.

5. Reducing Transaction Costs/Creating Wealth

A legitimate criterion for corporate law is evaluating the extent to which it reduces the transaction costs of the parties themselves, or of the government in responding to private ordering. (See, e.g., Part IV of the Klein criteria.) But mention of transaction costs often suggests a zero-sum game in which the cost of law is a dead-weight loss, such that the savings must exceed the costs of law before the parties are better off than they would have been without law. Corporate law permits a more positive wealth-creating effect, getting parties to a place that they could not easily replicate with just private ordering. One example is merger laws. To some extent, corporations statutes authorizing mergers can be seen as reducing transaction costs. Instead of having to transfer each and every asset by a bill of sale or another such contract, the merger statute permits the wholesale transfer of all assets and liabilities by the magic of complying with the relatively few requirements of the statute. This usually simply entails approval of a merger agreement by the boards of directors of the constituent corporations, approval by the shareholders of those corporations, and a filing with the appropriate state official. The simplicity and orderliness of the statutory procedure not only reduces transaction costs, but thereby permits transactions that otherwise would not take place.

A second example is the creation of separate corporate entities. Creation is distinctively a function of law. While it would be possible for parties to replicate among themselves most of the legal rules that result from having a separate corporate entity as a party to a transaction, the legal magic of creation of a corporate form extends well beyond the immediate parties who bargain with each other, as it can affect a host of parties who deal with the corporation. Indeed, use of separate entities permits widespread externalization, which though a negative factor under point three above, is also a positive factor in that it expands the level of business activity and wealth creation. This positive feature ought to be included in our criteria for measuring good corporate law.

6. Getting the Preferred Balance in Our Federal System

Corporate law differs from tax law in that there remains a strong, if declining, effort to preserve the federal nature of our law-making, and, in particular, to refrain from federalizing the rules absent an express statement from Congress. This is clearly expressed in the Supreme Court's decision in

**Santa Fe Industries, Inc. v. Green:**

Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in Cort v. Ash, supra: “Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.”

Congress, in passing the Sarbanes-Oxley Act in 2002 (“Sarbox”), increased the federal role in specific circumstances, for example, by increasing the obligations of officers and enhancing the role of gatekeepers, particularly auditors, analysts, and attorneys. Yet the core state governance structure based on the central role of directors was in form undisturbed. In such a setting, any description of criteria of what makes good corporate law must necessarily include a metric that weighs this traditional federalism value.

**II. HOW THE CRITERIA CONCERNING THE RELATIVE ROLE OF LAW AND PRIVATE ORDERING MIGHT SHIFT AN ANALYSIS OF GOOD CORPORATE LAW**

With the additional category suggested above and the specific criteria attached to it, our analysis of what makes good corporate law would shift in both subtle and more direct ways. For example, “full disclosure” is already identified as the twelfth (and last) criteria relating to fairness. With the expanded categories suggested here, full disclosure likely gains a more important role. Not only does full disclosure permit shareholders to protect themselves (see Klein’s Criteria IV(A) and (III)(B)), but it also furthers goals underlying others of the specified criteria. Additional disclosure permits directors to better monitor managers, as boards are finding in the wake of new disclosure requirements added by Sarbox. Disclosure permits other gatekeepers (e.g. auditors, attorneys, analysts) to perform the economic functions that have become more important to our corporate governance system. Full disclosure permits more effective use of incentive contracts such as executive compensation, and a variety of other methods by which we seek to align the interest of managers with those whose money is at risk. Finally, additional disclosure deepens the ability of markets to shape corporate behavior.

Disclosure has long been the preferred mechanism for federal law relating to corporate governance, albeit developed under a “securities” label. Professor Louis Loss aptly captured the recurrent theme in the federal securities statute as “disclosure, again disclosure and still more disclosure.”


is hardly visible. Disclosure requirements in statutes are minimal, as they are limited to the corporation's obligation to provide a few reports and to allow for shareholder access to other documents. Courts regularly use disclosure in defining director obligations under fiduciary duty, but states, for the most part, have ceded to the federal government the task of developing disclosure obligations. The federal government's original role in developing disclosure requirements was related to specific investor decisions, particularly buying stock from the issuer or granting a proxy, but Sarbox reflects a far more expanded role for disclosure as a core method of influencing corporate governance. In such a setting, criteria against which to judge specific laws are needed. These include the bounded rationality, externalization, and transaction cost elements of the original list, and the focus on alternative control arrangements and our federal system that have been suggested here.

The expanded criteria would also permit a more complete evaluation of that part of corporate law that deals with separate corporate entities, limited liability, and piercing the veil. By outsourcing the creation of a separate entity to the sole discretion of a private party, the law facilitates exchange (Klein Criterion II(A)) among parties who structure their risk accordingly. A creditor who is dealing with a "no asset" or low asset corporation, as opposed to a well-endowed parent, will raise its price, or refuse to deal without a personal guarantee or some other assurance. Private bargaining is often better able to calibrate the terms of such a bargain in light of the specific context, and evaluate the ability and willingness of individual parties to bear a particular risk. Yet corporate law has long recognized the externalization inherent in leaving such planning entirely to the first mover. Early corporate law contained many more laws to counter the possible adverse effects of separate entities and limited liability than exist today. Minimum capital requirements were long required as a condition to incorporation.10 The law limited the types of consideration for fear that the corporation would not receive the real assets that it needed to survive.11 And statutes limited dividends that could be paid out in order to protect outsiders against possible unfair shifting of assets behind the corporate veil.12 While those laws originally might have reflected Klein Criterion II(C) (protect public involvement), they have morphed today into Criterion I(G) (allocate the cost of harmful conduct to the proper person). This debate would be more effectively captured under a criterion that more

10. These statutes disappeared as the statutory minimum, often $500 or $1000, was eroded by inflation, such that it provided little in the way of a cushion for creditors.

11. Some states continue to ban notes or contracts for future services as consideration for stock. See Del Code Ann. tit. 8, § 152 (2005).

12. For example, Delaware permits dividends only out of surplus, leaving "capital" outside the available category. But various ways exist to reduce capital such that creditors effectively have no effective protection against excessive dividends that may leave the corporation unable to pay creditors in the future. See tit. 8, § 170.
explicitly identified the externalization possibility that law is often written to prevent.

Statutory protections against the misuse of limited liability, as described in the previous paragraph, have given way to a judicial check via the common law doctrine of piercing the corporate veil. Unfortunately, the cases under this doctrine lapse into recitations of long lists of factors. Professor Blumberg has noted that this has become "jurisprudence by metaphor or epithet" and explained "[a]s a result we are faced with hundreds of decisions that are irreconcilable and not entirely comprehensible." Professor Blumberg has noted that this has become "jurisprudence by metaphor or epithet" and explained "[a]s a result we are faced with hundreds of decisions that are irreconcilable and not entirely comprehensible." Judge Easterbrook and Professor Fischel have concluded: "Piercing seems to happen freakishly. Like lightning it is rare, severe, and unprincipled." Limited liability illustrates how our approach to corporate law might improve with greater recognition of criteria of good corporate law. Under current law, hundreds of courts across the country whose judges seldom revisit the issue or develop expertise in the application of these factors determine whether to disregard the corporate entity or pierce the veil. While many of the factors can be tied to the "prevent externalization" criteria developed here or to "allocate[e] the cost of harmful cost to the proper person" developed in Klein I(G), the complexity of the current judicial applications in this area surely runs afoul of Klein criteria II(D), "predictability," or the efforts in Criteria IV(B) and (C) to limit the costs of enforcement.

A more effective approach might result from shifting to another of the Klein criteria—full disclosure. That element has been tried in a variety of areas of corporate law but is underused in limited liability and questions relating to separate entity. When a planner makes use of a separate corporate entity to undertake a part of the business that may be particularly risky, or even when a sole proprietor makes use of a separate corporation to avoid ordinary obligations, the disadvantaged party dealing with such a corporation often finds insufficient assets to cover torts, statutory, or even contract obligations, and has no way to easily determine who are the shareholders of such a corporation. Current disclosure obligations in corporate law do not require disclosure of relationships between corporate groups or disclosure of the shareholders' identities. Disclosure rules required by the securities laws can fill some of this gap, but these rules apply only to corporations whose shares are publicly held. As a result, creditors of privately held companies, where much of the abuse of the corporate form occurs, have little protection in law against externalization. Any information as to the owners and assets of a private corporation are often not available until litigation has begun. The risk of externalization in this

context is great enough that when the law affords to a private planner the sole
discretion of creating a separate entity (a corporation), the law should require
disclosure of corporate ownership so as to preclude externalization. When one
entity owns 100% of another entity or even a controlling interest in the
company, a legal rule requiring full disclosure of that ownership interest would
permit law to more completely effectuate the criteria of good corporate law.

III. CONCLUSION

Criteria of good corporate law ought to provide a basis for determining
when law can defer to private ordering or other constraints on corporate
behavior, and when law should step forward. Law already recognizes the
relative advantage of alternative constraints found in the market or by specific
private ordering, and does not seek to replicate incentives or monitoring that
can be more cheaply done by these alternative constraints. By adding this
category as a metric, we are more likely to get a richer and truer picture of the
constraints on human behavior than a legal-centric view would permit. At the
same time, we might better understand when law is particularly needed. In this
second category are non-contractual settings where issues of piercing the
corporate veil arise. The criteria for good corporate law discussed here are
more likely to make visible the occurrences of externalization that markets and
private ordering fail to adequately monitor, and that create the need for a legal
response. The criteria project might also lead us to disclosure as the preferred
method of such legal intervention.