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Clark's Treatise on Corporate Law: Filling Manning's Empty Towers

Ronald J. Gilson* & Reinier Kraakman**

Almost 45 years ago, in an elegantly depressive account of the then current state of corporate law scholarship, Bayless Manning announced the death of corporation law “as a field of intellectual effort.”¹ Manning left us with an affecting image of a once grand field long past its prime, rigid with formalism and empty of content:

When American law ceased to take the “corporation” seriously, the entire body of law that had been built upon that intellectual construct slowly perforated and rotted away. We have nothing left but our great empty corporate statutes—towering skyscrapers of rusted girders, internally welded together and containing nothing but wind.²

And so matters stood for awhile, certainly for the period that we were in law school. Aside from the development of the law of insider trading, hardly at the core of corporate law, the field, in truth, was worse than Manning described it. Rather than the remnants of a once great effort, it was simply boring.

Two developments combined to reanimate the corporate law enterprise: the appearance of new tools and new motivation. In 1976, Michael Jensen and William Meckling accelerated the deconstruction of the corporation.³ Like Toto drawing back the curtain behind which sat the real and less regal Wizard of Oz, Jensen & Meckling peered behind the formal corporate construct and saw a complex set of interactions among a number of participants in the business of the corporation. When these interactions are in equilibrium, treating the corporation as an entity is a useful and descriptively accurate shorthand. But the second development highlights the critical fact for the intellectual vigor of corporate law: all of the interesting and challenging issues involve the resolution of conflicts between corporate participants. The emergence of hostile takeovers in the late 1970s and early 1980s made this situation painfully obvious. A successful hostile takeover disrupts the “nexus of contracts” that describes the allocation of decision making and distribution of benefits within the corporate legal person: the stress lines within the corporation become painfully obvious.

It was in this charged atmosphere that Bob Clark wrote his masterful treatise on

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1. Bayless Manning, *The Shareholder's Appraisal Right: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962).

2. *Id.*

3. Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

corporate law.⁴ Clark's work was a comprehensive counterpoint to Manning's now Twain-like premature obituary of corporation law's demise. Clark met the new set of problems with an impressive array of tools, including but hardly limited to economics. And in doing so, he set the normative standard that corporate law had to meet. Corporate law at its heart is an exercise in pragmatism, as we will suggest shortly, a device not a model. The question is how law facilitates commercial activity, and the answer is driven by the problem and the variety of the contexts in which it will be applied.

Clark's timing was perfect, because hostile takeovers were only the beginnings of the tests to which corporate law would be put in the twenty years that followed publication of the treatise. Leveraged buyouts, junk bonds, the growth of institutional investors, deregulation, global competition, an explosion in the sophistication of the derivative markets, and most recently the rise of hedge funds as activist shareholders, all altered the relative value and bargaining endowments of those whose interests intersected through the metaphorical corporate nexus. Even change that increases the total value of corporate participants also results in shifting value among the participants. Corporate law, Clark taught us, provides the structure through which both the creation and division of value takes place.

The number and quality of articles that compose this celebration of the twentieth anniversary of Bob Clark's *Corporate Law* demonstrate the book's enduring contribution. Each article sees the treatise as a lens that illuminates a current problem in corporate law and illustrates the field's continuing intellectual vitality. As these articles demonstrate, Clark provided a comprehensive response to Manning's dirge and gave momentum to the rich scholarly debate this Volume illustrates.

Our goal in this introduction, in addition to joining in honoring Bob Clark's book, is to provide a readers' guide to the Volume's contents. We will group the articles along a set of themes and, like good discussion leaders, suggest questions that, if kept in mind, may enrich the reader's experience. In doing so, an overarching theme will emerge that helps to explain Bob Clark's observation that, on returning to corporate law teaching after his long deanship, he found "that so much is essentially the same."⁵ If one views corporate law as the response to a pragmatic problem of creating and dividing value, the context in which corporate law operates changes, but not the character of the problem at which it is directed. Part I introduces a cluster of four articles that all address, more or less directly, the corporation's objective function: in the end, is the exercise only about shareholder wealth? Part II introduces two articles that lie outside the main lines of debate over the corporation's objective function but nonetheless speak directly to the issues in this debate. Part III describes three articles that deal with problems of contract and fiduciary duty in corporate law. Finally, Part IV surveys the remaining three papers, which address the progress of federal law—specifically the Sarbanes-Oxley Act and the anti-fraud provisions of the securities acts—in regulating information flows, and through this, many of the most important substantive features of corporate governance.

4. ROBERT C. CLARK, *CORPORATE LAW* (1986).

5. Robert C. Clark, *Major Changes Lead Us Back to Basics*, 31 J. CORP. L. 591 (2006).

I. FOR WHOM THE BELL TOLLS: THE CORPORATION'S OBJECTIVE FUNCTION

Much to our surprise, almost half of the articles in this Volume address, in one way or another, questions of what the corporation should maximize or, framed in softer terms, to whom corporate decision makers are responsible. For purposes of introducing the articles it is helpful to consider them in two groups.

The first group consists of Lisa Fairfax's account of the *Rhetoric of Corporate Law*,⁶ and Henry Hansmann's *How Close is the End of History*.⁷ Fairfax asks a very interesting question. Acknowledging that, at least in the United States, stakeholder theory has had limited substantive impact on corporate law, she asks instead whether stakeholder theory has had an impact on corporate rhetoric. Do corporate actors "talk the talk" of stakeholder theory even if the rhetoric derives from or gives rise to norms, not law? If they do, perhaps it reflects the expectation that the public is growing dissatisfied with a corporate governance regime focused solely on shareholders. In this view, rhetoric is the canary of the corporate system, signaling expectations of the future direction of corporate governance reform. In support of her thesis, Fairfax presents an impressive body of evidence that, in annual reports, committee reports on corporate citizenship, web sites and the like, corporations genuflect rhetorically to stakeholder theory.

Hansmann, in contrast, reports a very different environment. Assessing the continued accuracy of the claims he and Reinier Kraakman made in their provocative article *The End of Corporate Law History*,⁸ Hansmann confirms that, as a matter of norms, efficiency and fact, the world continues to converge around "the 'standard shareholder-oriented model' of the business corporation."⁹ Convergence may move in fits and starts—witness the recent French student protests and the rise and fall of the European Community's Thirteenth Directive—but convergence it is.

Thus, we have two potentially conflicting characterizations of the current state of play: Fairfax claims corporations talk the talk of stakeholder theory; Hansmann says national systems walk the walk of shareholder-orientation. For the reader, the test is to assess how serious the conflict really is.

One approach is to dismiss the rhetoric as, well, just rhetoric. During the 1980s, a cynical but common reaction to the invocation of stakeholder rhetoric in response to a hostile takeover was that the target's concern over stakeholders was worth an additional \$2 per share, that was not payable to the stakeholders. A more textured response is that Fairfax and Hansmann are talking about different phenomena. For Hansmann, stakeholder theory is the full northern European version, where the corporation is an instrument of state social policy—long term, even if inefficient, employment is a substitute for unemployment insurance. As he says, a nation could conclude that employment stability "is preferable to lower prices on MP3 players."¹⁰ A nation can sustain that tradeoff, however, only with tariffs to protect its corporations from foreign

6. Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric of Corporate Norms*, 31 J. CORP. L. 675 (2006).

7. Henry Hansmann, *How Close is the End of History?*, 31 J. CORP. L. 745 (2006).

8. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEORGETOWN L.J. 439 (2001).

9. *Id.*

10. *Id.*

competitors not similarly burdened, or with subsidies to support them; protective strategies that the WTO and the European Union are making increasingly difficult to pursue. Hence, convergence to shareholder-orientation is the only available option. Fairfax, in contrast, may have in mind stakeholder theory light—a U.S. notion that in dividing the value it creates, the corporation should be just a little nicer to employees, the community and the environment. The stakeholder rhetoric Fairfax recounts, for example, does not advocate creating the kind of labor market rigidities that characterize the systems whose convergence toward a shareholder-centered orientation Hansmann and Kraakman observed and Hansmann here confirms.

The contribution of Jill Fisch, and that of Lynn Stout and Margaret Blair, operate in this narrower range of stakeholder concerns—about dividing the value created by the corporate enterprise, rather than about using the corporation as an instrument of social policy. Fisch begins with basics, taking on what she characterizes as the standard assumption that what matters is shareholder wealth.¹¹ Shareholder primacy, she writes, “defines the objective function of the corporation as maximization of shareholder wealth.”¹² Measuring the effect of a rule or practice on shareholder wealth may tell you, for example, whether hostile takeovers are good for target shareholders. But shareholder wealth, Fisch stresses, is not the same thing as social welfare. If one is concerned with the efficiency of a rule or practice, then the right measure is the value of the inputs of all participants in the corporation’s business—firm value, not shareholder value. Fisch is critical of much existing empirical scholarship for not recognizing that the assessment of the efficiency of a business practice or rule, as opposed to its desirability to shareholders, cannot be measured simply by calculating shareholder gains. Losses suffered by other stakeholders must be netted out to determine social gains.

Fisch is plainly right about the efficiency measure of corporate law—the social goal is to maximize firm value, not shareholder value. In a recent and admirably exhaustive survey of the corporate governance literature, economists Marco Becht, Patrick Bolton and Ailsa Röell describe a governance structure as efficient if “it generates the highest possible payoff for all the parties involved, shareholders, creditors, employees, clients, tax authorities, and other third parties that may be affected by the corporation’s actions.”¹³

Fisch’s second criticism—that “the empirical studies uniformly evaluate corporate law in terms of its impact on a shareholder-based component of corporate value”¹⁴—is more problematic. A 1995 casebook (and therefore hardly at the cutting edge of scholarship) notes that, with respect to measuring the efficiency of corporate acquisitions, “even positive net returns to both acquiring and target shareholders may reflect only wealth transfers from corporate stakeholders, like employees, to shareholders. Thus, the absolute magnitude of acquisition premia or the fact of positive net abnormal returns earned jointly by acquirer and target shareholders bear *no necessary relationship* to the efficiency gains created by takeovers if takeovers can also have a negative impact on

11. Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006).

12. *Id.*

13. Marco Becht, Patrick Bolton & Ailsa Röell, *Corporate Governance and Control* (ECGI Working Paper No. 02/2002), available at http://ssrn.com/abstract_id=343461.

14. Fisch, *supra* note 11.

non-shareholder groups.”¹⁵ Even though, as Fisch stresses, many empirical studies either implicitly conflate shareholder gains with efficiency gains or only seek to measure shareholder gains, a number of important studies do not make these mistakes. Ignoring them runs the risk of losing the intriguing results they report.¹⁶

That leaves us with Fisch's important analytical point. Just as shareholder wealth is the wrong measure of efficiency, the fact that fiduciary duties are owed only to shareholders does not mean shareholders are more equal than other corporate stakeholders. Rather she suggests that the matching of shareholder interests and judicial protection reflects only the institutional competence of the courts to address threats to shareholders. But this explanation is not the only one that would rationalize exclusively shareholder-oriented fiduciary duties with a stakeholder measure of efficiency. Shareholder primacy in access to the levers of corporate power and judicial protection also may be justified as an instrument—that is, as the best technique to increase firm, as opposed to just shareholder, value. Canvassing this alternative requires bringing Blair and Stout's contribution into the discussion.¹⁷

Invoking Thomas Kuhn's account of the punctuated equilibria of intellectual evolution,¹⁸ Blair and Stout announce that “a new paradigm is appearing in corporate law scholarship”¹⁹—a team production model of corporate governance in which the board of directors mediates between the competing demands of various stakeholders including shareholders. Each stakeholder makes a firm specific investment in the firm on the condition that the board of directors protect the returns on their vulnerable investment from ex post opportunism by other stakeholders. Creating value requires this investment, which will not be made unless those providing it actually will receive their share when the value created is divided. In Blair and Stout's view, the need to protect stakeholder specific investment explains the attenuated power of shareholders—it keeps shareholders from opportunistically exploiting stakeholders. This limited influence, they stress, is inconsistent with a principal-agent model of the corporation.²⁰

15. RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 610 (2d ed. 1995) (emphasis in original).

16. For example, empirical studies report that leveraged buyouts prior to 1985 had a different impact on bondholders than those after 1985: pre-1985 bondholders did not lose as a result of the transaction, while post-1985 bondholders lost significantly. Even after 1985, however, leveraged buyouts resulted in a net gain—the increase in shareholder wealth exceeded the losses to bondholders. *Id.* at 626-27. Empirical studies also addressed whether shareholder gains from acquisitions exceeded losses to labor. *See id.* ch. 15.

17. Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 *J. CORP. L.* 719 (2006).

18. THOMAS KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* (3rd ed. 1996).

19. Blair & Stout, *supra* note 17. As a matter of taste, we confess to distaste for the invocation of Kuhn as a prediction of the power of an argument as opposed to an exercise in the history of science—like bubbles, paradigm shifts are difficult to recognize *ex ante*. As well, the urge to announce a paradigm shift runs the risk of doing to legal scholarship what Richard Nixon and Watergate did to journalism: causing us all to swing for the fences regardless of the likelihood of connecting. The best course may be simply to state one's points, and let others, in the fullness of time, assess the historical significance of the contribution.

20. It is useful to note here that there is a tendency to conflate the principal-agent model in economics with the law of agency. Here, the culprits are the economists, who use a legal term without recognizing that the law assigns it a quite specific content, which is different from what the economists have in mind. The same difficult exchange between lawyers and economists arises in the economists' use of the term “implicit contract,” which in legal terms is not a contract at all and in economic terms arises precisely because a legal contract is not

In assessing the new paradigm, readers may wish to consider whether this focus on protecting firm specific investment is a management strategy or a governance system. To see this, think of an income statement, revenue from customers at the top line, reduced by payments to suppliers and distributors, wages to employees, interest to lenders, and taxes to the community, leaving profit—for the benefit of shareholders—at the bottom line. What is self evident is that the bottom line—shareholder profit—depends on size of the payment to and the quality of the input from each of the stakeholders whose contribution to the corporation and share of the value created are shown higher up in the income statement. Put simply, a board of directors committed to shareholder primacy must be sharply focused on stakeholders. There can be no shareholder profit without them. The hard questions are the quality of the input needed and the price to be paid.

The puzzle then is to distinguish between a shareholder primacy board and a board of mediating hierarchs (meditating plutocrats?).²¹ Stakeholders and firm specific investment play different roles in different businesses and different companies have different strategies concerning their input providers. Silicon Valley high tech companies where employee human capital matters a lot²² provided stock options to employees deeply into the organization; rust belt companies did not. Governance system or management strategy? Firms in similar businesses have different strategies about employees. Costco is said to provide significantly better wages and health care to employees, in what looks like an efficiency wage strategy, than Sam's Club, their direct competitor.²³ Governance or management?

When might the difference matter? It may be that the difference may matter only ex post, when economic events devalue a stakeholders' firm specific investment, so that protecting it no longer creates value. Does the firm continue paying off the expected return to the devalued investment, or does it respond to external events? If stakeholders are risk averse, then providing insurance against bad outcomes encourages investment in the first place, but limiting the company's ability to respond quickly to competence destroying economic changes by respecting now devalued prior commitments rather than reducing wages or employment, reduces the firm's ability to survive in the new environment. Think of the changes in the value of capital and labor in the wake of airline deregulation. Governance can tip the balance in this situation, but not without cost. We have referred to this tradeoff as one between Burke and Schumpeter: protecting the firm's operations in normal times at the cost of speed in response to change.²⁴

Where does that leave us? As a counterpoint, the reader may wish to consider whether any single factor model adds very much to our understanding of how corporations are governed, as opposed to how they are managed. Hansmann's point is

possible.

21. There is a little bit more than just word play involved here. To the extent that a Blair & Stout board slides over into distributional concerns (encouraging firm specific investment is allocational), then the ugly problem of political legitimacy raises its head: do we want to encourage an institution that is disproportionately white, male and conservative to make social policy?

22. But which, the enormous mobility of Silicon Valley engineers suggests, is at best industry—rather than firm specific.

23. Ann Zimmerman, *Costco's Dilemma: Be Kind to Its Workers, or Wall Street?* WALL ST. J., Mar. 26, 2004, at p. B1.

24. See Ronald J. Gilson & Reinier Krrakman, *Takeovers in the Target's Boardroom: Burke versus Schumpeter*, 60 BUS. LAW. 1419 (2005).

that there seems to be a consensus that corporations whose management, in the end, are accountable to shareholders, in the sense that only shareholders can remove them, seem to create the most value for all stakeholders. Given our income statement metaphor, that is hardly surprising and characterizing that as either shareholder primacy or something else may not add very much to the analysis. The real debate is over the length of the leash the shareholders hold—how exposed should corporate management be to the market, where the speed with which shareholders can act measures the extent of the range of action given management? Takeovers versus elections? Shareholder access to the corporate ballot? Possible restrictions on hedge fund voting? It is worth considering whether the tradeoff turns not on one's model of corporate governance, but on one's model of how quickly economic markets are changing. The faster the change, the shorter the leash.

II. KNIGHTIAN ENTREPRENEURS AND DISAPPEARING SHAREHOLDERS

Two papers in this Volume stand outside the traditional debate about shareholder primacy, but nonetheless speak to it directly. The first is Charles R. T. O'Kelley's contribution to this Symposium,²⁵ which proposes that today's CEO might—just might—be able to fill the shoes of Frank H. Knight's mythic entrepreneur,²⁶ and that corporate law just might be designed to support the CEO in playing this role. The classic Knightian entrepreneur is a free market superhero, the person of superior ability and nerves of steel who pledges her personal assets to advance the enterprise while ensuring that ordinary citizens and cautious stakeholders can expect to be paid no matter what the outcome of the enterprise's endeavors. Of course, modern CEOs in widely-held firms cannot be literal Knightian entrepreneurs, since most of them own only tiny fractions of their companies. Nevertheless, O'Kelley argues that the principal-agent literature misunderstands the modern CEO as a self-interested agent who resists destabilizing risk. O'Kelley argues instead that the essential feature of the Knightian entrepreneur may be his psychological tolerance—or even taste for—uncertainty, rather than his ability to provide capital. It is on this psychological dimension that modern CEOs may resemble Knight's owner-entrepreneur. As a test of the thesis that corporate law supports the entrepreneurial CEO, O'Kelley looks to a recent Delaware Chancery Court opinion,²⁷ in which the court backed a majority shareholder-CEO in his struggle against two outside directors who were attempting to extrude him from his positions as CEO and director. O'Kelley argues that the Court's preference for the entrepreneur over the board in this instance supports the view that Delaware law today is entrepreneur-centered rather than board-centered.²⁸

O'Kelley's argument is open to the twin objections that one Chancery Court opinion does not a corporate law make, and that even this single victory for an entrepreneurial

25. Charles R.T. O'Kelley, *The Entrepreneur and the Theory of the Modern Corporation*, 31 J. CORP. L. 753 (2006).

26. FRANK H. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* (1921).

27. *Adlerstein v. Wertheimer*, No. CIV.A. 19101, 2002 WL 205684 (Del. Ch. 2002).

28. O'Kelley duels with the board-centric team-production, mediating hierarch papers of Lynn Stout and Margaret Blair, *see supra* note 17; *see, e.g.* Steven M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

controlling shareholder leaves unclear whether the entrepreneur prevailed as an entrepreneur-CEO or in his role as majority shareholder (the court stated that both facts were critical to its decision²⁹). Nevertheless, these questions should not distract from O'Kelley's more general point. As a practical matter, it is the CEO—not the board or the major shareholders—who is the most important actor in the hierarchy of the modern American public company. The success of even the largest widely-held company depends in significant part on its CEO's entrepreneurial abilities. Correlatively, much of the board's importance in the modern public company derives from its power to select and monitor the CEO. Since the judges on the Delaware Chancery Court know this too, we should expect them to be skeptical of irregular efforts by one faction on a divided board to displace a sitting CEO.

Frank Partnoy's contribution to this Symposium³⁰ adopts a different tact to questioning the dominant ideology of shareholder primacy in corporate law. Rather than proposing someone other than the shareholders to whom, in the eyes of the law, the board owes allegiance, Partnoy questions the internal coherence of the claim that corporate law should follow shareholder interests. The essential point of Partnoy's paper is that the capital structure of a typical modern corporation is likely to contain several ticket-holders with equity-like claims on the firm's cash flows. In any given conflict-of-interest scenario, forcing the board to favor the nominal shareholders over another class of the firm's residual claimants may have perverse consequences. Instead, lining up with Jill Fisch, Partnoy concludes that the board should maximize the economic value of the firm, regardless of how cash flows are ultimately distributed to the firm's security holders. We couldn't agree more.

This point is the implicit rationale for shifting the board's fiduciary duties from shareholders to creditors when the corporation is in the vicinity of insolvency and when, because the shareholders may have an incentive to cause the corporation to make negative net present value investments, creditor interests are more likely to align with maximizing the value of the firm. Partnoy's generalization, however, is that complex capital structures can separate nominal shareholder interests from policies that maximize the firm's value even when the firm is solvent. Although it is unclear how often such separation occurs outside the zone of insolvency, Partnoy argues that directors ought to maximize firm over parochial shareholder value when it does occur. The traditional maxim that directors owe a duty to the corporation apart from its shareholders acquires new importance in a world of option theory and complex capital structures. The board's leash needs to be long enough to allow it to maximize firm value. Correlatively, of course, as long as the board maximizes firm value, how claimants on the right side of the balance sheet carve up the firm's distributions does not affect social welfare.

III. CONTRACT AND FIDUCIARY DUTY

Only one chapter of *Corporate Law* addresses the objective function of the corporation, so it is fitting that at least half the articles in this Symposium address other topics of theoretical and practical importance in corporate law. Two articles in our

29. Adlerstein, 2002 WL 205684.

30. Frank Partnoy, *Financial Innovation and Corporate Law*, 31 J. CORP. L. 799 (2006).

Volume take on the broad and important topic of contract and default provisions in corporate law.

The first is Michael Klausner's arresting contrast between *Corporate Law* and its principal competitor in the early 1990s, *The Economic Structure of Corporate Law*, authored by Frank Easterbrook and Daniel Fischel.³¹ As Klausner notes is his contribution to this Volume,³² Easterbrook and Fischel—as well as much corporate law scholarship of the time—advanced a strong “contractarian” vision of corporate law, in which legal rules serve largely as default provisions that shareholders can freely modify to fit the circumstances of particular firms. The normative implication of this perspective was that corporate law ought provide those default terms, and then get out of the shareholders' way; they will contract out of the terms they do not like.

This contractarian perspective, which assumes a simple world of negligible contracting costs, has yielded important analytical insights, but it has not fared well as a working account of the real world. As Klausner points out, a strong contractarian perspective leads one to expect a plethora of highly individualized contracts—corporate charters—keyed to the governance requirements of particular companies. In fact, however, the boilerplate charters of American public companies show precious little diversity. Public companies tend to incorporate in Delaware and adopt similar charters, regardless of their line of business or ownership structure. Governance individuation, to the extent it occurs at all, happens outside the corporate contract, through a variety of institutions ranging from managerial reputation to corporate compensation practices. To account for this and other realities of corporate practice, a new generation of corporate law scholarship has abandoned the simplifying assumption of a zero transactions costs to explore the real—and costly—institutional underpinnings of corporate governance. In this respect, the post-Clark development of corporate law scholarship parallels the emergence of a new generation of finance scholarship, which has abandoned the simplifying perfect market assumptions that provide the foundation for the original models of capital structure irrelevancy, market efficiency and capital asset pricing, to explore the institutions whose performance determine the efficiency of real capital markets.³³

In contrast to Easterbrook and Fischel (and many other scholars of the late 1980s), Clark never embraced the contractarian perspective.³⁴ Indeed, as Klausner argues, Clark implicitly rejected it by advancing a regulatory model of corporate law in his treatise. And given the turn of recent scholarship, it appears that Clark's regulatory model has aged far better than Easterbrook & Fischel's strong contractarian approach. Corporate law matters in part because there are important transactions costs—Klausner's work, for example, highlights “learning and network externalities”—that makes law matter. It is often more practical to rely on legislatures and courts to modify the effective charters of

31. FRANK EASTERBROOK & DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

32. Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006).

33. See Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715 (2003).

34. Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989) (contracting is only one source of norm creation).

corporations than to attempt to change charter terms by contract.³⁵ So, in the end, Klausner's point is that the contractarians misread Coase, who framed the "law doesn't matter" theorem just to prove that it does.

By contrast, Jonathan Macey appears at first glance to offer a sharply different (and militantly contractarian) perspective is his contribution to this Symposium issue.³⁶ Macey begins by claiming that conflict of interest transactions "occur under conditions that in many ways resemble a perfect, Coasean world."³⁷ In other words, contracting is easy. But it soon turns out that, for Macey too, effective contracting is not so easy.

In the context of the corporation, shareholders and managers frequently fail to contract because they cannot anticipate the facts of conflict-of-interest transactions *ex ante*. *Ex post*, Macey argues, there is much less to the traditional distinction between "duty of care" violations and "duty of loyalty" violations than Delaware law, Robert Clark, or even Easterbrook and Fischel would have one believe. Violations of the duty of care can be just as costly, as difficult to detect, and as ethically suspect as violations of the duty of loyalty. But, regardless of the fragile distinction between the two sorts of delicts, the fact remains that the parties leave their obligations open to determination by the courts *ex post* precisely because they are unable to anticipate or contract over all of the relevant facts *ex ante*. This creates a vital role for the courts and for an open-ended doctrine of fiduciary duty in corporate law. Like Klausner's essay, then, Macey's paper directs our attention to the practical limits of contracting in corporate law, and the correlative importance of substantive legal doctrine.

Where Macey challenges the cogency of the distinction between duties of care and loyalty in corporate law, Professor Ethan Stone in his contribution to this Volume³⁸ takes on the Herculean task of rationalizing two lines of Delaware cases that frame the board's authority to defend its policies and position but do not fit in easily with the broader sweep of fiduciary case law—the *Unocal* and *Blasius* lines of cases. The key to understanding these cases, Stone argues, is to appreciate that the board's fiduciary obligations are contextual, and that the board typically functions in two different contexts in supervising the management of the firm's business operations on the one hand, and in managing the collective decision-making processes of disaggregated shareholders on the other. When exercising its "operating power," the board's obligation is to maximize the value of the corporation; when exercising its "coordinating power," the board's obligation is to facilitate collective shareholder decision-making. Stone is well aware that his reading of the *Unocal* and *Blasius* implies that shareholder interests are a prime mover of corporate law, and he devotes considerable ingenuity to defending this view of the Delaware cases. Of particular interest to us, however, is that Stone's discussion provides a rationale for adjusting the length of the board's leash—a very long leash in purely business matters; but in matters implicating legitimate shareholder choice in the governance of the firm, a

35. Transactions costs are not the only reason why corporate law matters, however. Corporate law, like other bodies of organizational law, also has property-like elements insofar as it alters the claims of third party creditors of firms and investors who are not privy to the contract. See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

36. Jonathan Macey, *The Nature of Conflicts of Interest Within the Firm*, 31 J. CORP. L. 613 (2006).

37. *Id.* at 615.

38. Ethan G. Stone, *Business Strategies and Election Commissioners: How the Meaning of Loyalty Varies with the Board's Distinct Fiduciary Roles*, 31 J. CORP. L. 893 (2006).

longer or shorter leash according to the situational impediments to a free and fully informed shareholder choice.

IV. THE EXPANSION OF FEDERAL LAW: SARBANES-OXLEY AND THE SECURITIES ACTS

Although Burger Court decisions in the mid-1970s slowed the federalization of American corporate law, anti-fraud provisions of the securities acts and the managerial and directorial duties that arise under Sarbanes-Oxley have continued to colonize the empty spaces left open by Delaware's reluctance to develop the duty of care. Donald Langevoort's important contribution to this Symposium³⁹ brings us up to date on how federal law has shaped the duty of the board and top management to ensure that the company's internal controls are in good working order.

Two decades ago, Robert Clark's treatise discussed at length Delaware's take on the board's responsibility for ensuring effective internal controls over the legality of corporate activity.⁴⁰ Federal law was important even then, in the form of the Foreign Corrupt Practices Act of 1997. But two more recent developments have ratcheted up the importance of implementing effective internal controls: Chancellor William Allen's landmark decision in *Caremark*,⁴¹ and the passage of Sarbanes-Oxley in 2002. Langevoort's contribution to the present Volume illuminates how SOX § 404 has extended the obligations of those corporate directors unlucky enough to serve on the Company's audit committee. But more importantly, Langevoort's discussion of the purpose of disclosure under the federal securities law reminds us that disclosure obligations are not exclusively—or even primarily—for the benefit of current shareholders of the company, but are also for the benefit of outside investors who might consider purchasing the company's shares. Thus, the interests of future shareholders may be as important as the interest of present shareholders in evaluating the disclosure obligations of corporate managers.

The remaining two contributions to this Symposium deal with another aspect of federal regulation that was important when Clark wrote *Corporate Law* and has become still more important to the practice of corporate law today: the evolving anti-fraud provisions under the securities acts, particularly Rule 10b-5. Although *Basic v. Levinson*,⁴² which gave the Supreme Court's imprimatur to the fraud-on-the-market doctrine, followed the publication of *Corporate Law* by two years, Robert Clark was well aware of both the importance of class actions brought under the federal antifraud provisions as deterrents to misinforming the market, and of the difficult tradeoff that these actions entail when the corporation (one group of innocent shareholders) must pay damages to compensate misinformed investors (that is, another group of innocent shareholders). Robert Thompson's contribution to this Volume⁴³ develops the thesis that the federal antifraud provisions have evolved into an alternative framework of corporate governance that overshadows traditional state-law fiduciary duties. The federal anti-fraud

39. Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems,"* 31 J. CORP. L. 949 (2006).

40. CLARK, *supra* note 4, at 305 (discussion of the *Allis-Chalmers* decision).

41. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

42. 485 U.S. 224 (1988).

43. Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty*, 31 J. CORP. L. 877 (2006).

provisions are rooted in the common law tort of deceit. Earlier efforts to subsume state fiduciary law into Rule 10b-5 were blocked by the Supreme Court in the 1970s, as Clark discusses.⁴⁴ Thompson argues, however, that today's tort-based approach to Rule 10b-5 also effectively supplants the balance of discretion and relation that governs managers and directors under the traditional state law of fiduciary duty. Equally disconcerting, the federal courts' adaptation of the common law elements of deceit against the backdrop of the Private Securities Litigation Reform Act is confused and often inconsistent, as a comparison of the three federal court opinions in the most recent fraud-on-the-market case, *In re Dura Pharmaceuticals, Inc.*,⁴⁵ amply demonstrates.

Finally, *Dura Pharmaceuticals* is also the focus of Merritt Fox's contribution to this Volume.⁴⁶ Unlike Thompson's sweeping discussion of the development of anti-fraud law, Fox pursues a sustained analysis of one of the most troubling doctrinal issues in fraud-on-the-market cases: what the plaintiff must show to establish causation. In Fox's view, the problem with much of the fraud-on-the-market case law arises because federal courts invoked the concepts of transaction causation and loss causation, which are serviceable for frauds based on traditional reliance but inappropriate for frauds based on the fraud-on-the-market theory. In lieu of the transaction/loss causation framework, Fox proposes a much simpler causation rule that is consistent with the logic of fraud-on-the-market: namely, the plaintiff must show that defendant's wrongful misstatement inflated the market price of the security that plaintiff purchased, from which it follows that plaintiff's remedy is "out-of-pocket" damages equal to the amount by which plaintiff's purchase price was inflated. Since the fraud-on-the-market doctrine requires only reliance on the fairness of price, all that should matter is that the price was wrong, regardless of a match between misstatement and price.

Although the Supreme Court in *Dura* retained the transaction/loss causation framework, Fox's reconceptualization nevertheless provides a framework for analyzing *Dura* and parsing out the issues it decides from those it leaves open. We have no doubt that Fox's Article is a much-needed contribution to the literature on this confused, technical, and very significant area of law. There is a tension, however, between Fox's detailed analytical work rationalizing out-of-pocket damage measures in a variety of circumstances, and the more general observations about the social efficiency of fraud-on-the-market actions that conclude his Article. If the principal justification for fraud-on-the-market actions is deterrence of misrepresentations, and the principal harm associated with misrepresentations are the social costs of distorted share prices, we might naturally ask: shouldn't the damages (or penalties) assessed against corporate actors who misrepresent material information be the social costs of their misrepresentations? The question answers itself as a matter of tort theory. But here is the sticking point. On the one hand, the losses of out-of-pocket investors bear no obvious relationship to the harm occasioned by misrepresentations. Ex ante, innocent investors might lose or gain from corporate misrepresentations, depending on whether they happened to be buyers or sellers. On the other hand, determining how to measure the real social costs of misrepresentations is such a difficult issue that it may be that any answer, no matter how tenuously supported

44. CLARK, *supra* note 4, at 340-43.

45. 544 U.S. 336 (2005).

46. Merritt B. Fox, *Causation in Fraud-on-the Market Actions*, 31 J. CORP. L. 829 (2006).

by theory, is better than no answer at all. We leave this matter to you, dear reader. Our function here is only to ask the questions. We don't have to answer them.

V. CONCLUSION

It is testimony to the many levels on which *Corporate Law* succeeds that it can inspire the contributors to this Volume to pen essays on such a wide variety of topics. The papers at the front of this Volume address the most general issue in corporate law, the objective function of the corporation. The papers in the middle address—appropriately—mid-level theoretical issues. And the last four essays included in this Volume engage with specific doctrine and precedent in corporate and securities law, often in considerable detail. But despite this diversity of subject matter and level of generality, every author in this collection can point to specific pages in *Corporate Law* where Robert Clark, writing twenty years ago, anticipated their issues and often spoke to them directly. There is no better test of classic text. Robert Clark richly deserves the praise he receives from all of the contributors to this Symposium.