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New Modes of Discourse in the Corporate Law Literature

Melvin Aron Eisenberg*

Over the years, numerous proposals to modernize corporate law have been made in the scholarly literature. Many of these proposals have in turn been criticized in the traditional style of scholarly discourse, and the result has been a continuing and productive debate about corporate law. Within the last ten years or so, however, a newer style of discourse has emerged in response to proposals to modernize corporate law. This new style has two modes. Both employ the form of scholarly discourse, but the techniques of political debate. The first mode criticizes proposals on the basis of their supposed provenance, rather than addressing the merits of the proposal itself. The second mode offers criticism that purports to be based on data generated by rigorous quantitative analysis, but in fact is based on conclusory statements that are unsupported by any reliable data.

Recently, much of the discourse in these new modes has focused on Parts II and III of the ALI Corporate Governance Project. The purpose of this Article is to examine some of that discourse. By way of background, I will first briefly summarize the relevant parts of the Project.

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I.

Parts II and III of the American Law Institute's *Principles of Corporate Governance and Structure: Analysis and Recommendations* ¹ tell a rather straightforward story. At the risk of oversimplification, here is the story.

A business corporation should have as its *objective* the conduct of business activities with a view to enhancing corporate profit and shareholder gain. However, even if corporate profit and shareholder gain are not thereby enhanced, in the *conduct* of its business the corporation (1) is obliged, to the same extent as a natural person, to act within the boundaries set by law; (2) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and (3) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes. ²

The business of a publicly held corporation is normally managed by its executives. Given the paramount place of the publicly held corporation in our economic system, there is a vital social need to ensure the accountability of its managers for proper management of the business. Both external and internal institutions contribute toward satisfying this need. The major external institutions are the product and capital markets, and the market for corporate control. The major internal institutions are direct review by the body of shareholders, oversight of managers by more senior managers, and oversight of senior managers by the board of directors and its committees.

All these institutions produce good effects, but all have important limitations. The discipline of product markets is limited by the fact that a corporation may earn profits and survive for a long period of time despite bad management, just as it may incur losses or even fail despite good management. The discipline of the capital market is blunted by the ability of corporations with large cash flows to meet their capital needs for a long period of time through internal and even external financing, although profits are lower than good management would produce. The discipline of the market for corporate control is limited by a number of elements, including the high transaction costs of takeover bids, the necessity to offer a premium well in excess of market price, the requirements of relevant statutes, the defensive techniques available, the incentives to take over efficiently run as well as inefficiency run com-

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2. Id. § 2.01.
panies, and the time lag often experienced by potential acquirors in ascertaining lack of managerial efficiency. Direct review by the body of shareholders is seldom an efficacious instrument of accountability in publicly held corporations because of the disparate and shifting nature of the shareholder body and the complexity of modern management issues. Oversight of managers by more senior managers is undoubtedly very effective as to middle and lower management, but cannot serve to hold accountable the corporation's top management, particularly the chief executive officer. Thus the board of directors and its committees, which do have the ability to hold top management accountable, take on particular significance. Undoubtedly, the character and ability of directors are the most critical elements in the ability of the board and its committees to assure managerial accountability. Nevertheless, assurance of managerial accountability is also closely related to the structure of the board and its committees, and to the objectivity of board and committee members.

Based on that background, the following principles should determine the structure and functions of the administrative organs of publicly held corporations.

First, the management of the business of a publicly held corporation (defined as a corporation with 500 or more shareholders and $3 million or more in assets) should be conducted by or under the supervision of senior executives designated by the board, subject to the power of the board to instruct, review, or override the executives, or for that matter, to manage the business of the corporation itself.

Second, the board of a publicly held corporation should elect, evaluate, and, where appropriate, dismiss the principal senior executives and oversee the conduct of the business with a view to evaluating whether those executives are properly managing it.

3. It is contemplated that certain corporate-law aspects of tender offers will be treated in subsequent parts of the Project.

4. Professor Fama has argued that subordinate managers monitor their superiors, presumably by reporting their shortcomings to their superiors' superiors. See Fama, Agency Problems and the Theory of the Firm, 88 J. POL. ECON. 288, 293 (1980). Probably this kind of reporting occasionally occurs, but it seems highly unlikely that it occurs often, partly because it would violate the chain of command, partly because it would seem disloyal, and mostly because it would be risky in the extreme. The adage "if you strike at a king, kill him" is applicable here. In any event, this type of monitoring, even when it occurs, can apply to a chief executive officer only if the board of directors (the CEO's sole superior) is independent of the CEO.

5. Tentative Draft No. 2, supra note 1, introductory note to Part III, at 53-55.

6. Id. §§ 1.23, 3.01, 3.02. The definition of a publicly held corporation is derived in part from Securities Exchange Act § 12(g), 15 U.S.C. § 78l(g)(1) (1982), SEC Rule 12g-1, 17 C.F.R. § 240.12g-1 (1984) and ALI, FEDERAL SECURITIES CODE § 402(a) (1982). The number of publicly held corporations, as so defined, is estimated to be approximately 7,000-8,500, including large publicly held corporations, which are defined as a subclass of publicly held corporations. See Tentative Draft No. 2, supra note 1, § 1.16.

7. Tentative Draft No. 2, supra note 1, § 3.02. "Principal senior executives" are defined as the chief executive, operations, financial, legal, and accounting officers of a corporation. Id. §§ 1.19, 1.25.
The board should also review and approve corporate actions that it considers major and changes in accounting principles that it considers material.8

Third, a large publicly held corporation (defined as a corporation with at least 2,000 shareholders and $100 million in assets) should be required by law to have an audit committee to oversee the auditing process. None of the members of the committee should be an executive or employee of the corporation or a relatively recent former employee, and at least a majority of the committee’s members should have no significant relationship to the senior executives, whose performance is reported in the financial statements the auditors are charged to review.9

8. Id. § 3.02.
9. Id. § 3.03. The definition of large publicly held corporations is derived in part from the listing standards of the New York Stock Exchange. See NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 102.01 (1983). The number of large publicly held corporations, as so defined, is estimated to be approximately 1,500-2,000. The term “significant relationship to the senior executive” is defined in section 1.26 of the Principles of Corporate Governance as follows:

(1) Except as provided in § 1.26(2), a director has a “significant relationship” with the senior executives [§ 1.25] of a corporation if, as of the record date for the annual meeting of shareholders:
   (a) He is employed by the corporation, or was so employed within the two preceding years;
   (b) He is a member of the immediate family [§ 1.18] of an individual who (a) is employed by the corporation as an officer [§ 1.19], or (b) was employed by the corporation as a senior executive within the two preceding years;
   (c) He has made to or received from the corporation, during either of its two preceding fiscal years, commercial payments [§ 1.04] which exceeded $200,000, or he owns or has power to vote an equity interest [§ 1.11] in a business organization [§ 1.03] to which the corporation made, or from which the corporation received, during either of its two preceding fiscal years, commercial payments that, when multiplied by his percentage equity interest in the organization, exceeded $200,000;
   (d) He is a principal manager [§ 1.21] of a business organization to which the corporation made, or from which the corporation received, during either of the organization’s two preceding fiscal years, commercial payments that exceeded 5 percent of the organization’s consolidated gross revenues for that year, or $200,000, whichever is more; or
   (e) He is affiliated in a professional capacity with a law firm that was the primary legal adviser to the corporation with respect to general corporate or securities law matters, or with an investment-banking firm that was retained by the corporation in an advisory capacity or acted as a managing underwriter in an issue of the corporation’s securities, within the two preceding years, or was so affiliated with such a law or investment-banking firm when it was so retained or so acted.

(2) A director shall not be deemed to have a significant relationship with the senior executives under § 1.26(1)(c)-(e) if, on the basis of countervailing or other special circumstances, it could not reasonably be believed that the judgment of a person in the director’s position would be affected by his relationship under § 1.26(1)(c)-(e).

Tentative Draft No. 2, supra note 1, § 1.26(1)-(2) (original emphasis). Section 1.04 defines “commercial payment” to mean:
Fourth, it is recommended that as a matter of corporate practice:

(a) The board of a large publicly held corporation should have a majority of directors who have no significant relationship to the senior executives, whose conduct of the business they oversee. The boards of other publicly held corporations should have at least three such directors.\(^{10}\)

(b) Smaller publicly held corporations should have an audit committee to oversee the auditing process, composed in the manner required for the audit committees of large publicly held corporations.\(^{11}\)

(c) All publicly held corporations should have a nominating committee to oversee the process of nominations to the board, composed in essentially the same manner as the audit committee.\(^{12}\)

(d) Large publicly held corporations should have a compensation committee to oversee the compensation of senior executives, composed in essentially the same manner as the audit committee.\(^{13}\)

(e) The audit, nominating, and compensation committees in publicly held corporations should perform certain minimum functions.\(^{14}\)

These recommendations concerning corporate practice are collected in a separate subchapter of Part III and are set in an ordinary typeface rather than in the boldface used for black-letter material. The recommendations are made to corporations and their counsel, not to courts or legislatures. Accordingly, they are not intended as legal rules, noncompliance with which would impose liability. Rather, their purpose is to further the voluntary adoption of structures that help enhance managerial accountability. The recommendations are generally comparable, although sometimes different in detail, to those made by the American Bar Association’s Section on...

\(^{10}\) Id. § 1.04. Section 1.21 defines “principal manager” to mean a senior executive of a corporation, a general partner of a partnership, a trustee of a trust, or a person holding a comparable position in any other business organization.

\(^{11}\) Id. § 3.04. The recommendation that large publicly held corporations have a majority of directors who are free of any significant relationship with the corporation’s senior executives does not apply if a majority of the corporation’s voting securities are owned by a single person, a family group, or a control group. In these circumstances, the recommendation that all publicly held corporations have at least three such directors applies.

\(^{12}\) Id. § 3.05.

\(^{13}\) Id. § 3.06. The recommendation concerning nominating committees does not apply if a majority of the corporation’s voting securities are owned by a single person, a family group, or a control group.

\(^{14}\) See id. §§ 3.05-07.
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Corporation, Banking and Business Law in the Corporate Director's Guidebook\(^{15}\) and The Overview Committees of the Board of Directors,\(^{16}\) and by the Business Roundtable in its Statement of Position Concerning the Role of Corporate Directors.\(^{17}\) It is intended that the recommendations would be accorded essentially the same kind of significance as would be accorded to the recommendations in those documents.\(^{18}\)

Fifth, those members of the board of a publicly held corporation who do not have significant economic relationships to the senior executives should be entitled, acting as a body, to retain legal counsel or other experts to consider extraordinary problems arising in the exercise of the oversight function, if such a retention is reasonably required for the proper exercise of that function.\(^{19}\)

II.

Against this background, I shall examine in Part II the mode of discourse that criticizes the supposed provenance of a proposal, as opposed to addressing the proposal on the merits. This mode is comprised of a cluster of techniques, which I shall call Manichaean, attributional, genetic, and motivational.

A. Manichaean Criticism

Manichaicism is a dualistic religious system involving a basic doctrine of conflict between Light (absolutely good) and Darkness (radically evil).\(^{20}\) Manichaean criticism in corporate law begins by dividing all thinking about corporations into two schools, one representing the force of Light and the other the force of Darkness. For example, one of the articles in this Symposium — The Independent Corporate Board: A Means to What End?, by Roberta Karmel\(^{21}\) — begins by claiming that American thinking about business corporations has long been split into two schools, between which American corporation law “ricochets.”\(^{22}\) One school

\(^{15}\) American Bar Association, Comm. on Corp. Laws, Corporate Director's Guidebook, 33 BUS. LAW. 1591 (1978).

\(^{16}\) American Bar Association, Comm. on Corp. Laws, The Overview Committees of the Board of Directors: A Report by the Committee on Corporate Laws, 34 BUS. LAW. 1837 (1979).

\(^{17}\) Business Roundtable, Statement of Position Concerning the Role of Corporate Directors, 33 BUS. LAW. 2033 (1978).

\(^{18}\) Tentative Draft No. 2, supra note 1, introductory note to Part III, chapter 1, at 53-59; introductory note to Part III, chapter 1, subchapter B, at 83.

\(^{19}\) Id. § 3.04. Another section of Part III, section 3.08, provides for directors' informational rights.


\(^{22}\) Id. at 535.
(Light) "views corporation law as basically private law and corpo-
rate governance as involving the definition of relationships, under
theories of trust law, between corporate managers and sharehold-
ers."\(^{23}\) The other school (Darkness) "considers corporation law as
a matter of public law because the states grant charters to corpora-
tions" —the so-called concession theory— "and because managers
are responsible not only to shareholders but to other constituencies
as well."\(^{24}\) Similarly, another article in this Symposium —
Revolution Versus Evolution in Corporation Law: The ALI's Pro-
ject and the Independent Director, by Barry Baysinger and Henry
Butler\(^{25}\) — effectively divides the world into "defenders of the
corporation" (Light) and "corporate reformers" (Darkness).\(^{26}\)

Any claim that all thought about corporate law falls into just
two schools completely misses the richness and complexity of the
subject and is likely to lead to a significant mischaracterization of
the positions of those who do not adhere to the School of the
Light. For example, neither of Karmel's two schools captures my
own views, which I think many others would share. Briefly, these
views are as follows: Managers are not responsible to constituencies
other than shareholders, but neither does corporation law boil
down to trust law. Corporation law is private law, but the public
has an interest in it. The public interest in corporation law is not
based on the concession theory, but on functional considerations
that give rise to a public interest in all important private legal in-
stitutions, such as the desirability of facilitating commerce, pro-
tecting fair and reasonable expectations, and maximizing the
efficiency of our national capital markets and our national system
of production and distribution.

Similarly, the division made by Professors Baysinger and Butler
into "reformers" and "defenders" of the corporation has little ap-
plication in the real world. Presumably a reformer is a person
who would like to make some change in corporation law that he
justifies on the ground that the change would improve the position
of shareholders, society, or both. However, virtually every serious
student of corporation law, whether an academic or a practicing
lawyer, has some change in corporation law that he would like to
see made and that he would justify on just that ground. For ex-
ample, some believe that the rules governing derivative actions
should be changed in ways that would have the effect of making it
easier to bring such actions; others believe those rules should be
changed in ways that would have the effect of making it harder.
Both groups would argue that the changes they propose would
make shareholders and society better off. How then are we to de-

\(^{23}\) Id. (footnote omitted).
\(^{24}\) Id. (footnote omitted).
\(^{25}\) Baysinger & Butler, Revolution Versus Evolution in Corporation Law: The
\(^{26}\) See, e.g., id. at 560-61, 562, passim.
termine which proposals for change seek to “reform” the corporation and which seek to “defend” it?

B. Attributional Criticism

The attributional technique of corporate-law criticism is related to the Manichaeian technique. Having divided corporate thinking into two schools, the Manichaeian critic believes it entirely appropriate to associate the proposals of one member of the School of the Dark with the views of another. For example, Karmel quotes Professor Donald Schwartz to the effect that the problem with corporation law in the United States is that it lacks policy content, and that this policy content should seek to balance economic goals and social responsibilities. She then associates this view with the Corporate Governance Project: “It appears that the ALI has determined to advocate the monitoring model as a means of injecting a new policy content into corporation law without calling for any discussion of the necessity or propriety of the change.”27 This statement is wrong from beginning to end: the ALI has not in any way suggested that corporation law should have a new policy content in which economic goals are balanced with social responsibilities. No proposal in the Project is cited in support of Karmel’s assertion, and none could be. Furthermore, every part of the Project has been subjected to the most extensive examination and debate imaginable.

A similar type of criticism is made by Baysinger and Butler, who state, in criticizing the Project, that “[c]orporate reformers” — people like those the authors regard as responsible for the ALI Project — “believe that managers will not generally act in their shareholders’ best interests unless formal legal and institutional arrangements force them to do so.”28 This is a strange sort of criticism from economists who, like Baysinger and Butler, subscribe to the so-called agency-cost theory. The thrust of this theory is that, in the absence of formal constraints, agents will frequently not act in their principal’s interest — just what “corporate reformers” are said to believe.

In any event, whatever “corporate reformers” believe, my own view, which I think many would share, is that in most areas of behavior most people will voluntarily conform their conduct to the aspirational standards expressed by the society through its laws and indeed through its morality. Thus, given the legal and moral obligation of managers to act in their shareholders’ best interests, managers generally will try to act in their shareholders’

27. Karmel, supra note 21, at 555.
best interests, even in the absence of "formal legal and institutional arrangements [that] force them to do so." The function of corporate law in the conflict-of-interest area is not to forcibly redirect evil human nature onto the path of good, but to reinforce and give greater precision to the general inclination to do right, and to address those very few situations in which a fiduciary does not share this inclination. In this regard, the long-term trend of the law relating to self-dealing has been to move away from strict prohibition toward review for fairness, as the courts have become increasingly comfortable with the ability of internal institutionalized decision making to resolve those conflict-of-interest problems that do come along. Indeed, it may well be that the most important contemporary problem concerning managerial accountability is not the manager who consciously violates his trust, but the manager who does his best but whose best is not good enough. It is largely to address this problem that the ALI proposals recommend a structure that will facilitate an atmosphere of objective internal oversight of, and full information concerning, the top managers' performance, so that the board is in a position to replace top managers who are markedly inefficient, although doing their moral best.

C. Genetic Criticism

The genetic technique of corporate-law criticism reflects the genetic fallacy in reasoning—that is, the fallacy of confusing questions of validity with questions of origin. For example, Karmel dwells on events, such as the illegal-payments debacle and the SEC's corporate governance hearings and proposals, which may very well have been among the factors that helped lead to the initiation of the ALI Corporate Governance Project, but which are in no way related to its substance. Some sort of genetic notion also seems to account for Karmel's extended discussion—not otherwise related to specific proposals in the Project—of the philosophies of Berle, Dodd, Douglas, and Nader.

D. Motivational Criticism

Legal analysis is accustomed to questions of purpose; in the traditional style of legal discourse, however, purpose is normally determined by objective criteria. The motivational technique of corporate criticism reverses this approach and brushes aside the objective content of a proposal to focus on the motive said to lie behind it. For example, section 2.01 of the Corporate Governance Project provides that: "A business corporation should have as its objective the conduct of business activities with a view to enhanc-

31. Id. at 536-38, 543-44.
ing corporate profit and shareholder gain.” Yet Karmel’s article suggests that the motive behind the Project is to move the board away from the interests of shareholders and toward the interests of society. Similarly, the introductory note to Part III states: “Direct review by the body of shareholders is seldom efficacious in publicly held corporations, because of the disparate and shifting nature of the shareholder body and the complexity of modern management issues.” Yet Karmel’s article suggests that the motive of the Project is to install shareholder democracy.

Equivalent nuggets can be plucked from a variety of other sources. For example:

The motivation of the corporate critics is unique: they fervently believe that the modern corporation has come loose from its legal moorings and that the exercise of power in its name by management is illegitimate.

Or:

The real hidden agenda of the independent director movement is to stave off more radical change by convincing politicians and the public that independent directors are a reformer’s panacea.

And my favorite:

[C]orporate law reformers . . . continue to espouse a peculiar hostility to the American corporation and businessmen. As Mr. Gilder has so well pointed out, “hatred of producers of wealth still flourishes and has become, in fact, the racism of the intelligentsia.”

I do not, of course, mean to suggest that Karmel, Baysinger, and Butler, or others who have engaged in these types of criticism, are anything but sincere and well-intentioned. Quite the contrary: for example, although Karmel is very wide of the mark when she does actually address the Project, or tries to relate the philosophies of others to the Project, she is generally fair and accurate.

32. Tentative Draft No. 2, supra note 1, § 2.01.
33. See Karmel, supra note 21, at 552-53, 555.
34. Tentative Draft No. 2, supra note 1, introductory note to Part III, at 54.
35. See Karmel, supra note 21, at 550 (quoting Walter Werner). It is, by the way, not easy to understand how the motives behind the Project include (i) moving the board away from the shareholders’ interests, and (ii) installing shareholder democracy.
38. Id. at 8.
39. For example, Karmel asserts that “many prominent scholars have rejected the monitoring model of corporate structure requiring a board of independent direc-
when describing those philosophies. Similarly, I am sure that the commentators who have engaged in these techniques of criticism sincerely and even passionately believe in the propriety of a Manichaean division of thought about corporate law, in the legitimacy of associating the proposals of one commentator with the views of another, in the accursed nature of the origins from which all proposals to modernize corporate law spring, and in the certainty that dreadful or foolish motives lie lurking behind these proposals. But sincerity and passion cannot justify, in scholarly work, a focus on provenance rather than merits. However well-motivated, and however effective as debate, the mode of criticism discussed in Part II of this Article is, to use a term of traditional discourse, irrelevant.

III.

The second new mode of discourse in the corporate law literature involves criticism that purports to be based on data generated by rigorous quantitative economic analysis, but in facts rests on conclusory statements that are unsupported by reliable data. As in the case of discourse based on provenance, recent discourse in this mode has tended to focus on the ALI proposals. Part III will discuss the paper by Baysinger & Butler and a widely circulated paper by Paul MacAvoy, commissioned and published by the Business Roundtable, entitled ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis.40

Because the ALI proposals have been in continual revision, some of the criticisms in these papers have been largely mooted. For example, both papers heavily criticize the concept that a majority of the board of a large publicly held corporation should consist of directors who have no significant relationship with the senior executives. Earlier ALI drafts had recommended this

40. MacAvoy, ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis (1983), reprinted in Statement of the Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Recommendations" (February 1983). MacAvoy's name on this paper is followed by three others: Cantor, Dana, and Peck. Since these names are set in much smaller type, I have treated MacAvoy as the paper's author.
structure as a matter of law, but Tentative Draft No. 2\textsuperscript{41} recommends it only as a matter of corporate practice. However, though some of the specific criticisms in these papers have been passed over by events, the mode of discourse exemplified in the papers remains worth examining.

Implicit in both of these papers is the assumption (which often seems to underlie much of the quantitative work in the corporate area) that a legal rule cannot be justified unless its value has been proved by quantitative data that meets the social scientist's test of statistical significance. Of course, this is an argument against almost all law, because in almost all aspects of life — including almost all corporate law — experience does not lend itself to such measurement. The proposals in the ALI Project draw on traditional empirical sources of law, such as practical observation of corporate operations, data collected by various institutions concerning corporate practice, the ABA's Corporate Director's Guidebook and The Overview Committees of the Board of Directors, the Business Roundtable's Statement of Position on the Role of Corporate Directors, and widespread (although not universal) perceptions concerning the reasonable expectations of investors, the way to preserve public confidence in corporate governance, and what constitutes fairness. The burden is not on the ALI to justify drawing on these traditional sources of empirical evidence, but on those who claim that statistically significant quantitative data is not simply a useful tool but an indispensable condition to the justification of law. An examination of the Butler's and Baysinger's and MacAvoy's papers will illustrate just how far short of carrying that burden the critics have fallen.

A.

The paper by Baysinger and Butler\textsuperscript{42} offers criticisms based on both theoretical economics and quantitative analysis. The most salient points made by Baysinger and Butler based on theory can be put in terms of three related propositions, which I will set forth together with a brief comments.

\textbf{Proposition 1:} The corporation potentially presents a problem of agency costs. Baysinger and Butler assume and allude to this proposition, but do not spell it out.\textsuperscript{43} Essentially, the term "agency

\textsuperscript{41} Tentative Draft No. 2, \textit{supra} note 1, § 3.04.
\textsuperscript{42} Baysinger & Butler, \textit{supra} note 25.
\textsuperscript{43} Much of the analysis in the Baysinger and Butler paper is intended to show that the potential agency-cost problem has not materialized as a result of market forces and voluntary responses to those forces. For example:

Defenders argue that the corporate-agency problem has never materialized due to the operation of competitive product, capital, and managerial-labor markets which provide managers with incentives to act in their
costs" is a shorthand expression for the hypothesis that "[if both parties to the [principal-agent] relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal."

For example, under this concept one would predict that, absent some sort of check, an agent would spend less time on his principal's business than he is obliged to spend, would divert to himself opportunities that should go to his principal, and might even cheat the principal out of funds.

Comment: Lawyers will quickly recognize that the agency-cost hypothesis is essentially a formal statement of a problem that the law has long recognized and addressed under the heading of conflict of interest. In its purest form, the hypothesis does not tell us much: "not always" could be one out of two cases or two million. Furthermore, the hypothesis seems implicitly to assume a state of nature in which there are no internal constraints on the agent, such as socialization and the acceptance of legal norms, and no informal constraints, such as the importance of one's reputation as a human being. Thus, as the hypothesis is developed in the literature, the focus is almost exclusively on formal external constraints, such as markets and monitoring, and the implication often seems to be that, in the absence of such constraints, agents will frequently act in their economic self-interest to maximize their own welfare in a manner that is incompatible with the duties they owe to their principal. Many or most lawyers, however, would believe that internal constraints are at least as important as external constraints; that agents, like other people, will normally attempt to conform their behavior to social aspirations embodied in law and in social morality. Accordingly, the aspirational role of law may be much more effective in reducing agency costs than either the sanctioning role or other external checks, like markets.

**Proposition 2:**

The corporate-agency problem has not materialized, due to the competitive product, capital, and managerial labor markets, which provide managers with incentives to act in their shareholders' best interests. In large corporations, directors are rewarded for ratifying appropriate management decisions and ensuring that these decisions are executed efficiently. There is a market for directorial services, and the market value of a director depends on whether he properly performs these functions. Rational directors will therefore strive to maintain their market value by acting as if they are independent.

Comment: It is worth observing at the outset that the agency-shareholder's best interests. . . . The evolutionary success of the corporation as an organizational form demonstrates that market governance has successfully solved the corporate-agency problem.

*Id.* at 560-61 (footnotes omitted).


cost literature often seems to be largely engaged in marching up the hill and then down again. Thus, under Proposition 1, the corporation potentially presents an agency-cost problem, and under Proposition 2 it does not after all.

Putting that aside, the analysis in Proposition 2 apparently rests on articles by Fama, Jensen, and Meckling that argue that market forces alone will result in the installation of monitoring institutions or incentive structures that will eliminate agency costs, or at least drive such costs down to an irreducible minimum. These arguments point to some important characteristics of the environment within which the rules of corporation law function. However, it is extremely unlikely that market forces acting alone will produce an optimal solution of agency-cost problems in the context of the publicly held corporation. Some monitoring institutions and incentive mechanisms that might result from market forces in a frictionless model entail substantial transaction costs — such as information and contracting costs — in the real world. Furthermore, in the real world the installation of monitoring institutions may be inhibited by conflicts of interest. The chief executive officer of a publicly held corporation has every incentive to install mechanisms that will monitor the competence and performance of his subordinates. He has considerably less incentive to install mechanisms that will monitor his own competence and performance. Fama and Jensen try to escape this problem, but they do so only by asserting a number of propositions that most observers (including seasoned directors) would, I believe, regard as outside their experience and observation. For example, Fama and Jensenassert, among other things, that:

(i) Lower-level managers continually monitor the managers who supervise them, with the object of "stepping over shirking or less competent managers," presumably by reporting their shortcomings to top managers or to the board and thereby getting their supervisors discharged.

(ii) The board "seeks information from lower-level managers about the decision initiatives and performance of top managers," which is then used by the board "to set the rewards of the top managers, to rank them, and to choose among their decision initiatives."

46. Fama, supra note 4; Fama & Jensen, Separation of Ownership and Control, 26 J. L. & ECON. 301 (1983); Jensen & Meckling, supra note 44.

47. Fama, supra note 4, at 293.

48. Fama & Jensen, supra note 46, at 314 (footnote omitted).
(iii) A primary function of outside directors is to act as "arbiters" or a "top-level court of appeals" in disagreements among internal managers.49

(iv) Outside directors "might best be regarded as professional referees whose task is to stimulate . . . competition among the firm's top managers."50

(v) "Outside directors are . . . disciplined by the market for their services which prices them according to their performance as referees."51

Boiling down these propositions, Fama and Jensen assert that market forces alone will generate adequate monitoring because: (1) directors will get good information about the shortcomings of top managers from subordinates of the top managers who are anxious to get ahead; and (2) directors will perform well because if they do not they will be disciplined by the market for directorial services. As to the proposition that the way for a subordinate to get ahead is to complain to the board about top executives, this will certainly strike many as novel advice for aspiring managers. As to the proposition that there is a market for directorial services that disciplines directors who fail to perform their oversight function in a satisfactory manner, as far as I can tell this is a market whose operations have so far never been directly observed. In my own view, which I think many would share, the major inducement for a director to perform well is not this apparently nonexistent market, but the incentive to perform an important social role in the manner defined by reasonable expectations, decency, and law.

Proposition 3: The evolutionary success of the corporation as an organizational form demonstrates that market governance has successfully solved the corporate-agency problem.52

Comment: This proposition is seriously misleading. First, it treats the corporation as if it had evolved in a legal vacuum. Given that the corporation has always been embedded in a rich matrix of law and morality concerning conflicts of interest, how can it possibly be assumed that the success of the corporation in overcoming conflict-of-interest problems is due solely to market forces? Managers of business associations have understood since the earliest days that theirs is a position of stewardship for capital furnished largely by others. A powerful moral force, grounded on this fundamental legal proposition, works to keep managerial conscience generally consistent with the shareholders' interests.

Second, Baysinger and Butler misconceive how evolution works. Evolution can select only from among those species it happens to find. A form that is successful is not necessarily the best form, but only the best-adapted among the forms that nature has so far produced. Therefore, even if the corporate form did entail greater agency-cost problems than did competing flora and fauna, the corporation's other survival traits — such as limited liability,
ual life, and free transferability of ownership interests — might be so advantageous that they would have overcome the agency-cost disadvantage. To put this more directly, in a competition between (1) a corporate form that had moderate agency-cost problems but carried limited liability, perpetual life, and free transferability of ownership interests, and (2) noncorporate forms that had somewhat less of an agency-cost problem but lacked limited liability, perpetual life, and free transferability of ownership interests, it is not too hard to see which form would have been likely to succeed.

The problem with Baysinger's and Butler's evolutionary analysis, however, goes even deeper than that. Corporations are not natural forms, like tigers. They are man-made forms, like hybrid corn. To argue, as Baysinger and Butler do, that the success of the corporate form shows that lawmakers should now get out of the corporate picture, is like arguing that the success of hybrid corn shows that agricultural geneticists should now get out of the corn picture.

B.

I shall now consider those parts of the critiques by Baysinger and Butler and MacAvoy that purport to be based on the quantitative analysis of economic data. In examining the methodology of such critiques, it is important to bear in mind that the ultimate issue they address is whether board and committee structures that conform to certain standards lead to better performance, taking corporations as a whole, than board and committee structures that do not conform to those standards. This issue cannot be determined by direct measurement, and the best available proxy — return to investors — is noisy and therefore unreliable. Return to investors in any given year, or even over a series of years, may depend on factors exogenous to current management, such as embargoes, changes in the tax law, and the strategic decisions of prior managers. Furthermore, because management, not the board, is the major factor on which corporate performance depends, board and committee structure is likely to affect performance only in those limited cases where management is inefficient, and an objective board will change management but a management-dominated board will not. (Indeed, it is possible that the most significant effect of an objective board and committee structure is to minimize the number of outliers — corporations that perform very badly because an obviously needed management change is not made by a management-dominated board.) Even in these cases, the effect of a change in management by the board may not show up for several years. Finally, managers themselves can frequently determine how much profit a corporation reports through the adroit ex-
ploitation of accounting conventions—for example, by timing the sale of investment securities or creating or not creating reserves. If such maneuvers were random across all corporations, they might not seriously interfere with the reliability of return to investors as a measure of performance. However, there is reason to believe that poorly performing companies make disproportionate use of such maneuvers to increase reported profits. For example, if managerial compensation and the conditions of default under corporate indentures depend partly on achieving a minimum level of earnings, there is more incentive to exploit accounting conventions to push earnings upward if they are unduly low than if they are normal.

Accordingly, in examining the impact of board and committee structure, quantitative data speaks to us only through a filter and against a very noisy background. Thus, it would be surprising if even a well-done study could reliably determine, purely on the basis of quantitative data, that any given proposal concerning these issues was justified or unjustified; and the two papers under examination were not well done. Indeed, although much of the data in these papers actually seem to support the ALI proposals, that support should not be relied upon, because of the inherent difficulty in studying the relevant issues through the methods of quantitative analysis and the serious flaws in the authors’ methodologies.

1. Baysinger and Butler

Baysinger and Butler report two major findings in the portion of their paper that concerns the quantitative analysis of economic data. Were these findings reliable, the first would support the ALI recommendation on board composition, and the second would conflict with that recommendation.

(a) The first finding. Baysinger’s and Butler’s first finding is that: “As corporate board independence increases, corporate financial performance tends to increase.”53 This finding was based on the board structure and financial performance of 266 corporations in 1970, 1975, and 1980. In analyzing data to arrive at this finding, Baysinger and Butler had to make three kinds of decisions: what corporations should go into their sample, how director independence should be measured, and how financial performance should be measured.

(i) The sample. The authors assembled their sample as follows:

The [266] firms represent a subset of Fortune 1000 business corporations. Our study includes only firms whose primary line of business is industry, transportation, or distribution. . . . We also limited the study to firms that have reported financial data under essentially the same name and organizational structure between 1970 and 1980. . . . [t]he study is limited to firms that are publicly traded. . . .54

53. Id. at 572 (footnote omitted).
54. Id. at 569 n. 56. Because of the manner in which this sample was constructed,
(ii) **Director independence.** Baysinger and Butler divided boards into a number of categories, such as insiders, retired employees, and lawyers, and sorted these categories into "executive," "instrumental," and "monitoring" components. The monitoring component consisted of professional directors; retired business decision makers; directors whose primary employer was not a business enterprise, such as educators and governmental officials; private investors, such as major shareholders; and decision makers of economic organizations that did not have an economic relationship to the corporation. The authors then measured director independence by the size of the monitoring component in relation to either the executive component or the executive and instrumental components.

(iii) **Financial performance.** Baysinger and Butler measured a corporation's financial performance by its return on equity, divided by the average return on equity for all corporations in the relevant industry so as to nullify industry effects and eliminate the effects of secular trends and the business cycle. On the basis of the data, Baysinger and Butler found no strong contemporaneous correlation between financial performance and board independence; that is, in the three years studied, firms with relatively more independent boards (measured by the size of the monitoring component) did not show better financial performance relative to firms with less independent boards. However, the authors concluded that greater board independence was correlated with better financial performance at a later date. This is just what the premises underlying the ALI recommendation would predict. The primary function of the board is not to manage the corporation, but to select, oversee, and where necessary, change management. In most cases, management is efficient, and an independent board will not make an important difference. The major difference will be found only in those marginal cases where management is inefficient. Accordingly, the impact of an independent board should not be reflected contemporaneously, as the impact of management itself might be, but over the long run, as independent boards weed out inefficient managers while other boards do not.

It excluded all corporations in the 1970 *Fortune* survey that were successfully acquired as target companies between 1970 and 1980. It is not unlikely that such companies were on balance poor performers. If so, their exclusion would have skewed the sample.


57. *Id.* at 572 & nn.63-64; B. Baysinger & H. Butler, *supra* note 55, at 20-22.
(b) *The second finding.* Baysinger’s and Butler’s first finding seems to support the recommendation of the Corporate Governance Project that a majority of the board of a large publicly held corporation should not have significant economic relationships to the senior executives. However, their second finding seems to conflict sharply with that recommendation. That finding is:

[T]he addition of independent directors to a corporate board is subject to . . . absolute declines in relative performance. . . . [B]eginning with a board composed entirely of insiders, corporate performance may be increased by adding independent directors up to the point where [they] account for approximately thirty percent of the directors. Beyond that percentage, adding more independent directors will result in *diminishing* financial performance. In other words, the marginal contributions of additional independent directors once thirty percent of the board is independent are negative. Thus, requiring that fifty percent of the board be independent would have a negative effect on many corporations.\(^{58}\)

This finding is also reflected in a graph.\(^{59}\)

![Graph: Diminishing Effect of Board Independence on Performance](image)

Unfortunately, neither the finding nor the graph is supported by the authors’ data. To begin with, the methodology for the second finding is hopelessly inadequate. The validity of this finding depends on the percentage of a corporation’s directors that are “independent” and therefore should be placed in the monitoring component. However, many of the directors that Baysinger and Butler placed in the “instrumental” component may have actually

\(^{58}\) Baysinger & Butler, *supra* note 25, at 573-75 (emphasis added).

\(^{59}\) *Id.* at 575.
been independent, at least by the definitions employed in the ALI Corporate Governance Project, so that they should have been placed in the monitoring component instead. For example, any director who was by occupation a lawyer or a "financier" was placed in the instrumental component, even if there was no evidence that he had a material economic relationship with the corporation — or, for that matter, an immaterial economic relationship. Similarly, a director was placed in the instrumental component if a corporation with which he was affiliated was a member of an industry to which the subject corporation's industry was related, without regard to whether the two corporations had an actual economic relationship.\(^6^0\) Thus, the size of the monitoring component in the sample corporations may have been significantly underestimated. This would, of course, vitiate the significance of a finding that a thirty percent level of independent directors was optimum, even if the authors' methodology and data were otherwise proper.

Furthermore, the construction of the sample was grievously flawed. Baysinger and Butler did not arrive at their second finding by studying the 266 firms whose performance was measured to arrive at the first finding. Rather, they examined only thirty-four firms. Worse, these firms were not selected scientifically, but on the ground that they were the top-rated firms in seventeen industries according to a Fortune survey that asked business professionals to rank firms in the seventeen industries by reputation. Worse yet, the rankings in the survey did not depend simply on reputation for financial performance, but on reputation for quality of management, quality of product or services, innovation, long-term investment value, financial strength, human resource management, social responsibility, and use of organizational resources.\(^6^1\) Worse still, the authors made no comparisons or statistical tests on the thirty-four firms. Instead, they reached their conclusions solely by inspecting the boards of the sample corporations apparently on the theory that because these corporations were, by hypothesis, extremely well-managed, the effect of independent directors on profitability could be deduced simply by eyeballing the data.

Finally, worst of all, even putting aside every question concerning methodology, Baysinger's and Butler's second "finding" conflicts with their own data. Here are the data:\(^6^2\)

\(^6^0\) Id. at 569-70; B. Baysinger & H. Butler, supra note 55, at 16-17 & n.3.
\(^6^1\) Baysinger & Butler, supra note 25, at 573 n.65; B. Baysinger & H. Butler, supra note 55, at 23-24.
\(^6^2\) Baysinger & Butler, supra note 25, at 573 n.65.
Relative Board Composition Among Large U.S. Business Corporations*

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<tr>
<th>Name</th>
<th>Mon</th>
<th>Exec</th>
<th>Inst</th>
<th>[Diff]</th>
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<td>88</td>
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<tr>
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<td>70</td>
<td>10</td>
<td>50</td>
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<tr>
<td>Kimberly Clarke</td>
<td>23</td>
<td>56</td>
<td>21</td>
<td>33</td>
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<td>Digital Equipment</td>
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<td>TRW</td>
<td>30</td>
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<tr>
<td>So. California Edison</td>
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<td>Gillette</td>
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<tr>
<td>ATT</td>
<td>66</td>
<td>29</td>
<td>5</td>
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</table>

Average                  38  50   12  24

Source: Fortune Magazine, January 10, 1983

* Board composition figure reflect composite data for the years 1978-1983.

Recall that Baysinger's and Butler's second finding was that beyond 30%, adding independent directors will result in absolute declines in financial performance, and that the curve in the graph illustrates this point by showing relative financial performance turning downward as the number of independent directors climbed above 30%. The data, however, show that almost three-fourths of the thirty-four corporations had more than 30% independent directors, even under Baysinger's and Butler's test of
independence. Therefore, far from showing that financial performance declines as the number of independent directors exceeds 30%, the author's data, if it were otherwise reliable, would show that only one-fourth of the best-performing corporations have as few as 30% independent directors.

2. MacAvoy

The central empirical conclusions of MacAvoy's paper are as follows:

Empirical evaluation of the ALI Model . . . [indicates] that the model is not now effective in the areas that the ALI claims it would be—law compliance, social responsibility and economic efficiency. Further, empirical findings . . . suggest that actual implementation of the model will have a negative impact on risk taking behavior and hence profits to the shareholders.63 None of these conclusions are supported by MacAvoy's data, and at least one actually conflicts with his data.

(a) Economic Efficiency: MacAvoy's conclusions concerning economic efficiency were based on a sample of 369 corporations. To create this sample, MacAvoy began with 532 corporations.64 He reduced this population to 369 by eliminating corporations that were not on the Industrial Compustat base,65 or that were in industries with less than ten members in the sample.66 MacAvoy then compared the financial performance of corporations with and without certain structural attributes at the board and committee levels. The most significant of these comparisons was between (i) corporations that had both an outside majority on the board, and an audit, nominating, and compensation committee, and (ii) corporations that had neither an outside majority nor all of the three committees. MacAvoy characterized the former category as "the ALI Model."67 Because the various ALI proposals concerning the board and these committees differ radically according to the size of the corporation in question, and because MacAvoy did not in fact test for certain critical features of the ALI recommendations, the term "ALI Model" is a misnomer. I shall therefore use the term "Target Model" in its place — except when quoting MacAvoy — to refer to corporations in MacAvoy's sample with an outside majority on the board and an audit, nominating, and compensation committee.

MacAvoy analyzed financial performance in terms of a number of variables: sales, assets, net earnings, and R&D expense; ratios

63. MacAvoy, supra note 40, at C-45.
64. Id. at C-27 n.61.
65. Id.
66. Id. at C-30 n.63.
67. See, e.g., id. at C-34.
of earnings to sales and to assets; growth of sales, assets, and net earnings; beta (degree of risk); and investor’s return and beta-adjusted investor’s return. 68 The key variables are the last two — most of the others do not reveal too much about how well a corporation is being run. For example, even a poorly run corporation can have large absolute assets, sales, and earnings. 69

MacAvoy’s central conclusion concerning financial performance is that “empirical findings . . . suggest that actual implementation of the [ALI] Model will have a negative impact on . . . profits to the shareholders.” 70 According to MacAvoy’s own data, however, in the two key areas of investors’ return and beta-adjusted investors’ return, Target Model corporations outperformed other corporations. The mean for investors’ return for Target Model corporations in the sample was 0.0015, whereas the mean for other corporations in the sample was -0.0275. More dramatically, the mean for beta-adjusted return of Target Model corporations was 0.0893, whereas the mean for other corporations was -0.0440. 71

A large part of MacAvoy’s paper is directed to showing that the superior financial performance of Target Model corporations was not statistically significant. This would not be surprising, given MacAvoy’s poor methodology and data. 72 Assume for a moment, however, that MacAvoy’s methodology and data were good. At best, MacAvoy might then conclude that it is not known whether Target Model corporations will have better returns to investors than will other corporations. That, however, is not MacAvoy’s claim. MacAvoy’s claim is that the empirical data suggest that “implementation of the model will have a negative impact on . . . profits.” 73 In short, MacAvoy’s principal claim is not only unsupported by his data, but flies in the face of his data.

Moreover, there are significant problems with MacAvoy’s approach and methodology on the issue of statistical significance.

To begin with, MacAvoy argues that data showing that Target Model corporations outperform other corporations should be rejected unless the data are significant at the 95% level of confidence. 74 This argument confuses the canons of an enterprise like social science, which involves the testing and validation of theories, with the canons of enterprises like business, government, and

68. Id. at C-37 (Table 8).
69. Indeed, the growth of assets would not be unexpected in a poorly run corporation since managers might try to cover poor profitability with a facade of growth.
70. MacAvoy, supra note 40, at C-45.
71. Id. at C-37 (Table 8).
72. See supra § III, B. and infra text accompanying notes 80-89.
73. MacAvoy, supra note 40, at C-45 (emphasis supplied). The full quote, set out infra text accompanying note 63, is that “empirical findings . . . suggest that actual implementation of the model will have a negative impact on risk taking behavior and hence profits to the shareholders.” I have elided from that quote because there is no reason to use risk-taking as a proxy for shareholder profits when MacAvoy has measured such profits directly.
74. Id.
law, which involve making decisions in the world on the best available evidence. A requirement of a very high statistical level of confidence is appropriate to the former type of enterprise, but not to the latter. It is generally accepted that in the social sciences it is much more serious to make an error that wrongly takes a theory as correct (a Type II error) than an error that wrongly takes a theory as incorrect (a Type I error). One obvious reason is that in the social sciences the costs of a Type I error are pretty low; the only real loss is likely to be theoretical, and even that loss will probably be temporary, since if a theory is correct further data should eventually pile up in its support. Accordingly, under the canons of social science, new theories are normally rejected unless their truth is established at a 90 or 95% level of confidence. But, in business, government, and law, the costs of a Type I error may be just as great as the costs of Type II error. Wrongly failing to change a business or government policy, or a legal rule, can be fully as costly as wrongly changing such a policy or rule. Accordingly, it would make no sense in these areas to adopt a canon that mandates the status quo unless the factual premises on which a change would be based are established at the 95% level of confidence. Instead, decisions in these areas must be and are based on the balance of probabilities: few nontrivial judgments in these areas are based on factual premises that would be accepted by social scientists as scientifically established. If MacAvoy’s argument were applied to business decisions, business would grind to a halt; if it were applied to law and government, the United States would not have adopted a single clause of the Constitution, nor, in all likelihood, a single statute thereafter. Few decision makers, whether legislators, judges, or businessmen, would refuse to take actions except where the data necessary to justify their actions could be verified at the 95% level of confidence. This is all the more true in assessing the effect of board and committee structure on financial performance. As I have shown, such an assessment necessarily involves indirect, weak, and noisy measurements. Such measurements are bound to produce weak statistical effects, and criticizing the effects on the ground that they are weak is therefore very close to circular reasoning.75

Indeed, MacAvoy drops his concerns about statistical significance when he finds it handy to do so. One of MacAvoy’s arguments is that Target Model corporations will be more risk averse

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75. As it happens, MacAvoy also made a serious statistical error in testing for statistical significance. Although he claims to have used two tests that measured statistical significance at the 95% level of confidence, in one of his tests he actually used a formula that measures statistical significance only at the much higher 99% confidence level.
than other corporations. His data show that the betas for the Target Model corporations in his sample are somewhat smaller than the betas for other corporations in his sample.\textsuperscript{76} Under his own methodology, however, the difference is not statistically significant at the 95\% level of confidence.\textsuperscript{77} That gives him a little pause, but not much: "Betas seem to be smaller for ALI, which suggests that the ALI model would exacerbate risk aversion. . . . Though these facts are all statistically insignificant, used with theoretical predictions, they may indicate effects of putting the ALI instrument in place; risk aversion will increase and profits will decline."\textsuperscript{78} And in his conclusion, with less qualification: "[E]mpirical findings . . . suggest that actual implementation of the [ALI] model will have a negative impact on risk-taking behavior. . . ."\textsuperscript{79} In short, data that are not statistically significant at the 95\% level of confidence count if they support theoretical predictions that MacAvoy likes, but do not count if they support theoretical predictions he finds not to his taste.

Finally, a close analysis of MacAvoy's data shows that the corporations that he characterizes as following "the ALI Model" fail to conform in material ways to the ALI proposals. For example, the ALI proposals contain tests of what constitutes a significant relationship between directors and senior executives.\textsuperscript{80} MacAvoy, however, did not employ such tests,\textsuperscript{81} and accordingly he could not have determined whether the boards of corporations in his sample did or did not conform to the ALI proposals. Similarly, the ALI proposals treat as critical not merely the existence of audit, nominating, and compensation committees, but also their composition. In contrast, MacAvoy tested only for the existence of such committees, not for their composition.\textsuperscript{82} Accordingly, MacAvoy could not have determined whether the committees of corporations in his sample did or did not conform to the ALI proposals. Therefore, even if MacAvoy's methodology was otherwise proper, his data would be incapable of supporting any conclusions concerning the effect of adopting the ALI proposals regarding board and committee structure.

\textbf{(b) Social Responsibility:} Among MacAvoy's central empirical conclusions is that: "Empirical evaluation of the ALI Model . . . [indicates] that the model is not now effective in the areas that the ALI claims it would be . . . [including] law compliance [and] social responsibility."\textsuperscript{83} This should not be terribly surprising, because, contrary to MacAvoy's assertion, the ALI has not claimed that its proposals concerning board and committee structure would affect

\textsuperscript{76} MacAvoy, \textit{supra} note 40, at C-37 (Table 8).
\textsuperscript{77} Id.
\textsuperscript{78} Id. at C-34.
\textsuperscript{79} Id. at C-45.
\textsuperscript{80} See \textit{supra} note 9.
\textsuperscript{81} MacAvoy, \textit{supra} note 40, at C-26 to C-44.
\textsuperscript{82} Id. at C-34 n.71.
\textsuperscript{83} Id. at C-45.
either law compliance or social responsibility. Let us put that aside, however, and focus on MacAvoy's analysis, starting with his conclusion concerning the effect of the ALI proposals on social responsibility.

To begin with, the methodology underlying this conclusion is bizarre. Some mutual funds have the express purpose of investing in socially responsible companies. The criteria of social responsibility employed by these funds are stated in their prospectuses. MacAvoy picks two such funds, and then asserts that those corporations in his sample that were held in the portfolios of the two funds met the funds' criteria and therefore are socially responsible, whereas those corporations in his sample that were not included in the two portfolios did not meet the funds' criteria and therefore are not socially responsible. This methodology therefore assumes, with no apparent justification, that (1) the funds have perfect information concerning the social conduct of all corporations in the sample; (2) they are the final arbiters of what constitutes socially responsible behavior; and (3) they buy stock in every corporation that is socially responsible, regardless of the corporation's financial prospects.

Even on the basis of these strange hypotheses, MacAvoy's data, ironically, show that the Target Model corporations in his sample came out ahead of other corporations in his sample. Seven percent of those corporations in the sample that did have a majority of unaffiliated directors were represented in the two portfolios, as compared with only 5% of those corporations that did not. Similarly, 8% of those corporations in the sample that did have the three major overview committees were represented in the two portfolios, as compared with only 5% of those corporations that did not. However, as might be expected, MacAvoy dismisses this data on the ground that they are not statistically significant at the 95% level of confidence.

(c) Law Compliance: MacAvoy's methodology concerning law compliance also depends on strong assumptions. MacAvoy uses records that show civil and criminal actions brought (apparently by governmental agencies) against 357 corporations, together with their dispositions. He then compares the number of "guilty" and "not guilty" dispositions involving the Target Model corporations in his sample with the number of such dispositions involving other corporations in his sample. Applying this methodology to individuals, we would conclude that a known Mafia boss with no con-

84. Id. at C-40-42.
85. Id. at C-42 (Table 14).
86. Id. at C-42.
87. Id. at C-34-38.
victions was in compliance with law. In any event, even under this methodology the Target Model corporations came out ahead. Of the corporations in the relevant sample, 25% were Target Model corporations, and 75% were not. However, of the 958 “guilty dispositions” rendered in civil actions against corporations in the sample, 20% were rendered against Target Model corporations and 80% were rendered against other corporations. Thus a disproportionately low percentage of the guilty dispositions involved Target Model corporations. As usual, however, MacAvoy dismisses the data as not statistically significant at the 95% level of confidence. Whether or not that is so, it is clear that contrary to the claims in his conclusions, MacAvoy’s data completely fail to show that the ALI’s proposals are “not now effective in . . . law compliance, social responsibility and economic efficiency.”

Conclusion

A portion of the corporate-law literature has taken an unfortunate turn. Some of it trades on irrelevant matters of provenance, and some of it trades on wholly unreliable quantitative data. The result is discourse that has the appearance of scholarship but the substance of political debate. No proposal for the modernization of corporate law is immune from criticism, but this portion of the literature seems to treat the body of corporate law as immune from modernization. That approach does service to neither corporate scholarship, corporate law, nor the long-run health of the corporate institution.

88. Id. at C-41 (Table 13).
89. Id. at C-38.