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A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer

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A SYSTEMS APPROACH TO CORPORATE GOVERNANCE REFORM: WHY IMPORTING U.S. CORPORATE LAW ISN'T THE ANSWER

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INTRODUCTION

The task is daunting: Spur economic growth in developing countries. Much attention has focused on bringing economic prosperity to transitional economies, including Russia and other former Soviet bloc countries, such as Hungary, Poland, and Czechoslovakia. Developing countries in Asia, Latin America, and Africa have also been the subject of reform programs, many of which have been controversial, designed to promote economic growth through privatization, political change, and other means. Today, all eyes are on Iraq and Afghanistan. A recent article in the *Wall Street Journal*, titled *Taking Iraq Private*, summed up what many view as central to promoting economic growth in Iraq and elsewhere: Create property rights, the rule of law, and other institutions that will encourage private investment and foster free markets.¹ While I agree with the article's premise, its title is a misnomer. The goal is less about taking developing countries private than it is about taking them public.

One solution for spurring economic growth in the developing world is to promote securities markets. An established body of empirical studies shows, as one might suspect, a link between the development of capital markets and economic growth.² The basic intuition is straightforward: Robust capital markets allow businesses and entrepreneurs to tap into the financial resources needed to increase output, invest in new technologies, fund research and development, build new factories, hire more workers, and exploit business opportunities domestically and abroad. The question, then, becomes: What policies best promote securities markets as a means of economic prosperity in developing countries?

When it comes to promoting equity markets, the question is often rephrased to ask: What accounts for the Anglo-American pattern of finance, characterized by dispersed share ownership and the separation of ownership and control in the United States and the United Kingdom, and how can developing countries replicate this

1. Robert McFarlane & Michael Bleyzer, *Taking Iraq Private*, WALL ST. J., Mar. 27, 2003, at A10.

2. See *infra* note 32.

achievement? Suggesting the difficulties of achieving broad and deep stock markets in which shareholders are willing to hold minority stakes in companies, concentrated ownership structures are more typical around the globe.³

The “law matters” thesis claims that the law has a central role to play in the development of equity markets. In short, the law is essential to securing the property rights of shareholders. Strong legal protections shield shareholders, especially minority shareholders, from having their investments expropriated by insiders, including directors, officers, entrepreneurs, and controlling shareholders. Unless shareholders are protected from agency problems, such as excessive executive compensation, insider trading, self-dealing transactions, and shirking, they will be discouraged from investing. Those who do invest will pay a discount for shares in order to compensate them for the risk of opportunism they are otherwise forced to shoulder. By protecting shareholders from insider abuses, the law can instill in shareholders the confidence needed to invest, thereby leading to thicker and more highly valued equity markets. The “law matters” thesis is supported by an extensive body of empirical studies, led by the work of La Porta, Lopez-de-Silanes, Shleifer, and Vishny.⁴

Moving beyond whether law matters in concept, the practical question becomes: “What law?” Because the United States by all accounts has the world’s thickest equity markets, with over 7500 issues trading on the New York Stock Exchange and NASDAQ alone,⁵ attention often turns to the United States when policy-makers and others spearheading reform fashion corporate governance agendas for developing countries. Indeed, the “law matters” thesis holds out the possibility that if developing economies craft a corporate law regime like that of the United States, they can

3. See John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 642 n.2 (1999) (collecting citations to empirical literature).

4. See *infra* Part I.A.

5. See JOHN C. COFFEE, JR. & JOEL SELIGMAN, *SECURITIES REGULATION* 24-25 (9th ed. 2003) (citing MARSHALL E. BLUME, *THE STRUCTURE OF THE U.S. EQUITY MARKETS* (The Wharton School, Univ. of Pa., Working Paper No. 02-16, 2002), available at <http://fic.wharton.upenn.edu/fic/papers/02/0216.pdf>).

achieve developed securities markets. But is the U.S. approach to corporate governance right for developing countries?

One danger of transplanting U.S. corporate law to developing economies is that it might not fit with the "importing" country's economic structure, political system, social order, or cultural values. To be sure, the resulting "transplant effects" of any such misfit are important. My focus, however, is the other side of the transplant coin—namely, whether a market-based system of corporate governance, like that found in the United States, adequately protects shareholders in developing countries so as to promote equity markets there. Posed differently, to what extent should the government displace private ordering with more substantive regulation of corporate governance in developing countries?

U.S. corporate law, and Delaware corporate law in particular, reflect an enabling approach to corporate law made up largely of default rules that parties can opt out of to privately order their governance affairs. The law on the books is supplemented by the judge-made law of fiduciary duties, designed to ensure that directors and officers, who are charged with managing the corporation's business and affairs, exercise their authority over the business with due care, in good faith, and in the best interests of the corporation and its shareholders. While far from trivial, Delaware corporate law provides shareholders relatively few protections from insider abuses.⁶ Indeed, Delaware corporate law affords directors and officers a great deal of discretion in managing the business free from the interference of shareholders and judges. The gaps in the law are filled by a host of other formal and informal mechanisms that hold management accountable. The market for corporate control and incentive-based compensation, such as stock options, are frequently cited as examples of the nonlaw components that contribute to the U.S. corporate governance system. At bottom, instead of depending primarily on substantive corporate law to protect shareholders, the market-based approach of U.S. corporate governance relies on markets, contracts, and norms, supported by a host of other institutions, to discipline directors and officers.

6. See *infra* note 60.

Not every country has the institutional makeup that allows it to eschew a more heavy-handed corporate law regime and still develop thick equity markets. Most developing countries lack the institutional mix that makes a market-based corporate governance system, with an enabling corporate law, workable. For example, the U.S. governance model presupposes that developed capital markets already exist, but they obviously do not exist in developing economies. The bottom line for most developing countries is that importing a corporate law regime along the lines of the U.S. model, or otherwise depending on a market-based model of governance, is not a viable option. More to the point, importing U.S. corporate law falls far short of replicating the U.S. system of corporate governance in developing countries, leaving many of the most important parts behind.

The alternative I recommend for developing countries is a mandatory model of corporate law that fixes key features of corporate governance—such as banning self-interested transactions, capping executive compensation, requiring shareholder approval for significant acquisitions, mandating the payment of dividends, and granting shareholders a limited put right and the right to make proposals that bind management—in order to protect shareholders from insider abuses and mismanagement. As compared to the U.S. governance system, the mandatory governance model I envision further restricts directors' and officers' discretion in managing the enterprise and allocates to shareholders additional authority, allowing shareholders to hold management more accountable and to exert more direct control over the business and how it is run.⁷ Law matters in developed countries, but it really matters in developing countries where the institutional infrastructure that otherwise protects shareholders is nascent or simply nonexistent. Having said this, a caveat is in order. To the extent that corporate

7. For a discussion of the differences between the mandatory model of corporate law that this Article proposes and the related "self-enforcing" model of corporate law proposed by Bernard Black, Jonathan Hay, and Reinier Kraakman, see *infra* notes 243-48 and accompanying text. The self-enforcing model is an important initial step toward stronger legal protections for shareholders, but the mandatory model goes further. It is considerably more restrictive of management, contemplates that shareholders will have more direct say over the business, and provides fewer opportunities for the private ordering of internal corporate affairs.

governance reform is part of a larger privatization effort and move toward free markets, the more visible hand of the government in corporate governance matters should not extend further into the private sector to steer capital flows, prop up businesses, or favor certain industries or companies through subtle or not-so-subtle forms of industrial policy.

Although my focus is on corporate governance reform, and even more narrowly on the transplantability of the U.S. model of corporate governance to developing countries, the analysis offers several broad lessons that can promote successful reform of all types. First, a country's legal regime, including the law on the books and formal enforcement mechanisms, is simply one part of a much more complex set of formal and informal institutions. The law must fit with a country's broader institutional mix, and legal reform should therefore be considered in its larger context. Second, conduct can be shaped in lots of ways. When market mechanisms are inadequate, such as when market or contracting breakdowns occur, there is a strong argument for more state-sanctioned law. On the other hand, as institutions develop, it might be appropriate for the government to scale back the legal regime to allow people greater flexibility in organizing their economic, political, and social affairs. Third, a systems approach to reform, which attempts to understand the relationships among as many parts and subparts of a system as possible, should impress on policymakers and their advisors the difficulties of reform. Consequently, policymakers should be better able, and more willing, to consider a range of options, including those that might have been rejected elsewhere. Also, by engaging the complexities of reform, which is part and parcel of a systems approach, policymakers might demonstrate more humility in crafting reform programs. Fourth, early success is essential, and the benefits of reform should not be overpromised. Policymakers have few chances to get it right before political support for reform might wane, derailing the prospects for meaningful change. Finally, there is no one approach that works best everywhere. The right governance regime for a country depends on its institutions and its goals.

This Article begins in Part I by exploring the "law matters" thesis and the prospect for transplanting U.S. corporate law to developing countries. Part II asks: "What is U.S. corporate governance?" A

systems approach pieces together the key components of the U.S. governance system that complement each other to create a whole that is greater than the sum of its parts and that depends on relatively little substantive corporate law to protect shareholders. The systems analysis also makes clear that an enabling corporate law, such as the Delaware corporation code, is not readily transplantable to developing countries. More generally, Part II demonstrates, as others have pointed out, that institutions matter.⁸ Part III further develops the argument that a market-based model of governance is not feasible for developing countries. Part IV proposes a framework for corporate governance reform in developing countries that is premised on a mandatory model of corporate law, the very regime the United States has rejected. In so doing, the analysis calls into question the likelihood of the worldwide convergence of corporate governance to the U.S. model as many have predicted in light of increasingly competitive global capital and product markets.⁹ Part IV ultimately pushes beyond the theoretical case for more law protecting minority shareholders, offering several specific suggestions for policymakers to consider in crafting the corporate law regimes of developing economies.

I. THE COMPARATIVE CORPORATE GOVERNANCE DEBATE: DOES LAW MATTER?

When will ownership and control separate?¹⁰ In other words, what are the preconditions for dispersed share ownership and thick equity markets? Two things are needed for securities markets to exist: willing buyers and willing sellers. Investors must be willing

8. See *infra* notes 168, 172.

9. For more on the corporate convergence debate, see, for example, Douglas M. Branson, *The Very Uncertain Prospect of "Global" Convergence in Corporate Governance*, 34 CORNELL INT'L L.J. 321 (2001); Brian R. Cheffins, *Corporate Governance Convergence: Lessons from Australia*, 17 TRANSNAT'L LAW. 13 (2002); Coffee, *supra* note 3; Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001); Brett H. McDonnell, *Convergence in Corporate Governance—Possible, But Not Desirable*, 47 VILL. L. REV. 341 (2002).

10. The separation of ownership and control was, of course, made famous by Berle and Means. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (rev. ed., Harcourt, Brace, & World, Inc. 1968) (1933).

to invest, and managers, entrepreneurs, and controlling shareholders, who we can think of as "insiders," must be willing to sell stakes in their companies for securities markets to develop. Investors will be reluctant to invest if they are not confident that insiders will not expropriate their investments by paying excessive compensation to executives, filling key positions with friends and family, engaging in self-dealing transactions, trading on inside information, shirking, or stealing.¹¹ In other words, investors will withhold funds if they are not adequately protected from agency problems.¹² The U.S. securities markets provide a vivid case in point, as investors withdrew after the scandals at Enron, WorldCom, Tyco, and elsewhere.¹³ Shareholders are especially subject to the risk of expropriation because of the firm-specific nature of their investments and the fact that they are last in line as a company's residual economic claimant, thereby only receiving a return on their investments after other claimants, such as employees and creditors, are paid.¹⁴ Even if investors are willing to invest, there are no assurances of thick securities markets. The premiums investors demand to protect

11. For discussions of various types of insider expropriation, see, for example, Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1660-63 (2002); John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2157-59 (2001) [hereinafter Coffee, *Do Norms Matter?*]; John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 24-25 (1999) [hereinafter Coffee, *Privatization*]; Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22-26 (2000); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 4 (2000).

12. Although investors are accustomed to pricing business risks, it is more difficult to price the risk of being exploited by insiders. Even if investors invest, they will demand a premium to compensate them for the risk of opportunism and mismanagement and, as a result, market valuations will be lower and securities will be less liquid.

13. During the period from March 2000 to July 2002, the Wilshire Total Market Index fell over \$7 trillion. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 623-24 (2003).

14. For more on the firm-specific nature of shareholders' investment and their status as a corporation's primary residual economic claimants, see Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983); Troy A. Paredes, *The Firm and the Nature of Control: Toward a Theory of Takeover Law*, 28 J. CORP. L. (forthcoming 2004); BERNARD S. BLACK, *CORPORATE LAW AND RESIDUAL CLAIMANTS* (Berkeley Olin Program in Law & Econ., Working Paper No. 27, 1999) (unpublished manuscript, on file with author); see also *infra* note 211 and accompanying text (explaining how nonshareholder constituencies are better able to protect themselves from the risk of expropriation). For a contrary view based on the "team production" model of the firm, see, for example, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

against the risk of expropriation might be so great that insiders, particularly those who have no intention on siphoning off private benefits, refuse to sell stakes in their companies at the demanded discounts.¹⁵ Even if willing buyers and sellers can be found at reduced share prices, the resulting equity markets will suffer from fewer offerings, less liquidity, and, of course, lower valuations, compromising the ability of companies to raise capital.¹⁶

A. Law Matters

From this vantage point, protecting shareholders from insider abuses is a *sine qua non* of thick equity markets, the hallmark of which are widely held companies with dispersed share ownership structures (i.e., the separation of ownership and control).¹⁷ The immediate question, then, is: How can shareholders be protected adequately from insider expropriation so as to encourage them to invest in companies? Many economists and legal academics contend that the law has a central role to play in protecting shareholders, especially minority shareholders, and thus in influencing corporate finance and ownership structures around the globe.¹⁸ According to

15. This rings of the classic “lemons” problem. See George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970); see also Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 838 (2001) (explaining that in a “lemons equilibrium” with weak securities market institutions, honest companies will often refrain from issuing shares to the public). For more on this point, see LUCIAN ARYE BEBCHUK, A RENT-PROTECTION THEORY OF CORPORATE OWNERSHIP AND CONTROL (Nat’l Bureau of Econ. Research, Working Paper No. 7203, 1999), available at <http://www.nber.org/papers/w7203.pdf>.

16. Plus, even if shares are successfully sold to the public, those shares might eventually reaggregate into the hands of a controlling or majority shareholder if the private benefits of control are large enough. See, e.g., BEBCHUK, *supra* note 15.

17. To be clear, this is not to suggest that strong shareholder protections are alone enough for securities markets to develop.

18. For consideration of the “law matters” thesis, see, for example, Choi, *supra* note 11; John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001); Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right*, 30 J. LEGAL STUD. 503 (2001); Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539 (2000); THORSTEN BECK ET AL., LAW AND FINANCE: WHY DOES LEGAL ORIGIN MATTER? (Univ. of Minn. Working Paper, 2002), available at <http://ssrn.com/abstract=355820>; BRIAN R. CHEFFINS, CORPORATE LAW AND OWNERSHIP STRUCTURE: A DARWINIAN LINK? (June 2002), available at <http://ssrn.com/abstract=317661> [hereinafter CHEFFINS, DARWINIAN LINK]; BRIAN R. CHEFFINS, LAW AS BEDROCK: THE FOUNDATIONS OF AN ECONOMY DOMINATED BY WIDELY

these proponents of the "law matters" thesis, law matters in that strong legal protections give shareholders comfort that insiders will be less able to expropriate their investments, thereby instilling in shareholders the confidence needed for securities markets to develop. Moreover, when laws are in place, parties can rely less on personal and family relationships when transacting, allowing them to engage in transactions with strangers. Strong legal protections for shareholders expand the available pool of capital for businesses and entrepreneurs and facilitate contracting by shoring up shareholder rights. At its core, the "law matters" thesis expounds strong and enforceable shareholder property rights as a basis for promoting securities markets and economic growth.

Something akin to the "law matters" thesis has been at work in the United States recently. Congress and the Securities and Exchange Commission (SEC), as well as the major stock markets, have adopted a number of historic corporate governance and accounting reforms to shore up investor confidence in the aftermath of the recent corporate scandals. The cornerstone of the reforms, of course, was the passage of the Sarbanes-Oxley Act of 2002.¹⁹

In addition to its theoretical underpinnings, the "law matters" thesis has the backing of an impressive body of empirical research, most notably the seminal work of La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV).²⁰ In a series of influential studies, LLSV have examined the relationship between the degree of shareholder protection and securities market development for nearly fifty countries.²¹ LLSV have developed an "antidirector rights

HELD PUBLIC COMPANIES (Aug. 2001), available at <http://ssrn.com/abstract=279350> [hereinafter CHEFFINS, LAW AS BEDROCK]; EDWARD GLAESER & ANDREI SHLEIFER, LEGAL ORIGINS (Nat'l Bureau of Econ. Research, Working Paper No. 8272, 2001), available at <http://www.nber.org/papers/w8272.pdf>; KATHARINA PISTOR ET AL., LAW AND FINANCE IN TRANSITION ECONOMIES (European Bank for Reconstruction & Dev., Working Paper No. 48, 2000), available at <http://ssrn.com/abstract=214648>; see also *infra* note 20.

19. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

20. See Rafael La Porta et al., *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1 (2000); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); La Porta et al., *supra* note 11; Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) [hereinafter La Porta et al., *Law and Finance*]; Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter La Porta et al., *Legal Determinants*].

21. See La Porta et al., *supra* note 11 (summarizing earlier studies); La Porta et al., *Law and Finance*, *supra* note 20; La Porta et al., *Legal Determinants*, *supra* note 20.

index" that measures the shareholder protection of a country based on six factors: (1) the ability of shareholders to mail their proxy votes; (2) whether shareholders are required to deposit their shares prior to the shareholders' meeting in order to vote them; (3) the existence of cumulative or some other form of proportional voting; (4) whether minority shareholders are able to challenge perceived director oppression in court or otherwise; (5) the ability of shareholders holding fewer than ten percent of a company's shares to call a special shareholders' meeting; and (6) whether shareholders have preemptive rights.²² LLSV also measure the extent of law enforcement for each country, using the following as proxies: the efficiency of the judicial system, the rule of law, corruption, and accounting standards.²³

LLSV report two core findings: first, countries with stronger legal protections for minority shareholders have broader, deeper, and more highly valued stock markets as measured by stock market capitalization, the number of publicly traded companies, and the number of initial public offerings;²⁴ and second, common law legal systems provide shareholders stronger legal protections that result in thicker stock markets than are typically found in civil law countries.²⁵ Not only does substantive corporate law matter, legal origin appears to matter too.²⁶

22. See La Porta et al., *supra* note 11, at 10-11. LLSV developed a similar "creditor rights index" to study the relationship between strong creditor protections and debt financings. See La Porta et al., *Law and Finance*, *supra* note 20, at 1122-25; La Porta et al., *Legal Determinants*, *supra* note 20, at 1133-39.

23. See La Porta et al., *supra* note 11, at 8-12; La Porta et al., *Law and Finance*, *supra* note 20, at 1140-45. For an important extension of LLSV's original empirical studies to include several factors other than the law on the books that impact the development of securities markets, see Daniel Berkowitz et al., *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 1 (2003); PISTOR ET AL., *supra* note 18.

24. See La Porta et al., *supra* note 11, at 15-16; La Porta et al., *Law and Finance*, *supra* note 20, at 1151-52; La Porta et al., *Legal Determinants*, *supra* note 20, at 1137-39.

25. See La Porta et al., *supra* note 11, at 13-15; La Porta et al., *Law and Finance*, *supra* note 20, at 1151-52; La Porta et al., *Legal Determinants*, *supra* note 20, at 1137-39. LLSV also find that French civil law countries provide the least protection, with German civil law and Scandinavian civil law countries somewhere in the middle.

26. For interesting empirical studies showing that corporate governance affects firm value across companies within a single country, in addition to affecting the development of equity markets across countries, see, for example, BERNARD S. BLACK ET AL., DOES CORPORATE GOVERNANCE AFFECT FIRMS' MARKET VALUES? EVIDENCE FROM KOREA (John M. Olin Program in Law & Econ., Stanford Law School, Working Paper No. 237, 2003), available at <http://>

The “law matters” thesis claims to solve a puzzle that has seized comparative corporate governance scholars lately: Why do the United States and the United Kingdom have dispersed share ownership structures, while countries throughout the rest of the developed world, including Germany and Japan, have concentrated ownership?²⁷ The separation of ownership and control was supposed to win a “Darwinian struggle” over concentrated ownership,²⁸ and some boldly declared the “end of history” for global ownership and governance patterns as the Anglo-American model of dispersed share ownership and shareholder primacy—the idea that directors and officers should run the business in the best interests of shareholders—would ascend worldwide, if it had not already.²⁹ The logic propelling dispersed ownership to its alleged dominance is straightforward. First, as companies increase in size to exploit economies of scale, they would be forced to turn to outside sources of capital. Second, separating ownership and control would allow companies to hire professional managers who could run the business better than shareholders.³⁰ To the extent the separation of ownership and control offers capital-raising and managerial advantages, pressure to converge to the Berle and Means firm marked by dispersed share ownership has mounted in recent years as capital and product markets have become increasingly global and competitive. The predicted convergence, however, has not occurred. In

ssrn.com/abstract=311275 (reporting evidence that corporate governance affects the market value of Korean public companies); Bernard S. Black, *Does Corporate Governance Matter? A Crude Test Using Russian Data*, 149 U. PA. L. REV. 2131 (2001) (studying the effects of corporate governance on the market value of Russian firms).

27. For extensive consideration of this question, see, for example, MARK J. ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT* (2003); Black, *supra* note 15; Coffee, *supra* note 18; Hansmann & Kraakman, *supra* note 9; La Porta, *Legal Determinants*, *supra* note 20; McDonnell, *supra* note 9; Roe, *supra* note 18; Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States*, 150 U. PA. L. REV. 527 (2001).

28. See, e.g., Cheffins, *supra* note 9, at 13-18; Coffee, *supra* note 18, at 3.

29. Hansmann & Kraakman, *supra* note 9.

30. For discussions of the specialization of function whereby managers run the enterprise and shareholders bear risk as a company's residual claimants, see generally Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 307-17 (1983); CHEFFINS, *LAW AS BEDROCK*, *supra* note 18, at 23-30; see also Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (arguing in favor of director primacy in exercising managerial control over the company, free from shareholder interference).

advanced economies other than the United States and the United Kingdom, companies frequently have a controlling shareholder, such as a family, a bank, a corporate group, or the state, that not only holds a large block of stock but that exerts considerable influence over the company. According to the “law matters” thesis, strong minority shareholder protections in the United States and the United Kingdom account for these countries’ dispersed ownership structures; investor protections in the rest of the developed world are supposedly inadequate for equity markets to develop to any significant degree.³¹

The “law matters” thesis has even more profound implications for developing economies. A growing literature shows a link between economic growth and capital markets. The basic relationship is that robust capital markets enable businesses and entrepreneurs to tap into the financial resources necessary to commercialize innovations, expand production, and invest in capital improvements and new technologies.³² In addition, developed capital markets can promote savings and a more efficient allocation of an economy’s resources to more productive uses as investors search for the highest returns. However important it might be to further equity markets in more

31. See, e.g., La Porta et al., *supra* note 11, at 15:

In sum, the evidence has proved to be broadly consistent with the proposition that the legal environment shapes the value of the private benefits of control and thereby determines the equilibrium ownership structures. Perhaps the main implications of this evidence for the study of corporate governance are the relative irrelevance of the Berle and Means corporation in most countries in the world and the centrality of family control.

The flip side is that concentrated ownership will occur where legal protections do not adequately protect investors, because investors need blockholders to monitor management. For more on concentrated ownership and the blockholder model of finance, see, for example, William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT’L L. 213 (1999) [hereinafter Bratton & McCahery, *Case Against Global Reference*]; William W. Bratton & Joseph A. McCahery, *Incomplete Contracts Theories of the Firm and Comparative Corporate Governance*, 2 THEORETICAL INQUIRIES L. 745 (2001); Reinhard H. Schmidt & Gerald Spindler, *Path Dependence, Corporate Governance and Complementarity*, in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon & Mark J. Roe eds., forthcoming 2004).

32. For discussions of the data linking capital markets and economic growth, see, for example, Black, *supra* note 15, at 831-38; Choi, *supra* note 11, at 1660-94; Frank B. Cross, *Law and Economic Growth*, 80 TEX. L. REV. 1737, 1769-70 (2002); La Porta et al., *supra* note 11, at 16-17.

advanced economies, the stakes are higher and the challenges are greater when it comes to creating strategies for promoting securities markets in developing countries such as Ghana, Nepal, Indonesia, Romania, Turkey, and Colombia, not to mention Iraq and Afghanistan. The "law matters" thesis offers a clear policy prescription that calls for developing countries to adopt laws and create enforcement mechanisms that will protect shareholders from insider expropriation to create thick equity markets as a means of economic prosperity. This is an extremely difficult task, a point to which I return later.

The "law matters" thesis has detractors who assert that factors other than law are key to dispersed share ownership. In Mark Roe's view, for example, politics matter more than law in explaining the separation of ownership and control, at least in developed economies.³³ Together with Lucian Bebchuk, Roe has also argued that because of path dependence, a country's starting point strongly influences its corporate governance and ownership structures; in other words, history matters.³⁴ Culture has also been identified as shaping a country's corporate governance and finance patterns.³⁵ John Coffee and Brian Cheffins make related claims that market-based investor protections through bonding mechanisms and self-regulation, such as stock exchange listing standards, account for dispersed ownership in the United States and the United Kingdom.³⁶ Coffee also posits, with Cheffins in agreement, that the

33. See ROE, *supra* note 27; Roe, *supra* note 18.

34. See Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999); Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 643-46 (1996); see also Schmidt & Spindler, *supra* note 31 (explaining path dependence in corporate governance in terms of complementarity).

35. See generally Amir N. Licht, *The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147 (2001); AMIR N. LICHT, LEGAL PLUG-INS: CULTURAL DISTANCE, CROSS-LISTING, AND CORPORATE GOVERNANCE REFORM (Interdisciplinary Ctr. Herzliyah-Radzyner School of Law, Working Paper, 2003) [hereinafter LICHT, LEGAL PLUG-INS], available at <http://ssrn.com/abstract=386320>; AMIR N. LICHT ET AL., CULTURE, LAW, AND FINANCE: CULTURAL DIMENSIONS OF CORPORATE GOVERNANCE LAWS (Interdisciplinary Ctr. Herzliyah-Radzyner School of Law, Working Paper, 2001), available at <http://ssrn.com/abstract=277613>.

36. See Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459 (2000); Coffee, *supra* note 3; Coffee, *supra* note 18; CHEFFINS, LAW AS BEDROCK, *supra* note 18, at 15.

causal chain might not flow from legal protections to robust markets; rather, investors and other interested groups might demand greater legal protections after entering a burgeoning market and becoming a more powerful political constituency.³⁷ Curtis Milhaupt offers an amalgam of the above views, contending that an economy's broader property rights institutions explain financial structures.³⁸ Finally, the fear of corruption matters. If a country suffers from widespread corruption, its substantive law can do little to foster securities markets. Corruption in the legal, economic, or political system of a country stymies, if not blocks its economic growth.³⁹

Even those who share the "law matters" view debate why legal origin is important. A leading explanation is that common law judges can use flexible fiduciary duties to root out more effectively insider abuses by filling the inevitable gaps left by statutes. Civil law judges, on the other hand, are relegated to interpreting the relevant code and have less flexibility to apply general standards of loyalty, due care, and good faith to fill problematic gaps.⁴⁰ Roe captures the claim this way: "Wheeler-dealers run rings around the civil law judges, who read the legislative texts too narrowly; those wheeler-dealers cannot easily run rings around the tough common law judges, who, with the bludgeon of open-ended fiduciary duties, eventually catch up with the thieves."⁴¹ An alternative—and more

37. See Coffee, *Do Norms Matter?*, *supra* note 11, at 2171; CHEFFINS, *LAW AS BEDROCK*, *supra* note 18, at 50; see also Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2122-23 (2001) ("Law and its enforcement may not determine the structure of corporate groups; rather, important corporate and financial groups in a given society may drive the development of legal institutions and enforcement practices by affecting the demand for law, at least in part through norm creation and destruction.").

38. See generally Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145 (1998).

39. For more on corruption, see *infra* notes 271-77 and accompanying text. For an extensive analysis of the impact of corruption, see Daniel Kaufmann, *Rethinking Governance: Empirical Lessons Challenge Orthodoxy*, available at <http://ssrn.com/abstract=386904> (Mar. 11, 2003). LLSV do account for corruption in their studies, although the law on the books is their central focus. See, e.g., La Porta et al., *supra* note 11, at 10-11.

40. Interestingly, if the advantage of the common law tradition over the civil law tradition is rooted in the law of fiduciary duties, fiduciary duties are not included in LLSV's "antidirector rights index." La Porta et al., *supra* note 11, at 10-11.

41. Mark J. Roe, *Institutional Foundations for Securities Markets in the West* 4 (2002), at <http://www.econ.nyu.edu/user/frydmanr/Roe-AER2003.doc>.

political—explanation of the significance of legal origin is that common law countries have greater respect than civil law countries for individual autonomy over governmental authority. Accordingly, property rights are more secure, particularly from state expropriation, in common law systems, and the state is less intrusive in economic and commercial affairs, leaving these matters to the private sector.⁴²

Whether law matters more than politics, history, culture, or any other factor is debatable. At the very least, law plays a significant role in protecting shareholders; and, as I argue below,⁴³ law has an essential role to play in promoting securities markets in developing economies, even if other factors are largely responsible for the separation of ownership and control in advanced economies. Assuming that law matters and that financial development spurs economic growth, the challenge for policymakers is to operationalize the “law matters” thesis by enacting laws appropriate to fostering dispersed ownership and broad and deep equity markets. But what does an “appropriate” legal regime look like for a developing country? What particular legal protections matter to shareholders? As is often the case, policymakers fix on the U.S. models of corporate governance and finance for guidance.⁴⁴

B. Transplanting U.S. Corporate Law

The “law matters” thesis is encouraging because it suggests that developing countries can achieve financial development and economic growth by adopting a corporate law regime similar to the United States, which has the broadest and deepest securities markets in the world.⁴⁵ In recent years, many developing coun

42. For more on the debate over the significance of legal origin, see BECK ET AL., *supra* note 18; Coffee, *Privatization*, *supra* note 11, at 5-10; La Porta et al., *supra* note 11, at 9-12; Mahoney, *supra* note 18.

43. See *infra* Part IV.A.

44. See *infra* note 47.

45. As Lynn Stout described: “[I]t is a tempting prospect to think that, by modifying their rules to more closely approximate U.S.-style corporate law, such nations might spur the process of economic development.” LYNN A. STOUT, ON THE EXPORT OF U.S.-STYLE CORPORATE FIDUCIARY DUTIES TO OTHER CULTURES: CAN A TRANSPLANT TAKE? 2 (UCLA School of Law, Working Paper No. 02-11, 2002), available at <http://ssrn.com/abstract=313679>. Strong legal shareholder protections are particularly important in developing countries; however, financial

tries, often at the urging of influential organizations, such as the World Bank and the Organization for Economic Cooperation and Development,⁴⁶ have reformed their corporate governance structures to better protect minority shareholders from insider abuses. Frequently, these efforts involve enacting corporate law reforms that reflect many of the key features of U.S. corporate law.⁴⁷

Numerous countries are considering corporate governance reforms or will need to soon as part of a broader economic reordering toward freer markets. One high-profile reform effort occurred in Russia, where leading U.S. academics helped craft the country's corporate law regime along the general lines of the United States'.⁴⁸ Economic reforms in Iraq are sure to receive even greater attention, and it is a reasonable bet that corporate governance reforms in Iraq, once the rebuilding of the country reaches that stage, will be informed by, if not based on, the U.S. approach to corporate governance.⁴⁹

development and economic growth depend on more than strong law.

46. See CTR. FOR INT'L PRIVATE ENTERPRISE, *INSTITUTING CORPORATE GOVERNANCE IN DEVELOPING, EMERGING AND TRANSITIONAL ECONOMIES: A HANDBOOK* (2002), available at http://www.cipe.org/programs/corp_gov/index.htm [hereinafter CIPE HANDBOOK]; ORG. FOR ECON. COOPERATION AND DEVELOPMENT, *OECD PRINCIPLES OF CORPORATE GOVERNANCE* (1999), available at <http://www.oecd.org>; THE WORLD BANK GROUP, *PRIVATE SECTOR DEVELOPMENT STRATEGY-DIRECTIONS FOR THE WORLD BANK GROUP* (2002), available at <http://rru.worldbank.org/documents/PSDStrategy-April%209.pdf> (Apr. 9, 2002).

47. See Coffee, *Privatization*, *supra* note 11, at 6; Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 839 (2002); MARGARET M. BLAIR, *SHAREHOLDER VALUE, CORPORATE GOVERNANCE AND CORPORATE PERFORMANCE: A POST-ENRON REASSESSMENT OF THE CONVENTIONAL WISDOM* 2 n.3 (Georgetown Univ. Law School, Working Paper No. 334240, 2002), available at <http://ssrn.com/abstract=334240>; LICHT, *LEGAL PLUG-INS*, *supra* note 35, at 62; see generally Hansmann & Kraakman, *supra* note 9 (alleging the end of history for corporate law as corporate governance regimes around the globe converge to the shareholder-oriented U.S. model); CIPE HANDBOOK, *supra* note 46. Even when countries do not adopt U.S.-style corporate law, individual companies can in effect adopt it for themselves by cross-listing on U.S. stock exchanges. See, e.g., Coffee, *supra* note 3.

48. The Russian reforms were ultimately less successful at encouraging investment and promoting capital markets than anticipated. For an extensive discussion of Russian reform efforts, see generally Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000); Bernard S. Black & Anna S. Tarassova, *Institutional Reform in Transition: A Case Study of Russia*, 10 SUP. CT. ECON. REV. 211 (2003); Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons from Russian Enterprise Fiascoes*, 75 N.Y.U. L. REV. 1720 (2000).

49. As the *Wall Street Journal* recently reported, "Remaking Iraq's economy in America's image has been doctrine in Washington since well before the war." Neil King, Jr., *Selling*

But U.S. corporate law might be inappropriate for promoting equity markets in developing countries.⁵⁰ Transplanting the law of the United States, or any other country, has the benefit of being relatively easy and inexpensive, in comparison to crafting statutes, rules, and regulations from scratch.⁵¹ There are, however, dangers with legal transplants. As a result of any number of differences between the “importing” and “origin” countries, including different economies, political systems, and social structures, as well as unique value systems and priorities, an “importing” country might not be ready to receive the transplant.⁵² Further, the “importing” country simply might not understand the law it is importing and how it is supposed to work.⁵³ As a result, the transplant might not take root or might evolve differently in the “importing” country than in the “origin” country.⁵⁴ In any case, the transition to a new regime

Iraqis on Selling Iraq: U.S. Pushes Iraq to Put State Firms on the Block; Skeptics Warn of Unrest, WALL ST. J., Oct. 28, 2003, at A4.

50. For important work addressing corporate law transplants, see, for example, Berkowitz et al., *supra* note 23; Katharina Pistor, *The Standardization of Law and Its Effects on Developing Economies*, 50 AM. J. COMP. L. 97 (2002); Pistor et al., *supra* note 47; HIDEKI KANDA & CURTIS J. MILHAUPT, RE-EXAMINING LEGAL TRANSPLANTS: THE DIRECTOR'S FIDUCIARY DUTY IN JAPANESE CORPORATE LAW (Columbia Law & Econ., Working Paper No. 219, 2003), available at <http://ssrn.com/abstract=391821>; KATHARINA PISTOR & CHENG-GANG XU, FIDUCIARY DUTY IN TRANSITIONAL CIVIL LAW JURISDICTIONS: LESSONS FROM THE INCOMPLETE LAW THEORY (ECGI Working Paper No. 01, 2002), available at <http://ssrn.com/abstract=343480>; STOUT, *supra* note 45.

51. See, e.g., KANDA & MILHAUPT, *supra* note 50, at 7 (“Why are legal transplants ubiquitous? Several interrelated answers are possible. First and most obviously, they are a cheap, quick and potentially fruitful source of new law ... and may be the only feasible means of law reform in some instances”). In the extreme, an “importing” developing country could simply codify something like the Delaware General Corporation Law or the Model Business Corporation Act.

52. See, e.g., *id.* at 9 (“We believe that ‘fit’ between the imported rule and the host environment is crucial to the success of a transplant.”).

53. See Berkowitz et al., *supra* note 23, at 16-17 (discussing the importance of “familiarity” with the transplanted law); Pistor, *supra* note 50, at 98 (explaining that law is a “cognitive institution” that must be “understood and embraced not only by law enforcers, but also those using the law”).

54. As Jerome Frank stated:

Yet, although borrowing may sometimes be wise, often a danger lurks in transferring a legal rule or practice to an alien culture. We may find a parable in the fact that rabbits, harmless in their native habitat, when imported into Australia turned out to be a menace to Australian farmers. We should note too the biologist's report that “identical living cells develop differently in different parts of the organism,” and that, so some believe, cancer is caused by the unregulated growth and spread of normal cells.

can be socially disruptive and is likely to be rife with ongoing challenges and unanticipated consequences—for better and for worse. “[Transplanting] may give the importing country something like the ‘bends.’”⁵⁵

These questions of “macro-fit”⁵⁶ between the transplanted law and an “importing” country’s broader social institutions and political economy certainly deserve considerable attention. But I want to focus instead on the other side of the transplant coin: Would a corporate law regime like the United States’ adequately protect shareholders in developing countries?⁵⁷ Asked differently, is a market-based model of corporate governance right for developing countries? My basic concern is that developing economies can suffer serious economic setbacks if they inadvertently design a corporate law regime that affords minority shareholders too few protections. Although my analysis is couched in terms of transplanting U.S. corporate law, the broader inquiry concerns the proper role of the government in regulating corporate governance in developing economies.

The “law matters” thesis places formal legal rules—the core of which we might think of as the law on the books—at the forefront of financial development. Placing as much emphasis on the law on the books as the “law matters” thesis, however, raises problems. One problem is methodological. LLSV’s “antidirector rights index,” for example, includes six items that, in and of themselves, do very little to protect shareholders.⁵⁸ This is not to say that the empirical

Jerome Frank, *Civil Law Influences on the Common Law—Some Reflections on “Comparative” and “Contrastive” Law*, 104 U. PA. L. REV. 887, 915 (1956) (footnotes omitted).

55. *Id.*

56. The phrase “macro-fit” is borrowed from Hideki Kanda and Curtis Milhaupt. KANDA & MILHAUPT, *supra* note 50, at 9.

57. The question I pose here is akin to Kanda and Milhaupt’s concept of “micro-fit.” *Id.* (“Micro-fit is how well the imported rule complements the preexisting legal infrastructure in the host country.”); see also Bernard S. Black et al., *Corporate Law from Scratch*, in 2 CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA: INSIDERS AND THE STATE 245 (Roman Frydman et al. eds., 1996) (developing a “self-enforcing” model of corporate law in arguing against transplanting the enabling corporate law of the United States to emerging economies); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996) (further developing a “self-enforcing” model of corporate law).

58. See Coffee, *supra* note 18, at 8 (“The specific ‘anti-director’ rights that [LLSV] identify as the central factors distinguishing common-law from civil-law systems strike many commentators as only tangentially related to effective legal protection for minority

work undergirding the “law matters” thesis is not important; nor is this to say that the law on the books does not matter. I am convinced that law matters to corporate governance and finance; but most corporate law scholars and attorneys would agree that the legal rules the empirical research focuses on are not key features of any corporate law regime, including U.S. corporate governance.

The real-life problems that arise by focusing on formal legal rules, however, are more serious than the methodological ones. Much more than the formal rules of the game matter, whether one is considering economic reform, political reform, or any other reform effort. The law is but one part of a much more complex institutional mix that must be taken into account. It is particularly important to bear this in mind when considering whether to fashion a corporate law regime in a developing country after the United States or, more generally, when considering any market-based approach to corporate governance.⁵⁹ As I explain more in the next Part, corporate law on the books in the United States affords shareholders fairly weak protections from insider abuses. It is not much of an overstatement to say that, with a few notable exceptions, the Delaware corporation code is largely beside the point when it comes to shareholder rights, providing shareholders few legal protections. U.S. corporate law has even been called “trivial.”⁶⁰ In the U.S. system of corporate governance, shareholders are not protected primarily by formal legal rules—and especially not by the protections contained in the “antidirector rights index”⁶¹—but rather by nonlegal mechanisms, such as market pressures, contracts, and norms of good practice that directors and officers follow. To the extent substantive corporate law matters in the United States, it is not the law on the

shareholders.”); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 252 n.28 (2002) (explaining that the items included in the index are “not likely to be near the top of most American lawyers’ lists of Delaware corporate law’s most important legal protections”).

59. For others arguing for a broader approach to corporate governance reform that focuses on more than the formal rules of the game, see, for example, Berkowitz et al., *supra* note 23; Milhaupt, *supra* note 37; Milhaupt, *supra* note 38; Pistor et al., *supra* note 47; PISTOR ET AL., *supra* note 18; see generally *infra* note 172.

60. Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990); see also Black & Kraakman, *supra* note 57, at 1914 (explaining that corporate law “plays a relatively small, even ‘trivial’ role” in the corporate governance regimes of developed countries).

61. See *supra* note 58 and accompanying text.

books but the common law of fiduciary duties that judges craft. Billions of shares exchange hands daily on the New York Stock Exchange and NASDAQ, not because of strong laws on the books that favor shareholders, but despite weak ones.

When attention focuses on the United States as a model of corporate governance and thick securities markets, the question for policymakers is whether developing countries can replicate the U.S. corporate governance system, not just whether they can enact a code that resembles the Delaware corporation code or the Model Business Corporation Act or that even codifies the common law of fiduciary duties. Enacting corporate law along the lines of the U.S. model is a far cry from developing a governance regime that protects shareholders from expropriation. To recast this point, a market-based model of corporate governance will not adequately protect shareholders in developing countries unless a host of other institutions exist that complement the law in holding insiders accountable. If the entire U.S. governance system, or something approaching it, cannot be recreated, simply transplanting one piece of it (i.e., the law) might do more harm than good, especially when the “importing” country’s forgone opportunity to adopt a different regime is considered. While corporate law scholars generally understand the complexities of corporate governance, including the secondary role substantive corporate law plays in the United States, I worry that many, perhaps most, policymakers shaping corporate governance reform in developing countries do not.⁶² When developing a corporate governance reform agenda, focusing on a simplified model of governance that emphasizes formal legal rules is problematic.

II. THE U.S. CORPORATE GOVERNANCE SYSTEM

What is the U.S. model of corporate governance? The answer is not substantive corporate law, although to be sure, the law plays a more important role post-Sarbanes-Oxley and other recent regulatory reforms. Corporate law is one small part of a complex U.S. corporate governance system comprising a wide array of complementary institutions, incentive structures, constraints, and

62. Cf. CIPE HANDBOOK, *supra* note 46, at 10-12 (explaining that policymakers have adopted a simplified model of corporate governance).

practices that work together to create a whole that is greater than the sum of its parts.⁶³ My purpose in this Part is to take inventory of U.S. corporate governance—focusing in particular on Delaware, the most influential state for corporate law⁶⁴—by explaining the relationship among key features of the U.S. corporate governance system.⁶⁵ Such a “systems approach” to understanding corporate governance is important because no one part can be understood on its own, outside the larger framework to which it contributes.⁶⁶ Thinking of corporate governance as a system of complementarities is especially useful when fashioning reform agendas for developing countries because it sheds light on the transplantability of U.S. corporate law and ultimately on the type of governance regime that is most likely to promote equity markets in developing economies.⁶⁷

63. For an interesting recent discussion of the limits of corporate law, see Roe, *supra* note 58 (focusing on the limits of corporate law in controlling management (i.e., bad business decisions) as compared to disloyalty). The general complementarities framework I employ below to analyze U.S. corporate governance is not unique to me. For more on the closely related proposition that institutions matter, see *infra* notes 168, 172 and accompanying text.

64. Delaware is the most important state for purposes of corporate law, not only because the majority of public companies are incorporated there, but also because other states look to Delaware corporate law for guidance. See generally Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002).

65. For an extensive, but more general, discussion of the various laws and institutions that are important to creating a corporate governance system that can support thick securities markets, see Black, *supra* note 15. For a useful but more condensed description of the U.S. corporate governance system than this Article offers, see Black & Kraakman, *supra* note 57, at 1914-21.

66. For more on a “systems” approach to legal analysis, see generally Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479, 480 (1997). LoPucki has summarized a systems analysis as follows: “To ‘analyze’ a system is to break it down into its constituent parts, to determine the nature and identity of its subsystems, and to explain the relationships among them.” *Id.* at 482-83.

67. *Cf. id.* at 480 (“Restricting one’s attention to particular aspects of reality reduces complexity, making it possible to solve problems that otherwise would boggle the mind. The disadvantage in restricting one’s attention, however, is that it often screens out important aspects and leads the analyst to the wrong conclusion.”).

Each component of the U.S. corporate governance system that I identify is itself made up of subsystems and so on, and any number of relationships among the various parts could be highlighted in a systems analysis. Indeed, various scholars have analyzed pieces of U.S. corporate governance in greater detail than I attempt to do here. Moreover, corporate governance itself needs to fit into a country’s larger political, economic, and social structures, raising a host of tough questions that, for the most part, are beyond my present scope. The analysis below, however, covers the core components of the U.S. system and captures its overall complexity.

A. The Formal Rules of the Game

Since the “law matters” thesis is our jumping-off point, I will begin with Delaware corporate law. Delaware has opted for an enabling approach to corporate law that affords corporate constituencies—by which I primarily mean directors, officers, and shareholders—flexibility to order their affairs privately.⁶⁸ The asserted benefit of private ordering is that it affords a corporation and its constituencies the flexibility to adapt the company’s governance structure as appropriate to fit the company’s particular governance and business needs over time.⁶⁹ This stands in contrast to a mandatory model of corporate law, in which a fixed set of typically more restrictive rules would be imposed on companies, reflecting a “one-size-fits-all” approach to regulating corporate governance.⁷⁰ If all companies were the same, a mandatory “one-size-fits-all” approach might make sense. The reality, though, is that companies have different business needs, different corporate cultures and ways

68. See, e.g., Leo E. Strine, Jr., *Delaware’s Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough? A Response to Kahan & Kamar’s Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1257 (2001) (arguing in favor of Delaware’s enabling approach to corporate law); E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—Or Vice Versa?*, 149 U. PA. L. REV. 2179, 2179 (2001) (describing the enabling model as being “based on a few fundamental statutory guideposts and latitude for private ordering, with primary reliance on self-governance centered around judicial decision making in applying fiduciary duties to fact-intensive settings”); see generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) (developing the contractarian approach to the firm and corporate law). The U.S. approach is not only enabling insofar as the content of corporate law is concerned, but also in that there is regulatory competition among the states for corporate charters. Accordingly, to the extent that certain legal rules are mandatory, parties can opt out of them by incorporating in other jurisdictions. The argument that corporate law should be enabling is part and parcel of the contractarian model of the firm.

69. For further development of this point in the context of the regulatory responses to the scandals at Enron and elsewhere, see Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, in *ENRON: CORPORATE FIASCOS AND IMPLICATIONS* (Bala Dharan & Nancy Rapoport eds., 2003).

70. For criticism of a “one-size-fits-all” mandatory approach to corporate governance, see Stephen M. Bainbridge, *A Critique of the NYSE’s Director Independence Listing Standards*, 30 SEC. REG. L.J. 370 (2002); Paredes, *supra* note 69; Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2003).

of doing things, and different people and personalities, all of which are subject to change.⁷¹

Delaware's enabling approach is not without moorings, however. The Delaware corporation code contains a number of key provisions, although most are default rules that can be transacted around and few of the provisions limit the expropriation of wealth by insiders to any significant extent.⁷² In fact, one of the most important statutory provisions is Delaware General Corporation Law section 141(a), which provides that the "business and affairs of every corporation ... shall be managed by or under the direction of a board of directors."⁷³ This provision provides an expansive grant of authority to the board and, in effect, the officers to whom the board typically delegates day-to-day managerial control.

This is not to say that shareholders do not have any "positive" control rights over the corporation granting them direct input into and say over how the corporation is governed or whether certain business opportunities are pursued. Shareholders have the right to vote for the board of directors, most importantly, and can make recommendations on governance and business matters to the board through the shareholder proposal process.⁷⁴ Shareholders also have the right to vote on certain mergers and on any proposed sale of all or substantially all of the corporation's assets. In addition, a company's articles of incorporation cannot be amended without shareholder approval, and shareholders can vote to amend the

71. See Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1491-92 (1984).

72. Often defaults turn out to be quite inflexible in practice as a result of, among other things, endowment effects, anchoring and framing biases, and transactions costs. The distinction between mandatory and default rules, therefore, is less sharp in reality than in theory. For an interesting analysis of the psychological effects of default rules, see Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998).

73. DEL. CODE ANN. tit. 8, § 141(a) (2001). This provision is typical of other states. See, e.g., MODEL BUS. CORP. ACT § 8.01 (1984).

74. Notably, nonshareholder constituencies, such as employees, have no legal authority over a corporation's internal affairs, unless they also happen to be shareholders. Nonshareholder constituencies, nonetheless, can often exert a great deal of pressure on management. For interesting discussions of the role of employees in corporate governance, see EMPLOYEES AND CORPORATE GOVERNANCE (Margaret M. Blair & Mark J. Roe eds., 1999); see also Blair & Stout, *supra* note 14 (developing a team production model of the firm in which shareholders do not have primacy over other corporate constituencies).

bylaws. Shareholders, however, do not have any authority to manage the day-to-day business directly or to set overall corporate policy and strategy, unless granted such control in the certificate of incorporation, which happens rarely, if ever.

The Delaware courts have further cabined shareholder control rights by broadly interpreting the board's authority to manage the business. The Delaware courts, for example, have held that directors have the right to take defensive steps to fend off a hostile bidder, which effectively blocks shareholders from selling their shares, even though the bidder might have offered a significant premium for the company.⁷⁵ In most instances, the board, and not shareholders, also gets to decide whether to bring a derivative suit against directors and officers who allegedly breached their fiduciary duties.⁷⁶ Deciding whether to sell the company to a hostile bidder or to sue directors and officers are not, however, ordinary business decisions akin to deciding whether to build a new factory, to hire additional employees, or to enter a new line of business.⁷⁷ Rather, they are perhaps better characterized as "ownership" issues that shareholders should have final say over because they directly affect the right of shareholders to sell their shares and to enforce the fiduciary duties management owes them.⁷⁸

75. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); see generally ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, *TAKEOVER DEFENSES* (6th ed. 2000 & Supp. 2002). For recent arguments in favor of expanding shareholder choice in the takeover setting by constraining boards in adopting defensive tactics, see Paredes, *supra* note 14; Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001).

76. For a discussion of the demand requirement in derivative litigation, see ROBERT C. CLARK, *CORPORATE LAW* §§ 15.1-15.3 (1986); CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS* 325-69 (4th ed. 2003).

77. See generally Paredes, *supra* note 14; Thompson & Smith, *supra* note 75.

78. See Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 5-6 (1985) (distinguishing "ownership" from "enterprise" issues). Not to mention, of course, that directors and officers might find themselves in an inherently conflicted position when evaluating a hostile bid that will result in their ouster or when deciding whether to sue themselves or other members of the management team. For arguments that the right to respond to hostile takeover attempts falls within the scope of the right of shareholders to vote and sell their shares, see Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Paredes, *supra* note 14; Thompson & Smith, *supra* note 75. For the view that

Not only are the rights of shareholders to sell and sue restricted in practice, but the shareholder franchise is also limited in practice.⁷⁹ For the most part, management controls the shareholder voting process and sets the voting agenda, which heavily influences results. The federal proxy rules⁸⁰ supplement shareholder voting rights under state corporate law by granting shareholders limited access to the company's proxy materials for the purpose of making proposals for a shareholder vote; but even here, the board of directors can omit many, if not most shareholder proposals from the corporation's proxy materials and can ignore other proposals that relate to how the business is run, even if they receive a majority shareholder vote.⁸¹ Finally, few shareholders, other than institutional investors, own enough stock to make it worthwhile to monitor the company actively. Likewise, the cost of complying with the extensive disclosure requirements of the federal proxy rules as well as the risk of liability for failing to comply can chill shareholder communication and deter shareholders from waging proxy contests, which can cost millions of dollars. In other words, coordination difficulties and rational apathy frustrate shareholder efforts to exercise their franchise, although proxy solicitation and shareholder service firms, such as Institutional Shareholder Services and the Investor Responsibility Research Council, have helped mitigate

the right to fend off a hostile bid falls within the scope of the board's authority to manage the enterprise, see, for example, Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791 (2003); Martin Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980). For a good recent summary of the debate between those who advocate shareholder choice and those who support the board's right to respond to hostile bids, see Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. (forthcoming 2004).

79. For a useful overview of the right of shareholders to vote, sell, and sue, see generally Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215 (1999).

80. For an overview of the federal proxy rules, see LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 488-561 (4th ed. 2001).

81. See Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2003). Rule 14a-8 affords shareholders limited access to their company's proxy materials. The company can omit shareholder proposals in several instances, such as when the shareholder proposal relates to the company's ordinary business or is not considered a proper subject of shareholder action under state law, although shareholders can get around this by making precatory proposals that are nonbinding on management. *Id.* For an overview of the shareholder proposal process, see LOSS & SELIGMAN, *supra* note 80, at 510-33.

these problems. This all having been said, the SEC has recently taken important steps toward amending its rules under the federal securities laws to allow shareholders to include shareholder-nominated directors in the corporation's proxy statement.⁸² Greater shareholder access to the company's ballot for electing directors could have significant implications for how corporations are run, easing concerns arising from the fact that shareholders exercise little control over the firm otherwise.

Given the far-reaching authority directors and officers have to manage the business, which characterizes the separation of ownership and control, the key corporate governance challenge is to control agency costs. When the interests of directors and officers conflict with the best interests of the corporation and its shareholders, the concern is that management will tend to act in its own self-interest. For example, managers might decide to shirk, pay themselves excessive compensation packages, have fancy corporate jets and other perks, or build an empire by acquiring companies, all to the detriment of the company and shareholder value.

Although fiduciary duties do not reallocate control to shareholders, fiduciary duties constrain management's exercise of its authority and thus are a sort of "negative" control right that shareholders exert over the business.⁸³ The fiduciary duty of care requires managers to run the company with reasonable care.⁸⁴ Directors and officers, for example, are expected to spend the time and effort needed to make prudent business decisions and to set an appropriate course for the company. The duty of loyalty charges directors and officers with acting honestly and prohibits them from looting the company, engaging in self-dealing transactions unfair to the corporation, or otherwise acting in their own self-interest.⁸⁵ The concept of good faith is marbled into both the duty of care and the

82. See Security Holder Director Nominations, Exchange Act Release No. 48,626, Fed. Sec. L. Rep. (CCH) ¶ 87,101, at 88,401 (Oct. 14, 2003).

83. Controlling shareholders also owe fiduciary duties to minority shareholders. For more on the complex relationship between controlling and minority shareholders, see F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS (2d ed. 1985).

84. See CLARK, *supra* note 76, §§ 3.4-3.5; O'KELLEY & THOMPSON, *supra* note 76, at 230-75.

85. See CLARK, *supra* note 76, §§ 5.1-5.4; O'KELLEY & THOMPSON, *supra* note 76, at 276-324.

duty of loyalty, although the Delaware Supreme Court—Chief Justice E. Norman Veasey, in particular—has suggested that there is a separate fiduciary duty of good faith.⁸⁶ The sum and substance of the fiduciary duty of good faith remains unknown, but one can surmise that, when fleshed out, it will be more substantive in nature than the procedural duty of care.

Fiduciary duties, like any other open-ended standard, are flexible. The Delaware judiciary can accordingly develop corporate law in an incremental fashion on a case-by-case basis, and can adapt the law of fiduciary duties to respond to changes in business and governance. This results in what many believe to be a more efficient law—one that is better tailored to the evolving needs of corporations and their constituencies.⁸⁷ A dark side, however, accompanies this flexibility: uncertainty. Some have criticized Delaware corporate law as too indeterminate.⁸⁸ The concern should not be exaggerated, however. Today, Delaware has a very well-developed body of case law, making it more rule-like. More importantly, a very sophisticated and experienced judiciary administers the law of fiduciary duties against the background norm of shareholder primacy.⁸⁹ The

86. See, e.g., *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 444-46 (2003).

87. For more on the efficiency of the common law generally, see George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977); Paul H. Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977). Noteworthy in this regard is the lack of any meaningful legislative response, to date, in Delaware following Enron and the other scandals. The Delaware courts, however, are already reconsidering the law of fiduciary duty and related principles in light of the recent abuses. See, e.g., *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) (finding that certain social and personal ties compromised the independence of directors on a special litigation committee); Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1377-85 (2002) (discussing possible impacts of the corporate scandals on the development of Delaware corporate law).

88. See Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205 (2001). But see Strine, *supra* note 68 (arguing in favor of the flexibility of Delaware corporate law).

89. As Vice Chancellor Strine commented:

While the Delaware Model might subject firms to litigation, these firms readily accept that risk as a cost of greater flexibility, especially because they know that the litigation they face will have the following two characteristics: (1) it will likely be administered by a Delaware judiciary well schooled in corporate law and with a track record of producing rational results, and (2) it will be governed by a body of statutory and decisional corporation law which articulates many

combination of these factors limits the range of likely outcomes in any given case; and the Delaware judges themselves seem to recognize the need to avoid “wild doctrinal swings” that can interfere with the private sector by injecting too much uncertainty into economic and commercial affairs.⁹⁰ The norm of shareholder primacy is particularly important to shareholders if fiduciary duties are to protect them against insider abuses or, for that matter, against the interests of other constituencies, such as employees or creditors, that might conflict with maximizing share value.⁹¹

The efficacy of fiduciary duties in holding directors and officers accountable, though, is limited. First, courts are reluctant to second-guess management and, under the business judgment rule, generally defer to directors and officers in the exercise of their authority so long as they have acted in good faith and loyally.⁹² The fiduciary duty of care, for example, is about *procedural* due care and not *substantive* due care. Courts review the decision-making process of directors and officers, but generally do not regulate the substance of their business decisions. Although management is supposed to act reasonably, directors and officers will not be held liable for faulty

norms that, if followed at a time of the transaction being litigated, can limit the possibility of an adverse judgment.

Strine, *supra* note 68, at 1263.

The shareholder primacy norm has been called into question by some on both positive and normative grounds. See, e.g., Blair & Stout, *supra* note 14; Bruce Chapman, *Trust, Economic Reality, and the Corporate Fiduciary Obligation*, 43 U. TORONTO L.J. 547 (1993); G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887 (2000); Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002). I have responded to a number of the critiques of shareholder primacy elsewhere. See Paredes, *supra* note 14.

90. Veasey, *supra* note 68, at 2180 (“At the same time, courts should be reluctant to interfere with business decisions and should not create surprises or wild doctrinal swings in their expectations of directorial behavior.”); see also William T. Allen, *The Pride and the Hope of Delaware Corporate Law*, 25 DEL. J. CORP. L. 70, 71 (2000) (“But the Delaware General Corporation Law has survived and even though it is kept evergreen by careful annual amendment, it continues to reflect its original commitment to private ordering, flexibility, predictability and fairness.”).

91. The debate over the value of Delaware’s flexible approach to corporate law has spawned an interesting empirical literature of late. See, e.g., Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001); GUHAN SUBRAMANIAN, *THE DISAPPEARING DELAWARE EFFECT* (Harvard Law & Econ. Discussion Paper No. 391, 2002), available at <http://ssrn.com/abstract=345040>.

92. See CLARK, *supra* note 76, §§ 3.4-3.5; O’KELLEY & THOMPSON, *supra* note 76, at 230-60.

process unless they were grossly negligent.⁹³ It is true that courts more aggressively monitor the duty of loyalty, but the legal sanctions for disloyalty and self-dealing remain relatively modest. Generally, an abusing insider is required to pay a "fair price" for the self-dealing transaction or to disgorge himself of any personal gain arising from a corporate opportunity that belonged to the corporation.⁹⁴ The duty of loyalty would discourage self-interested conduct more strongly if it were backed by stricter legal sanctions.⁹⁵

This, of course, all assumes that shareholders can even bring a suit for breach of fiduciary duty. As mentioned earlier, shareholders face a number of procedural hurdles, most notably the demand requirement, before they can bring a derivative action against directors and officers for breach of fiduciary duty.⁹⁶ Even if a suit is brought and won, management is still insulated from liability, especially in duty-of-care cases, by exculpatory charter provisions

93. The duty of care generally requires directors to exercise reasonable care in performing their duties. Courts are reluctant to find that a board has breached its duty of care. As Professor Eisenberg has pointed out, although directors are supposed to "act reasonably," courts generally have adopted a more lax standard of review. See Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993) [hereinafter Eisenberg, *Divergence of Standards*]. Directors are rarely, if ever, held liable for simple negligence. In most cases, directors will not be held liable for breach of the duty of care unless they were grossly negligent. See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). Accordingly, Eisenberg has suggested that the duty of care reflects more of an aspiration or norm than a legal mandate. See Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1265-71 (1999) [hereinafter Eisenberg, *Social Norms*].

The focus on the process of corporate decision making rather than its substance reflects two key concerns: first, that with the benefit of hindsight, courts will tend to be too critical of management and management will become too risk averse; and second, that judges lack the business competency to challenge management's good faith business judgment. The business judgment rule, further, reflects a hands-off approach that allows the parties to govern themselves and to work out their disagreements and order their affairs without excessive judicial interference. See Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001) (explaining that corporate law carves out a large swath of corporate conduct to be regulated by "nonlegally enforceable rules and standards").

94. See, e.g., STOUT, *supra* note 45, at 5-8 (summarizing sanctions for breach of the fiduciary duty of loyalty).

95. See *id.* at 6 (calling the duty of loyalty "toothless[]").

96. Before bringing a derivative action, shareholders are generally required to make a demand on the board of directors to initiate the suit on the corporation's behalf unless it would be futile to do so. See *supra* note 76 and accompanying text.

insulating directors from monetary damages,⁹⁷ indemnification rights,⁹⁸ and directors and officers (D&O) insurance.

B. Why Do Shareholders Still Invest?

Given the limited protection Delaware corporate law provides shareholders, especially when it comes to bad business decisions,⁹⁹ why do shareholders still invest? In other words, what controls managerial agency costs if corporate law does not? One well-known answer is that corporations typically “bond” management in a way that aligns management’s interests with those of shareholders. Here we can think of stock options, restricted stock, and other forms of incentive-based compensation that encourage directors and officers to maximize corporate profits.¹⁰⁰

Markets also protect investors. Product markets, the market for capital, the market for corporate control, and the market for management are all said to discipline directors and officers to run

97. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); O’KELLEY & THOMPSON, *supra* note 76, at 260-65.

98. See, e.g., DEL. CODE ANN. tit. 8, § 145 (2001); CLARK, *supra* note 76, § 15.10; O’KELLEY & THOMPSON, *supra* note 76, at 370-78.

99. See, e.g., Roe, *supra* note 58 (explaining the limits of corporate law in protecting shareholders, especially against bad business decisions).

100. Of course, as we recently discovered with the wave of corporate scandals starting with Enron, one way to raise earnings is to run the business better; another way is to “cook the books.” Incentive-based compensation was intended to ameliorate agency costs by aligning the interests of directors and officers with the shareholders’ interests. It turns out that the huge equity compensation packages might also have created pressures to manage earnings. See Arthur Levitt, The “Numbers Game,” Remarks at N.Y.U. Center for Law & Business (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>. At the very least, tying compensation to stock performance might bias directors and officers to focus too much on the short term, at the expense of more effective long-term business planning, in an effort to beat upcoming earnings targets. For more on earnings management and the role it played in the recent corporate scandals, see JOHN C. COFFEE, JR., WHAT CAUSED ENRON?: A CAPSULE SOCIAL AND ECONOMIC HISTORY OF THE 1990’S (Columbia Law & Econ. Working Paper No. 214, 2003), available at <http://ssrn.com/abstract=373581>. The SEC has responded to concerns about earnings management by, among other things, requiring more disclosure regarding pro forma financial measures and earnings announcements. See Conditions for Use of Non-GAAP Financial Measures, Exchange Act Release No. 47,226 [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,816 (Jan. 22, 2003). In addition, part and parcel of the market-based U.S. governance system, companies have begun to structure compensation packages so that they are tied to long-run performance.

the business more profitably.¹⁰¹ Lately, market pressures have caused companies to revamp their governance structures in response to concerns about corporate abuses.¹⁰² The general logic is that companies need to be run efficiently and managed properly to succeed in a competitive marketplace. Further, if profits drop, a company should face a higher cost of capital, which could further impede its competitiveness against companies with lower cost structures and perhaps less constraining debt covenants and less burdensome principal and interest payments. If a company is not run well or its governance is questionable, its shareholders can always follow the "Wall Street Rule" and sell into the market, putting downward pressure on the company's share price. At some point the company might become a takeover target, in which case the board and top executives are likely to be ousted. Short of the company being acquired, the board might remove senior executives if the company's share price continues to fall. It is also possible for shareholders to elect new directors if they become dissatisfied with the direction in which the incumbent board is taking the company.

Not only do managers worry about retaining their jobs, maximizing their bonuses, and keeping their companies competitive, but they worry about their reputations. In addition to job loss, fewer directorship opportunities, or a personal financial hit, directors and officers worry about the shame and embarrassment—the "disdain in the eyes of one's acquaintances"¹⁰³—they might suffer when, for example, they are scorned in the papers or on CNBC for rejecting good corporate governance practices, allegedly looting the business by receiving an excessive compensation package, or simply taking the company in some ill-advised direction.¹⁰⁴ One from time-to-time

101. See generally O'KELLY & THOMPSON, *supra* note 76, at 11-12 (summarizing the role of markets in corporate law). Mark Roe has recently stressed the importance of markets and other nonlegal pressures when it comes to monitoring bad business decisions. See Roe, *supra* note 58.

102. For more on market-based responses to the scandals at Enron, WorldCom, and elsewhere, see Paredes, *supra* note 69; Ribstein, *supra* note 70.

103. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1104 (1997).

104. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1793-97 (2001); Eisenberg, *Social Norms*, *supra* note 93, at 1268-71; Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003); Rock,

sees full-page advertisements in the *Wall Street Journal* urging management to take some course of conduct or criticizing management for some ill-advised behavior. These types of “shaming” sanctions are an important complement to other sanctions and monitoring mechanisms holding directors and offices accountable.

No company or top executive is immune from market pressures or shame and embarrassment. Microsoft and Jack Welch, for instance, provide two recent examples of the significant impact these influences can have. Microsoft has decided to give employees restricted stock instead of stock options and has declared its first dividend.¹⁰⁵ The highly respected Welch, after retiring at the end of a very successful run as CEO and chairman of General Electric, decided to restructure his retirement package in the face of the public’s outcry over what it saw as an outlandish exit package for him.¹⁰⁶

The U.S. corporate governance system also relies on directors and officers “to do the right thing” by voluntarily taking steps to maximize firm value even when nobody is watching and there is little if any risk of market or legal sanction. Norms have received a great deal of recent attention as an important extralegal governance device.¹⁰⁷ By “norms” I do not mean those steps that managers take to please the market or to avoid shame or a lawsuit, although sometimes “norms” is used broadly this way. Rather, I am referring to a sense of right and wrong—a sense of duty and responsibility—that directors and officers internalize and enforce on them—

supra note 103; Rock & Wachter, *supra* note 93, at 1694-97; David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001); *see also* Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339 (2000) (developing an expressive theory of the law that depends on the preference of people for approval).

105. *See* Ken Brown, *As Taxes Fall, Dividends Rise—And Executives Reap Big Gains*, WALL ST. J., Aug. 11, 2003, at A1; Robert A. Guth & Joann S. Lublin, *Tarnished Gold: Microsoft Ushers Out Era of Options*, WALL ST. J., July 9, 2003, at A1.

106. *See* Carol Hymowitz, *In the Lead: Investors Have to Lead the Charge to Keep Big Bosses in Line*, WALL ST. J., Sept. 17, 2002, at B1.

107. *See, e.g.*, Eisenberg, *Social Norms*, *supra* note 93; Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001); Rock, *supra* note 103; Symposium, *Norms and Corporate Law*, 148 U. PA. L. REV. 1607 (2001); *see generally* Symposium, *Law, Economics, & Norms*, 144 U. PA. L. REV. 1643 (1996). For more on the closely related concept of trust, which is also important in corporate law, *see* Blair & Stout, *supra* note 104.

selves simply because it is the right thing to do.¹⁰⁸ We could think of this in terms of a self-enforced obligation to act in the best interests of the corporation and its shareholders.¹⁰⁹ As Delaware Supreme Court Chief Justice Veasey has stated:

There is a significant self-governing aspect to the corporation law in that daily functions of the enterprise are based largely on norms Self-governance works for the most part because of the sensitivity of directors to do what is right, what is professional, what is honorable, and what is profitable.¹¹⁰

108. See, e.g., Blair & Stout, *supra* note 104 (explaining the importance of trust and trustworthiness in corporate law); STOUT, *supra* note 45, at 10 ("In lay terms, corporate insiders act like fiduciaries not only because they fear external sanctions, but also because they have internalized a sense of obligation or responsibility toward others"); LYNN A. STOUT, OTHER-REGARDING PREFERENCES AND SOCIAL NORMS (Georgetown Law & Econ. Working Paper No. 265902, 2001), available at <http://ssrn.com/abstract=265902>. Rock explains:

All of us internalize rules and standards of conduct with which we generally try to comply. We do this not only because we may fear some sanction, formal or informal, but also because doing so is important to our sense of self-worth, because we believe that doing a good job is the right thing to do.

Rock, *supra* note 103, at 1013; see also ROBERT COOTER, DO GOOD LAWS MAKE GOOD CITIZENS? AN ECONOMIC ANALYSIS OF INTERNALIZING LEGAL VALUES (UC Berkeley Law & Econ. Working Paper No. 2000-8, 2000), available at <http://ssrn.com/abstract=229950> (providing an economic analysis of values).

109. Self-enforcement is particularly important because it eases the burden on the market to monitor management and does not depend on the risk of legal sanctions to deter directors and officers. Lynn Stout states:

[E]xternal incentives, alone, can only influence the behavior of the rationally selfish actor when two criteria are met. First, her behavior must be observable to others. Second, some one [sic] (or something) must be willing and able to reward her good behavior and to punish her bad behavior—and to reward or punish sufficiently.

STOUT, *supra* note 108, at 20. Further, many obstacles compromise the ability of the market and of the law to discipline managers. Plus, by the time market or legal sanctions are imposed, the damage is often already done.

110. Veasey, *supra* note 68, at 2180. Former Chancellor Allen amplified the point this way: Corporate directors are, for the most part, morally of the same sort as the rest of us. They prefer to do the right thing Moreover, like the rest of us, they will even prefer to incur some cost to be able to say to themselves (and their families) that they have done the right thing.

William T. Allen, *20th Century Evolution and Growth of Delaware Corporation Law*, 17 WTR DEL. LAW. 16, 20 (2000). Chancellor Allen's point echoes the argument above that shaming and embarrassment are important control devices. See *supra* notes 103-06 and accompanying text.

The duty of care is often cited as evidence that managers regulate themselves. Directors and officers widely comply with the standard of care to act reasonably, although there is very little risk of legal liability for falling short, as explained earlier.¹¹¹

How norms get internalized is unclear. It might be that we feel good about ourselves when we do what we think is right; or we might in fact be genuinely concerned about the welfare of others, a purer form of altruism. Whatever the explanation, studies show that people often act in an other-regarding manner or in a way that seems to benefit others, and not in their narrow self-interest like *homo economicus*.¹¹²

Consistent with the view that the law serves an expressive function,¹¹³ the Delaware judges are active and influential “norm entrepreneurs.”¹¹⁴ Despite taking a more-or-less hands-off approach when it comes to holding directors and officers liable for breaching their fiduciary duties, Delaware judges nonetheless encourage management to adopt standards of good corporate conduct. Ed Rock, for example, has argued that judges are able to successfully inculcate good corporate conduct through their opinions—which he

111. See, e.g., Blair & Stout, *supra* note 104, at 1789-99; Eisenberg, *Social Norms*, *supra* note 93, at 1266-71; Rock & Wachter, *supra* note 93, at 1663-70; STOUT, *supra* note 45, at 10.

112. See Jennifer Arlen et al., *Endowment Effects within Corporate Agency Relationships*, 31 J. LEGAL STUD. 1, 31-32 (2002); Blair & Stout, *supra* note 104, at 1789-99; STOUT, *supra* note 45, at 3; STOUT, *supra* note 108, at 4. “*Homo economicus*” refers to the model of human behavior that assumes that individuals are rational and act in their narrow self-interest, affording no room for individuals to act in the best interests of others. See, e.g., Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407, 410 (2002) (describing members of the “species *homo economicus*” as “cool, calculating and purely self-interested actors”).

113. For more on the expressive function of law, see *infra* notes 278-82 and accompanying text.

114. See Blair & Stout, *supra* note 104, at 1789-99; Eisenberg, *Social Norms*, *supra* note 93, at 1266-71; Rock, *supra* note 103, at 1015. Lynn Stout explains:

The natural implication is that courts and legislatures can change or support norms through their pronouncements of what people “ought” to do, and so influence behavior *without actually imposing legal sanctions*. In other words (as many scholars have suggested) the law can change behavior through its “expressive function.” Conversely, when a social norm is not supported by the law (or by some other respected authority, such as a religious institution), it will likely prove far more ephemeral.

STOUT, *supra* note 108, at 30; see also STOUT, *supra* note 45, at 30-31 (discussing the role of the Delaware courts in shaping norms). For more on “norm entrepreneurs” generally, see Robert C. Ellickson, *The Market for Social Norms*, 3 AM. L. & ECON. REV. 1, 10-17 (2001); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 909, 929-30 (1996).

describes as “corporate law sermons”—by expressing how management *should* act, in effect leveraging the other-regarding preferences of directors and officers.¹¹⁵ The Delaware judges often express their views of the best corporate practices in dicta, laying out “roadmaps” instructing management how to conduct itself, while at the same time finding the defendants in the particular case at hand not liable.¹¹⁶ Many judges also take the opportunity to exhort directors and officers to “do the right thing” through speeches and writings. Chief Justice Veasey has regularly encouraged directors to adopt the seven specific “aspirational norms for good corporate practice” that he has offered,¹¹⁷ and Vice Chancellor Strine is as prolific a writer on corporate law as many top legal scholars.¹¹⁸ In addition, it is fair to assume that some judges pass along their views even more informally through casual conversations with members of the bar and participation in conferences. The relevant legal and business communities are, for all intents and purposes, small and tight-knit, which helps ensure that the judges’ views, whether expressed in opinions or otherwise, are spread throughout the legal

115. Rock states:

[T]he Delaware courts generate in the first instance the legal standards of conduct (which influence the development of the social norms of directors, officers, and lawyers) largely through what can best be thought of as “corporate law sermons.” ... Taken as a whole, the Delaware opinions can be understood as providing a set of parables—instructive tales—of good managers and bad managers, of good lawyers and bad lawyers, that, in combination, fill out the normative job description of these critical players. My intuition is that we come much closer to understanding the role of courts in corporate law if we think of judges more as preachers than as policemen.

See Rock, *supra* note 103, at 1016.

116. See Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 104-05 (1990); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1079-80 (2000).

117. See, e.g., E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681 (1998); Veasey, *supra* note 68.

118. See, e.g., William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287 (2001); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. (forthcoming 2004); Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919 (2001); Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic “Just Say No” Question*, 55 STAN. L. REV. 863 (2002); Strine, *supra* note 87.

community and ultimately reach top executives and boardrooms.¹¹⁹ It is not only lawyers who pass what the Delaware judges say along to senior management and directors; the financial media, shareholder watchdog groups, and legal academics also disseminate the message the Delaware bench puts forth. The judiciary's role in expressing best practices has the added effect of reinforcing the role of shaming and embarrassment described earlier.

These judicial pronouncements serve two additional benefits unrelated to encouraging internalized norms. First, the best practice standards of conduct that the Delaware judges articulate reinforce the market mechanisms that discipline management. The Delaware judges express to shareholders what they should expect from directors and officers, and it is harder for management to reject the market's demands in the face of what at least some influential judges—indeed, those who are likely to preside over any disputes and cases involving alleged fiduciary duty breaches—have set forth as the proper standards of behavior.¹²⁰ In short, these norms serve

119. See Allen, *supra* note 90, at 73 ("Moreover, informal processes of interaction that are possible in small communities between judges and between lawyers are more possible and are enriching both to the judges and the lawyers."); see generally ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991). Rock has described the relevant community as follows:

The subjects of the study of U.S. corporate governance—the senior managers and directors of large, publicly held corporations, and the lawyers who advise them—form a surprisingly small and close-knit community. The directors of large, publicly held corporations number roughly four to five thousand. A small group of lawyers, centered in New York and Wilmington, with others in Chicago and Los Angeles, specialize in Delaware corporate law. The community has its own court, the Delaware Chancery Court, with review by the Delaware Supreme Court. It has its own newspapers: the *Wall Street Journal* and, for the lawyers, the *New York Law Journal*. People know each other and ... apparently care about their reputation in the community.

Rock, *supra* note 103, at 1013. Lawyers, of course, have a strong incentive to deliver the message to their clients, and it will become readily apparent if they fail to, given, for example, the flurry of client memos law firms distribute highlighting key legal developments.

120. Cf. Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1674-75 (1996) (explaining that while states typically do not strictly enforce no-smoking ordinances, the posting of such ordinances can embolden private citizens to enforce the rules against smokers); Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175, 1180 (1989) ("The chances that frail men and women will stand up to their unpleasant duty are greatly increased if they can stand behind the solid shield of a firm, clear principle enunciated in earlier cases."). For more on how a clear articulation of best practices can facilitate cooperation, see *infra* notes 281-88 and accompanying text.

as a checklist that the market can use to monitor and hold management accountable. The flip side is that directors and officers can signal that they are good, honest, and loyal managers by complying voluntarily with the judicial suggestions, in effect going above and beyond what the law mandates.¹²¹ Second, through their informal communications with the bar and business leaders, the Delaware judges can give a kind of "preview" of future doctrinal developments, injecting additional predictability and certainty into corporate law. For example, Chief Justice Veasey recently remarked, as the leading financial press reported, that the Delaware courts would take a harder look at executive compensation in applying the fiduciary duty of good faith.¹²² By way of another example, Vice Chancellor Strine recently found that a number of Stanford University colleagues serving on a special litigation committee of Oracle's board were not independent because of their social and professional connections to each other and to the defendants, including Larry Ellison, Oracle's CEO and chairman.¹²³ Vice Chancellor Strine's *Oracle* decision portends an important doctrinal turn in Delaware, where directors typically have been found to be independent unless they have a financial relationship with an interested party or an interested party otherwise exercises "dominion and control" over the director.¹²⁴ The case, however, should come as no surprise to anybody who read the Vice Chancellor's 2002 article suggesting that the Delaware courts should reconsider their standard of independence in light of the recent wave of corporate scandal and abuse.¹²⁵

One could think of the Delaware judiciary, particularly the Delaware Court of Chancery,¹²⁶ in terms of a specialized administra

121. See *infra* notes 283-86 and accompanying text.

122. Tom Becker, *Delaware Justice Warns Boards of Liability for Executive Pay*, WALL ST. J., Jan. 6, 2003, at A14. For a recent "hard look" at executive compensation, see *In re The Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003).

123. See *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003). For more on board independence generally, see, for example, Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998).

124. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 810-11 (Del. 1984).

125. See Strine, *supra* note 87, at 1372-74.

126. For an extensive discussion of the unique role played by the Delaware courts in

tive agency like the Securities and Exchange Commission (SEC).¹²⁷ Members of the Delaware bench are well respected and are sophisticated and experienced in corporate law matters, often having been plucked from the ranks of the corporate bar.¹²⁸ The large number of cases they see allows the judges to remain current on important legal questions and to develop a textured approach to fiduciary duties.¹²⁹ The judges are also able to keep their fingers both on the pulse of the legal community and on governance practices by remaining actively engaged in legal and business circles after taking a seat on the bench.¹³⁰ Consequently, the judiciary remains attuned to the kinds of legal developments that might be necessary to better shape governance structures and corporate practices. On a more practical level, the Delaware courts are known

corporate law, see Fisch, *supra* note 116, at 1089 (emphasizing the responsiveness and sophistication of the Delaware judiciary, including its ability to "fine-tune" its case law in response to "business developments"); see also Black, *supra* note 60, at 585-91; John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Rock, *supra* note 103.

127. See Fisch, *supra* note 116, at 1077-78 (describing Delaware courts as "specialized courts"); see also Coffee, *Privatization*, *supra* note 11, at 29-31 (discussing the role of "specialized courts" generally).

128. Rock notes:

Because of the enormous discretion exercised by Delaware Chancery and Supreme Court judges, the personnel are critical. If one is to depend on the courts to fill out the details of proper behavior in the corporate community, the judges must be respected by the community. Delaware accomplishes this in two ways. First, a substantial number of the judges are drawn from the very world at issue, that is, they are experienced and respected practitioners of Delaware corporate law. Second, the Delaware courts have traditionally been characterized by a very high degree of collegiality among the judges, so that even those judges who did not practice in the area are socialized into the peculiar practices after joining the court.

Rock, *supra* note 103, at 1102.

129. See Black, *supra* note 60, at 589-90.

130. As former Chancellor Allen notes:

Moreover, informal processes of interaction that are possible in small communities between judges and between lawyers are more possible and are enriching both to the judges and the lawyers. You have better information on both sides than you can have in New York, for example. And in small professional communities such as the Delaware bench and bar, pride in the tradition of excellence and the importance that Delaware law has played nationally act as an important non-economic incentive for judges who serve under the light of national publicity to work hard and do their best. Part of the secret of Delaware law is you have judges who are very, very diligent.

Allen, *supra* note 90, at 73.

to decide cases very quickly,¹³¹ which is particularly important for fast-moving transactions where timing is key. The Delaware Supreme Court also has a history of acting unanimously in significant cases, dampening legal uncertainty by speaking with a unified voice.¹³²

Finally, although the judges do not hesitate to express their aspirations for management, the Delaware judges generally exercise judicial restraint, at least when it comes to imposing liability and second-guessing management's business decisions. Judicial restraint is essential to an enabling approach to corporate law, which allows the parties to organize their affairs as they see fit and does not interfere unnecessarily in business.¹³³ It is possible that the Delaware judges have themselves internalized a norm of judicial restraint.¹³⁴ Regardless, the judges are able to ensure judicial restraint, as well as institutional discipline to shareholder primacy, by holding each other accountable to these standards of judicial conduct and decision making. The corporate bar, moreover, is itself a constant monitor of the bench.¹³⁵ At bottom, a simple observation might best capture the important role the Delaware courts play: The Delaware legislature has taken minimal action in response to Enron, WorldCom, Tyco, Global Crossing, and other scandals. It has been left to the Delaware judiciary to update Delaware corporate law, primarily through the evolving law of fiduciary duties.

An important set of "second-order" institutions ensures that the rest of the corporate governance system works. These institutions include investment bankers, securities analysts, accounting firms,¹³⁶

131. See Black, *supra* note 60, at 590.

132. See Fisch, *supra* note 116, at 1078-79; David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127 (1997). This explains part of the surprise over the Delaware Supreme Court's 3-2 split in a recent and important takeover case. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

133. See, e.g., Rock & Wachter, *supra* note 93.

134. See Veasey, *supra* note 117, at 694 (explaining that courts have the obligation to: "(i) be clear; (ii) be prompt; (iii) be balanced; (iv) have a coherent rationale; (v) render decisions that are stable in the overall continuum; (vi) be intellectually honest; and (vii) properly limit the function of the court").

135. The Delaware judges can monitor each other because it is a very small and tight-knit community. Furthermore, the Delaware and New York corporate bars can in turn monitor the entire Delaware bench to ensure that the judiciary does not overreach by intruding too much into internal corporate affairs and business matters.

136. Also included are institutions supporting the accounting industry, such as generally

lawyers,¹³⁷ credit-rating agencies, broker-dealers, shareholder watchdog groups, shareholder service firms, and proxy solicitation firms.¹³⁸ The financial media is also important. These supporting institutions, which by and large comprise experienced and sophisticated professionals who see a great amount of "deal flow,"¹³⁹ perform a number of essential functions that are required for an enabling model of corporate law to work where atomized share ownership undercuts shareholder monitoring. These functions include: ensuring financial transparency; valuing securities; interpreting and filtering disclosures; monitoring management; evaluating companies' creditworthiness, and now, their governance structures; structuring transactions; negotiating settlements; bringing lawsuits against directors and officers; marketing and underwriting securities offerings; advising shareholders on how to vote; articulating "best practices"; and spotting takeover targets.¹⁴⁰ These institutions, especially underwriters, lawyers, and auditors, also serve an important role as reputational intermediaries. Specifically, these institutions facilitate securities offerings and other transactions when engaged by new or less mature companies that investors

accepted accounting principles, generally accepted auditing standards, the Financial Accounting Standards Board, and the new Public Company Accounting Oversight Board.

137. The broader litigation infrastructure of law firms, contingent fees, experienced attorneys, and relatively easy access to the judicial system should also be noted. *Cf.* Coffee, *Do Norms Matter?*, *supra* note 11, at 2164-65 ("Together, these three elements—the class action, the contingent fee, and the American rule on fee shifting—have created in the United States (but basically nowhere else to any equivalent degree) an entrepreneurial system of private law enforcement."). Active private law enforcement eases the need for more active public enforcement of corporate law.

138. For a more extensive accounting of these institutions, see Black, *supra* note 15, at 793-96, 799-801; see also Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 255 (1984) (explaining that lawyers are "transaction cost engineers"); Curtis J. Milhaupt & Mark D. West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 U. CHI. L. REV. 41, 58 (2000) (discussing "transaction cost engineers"). One might also include corporate law and securities regulation scholars in the mix.

139. By "deal flow," I mean a steady stream of transactions and matters on which to work.

140. For an argument that breakdowns at investment banks, accounting firms, law firms, and other "gatekeepers" are largely responsible for the recent scandals, see John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid."* 57 BUS. LAW. 1403 (2002). The blame lumped on the gatekeepers, and the extensive regulatory reforms enacted to address gatekeeper conflicts of interest and other gatekeeper-related concerns, are testaments to the critical role these supporting institutions play in U.S. corporate governance.

might steer clear from because they are largely unknown and have no track record or history for the market to evaluate.¹⁴¹

Notwithstanding these important institutions, not all shareholders can be passive. Institutional investors, therefore, as well as individual shareholders with significant holdings in companies, also have an active role to play in overseeing and monitoring companies and their management. These actors tend to be more active because of their large financial stakes and better ability to coordinate.¹⁴² Not surprisingly, shareholder activism is on the rise in the wake of the recent scandals.¹⁴³ Not all shareholder influence is exercised through the formal channel of the vote or even by selling or suing. Institutional and large private investors can also bring pressure to bear on management more informally, such as through phone calls, letters, and meetings, thereby influencing a corporation's governance and business plans from behind the scenes.¹⁴⁴

141. Companies can signal that they are honest and reputable businesses with solid management teams by, in effect, renting the reputation of reputational intermediaries (i.e., by hiring top law firms or engaging well-respected underwriters). See, e.g., Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 619-21 (1984); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001).

142. Vice Chancellor Strine of the Delaware Court of Chancery explained: "[Q]uite bluntly, it is questionable whether costly government policies ought be directed at placing crutches under well-heeled investors who can walk for themselves. The most vigorous enforcement of director fiduciary duties cannot hope to substitute for careful monitoring performed by rational and active investors" Strine, *supra* note 87, at 1402. For more on institutional investor activism, including questions that have been raised about the motivations of institutional investors and portfolio managers, see Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837 (1994); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117 (1988); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001).

143. See, e.g., Claudia H. Deutsch, *Revolt of the Shareholders*, N.Y. TIMES, Feb. 23, 2003, § 3 (Money & Business), at 1; INVESTOR RESPONSIBILITY RESEARCH CTR. & INTERFAITH CTR. ON CORPORATE RESPONSIBILITY, 2003 SHAREHOLDER PROXY SEASON OVERVIEW: SOCIAL AND CORPORATE GOVERNANCE RESOLUTIONS TRENDS (2003), available at http://www.shareholderaction.org/files/proxy_season_overview_2003.PDF.

144. For more on the "political model" of corporate governance, which depends in large part on informal pressures being brought to bear by institutional investors on directors and officers, see John Pound, *The Rise of the Political Model of Corporate Governance and*

Although U.S. corporate law is state law, the mandatory disclosure regime of the federal securities laws makes possible the market-based corporate governance system of the United States.¹⁴⁵ Mandatory disclosure, backed by stringent antifraud provisions, plays a critical role in U.S. corporate governance by ensuring that investors, with the assistance of the supporting institutions described above, have adequate information to exercise their rights to vote, sell, and sue.¹⁴⁶ The ability to exercise these rights allows investors to protect their interests without the need for more substantive regulation of internal corporate affairs at either the state or federal level. Further, consistent with the notion of

Corporate Control, 68 N.Y.U. L. REV. 1003 (1993).

Corporate law in the United States has traditionally been left to the states. The states, and not the federal government, have primary responsibility for the substantive regulation of corporate governance. (Noticeably, state attorneys general, especially Attorney General Elliot Spitzer of New York, have shown an increased willingness to get involved in regulating capital markets—although not internal corporate affairs as such—following the recent scandals.) Companies can choose which state's corporate law to be subject to by their choice of where to incorporate, with Delaware emerging as the jurisdiction of choice. The resulting regulatory competition among the states for corporate charters is another enabling feature of the U.S. system of corporate governance. Whether it is better characterized as a "race to the top" or "to the bottom," regulatory competition helps ensure that corporate law does not become too management-friendly and constrains what otherwise could be legislative and judicial swings in the law that could harm shareholders if there were no "market check" on regulators. The literature debating whether there has been a race to the bottom or to the top is extensive. See, e.g., ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law*, 90 CAL. L. REV. 1775 (2002); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001); Fisch, *supra* note 116; Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947 (1990); Ralph Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). Further, as Sarbanes-Oxley indicates, Congress always can regulate corporate governance if state corporate law is perceived as too lax. For an interesting article arguing that the real race is not among states, but between states (namely, Delaware) and the federal government, see Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

145. La Porta, Lopez-de-Silanes, and Shleifer have recently found that securities laws, coupled with effective private enforcement, promote initial public offerings of stock. Interestingly, their study found little evidence that the public enforcement of securities laws promotes IPOs. LA PORTA ET AL., *WHAT WORKS IN SECURITIES LAWS?* (Tuck School of Business at Dartmouth, Working Paper No. 03-22), available at <http://ssrn.com/abstract=425880>.

146. For a summary of the mandatory disclosure regime of the federal securities laws, see LOSS & SELIGMAN, *supra* note 80, at 25-37; Paredes, *supra* note 104, at 421-31; Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 869-86 (2003).

shaming, mandatory disclosure can indirectly affect corporate governance by deterring misconduct.¹⁴⁷ As Louis Loss has stated, "People who are forced to undress in public will presumably pay some attention to their figures."¹⁴⁸ In addition, as Louis Lowenstein has explained, disclosure requires directors and officers to focus on aspects of their own conduct and corporate performance that might otherwise go unnoticed,¹⁴⁹ in effect forcing insiders to confront "disagreeable realities" about the business "in detail and *early on*."¹⁵⁰ Consequently, the process of disclosure might bring the directors and officers to a level of self-awareness about how the company is being run that will result in steps to improve corporate performance.¹⁵¹ Along similar lines, Robert Thompson and Hillary Sale reveal in an interesting study that securities fraud class actions often focus on how the business has been operated, in effect regulating corporate managers by subjecting them and their business decisions to greater scrutiny.¹⁵²

147. For more on how mandatory disclosure reduces agency costs, see Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS. 113 (1999); Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995); Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335 (1996); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995); A. A. Sommer, Jr., *Therapeutic Disclosure*, 4 SEC. REG. L.J. 263, 263-66 (1976).

148. LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 36 (1st ed. 1983).

149. See Lowenstein, *supra* note 147, at 1342-45; see also Fox, *supra* note 147, at 123-25 (supporting Professor Lowenstein's reasoning).

150. Lowenstein, *supra* note 147, at 1342.

151. *Id.* at 1342-52. Professor Fox has done a good job summarizing Lowenstein's position:

Professor Louis Lowenstein has argued that required disclosure can improve managerial performance simply by forcing managers to become more aware of reality When managers have the legal obligation to disclose certain information, they may have to gather and analyze information they would otherwise ignore. The proposition that this consciousness raising will lead to an improvement in shareholder welfare rests on two assumptions. First, without required disclosure, management will not gather and analyze all of the information that could, in a cost-effective fashion, help it pursue its own objective function. Second, the managerial objective function is sufficiently congruent with the best interests of shareholders so that if management, because of required disclosure, determines how to better pursue its objective function, the actions it will take will also improve shareholder welfare. Both assumptions, though debatable, are plausible.

Fox, *supra* note 147, at 123-24.

152. See Thompson & Sale, *supra* note 146.

Notwithstanding its disclosure orientation, the federal securities laws regulate corporate governance more directly in important ways. The federal securities laws, for example, regulate proxies, shareholder proposals, and tender offer bids, generally in a manner protective of shareholders.¹⁵³ They also regulate broker-dealers and investment companies,¹⁵⁴ as well as authorize the SEC to oversee the stock exchanges.¹⁵⁵ To the extent the law on the books matters in the United States, it is the federal securities laws that have the most impact.¹⁵⁶ Indeed, the principal regulatory response to the scandals at Enron, WorldCom, and elsewhere was Sarbanes-Oxley, which revamped the federal securities laws to require more disclosure and to redress flaws in the U.S. corporate governance system that allegedly compromised many of the institutions on which the market relies, particularly such gatekeepers as analysts, accountants, and lawyers. Not to be overlooked when considering federal securities regulation is that the SEC, responsible for administering the federal securities laws, is a highly regarded federal administrative agency with a sophisticated and experienced staff of professionals.¹⁵⁷

The stock exchanges are a final source of rules to mention. To list on the New York Stock Exchange (NYSE) or NASDAQ, for example, a company must comply with extensive listing requirements, which, to a greater extent than the federal securities laws, regulate internal corporate affairs; but unlike the enabling approach of Delaware corporate law, listing requirements are mandatory in nature, at least for companies who choose to list on a particular exchange.¹⁵⁸ Following Enron and the other scandals, the NYSE and

153. See LOSS & SELIGMAN, *supra* note 80, at 488-630.

154. See *id.* at 753-836.

155. See *id.* at 715-34.

156. For a more extended consideration of this point, see Roe, *supra* note 144.

157. Although the federal securities laws are extensive and complex, "no-action letters" help reduce transactional and legal uncertainty and provide some measure of predictability.

Also, the SEC, together with the Department of Justice, is facing its own regulatory competition lately, as state attorneys general, most notably New York Attorney General Eliot Spitzer, have stepped up their efforts to prosecute directors, officers, corporations, major Wall Street firms, analysts, and others for alleged corporate abuses and frauds. See Deborah Solomon, *Zealous States Shake Up Legal Status Quo*, WALL ST. J., Aug. 28, 2003, at A4.

158. Stock exchange listing standards are voluntary in the sense that a company can choose not to list on a particular exchange; they are, however, mandatory once a company is listed and begins to trade on the exchange. For more on the potential role of listing standards

the National Association of Securities Dealers, Inc. (NASD) have adopted extensive revisions to their listing standards, especially when it comes to the board of directors, perhaps filling a gap left by the state legislatures.¹⁵⁹

Lastly, the importance of the backdrop of political, economic, and social stability against which all of the foregoing plays out cannot be overstated. There is confidence, for example, that the rules of the game will not change too dramatically too quickly, that bribery and corruption are not rampant, that the government will not nationalize businesses or industries or direct capital flows, that the corporate governance system works effectively, and that people can trust one another and have reason to cooperate. In short, the rule of law and governmental respect for private property, individual autonomy, and the private control of business matter, as do a host of other legal and enforcement institutions that are in the background, not the least of which being the institutions of contract law and property law. At an even more basic level, in the main, there is no concern in the United States about violence over a business deal. In contrast, recent reports suggest that the fear of violence and an overhang of general insecurity are deterring business and investment in Iraq.¹⁶⁰ However disgruntled some people might be with how things are done in the United States, the concerns are not so great as to seriously disrupt order. Further, because people expect, or at least hope, to be repeat players, in business tomorrow and into the foreseeable future, their reputations matter, making market and shaming sanctions workable and facilitating cooperation.

The real harm from Enron, WorldCom, and the other scandals was not the billions of dollars that investors lost or the thousands of jobs lost, troubling as this was, but the fact that these scandals shook the confidence upon which our corporate governance system, our securities markets, and our overall economic structure depend. Interestingly, for a corporate governance system dependent on relatively little law, strong regulatory steps were taken to restore confidence.

to financial development, see Coffee, *supra* note 18; CHEFFINS, LAW AS BEDROCK, *supra* note 18.

159. The NASD, of course, also regulates broker-dealers and securities analysts.

160. See King, *supra* note 49 (reporting that "continuing shootings and explosions ... have snuffed out much of the early investor enthusiasm").

C. Overall Coherence and "System Logic"

The U.S. model of corporate governance does have a coherent "system logic." It strikes an important balance between managerial discretion for directors and officers to run the business on the one hand and adequate shareholder protection on the other, while allowing parties to organize their corporate affairs as they see fit given their company's particular needs over time.¹⁶¹ U.S. corporate law generally achieves this balance through a set of nonmandatory default rules that the parties can contract around. To be sure, there can be too little shareholder protection—in other words, too little managerial accountability—but there can also be too much. The concern is that too much accountability, especially legal accountability, will regulate risk out of the market as managers become overly cautious and tentative to the detriment of shareholders and economic growth more broadly. To encourage innovation, entrepreneurship, and risk taking, the balancing of the U.S. system errs on the side of managerial discretion, particularly when it comes to substantive corporate law.¹⁶² Further, wide leeway for directors and officers in steering the company's course encourages thick capital markets by easing the managerial burden on shareholders who either prefer to be passive or are simply unable to coordinate. Managerial discretion, then, is part and parcel of the specialization of function—where professional managers specialize in managing

161. For more on this balance and the benefits of flexibility, see Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 31-33 (2002) (discussing the tradeoff between managerial discretion and corporate accountability); Black & Kraakman, *supra* note 57, at 1920-21 (explaining that developed economies can rely on private control mechanisms, instead of mandatory rules, to discipline management); Pistor et al., *supra* note 47, at 796 (explaining that corporate law regimes fall on a "flexibility-rigidity continuum" and that greater flexibility depends on the presence of nonlegal "complementary control devices" that hold management accountable).

162. See, e.g., Black & Kraakman, *supra* note 57, at 1921 ("These multiple private and legal controls shoulder much of the burden of protecting investors in public companies, so that the corporate law itself can tilt far in the direction of providing managerial discretion and enhancing transactional flexibility."); Strine, *supra* note 68, at 1279 ("Delaware corporate law generally permits corporate managers wide flexibility and errs on the side of managerial freedom.").

and shareholders specialize in bearing economic risk—that is a hallmark of dispersed ownership.¹⁶³

Even after the recent corporate scandals, investor confidence has been restored. U.S. equity markets and the U.S. corporate governance system have been able to withstand the fraud, abuse, and mismanagement that inevitably creep in as a cost of managerial discretion and private ordering and that often leave shareholders exposed to insider abuses.¹⁶⁴ In fact, the cost of rooting out more fraud, abuse, and mismanagement is too high in terms of forgone risk-taking, the distraction of management's attention from running the business to focusing on governance matters, and out-of-pocket costs of complying with a host of new requirements.¹⁶⁵ Perhaps the best indicator of the resilience of the U.S. system is that U.S. stock markets have rebounded following the major sell-off after the wave of scandals broke starting with Enron. Although concerns remain, the market discount for corporate governance troubles has largely been wrung out of stock prices, and there was never any serious concern that U.S. equity markets would collapse or become so illiquid as to cease being functional.

This is not to say that the U.S. corporate governance system, or Delaware in particular, is perfect or that the balance referred to above does not tilt too heavily in management's favor from time to

163. In this view, specialization is an efficiency-based argument for separating ownership from managerial control. For more on the specialization of function between managers and shareholders, see Fama & Jensen, *supra* note 30, at 307-17; Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 353 (1991); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 261 (1967); CHEFFINS, *LAW AS BEDROCK*, *supra* note 18, at 15-30.

164. Pistor and her co-authors explain:

Our analysis of the evolution of corporate law suggests that the function of corporate law is much more complex, involving a tradeoff between agency problems and flexibility.... [A] corporate law that allows greater flexibility implies more misuse, and thus higher agency costs. The historical challenge of the corporate law has been to balance these two conflicting interests and develop complementary legal control mechanisms that afforded corporations (i.e., corporate management) with substantial flexibility without creating a control vacuum.

Pistor et al., *supra* note 47, at 796. There is, of course, a dark side to confidence, which is complacency. See Ribstein, *supra* note 70, at 24-25.

165. These very concerns have been expressed about the new requirements Sarbanes-Oxley mandates.

time.¹⁶⁶ In fact, the scandals signaled that the balance had gone awry and that the governance system suffered from a number of deep flaws. U.S. corporate governance has reequilibrated itself, however. In addition to a strong regulatory response from Congress, the SEC, and the stock exchanges (not to mention New York Attorney General Spitzer and the U.S. Department of Justice), several strong market-based responses occurred, including a major sell-off of stocks and a rise in shareholder activism, to which issuers, accounting firms, investment banks, individual directors and officers, and others have responded.¹⁶⁷ The ability of the U.S. capital markets to withstand a series of scandals on the scale of Enron, WorldCom, Tyco, and Adelphia, to name just a few, demonstrates the U.S. corporate governance system's overall effectiveness and resilience. Can a market-based model of corporate governance like that of the United States be replicated elsewhere, though? Should policymakers even try?

III. IS THE U.S. CORPORATE GOVERNANCE SYSTEM TRANSPLANTABLE?

In the U.S. corporate governance system, the corporate law on the books is a small part of a more complex system. What matters for U.S. corporate governance, or any other market-based approach to corporate governance, is the overall set of relationships, duties, obligations, interactions, customs, and practices that discipline insider abuses and encourage managers to maximize share value while giving them enough leeway to do so. Put differently, formal and informal institutions are what matter; a view that others have emphasized in various settings, including corporate governance, and

166. For example, norms can be sticky and inefficient; stock options and other incentive-based executive compensation packages can create perverse incentives for management to manage earnings or otherwise "cook the books"; companies often have to underperform for a sustained period of time before being out-competed by rivals; the interests of mutual fund managers and institutional investors often conflict with the interests of individual investors; directors have a great deal of discretion to fend off hostile bids, insulating themselves from the disciplining pressures of an active market for corporate control; and states, in competition with one another for corporate charters and the fees and other benefits that go along with them, might adopt corporate law regimes that are favorable to management which decides where to incorporate, potentially at the expense of shareholders.

167. See, e.g., Paredes, *supra* note 69; Ribstein, *supra* note 70.

which is closely related to the school of thought known as "new institutional economics."¹⁶⁸

On one level, the "institutions matter" perspective, in which corporate law takes a backseat to other factors in explaining dispersed share ownership in the United States, is at odds with the "law matters" thesis. After all, "law matters" adherents claim that the formal rules of the game are largely determinative. On a more general level, however, the "institutions matter" perspective is entirely consistent with the "law matters" thesis. The functional core of the "law matters" thesis is not that law matters as such, but that investors need to be protected adequately for thick securities markets to develop.¹⁶⁹ The law can certainly protect shareholders, but so can a range of other factors that influence incentive structures.¹⁷⁰ The formal rules of the game, in other words, are simply one of many ways to regulate corporate conduct and behavior. As Nobel laureate Douglass North has explained: "Enforcement [can be] carried out by the first party (self-imposed codes of conduct), by the second party (retaliation), and/or by a third party (societal sanctions or coercive enforcement by the state)."¹⁷¹ The United

168. For more on the new institutional economics approach, see generally *THE FRONTIERS OF THE NEW INSTITUTIONAL ECONOMICS* (John N. Drobak & John V.C. Nye eds., 1997); DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (1990); Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LIT. 595 (2000); OLIVER E. WILLIAMSON, *WHY LAW, ECONOMICS, AND ORGANIZATION?* (U.C. Berkeley School of Law, Public Law and Legal Theory, Working Paper No. 37, 2000), available at <http://ssrn.com/abstract=255624>; see also *infra* notes 171-72, 178-79.

169. See *supra* notes 17-39 and accompanying text.

170. As Professor Coffee writes:

[T]he relative success of self-regulation in the United States may initially seem inconsistent with the "law matters" hypothesis, much depends on what we count as "law." Stripped to its essentials, the LLS&V hypothesis asserts (or, at least, need assert) only that strong equity markets require strong minority rights. Those minority rights could in principle come from any source (legislative, judicial or self-regulatory), or from a combination of sources.

Coffee, *supra* note 18, at 60.

171. Douglass C. North, *Institutional Change: A Framework of Analysis*, in *INSTITUTIONAL CHANGE: THEORY AND EMPIRICAL FINDINGS* 35, 36 (Sven-Erik Sjöstrand ed., 1993); see also Douglass C. North, *Economic Performance Through Time*, 84 AM. ECON. REV. 359, 360 (1994) [hereinafter North, *Economic Performance*] ("Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies.").

States has the necessary institutions to rely on a heavy dose of enforcement that does not depend on state-imposed sanctions to protect shareholders from expropriation. Do developing economies?

A. Complementarities Critique

Many commentators have studied in greater depth than I do here various nonlaw features of corporate governance.¹⁷² In extending their analyses beyond the formal rules, these commentators tend to fasten on some other part of the system. By taking a still broader perspective, the systems approach this Article takes better captures the numerous interdependencies and complementarities that contribute to corporate governance. Further, by revealing the overall complexity of corporate governance, a systems approach should better impress on policymakers the challenges of economic reform and, in particular, the risks associated with trying to fit the law of another country into an “importing” country’s different institutional makeup.¹⁷³ Notwithstanding that scholars have stressed the important role that norms, market influences, and bonding strategies play in the United States, there is still a tendency to focus on U.S. corporate law when considering corporate governance reform elsewhere. Policymakers who adopt a systems approach should develop a more pragmatic outlook and a better sense of the realistic opportunities for promoting equity markets in

172. For other examples of corporate governance analyses that explicitly or implicitly adopt a complementarities perspective, consistent with the view that institutions matter, see Masahiko Aoki, *The Japanese Firm as a System of Attributes: A Survey and Research Agenda*, in *THE JAPANESE FIRM: THE SOURCES OF COMPETITIVE STRENGTH* (Masahiko Aoki & Ronald Dore eds., 1994); Berkowitz et al., *supra* note 23; Black & Kraakman, *supra* note 57; Black et al., *supra* note 57; Black, *supra* note 15; Black et al., *supra* note 48; Bratton & McCahery, *Case Against Global Reference*, *supra* note 31; Paul Milgrom & John Roberts, *Complementarities and Systems: Understanding Japanese Economic Organization*, 9 *ESTUDIOS ECONOMICOS* 3 (1994); Milhaupt, *supra* note 37; Curtis J. Milhaupt, *Privatization and Corporate Governance in a Unified Korea*, 26 *J. CORP. L.* 199 (2001); Milhaupt, *supra* note 38; PISTOR ET AL., *supra* note 18; Pistor, *supra* note 50; Schmidt & Spindler, *supra* note 31; RALPH P. HEINRICH, *COMPLEMENTARITIES IN CORPORATE GOVERNANCE: OWNERSHIP CONCENTRATION, CAPITAL STRUCTURE, MONITORING AND PECUNIARY INCENTIVES* (Kiel, Inst. of World Econ., Working Paper No. 968, 2000), available at <http://ssrn.com/abstract=216389>.

173. Cf. Milhaupt, *supra* note 38, at 1189 (“This suggests that policymakers and private actors should tread carefully before importing foreign governance technology into their own institutional framework. Without a clear understanding of alternative systems, let alone a vision of a ‘model’ system, intellectual arbitrage has its limitations.”).

developing economies—an important first step in designing an effective reform agenda.¹⁷⁴ Quick success is not only important because it results in economic growth sooner rather than later, but also because policymakers cannot depend on a generous public that will afford them two or three chances to get it right. Economic reform is not easy. Even under the best circumstances, the transition can cause painful and difficult economic, social, political, and cultural disruptions. When the high hopes for reform are not met, people are not always willing to try it again. As political and social support for reform erodes, people sometimes agitate for the old order to return. A less-than-full step forward can lead to several steps back. The long-run success of economic reform, then, depends on modest short-run goals that are achievable.

What does this mean for corporate governance reform efforts modeled after U.S. corporate governance? In other words, is a market-based approach to corporate governance feasible for developing countries? The answer should be clear: Developing countries lack most of the formal and informal institutions that are necessary to complement an enabling corporate law, characterized as having relatively few shareholder protections, to create an effective system of governance.¹⁷⁵ For example, of immediate note, developing countries lack the capital markets and market for corporate control that are keys to the U.S. system. Indeed, the whole point of the reform efforts is to *create* securities markets. Further, developing economies often lack an effective judicial system, including basic property right and contract enforcement mechanisms, let alone a highly regarded judiciary with the sophistication and experience of the Delaware courts.¹⁷⁶ And judges in a civil law system may be reluctant to exercise the kind of discretion required

174. According to Professor Milhaupt:

[W]hat matters is that we continue to refine our understanding of the attributes of successful and unsuccessful governance systems and the potential for reform within a given system. For that, we need to unpack the black box of property rights and explore the political dynamics of institutional change across countries.

Id. at 1193.

175. For a similar view, see Black & Kraakman, *supra* note 57, at 1913-14, 1920-29 (explaining that emerging economies lack the institutions that support corporate governance regimes in developed countries).

176. Indeed, it is not certain that any state other than Delaware has the requisite judiciary.

to apply open-ended fiduciary duties. The law of fiduciary duties is ineffectual if judges are not willing to exercise their discretion when called on to apply those standards or if the judges are not respected enough for their decisions to have legitimacy. In addition, to the extent developing countries have closed economies, protectionist trade policies, or businesses otherwise subsidized by the state, managers are insulated from the pressures of stiff competition for goods and services. Moreover, the "second-order" institutions, such as investment bankers, accountants, lawyers, and the like, are largely nonexistent; at the very least, they are not as experienced and ubiquitous as in developed economies. In fact, there might be few experienced managers to run companies in developing countries, which challenges a basic presupposition of the Berle and Means firm that it is efficient for dispersed shareholders to hire expert managers. Finally, the proclivity to internalize norms of good corporate conduct might be less in certain countries than among U.S. managers, as studies suggest that the inclination toward other-regarding behavior varies across cultures.¹⁷⁷ The bottom line, then, is that enacting substantive corporate law similar to the United States, including attempts to codify the law of fiduciary duties, will not replicate the U.S. corporate governance system, or even approximate it, in developing countries that lack the requisite complementary institutions that make up the U.S. system.¹⁷⁸ In other words, a market-based model of corporate governance cannot be expected to result in broad and deep securities markets in developing economies.

177. See STOUT, *supra* note 45.

178. For similar observations, see Black & Kraakman, *supra* note 57, at 1913 ("[E]merging economies cannot simply copy the corporate laws of developed economies. These laws depend on highly evolved market, legal, and governmental institutions and cultural norms that often do not exist in emerging economies."); Milhaupt, *supra* note 37, at 2124 (explaining that "legal rules are highly complementary within a given legal system, so that legal improvements require reforms of entire legal systems," not simply substantive corporate law); North, *Economic Performance*, *supra* note 171, at 366 (explaining that the "formal rules" of one country will perform differently in another country because of different norms and enforcement institutions); accord STOUT, *supra* note 45, at 35 ("Perhaps the most basic lesson is that the adoption of formal rules of law that resemble U.S. corporate law may not, alone, be sufficient to produce results similar to those observed in U.S. corporations."). For extensive and insightful analyses of the challenges associated with corporate law transplants, see Berkowitz et al., *supra* note 23; Pistor et al., *supra* note 47; Pistor, *supra* note 50; PISTOR & XU, *supra* note 50.

Developing countries are still better off by importing U.S. corporate law than doing nothing at all. These are not, however, the only choices a country faces. The complementarities framework described above has its root in more formal economic models.¹⁷⁹ In these models, a part is said to be complementary to a system—whether a corporate governance system, a manufacturing system, or something else—if adding it increases the returns to the other components.¹⁸⁰ When complementary parts fit together, they create a system that, because of synergies, is greater than the sum of its parts.¹⁸¹ There is, however, a flip side to these “systems effects.”¹⁸² If an “importing” country cannot replicate the preferred corporate governance system in its entirety, not only will it fail to achieve the desired results by only instituting part of it, but the country probably can do better by adopting an entirely different system for which it does have all the components.¹⁸³ This is the case even if the alternative system is generally thought to be inferior to the preferred one. As Paul Milgrom and John Roberts have explained, the “organizational ‘mix-and-match’” that results when a country copies part of a governance system leads to an “ill-adapted misfit.”¹⁸⁴ More to the point, although the U.S. corporate governance system is associated with the thickest capital markets—and thus might be considered the “preferred” system—a developing country that lacks

179. See, e.g., Aoki, *supra* note 172; Paul Milgrom & John Roberts, *Complementarities and Fit: Strategy, Structure, and Organizational Change in Manufacturing*, 19 J. ACCT. & ECON. 179 (1995); Milgrom & Roberts, *supra* note 172; Schmidt & Spindler, *supra* note 31; NICOLAI J. FOSS, UNDERSTANDING BUSINESS SYSTEMS: AN ESSAY ON THE ECONOMICS AND SOCIOLOGY OF ECONOMIC ORGANIZATION (Copenhagen Business School, Working Paper No. 97-6, 1997), available at www.cbs.dk/departments/ivs/wp/wp97-6.pdf; HEINRICH, *supra* note 172.

180. See Milgrom & Roberts, *supra* note 172, at 6 (“[W]e say that a group of activities are (Edgeworth) complements if doing more of any subset of them increases the returns to doing more of any subset of the remaining activities.”).

181. *Id.* at 4.

182. Milgrom & Roberts, *supra* note 179, at 180.

183. See, e.g., Milgrom & Roberts, *supra* note 172, at 11 (“[A]dopting only some of the features of the better performing pattern may actually worsen performance. Thus, in particular, adopting only some of the features of a successful economic system while adhering to other elements from another coherent system may be disastrous.”); see also *id.* at 12 (“Even if a coordinated adjustment on all relevant dimensions might yield an improvement in performance, it may be that until all the features of the new pattern have been implemented, the performance of the system may be much worse than in the original position.”). Complementarity, therefore, might help explain path dependence. See *id.* at 13; Schmidt & Spindler, *supra* note 31.

184. Milgrom & Roberts, *supra* note 172, at 5 (describing Japanese economic organization).

a sophisticated judiciary, competitive product markets, experienced investment bankers, and a mandatory disclosure regime likely will fare better by adopting an entirely different approach to corporate governance and finance than the United States has. For example, a country lacking the panoply of institutions from which the U.S. governance system benefits would be better suited with a more mandatory legal regime that affords managers less discretion and gives shareholders more control or even one that encourages the formation of blockholders who can more effectively monitor management.¹⁸⁵ The broad lesson of the complementarities take on corporate governance is that no optimal model of governance and finance can be identified in the abstract.¹⁸⁶ The best model for a country is highly contingent on its complement of institutions; one size of corporate governance and finance does not fit all.

B. Private Ordering Critique

The above complementarities-based critique highlights some of the technical barriers countries face in creating a system of corporate governance like that employed in the United States. In short, many, if not most of the key components are simply missing. Beyond these challenges, however, is another set of hurdles that more directly bears on the feasibility of private ordering, and thus of an enabling corporate law in developing economies. Private ordering is not spontaneous. It is not workable to turn an economy loose, so to speak, and to instruct the parties to organize their affairs as they see fit, even if the formal corporate law provides a general framework for contracting. Rather, successful private ordering as the basis of corporate governance depends on certain preconditions, three of which I focus on here: (1) the contracting parties need to know what to contract for; (2) transactions costs must be relatively low; and (3) tomorrow has to matter. Each of these factors is important, whether we are talking about large-scale

185. For more on the blockholder model of governance, see *supra* note 31.

186. See Milhaupt, *supra* note 38, at 1194 (explaining that “there appears to be no optimal corporate governance system, only collections of complementary mechanisms that fit or fail within a country’s institutional framework”).

contracting across capital markets, ranchers in Shasta County,¹⁸⁷ or diamond merchants in New York.¹⁸⁸

For private ordering effectively to fill in the gaps of an enabling corporate law, the relevant parties need to know what to negotiate for. For example, parties can negotiate over such complex matters as independent directors, dual-class voting stock, special litigation committees, debt covenants, lead directors, shareholder ratification, board committees, shareholder action by written consent, shareholder special meetings, shareholder proposals, staggered boards, cumulative voting, supermajority voting requirements, separating the positions of CEO and chairman of the board, exculpatory charter provisions, standstill agreements, no-shop provisions, fiduciary outs, termination fees, appraisal, tag-along and drag-along rights, golden parachutes for senior management, poison pills, and antitakeover charter provisions. For private ordering to work, particularly on a scale similar to the United States, the parties involved in negotiating, or at least "pricing," what amounts to the corporate contract need to understand these and other contract terms.¹⁸⁹ In other words, the parties need to know how to organize a corporation's internal affairs, how to implement a governance structure, and how to evaluate various terms and governance practices. This requires more than spotting the issues. The parties need a textured understanding of all sides of the issues and of the possibilities for addressing each party's concerns, as well as insight into what a reasonable allocation of rights, duties, and risks might be for a particular company given its characteristics, such as its management team, track record, financing needs, operating history, financial condition, business prospects, and capital structure.

U.S. capital markets are populated by sophisticated entrepreneurs, directors, officers, and financiers, not to mention sophisticated judges. Equally important is that U.S. capital markets are populated by what Ron Gilson calls "transaction cost engineers."¹⁹⁰

187. ELLICKSON, *supra* note 119.

188. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

189. For more on the corporate contract, see *infra* note 200.

190. Gilson, *supra* note 138, at 255; see also Black & Kraakman, *supra* note 57, at 1923 (explaining the importance of "savvy investors and issuers" to an enabling approach to corporate law); Milhaupt & West, *supra* note 138, at 43 ("[I]n order to be effective, private ordering often requires the participation of intermediaries who possess information, time, and

Broadly speaking, these are the investment bankers, securities analysts, accountants, and lawyers who, as market intermediaries supporting both issuers and investors, are largely responsible for structuring, interpreting, monitoring, and evaluating corporate governance structures and practices. Along these lines, in Enron's wake, shareholder watchdog groups and credit-rating agencies have started grading a company's corporate governance structure, just as Standard & Poor's or Moody's might grade its debt.¹⁹¹

These intermediaries are effective because they are experienced in corporate matters and have an appreciation for what does and does not matter.¹⁹² Their expertise goes far beyond taking the present value of a stream of earnings, pricing options using Black-Scholes, deciding over what period an asset should be depreciated, or drafting a Form 10-K annual report. Notwithstanding the importance of such formal training, the requisite sophistication can only be achieved by "deal flow"—namely, the experience that comes by structuring and monitoring transactions. Much of what these intermediaries do and know is not written down in any book, but is learned on the job. Further, bankers, lawyers, accountants, and other market intermediaries generally draw from a similar set of experiences and a shared mental model of business dealings and corporate governance.¹⁹³ This can reduce transactions costs by ensuring that the parties are "on the same page," which is to say by creating a common understanding of the consequences of various corporate governance practices and a common set of expectations regarding what a reasonable governance structure is.

skill").

191. Such corporate governance ratings are growing more common and more accessible to the public. See, e.g., Governance Metrics International Home Page, at <http://www.gmiratings.com> (last visited Feb. 11, 2004); Institutional Shareholders Services Home Page, at <http://www.isscgq.com> (last visited Feb. 11, 2004); Standard and Poor's Home Page, at <http://www.standardandpoors.com> (last visited Feb. 11, 2004).

192. Recent concerns about gatekeeper conflicts of interest, however, suggest that relying on investment bankers, securities analysts, lawyers, accountants, and other market intermediaries to undergird the system has its risks.

193. See North, *Economic Performance*, *supra* note 171, at 362-63 (explaining the importance of "learning" and "mental models" by economic participants); see also Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498, 1504-21 (1996) (explaining that legal communities "forge and share a mental model of the community's work").

Intermediaries can only gain experience over time as the private sector develops and as they are repeatedly called on to structure transactions, evaluate business opportunities, and resolve disputes. It is overly optimistic, therefore, to expect many of the "transaction cost engineers" who work in developing economies to have the experience and sophistication on which private ordering depends.

The lack of experience gives rise to a more particular problem for legal transplants. Not only does a country fall short of replicating the U.S. corporate governance system when it imports U.S. corporate law, it also falls short of importing U.S. corporate law. An "importing" country can copy the law on the books and possibly codify the law of fiduciary duties. Although as Lynn LoPucki has explained, much of the law is neither on the books nor in cases; it is in lawyers' heads.¹⁹⁴ Based on experience, lawyers have a mental model of the law. If you talk to experienced lawyers, they often refer to the unwritten "lore" they draw on or to the "gloss" on a statute or regulation.¹⁹⁵ Further, and echoing some of the points made earlier, lawyers also know, without having to give it much thought, the steps needed to close a deal or to litigate a case and, in many instances, how the negotiations or case will take shape. Whether they are right or wrong in their understanding of the law, lawyers bring it to bear everyday to solve complex problems; it is not worth the time and effort to question the received wisdom, and it might not be possible to convince others that the law in their heads is

194. LoPucki, *supra* note 193, at 1510-16.

195. Dean Clark offers a useful analogy:

Even the most ordinary house results from a set of construction activities that are guided by literally thousands of traditional rules of practice. Most of these rules were the result of a conscious assessment by someone in the past of the consequences of alternative practices and of their costs and benefits. Yet present contractors and workers mostly follow the rules rather than make them or "choose" to follow them. The carpenters place rafters no more than 16 inches apart, and use wood no smaller than two by eight inches wide. They understand in a rough way why these guidelines exist, but usually do not have anything like a precise knowledge of what would happen if they deviated from them to this or that extent. The plumbers know that they ought to install P-traps under every drain, but some of them may not even have an accurate general knowledge of why this requirement exists (to create a water barrier that will prevent backup of disease-carrying sewer gas).

Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1727-28 (1989) (footnotes omitted).

wrong.¹⁹⁶ Transactions costs would skyrocket if lawyers felt the need to research and consider in detail every issue. To a great extent, it is the law in lawyers' heads that matters and that is seen in action.¹⁹⁷ Yet, it is the law in lawyers' heads that cannot readily be transplanted and in some cases is difficult to identify or pin down. Any legal transplant, therefore, will necessarily be incomplete.¹⁹⁸

Parties responsible for structuring and monitoring internal corporate affairs in developing countries can help offset their lack of experience by undergoing formal training, often a part of reform efforts, or seeking advice and counsel from top investment banks, accounting firms, and law firms in the United States or other developed countries.¹⁹⁹ Nonetheless, the transactions costs of "getting up to speed" and of hiring outside advisors are significant, which raises a related concern that further challenges effective private ordering in developing countries—that is, the lack of standardized corporate contracting.²⁰⁰ Standardization in corporate

196. Dean Clark has expressed concern, however, that:

With either type of tradition, those who follow their rules usually do so without a full and critical awareness of the reasons for the rules. In the case of technical traditions, this happens because of the sheer information processing limits of individual human brains. The amount of received lore is enormous; it is hard enough to find the rules or models relevant to one's specific task. Mental power is limited, and life is too short and full of alternative tasks yielding a higher value for one's efforts than reexamination of traditional lore. Consequently, very few who use a technical tradition will find it sensible to try to master all its parts and all its reasons. In the case of organic traditions, rule followers do not acquire a full and accurate appreciation of the rationale of the rules because virtually no preceding individuals ever did, and it is too hard to fathom them.

Id. at 1729.

197. See LoPucki, *supra* note 193.

198. See Berkowitz et al., *supra* note 23, at 167 (explaining that the failure to understand the meaning of transplanted rules, including their origin, history, and development, undermines the efficacy of legal transplants); Frank, *supra* note 54, at 916-17 ("At home it is surrounded by many usages which are never written down but taken for granted and more or less unconsciously accepted ... [b]ut those checks can seldom be exported."); Pistor, *supra* note 50, at 112 ("Assuming that a cognitive gap exists between any rule that is supplied and the understanding of that rule by its end-users, and that this gap impedes the effectiveness of transplanted rules, the question arises, how this gap could be closed."); PISTOR & XU, *supra* note 50, at 5 ("The same qualities that make the concept of fiduciary duties so resilient over time make it extremely difficult to transplant to other legal systems. The meaning of fiduciary duty cannot easily be specified in a detailed legal document.").

199. U.S. firms often seek business in developing economies, frequently opening an office in such countries.

200. The following discussion of standardized contracting builds on the work of Marcel

contracting, which is an important feature of U.S. corporate governance, reduces drafting and haggling costs. Further, there is likely to be more case law interpreting a standard term and common usages of the term. Accordingly, standard terms are generally easier and cheaper to understand and they reduce uncertainty; they require less expertise and sophistication to evaluate. This is not to say that standardization does not present problems. It can, for example, impede innovations in contracting and lock in inefficient governance practices. More importantly, for countries undergoing economic reform, standardized contracting facilitates transactions and allows parties to allocate their resources to productive uses, such as managing businesses or investing in them, as opposed to wasting resources on corporate contracting matters. Repeat usage of terms, moreover, allows contracting parties to develop the kind of expertise and sophistication that comes from experience and that is ultimately drawn on when structuring corporate affairs. Although easy to do, copying the corporate contracts from elsewhere is of limited benefit because standardized contracts reflect any number of important factors, such as the law in lawyers' heads, specific risk-allocation strategies, and a host of legal developments that may not be appropriate for the "importing" country.

Finally, for a model of corporate governance that depends on relatively few legal mandates to work well, tomorrow has to matter. Tomorrow has to matter in the sense that the long-term payoffs of

Kahan and Michael Klausner. See Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996) [hereinafter Kahan & Klausner, *Path Dependence*]; Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997) [hereinafter Kahan & Klausner, *Standardization and Innovation*]; Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995). In addition to the particular provisions of a corporation's articles of incorporation and bylaws, the "corporate contract" comprises the relevant corporation code and a company's governance practices. Even fiduciary duties can be thought of contractually as the protections shareholders would negotiate for, if given the opportunity. Not only are there standard article and bylaw provisions from which companies usually choose, but the corporation code also provides a standard "off-the-rack" contract that can be used as a default. Certain widely accepted corporate governance practices provide additional standard terms that many companies follow as a matter of course. As a practical matter, little face-to-face negotiation takes place over a company's governance structure, although more negotiation takes place post-Enron than before. For the most part, the contracting process is implicit as investors, with the support of market intermediaries, "price" a company's governance structure.

cooperation exceed the short-term benefits of defection, which can be thought of in terms of opportunistic behavior by directors, officers, controlling shareholders, or any other corporate constituency. Tomorrow matters more when a person expects to engage in a series of repeated transactions, where his reputation for cooperation and honest dealing is essential.²⁰¹ At least when it comes to doing business, there is reason to believe that tomorrow matters less in developing countries than in the United States. The prospects of economic reform are always uncertain, particularly when coupled with background political, social, and economic instability. Consequently, the future payoffs from cooperating today are in doubt and should be heavily discounted.²⁰² Further, reputation is beside the point if the market cannot readily detect defections. The lack of sophistication and experience discussed above can make it difficult for market participants to police one another and detect uncooperative behavior. The dominant strategy for many, therefore, is probably to defect (i.e., not to cooperate but to try to expropriate value from others), especially if judicial enforcement of the law and other terms of the corporate contract are lax. Even those who are "cooperators" will find it hard to signal their willingness to cooperate if they have no track record or reputation of cooperation to speak of. It might also be difficult to commit credibly by contract or

201. For more on complex strategies of cooperation, see, for example, ROBERT AXELROD, *THE COMPLEXITY OF COOPERATION: AGENT-BASED MODELS OF COMPETITION AND COLLABORATION* (1997); SERGIO G. LAZZARINI ET AL., *ORDER WITH SOME LAW: COMPLEMENTARITY VS. SUBSTITUTION OF FORMAL AND INFORMAL ARRANGEMENTS* (John M. Olin School of Business Working Paper, 2001), available at <http://ssrn.com/abstract=293803>; see also Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1770-71 (2001) (discussing the importance of "making the future more important relative to the present" in encouraging cooperation); North, *Economic Performance*, *supra* note 171, at 365 (discussing the importance of repeated interactions to change payoffs in favor of cooperation).

202. Professor Roe explains:

Some societies are in such turmoil that complex private institutions cannot be built. Reputations are not worth developing, because there are no assurances that, once built, the reputation can be used. Private ordering via, say, a stock exchange would not work, because investors lack confidence in the exchange and fear who might capture it. But once a society has sufficient regularity that reputations, private institutions, and, if need be, corporate law can be built, then if political and economic conditions are otherwise ripe, large enterprises can arise and ownership can separate.

Roe, *supra* note 58, at 265.

otherwise to cooperate if the courts and other enforcement institutions are not well established or trusted.²⁰³ These factors set the stage for a "lemons" problem as "cooperators" exit the market.²⁰⁴ This, of course, explains why well-regarded investment banks, law firms, and other intermediaries whose reputations can, in effect, be rented are important; but as noted above, these institutions, too, are lacking in developing economies.

C. Nonshareholder Primacy Critique

A shareholder-oriented model of corporate governance is probably inappropriate for many developing countries. Shareholder primacy might not fit with the cultural values of a country if it has a weak tradition of markets or capitalist values or places greater emphasis on equality and community than the U.S. corporate governance system does.²⁰⁵ These countries might be willing to sacrifice some capital formation and economic growth to accommodate other values or might simply be hostile to and distrustful of capitalism and capitalists, especially outside foreign investors. Mark Roe, for example, has recently argued that "[s]ocial democracies and the American-style public firm mix badly."²⁰⁶ Roe's core point is that the shareholder orientation of the U.S. approach, and specific parts of the U.S. governance system, such as hostile takeovers and incentive compensation, are inconsistent with the values and politics of social democracies, where employee interests and distributional concerns, and not shareholder value, are the top priorities.²⁰⁷ It should be

203. See Coffee, *Privatization*, *supra* note 11, at 4 (explaining that "managers and shareholders are thrown together as legal strangers" during privatization, making it difficult to contract or pledge reputational capital, which they have not been able to "carefully [build] up over years of service"); Fox & Heller, *supra* note 48, at 1762-65 (explaining that a similar breakdown contributed to the failed privatization efforts in Russia). There is, accordingly, a "catch-22" quality to cooperation. Established reputations facilitate cooperation and transacting; but it is difficult to get a reputation without a history of deal making.

204. See Akerlof, *supra* note 15, at 489-90; see also Black, *supra* note 15, at 838.

205. For more on the relationship between a country's culture and values and shareholder primacy, see Peter A. Gourevitch, *The Politics of Corporate Governance Regulation*, 112 YALE L.J. 1829, 1865-66 (2003); Mark J. Roe, *Can Culture Constrain the Economic Model of Corporate Law?*, 69 U. CHI. L. REV. 1251, 1261-62 (2002); BLAIR, *supra* note 47, at 7-8; LICHT, *LEGAL PLUG-INS*, *supra* note 35, at 19-23.

206. Roe, *supra* note 18, at 542.

207. *Id.* at 543; see also Roe, *supra* note 205, at 1260-62.

noted that shareholder primacy in the United States is itself subject to ongoing challenge, although it is holding firm as a core governance principle. There are heated debates over the role nonshareholder corporate constituencies, especially employees, should play in United States corporate governance and over the proper role of corporations in society; and as a practical matter, managers do have discretion to take nonshareholder interests into account, at least at the margins.²⁰⁸

Equally important as these questions of cultural and political fit is the question of what the theory of the firm predicts about the allocation of corporate control and shareholder primacy in developing countries. The influential contractarian model of the firm, as applied to publicly held firms in the United States, starts with the assertion that shareholders are a corporation's sole, or at least primary, residual economic claimants. This is because they receive a return on their investment only after the corporation's fixed claimants, such as its employees and creditors, are paid.²⁰⁹ Shareholders, in this view, have better incentives than other corporate constituencies to maximize firm value.²¹⁰ In addition, shareholders are said to be less able than other corporate constituencies to protect themselves contractually against the risk of expropriation. As Oliver

208. For various arguments against shareholder primacy and in favor of a greater role in governance for nonshareholder constituencies, see *EMPLOYEES AND CORPORATE GOVERNANCE*, *supra* note 74; *PROGRESSIVE CORPORATE LAW* (Lawrence E. Mitchell ed., 1995); Blair & Stout, *supra* note 14; Gulati et al., *supra* note 89; Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 *TEX. L. REV.* 579 (1992); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 *CORNELL L. REV.* 899 (1993).

209. For more on the contractarian model of the firm and the residual claimant status of shareholders, see, for example, *EASTERBROOK & FISCHEL*, *supra* note 68; Easterbrook & Fischel, *supra* note 14; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976); see also *BLACK*, *supra* note 14. *But see* Blair & Stout, *supra* note 14 (arguing a contrary view based on the "team production" model of the firm). In the traditional principal-agent model of the firm, shareholder primacy and the sole right of shareholders to vote is easy to justify, as shareholders are considered the "owners" of the firm. For more on the principal-agent model of the firm, see Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 *J. POL. ECON.* 288 (1980); Fama & Jensen, *supra* note 30; Thompson & Smith, *supra* note 75, at 268-69.

210. Embedded in this argument is the normative view that the goal of corporate law should be to maximize firm value. To be sure, not everybody agrees with this goal. *See supra* note 208.

Williamson, in the context of the closely related transaction cost model of the firm, explains:

Stockholders as a group bear a unique relation to the firm. They are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal. Labor, suppliers in the intermediate product market, debt-holders, and consumers all have opportunities to renegotiate terms when contracts are renewed. Stockholders, by contrast, invest for the life of the firm and their claims are located at the end of the queue should liquidation occur.²¹¹

Accordingly, shareholders are said to value control rights more than other suppliers of inputs and ultimately to bargain for them. Due to coordination problems, however, dispersed shareholders are unable to exercise control over the firm on a day-to-day basis. Consequently, they delegate managerial control to managers who specialize in running the business on the shareholders' behalf, and the board of directors is then engaged to monitor the managers.²¹² Shareholders, however, retain key control rights—the right to elect and remove members of the board and to vote on certain fundamental matters. The bottom line is that directors and officers have broad discretion to exercise their delegated authority over the enterprise, so long as they act in the best interests of shareholders. Further, shareholders are at the top of the governance hierarchy, but other corporate constituencies have no formal role to play in corporate

211. Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984) (footnote omitted). Williamson specifically addresses the ability of other constituencies, including labor, lenders, suppliers, customers, communities, and managers, to protect themselves other than through governance mechanisms. *Id.* at 1207-20.

212. See, e.g., Easterbrook & Fischel, *supra* note 14, at 402-03 (stating that because the cost of voting is high, shareholders will reserve its use for important situations and leave the day-to-day operations of the firm in the control of the managers); see also Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 79 (1989) (stating that decision making is done by managers for reasons of expertise, efficiency, and lack of ability on the part of shareholders). In Fama and Jensen's terminology, shareholders retain "decision control," which includes the ratification (choice of the decision initiatives to be implemented) and monitoring (measurement of the performance of decision agents and implementation of rewards) of decisions. Shareholders delegate "decision management," which includes the initiation (generation of proposals for resource utilization and structuring of contracts) and implementation (execution of ratified decisions) of decisions. Fama & Jensen, *supra* note 30, at 304, 309-10, 322-23.

governance.²¹³ For the most part, positive corporate law and governance practices in the United States reflect the governance structure the contractarian model of the firm predicts.²¹⁴

This is a simplified explanation of the theory of the firm, but it serves present purposes. Two key assumptions at work in the model are unlikely to obtain in many developing countries. First, other values and interests might trump the goal of maximizing firm value, calling into question the contractarian model's normative dimension favoring shareholder primacy. Second, nonshareholder constituencies in developing countries might not be better able to protect themselves from opportunism than shareholders are, thus undercutting a standard assumption of the contractarian model of the firm. In the United States, creditors protect themselves through highly negotiated credit agreements or indentures, while employees are protected by labor codes, unions, employment contracts, common law doctrines such as wrongful discharge, the ability to negotiate for higher wages given labor market conditions, and ERISA. The full panoply of devices that protect creditors, employees, and other stakeholders from the risk of expropriation are unlikely to exist in developing economies. La Porta, Lopez-de-Silanes, Shleifer, and Vishny have themselves shown that creditor protections vary across countries.²¹⁵ The bottom line is that nonshareholder constituencies probably should play a greater role in corporate governance in many developing countries than in the United States, at least in the view of the contractarian model.²¹⁶ In the hypothetical, and sometimes

213. For similar reasons—namely, that shareholders are subject to a greater risk of opportunism because of their firm-specific investment and are least able among the various corporate constituencies to protect themselves contractually—the transactions cost model of the firm also places shareholders at the top of the corporate governance hierarchy. For more on the transactions cost model, see OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* 171-94 (1996); Thompson & Smith, *supra* note 75, at 269-70, 272-73; Williamson, *supra* note 211, at 1198-1230.

214. *But see* Stout, *supra* note 89, at 1195-99, 1201-07 (challenging shareholder primacy on both positive and normative grounds).

215. La Porta et al., *Law and Finance*, *supra* note 20, at 1151 (showing that common law countries provide creditors the most protection, while civil law countries provide the least protection).

216. In fact, labor has asserted itself into corporate governance in the United States through union pension funds. *See, e.g.*, Marleen A. O'Connor, *Organized Labor as Shareholder Activist: Building Coalitions to Promote Worker Capitalism*, 31 U. RICH. L. REV. 1345 (1997); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998).

actual, bargain that drives the contractarian model of the firm, these stakeholders will often bargain for additional control rights. By reducing the risk of opportunism the various inputs to production face, dispersing corporate control more broadly can also serve an important industrial organization function. In short, firm-specific investments that increase the value of the firm can be encouraged.²¹⁷ Shareholders may be willing, therefore, to give up some control in order to increase the value of their stake in the firm.²¹⁸

Finally, however control is ultimately allocated among shareholders and other corporate constituencies in developing economies, there is reason to think that directors and officers would be delegated less control and afforded less discretion over the enterprise than they enjoy in the United States.²¹⁹ To the extent nonlegal control devices do not adequately discipline management, the alternative is for shareholders, possibly together with employees, creditors, and other constituencies, to exercise additional authority over the business. This would create additional "negative" control

217. In explaining the structure of Japanese corporate governance, Ronald Gilson and Mark Roe have also focused on the ways corporate governance structures can encourage certain inputs to production, such as employees, to make firm-specific investments. See Ronald J. Gilson, *Reflections in a Distant Mirror: Japanese Corporate Governance Through American Eyes*, 1998 COLUM. BUS. L. REV. 203, 207-12; Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 884-85 (1993).

218. This recalls recent arguments made by some in the United States against shareholder primacy, as well as the debate relating to the use of antitakeover charter provisions as pre-commitment strategies that insulate nonshareholder constituencies from the risk of expropriation associated with hostile takeovers. For more on the debate over antitakeover provisions and other pre-commitment strategies, see, for example, Stephen M. Bainbridge, *Dead Hand and No Hand Pills: Precommitment Strategies in Corporate Law* (2002), available at <http://ssrn.com/abstract=347089>; Lucian A. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. (forthcoming 2004); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J.L. ECON. & ORG. 83 (2001); Marcel Kahan & Edward Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, 152 U. PA. L. REV. (forthcoming 2004); Michael Klausner, *Institutional Shareholders, Private Equity, and Anti-takeover Protection at the IPO Stage*, 152 U. PA. L. REV. (forthcoming 2004); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845 (2002); Lynn A. Stout, *The Shareholder as Ulysses: An Empirical Exploration of Why Public Corporations Are Controlled by Boards of Directors*, 152 U. PA. L. REV. (forthcoming 2004).

219. In the United States, however, shareholders are becoming more active and are pushing for more control. In addition, union pension plans, by turning labor into shareholders, have pulled out a seat for labor at the corporate governance table.

rights, in the sense of heightened fiduciary duties, as well as additional "positive" control rights, in the sense of having the right to vote on a number of important business decisions that directors and officers currently have authority to decide in the United States.²²⁰

D. Capital Structure Critique

There is no reason to assume that the majority of companies in developing economies will be capitalized by selling common stock to public investors. Not every company is ready to be publicly held. Indeed, not every company's capital needs merit a public offering. It is very risky to invest in an early stage company. For example, an early stage company, even if past the start-up stage, has only a limited track record for investors to evaluate and faces a number of future challenges and decisions that will determine the company's fate.²²¹ Ron Gilson has explained it this way: "Virtually all of the important decisions bearing on [an early stage] company's success remain to be made, and most of the significant uncertainties concerning the outcome of the company's efforts remain unresolved."²²² Complicating matters, young companies often have inexperienced management teams. In the United States, these companies are financed by venture capital, not public shareholders, and the venture capitalists contract for significant control over the business.²²³ Venture capitalists are far from passive; ownership and control are not separated. It takes time before companies are mature enough to go public, a lesson recently learned by U.S. capital markets with the bursting of the dot-com bubble. In short, many companies are simply not "IPO ready" as a matter of business and finance, even if the preconditions exist for ownership and control to separate.

Why, then, do corporate governance reform efforts focus on creating the preconditions for publicly held companies to exist?

220. This basic insight motivates the mandatory model of corporate law. See *infra* Part IV.

221. See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076 (2003).

222. *Id.* at 1076-77.

223. For a good overview of venture capital markets, see Gilson, *supra* note 221; Ronald J. Gilson & Bernard S. Black, *Does Venture Capital Require an Active Stock Market?*, 11 J. APPLIED CORP. FIN. 36 (1999).

Instead of emphasizing the Berle and Means firm with "strong managers" and "weak owners,"²²⁴ it might be more effective to focus on establishing the institutional mix that supports the venture capital markets that incubate companies until they are ready to go public. Although the two reform agendas certainly overlap—Ron Gilson and Bernard Black, for example, have argued that an active securities market is necessary for venture capital to flourish because it gives private investors a profitable exit strategy²²⁵—venture capital raises its own unique governance and finance issues. The question of how to develop venture capital markets deserves attention, although it is beyond this Article's scope.²²⁶ My more modest point here is simply that by fixating on how to develop thick equity markets, economic reform agendas might be putting the cart before the horse, emphasizing the capital and governance structures of mature companies when most businesses in developing countries are early stage companies or, at the very least, more akin to small- and micro-cap companies than to Fortune 500 corporations.²²⁷

IV. LESSONS FOR DEVELOPING COUNTRIES: A FRAMEWORK FOR CORPORATE GOVERNANCE REFORM

A. When Law Really Matters

Ronald Coase said in his Nobel Prize lecture, "[E]x-communist countries are advised to move to a market economy, and their leaders wish to do so, but without the appropriate institutions no market economy of any significance is possible. If we knew more about our own economy, we would be in a better position to advise them."²²⁸ Coase's sentiment—that institutions matter and that

224. See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

225. Gilson & Black, *supra* note 223.

226. For insightful consideration of this question, see *id.*; see also Gilson, *supra* note 221; Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865 (1997).

227. See Black et al., *supra* note 57, at 297 ("[V]enture capitalists are likely to be important sources of equity capital in emerging economies, where most companies are highly risky because of a rapidly changing economic environment, whatever their size or prior track record.").

228. R.H. Coase, *The Institutional Structure of Production*, 82 AM. ECON. REV. 713, 714 (1992).

policymakers should be cautious in advocating market-based reforms for economies that might not have the institutional infrastructure to support a meaningful market economy—captures the purpose behind a systems approach to corporate governance reform. By carefully taking stock of the U.S. corporate governance system, it becomes clear that few, if any, developing countries have the necessary institutional mix to replicate the U.S. model of governance. To place this point in the context of broader economic reforms, successful privatization programs require the state to do more than simply distribute formal property rights to the private sector. In an important study of the prospects for capitalism in developing and former communist nations, Hernando de Soto urged governments to formalize interests in land and allocate clear title to property owners, in effect giving a property owner a piece of paper he can brandish when his interest is challenged.²²⁹ While important, this is too simplistic of an approach. While formal title to property is important, whether evidenced by a deed to a parcel of land, a valid patent, or a stock certificate, property rights need to be secured by a myriad of institutions, of which the law is only one.²³⁰ Formal property rights are of little value if they cannot be exploited for economic gain and enforced effectively against both individuals and the state.²³¹ Accordingly, many now recommend staged privatization, which buys time for the development of market

229. HERNANDO DE SOTO, *THE MYSTERY OF CAPITAL* 39-67 (2000).

230. See, e.g., Black & Tarassova, *supra* note 48 (explaining the importance of institutions to successful privatization); Milhaupt, *supra* note 38 (discussing the importance of different property rights institutions in the United States, Japan, and South Korea). Shareholders, for example, need adequate control rights over the corporation that are enforceable in order to realize their economic claim on the company.

231. Oliver Williamson has explained it this way: "The merits of privatization ... need to be assessed with reference to both the rules of the game and the play of the game." Williamson, *supra* note 168, at 611. Similarly, according to Milhaupt:

[S]imply moving assets from the state to private hands does not ensure a climate conducive to growth, investment, and effective corporate governance. Thus, the quality of institutional design trumps several other important considerations in the formulation of a privatization plan for Korea, including speed and mass participation in the process.

Curtis J. Milhaupt, *Privatization and Corporate Governance in a Unified Korea*, 26 J. CORP. L. 199, 200-01 (2001); see also PISTOR ET AL., *supra* note 18 (stressing the importance of enforcement).

institutions that support and give practical meaning to formal property rights.²³²

A corporate governance regime based on private ordering and market monitoring cannot be achieved overnight. Even under the best of circumstances, it can take decades to develop the necessary institutions. As Douglass North explained, institutions are the “product of a long gestation” and the “process of [institutional] change is overwhelmingly incremental.”²³³ Complicating things, it is difficult for policymakers to nurture institutions along or to accelerate their development because the process of institutional change and development is uncertain. Much work remains to be done to understand how and why institutions develop the way they do and to ascertain what the right institutions are in each setting. In developing a corporate governance regime, a country could speed things up by “piggybacking,” to some degree at least, on the law firms, investment banks, accounting firms, and credit rating agencies of developed countries.²³⁴ “Piggybacking,” however, goes only so far; although these market-supporting institutions are important, they fall far short of what it takes for a market-based governance system to work.

Copying the U.S. model of corporate governance, including the importation of U.S.-style corporate law, is not the answer—at least not in the near term—for developing countries hoping to reform their corporate governance regimes to achieve broad and deep capital markets.²³⁵ The necessary institutional infrastructure cannot simply be put into place overnight, but takes sustained effort to

232. See, e.g., Black et al., *supra* note 48 (addressing the flaws with the “rapid, mass privatization” in Russia); Coffee, *Privatization*, *supra* note 11, at 31-33 (suggesting a “gradual form of privatization” as a model); Williamson, *supra* note 168, at 609 (counseling a “more cautious and selective program of privatization”); see also Andrzej Rapaczynski, *The Roles of the State and the Market in Establishing Property Rights*, 10 J. ECON. PERSP. 87 (1996) (explaining that the necessary institutions to support privatization and a market-based economy can only develop as the market develops).

233. NORTH, *supra* note 168, at 192.

234. See Black, *supra* note 15, at 816-31 (discussing “piggybacking”); Gilson, *supra* note 9, at 345 (noting that “these substitutes can facilitate adoption during the period that local institutions develop to achieve formal convergence”). Cross-listing on another country’s stock exchange, thereby opting into its legal regime, at least in part, is a variation on the idea of “piggybacking” on another country’s institutions. See, e.g., Coffee, *supra* note 3 (examining cross-listing of shares).

235. See *supra* notes 50-62 and accompanying text.

develop. Further, nothing assures that by privatizing or adopting a market-based corporate governance model today that the requisite market institutions will follow to fill the gaps left by an enabling corporate law that offers relatively few shareholder protections. As some of the leading architects of the Russian corporate law in the early and mid-1990s have written of Russia's privatization:

The weak legal and institutional framework was no secret to the privatizers. But writing good laws can take years and building good institutions takes decades. The privatizers weren't willing to wait. They chose to privatize immediately, and hope[d] that the laws and institutions would follow later. The laws did indeed follow.... But the privatizers hoped for more than just decent laws. They hoped that broad private ownership would create a constituency for strengthening and enforcing those laws. That didn't happen.²³⁶

Bernard Black and Anna Tarassova summed up the postmortem on Russia's rapid privatization attempt this way: "[T]he shock therapy shortcut did not deliver the desired results."²³⁷

The instincts of the Russian privatizers, though, were partly right. Developing countries do not have the luxury of waiting for institutions to develop before taking steps to reform their economies. As Oliver Williamson has explained, "Real-time events ... cannot be put on hold. Hard choices have to be made."²³⁸ One hard choice is what type of corporate governance regime should be adopted if a market-based enabling approach similar to the U.S. model is not a feasible option. Markets are just one mode of governance; there are many ways parties can organize their affairs.²³⁹ When market failures persist, such as when contracting

236. Black et al., *supra* note 48, at 1753.

237. Black & Tarassova, *supra* note 48, at 216. For more on Russia, see *supra* note 48.

238. Williamson, *supra* note 168, at 609.

239. See, e.g., *id.* at 602-04 (discussing alternative governance modes of "spot markets, incomplete long-term contracts, firms, bureaus, etc."); WILLIAMSON, *supra* note 168, at 9 ("Markets, hybrids, firms, bureaus, etc. are simply alternative modes of governance with distinctive strengths and weaknesses. The need is to uncover the strengths and weaknesses of each. Organization theory is pertinent to all."). From a transactions cost perspective, one could think of law in terms of hierarchy—in particular, as the law giving shareholders in developing countries additional say at the top of the corporate hierarchy as compared to their counterparts in the United States.

and information costs are high, or when nonlegal modes of governance are otherwise inadequate, there is a strong case to be made for more law.²⁴⁰ Market failures are significant in developing countries where the very goal of corporate governance reform is to establish well-functioning securities markets.²⁴¹ I therefore agree with the view that stronger corporate law, providing minority shareholders greater protection from insider abuses, is needed to promote securities markets in developing countries.²⁴² The "more law" prescription is part and parcel of the "law matters" thesis. Even though law plays a secondary role in U.S. corporate governance, law really matters in developing countries.

In considering how corporate law should be crafted from scratch, Bernard Black, Reinier Kraakman, and Jonathan Hay (BKH), drawing from their experience drafting Russia's new corporate law after the collapse of the Soviet Union, offered an important "self-enforcing" model of corporate law for developing countries that responded to many of the same concerns this Article raises about the need for stronger law to compensate for the lack of market institutions outside developed economies.²⁴³ The essence of BKH's self-enforcing model is to grant shareholders additional procedural protections that they can enforce directly, as much as possible, without having to appeal to or rely on others to secure their property rights, such as judges, regulators, law firms, accounting firms, or the media.²⁴⁴ The self-enforcing model stands in contrast

240. See generally Williamson, *supra* note 168; WILLIAMSON, *supra* note 168; OLIVER E. WILLIAMSON, *THE LENS OF CONTRACT: PRIVATE ORDERING* (Univ. of Cal. at Berkeley Haas School of Business, Working Paper, 2002), available at <http://groups.haas.berkeley.edu/bpp/ow/lensofcontract.pdf>.

241. See Black et al., *supra* note 57, at 247 (explaining that in emerging economies without market institutions, the "market" cannot fill the regulatory gaps that an enabling-type corporate law leaves behind); Rapaczynski, *supra* note 232, at 91 ("It is this complex institutional framework of a market economy that constitutes, in large part, the background regime necessary to support modern forms of private property, which, consequently, cannot be 'put in place' in advance of its creation.").

242. See *supra* Part I.A; see also Black et al., *supra* note 57 (arguing that shareholders need more legal protections in developing countries in advancing a self-enforcing model of corporate law); Black & Kraakman, *supra* note 57 (developing further a self-enforcing model of corporate law with greater shareholder protection). For a leading article that makes the case for mandatory corporate law in the United States, see Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989).

243. See Black et al., *supra* note 57; Black & Kraakman, *supra* note 57.

244. Black et al., *supra* note 57, at 249-51, 256-57; Black & Kraakman, *supra* note 57, at

to a more mandatory "prohibitive" model, rejected by BKH, which would simply prohibit certain "suspect" transactions.²⁴⁵ Self-enforcing corporate law relies primarily on bright-line rules that are easier to understand, administer, and implement than standards.²⁴⁶ BKH made a number of specific recommendations, including requiring shareholder approval, by a supermajority vote in some cases, of self-interested transactions and major transactions (e.g., mergers, large sales or acquisitions of assets, reorganizations, and liquidations); cumulative voting for directors; no staggered boards; no dual-class stock; generous appraisal rights for shareholders; preemptive rights that protect shareholders against dilutive share issuances; and "tag-along" rights that allow minority shareholders to sell their shares on the same terms and conditions as a controlling shareholder sells its shares.²⁴⁷

The self-enforcing model is an important step toward more law, but it does not go far enough. Self-enforcing corporate law still depends on a host of institutions to be effective.²⁴⁸ Shareholders, investment bankers, lawyers, judges, and others still need experience and sophistication to evaluate many open-ended governance terms; tomorrow has to matter to achieve the voluntary compliance the model anticipates; and effective enforcement mechanisms, including an uncorrupted judiciary, are needed so shareholders can enforce their rights when insiders ignore a shareholder vote or otherwise do not comply voluntarily with what the law requires. The self-enforcing model, therefore, suffers the same shortcomings as the enabling model, even if to a somewhat lesser degree.

Ultimately, what developing countries need is a more mandatory model of corporate law, still comprising bright-line rules, that gives shareholders additional "negative" and "positive" control rights. In other words, a corporate law regime that is both more prescriptive and proscriptive in nature, placing further restrictions and imposing additional requirements on directors and officers, as well as

1916-17, 1932.

245. See Black et al., *supra* note 57, at 255-56 (explaining the "prohibitive" model); Black & Kraakman, *supra* note 57, at 1930-32 (explaining the "prohibitive" model).

246. Black et al., *supra* note 57, at 251, 286; Black & Kraakman, *supra* note 57, at 1916, 1934-43.

247. Black et al., *supra* note 57, at 258-86; Black & Kraakman, *supra* note 57, at 1943-67.

248. See Black et al., *supra* note 48, at 1756-57 (explaining the institutional shortcomings that compromised Russia's self-enforcing model of corporate law).

controlling shareholders, and giving shareholders a greater role in corporate governance and a greater say over the business.²⁴⁹ Further, the mandatory regime should be more rigid than the default rules central to Delaware corporate law, which limits the flexibility of entrepreneurs, investors, and other corporate constituencies to contract around the law; the parties should be able to opt out of few, if any, of the legal requirements. Even the United States started off with a much more restrictive corporate law regime than it has today,²⁵⁰ and Congress, the SEC, and the stock exchanges have adopted an historic set of demanding corporate governance mandates in response to the recent wave of corporate scandals. Coupled with more mandatory legal rules should be a greater degree of public enforcement, especially if the judicial system or other private enforcement mechanisms are not adequately developed and consequently are ineffective.²⁵¹ The United States, for example, has well-developed and respected regulatory bodies, such as the SEC, the NASD, the NYSE, and the new Public Company Accounting Oversight Board, not to mention the Department of Justice, state attorneys general, and even state securities commissioners. Even the Delaware judiciary, especially the Chancery Court, resembles a

249. As noted earlier, in formulating the self-enforcing model of corporate law, BKH expressly rejected a mandatory, which they termed "prohibitive," approach to corporate law. See Black et al., *supra* note 57, at 255-56; Black & Kraakman, *supra* note 57, at 1930-32.

250. See Black & Kraakman, *supra* note 57, at 1930 (explaining that the "prohibitive model" of corporate law is "familiar from nineteenth-century corporation statutes in the United States"); PISTOR & XU, *supra* note 50, at 4 ("As many have pointed out, the corporate law in the U.S., especially in Delaware, has developed from a (fairly) prohibitive, or mandatory law into an enabling corporate law, which allows shareholders to opt out of many legal provisions and substitute their own contractually determined arrangements."). Poland, particularly when contrasted with Czechoslovakia as it often is, is a recent example of how a more mandatory approach to corporate governance can lead to success. See generally Coffee, *Privatization*, *supra* note 11, at 9-25; La Porta et al., *supra* note 11, at 22-23; SIMON JOHNSON & ANDREI SHLEIFER, COASE V. THE COASIANS, 14-38 (Nat'l Bureau of Econ. Research, Working Paper No. 7447, 1999), available at <http://papers.nber.org/papers/w7447.pdf>. For an interesting study of how stronger law resulted in the separation of ownership and control in the Japanese cotton textile industry as early as the turn of the last century, see Yoshiro Miwa & Mark Ramseyer, *Corporate Governance in Transitional Economies: Lessons from the Prewar Japanese Cotton Textile Industry*, 29 J. LEGAL STUD. 171 (2000).

251. For more on public enforcement versus private enforcement, see generally A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. ECON. LIT. 45 (2000); JOHNSON & SHLEIFER, *supra* note 250; RAFAEL LA PORTA ET AL., WHAT WORKS IN SECURITIES LAW? 4-5, 11-18 (Nat'l Bureau of Econ. Research, Working Paper No. 03-22, 2003), available at <http://ssrn.com/abstract=425880>; PISTOR & XU, *supra* note 50, at 13-17.

regulator in some ways, because of its expertise in corporate law matters. Delaware judges do not simply wait for parties to bring cases to them but are more proactive than most courts, engaging in what might be characterized as a form of informal rulemaking through speeches, articles, and networking.²⁵²

The chief criticisms of mandatory corporate law are that it deprives managers of the flexibility needed to run the business and that one size of corporate governance is not appropriate for every company.²⁵³ More to the point, the give-and-take of an enabling corporate law comprising default rules allows a more efficient set of governance techniques to evolve over time and for each company and its shareholders to pick and choose the measures that work best for the enterprise in light of its changing needs. Further, a market-based governance system is less likely to regulate risk out of the market than a more mandatory approach, especially one that is backed by stiff legal sanctions. I have made these very points elsewhere in arguing against the mandatory one-size-fits-all approach of Sarbanes-Oxley and the amendments to the NYSE listing standards and in favor of market-based responses to the rash of corporate abuses at Enron, WorldCom, Tyco, and other companies.²⁵⁴ I take a different tack when considering corporate governance reform in developing countries where the institutions do not exist to allow the market to hold managers accountable without more law. In addition, although the balance appropriately tilts in favor of managerial discretion in the United States,²⁵⁵ the balance should tilt in favor of shareholder protection in developing countries, where a premium should be placed on reducing agency costs and boosting investor confidence.

The real concern of a mandatory approach to corporate law in developing economies is not that management will find its hands tied in some instances, because constraining management is the whole point of a more mandatory governance structure, and the upside of mitigating agency problems outweighs the cost of some forgone business opportunities and additional compliance costs. The real concern is that the state will ultimately insert itself into the

252. See *supra* notes 113-25 and accompanying text.

253. See *infra* notes 270, 293-95 and accompanying text.

254. See Paredes, *supra* note 69.

255. See *supra* notes 161-67 and accompanying text.

economy too much, undercutting privatization and the private sector and blocking a broader move to free markets. Admittedly, mandatory corporate law is in tension with a move to free markets and a capitalist economic system, but an important distinction needs to be made. Mandatory corporate law is about shifting authority from directors and officers to shareholders, and possibly other stakeholders. Mandatory corporate law, at least as envisioned here, does not call for the state to substitute its business judgment for the business judgment of managers and investors. My argument for more mandatory corporate law in developing countries is not a call for a command-and-control economy in which the government bets on specific companies by influencing capital flows or funding businesses directly; picks particular industries to promote; or decides which factories to open or shut, which technologies to employ in production, or whether a company should make red or blue widgets. Business decisions should be left to directors, officers, and shareholders, together with other corporate constituencies with a role in corporate governance. In short, the market, not the state, should make business decisions.

The corollary is that while strong legal protections should shield shareholders from the risk of expropriation and insider opportunism, shareholders should not be shielded from business risks; companies should be allowed to go under and investors should be allowed to lose money. Assuming that a country's overarching goal is to develop a market economy, the state's involvement in corporations will have to be cabined so that businesses are not in effect nationalized, or even propped up, through an overreaching corporate law regime that ultimately retards economic advancement by serving as a basis for greater state intrusion into the private sector.²⁵⁶

For those who are particularly reluctant to embrace mandatory corporate law, even for developing countries, it is worth noting that an initial mandatory governance system might ultimately give way to an enabling market-based approach. As investors enter the

256. This view is consistent with a broad theme of the "law matters" thesis, which claims that the common law tradition promotes financial development because it elevates the individual over the state and respects private property, a critical aspect of which is private decision making in economic affairs. *See supra* note 42 and accompanying text; *see also* Milhaupt, *supra* note 38, at 1166-79 (stressing the importance of economic freedom).

market in response to strong legal protections, market-supporting institutions are likely to follow, though it could take years.²⁵⁷ Financial development creates business opportunities for lawyers, bankers, and accountants, among others, and one can expect both the growing investor class as well as issuers to welcome these "transaction cost engineers." Indeed, issuers might seize on the chance to leverage the arrival of these professionals to argue that legal mandates should be scaled back. To be clear, however, the mandatory approach to corporate law that I recommend in this Article does not depend on its ultimately giving way to a more flexible scaled-back legal regime. In fact, there are no assurances that a more flexible system will be achievable in most countries; even if the requisite market institutions develop, path dependence might keep an economy from switching gears to a more enabling governance regime.²⁵⁸ It might be inefficient to switch from a mandatory system that has been in place for some time and around which practices and customs have evolved, and entrenched interests who benefit from the extant (mandatory) regime might wield enough political influence to block any future reforms.

It is easier to change the law on the books than to implement other institutional reforms or to change norms of conduct.²⁵⁹ In fact, many of the important governance institutions discussed earlier cannot arise in any meaningful way until capital markets have

257. See, e.g., Coffee, *supra* note 3, at 696 ("[W]here legal forces exist to protect the minority shareholder, an institutional and cultural infrastructure—composed of such important actors as security analysts, rating agencies, and business journalists—soon follows."). This recalls Coffee's suggestion that as an influential investor class takes hold, it pushes for additional legal protections, challenging the causal story behind the traditional "law matters" thesis. See *supra* note 37. My point here is that as an investor class develops and markets mature, it might be possible to scale back strong legal shareholder protections as markets are able to hold management accountable more effectively. For a broader discussion of how markets, property rights, and legal and nonlegal institutions develop hand-in-hand in a "gradual, incremental and evolutionary process," see Rapaczynski, *supra* note 232.

258. For more on path dependence, see Bebchuk & Roe, *supra* note 34; see also Coffee, *Privatization*, *supra* note 11, at 9 ("In a path-dependent world, it may simply be politically impossible to get from here to there, even when it is clear to most that such a transition would be efficient and would yield significant economic growth.").

259. See, e.g., NORTH, *supra* note 168, at 192; Milhaupt, *supra* note 38, at 2096-2119 (explaining the process by which norms are created and destroyed); Richard A. Posner, *Creating a Legal Framework for Economic Development*, in WORLD BANK RES. OBSERVER 1, 3-4 (1998) (describing a "rules-first strategy" of law reform).

already begun to develop and take shape.²⁶⁰ Still, the kind of law reform suggested here is challenging; and the challenges should not be understated, nor should the benefits of reform be overpromised. There is sure to be resistance to changing the "rules of the game." Financial development and the transition to freer markets are certain to cause painful disruptions for many people, and others who are simply losing valuable rents they have accumulated in the current regime will presumably seek to preserve them one way or another. If political support wanes, reform efforts could be doomed.

Simply adopting a mandatory corporate law regime is not enough. The law's substance matters. Just as a systems approach is important when studying U.S. corporate governance, a systems approach is also important when developing the corporate law regime of any other economy. A complementarities perspective teaches that Indonesia, Bulgaria, Kazakhstan, Colombia, Ghana, and Iraq all need different corporate governance structures; and it may turn out that some developing countries actually can sustain a more enabling approach to corporate law. As stressed earlier, simply copying the law on the books from elsewhere or cobbling together a corporation code by mixing and matching the laws of other countries, while relatively quick and easy to do, is a shortcut that can have disastrous consequences for the "importing" country. Coming up with the appropriate corporate law regime for an economy takes deliberate consideration of the country's institutional makeup, history, political economy, social structure, and cultural values; it is a process that should not be rushed. The work is not finished, but is just beginning, once the new rules are in place. The legal regime needs to be implemented, monitored, and revised if necessary to ensure it fulfills its function. Patience is needed, both in taking the time required to craft and enforce an effective new legal system and in awaiting its benefits. I offer some specific suggestions for reform below.

260. Bernard Black and his co-authors note:

Moreover, many of the necessary institutions can develop only as the market develops. The securities commission and criminal prosecutors need fraud to practice on, if they are to become skilled at combating fraud. Accountants, investment bankers, and other reputational intermediaries also learn from their mistakes—from the frauds they didn't catch.

Black et al., *supra* note 48, at 1798; *see also* Rapaczynski, *supra* note 232 (explaining that market-institutions and the market develop in tandem).

Finally, even if a country adopts the “right” corporate law, there are no guarantees that thick securities markets and economic growth will follow. Although an effective corporate governance system is key, financial development and economic growth depend on much more. Corporate governance is itself just one of many parts that need to fit together for investors to invest and for an economy to grow.²⁶¹

B. “Ground-Level” Benefits of Mandatory Corporate Law

Having made the philosophical case for a mandatory model of corporate law, I want to describe further some of its practical “ground-level” benefits.²⁶² A mandatory corporate law system should, to the extent possible, comprise bright-line rules, as opposed to more ambiguous open-ended standards.²⁶³ The rules versus standards debate is well-known, so I can be brief here in outlining the virtues of rules.²⁶⁴ First, bright-line rules generally are more straightforward and clearer than standards and are therefore more predictable.²⁶⁵ The Delaware law of fiduciary duties is itself more rule-like and predictable than many standards, having been fleshed out by an extensive body of case law precedent that reflects a consistent underlying norm of shareholder primacy.²⁶⁶ Legal

261. For a discussion—and a very detailed chart—of the range of institutions needed for economic growth, see, for example, Black & Tarassova, *supra* note 48.

262. The following discussion draws from and builds on two overlapping literatures: (1) the literature discussing the relative merits of rules and standards; and (2) the literature discussing the relative merits of mandatory versus enabling approaches to corporate law. *See, e.g.*, Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); Kahan & Kamar, *supra* note 86; Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23 (2000); Strine, *supra* note 68. For analyses focusing on developing economies, see, for example, Black et al., *supra* note 57; Black & Kraakman, *supra* note 57; Jonathan R. Hay et al., *Toward a Theory of Legal Reform*, 40 EUR. ECON. REV. 559 (1996); Posner, *supra* note 259.

263. The distinction between rules and standards is not so clear in practice. There is a continuum between laws that are more rule-like and those that are more standard-like, and how clear and understandable the law is—whether more rule-like or more standard-like—has a great deal to do with the drafting.

264. *See supra* note 262.

265. Having bright lines is not enough to ensure a rule's clarity. There can be so many rules, subrules, exceptions, and the like that rules become a complicated maze that is too difficult to make one's way through. The Internal Revenue Code comes to mind as an example.

266. Securities regulation, of course, comprises an extensive set of detailed statutes, rules,

certainty, which is part and parcel of well-defined property rights, is a valuable asset that facilitates business and investing, aside from how the law actually allocates rights and responsibilities.²⁶⁷ Stating the strong form of this view, Justice Scalia has explained: "There are times when even a bad rule is better than no rule at all."²⁶⁸ Second, bright-line rules should be simpler to interpret and apply than standards. As Judge Posner explained, "determining whether [rules] have been violated is a relatively mechanical, cut-and-dried process rather than one requiring the exercise of discretion or the determination of numerous facts."²⁶⁹ A key virtue of standards—that they are more efficient than rules since courts can more precisely tailor them to fit the case at hand, whereas rules are inflexible and tend to be both overinclusive and underinclusive—is unlikely to be realized in developing countries where courts generally lack the sophistication and experience necessary to apply open-ended corporate law standards in a textured, fact-specific manner.²⁷⁰ When exercising the kind of discretion on which standards depend would strain judicial competency too much, easily administered bright-line rules have a comparative advantage.

and regulations. For an argument that the United States built a "regulatory structure" based on rules—namely, the SEC and the federal securities laws—to improve on the standards-based law of fiduciary duties, see *Roe, supra* note 41, at 4-7.

267. See, e.g., Neil King, Jr., *Iraq's Business Elite Gropes in the Dark: Absence of a Legal System and Fear of Foreign Investors Sow Confusion and Doubt*, WALL ST. J., June 24, 2003, at A4; see also Gordon, *supra* note 242, at 1564-67 (explaining that the desire to achieve greater certainty is a basis for mandatory corporate law).

268. Scalia, *supra* note 120, at 1179; see also *id.* at 1178 ("Much better, even at the expense of the mild substantive distortion that any generalization introduces, to have a clear, previously enunciated rule that one can point to in explanation of the decision.").

269. Posner, *supra* note 259, at 4; see also Hay et al., *supra* note 262, at 566-67 (explaining the importance of bright-line rules that are easy for courts to apply); Posner, *supra* note 259, at 5 ("The first is that the application of rules places fewer demands on the time and the competence of the judges and is therefore both cheaper and more likely to be accurate.").

270. According to Judge Posner:

The accuracy [of rules] is a little illusory, because it is a property of governance by rules that they never quite fit the complex reality that they govern. But this observation is consistent with their being more efficient than standards if administered by a judiciary that has a limited capability for the kind of nuanced and flexible decisionmaking that standards require.

Posner, *supra* note 259, at 5; see also Hay et al., *supra* note 262, at 566 ("[V]ague rules would leave courts too much discretion, and would therefore either not be used at all, or be abused by courts."); JOHNSON & SHLEIFER, *supra* note 250, at 854 ("Judges must be able, and more importantly willing, to read complicated contracts, verify whether the events triggering particular clauses have actually occurred, and interpret broad and ambiguous language.").

Corruption is an especially acute problem in many developing countries and undercuts the rule of law and economic growth, whether a legal system is based on rules or standards.²⁷¹ If judges, together with regulators and other public enforcement agencies, are more effectively monitored, it can go a long way to instilling trust and confidence in the legal system. If people have trust and confidence in the legal system, they are more likely to use it to resolve their disputes as opposed to relying on self-help remedies, such as organized crime.²⁷² In addition, they are more likely to comply with the law themselves, with the added benefit of reinforcing trust and confidence in the legal system.²⁷³ To be sure, even under the best of circumstances, judges will sometimes misapply the law, and the judiciary will always have some bad actors in it. However, judges need to be seen as applying the law fairly, equitably, and in good faith, with at least a minimum degree of competency.²⁷⁴ As Justice Breyer has remarked, people need to "perceive" that judges actually "decide [cases] independently

271. For example, corruption has been identified as a major corrosive influence in Russia that compromised its attempt at privatization and corporate governance reform. See, e.g., Black & Tarassova, *supra* note 48, at 226-38.

272. For an interesting analysis of how organized crime arises to fill gaps between formal property rights and their effective enforcement, see Milhaupt & West, *supra* note 138.

273. Cf. Posner, *supra* note 259, at 5 (observing that "understanding and acceptance are important to achieving voluntary compliance as well as to the sensible decision of cases by lay adjudicators").

274. H.L.A. Hart expressed a similar point this way:

Up to a certain point, the fact that some rulings given by a scorer are plainly wrong is not inconsistent with the game continuing: they count as much as rulings which are obviously correct; but there is a limit to the extent to which tolerance of incorrect decisions is compatible with the continued existence of the same game, and this has an important legal analogue. The fact that isolated or exceptional official aberrations are tolerated does not mean that the game of cricket or baseball is no longer being played. On the other hand, if these aberrations are frequent, or if the scorer repudiates the scoring rule, there must come a point when either the players no longer accept the scorer's aberrant rulings or, if they do, the game has changed. It is no longer cricket or baseball but "scorer's discretion"; for it is a defining feature of these other games that, in general, their results should be assessed in the way demanded by the plain meaning of the rule, whatever latitude its open texture may leave to the scorer. In some imaginable condition we should say that in truth the game being played was "scorer's discretion" but the fact that in all games the scorer's rulings are final does not mean that that is what all games are.

H.L.A. HART, *THE CONCEPT OF LAW* 141 (1961).

according to law.”²⁷⁵ As Justice Breyer’s colleague, Justice Scalia, put it, “the trouble with the discretion-conferring approach to judicial law making is that it does not satisfy [a] sense of justice very well.”²⁷⁶ When the law is made up of clear-cut rules that afford judges relatively little discretion, directors, officers, shareholders, and others can more readily police the courts because it is cheaper and easier to detect when the law has been misapplied. Greater judicial accountability should not only encourage judges to make a greater effort to apply the law correctly, but should also mitigate judicial corruption and dissuade judges from giving preferential treatment to certain corporate interests.²⁷⁷

Clear rules offer additional advantages over standards by encouraging forms of self- and market-enforcement of the law and good corporate governance practices. One way the law “works” (i.e., deters undesirable conduct, such as insider looting) is by relying on the heavy hand of the state to impose legal sanctions on wrongdoers. In addition to its sanctioning role, the law can shape conduct in two other notable respects, which are sometimes associated with the law’s expressive function.²⁷⁸ First, directors and officers might

275. Stephen G. Breyer, *Judicial Independence in the United States*, 40 ST. LOUIS U. L.J. 989, 996 (1996).

276. Scalia, *supra* note 120, at 1178.

277. Posner notes:

[R]ules facilitate monitoring of the judges and so reduce the likelihood of bribery and the influence of politics in the judicial process. The less discretion a judge has in making decisions, the easier it will be to determine whether a case has been decided contrary to law or whether there is a pattern of favoring one class or group of litigants over another.

Posner, *supra* note 259, at 5; see also Black & Kraakman, *supra* note 57, at 1942 (“A corrupt judge can twist a ‘reasonableness’ standard to reach the decision he was paid to reach, but cannot so easily twist a requirement that the company provide cumulative voting or appraisal rights.”). For the same reason, bright-line rules make it easier to monitor regulators and hold them accountable. The monitoring of judges and regulators, however, is only effective if aggrieved parties are able to seek remedies from a competent higher authority that is not itself corrupted or subject to the influence of special interests.

278. The view that the law serves an expressive role contends that, above and beyond imposing legal sanctions, the law can make a statement about how people are supposed to behave—that is, it can express certain social values and expectations—and thereby shape conduct. For different views on the expressive function of the law, see Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363 (2000); Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503 (2000); Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998); Alex Geisinger, *A Belief Change Theory of Expressive Law*, 88 IOWA L. REV. 35 (2002); Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649 (2000);

internalize the values and expectations expressed by a clear set of legal rules aimed at rooting out insider abuses, possibly holding themselves to an even higher standard of conduct than what the law technically requires.²⁷⁹ A mandatory corporate law that clearly pronounces society's expectations, and that parties cannot contract around, is more likely to change norms than ambiguous standards that send a more muffled message.²⁸⁰ A clear statutory mandate might be particularly important in developing countries, especially those with a civil law tradition, where judges lack the stature of the Delaware judiciary.

Second, clear rules can facilitate cooperation, even when parties do not develop an internal "taste" for it.²⁸¹ There is always some incentive to circumvent the law, particularly if the law is especially burdensome or seen as invalid and illegitimate. It is usually easier, however, to detect when bright-line rules are being circumvented than when ambiguous standards are. To use a common example, it is easier to verify that a person is driving sixty-five miles per hour than to determine whether she is driving "carefully," particularly if there is no extensive body of case law interpreting what it means to drive "carefully." Similarly, it is easier to monitor whether directors and officers are following specific legal mandates than to verify that they are running the business in good faith, loyally, and with due care. Bright-line rules should, therefore, assist burgeoning capital markets in holding insiders accountable, adding to the deterrent effect of legal sanctions.²⁸²

Bright-line rules also help insiders signal to the market that they are "cooperators" (i.e., honest, trustworthy, and loyal).²⁸³ By

Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996); RICHARD H. MCADAMS & JANICE NADLER, A THIRD MODEL OF LEGAL COMPLIANCE: TESTING FOR EXPRESSIVE EFFECTS IN A HAWK/DOVE GAME (2003), available at <http://papers.ssrn.com/abstract=431782>.

279. See *supra* notes 107-25 and accompanying text.

280. See Korobkin, *supra* note 262, at 55 ("[R]ules, because of their *ex ante* clarity, are more likely to affect social norms than are more ambiguous standards.... The problem is that such a vague standard sends an unclear signal"); STOUT, *supra* note 45, at 30-31 (discussing the role of authority in shaping norms). Indeed, one of the messages Sarbanes-Oxley sends, as did the Securities Act and Exchange Act after the 1929 stock market crash, is that fraud and other corporate misconduct will not be countenanced.

281. For a similar point, see *supra* notes 120-21 and accompanying text.

282. See *supra* notes 120-21 and accompanying text.

283. See *supra* notes 121, 201-04 and accompanying text.

developing a track record of law compliance that the market recognizes, a manager can cultivate a reputation as a "cooperator" in whose company investors should be willing to invest, assuming the company has a worthwhile business model.²⁸⁴ In fact, honest-dealing managers might prefer stringent legal mandates that are strictly enforced.²⁸⁵ If legal rules are less demanding, or if their enforcement is lax or the sanctions for noncompliance are weak, it is easier for disloyal and untrustworthy managers to mimic the behavior of cooperating managers because complying with the law is relatively cheap. When the law is weak, a reputation for law compliance is less meaningful to the markets since it sends a weaker signal that a manager is willing to cooperate. From the perspective of a more explicit game-theoretic framework involving shareholders and management,²⁸⁶ noncompliance with the law becomes more costly for management when corporate law primarily

284. See Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1786-91 (2000) (offering a model of tax compliance in which people comply with the tax law in order to signal that they are "good types" with low discount rates who are likely to cooperate and thus less likely to cheat). Lisa Bernstein notes:

In general, in order for cooperation to emerge in a particular market, transactors must each adopt strategies of cooperating at the beginning of each contracting relationship and thereafter responding to cooperative behavior with cooperation and responding to uncooperative behavior (defection) with punishment (such strategies are called "tit-for-tat" strategies). Each transactor must also be able to obtain information about the reputations of other market participants, and reputation must be at least partially dependent on how a transactor behaved in previous transactions. In addition, each transactor must be able to observe whether the person he is dealing with has cooperated or defected.... Because these noncooperative responses tend to reduce his future trading opportunities, the long-run cost of defection will often be greater than the short-term gain from defection, so a transactor who is not in financial distress is more likely to cooperate than to defect.

Bernstein, *supra* note 201, at 1763-64 (2001). For a general discussion of signaling, see DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 122-58 (1994); PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION & MANAGEMENT* 154-59 (1992); A. MICHAEL SPENCE, *MARKET SIGNALING: INFORMATION TRANSFER IN HIRING AND RELATED SCREENING PROCESSES* (1974).

285. See Gilson & Kraakman, *supra* note 141, at 605 (explaining that "trade associations that are dominated by high quality firms often lobby for more stringent legislative standards and greater enforcement of those standards" in order to drive lemons from the market). Another way companies signal that they are "good" is by renting the reputation of reputational intermediaries, for example by hiring top law firms or engaging well-respected underwriters. See *supra* note 141.

286. For such a model, see, for example, Cooter, *supra* note 120.

consists of strict, clear-cut rules. The payoff to defection decreases because noncooperation will more likely be detected and punished, whereas the payoff to cooperation increases because “cooperators” are better able to distinguish themselves from defectors. The bottom line is that we should expect more cooperation, reducing agency problems.

In addition to lowering agency costs, there are two additional benefits of cooperation worth mentioning. The first is straightforward: voluntary compliance with the law places fewer demands on the legal system. The strain on the system is further reduced if insiders voluntarily comply with the best corporate governance practices that the judiciary, a respected regulatory body, or market intermediaries might articulate. Second, there is a positive externality from cooperation. Cooperation begets more cooperation. As people cooperate more, they might develop a preference for cooperation and begin to internalize a norm of cooperation and trustworthiness.²⁸⁷ Even if no such norm takes hold, as parties begin to cooperate more and to expect cooperation from others, the expected payoffs from cooperation should increase. Tomorrow should matter more as the opportunity for repeated interactions increases with more cooperation throughout the private sector, making a party’s reputation and the future both more valuable. Recognized patterns of cooperation in business and finance can increase trust and confidence in transactions throughout the economy, overcoming a big obstacle to wealth-increasing transactions and economic growth. There is, in other words, a sort of snowballing effect: as more and more parties adopt a strategy of cooperation, others should too.²⁸⁸

A number of other benefits flow from a mandatory approach to corporate law. For example, capital market participants have to understand and evaluate fewer terms and corporate governance practices when the range of options is narrowed, and because there are fewer options, contracting and information costs should decrease.²⁸⁹ Investors, analysts, bankers, and others can focus more

287. See, e.g., Blair & Stout, *supra* note 104; STOUT, *supra* note 108.

288. “More cooperation increases the level of trust, which increases the expected value of the game to all of the players. Consequently, everyone enjoys a positive externality when more agents cooperate and fewer agents appropriate.” Cooter, *supra* note 120, at 1666.

289. See Bernstein, *supra* note 201, at 1741-42 (explaining how a well-defined set of

attention on a company's operating and financial performance.²⁹⁰ Further, there is less uncertainty when investing, at least from a corporate governance perspective. With key features of the governance regime fixed, transactions are less likely to reach an impasse over corporate governance concerns. In addition, by engaging in repeated dealings with respect to fewer corporate contract terms and governance practices, investors, managers, investment bankers, lawyers, judges, and others should gain valuable experience, as well as a common perspective on governance.²⁹¹ The parties' experience

standardized rules "reduce[s] the negotiation costs, specification costs, information costs, and relational costs of contracting, as well as the risk of transaction breakdown") (footnotes omitted); Coffee, *supra* note 126, at 1678 (averring standardized terms reduce "information costs"); Kahan & Klausner, *Path Dependence*, *supra* note 200, at 350 (noting "[t]he benefits of [standardized] terms include avoidance of formulation errors, ease in drafting, availability of judicial rulings on the validity and interpretation of the term, and familiarity among the investors and securities analysts who, implicitly or explicitly, will put a price on the term"); Kaplow, *supra* note 262, at 571-72 (explaining that it is cheaper to learn about a rule than a standard).

290. Cf. Coffee, *supra* note 126, at 1677 (stating that a benefit of mandatory corporate law is that "both investors and securities analysts can virtually ignore the corporate charter and focus exclusively on disclosures that relate to cash flow and breakup value").

291. Kahan & Klausner explain:

Contractual network benefits [from standardized contracting] include higher quality and lower cost legal and professional services in the future, as lawyers and accountants gain (and retain) expertise by encountering questions or disputes regarding a particular contract term. They also include the availability of a large number of investors and securities analysts who will learn how to price a firm's securities at later public offerings and on the secondary market. Finally, network benefits include judicial interpretations that courts issue during the period in which a firm has a term in its contract.

Kahan & Klausner, *Standardization and Innovation*, *supra* note 200, at 726 (footnotes omitted); see also Kahan & Klausner, *Path Dependence*, *supra* note 200, at 350-53 (summarizing the "learning benefits" and "network benefits" of standard terms); Klausner, *supra* note 200, at 761. Jeffrey Gordon adds:

More judicial precedents [relating to standard contract terms] can be expected, on average, to enhance the clarity of the term[s]. Common business practices implementing the term[s] may become established, further reducing uncertainty. Legal advice, opinion letters and related documentation will be more readily available, more timely, less costly, and more certain. Finally, firms may find it easier to market their securities.

Gordon, *supra* note 242, at 1567-69 (discussing a "public good" rationale for mandatory corporate law that depends on repeat usage of terms); cf. Bernstein, *supra* note 201, at 1741 n.82 (explaining that in many contexts, parties contract "with an idea of how similar transactions are usually structured; they have in their minds an implicit form contract made up of clauses such as price that are commonly negotiated, boilerplate provisions, and legal default rules [and extralegal provisions]").

and shared mental model should not only facilitate transactions and the resolution of disputes when they do arise, but eventually can be leveraged in urging policymakers to move to a more flexible corporate law system as the marketplace and the judiciary become more sophisticated. Particularly important for the judiciary is the credibility judges should earn as they build expertise and a body of case law to which parties have acceded.²⁹² In short, mandatory corporate law replicates many of the transactions cost-reducing benefits of standardized contracting. With the caveat that corporate governance is complex, and that trying to simplify it too much runs the risk that an unacceptably inefficient set of rules will be crafted, policymakers should attempt to draft a corporate law for developing countries that is straightforward and easy to interpret and apply.

The strongest critique of mandatory corporate law is that it denies directors and officers the flexibility they need to run the business profitably and that it chills management from taking prudent business risks, especially when the law is backed by strict sanctions.²⁹³ In this sense, mandatory rules are overinclusive, prohibiting, or at least discouraging, corporate conduct that is in the best interests of the corporation and its shareholders. If anything, the balance between managerial discretion and shareholder protection in the U.S. governance system tilts in management's favor, erring on the side of underregulation. Even with Sarbanes-Oxley and the other recent regulatory reforms, some mismanagement, fraud, shirking, and disloyalty is tolerated as the price that has to be paid for entrepreneurship, innovation, and risk taking. Although these agency problems can certainly stress the markets if widespread, the U.S. capital markets can withstand them, as the rebound of equities after Enron and WorldCom attests. Indeed, the sell-off of stocks after the scandals came to light is part and parcel of how capital markets discipline management and it

292. See Hay et al., *supra* note 262, at 567 ("As laws are used more, courts will begin to gain credibility as places to resolve disputes. They will also become more predictable as a body of precedents develop"). As judges develop expertise and a corresponding body of precedent with respect to a limited range of corporate contract terms and governance practices, the legal risk facing parties should be mitigated.

293. Even mandatory corporate law rules, though, have a voluntary quality to them in that a corporation can avoid most of the requirements by choosing not to issue shares to the public.

validates that the U.S. corporate governance system can rely on relatively little corporate law.

The calculus is different in developing countries. Whatever one thinks of the balance struck in the United States, shareholders should be afforded greater protection in developing countries, at the expense of managerial leeway for directors and officers. Returning to the logic of the "law matters" thesis, nascent and emerging capital markets are unlikely to pass the stress test of corporate scandal and insider abuse. Developing economies have not yet built up any sort of resilience to agency problems and lack the self-corrective mechanisms needed to keep the abusive practices and fraud from spreading. By way of contrast, in addition to the major sell-off of equities in the United States after the wave of scandal, there were numerous market-based responses that addressed a number of flaws in the U.S. governance system, and investor confidence was ultimately restored.²⁹⁴ A more fragile and immature capital market might very well collapse under similar pressure. Thus, agency problems—or even just the perception of them—pose a greater risk to developing countries in an earlier stage of financial development than to developed capital markets in advanced economies. Consequently, even at the risk of going too far and overregulating, policymakers should be willing to regulate more entrepreneurship, innovation, and risk taking out of the market in developing economies by affording management less discretion and allocating additional control to shareholders.²⁹⁵ Reducing agency problems is worth the price of tying management's hands and forgoing some business opportunities. As between regulating some risk out of the market or not having much of a capital market to regulate, the former is preferable. Furthermore, without stronger

294. For a discussion of market-based responses to the wave of corporate scandal, see Paredes, *supra* note 69; Ribstein, *supra* note 70.

295. In criticizing Stephen Choi's proposal favoring regulatory competition and issuer choice as means to promote financial development, John Coffee has also recently suggested that overregulation may be preferable to underregulation. See John C. Coffee, Jr., *Law and Regulatory Competition: Can They Co-Exist?*, 80 TEX. L. REV. 1729, 1733-34 (2002) (noting that "underregulation may be a greater danger to financial development than overregulation" and that a company in an emerging economy should therefore be precluded from "exiting" its home country's laws by opting into the "weak" legal regime of another country). *But see* Choi, *supra* note 11, at 1702-26 (arguing in favor of regulatory competition to promote financial development).

legal protections for shareholders in developing countries, the balance of power would tilt even more heavily in management's favor than it does in the United States, because developing countries lack the rest of the U.S. system that constrains managers. Even if the goal were to replicate the U.S. balance between managerial discretion and shareholder protection, it would not be achieved simply by transplanting U.S.-style corporate law.

To cast this point in slightly different terms, capital markets, including those in advanced economies, depend on investor confidence. Instilling investor confidence and promoting capital market integrity are more important goals in developing countries than managerial discretion to run the business.²⁹⁶ By adopting a demanding mandatory corporate law, policymakers can boost investor confidence and shore up the integrity of securities markets by signaling that shareholders will be protected adequately and by convincing the markets that there is a cop on the beat. The United States itself is a case in point. Congress responded to the stock market crash of 1929 and the erosion of investor confidence that followed with a historic regulatory regime: the Securities Act of 1933 and the Securities Exchange Act of 1934.²⁹⁷ More recently, Sarbanes-Oxley, coupled with numerous rules and regulations adopted by the SEC, helped restore investor confidence in the aftermath of the scandals at Enron, WorldCom, and elsewhere.

The distinction between the public and the private spheres is not as clear when it comes to corporate law as many claim. Self-dealing, shirking, or fraud at a few companies can destroy overall investor confidence.²⁹⁸ The United States provides another example. After

296. See Black et al., *supra* note 57, at 246 ("[I]n many emerging markets, corporate law must serve a second goal: to foster public confidence in capitalism and in private ownership of large firms."); Coffee, *Privatization*, *supra* note 11, at 22 (noting that the "true independent variable in [a model of legal development designed to promote securities markets] may be investor confidence").

297. For a history of the SEC and the federal securities laws, see JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* (2003).

298. See Black & Kraakman, *supra* note 57, at 1925 (explaining that scandals create negative externalities "that become more serious as legal rules allow greater insider discretion"); Coffee, *Privatization*, *supra* note 11, at 23 (explaining that "anything that invites public scandal (including weak legal protections) creates a negative externality" and that policies that foster investor confidence can be justified even if they compromise capital formation); Cooter, *supra* note 120, at 1666 ("[A]ll players suffer a negative externality when

the scandals at a few leading companies broke, investors became skittish about all companies—waiting for the proverbial other shoe to drop—and left stocks for more-secure investments. Private ordering cannot be relied upon to ensure that enough confidence is injected into developing securities markets. There is no reason to expect directors, officers, and shareholders to take the negative externalities of agency problems at their company into account when organizing their internal corporate affairs. Indeed, some investors will be more than willing to assume a greater risk of governance failure and simply price the risk into a company's stock price, even though any resulting abuses can jeopardize the capital markets as a whole. A more heavy-handed legal regime, then, is required to remedy the externalities stemming from what otherwise might appear to be localized abuses at particular companies in developing economies.

Throughout most of the foregoing discussion, I have implicitly assumed that policymakers will at least try their best to craft an effective corporate law. In reality, though, the lawmaking process is likely to be subject to forceful lobbying efforts from influential interests and to an array of other well-known public choice pressures.²⁹⁹ In addition, policymakers do not have perfect information, and because of bounded rationality, they cannot consider the full range of eventualities a company might encounter or all the possibilities for dealing with them. Complicating matters, policymakers, like everybody else, are subject to a host of cognitive biases that can affect their decision making.³⁰⁰

These concerns obtain whether policymakers are crafting a mandatory or an enabling corporate law. However, default rules act

more players appropriate.”).

299. See, e.g., *PERSPECTIVES ON PUBLIC CHOICE* (Dennis C. Mueller ed., 1997); *PUBLIC CHOICE AND PUBLIC LAW: READINGS AND COMMENTARY* (Maxwell L. Stearns ed., 1997).

300. The study of cognitive biases and other deviations from rationality are at the core of behavioral law and economics. See, e.g., *BEHAVIORAL LAW & ECONOMICS* (Cass R. Sunstein ed., 2000); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 *STAN. L. REV.* 1471 (1998); Russell Korobkin, *A Multi-Disciplinary Approach to Legal Scholarship: Economics, Behavioral Economics, and Evolutional Psychology*, 41 *JURIMETRICS J.* 319 (2001); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 *CAL. L. REV.* 1051 (2000); Jennifer Arlen, Comment, *The Future of Behavioral Economic Analysis of Law*, 51 *VAND. L. REV.* 1765 (1998). For an interesting behavioral analysis of the SEC, see Stephen J. Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 *STAN. L. REV.* 1 (2003).

as a sort of safety valve. If the law primarily consists of defaults, parties can contract around them if they are too inefficient. By their nature, mandatory rules are harder to contract around. The real safety valve is to convince the legislature to change the law on the books, which is no easy task. Similarly, mandatory corporate law, as compared to fiduciary standards that evolve over time, is less likely to accommodate new finance and governance developments that might argue for new rules. How the lawmaking process might play out in developing countries is beyond this Article's scope, but deserves further study. The more modest point I make here is that any corporate governance reform program has to ensure that the lawmaking process goes as smoothly as possible, and that steps are taken to avoid regulatory capture, to counter the influence of special interests, and to provide policymakers with expert advice and counsel, as well as the information they need to make informed decisions both in enacting the law and in ensuring its effective implementation over time.

C. Some Proposals to Consider

To summarize, this Article has stressed a variety of factors that need to be taken into account when crafting a country's corporate law regime to ensure that it fits with the rest of the country's institutional mix, and has cautioned that a country's corporate governance system needs to mesh with its economic organization, politics, social structure, history, and cultural values. Further, to help ensure that the private sector develops, and that there are business opportunities worth financing, it is important that the corporate law regime does not mutate into a form of industrial policy that displaces a growing market economy. The government's more visible hand in shaping corporate governance should not be so heavy as to stifle private economic activity. Rather, as capital markets mature, policymakers should revisit corporate law reform to accommodate the evolving needs and concerns of businesses and shareholders to ensure that the country's legal regime remains up-to-date.

Two additional considerations should be weighed when crafting a country's corporate law. The first concerns early-stage financing (i.e., venture capital), which is an important step toward economic

growth.³⁰¹ Venture capital financings are largely contractual in nature, relying on a high degree of private ordering in structuring internal corporate affairs.³⁰² As compared to a set of default rules that parties can contract around, such as the Delaware corporation code, a mandatory regime could compromise the kind of private ordering on which venture financing depends.³⁰³ The corporate law of developing countries, therefore, should have enough play in the joints, at least for private companies, to avoid crowding out venture capital. It is by no means easy to design a mandatory model of corporate law that strikes the right balance between stronger shareholder protections on the one hand and enough flexibility for early-stage financings on the other. Fortunately, although it is a legitimate concern that needs to be accounted for, the worry that mandatory corporate law will undercut venture capital might be overstated. In the United States, venture capitalists typically contract around default rules to assume a much greater governance role and are more active in managing the business. If the same is true elsewhere—and there is no reason to think it would not be—then early-stage financiers in developing countries might contract for more protections and a greater say over the enterprise than even a mandatory corporate law regime provides.

Second, a corporate law regime that shifts control to shareholders will require more shareholder participation in corporate governance and a company's business affairs. More demands, therefore, will be placed on shareholders to be informed, to be active, and to find a way to coordinate better. These are real challenges and are a key reason, at least in theory, why ownership and control separate—so managers can specialize in running the company and shareholders can specialize in bearing risk. (It should be noted, however, that a market-based approach to corporate governance also requires at least some investor activism to hold managers accountable. Even Berle and Means did not view shareholder passivity as an unmiti-

301. See *supra* notes 221-27 and accompanying text.

302. For more on the private ordering on which venture capital depends, see Gilson, *supra* note 221; Gilson & Black, *supra* note 223.

303. Proponents of the self-enforcing model of corporate law expressed similar concern that the self-enforcing model—which is more constraining than Delaware's enabling approach, although less restrictive than the mandatory model proposed here—would frustrate venture capital markets in emerging economies. See Black et al., *supra* note 57, at 297.

gated good, but rather as a source of agency problems as senior executives hijacked control of the board.³⁰⁴) Ensuring that shareholders are adequately informed and can readily communicate, then, are important factors in crafting a corporate law regime that calls for greater shareholder involvement.³⁰⁵ Policymakers also need to account for a range of shareholder voting strategies that present a host of complex social choice and game-theoretic questions that argue against shareholder control.³⁰⁶ The corporate law regime in developing countries also must be sure to protect minority shareholders from expropriation by controlling shareholders. To the extent shareholders are expected to be more involved in governance and corporate affairs, equity markets might be thinner and share ownership might be more concentrated in developing economies. Some investors might opt for more passive investments, while others accumulate enough shares to make it worth their while to participate actively in the company.³⁰⁷ Nonetheless, securities markets should still be broader and deeper with a legal system that provides shareholders greater protection, even if it requires greater shareholder involvement.

While the mandatory corporate law framework outlined here is a call for shareholders in developing countries to be closer to corporate decision making, it is not a call for a system of direct corporate democracy and does not anticipate that shareholders will weigh in on each issue or business opportunity the company faces. In broad terms, the law will fix certain features of the corporate governance structure to enable shareholders to hold management more accountable and to otherwise protect them from insider abuses by precluding certain transactions. Shareholders will also have direct say over additional big-ticket items that management has the discretion to pursue on its own in the United States. Although afforded less leeway, directors and officers will still have primary

304. See BERLE & MEANS, *supra* note 10, at 122-25.

305. By simply precluding directors and officers from engaging in certain transactions and by mandating particular governance practices, without allocating to shareholders many additional "positive" control rights, the corporate law regime eases the burden placed on shareholders and market intermediaries.

306. Jeffrey Gordon has explored many of these concerns in arguing against greater shareholder control in the United States. See Gordon, *supra* note 163.

307. Strong legal protections, therefore, must guard minority shareholders from potential controlling or majority shareholder abuses.

responsibility for managing the business and affairs of the corporation.

When shareholders do vote, requiring a supermajority vote would probably be prudent in many, if not most, instances. The tougher question is whether to require a supermajority vote of shares cast, of shares outstanding, of shareholders voting, of shareholders holding shares, or of some combination. Matters become more complex still if nonshareholder constituencies are given a role in governance.

These and other important features of a developing country's corporate law regime will have to be resolved. There are no easy answers, and the solutions are complicated by the possibility that legal requirements should vary for different sized companies to avoid overburdening small businesses and for established companies with solid track records, such as companies that have traded publicly for a minimum number of years or that satisfy minimum capitalization requirements. It is important, though, that steps be taken toward concrete proposals, and specific code provisions must be crafted. Accordingly, I conclude by moving beyond the conceptual case for a more mandatory corporate law regime to offer some specific provisions, keeping in mind that one size of corporate governance regime does not fit all countries. Many of the recommendations build on recent regulatory reforms and best governance practices proposed in the United States in the aftermath of Enron and WorldCom and on corporate governance reform programs that have been advocated, and in some instances adopted, to promote financial development around the globe.³⁰⁸ The suggestions offered

308. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002); Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc., Exchange Act Release No. 48,745, Fed. Sec. L. Rep. (CCH) ¶ 87,110, at 88,647 (Nov. 4, 2003) (approving NYSE and NASDAQ revised listing standards); CIPE HANDBOOK, *supra* note 46; THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE: FINDINGS AND RECOMMENDATIONS (Part 2) (Jan. 9, 2003); Bernard Black et al., *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness, Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea*, 26 J. CORP. L. 537 (2001); PISTOR ET AL., *supra* note 18, at Appendix 1; CalPERS, *Global Corporate Governance Principles* (1999), at <http://www.calpers-governance.org/principles/international>; Organisation for Economic Co-operation and Development, *Principles of Corporate Governance* (1999), at <http://www.oecd.org>. For specific recommendations arising from the self-enforcing model of corporate law, some of which overlap with the suggestions offered below in connection with the mandatory model, see Black

here are not exhaustive, and the details of any code would have to be worked out as part of the lawmaking process. Further, companies might decide to opt into additional legal requirements by, for example, cross-listing on the NYSE.³⁰⁹

Although both insider disloyalty and mismanagement can destroy shareholder value, corporate law reforms intended to promote securities markets in developing countries should emphasize rooting out and punishing insider self-dealing and looting. Whether investing in developing or advanced economies, shareholders cannot avoid the risk that their managers will exercise poor business judgment, that the company's business plan will prove to be poor, or that the company's competitors will simply execute their corporate strategy more effectively. Investors are willing to assume these types of business risks, but they understandably are unwilling to assume the risk of insider disloyalty. Indeed, from the perspective of shareholders, insider self-dealing and looting are a form of "heads you win, tails I lose." Furthermore, mismanagement is self-correcting, at least to some extent, as better run companies outcompete poorly managed ones, and as poor managers are replaced with good managers, assuming that there is an active market for management and that management is unable to entrench itself. As a market economy develops, executives and directors, as well as middle-level managers, should become more sophisticated and savvy in business matters.³¹⁰

In addition to focusing on rooting out disloyalty, early on, corporate law rules should be simple, straightforward, and relatively easy to interpret, apply, and understand.³¹¹ More complexity and nuance can be added to the corporate law regime as securities markets mature.

To address the core concern of disloyalty, at a minimum, a developing country's corporation code could simply prohibit self-

et al., *supra* note 57, at 258-86; Black & Kraakman, *supra* note 57, at 1943-67.

309. See, e.g., Coffee, *supra* note 3; John C. Coffee, Jr., *Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002); Gilson, *supra* note 9; LICHT, LEGAL PLUG-INS, *supra* note 35.

310. Plus, as compared to rooting out self-dealing and looting, monitoring and disciplining mismanagement requires a more nuanced approach, as evidenced by the business judgment rule in the United States.

311. See *supra* notes 263-92 and accompanying text.

dealing transactions. Although transactions between a corporation and a director, officer, or controlling shareholder can sometimes be in the corporation's best interests, interested-party transactions pose a serious risk of insider abuse and provide a blatant opportunity for insiders to expropriate value. A flat prohibition on self-dealing transactions avoids the complexity of the U.S. approach, which permits such transactions if they are ratified by an informed vote of a corporation's disinterested directors or shareholders or if they are otherwise fair to the corporation. An absolute ban on transactions between a corporation and its insiders also sends a clear message that ensuring insider loyalty and honest dealing is paramount. If a flat bar is seen as too restrictive, policymakers could prohibit self-dealing transactions above a certain size or allow *ex ante* (although not *ex post*) approval by both the disinterested shareholders and the disinterested independent directors of a corporation.

Other anticipated avenues that insiders might take to expropriate value also should be blocked. First, the cash compensation and equity-based compensation of executives could be capped. Shareholders could also have the right to vote on equity-based compensation packages.³¹² Second, cash-out mergers, whereby a controlling shareholder squeezes out the minority, could be prohibited. The concern here, of course, is that minority shareholders will be forced to take an inadequate price for their shares. A more permissive alternative would allow a cash-out merger so long as a majority of the minority shareholders and a majority of the corporation's disinterested independent directors vote in favor of it, or so long as the controlling shareholder offers to acquire the minority's shares for a minimum premium, such as fifty or seventy-five percent above the highest price at which the company's stock has traded during the preceding six months. Third, most people would probably agree that insider trading on the basis of material nonpublic information should be prohibited. Policymakers, however, could go further and also limit the number of shares an insider can either purchase or sell during a given time, such as during any three-month period. To the extent insiders do buy or sell stock in their company, they could

312. Further, executives could be required to hold shares acquired upon the exercise of options for a minimum period, such as one year.

be required to disclose their planned trades at least three business days before trading.

Although boards of directors serve many roles in a business, their most important function in developing economies should be to hold management accountable. The board should be actively engaged in overseeing the enterprise and monitoring management, and a premium should be placed on ensuring that directors are not beholden to the CEO or other senior executives. Perhaps the simplest reform—and one that has recently swept through the United States—is to require that independent directors fill at least a majority of the seats on the board, and “independence” could be defined very strictly. Policymakers could also mandate term limits for directors. For example, directors could be prohibited from serving more than five years on a company’s board, with a possible exception for shareholder-nominated directors. In terms of the board’s structure, boards could be required to have separate audit, compensation, and nominating committees that are composed entirely of independent directors, with the chairman of each committee rotating at least every three years. The corporation code could also require that boards meet regularly, such as once a month, with the independent directors meeting separately. More importantly, though, would be to require that separate people serve as chairman of the board and chief executive officer, with the chairman of the board possibly rotating at least every three years. Shareholders could even be given the right to remove the CEO without a board vote.

To make it easier for shareholders to elect their preferred representatives to the board, shareholders could be allowed to nominate directors and to include their nominees on the company’s ballot at the company’s expense, instead of being presented with only the management-sponsored slate of nominees or the nominees chosen by the board’s nominating committee. A more far-reaching provision would require that shareholder nominees actually fill a minimum number of board seats. To avoid the risk that a controlling shareholder could elect its entire slate of nominees, the code could require that minority shareholders have the right to elect at least one or two directors, depending on the size of the board. Cumulative voting, of course, is a more conventional way of ensuring minority board representation.

In addition to voting for the board, shareholders in the United States have the right to approve mergers, the sale of all or substantially all of the corporation's assets, and amendments to the company's articles and bylaws, but otherwise have little, if any, direct control over the business. In developing economies, shareholders could be allocated expanded authority, in effect affording shareholders a greater say over how the enterprise is run, as opposed to relegating them to voting for the board and on a handful of fundamental corporate changes. For example, shareholders could have the right to demand that the corporation pay a dividend.³¹³ In addition, shareholder approval could be required for the sale of any division or line of business, or for the sale of any assets with an aggregate value above some amount. Shareholders could also have the authority to block any major acquisition or expansion by the company, such as when the company makes a tender offer to acquire a target or seeks to open a new factory.

In terms of financing transactions, the code could mandate shareholder approval before a corporation pledges a substantial portion of its assets as collateral or incurs material obligations, such as by borrowing from a bank or issuing bonds. A corporation, for example, could be prohibited from borrowing or selling bonds in excess of some amount or if to do so would render the company too leveraged, as determined, for example, by the company's debt-to-equity ratio or debt-to-total assets ratio exceeding some threshold. Shareholders could also be required to approve the issuance of additional shares, or authorized but unissued shares could simply be prohibited.

Finally, there is the possibility of a "catch-all." Policymakers could adopt a provision to the effect that a shareholder proposal receiving the affirmative vote of, for example, seventy-five percent of the outstanding shares is binding on the board and the management team, even if the proposal relates to the corporation's ordinary business.

Regardless of how much authority shareholders ultimately are allocated, they need the means to exercise their franchise effectively for the right to vote to be meaningful. To this end, shareholders could be given liberal rights to act by written consent, to vote

313. As an alternative, the code could mandate a minimum dividend payout.

confidentially, and to inspect corporate books and records. In addition, shareholders holding some threshold of shares, such as five percent of the corporation's outstanding shares, could be given the right to call a special shareholders meeting at any time without significant delay. Whether a controlling shareholder holds supervoting shares is perhaps of greater concern to minority shareholders than whether various procedural protections that facilitate the franchise exist. Accordingly, dual-class voting structures could be prohibited (i.e., one share/one vote could be mandated) or, at the very least, a shareholder's voting interest could be capped at some multiple of its economic interest in the company, such as three-to-one. To further amplify the voice of minority shareholders, voting procedures could be established that neutralize the votes of directors and officers when voting in their capacity as shareholders. For example, when a shareholder vote is called for, the majority vote of nonmanagement shareholders could be required.

Shareholder voice in corporate governance is important, but so is the right of shareholders to exit. In addition to the right to sell their shares into the market—the equivalent of the “Wall Street Rule”—shareholders in developing countries could be afforded greater discretion than their U.S. counterparts to sell their shares collectively to a bidder for the entire enterprise. The code could allocate shareholders greater control over the decision to sell the company by limiting a board's authority to take defensive steps to fend off unsolicited takeover attempts. Indeed, target boards could be obligated to run a fair auction for the company once a bid is made, and the code could articulate minimum steps a board must take in satisfying its obligation to sell the company to the highest bidder. The goal, of course, would be to limit the ability of an incumbent board and management team to entrench itself and to spur an active market for corporate control.

To protect minority shareholders against the risk of looting once a shareholder acquires a controlling stake, policymakers could require any shareholder who crosses a certain percentage ownership, such as forty percent of the company's outstanding shares, to offer to acquire the rest of the company's outstanding shares at the highest price the shareholder paid for its shares during the preceding year. The flip-side concern, of course, is that a major shareholder might sell out, leaving the other shareholders behind.

To address this risk, minority shareholders could have “tag along” rights. If a shareholder holding more than, for example, thirty percent of the company’s shares agrees to sell its stake in a negotiated transaction, the minority shareholders could have the right to “tag along”—that is, to sell their shares to the buyer on the same terms and conditions as the controlling shareholder is selling its interest.

Shareholders, though, might want greater ability to exit even when there is no control transaction. To this end, shareholders could be given the right, without a board vote, to liquidate the corporation or to put it in bankruptcy if its market-to-book value drops below some threshold or if its debt-to-equity or debt-to-total assets ratio exceeds some ceiling.

Whatever the substantive provisions are of the corporation code in a developing country, investors need access to accurate, timely, and understandable information to exercise their rights effectively and in an informed manner. A mandatory disclosure regime is therefore recommended, although the regime could be simpler than the U.S. disclosure system under the federal securities laws. The mandatory disclosure requirements could be supported by a straightforward antifraud provision that avoids the nuances and complexities of the U.S. approach to securities fraud. For example, those charged with making, or even aiding and abetting, a material misstatement or omission could be held strictly liable without inquiring into such matters as scienter (i.e., intent to defraud) or whether investors relied on the material misstatement or omission in deciding to buy or sell or how they were going to vote their shares.

Finally, a corporate law regime will not be effective if it is not enforced.³¹⁴ Shareholder rights are only meaningful to the extent they are protected. Simple bright-line rules and greater transparency facilitate enforcement, but more is needed. Rooting out corruption is essential to promoting the rule of law and is a precondition to any effective legal system. The law must be crafted

314. See, e.g., Berkowitz et al., *supra* note 23 (stressing the importance of enforcement to the law’s effectiveness, which the authors refer to as the law’s “legality”); PISTORE ET AL., *supra* note 18 (arguing that the law on the books will not promote financial development unless law enforcement is effective); see also Hay et al., *supra* note 262 (proposing reforms to transform dysfunctional legal systems into well-functioning ones that parties will use).

and enforced by honest-dealing and competent judges, lawmakers, and regulators, and scores cannot be settled by bribes, violence, and politics. On the ground, countries could consider establishing specialized courts (like the Delaware Court of Chancery), administrative agencies (like the SEC), and self-regulatory organizations (like the NYSE and the NASD) to resolve corporate law and securities disputes and to regulate in the area. Steps could also be taken to make it easier and cheaper for private individuals to access the judicial system so that private enforcement can supplement the public enforcement of the law. One important reform would be to create institutions such as the class action lawsuit. At a minimum, procedural hurdles such as the demand requirement could be avoided so that shareholders have a greater say over whether a suit is brought against a corporation's directors and officers. Until the institutions that support private litigation are in place, the even-handed public enforcement of corporate law by regulators is critical. As compared to designing and fostering institutions to ensure the effective enforcement of the law, crafting the substantive provisions of a corporate law regime for a developing country might be easy.

CONCLUSION

At bottom, corporate governance reform is a matter of comparative institutional analysis. The right corporate governance regime for a country depends on its unique institutional makeup. In adopting a program of reform, therefore, policymakers ultimately must be pragmatic, looking past ideals and ideologies to what is possible and realistic. Even if the market-based corporate governance model of the United States, with its enabling corporate law, is the most effective system of governance for realizing the broadest and deepest securities markets, the U.S. approach is not achievable everywhere. Although not news to many of us, others need to be reminded that the institutions supporting the U.S. system of governance cannot be wished into existence or created overnight in developing countries. In other words, developing economies cannot leapfrog the process of development to land at the finish line of developed markets. With the U.S. approach off the table for most countries, policymakers are in a world of the second best, where the remaining best option is a mandatory model of corporate law.

A current debate in comparative corporate governance centers on whether corporate governance systems around the world will converge toward the U.S. model. A systems analysis calls into question the likelihood of corporate convergence toward the U.S. model or any other model of governance, especially at the level of the formal rules of the game. The very point of this Article, for example, is to recommend mandatory corporate law—the scheme the United States has eschewed—for developing countries and to suggest that U.S.-style shareholder primacy is probably inappropriate in many places around the world. A systems approach helps remove blinders that can otherwise prevent policymakers and their advisors from identifying a host of viable options and alternatives, many of which might have been rejected elsewhere. To the extent convergence does take place, it will likely be at the general level of function and not form, with corporate governance practices of various shapes and sizes developing around the globe to provide minority shareholders adequate protection from insider abuses, inducing ownership and control to separate to a meaningful degree, even if to a lesser extent than in the United States.³¹⁵

Successfully reforming the economic structure of a country is difficult. A healthy dose of humility on the part of the policymakers charged with developing and carrying out new regimes is an essential ingredient to any effective reform program. One of the benefits of a systems approach to corporate governance reform is that it impresses the complexities of corporate governance—and the corresponding challenges of corporate governance reform—on policymakers and the administrators and bureaucrats responsible for implementing and monitoring the new regime. Policymakers cannot foresee every eventuality, and when reforms are instituted, there will always be surprises, both for better and for worse. Even when a country's corporate law is itself mandatory, the lawmaking process has to be nimble enough to accommodate midstream corrections if necessary, which depends, in part, on the willingness of lawmakers to admit mistakes.

Under the best of circumstances, let alone the worst, significant reform of any kind can involve serious disruptions for large

315. See Gilson, *supra* note 9, at 337-40 (discussing the prospects of functional convergence).

segments of the population. Although people might be willing to shoulder the burdens of transition in hopes for a better tomorrow, they might very well, and understandably, become disillusioned if the reforms are not successful in short order. Consequently, to minimize the risk of unfulfilled hopes and goals, it is important to manage expectations and to avoid overpromising the benefits of reform. It is more important still that policymakers do not overreach, but strive for corporate governance reforms that are attainable with near-term tangible benefits. Early achievements are critical to the long-run success of reform.