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PROFESSOR BAINBRIDGE AND THE ARROWIAN MOMENT:  
A REVIEW OF THE NEW CORPORATE GOVERNANCE IN THEORY 
AND PRACTICE

BY BRETT H. MCDONNELL*

ABSTRACT

The New Corporate Governance in Theory and Practice, a new book by Stephen Bainbridge, pulls together the leading arguments for director primacy that Bainbridge has made in a series of articles. In his core argument, Bainbridge uses theoretical work by Kenneth Arrow to explain the attractions of the separation of ownership and control with a centralized hierarchy headed by a board of directors. Bainbridge posits that achieving an optimal trade-off between authority and accountability is the central problem of corporate law. He uses a key passage from Arrow to argue that in making this trade-off, lawmakers should always make a presumption in favor of preserving managerial authority. This article examines Bainbridge's argument, and shows that he does not succeed in justifying this presumption. Arrow's argument persuasively shows why rules that lead to constant review of all board decisions would effectively eliminate board authority, and that this would be unattractive. None of the major pro-accountability reform proposals currently in play, however, comes even close to eliminating board authority. Arrow's argument cannot tell us whether reform in favor of somewhat more accountability at the expense of some loss in authority, but far from a total loss in authority, is a good idea or not. That is, Bainbridge's use of Arrow does not help us determine the wisdom of current reform proposals. Bainbridge's attempt to use Arrow thus falls short of his target. Bainbridge has other, less original, arguments which supplement his core argument for board authority. This article considers the leading supplementary arguments as well, and also finds them wanting. The article ultimately moves beyond a critique of Bainbridge to argue more affirmatively for greater accountability for boards.

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I. INTRODUCTION

Large public corporations are hierarchical organizations. At the apex of the hierarchy stands the board of directors. Most formal legal authority within the corporation is vested in the board, although the board delegates much of its authority to the top officers, who in turn delegate many decisions to middle-level managers, and so on down the chain. These corporations have created great wealth. They have, however, placed the control of that wealth in the hands of a small number of people. This creates temptation: what keeps those at the top working faithfully for the interests of their organizations?

The mix of state and federal law that regulates corporate governance in the United States faces two tasks at tension with each other. It must create a flexible structure that allows those in positions of authority to effectively manage these huge institutions, while also limiting their discretion to abuse the trust reposed in them. How does, and how should, corporate law balance these two tasks?

The heart of American corporate law resides in the Delaware General Corporation Law and particularly in the judicial cases interpreting and applying that law to Delaware corporations. This body of law is, of course, complex and multilayered, but its central characteristic is the great degree of authority it places in the board, and the great deference it shows to board behavior exercising that authority. There are mechanisms in the law for holding boards accountable for particularly egregious misuses of their authority, but those mechanisms are quite limited. Shareholders do get a voice in certain matters, but only a very few, and even then their voice is sharply circumscribed. Corporate law must balance authority against accountability but most of the time, in Delaware and the United States generally, the law strikes that balance in favor of authority.

How should we balance authority and accountability? That is the central normative question of corporate law. Interestingly enough, there is not much corporate law scholarship that vigorously defends the strong way in which American law vests authority in the board. Many corporate law scholars argue for reforms that give more strength to legal accountability mechanisms, such as shareholder voting, shareholder bylaws, or the ability of shareholders to sue directors who violate their fiduciary duties to the corporation. Even market-oriented, economics-trained scholars who tend to defend existing law are rather hardpressed to explain and defend why that law so rigidly entrenches strong board authority. The leading economics-based theories see corporate law as providing useful default rules which corporations should be able to contract around. The law, however, often makes it hard to contract around the grant of authority to boards.
The leading defense of this hardwired grant of authority to boards is Stephen Bainbridge's director primacy theory. Starting early this decade, in a series of articles and a book, Bainbridge has laid out a core argument concerning the trade-off between authority and accountability, and has argued that most of the time the law should favor authority over accountability. He has then applied this argument to many of the leading topics in corporate law, including shareholder voting, the business judgment rule, fiduciary duties, executive compensation, and the law governing hostile takeovers. Taken together, Bainbridge's work ties together American corporate law and treats its core tendencies as a relatively coherent intellectual whole that rightly takes board authority as its leading value.

Bainbridge has now published a new book which draws together his core arguments for director primacy in one place, including many of his applications of those arguments to leading topics in corporate law. Pulling this material together in one book is a natural development—the exigencies of law review scholarship entail repeating the same argument in multiple articles before going on to apply that argument to specific topics. The book allows Bainbridge to bring his full set of arguments together along with the


2Stephen M. Bainbridge, CORPORATION LAW AND ECONOMICS (2002).

3See Voting Rights, supra note 1, at 619-28; Shareholder Disempowerment, supra note 1, at 1749-51.

4See Abstention Doctrine, supra note 1, at 102-04.

5See id. at 88-90; Good Faith, supra note 1, at 567-74.

6See generally Executive Compensation, supra note 1.

7See Primacy in Takeovers, supra note 1, at 809-11; Precommitment Strategies, supra note 1; Unocal at 20, supra note 1, at 818-28.
major applications of those arguments to specific topics. *The New Corporate Governance in Theory and Practice (The New Corporate Governance)*\(^8\) thus provides a good chance to take a close look at Bainbridge's arguments.

Bainbridge makes a great advance in framing the debate over corporate governance as a trade-off between authority and accountability, and he does an excellent job in extolling the benefits that authority brings. But, does Bainbridge succeed in persuasively justifying the supreme value of authority? No. This article first lays out Bainbridge's argument, and then explains why that argument fails to succeed.

Bainbridge has a core argument which underlies all of his work in the director primacy series. A key and welcome part of that argument is his extensive reliance on a great book by Nobel Prize winner Kenneth Arrow, *The Limits of Organization*.\(^9\) Indeed, bringing Arrow into the dialogue of contemporary corporate law scholarship is, on its own, a great service.\(^10\) Bainbridge uses Arrow to highlight the important role that hierarchical authority plays within a large organization.\(^11\) Such authority is often the only way to process and disseminate information in a remotely efficient manner. Bainbridge also uses Arrow to stress the inherent conflict between authority and accountability.\(^12\) Mechanisms used to hold a particular decision maker accountable to those in whose interests he is supposed to act may undermine authority if they allow the reviewer too much discretion in overturning decisions of the reviewed.

Bainbridge also follows Arrow in stating that both authority and accountability are important, and that any effective organization must achieve a sensible balance between them.\(^13\) Prior economics-influenced scholarship on corporate law largely focused on agency costs and accountability; Bainbridge changes that focus. Up to this point, I find Bainbridge's argument both important and hard to argue with in any way beyond small quibbles. But then a funny thing happens. In each of his articles, and now


\(^11\) Director Primacy, *supra* note 1, at 557-58.

\(^12\) Id. at 557. Arrow actually uses the term "responsibility" rather than "accountability," but Bainbridge normally uses the latter term. I follow Bainbridge's usage here.

\(^13\) Id. at 573.
in *The New Corporate Governance*, Bainbridge moves very, very quickly from recognizing the tension between authority and accountability to arguing that we should presume a legal structure that favors authority over accountability, unless there are strong arguments against that presumption.

How does Bainbridge make that move? He does so with an argument that I call "the Arrowian moment." A few particular sentences from *The Limits of Organization*¹⁴ are the telltale tipoff that one has reached the Arrowian moment in a Bainbridge article or book. The central work in each piece of the director primacy series occurs in this moment. If it worked, it would be a great achievement.

But it does not work. The argument that Bainbridge borrows from Arrow only tells us that there is a trade-off between authority and accountability,¹⁵ and that both have real value. It also tells us that it will generally be unwise to choose a structure that eliminates authority completely in favor of accountability, or vice versa. None of the major proaccountability reform proposals currently in play, however, comes even close to eliminating board authority. In the world in which we live today, Arrow's argument is not able to tell us whether reform in favor of somewhat more accountability at the expense of some, but far from a total, loss in authority is a good idea or not. Bainbridge's attempt to use Arrow falls far short of his target.

Bainbridge has a variety of other subsidiary, less original arguments to buttress his case for strengthened authority. He claims that the internal dynamics of boards themselves lead to effective self-regulation. He points to the use of various markets to make boards accountable. Bainbridge argues that economic pressures tend to lead to optimal state corporate law. He warns of the dangers of special interest shareholders. He claims that a legal and economic structure that has survived a long time and accomplished much is entitled to a presumption against serious change. Most of these arguments, however, have been made in more detail elsewhere, and also critiqued in much detail. Bainbridge's use of each argument does not get him where his more original argument using Arrow is similarly unable to go. Thus, the leading sustained defense of the American legal system's grant of nearly unaccountable power to the board of directors falls short.

This article is organized as follows: Part II lays out the first part of Bainbridge's basic argument, leading up to the Arrowian moment. Part III

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¹⁴ ARROW, supra note 9, at 78 ("If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.").

¹⁵ *Id.* ("To maintain the value of authority, it would appear that responsibility [or accountability] must be intermittent.").
describes the moment itself, and the puzzle of how Bainbridge uses Arrow to move from recognizing a trade-off between authority and accountability to staking out a position in choosing between the two. Part IV examines possible answers to this puzzle. First, Part IV looks at Bainbridge’s use of the Arrowian moment and argues that Arrow only supplies an argument against extreme proposals that would attack authority altogether, and that this does not fit existing corporate law reform proposals. The remainder of Part IV examines a variety of other arguments that Bainbridge invokes to defend the primacy of board authority, including self-regulation, board internal dynamics, the use of market mechanisms, the race to the top in corporate law, the dangers of special interest shareholders, and a Burkean argument for sticking with the status quo. I argue that none of these arguments succeed. Part V moves beyond a critique of Bainbridge to argue more affirmatively for greater accountability for boards. This starts by reflecting upon where Bainbridge goes right, and where he goes off track.

Arrow and the basic tension between authority and accountability is a great starting point. Bainbridge, however, goes wrong by trying to privilege one value over the other. Both truly matter. Moreover, if we consider the political and economic forces underlying the evolution of corporate law, the law will likely evolve to put too much emphasis on authority over accountability. For a variety of reasons, corporate officers and directors are likely to exercise undue influence over the political and legal process and, thus, bend the law too far in their direction. Legal scholars, who are relatively unbeheld to any special interests in this battle, should use whatever limited influence they may have to try to reinforce the troops in favor of accountability. Hence, they should argue for responsible, sensible ways to increase board accountability. In the end, I argue that this is more consistent with Arrow than Bainbridge’s application of Arrow’s great book.

II. BAINBRIDGE’S CORE ARGUMENT—THE LEAD-UP TO THE MOMENT

There is a lengthy core argument at the heart of Bainbridge’s director primacy theory, which he must repeat (law review publishing being what it is) in every article and book in the director primacy series before applying that argument to the specific topic at hand in each piece. The initial Northwestern University Law Review and, to a lesser extent, Iowa Law Review articles lay out the basic argument. Then, in a series of articles and

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16Director Primacy, supra note 1, at 552-63.
17Nexus, supra note 1, at 9-11.
books, Bainbridge applies the argument to the leading topics of corporate law—the business judgment rule,\(^8\) fiduciary duty in takeovers and acquisitions,\(^9\) shareholder voting power,\(^10\) and piercing the corporate veil,\(^11\) among others.

*The New Corporate Governance* is laid out in five chapters plus an introduction. Chapter one, "The Means and Ends of Corporate Governance," lays out Bainbridge's core conception of the corporation and develops the first part of his argument for director primacy.\(^22\) Chapter two, "Why a Board?,” presents explanations for why a group rather than an individual is at the top of the corporate pyramid.\(^23\) Chapter three, "Director Primacy in the Courts," contains the core Arrowian moment in this book, and is really at the heart of Bainbridge's argument.\(^24\) In this chapter Bainbridge applies his arguments to the topics of fiduciary duties and takeover bids.\(^25\) Chapter four, "The Shift from Managerialism to Director Primacy," is a more historical section that aims to fend off criticisms that managerialism rather than board primacy is a better descriptive theory of contemporary American corporations.\(^26\) The final chapter, "The Future of Corporate Governance: Director or Shareholder Primacy," takes on current debates over efforts to increase shareholder power within public corporations, and returns at the end to the core Arrowian moment.\(^27\) In this review of Bainbridge's work I will consider each of these chapters, although not always quite in the order that Bainbridge follows in his book.

Bainbridge's books and articles lay out the best existing defense for the great power that American corporate law puts in the hands of corporate boards, and the correspondingly extremely limited power it gives shareholders. They also represent the most extensive use in corporate law scholarship of Kenneth Arrow's marvelous *The Limits of Organization*,\(^28\) in

\(^8\) See generally Abstention Doctrine, supra note 1 (applying the director primacy theory to the business judgment rule).

\(^9\) See generally Primacy in Takeovers, supra note 1 (applying the director primacy theory to corporate takeovers); Precommitment Strategies, supra note 1 (applying the director primacy theory to poison pills); Unocal at 20, supra note 1 (applying the director primacy theory to corporate takeovers).

\(^10\) See Voting Rights, supra note 1; Shareholder Disempowerment, supra note 1.

\(^11\) See Much Ado, supra note 1.

\(^22\) BAINBRIDGE, supra note 8, at 23-75.

\(^23\) id. at 77-104.

\(^24\) id. at 105-54.

\(^25\) id. at 111-14, 134.

\(^26\) BAINBRIDGE, supra note 8, at 155-200.

\(^27\) id. at 201-35.

\(^28\) ARROW, supra note 9.
itself a good enough reason to respect Bainbridge’s accomplishment. We shall see, however, that Bainbridge’s use of Arrow does not successfully get him to where he wants to go.

Bainbridge’s concept of director primacy has two main parts: (1) in large public corporations the board of directors has, and should have, ultimate decision-making power; and (2) the board’s fiduciary duty runs to shareholders and not to other corporate constituencies—that is, the board should make its decisions in the best interests of shareholders rather than in the interests of employees, creditors, the community, or so forth. My concern here is with the first part, namely who does and who should have ultimate decision-making power in a public corporation.

For argument’s sake I will accept the second part, that the duty runs to shareholders only. This is the dominant position in American corporate law scholarship, although I do not personally share it. In his new book, the argument for this shareholder wealth maximization norm occurs in the last part of the first chapter. Bainbridge argues that a shareholder wealth maximization norm is what shareholders and other stakeholders in most firms would bargain for if we were to ask for an explicit agreement on whose interests a corporation should pursue. The main arguments he uses to justify this hypothetical bargain have been around in the literature for a while. Namely, he claims that shareholders, as the corporation’s residual claimants, are more vulnerable to director misconduct than other groups and less able to protect themselves contractually. Easterbrook, Fischel, and Macey, among others, made these arguments in the late 1980s and early 1990s when the adoption of corporate constituency statutes led to a flair up in the old debate over whose interests a corporation should pursue. Others have already sharply called these arguments into question. For instance, employees with firm-specific investments are also residual claimants, in effect, and it is not at all clear that employees can protect their interests more

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easily by contract than can shareholders. Most blatantly, shareholders of a public corporation limit their exposure to any management team's misbehavior through diversification; employees cannot do that. Bainbridge does not seriously come to terms with these responses. Bainbridge's final argument is that other constituencies can protect themselves better through political means than can shareholders. Is he serious? Do unions in the United States today really possess "enormous political power"? Are shareholders as a class a more loosely defined group than employees? Certainly shareholders include in their midst people who are much more politically powerful and wealthy than employees as a group. This claim needs a much more vigorous and detailed defense than Bainbridge provides.

So much, then, for the shareholder wealth maximization norm. My main concern here is with the first part of director primacy, the argument over who should exercise authority within corporations. Bainbridge's argument for board control over corporate decision making is both a descriptive and a normative claim. Descriptively, he argues that American corporate law gives shareholders very little power over corporate decisions. Normatively, he argues that board control is a good thing. The descriptive claim is right. Shareholders have very little power over corporate decisions. Their main alleged power is the right to elect directors. As the current controversy over shareholder voting and proxy access makes clear in practice, however, this power is quite feeble in corporations with dispersed shareholders (the type of corporation that Bainbridge focuses on). The combination of state and federal law governing shareholder voting and proxy solicitation makes it prohibitively expensive for shareholders to put up their own candidates for the board, and they almost never do so except in the (increasingly rare) case of a hostile takeover. Thus, boards nominate the only candidates, and those candidates are guaranteed victory. This system may be on the verge of major change, but that change is far from certain—and Bainbridge is a vehement opponent.
Shareholders get to vote only in a very limited number of other circumstances. They get to vote on amendments to the certificate of incorporation, some mergers, sales of substantially all assets, and dissolutions. These are big events that do not occur terribly often. More importantly, shareholders get to vote on these matters only if the board has first approved the decision. Shareholders in the United States have no right to initiate any of these actions. Thus, the shareholder voting power, outside of board elections, consists only of ratifying board decisions on a few big-ticket items.

The one area where American shareholders do have some ability to initiate action without prior board approval is in enacting bylaws. It is disputed how extensive this bylaw power is. Bainbridge has not devoted a lot of attention to the matter, although in limited comments he, predictably, opposes an expansive interpretation of the shareholder bylaw power. Here, I expect that he may prove to be somewhat mistaken about the law, which I believe gives shareholders power to decide a fairly broad range of corporate governance matters. However, the scope of the bylaw power remains, for now, subject to much uncertainty. The very paucity of such cases shows that so far shareholders have not extensively mobilized to test their power under the bylaws. This may be changing, but for the moment the bylaw power still remains a—rather, the—limited exception to the general story of limited shareholder power, with virtually no power to initiate corporate actions.

The Delaware Supreme Court recently decided an important case in this

45 Id. § 251(c).
46 Id. § 271(a).
47 Id. § 275(a).
48 See, e.g., Del. Code Ann. tit 8, § 109 (2001). This is not true in some other countries.
See infra notes 202-03 and accompanying text.


50 See Bainbridge, supra note 2, at 46-48. In his new book, Bainbridge reviews the state of the bylaw debate. Bainbridge, supra note 8, at 214-19. At that point, however, he does not really take a normative position. Later, in chapter five, he takes a general position against attempts to expand shareholder power, but does not specifically refer back to the bylaw debate. Id. at 228-35.

51 See McDonnell, supra note 49.

52 This statement holds for American corporations. As we shall see, in the U.K. shareholders have a moderately more expansive power. See notes 200-01 and accompanying text.
The shareholders lost, but the reasoning underlying the decision is rather slippery and it is not yet clear what it will mean for other shareholder bylaws. Indeed, the case would seem to allow shareholders to craft bylaws with fairly expansive powers so long as they include fiduciary-out clauses.

Thus, I do not disagree much with Bainbridge's descriptive claim that shareholders have very little power—most corporate decision-making power is indeed vested in the board. Bainbridge celebrates and defends that fact. The normative claim is my target here. Bainbridge's normative defense of board authority is the leading academic defense available for the basic contours of American corporate law. The two leading academic alternatives to Bainbridge—contractarianism and shareholder primacy—do not explain American corporate law as well.

The contractarian law and economics tradition of scholars such as Roberta Romano and Frank Easterbrook and Daniel Fischel do explain and defend much of corporate law. As I have noted elsewhere, however, that tradition does not do a great job of explaining why board authority is so hardwired into our corporate law. It is relatively easy to explain why board authority should be the default rule for most parts of the law. It is harder to explain, however, why the law makes it so hard to opt out of the presumption favoring board authority. That is, why are corporate law's altering rules, which dictate what is required to opt out of a particular default, so sticky in support of board authority? As Bainbridge puts it, "Corporation law virtually carves the separation of ownership and control into stone."

Examples of this stickiness include limits on the scope of bylaws, the requirement of board approval of certificate amendments (which is not true in many other countries), the rules allowing boards to block hostile takeovers, rules restricting shareholder agreements that limit board power, and the independent significance doctrine as applied in a range of Delaware cases involving preferred shareholder rights. The standard contractarian position would seem to argue in favor of making opting out of board authority easier than is observed.

The other leading academic alternative to Bainbridge that argues for strengthened shareholder power, is led by the copious writing of Lucian

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53 CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008).
56 EASTERBROOK & FISCHEL, supra note 36.
58 BAINBRIDGE, supra note 8, at 4.
Bebchuk. This literature quite explicitly criticizes important parts of state corporate law, especially Delaware's corporation statute, as vesting too much power in boards. It does not even attempt to defend the status quo.

A simple graph may help illustrate the relationship between the leading scholarly positions and Delaware law, as currently interpreted by Delaware courts. Consider two dimensions of corporate law. The first dimension is the split of power between shareholders and the board under the basic default rules of the law. In Figure 1, this split is displayed on the horizontal axis. A move to the right represents giving more authority to the board; a move to the left gives more authority to the shareholders. The second dimension is the stickiness of those default rules in allocating power. In Figure 1, stickiness is displayed on the vertical axis. Stickiness can vary from an extreme Teflon rule at the bottom of the graph, to a mandatory rule at the top.


\[60\] Of course, the division of power is more complicated than a simple one-dimensional line can convey. Consider two complications. First, other groups besides the board and shareholders may get some degree of decision-making power. One could add new dimensions to convey that, but we need not add that hard-to-picture wrinkle for our purposes here. Second, what matters is not simply the total amount of power granted to the board or shareholders, but how that power is granted for various specific matters.
Figure 1 displays the relative position along these two dimensions of Delaware law and three leading academic positions: contractarianism, Bebchuk, and Bainbridge. Delaware is far to the right in Figure 1, representing the fact that the board receives most power and shareholders receive very little. On the vertical axis, the stickiness dimension, Delaware is closer to the bottom than the top—this reflects the well-known, nonmandatory nature of most Delaware law. On the other hand, Delaware is not completely down at the bottom of the graph by any means—this reflects the significant degree of stickiness surrounding the grant of board authority discussed above.

The contractarian position appears as a line in Figure 1. This line is near the bottom, reflecting the contention that corporate law’s default rules should be easy to alter. This seems to be a core contention of all serious contractarians. Contractarians differ among themselves, though, as to how strongly the default rules should favor the board over shareholders. Some, such as Easterbrook and Fischel, favor giving some real power to shareholders (particularly in the area of hostile takeovers), while others,

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61 See EASTERBROOK & FISCHEL, supra note 36, at 171.
such as Romano, approve of the extreme grant of board power that we observe in Delaware.62

Bebchuk appears in a different part of Figure 1. He is well to the left of Delaware and most of the contractarians, reflecting his preference for giving more power to shareholders. He is also more towards the top, reflecting some preference for less sticky law. That point is more complicated than a simple graph can convey. In some areas, Bebchuk would protect shareholder power with mandatory rules that are harder to alter than current law. In other areas, though, Bebchuk argues that a proshareholder position would actually lead to a default position that is easier to alter than a proboard default, and he defends the proshareholder defaults on that ground.63 On balance, though, it seems fair to portray Bebchuk as favoring stickier law than we see in Delaware.

Finally, there is Bainbridge. His point in Figure 1 is much closer to Delaware than the contractarians or Bebchuk. On the stickiness dimension, his position seems to fit Delaware law well. On the power dimension, I would place Bainbridge somewhat to the right of Delaware, representing an even more extreme proboard allocation of power, but not that much further right. His main difference from Delaware is on the question of the bylaw power, as discussed above.64 It could ultimately be, however, that Delaware will decide the bylaw question in a way that will make its position coincide with Bainbridge's.

I thus take Bainbridge as the leading academic normative defense for American state, especially Delaware, corporate law. This makes detailed exploration of his defense quite interesting—if his argument does not hold up to that exploration, we are not left with much in the way of a well-worked-out defense for our corporate law.65 So, how does Bainbridge defend the broad grant of authority to boards in American corporate law?

62Romano, supra note 55, at 149-50.
64See supra notes 49-52 and accompanying text.
65The next most influential defense of board authority in the current academic literature is probably the team production theory of Margaret Blair and Lynn Stout. See generally Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1999) (analyzing the team production theory). They are not my target here. I would rank them as somewhat less important and influential than Bainbridge for two reasons. First, they are somewhat heterodox within the ranks of American law because they do not defend the norm of shareholder wealth maximization. Being heterodox does not make them wrong—indeed, I agree with them on that point—it just makes them more of a minority and dissident position than Bainbridge. Second, to date Blair and Stout have not explored the full range of major corporate law doctrines through the lens of their theory as thoroughly as Bainbridge has done with his. In his new book, Bainbridge
He begins with the nexus of contracts model that dominates law and economics corporate law scholarship. According to that model, the corporation is a legal fiction for a complex web of voluntary, often long-term relationships among the various constituent groups involved—shareholders, managers, creditors, employees, customers, suppliers, and the like. The firm provides a useful way of coordinating these complicated relationships. Corporate law provides hopefully efficient off-the-rack default rules that mimic the rules that the parties in most corporations would choose, saving the transaction costs that would be involved in writing those contracts from scratch for every corporation.

Many of these contracts, however, are necessarily wildly incomplete. The parties are often involved in a corporation over a long period. In this time they will inevitably face a host of situations that the parties could not feasibly have anticipated and provided for in advance. The question then arises: who will make decisions as to what to do when an uncontracted-for event occurs?

At this point, Bainbridge draws heavily upon Ronald Coase's influential theory of the firm. For Coase, the defining characteristic of a firm is the existence of an authoritative decision maker who has fiat power to choose what to do. Actions will be done within a firm where the costs associated with such an authoritative decision maker are less than the costs of market bargaining and price setting to determine what to do. As Bainbridge puts it, it is not that the firm is a nexus, rather, the firm has a nexus.

The fiat decision maker, however, need not be a single person. Indeed, in a large corporation, it is not a single person. Rather, there is a
hierarchy of decision makers. Moreover, at the top of that hierarchy is a
group (the board), not an individual. In smaller businesses, all or some of
the employees or owners may make decisions collectively. Thus, even given
decision making by an authoritative person or body ex post, as opposed to
contractually-agreed-upon actions ex ante, one must still explain who makes
which decisions and why.

Here, Bainbridge turns to Arrow. Arrow distinguishes two basic
kinds of decision-making structures: "consensus" and "authority."72 Under
consensus, all members of a relevant team agree on what they should do.73
Under authority, a central agency receives information from team members,
decides what to do, and then tells the team members what to do.74

Consensus works where all team members have identical interests and
identical information. In that case, they need not spend costly time arguing
over what to do—everyone will reach the same decision without argument.
Alas, a move away from identity of either interests or information gums up
the works.75 If different members have different goals, then even with the
same information they may not agree as to what they should do. Imagine a
group of persons building a house. Even if they all have the same
information as to the relevant materials, costs, and the like, they may
disagree on what to do if one cares mainly about building an energy-efficient
house, another cares mainly about building a dramatically beautiful house, a
third focuses mainly on keeping costs down, and so on. More subtly, even if
everyone shares exactly the same interests, they may have difficulty agreeing
if they have very different information. Among our housebuilders, if some
think that wood is more energy efficient, while others believe that aluminum
siding is more energy efficient, then even if they all agree on energy
efficiency as a goal they may spend much valuable time arguing over wood
versus aluminum. The further we move from either identical interests or
identical information, the more costly consensus becomes.

In a large corporation, no major constituency group comes close to
achieving identical interests or identical information. Shareholders come

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72 ARROW, supra note 9, at 63-79.
73 Id. at 69-70; see also BAINBRIDGE, supra note 8, at 37 ("Consensus requires that each
member of the organization have identical information and interests so that preferences can be
aggregated at low cost.").
74 ARROW, supra note 9, at 69-70; see BAINBRIDGE, supra note 8, at 37 ("[A]uthority-based
decision-making structures arise where group members have different interests and information.").
75 See BAINBRIDGE, supra note 2, at 201-03; BAINBRIDGE, supra note 8, at 40-44;
Abstention Doctrine, supra note 1, at 106; Voting Rights, supra note 1, at 605-07; Primacy in
Takeovers, supra note 1, at 799-80; Shareholder Disempowerment, supra note 1, at 1745-46;
Director Primacy, supra note 1, at 557-58; Unocal at 20, supra note 1, at 782-84; Executive
Compensation, supra note 1, at 1652-53.
They can largely agree to focus on their financial interests in the business. Even so, they may have different time horizons or be in different tax brackets. The growth of equity derivatives further separates the interests of shareholders. Shareholders are more fundamentally divided by the information they have. Most shareholders have little stake in any one corporation, and are thus rationally apathetic—they have little incentive to gather the information needed to make a good decision on most matters. Getting the thousands of shareholders in a public corporation to agree on every operating decision is an obviously Herculean and pointless task. The task is even more desperate for the other major corporate constituencies.

This suggests a need for centralized decision making. In a large corporation, however, bounded rationality clearly makes it impossible for one person to make all decisions. This leads to a branching hierarchy. The top of the hierarchy makes high-level decisions and delegates implementation of those decisions to the next level down, while monitoring its performance. The next level of managers, in turn, delegates a series of small decisions to yet lower-level managers, and monitors them. And so on.

Several questions arise at this point: which constituency group or groups should choose the top decision maker(s)? Why is the top authority in corporations a group rather than an individual? And, what is the proper relationship between the constituency which chooses the top decision makers, namely shareholders, and those decision makers, namely the board of directors?

On the first question, Bainbridge first argues that only one constituency group should choose the top decision makers; having more than one group choose (as in German codetermination) would lead to overly wide divergences in interests and information, thus causing great problems under Arrow's theory. This answer could use greater exposure to experiences with codetermination—Bainbridge too quickly accepts the common story

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76 BAINBRIDGE, supra note 8, at 50-51; Voting Rights, supra note 1, at 606-16; Director Primacy, supra note 1, at 557-58.


78 BAINBRIDGE, supra note 8, at 55-57.

79 BAINBRIDGE, supra note 2, at 232-33; BAINBRIDGE, supra note 8, at 42; Stephen M. Bainbridge, Privately Ordered Participatory Management: An Organizational Failures Analysis, 23 DEL. J. CORP. L. 979, 1004-07 (1998); see generally Roy Radner, Hierarchy: The Economics of Managing, 30 J. ECON. LITERATURE 1382 (1992) (discussing hierarchy systems in modern firms).

80 BAINBRIDGE, supra note 8, at 45-49.
that codetermination results in inefficient conflict. Be that as it may, having decided that just one group should choose the top decision makers, Bainbridge argues that the group doing the choosing should be shareholders. That is both because they have less internally divergent interests and information than other groups, and also because they are the residual claimants.  

That brings us to the next question: why do we find a group (the board) rather than one person (the CEO) at the top of the hierarchy in the corporate form? One possible answer to this is that we do not, really—the CEO is the true source of real power in public corporations. The CEO effectively controls who will be on the board, and thus dominates the business. This managerialist theory was once the dominant understanding of the American corporation, and many still believe that it describes large American businesses. Bainbridge, however, does not accept this description. He believes that in recent decades a variety of changes have empowered boards enough that they do indeed exercise independent authority over the corporation. Bainbridge devotes chapter four to making this point.

Accepting for now that Bainbridge is right on that point, why might it be a good thing? Bainbridge devotes chapter two of *The New Corporate Governance* to that question. He spends many pages discussing empirical literature on when group decision making is likely to be better than individual decision making. Ultimately, he argues that the board is an effective monitoring device. Managers at each level of the hierarchy monitor those in the level below. But, at the very top, who will monitor the monitor? That is the board's job. The question, of course, then repeats itself—who will monitor the board? Part of Bainbridge's answer is that directors will monitor each other. A board is a small, close-knit group of persons that interacts with each other over many years. This allows them to closely observe each others' behavior, to evolve norms of hard work, and to monitor whether their colleagues are abiding by those norms.

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81 Id. at 50-57.

82 See id. at 155-200 (discussing the recent change in the board of directors' role in a corporation). I shall deal with a few aspects of this chapter below. See also BAINBRIDGE, supra note 2, at 205-06; Director Primacy, supra note 1, at 561-63. For a critique of director primacy that strongly contests this point, see George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOUS. L. REV. 1213, 1240-44 (2008).

83 See BAINBRIDGE, supra note 8, at 78-104.

84 BAINBRIDGE, supra note 2, at 210-13; BAINBRIDGE, supra note 8, at 100-04; Nexus, supra note 1, at 25-29; Director Primacy, supra note 1, at 567-74.

85 BAINBRIDGE, supra note 2, at 211-13; BAINBRIDGE, supra note 8, at 100-04; Nexus, supra note 1, at 25-29. We shall see that Bainbridge has other answers as well.
This is an interesting and valuable discussion. There is, however, an odd gap in the argument. Nowhere in chapter two does Bainbridge harken back to his discussion of Arrow on the benefits of consensus versus authority, even though this would seem to be highly relevant to the discussion at this point. There seems to be at least some significant tension between the argument in chapter two and Arrow's point. After all, modern monitoring boards contain mostly outside directors, but they still have at least one insider, the CEO, who in American corporations is still usually the chair of the board. If the outsiders are focused on monitoring both themselves and the insiders, this will create significant conflicts of interest within the board. Bainbridge briefly confronts this problem in chapter four, which describes and defends the rise of the board-as-monitor model. There, he says that Arrow's arguments on consensus, as applied to the board, suggest that consensus should work better in an insider-dominated board. He then quickly suggests that countervailing considerations suggest benefits to outsider-dominated boards. I think he needs to do more work on this point. Arrow's argument on consensus versus authority is central enough to Bainbridge's core argument that he needs to do a better job of reconciling Arrow with his story of the internal dynamics of modern boards.

Bainbridge is no fool—he is well aware that director self-monitoring is far from a complete solution to the agency problem. Both top managers and the board of a large public corporation have control over a vast amount of wealth and resources. The temptation to divert some of this to their own pockets is quite strong. What stops them from doing so? How the law may help reduce this agency problem has of course been a central focus of corporate law scholarship at least since the days of Berle and Means. This brings us to our third question: what should be the relationship between shareholders and the board?

Part of Bainbridge's answer to this question is that effective regulation of corporations is not only about managing the agency problem. Efficiently structuring decision-making authority to allow for a good, cheap flow of information and decisions is also critical. Bainbridge, however, does acknowledge the importance of the agency problem as well. Thus, there are two core values which both matter to corporate law: authority and

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86 Bainbridge, supra note 8, at 189.
87 Id. at 189-90.
89 Director Primacy, supra note 1, at 572.
90 Id. at 573.
accountability. Bainbridge borrows heavily from Michael Dooley on the trade-off between authority and responsibility. Both Bainbridge and Dooley harken explicitly to Arrow in describing and understanding this trade-off. Each piece in the director primacy series contains at least one statement along the following lines:

On the one hand, directors must be held accountable for violating their obligation to maximize shareholder wealth. On the other hand, the substantial virtues of fiat can be ensured only by preserving the board's decision-making authority from being trumped by either shareholders or courts. Resolving that tension turns out to be the chief problem of corporate governance.

This is Bainbridge's core, and best, insight.

The question then becomes: how does and how should the law establish the proper mix of authority and accountability? For Bainbridge, the answer will be that at virtually every contested point, the law does and should side with authority over accountability. We shall explore how Bainbridge gets to that answer, and whether he provides an adequate justification for it.

III. THE MOMENT AND THE PUZZLE

This brings us to the central conceptual move in Bainbridge's work: the Arrowian moment. The moment is present at least once in virtually every piece in the director primacy series.

Let us see how the moment evolves. Chapter one develops the argument described in the last part of the previous section, giving good

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91See generally Dooley, supra note 10 (analyzing two models of corporate governance: the authority model and the responsibility model).
92BAINBRIDGE, supra note 8, at 75. For similar statements in Bainbridge's director primacy series, see BAINBRIDGE, supra note 2, at 207, 253; BAINBRIDGE, supra note 8, at 113; Abstention Doctrine, supra note 1, at 109; Voting Rights, supra note 1, at 626; Primacy in Takeovers, supra note 1, at 806; Shareholder Disempowerment, supra note 1, at 1747; Director Primacy, supra note 1, at 573; Unocal at 20, supra note 1, at 786; Executive Compensation, supra note 1, at 1653.
93BAINBRIDGE, supra note 2, at 207, 253, 517; BAINBRIDGE, supra note 8, at 113, 133, 235; Abstention Doctrine, supra note 1, at 108; Voting Rights, supra note 1, at 626; Primacy in Takeovers, supra note 1, at 806; Shareholder Disempowerment, supra note 1, at 1747; Director Primacy, supra note 1, at 573; Much Ado, supra note 1, at 367; Unocal at 20, supra note 1, at 786; Executive Compensation, supra note 1, at 1650, 1653-54.
94See supra notes 66-81 and accompanying text.
reasons why in a large corporation most decisions, most of the time, will be made within a branching hierarchy. Chapter two then gives the arguments for why a group, the board, sits at the top of that hierarchy. Bainbridge, however, cannot stop there. He has at least two problems he must attend to. First, as we have just seen, the vesting of power in the board creates an accountability problem, and self-monitoring alone seems like a pretty thin answer to that problem. What more, if anything, can and should be done to make boards accountable to shareholders? Second, he must explain the stickiness of the rules favoring board authority. Even if shareholders will normally want board authority for the reasons developed in chapters one and two, why not make it easy for them to limit that authority in the name of greater accountability where the shareholders of a particular corporation so choose? The arguments in chapters one and two do not give adequate answers to those questions.

In *The New Corporate Governance*, Bainbridge repeats his core answer to these questions in the chapter on director primacy in the courts. Why not give either courts or shareholders more power to review or overturn board decisions? Bainbridge argues that doing so would overturn the basic grant of authority to the board to make most decisions. He quotes the following text from Arrow (this text is the key sign that Bainbridge has reached the Arrowian moment): "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem."  

Bainbridge goes on to quote Chancellor Allen: "'To recognize in courts a residual power to review the substance of business decisions for "fairness" or "reasonableness" or "rationality" where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors.'" Bainbridge says that the theory of the firm must balance authority and accountability. Alas, "they are ultimately antithetical: one cannot have more of one without also having less of the other." 

So far, though, this simply says that there is a trade-off between authority and accountability. That seems unquestionably true. It is not always true—from some bad starting points, of truly inefficient law, it might

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95See BAINBRIDGE, *supra* note 8, at 105-53.
96Id. at 113 (quoting ARROW, *supra* note 9, at 78). For other Bainbridge citations to this quote in the director primacy series, see *supra* note 93.
98Id.
be possible to achieve more of both. At some point, however, we will need to choose between the two.

![Authority/Accountability Trade-off Graph](image)

**Figure 2. The Authority/Accountability Trade-off**

One can visualize this as an efficiency frontier curve as illustrated by Figure 2. On one axis is accountability and on the other is authority. From an inferior point such as A, it is possible to move to a point like B on the efficiency frontier that features more of both accountability and authority. For an example of a point A-type law, consider a mandatory disclosure rule that requires extensive disclosure of some minute detail that no sane shareholder would ever care about. Mandating this disclosure reduces board authority (at least over the decision whether or not to disclose that information) but does nothing to increase accountability, since shareholders do not care about that information. Eliminating this mandatory disclosure rule would increase authority without decreasing accountability. In a political and legal system that works tolerably well, one would not expect to find too many rules that are blatantly and uncontroversially inefficient in this way. Once one is on the frontier, at a point like B, however, one must choose. One can move from B to C and gain more accountability, but at the cost of impairing authority; or one can move from B to E and gain more authority, but at the cost of losing accountability.99

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99 Another possibility is that there are points like F that lie beyond the efficiency frontier—
To say that a trade-off between authority and accountability exists at some point should be uncontroversial, though it remains valuable to stress that there is such a trade-off. The hard question is to argue where on the efficiency frontier the law should be. Given our current starting point (presuming we are on the efficiency frontier), should we move to more accountability and less authority, move to more authority and less accountability, or stay where we are? Having made the arguments we have reviewed so far, and having recognized the trade-off, here is Bainbridge's conclusion: "Given the significant virtues of discretion, however, one must not lightly interfere with management or the board's decision-making authority in the name of accountability. There ought to be a rebuttable presumption in favor of preservation of managerial discretion." 100

But, does the argument preceding this sentence justify that conclusion? Bainbridge has indeed shown the value of authority. He has done so with more detail and vigor than most corporate law scholars. Very few, however, would deny that authority has great value in the context of a large corporation. Bainbridge has also argued persuasively that there is a trade-off between authority and accountability—choosing more accountability will impair the board's authority. Very few would deny that either. But, accountability has value, too—Bainbridge does not deny this, although he dwells on it less than most corporate law scholars.

The key dilemma is figuring where on the efficiency frontier, in Figure 2, we reach an optimal trade-off between authority and accountability. Saying that authority has value, and that more accountability implies less authority, does not answer the question in favor of authority—it simply restates the fact that we face a trade-off. Yet, Bainbridge moves almost immediately from stating that we face a trade-off to stating that in making this trade-off we should always presume an answer in favor of authority over accountability.

100 Bainbridge, supra note 8, at 113. For other references to the "presumption" idea, see Bainbridge, supra note 8, at 130, 132, 235; Voting Rights, supra note 1, at 628; Shareholder Disempowerment, supra note 1, at 1751; Much Ado, supra note 1, at 367; Unocal at 20, supra note 1, at 787. In early articles in his series, Bainbridge expresses the same idea in terms of a "null hypothesis" in favor of board authority. See Bainbridge, supra note 2, at 208, 253, 517; Abstention Doctrine, supra note 1, at 109; Primacy In Takeovers, supra note 1, at 807; Director Primacy, supra note 1, at 573.
IV. DEFENSES OF THE PRIORITY OF AUTHORITY

Does anything in Bainbridge's argument justify this final step? I shall ultimately answer "no." In this section, I shall consider a variety of Bainbridge's arguments that might help him get to his conclusion. The most distinctive of these is the Arrowian moment itself, and I shall consider it first. Bainbridge also uses a variety of other arguments that are more standard and widespread in corporate law scholarship. I look at each in turn, and question whether each explains why we should maintain a null hypothesis or a presumption in favor of preserving the board's power of fiat.\footnote{See supra note 100.}

A. The Arrowian Moment

The central and most distinctive argument in Bainbridge's work for the priority of authority over accountability is the Arrowian moment itself. How, though, can Bainbridge use Arrow to move beyond recognizing an authority/accountability trade-off to telling us something about how we should make that trade-off? I think that what Bainbridge does here is implicitly exaggerate the proaccountability positions he opposes.\footnote{Although one proposal does come close to fitting his caricature, see infra notes 115-18 and accompanying text.} Once one sees this, Bainbridge's use of Arrow falls short of demonstrating what Bainbridge thinks it demonstrates.

Recall Arrow's point: "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem."\footnote{ARROW, supra note 9, at 78. For Bainbridge's citations to this quote, see supra note 93.} Bainbridge immediately follows with this: "To recognize in courts a residual power to review the substance of business decisions for "fairness" or "reasonableness" or "rationality" where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors."\footnote{BAINBRIDGE, supra note 8, at 113 (quoting In re RJR Nabisco, Inc. S'holders Litig., No. 10,389, 1989 WL 7036, at *13 n.13 (Del. Ch. Jan. 31, 1989), reprinted in, 14 DEL. J. CORP. L. 1132, 1156 n.13 (1989)).}

In a sense, this is uncontroversial. It merely says that in Figure 2, one can reach a point like D where we find an extreme of high accountability with absolutely no authority. Clearly that is right—an extensive and continuous-enough review power does indeed eventually remove all authority from the person being reviewed.
But, does that tell us anything about the active controversies that we face within mainstream corporate law scholarship and policymaking today? Does anyone out there with even the slightest chance of being taken seriously argue for an extreme position that would take us to point D? Bainbridge's use of Arrow here works as a refutation only of persons who take such an extreme position. And yet, I do not think one can fairly characterize any proposals out there in those terms.

There are two main reviewing bodies which could undermine the authority of boards: shareholders and courts. Bainbridge considers the former in chapter five of *The New Corporate Governance*, and the latter in chapter three. I will consider the leading contemporary debates surrounding each, and see whether or not Bainbridge's Arrowian moment scores crucial points against any proponents in those debates.

First, let us consider the leading types of proposals in play today for expanded shareholder power in decision making. Bainbridge divides these into three categories: "the director nomination process; the mechanics of voting; and expanding the substance of what shareholders may decide by vote." I shall consider the first two together, and subdivide the third into two subcategories. Many proposals today would make it easier for shareholders to nominate and vote for members of the board other than the board-approved nominees. This may or may not be a good idea. Bainbridge strongly attacks these sorts of proposals. Even making it much easier for shareholders to put forward board nominees at annual meetings, however, would not remove all board authority, not by any stretch of the imagination.

Indeed, a more effective shareholder voice in board elections fits quite nicely with Arrow's position. Right after the sentence that Bainbridge quotes in the Arrowian moment, Arrow makes a further point that Bainbridge also frequently quotes (indeed, these quotes really constitute an alternative version of the Arrowian moment): "To maintain the value of authority, it would appear that responsibility must be intermittent." Annual board elections are a paradigmatic example of intermittent responsibility. Making it easier for shareholders to challenge board nominees would simply strengthen this intermittent accountability method. Shareholders get to vote

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105 *Id.* at 201-35.
106 *Id.* at 105-53.
107 *Id.* at 222.
108 BAINBRIDGE, *supra* note 8, at 222-35; see generally *Voting Rights, supra* note 1 (arguing against modifying the existing director primacy-based system of corporate governance).
just once a year, and they only get to vote on keeping or replacing individuals, not on particular policy matters. Thus, reforms of the board election mechanism do not even remotely threaten to undermine all board authority in the way that Bainbridge hints at.

Other current proposals would expand the substance of what shareholders can vote on. These come in two forms: votes on bylaws and votes on certificates of incorporation. First, consider proposals for expanded shareholder decision-making power through shareholder-enacted bylaws. Reformers have suggested and sometimes pressed for a variety of bylaws, including bylaws to expand the shareholders' role in electing directors and bylaws to limit the power of boards to protect against hostile takeovers. Might shareholder bylaws cause the disintegration of board authority that Bainbridge fears?

No. The exact scope of the shareholder bylaw power is disputed and somewhat uncertain. Elsewhere I have examined that question; and, following John Coffee, I argue that bylaws are limited to questions of procedure and/or corporate governance. Shareholders cannot use bylaws to make ordinary business decisions. Procedure and corporate governance give an important and somewhat broad range of scope for shareholder action through bylaws. That scope, however, remains limited. The exclusion of bylaw power over ordinary business decisions rather precisely rules out the sort of plenary grant of authority to shareholders that Bainbridge fears. Indeed, one can use Bainbridge's own theory as a persuasive justification for the procedure or corporate governance versus substantive business decision distinction for distinguishing valid bylaws.

Somewhat surprisingly, Bainbridge has not yet (to my knowledge) paid close attention to the shareholder bylaw power. The following passage, though, seems to capture some of his concern, in this and related areas:

Shareholder activism necessarily contemplates that institutions will review management decisions, step in when management performance falters, and exercise voting control to effect a

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110 See generally McDonnell, supra note 49.
111 See Coffee, Jr., supra note 49.
112 See McDonnell, supra note 49.
113 In The New Corporate Governance, Bainbridge devotes several pages to a description of the legal issue. BAINBRIDGE, supra note 8, at 214-19. In this passage, though, he does not take a normative position. Later in the chapter he takes a general stance against all attempts to expand shareholder power. At that point, however, he does not specifically refer back to the bylaw issue. See id. at 228-35.
change in policy or personnel. For the reasons identified above, giving investors this power of review differs little from giving them the power to make management decisions in the first place. Even though investors probably would not micromanage portfolio corporations, vesting them with the power to review board decisions inevitably shifts some portion of the board's authority to them. This remains true even if only major decisions of A are reviewed by B.¹¹⁴

This is wrong. Corporate governance bylaws and expanded shareholder power in board elections would shift "some portion" of board authority to shareholders. But only some portion, not all. A very crucial distinction remains between shareholders and the board—crucial according to the logic of Bainbridge and Arrow. The board does not choose to micromanage every decision within the corporation. However, that is its choice. The board can, if it wants to, step in to direct any particular decision that it wants to review. That is not so for shareholders, even if the reform proposals were to pass. With increased voting power, shareholders can replace directors who sufficiently anger them. With the bylaw power, they can also set corporate rules of a certain type, namely those that determine procedures or corporate governance. Shareholders cannot, however, choose to intervene on most particular business decisions. That is not their choice—it lies beyond their legal power to do so, and that will continue to be so even if shareholders come to much more actively invoke their bylaw powers under existing law.

Consider one additional type of proposal for expanded shareholder decision-making power. Lucian Bebchuk has proposed that the United States emulate other countries and allow shareholders to amend the certificate of incorporation without board approval.¹¹⁵ This would extend shareholder power further than bylaws can go because charter amendments are not limited to procedural or corporate governance topics in the same way that bylaws are. The core statutory grant of authority to the board allows the certificate or articles to restrict that grant, without limitation on the ways in which the certificate can restrict board authority.¹¹⁶ I highly doubt that one would see charter amendments attempting to micromanage ordinary business decisions in large public corporations. In this case, however, as opposed to the case of board elections or bylaws, shareholders would, as a matter of law,

¹¹⁴Id. at 234. This repeats verbatim a passage in Voting Rights, supra note 1, at 626.
¹¹⁵Bebchuk, Increasing Shareholder Power, supra note 59, at 865-69.
¹¹⁶See DEL. CODE ANN. tit. 8, § 141(a) (2001); MODEL BUS. CORP. ACT § 8.01(b) (2007).
have the power to do so. This does seem to bring us closer to the Arrowian critique of a continuous power of review.

And yet, many advanced countries do allow shareholders to amend corporate charters without suffering catastrophic collapses of board authority.\textsuperscript{117} How can that be? Part of the answer to that question may be that the practical unlikelihood of shareholder action is more important than Bainbridge recognizes in the above quote. Boards can intervene in any particular management decision much more easily than thousands of dispersed shareholders. The practical limits on shareholder action may work to protect board authority as effectively as legal limits on shareholder authority to intervene.

In addition, the law in other countries does impose an important legal limit on the ability of shareholders to intervene through charter amendments. Other countries impose supermajority requirements, typically two-thirds or three-quarters, on shareholder charter amendments.\textsuperscript{118} This significantly increases the practical difficulty of shareholder intervention. Look at it this way: with a dispersed shareholder base, a unanimity requirement on shareholder charter amendments would be practically identical to forbidding such amendments entirely. Large supermajority requirements leave somewhat more room for shareholder action, but if the threshold is high enough, they effectively limit shareholders to the kind of intermittent review that safely passes the Arrow test. Thus, any jurisdiction that may consider Bebchuk’s proposal for shareholder power to amend charters should probably follow the practice of other countries and impose a supermajority requirement for such shareholder votes.

The other class of proposals for greater board accountability focuses on courts, not shareholders, as the reviewing body. The main judicial review of board decisions, at least at the state level, comes through the law of fiduciary duties. Here, there are many ongoing controversies as to whether current law, especially Delaware law, provides overly lax oversight, overly strict oversight, or gets it just about right. In chapter three of \textit{The New Corporate Governance}, Bainbridge focuses on two key elements of fiduciary law: the business judgment rule and Delaware’s law concerning takeover defenses.\textsuperscript{119} As to the business judgment rule, Bainbridge applies the

\textsuperscript{117} See Companies Act, 2006, c.46, §§ 21(1), 283 (U.K.); Aktiengesetz [AktG] [Stock Corporation Act], § 179, \textit{reprinted in} GERHARD WIRTH ET AL., CORPORATE LAW IN GERMANY § 179, at 377 (2004).


\textsuperscript{119} Bainbridge explored these points in earlier articles. \textit{See} Abstention Doctrine, supra note
Arrowian moment to argue that giving courts plenary power to review any sort of board decisions they choose, whenever they choose (more precisely, whenever a shareholder plaintiff asks them to review), would move one to point D in Figure 2.

I think that is a very strong point. If someone were to argue for eliminating the business judgment rule altogether, Bainbridge may have produced the best argument against doing so. I would be hard pressed to think, however, of anyone today who is taken at all seriously and is advocating a radical expansion of fiduciary duty law, such that courts would be continually second-guessing board decisions in a way that removes all board authority. The business judgment rule is well entrenched, and while there are scholars who suggest limiting its scope in some ways, I am aware of no serious attempt to do away with it completely.

Moreover, Bainbridge does not deny that some board decisions should receive judicial scrutiny. The key question then becomes: what sorts of board decisions should courts review? Traditionally courts have given heightened scrutiny to transactions where directors or officers have a material conflict of interest, and Bainbridge agrees with that. The main debate today occurs over whether any sort of heightened scrutiny should apply in situations beyond the traditional sorts of conflicts of interest. I myself have advocated using the idea of good faith to modestly increase judicial oversight of types of decisions where structural bias is a systematic problem.\footnote{1} Bainbridge opposes the expanded use of good faith, including a relatively rare disagreement with the Delaware courts.\footnote{2} Arrow will not help decide between Bainbridge's position and mine. Neither of us argues for a judicial power of plenary review. We both agree that strict judicial review should be limited to types of decisions that raise structural concerns about board impartiality. We just disagree about where to draw the line. Note that the situation here is the same as with the proposals for expanded shareholder power. Bainbridge's use of Arrow does a great job at explaining the limits of current debates. It does not help defend Bainbridge's particular preferred points within those debates.

It also bears noting that Bainbridge's strong defense of the business judgment rule in chapter 3 is in some tension with parts of his argument in

\footnote{1; Unocal at 20, supra note 1.}

\footnote{2} Briefly consider Bainbridge on the takeover case law below, see infra note 145-48 and accompanying text.


\footnote{4} Good Faith, supra note 1, at 584-85.
chapter four. Chapter four looks at important developments in recent decades that have moved us from managerialism to board primacy. Delaware judicial decisions play a large part in that story. These decisions are not completely irreconcilable with the presumption in favor of authority—the presumption, after all, is not supposed to be irrebuttable (though at times it may seem that way). Those who favor a strong business judgment rule, however, should be uneasy with the developments that Bainbridge describes in chapter four—Chancellor Allen makes that very point in a recent article. Yet, Bainbridge describes these cases in positive terms, as helping to bring his great idea, director primacy, into being.

In sum, the Arrowian moment on its own does not succeed as a critique of existing proposals for greater accountability through expanded shareholder power. Arrow does support Bainbridge in arguing that authority matters and that authority has many good qualities. Arrow also supports Bainbridge in arguing that ultimately there is a trade-off between authority and accountability, and policies that go too far in seeking accountability will undermine authority altogether. This is not enough, however, to criticize actual proposals today for greater accountability of boards to shareholders. The battle today is in the middle ground. In this middle ground, Arrow simply tells us that both authority and accountability have value, and we should reject policies that completely subordinate one to the other. It may well be that Bainbridge's theory explains why debate now occurs within this middle ground (i.e., why serious critics do not advocate proposals that would completely undermine board authority). That is an important contribution. It does not help Bainbridge, however, when he goes on to argue for particular positions within this contested middle ground.

Indeed, if anything, Arrow's argument, properly understood, calls Bainbridge's own positions into doubt. While Bainbridge does affirm that accountability matters, when push comes to shove, he virtually always favors

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125 I shall return later to the tension between chapter 4 and the rest of the book, see infra notes 190-92 and accompanying text. I have already discussed an instance of this. See supra notes 85-87 and accompanying text.
authority. He thus risks moving to a position like point E, where one maximizes authority but loses all accountability. Point E is no more in keeping with Arrow than point D. One page after the sentences that Bainbridge so loves to quote, in the very final paragraph of his wonderful book, Arrow says, "[T]he unthinking acceptance of authority based on echoes from religion and kingship is, I believe, gone." I have not seen Professor Bainbridge quote that one.

B. Board Dynamics

At one point early in The New Corporate Governance, Bainbridge seems to acknowledge, to a degree, the limitation of his core argument. He writes that "[t]o say that such proposals would shift authority from directors to shareholders is more of a description than an argument." Bainbridge also says that he "acknowledge[s] that the argument to this point rarely will prove dispositive." How does he reply to this? In part, he rather unhelpfully asserts that the argument does show enough value to authority to justify a presumption in its favor, which we have seen is really not so. He also says, however, that other sorts of arguments will also be needed, and used in the book, to defend the presumption favoring authority. We must now, then, turn to those other arguments.

Scattered through The New Corporate Governance and the director primacy articles are a variety of other arguments for privileging authority over accountability. These arguments are far less distinctively Bainbridgean than the Arrowian moment. He draws on standard law and economics arguments that many corporate law scholars before him have used. Still, a full understanding and critique of his arguments for director primacy requires consideration of these more standard points. I shall consider the main points that Bainbridge uses, and respond to each with the standard replies that many corporate law scholars before me have used. There are a few twists along the way, though.

126 See supra p. 160 fig.2.
127 ARROW, supra note 9, at 79.
128 It is unfair to covertly imply that Bainbridge's acceptance of authority is unthinking—that, it is certainly not. However, "echoes from religion and kingship" does, I believe, accurately capture a real strand of the Burkean Bainbridge. Not that this is a bad thing—I think deep values other than efficiency should be a greater part of our debate over corporate law. See infra notes 211-12 and accompanying text.
129 BAINBRIDGE, supra note 8, at 12.
130 Id.
Perhaps the most distinctive further set of arguments that Bainbridge focuses on are the dynamics within the board itself. Recall that in chapter two of *The New Corporate Governance*, Bainbridge argues that a group, rather than a person, sits at the top of the corporate hierarchy in good part because a group is likely to engage in better monitoring of subordinates and also in self-monitoring. Chapter four describes a variety of developments in recent decades that have increased the monitoring role of the board. I particularly like Bainbridge's emphasis on the role of norms in guiding board behavior.

On Bainbridge's own account, however, we do not simply leave it to the directors themselves to develop and enforce their norms as they see fit. Far from it. A variety of governmental and quasi-governmental institutions work to help shape those norms. Institutions like the Delaware courts, the stock exchanges, and the Securities and Exchange Commission (SEC) are effective in helping shape norms and best practices. This is in part because they are focal-point actors, so that their articulations of best behavior in various circumstances will be followed closely by board advisors, particularly lawyers, and thereby conveyed to the directors themselves. Moreover, even a small probability of legal liability will help focus the mind. Relatedly, even where subpar behavior does not ultimately give rise to liability, it may lead to lengthy cases before final victory for defendants, victory which would have come much quicker with better behavior. The *Disney* case is a good example.

Governmental and quasi-governmental actors play a big role in many of the developments in board behavior that Bainbridge surveys in chapter four. Delaware courts have helped shape norms and encourage director independence. Congress and the SEC have pushed for stronger board independence in Sarbanes-Oxley and the rules implementing it. The stock exchanges have pushed for board independence even more strongly with their corporate governance rules, and those exchanges are nominally private entities that the SEC strongly oversees and tends to push in its preferred directions. Bainbridge also sees modern board compensation

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131 See *supra* notes 83-85 and accompanying text.
132 See *supra* note 8, at 101-04, 163-67.
133 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006). See also *Disney, Good Faith, and Structural Bias, supra* note 121 (discussing the lengthy shareholder suit over Michael Ovitz's severance package).
134 See *supra* note 8, at 172-76.
135 *Id.* at 176-77.
136 *Id.* at 177-87.
137 Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State
practices as encouraging more vigorous boards. Even if one accepts this, it is worth pointing out that a major impetus for the move to stock-based compensation was the Congressional enactment of Internal Revenue Code section 162(m). Thus, although internal board dynamics and norms are indeed an important part of achieving accountability, that does not necessarily mean that outside regulators should take a hands-off approach and always defer to board authority. Indeed, Bainbridge's own account shows that achieving better functioning boards requires outside regulators to step in to encourage greater accountability.

C. Market Accountability

One common argument is that shareholders require little in the way of legal accountability mechanisms because they already have effective, nonlegal, market-based accountability mechanisms. These market mechanisms include labor markets, product markets, the market for corporate control, executive compensation contracts, and capital markets. These mechanisms all provide some accountability. They are also all highly imperfect. The question is whether individually, or in combination, they work well enough that little legal intervention is required to protect shareholders, or if instead, these markets are so deeply imperfect that there is much room for legal intervention.

Executive labor markets, both internal and external, provide some limits on managerial misbehavior. Managers who do a good job are more likely to get promoted internally or hired for higher-paying positions elsewhere. On the other hand, there are important limits to labor markets. It is often very hard to disentangle the contributions of individual managers to firm success, and problems arising from one manager's actions may not appear until that person has gone on elsewhere. For older managers, especially CEOs, there is an end game problem—they are tempted to cheat.


\(^{138}\) A point that some vigorously debate. See infra notes 143-53 and accompanying text.

\(^{139}\) I.R.C. § 162(m) (2008). See also BEBCHUK & FRIED, supra note 1, at 72 (discussing the purpose behind the enactment of I.R.C. § 162(m)).

\(^{140}\) Bainbridge makes elements of these arguments in a variety of places. See BAINBRIDGE, supra note 2, at 206; BAINBRIDGE, supra note 8, at 55, 112, 123, 151-52, 197-98. See also Abstention Doctrine, supra note 1, at 122; Primacy in Takeovers, supra note 1, at 806; Shareholder Disempowerment, supra note 1, at 1737-41; Director Primacy, supra note 1, at 562, 568 n.103. This argument has a long history in economics-influenced corporate law scholarship. See EASTERBROOK & FISCHEL, supra note 36, at 4-6; ROMANO, supra note 55, at 14-15.

and cash in with their current job because they do not have many years left in any case, and hence their reputation matters less to them.\footnote{142}{See Eric Talley, \textit{Taking the "I" out of "Team": Intra-Firm Monitoring and the Content of Fiduciary Duties}, 24 J. CORP. L. 1001, 1029 (1999).}

Product markets impose further constraints on corporate governance. A poorly run firm will not be able to produce high quality goods or services at a low price and will find its market share shrinking. Eventually, bankruptcy may ensue and the managers will lose their jobs. For well-established companies, however, this is a quite lax constraint—it takes many years of seriously bad performance to affect the existence of a poorly run business.\footnote{143}{See Brett H. McDonnell & Daniel A. Farber, \textit{Are Efficient Antitrust Rules Always Optimal?}, 48 ANTITRUST BULL. 807, 817 (2003).}

At least since Henry Manne, those who believe markets do a good job of constraining managers have frequently pointed to the market for corporate control.\footnote{144}{See Henry G. Manne, \textit{Mergers and the Market for Corporate Control}, 73 J. POL. ECON. 110, 112 (1965).} If managers do a bad job, the firm's stock price will decline so that eventually it will become vulnerable to a hostile takeover. This stops bad performance in two ways. Most directly, bad performers get removed in takeovers. More indirectly, the fear of this keeps managers from doing too bad a job.

The market for corporate control, however, has inherent limits and it has become increasingly weak in recent years. Hostile takeovers occur only for companies that underperform quite badly—there is plenty of room to do a moderately bad job without facing a threat. Worse still, states have allowed companies to develop a variety of antitakeover defenses that make genuinely hostile takeovers almost impossible today in most companies.\footnote{145}{See ROMANO, supra note 55, at 54-57.} Even where control of an underperforming company does change and bad managers get removed, at least for the top executives this will happen only if they have managed to arrange very cushy golden parachutes for themselves. Thus, the threat of a takeover has lost its sting for those at the top.\footnote{146}{See generally Lucian Arye Bebchuk et al., \textit{The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy}, 55 STAN. L. REV. 887 (2002) (discussing the success of the combination of staggered boards and poison pills in preventing hostile takeovers).} Interestingly, Bainbridge supports the law in allowing antitakeover defenses on director primacy grounds.\footnote{147}{BAINBRIDGE, supra note 2, at 718-38; BAINBRIDGE, supra note 8, at 136-53; \textit{Primacy in Takeovers}, supra note 1, at 807-09; Unocal at 20, supra note 1 (discussing the balance between boards' discretionary authority and director accountability, and arguing the Delaware Supreme Court appropriately balanced director authority and accountability by providing a mechanism to evaluate...
with the way this undermines one of the leading market accountability mechanisms. Or rather, at several points he basically gives up the ghost on this point and admits that takeovers are not the key disciplinary limit on corporate managers—instead, he claims, the board is.148

Properly designed compensation contracts can give managers good incentives to look after shareholder interests.149 Poorly designed compensation contracts, however, can divert resources to managers and give them poor incentives; and, in a poorly run company, the managers often get to set their own contracts through their domination of the board. There is, of course, much debate currently over this topic. Bebchuk and Fried have vigorously argued that managerial power explains much executive compensation in the United States today.150 Bainbridge disputes this.151 Part of his argument points to conflicting empirical evidence and theoretical arguments, and makes the true, but hardly dispositive, point that Bebchuk and Fried's hypothesis is "often plausible but contestable."152 Bainbridge has not done the hard and lengthy work of disentangling the various conflicting theoretical arguments and empirical evidence153—one must look elsewhere for this. Bainbridge also argues, in a review of Bebchuk and Fried, that executives are probably more motivated by self-esteem and reputation than incentive compensation.154 Perhaps, but if so then this particular strand in the web of accountability mechanisms that anti-interventionist scholars generally cite is of little value.

Informationally efficient capital markets also help constrain managers on their own and in conjunction with some of the above mechanisms.155 Firms that do well will have higher stock prices. This makes it easier for them to raise money and expand. It also makes stock-based compensation mechanisms work better and underlies the working of the market for corporate control. Bainbridge simply asserts or assumes the relative efficiency of

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148 BAINBRIDGE, supra note 8, at 151; Unocal at 20, supra note 1, at 826.
149 Michael C. Jensen & Kevin J. Murphy, Performance Pay and Top-Management Incentives, 98 J. POL. ECON. 225 (1990) (analyzing the different incentive mechanisms for improving performance).
150 BEBCHUK & FRIED, supra note 1, at 61-64.
151 BAINBRIDGE, supra note 8, at 167-70; Executive Compensation, supra note 1, at 1626-43.
152 Executive Compensation, supra note 1, at 1629.
153 Of course, neither have I.
154 Executive Compensation, supra note 1, at 1632.
capital markets and never seriously comes to grips with the major challenges to the efficient capital market hypothesis that have arisen in recent years.\textsuperscript{156}

Much more could be said on the hard empirical questions that arise in assessing how well these various market mechanisms function to maintain managerial accountability, both individually and in combination with each other. The empirical evidence is mixed and controversial. Further exploration, however, is not necessary here because, in truth, Bainbridge does not put much heart into this line of argument.\textsuperscript{157} He occasionally makes the standard law and economics case for these sorts of market mechanisms, but in no detail at all. It is really more of a toss-off point for him, not a central part of his defense of board authority.

D. State Law and the Race to the Top

A common economic argument for the efficiency of Delaware law is the race-to-the-top thesis.\textsuperscript{158} According to this, corporations have incentives to offer efficient corporate governance structures because investors will pay less to invest in companies which are subject to theft by their managers. In turn, states have an incentive to offer good corporate laws because shareholders will pay more to invest in companies governed by good laws, and managers will want to incorporate in good states. In most of his work, Bainbridge has not actually relied much on this sort of argument. He makes glancing reference to it at several points in \textit{The New Corporate Governance}.\textsuperscript{159} In a recent reply to Lucian Bebchuk's work on increasing shareholder power, however, Bainbridge uses this line of argument at some length in a section refreshingly entitled "Hail Pangloss"\textsuperscript{160}

But Pangloss has a bad reputation for a reason, and Bainbridge does not go into this debate in enough detail to shift longstanding battle lines. Bainbridge points to some empirical evidence in favor of efficient state competition\textsuperscript{161} but does not confront the counterevidence.\textsuperscript{162} He assumes

\textsuperscript{156}\textit{BAINBRIDGE, supra note 8, at 57; Shareholder Disempowerment, supra note 1, at 1737. For extensive discussion of challenges to the theory of informationally efficient capital markets and the rise of the field of behavioral finance, see ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000). Dent's critique of director primacy also emphasizes this point. See Dent, \textit{supra} note 82, at 1225-26.}

\textsuperscript{157}\textit{See \textit{supra} note 140.}


\textsuperscript{159}\textit{BAINBRIDGE, \textit{supra} note 8, at 35-36, 155.}

\textsuperscript{160}\textit{Shareholder Disempowerment, \textit{supra} note 1, at 1736-44. He makes the same assumption in his new book. BAINBRIDGE, \textit{supra} note 8, at 144-45, 227.}

\textsuperscript{161}\textit{Shareholder Disempowerment, \textit{supra} note 1, at 1742-43.}
with little argument that investors in initial public offerings (IPOs) will accurately price the likely effects of corporate governance mechanisms.\textsuperscript{163} There is now much debate, however, over the accuracy of pricing in IPOs in general, and for this type of feature in particular. In part, this is just an implication of the broader debate over capital market efficiency. Even if secondary markets for established companies are relatively efficient, however, it is far from clear that IPO markets are also efficient—they are subject to much greater informational problems and there is well-known evidence that IPO prices are not well behaved.\textsuperscript{164}

Elsewhere I have explored the race-to-the-top debate in much further detail.\textsuperscript{165} I argue for an intermediate position. Competition between states does provide for experimentation and flexibility. The control of managers over the incorporation decision, however, also tends to make Delaware law overly biased in favor of managers. U.S. law partially protects against this managerial bias through the threat, and occasional reality, of federal securities law occupation of part of the field in corporate governance. The world is not all doom, but it is not the best of all possible worlds either. At any rate, Bainbridge does not advance the ball much in this area, aside from the wonderfully honest section title.

E. Special Interest Shareholders

In some of his most recent director primacy articles, Bainbridge added a new argument against expanded shareholder power.\textsuperscript{166} This argument is now a central part of his case in chapter five of \textit{The New Corporate Governance} against proposals for greater shareholder power. Throughout the whole director primacy series, he has been skeptical about the likelihood of shareholder activism occurring very often because of the standard reasons related to collective action problems and the ease of shareholder exit (the "Wall Street rule").\textsuperscript{167} That argument suggests that shareholder activism

\textsuperscript{162}See Lucian Bebchuk et al., \textit{Does the Evidence Favor State Competition in Corporate Law?}, 90 CAL. L. REV. 1775 (2002).

\textsuperscript{163}Shareholder Disempowerment, supra note 1, at 1737.


\textsuperscript{166}See Voting Rights, supra note 1, at 629-35; Shareholder Disempowerment, supra note 1, at 1751-57.

\textsuperscript{167}See \textit{BAINBRIDGE}, supra note 2, at 515; \textit{BAINBRIDGE}, supra note 8, at 202-09; \textit{Director Primacy}, supra note 1, at 571-72.
would not create many benefits, but also that its costs would not be terribly high.

More recently, though, shareholder activism has become more common and more effective. Corporate governance proposals now frequently receive votes in the thirty and forty percent range, and occasionally pass. In response, Bainbridge now adds a rather different point. The institutional investors most likely to engage in shareholder activism are union and public employee pension funds. These investors, though, may be self-dealing, pursuing the interests of their managers or their beneficiaries where those interests conflict with those of other shareholders. Indeed, there is some empirical evidence, both anecdotal and econometric, that this happens.

But should this concern us as much as it does Bainbridge? It is certainly of less concern, and indeed a reason to approve of such activism, for those who, like me, take a stakeholder approach to the question of the proper goal of the corporation. The nonshareholder constituency with the strongest claim to a place in the corporate objective function is its employees. Insofar as union pension funds are trying to advance the interests of employees, that would be a good thing. Public employee pension funds, too, may show concern for a corporation's employees. They may also be interested in a variety of other issues that concern the general public, e.g., environmental issues. Of course, those who control such public pension funds are themselves subject to serious agency problems. So long as they are ultimately to some degree accountable to a plausible version of the public interest, however, they should still tend to be a force for the good. Obviously, the topic of the proper objective function for corporations is highly debated, and I do not intend to go any further into that debate here.

Even accepting Bainbridge's premise of an objective of maximizing shareholder value, shareholder activism by union and public employee pension funds may still be a good thing. Bebchuk argues that union or public employee fund proposals can succeed only if they receive a majority

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169 See BAINBRIDGE, supra note 8, at 228-32; Voting Rights, supra note 1, at 634-35 n.88; Shareholder Disempowerment, supra note 1, at 1754-55.
171 See McDonnell, supra note 32 (arguing for employee primacy in corporate governance).
Thus, they must get nonspecial interest shareholders to agree with them. Therefore, only proposals that benefit all (nonmanagement) shareholders are likely to succeed.

Bainbridge has several responses to this counterargument. First, he argues that risk averse managers may give in to blackmail by fund managers even if the corporate managers would probably win if the blackmailers actually brought their proposal to a vote. But managerial risk aversion may also have good effects. Many value-increasing proposals are probably unlikely to succeed because of the standard collective action problems. Managerial risk aversion may cause boards to nonetheless make good, value-increasing responses to such positive-but-unlikely-to-succeed measures. It is then a tough empirical question whether managerial risk aversion magnifies value-decreasing or value-increasing proposals more.

Second, Bainbridge raises the possibility of special interest funds proposing value-increasing proposals, but then dropping them for private benefits. This could happen, but it seems a bit of a stretch to think that it is likely to be a problem of first-order significance. Moreover, even when it does happen, the initial threat may signal to other potential shareholder activists the potential for a value-increasing proposal, which they may then pursue. The net effects of shareholder activism may in such cases still be positive.

A third response that Bainbridge makes to Bebchuk's argument on the need for majority approval is that special interest funds may bundle value-increasing and value-decreasing proposals in order to further the latter. This, however, seems likely to succeed in getting votes only where the net effect is value increasing—presumably a good outcome, on balance. Bainbridge also suggests that pension funds may offer side payments to other shareholders to ensure passage. But two can play that game—corporate managers can do the same, using corporate funds. A basic Coasean argument suggests that the net result of this gaming should be that only proposals that increase value on balance will succeed.

Furthermore, although Bainbridge is right in that sometimes the interests of union or public employee pension funds will diverge from the interests of other shareholders, often their interests will not conflict. Their

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172 See Bebchuk, Increasing Shareholder Power, supra note 59, at 885.
173 Bainbridge, supra note 8, at 231; Shareholder Disempowerment, supra note 1, at 1756.
174 See supra note 173.
175 Bainbridge, supra note 8, at 232; Shareholder Disempowerment, supra note 1, at 1756.
176 Bainbridge, supra note 8, at 232; Shareholder Disempowerment, supra note 1, at 1756-57.
proposals are more likely to succeed where their interests converge with those of other shareholders. With the types of shareholder proposals that currently receive a substantial percentage of shareholder votes (more than, say, five percent), it certainly appears that there is no good reason to see a divergence of interests. In the 2007 proxy proposal season, the types of proposals that were most common and received the highest percentage of votes were those calling for majority voting, advisory votes on compensation, board declassification, pay for performance, independent board chairs, and rescinding supermajority requirements. It is hard to paint these proposals as leaning heavily to special shareholder interests, although the executive compensation proposals probably have some redistributive political kick to them.

Indeed, the fact that the managers of union and public employee pension funds are less constrained to maximize the monetary return to their beneficiaries than are the managers of other sorts of funds may well serve to help the interests of shareholders as a group. The free rider problem keeps other sorts of fund managers from pursuing activist proposals because their funds will not reap the full benefits of their activism. Union and public fund managers may be able to avoid this free rider problem precisely because they are less tied to a goal of maximizing financial return for their beneficiaries. One agency problem may thus help solve a different agency problem.

Finally, in *The New Corporate Governance*, Bainbridge has for the first time (as far as I can determine) addressed the question of a different sort of shareholder activist. Some hedge funds are now getting more involved in some types of shareholder activism. These do not pose the same special interest concerns as do union and public pension funds—although they may pose different special interest concerns. Corporate governance scholars will grapple with the promises and perils posed by this new kind of actor. Bainbridge begins to do so in the new book. He argues that the evidence to date suggests that where hedge funds have succeeded in increasing shareholder value, they have done so by creating or encouraging change in control transactions, not through corporate governance activism.

This conclusion about the empirical effects of hedge fund activism is convenient for Bainbridge’s position, but he jumps to it too quickly. Hedge fund activism is new, and we are just starting to study and understand it. In reaching his conclusion, Bainbridge mainly relies on one unpublished

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177See *RiskMetrics Group*, supra note 168, at 6.
179BAINBRIDGE, supra note 8, at 205-07.
study. Other recent studies, however, suggest that hedge funds are achieving positive gains through broader forms of activism than Bainbridge argues for, including activism focused on corporate governance. It will take time to sort this out, and presumably hedge fund activism will continue to evolve. My reading of the evidence to date, however, suggests this new development represents more of a threat to the director primacy model than Bainbridge allows.

F. The Burkean Argument

Another sort of argument occasionally appears in the director primacy series, an argument that actually goes back to an older work by Bainbridge. Bainbridge is a Burkean conservative, and hence he is prone to make evolutionary, survival-based arguments in favor of the board-centric status quo. This existing system has been around for a while, and it has served us well. We should, therefore, be reluctant to change it.

There is something to this sort of argument. Large corporations have long been a central part of the U.S. economy, and that economy has generated a standard of living never before achieved in human history. One should be careful before tinkering with this system too radically.

But what precisely is it that has survived for so long and performed so well? What features are essential, and what can we safely tinker with? Here is where the Burkean argument falters. At some points, Bainbridge characterizes the object of his solicitude quite broadly as the separation of ownership and control. This goes back quite far—at least as far back as Berle and Means, and Bainbridge argues back even further, to the nineteenth century origins of American big business. Perhaps so, but the board primacy model, which Bainbridge defends, does not go back so far. Although corporate law has put legal authority in the hands of the board for
many decades, one does not have to go terribly far back to find a system where inside officers, led by the CEO, dominated the corporation, not the board. This is still the case for many corporations.

Indeed, elsewhere Bainbridge makes this point himself. He is at pains to distinguish managerialism from board primacy. He admits that once inside managers dominated U.S. corporations. He argues, however, that in the last few decades many developments have led to more active oversight and control by boards. These developments include stock-based compensation, the market for corporate control, more active shareholder litigation, and stock market rules concerning corporate governance. In The New Corporate Governance, he devotes a whole chapter to defending this point.

One may question whether these measures have yet led to a real escape from managerialism. Let us, however, concede this point to Bainbridge. The fact remains that Bainbridge's model of the large public corporation, as an actual depiction of reality, is at best a recent achievement. Moreover, that model is constantly evolving. Stock-based compensation came on strong in the 1980s and 1990s. The market for corporate control became really important only in the 1970s and 1980s and has since waned. Shareholder litigation has grown gradually over time. Stock market rules have come in several waves, some only quite recent. Sarbanes-Oxley is another recent development that pushes some of these trends further.

Bainbridge thus faces a variant of the problem that plagues American Burkeans generally. How does one use tradition to defend a social, economic, and legal system which has as a central, defining feature constant, sometimes dramatic, change? Board primacy, if indeed it does exist, does so only because of an ongoing series of reforms that strive to make managers more accountable to the board. On what principle do we suddenly decide that enough is enough and cut off that evolution?

The last point suggests further that one can dispute Bainbridge's characterization of the many changes in recent decades. He sees them as increasing board authority vis-à-vis managerial authority. One, however, can also characterize them as movements towards greater accountability and away from unaccountable authority. As such, they are in real tension with

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186 Shareholder Disempowerment, supra note 1, at 1741; Director Primacy, supra note 1, at 562-63.
187 BAINBRIDGE, supra note 8, at 155-200.
188 Dent's critique of director primacy also notes that our system of corporate governance continues to evolve and seems to be moving away from director primacy. See Dent, supra note 82, at 1264-73.
Bainbridge's presumption in favor of authority over accountability. We have already seen that Bainbridge acknowledges that the move towards outsider-dominated boards does not fit well with Arrow's basic account of consensus and authority. We have also seen that his chapter four account of Delaware case law does not fit particularly well with his chapter three defense of the business judgment rule. Another instance of the tension comes in his account of the post-Enron stock exchange corporate governance rules. In *The New Corporate Governance*, he paints these rules as pressing for a stronger board, hence as increasing board primacy, which would appear to be a good thing for him. Yet, when the rules were first proposed, Bainbridge critiqued them as contradicted by the empirical evidence and as part of an undesirable trend of creeping federalization in corporate law. Of course, a scholar always reserves the right to change his mind and doing so reveals the virtue of open-mindedness. On balance, however, it seems to me that Bainbridge's original position is more in keeping with his overall theory. In his new book, Bainbridge does consider at some length the evidence on independent director performance, which he previously used to attack the new exchange rules. He admits that the empirical evidence is mixed and says that a one-size-fits-all rule does not fit all corporations. Yet, his bottom line conclusion is that the modern trends in board behavior, including the growth of independent directors, have led to stronger, more effective boards.

One variant of the Burkean argument is that we have recently engaged in quite a big burst of change—Sarbanes-Oxley, the stock market corporate governance rules, emerging case law on good faith, and so on. Since these will have uncertain effects which we are still learning, let us give them time before moving on to other new big changes. This strikes me as plausible, albeit not dispositive. But, as always, there are counter-considerations. For one, it is almost always worthwhile to at least put out decent reform proposals for discussion. Even if the time is not ripe, practically or politically, for their adoption, they will then be out there when the next

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189 See supra notes 86-87.  
190 See supra notes 123-25 and accompanying text.  
191 Bainbridge, supra note 8, at 177-87.  
193 Bainbridge, supra note 8, at 187-98.  
194 Id. at 197-98.  
195 Id. at 198-200.  
196 See Voting Rights, supra note 1, at 636.
scandal or crisis hits. That is the way most reforms develop—many provisions of Sarbanes-Oxley are examples.

Moreover, it is possible that further reform is politically achievable in the next few years. Change in the system for electing directors seems the most promising area currently for significant reform. Should Bainbridge's Burkean caution scare us off from this sort of change right now, so soon after Sarbanes-Oxley and related developments? I do not think so. Really significant reform in corporate governance does not come terribly often for powerful political reasons—people with great clout are hurt by such reform, and usually they can block it. It takes a moment of significant scandal or crisis to make big change possible. We may still be in such a moment in the aftermath of the bursting of the dotcom bubble, Enron, and the like. Reformers should take what the system will give them when they can—there is no telling when the next chance will come. If this moment turns out to have passed, these reform ideas will then be out there for the next moment. I return to these points in the next section.

Sometimes Bainbridge's Burkean/survivalist argument takes on a comparative edge: the U.S. economy has done well relative to other countries, and our corporate governance system is part of that success. Hence, we should be wary of change. In The New Corporate Governance and several recent articles he makes this point using the following quote from Bengt Holmstrom and Steven Kaplan:

Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. U.S. productivity gains in the past decade have been exceptional, and the U.S. stock market has consistently outperformed other world indices over the last two decades, including the period since the scandals broke. In other words, the broad evidence is not consistent with a failed U.S. system. If anything, it suggests a system that is well above average.\(^\text{197}\)

There are several problems with this sort of argument. For one, it is cyclical. Back in the 1980s and early 1990s, it was Japanese and German

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corporate governance that people looked to, as those countries grew rapidly. In the later 1990s, U.S. triumphalism became common. Today, all three countries' systems look rather suspect.198

A second problem with this comparative argument is that it ignores many elements, besides corporate governance, that help explain the macro-economic performance of economies. The link between corporate governance and economic growth is tenuous.199 Did the United States outperform Japan and Germany in the nineties because of its corporate governance system? Or, was it due to wiser monetary policy, better fiscal policy, more favorable demographics, a more flexible labor market, a leaner welfare system, or a host of other possible factors that are plausibly relevant?

I should note that at this point Bainbridge is unwilling to push the implicit U.S. triumphalism of the Holmstrom and Kaplan quote very far at all. Indeed, in the introduction to The New Corporate Governance, he stresses that his analysis "focuses exclusively on corporate governance in the United States."200 He says it may be that director primacy is not "optimal in an absolute sense, but only relative to the set of possibilities defined by our legal system."201

Despite that disclaimer, it would be interesting to see Bainbridge pay much closer attention to comparative corporate governance in future work. Some of the key rules favoring director primacy that he points to in American, and especially Delaware, corporate law do not exist in other countries. In many advanced countries, shareholders can amend the corporate charter on their own; mergers require shareholder, but not board, approval.202 Boards face greater legal restrictions in opposing hostile takeovers.203 Shareholders can more easily nominate directors. A leading example of such a jurisdiction is the United Kingdom, which otherwise resembles the United States more so than most other countries. Yet somehow despite these big gaps in board primacy, British companies seem to do pretty well for themselves. If Bainbridge's core arguments were correct, it is hard to see how that could be so. Another problem is that the relative success of the American system, if true at all, may be due more to

199See id. at 360.
200BAINBRIDGE, supra note 8, at 13.
201Id.
203See id. at 164-68.
our federal securities law than to state corporate law, and Bainbridge tends to be more skeptical of federal than state law. I would like to see how he explains corporate law outside the United States—it poses a real challenge to his theory.

Let us pause to see where Bainbridge's arguments have taken us. He has given us a strong account of the role of fiat authority within large public corporations. He has also helped explain why a group, rather than an individual, stands at the apex of the corporation's authority relationships. He has also, however, presented us with a puzzle as he first grants the importance of balancing authority and accountability, but then almost immediately moves to arguing that we should almost always favor the former over the latter, unless powerful arguments counsel otherwise in particular cases.

We have searched for how Bainbridge justifies this move from recognizing two competing virtues to his stance of almost always siding with one virtue over the other. We now see that the search has been in vain. Bainbridge's most distinctive and characteristic argument is what I have called the Arrowian moment. Arrow, however, only takes us as far as recognizing the existence of the authority/accountability trade-off. He does not tell us how to make the trade-off. Bainbridge can only invoke Arrow in making this choice by implicitly painting his opponents as proposing an extreme position in which all board authority is lost. In real life today, though, we do not face that choice.

Bainbridge tries to buttress his position with a variety of more traditional arguments: the dynamics of boards themselves, the wonders of markets, the race to the top in corporate law, the evils of special interest institutional investors, and the evolutionary advantages of sticking with a proven status quo. None of his arguments in these areas succeed in bringing us out of the point/counterpoint battles of decades of corporate law scholarship. Each of these arguments gives us some reason to believe that the Delaware and United States status quo deserves some respect, but for each there are also good reasons to believe that the status quo could be usefully changed.

The leading body of work on comparative corporate and securities law suggests that vigorous protection of shareholders tends to lead to more successful securities markets. For a recent summary of that work by three of the leading researchers, see Rafael La Porta et al., The Economic Consequences of Legal Origins, 46 J. ECON. LITERATURE 285 (2008).

Bainbridge has made a brief foray into the comparative corporate law thicket in Stephen M. Bainbridge, Director v. Shareholder Primacy in the Convergence Debate, 16 TRANSNAT'L L. 45 (2002). In that piece, however, he pays little attention to the systems of other countries, and the non-U.S. jurisdiction that he does discuss as a case study is Slovenia, not exactly one of the leading alternatives to the United States. Id. at 53-55.
A final dynamic to note is the interaction of all the various accountability mechanisms that Bainbridge discusses. Even though each of them is flawed in the various ways considered above, they all do, to some degree, help make boards more accountable. Furthermore, successful accountability does not depend on any one of the mechanisms alone. They are all in play. Thus, even if one accepts my critique of each of the particular accountability mechanisms described above, perhaps the net effect of all of them combined works to constrain boards pretty well, and hence there is no need to move in the direction of greater accountability.

Perhaps, but there is no real reason to believe that is true. Maybe the mechanisms collectively currently achieve the optimal level of accountability, but is there any affirmative reason to believe this is true? Have they reached the optimal level by luck? That is an implausible story. To make this final argument work, one would have to show some mechanism whereby the corporate governance system as a whole, in all its complexity and various elements, was guided to the optimal level of authority and accountability. The most obvious place to look for such a mechanism is an efficient market story, but we have considered that above and found that Bainbridge does not adequately explore the arguments for and against market efficiency, and there are plenty of arguments against. Is there any other sort of mechanism that pushes all of the above factors collectively to an optimal level of accountability? I cannot think of one, and Bainbridge does not present us with anything beyond the arguments already considered above. Indeed, the evolutionary story he tells involves plenty of regulatory interventions favoring increased accountability, and it seems quite likely that further interventions like that will be called for in the future.

V. FOR MORE ACCOUNTABILITY AND LESS AUTHORITY

Where does that leave us? It may not have escaped the reader's notice that I tend to favor a legal balance tilted more to accountability and less to authority than Professor Bainbridge advocates. If you accept my arguments so far, they will have convinced you that he has not succeeded in making a strong case for the desirability of director primacy. Since this is the best existing defense of that system, which essentially characterizes actual American practice, this is of note.

That, however, does not provide a set of affirmative arguments for reforms that would create more accountability for corporate directors. If accepted, I have helped undermine some of the best arguments against such reforms, but serious change should have some affirmative reasons in its
favor. Does anything observed so far point the way to such affirmative reasons?

Bainbridge, following Arrow, provides a starting point. They are right—there is indeed a trade-off between authority and accountability, and both matter. Any corporate governance system that moves to an extreme of no authority or no accountability is likely to experience serious problems. Moreover, Bainbridge is right that the U.S. system has moved awfully far in the direction of favoring authority over accountability—far enough that we should worry about nearing the vicinity of point E in Figure 2, where we have all authority and no accountability. That is not a good place to be.

The arguments above in rebuttal of Bainbridge help push this point further. Do the internal dynamics of boards themselves succeed in adequate self-regulation, so that government regulators and shareholders need to do nothing? Even on Bainbridge's own account, outside regulators have a serious role to play in encouraging better internal board dynamics. Do market accountability mechanisms make legal accountability devices unnecessary? We have seen that there are serious problems in each of the relevant markets. Does state competition help reassure us that state law will reach an optimal balance? There are good reasons to doubt that. The growth of institutional investor activism provides some hope that there will be shareholders who can and will exercise greater power if such is granted to them. Our current system has indeed served us pretty well in some basic sense, but that is, in part, precisely because it has been open to constant evolution over time, evolution often guided by a need to create more accountability. With the memory of some of the greatest scandals in the history of corporate governance still quite fresh, now does not seem like a natural time to cut off this evolution in its tracks and stand pat.

I admit, however, that each of these points has counterpoints. How do we work our way out of this situation to a sensible evaluation of the proper balance between authority and accountability? One possible place to look is for a more detailed empirical study of the effects of different legal rules, including a comparative analysis across different countries. Although, traditionally, law and economics scholarship has been light on such empirical work, that has changed in recent years. Perhaps more, and

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206 See supra notes 141-56 and accompanying text.
207 See supra notes 162-65 and accompanying text.
208 See supra notes 168-78 and accompanying text.
209 See supra notes 184-203 and accompanying text.
better, empirical scholarship will help us put rough figures to the costs and benefits of different rules, and figure out which changes make sense and which ones do not.

Perhaps. It cannot hurt, and it will probably do some good. Serious empirical research in corporate law scholarship is welcome and past due. I do think that contemporary empiricists probably focus too much on econometric methodology—there are other ways of doing interesting and worthwhile empirical research, and we should also see more of those techniques. That quibble aside, more empirical research is clearly a part of the way forward.

Yet, I doubt that even vastly expanded empirical research is going to settle this debate. It will give us a clearer view of the effects of corporate law and help refine arguments on various sides. However, each side in the great debate between authority and accountability will find compelling empirical evidence for its preferred policies, which does not mean such research is not worth doing. It is unrealistic to expect any sort of academic writing to definitively settle this sort of dispute.

Part of the reason for the unending nature of this dispute is that it is not just a debate over what set of policies will maximize net corporate output. Other great and important values besides efficiency are at stake here, and drive proponents on both sides. It is no accident that the great defender of authority within corporations is a leading Burkean Catholic intellectual. Most of Professor Bainbridge's arguments are couched in terms of efficiency, as is expected of corporate law scholars today. Great values such as tradition, order, liberty, just dessert, and respect for earned authority, however, are just under the surface in his scholarship.

The other side (my side) has its own great values. These include an abhorrence of corruption and misused power, equality and respect for the common man, the public good, democracy, and a more affirmative sense of freedom (positive liberty, in Isaiah Berlin's terms) that focuses on the ability of all persons to fully develop their personal capabilities. A more honest and expansive form of corporate law scholarship than currently prevails among American legal academics would develop the relationship between corporate law and these values, and tie them to the great debates over efficiency that have dominated scholarship over the last few decades.


Professor Bainbridge would, I expect, be able to do a great job in making such arguments on one side of this great debate.212

A different sort of argument for greater accountability focuses on the political economy of lawmaking in this area. Scholars hope to influence policy developments with some of their writing, even if it does not happen nearly as often as they would like. Is there any reason to think that one side or the other in the great authority/accountability debate is more in need of whatever sort of aid scholars may be able to provide?

There is. The political deck is stacked in favor of managers and boards and against shareholders (and even more so against other corporate constituencies).213 Managers and boards are a more concentrated interest group than shareholders and hence, for traditional free riding reasons, are better able to organize politically.214 Managers and the board also control the choice of the state of incorporation and, hence, states vying for incorporations are prone to cater more to their interests. Within Delaware, the well-organized corporate bar tends to mostly promote the interests of management and directors.215 Managers and boards also have the considerable resources of the corporations they manage to pursue their preferred policy agenda—they do not have to spend their own money.216 For all of these reasons, the policy behind both state and federal (but especially state) corporate law naturally tends to favor manager and board over shareholder interests. The political tendency is to lead to a balance of authority and accountability that leans too far in the direction of authority.

If scholars want to affect that balance, they can serve a useful role by fighting against this political tendency. Scholars, who are mostly insulated from the material pressures that tend to favor managers and boards, can be a voice for those with less incentive or resources to speak for themselves.

Finally, let us return to Arrow. We have seen reason to believe that Bainbridge overplays Arrow's arguments. Arrow emphasizes the importance of both authority and accountability. Bainbridge at first does so, too, but then almost invariably sides with authority over accountability. Nothing in

212I attempt to make some of these arguments on the other side in McDonnell, supra note 32.

213I discuss the evidence surrounding this point in McDonnell, supra note 165.

214See MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965) (explaining his theory that organizations produce "public goods"—goods or services available to every member even if every individual did not endure the costs of providing such goods or services).


216See McDonnell, supra note 32, at 363-64.
Arrow supports that choice. A brief consideration of the historical context for Arrow's masterwork may help deepen our understanding of how Bainbridge misuses Arrow.

Arrow delivered the lectures on which his book was based in 1971. He was an economics professor at Harvard—a part of the liberal establishment. That establishment was under radical attack at the time. Students were besieging not just the government, but the offices of university presidents and deans as well. Ideas of participatory democracy were widespread. Authority was treated with contempt.

But authority was not acquitting itself terribly well either. The Vietnam War was the leading example, but not the only one. Corporations were, by Bainbridge's own account, much more managerialist than they are now. Thinking people had become aware of the racism and sexism that pervaded authority structures. Elite universities were hidebound places to help induct the children of the privileged into their own privileged futures. And so on.

As a member of the liberal elite, Arrow was trying to maintain a middle ground at a time that was quite an uncomfortable position. He affirmed the great benefits of authority against the then-current radical attacks against all kinds of authority. He also, however, stressed that authority figures and institutions needed to be held accountable. The country's great institutions did need to be held accountable, but reform, not revolution, was the right way forward. Hold our leaders more accountable, yes, but do not go so far as to undermine valid authority that serves real, useful purposes. This, as I see it, was the core message of Arrow's lectures.

Bainbridge goes wrong by taking sentences aimed at student activists in the late 1960s and using them against contemporary shareholder activists. Lucian Bebchuk is not Tom Hayden. Point D in Figure 2 (sacrificing all authority in the name of accountability) was a live political option (at least in intellectual circles) in the early 1970s. That was Arrow's target, insofar as he defended authority. Bainbridge's target is very different. Contemporary shareholder activists and their scholarly allies are leading a much less radical attack on authority. Arguments that accurately hit Arrow's target miss their mark when aimed at Bainbridge's target. Let us end, then, with the words that end Arrow's book, words that are a call for more accountability:

\[\text{supra note 9.}\]

\[\text{For that matter, Tom Hayden in 2008 is not Tom Hayden in 1971.}\]
Clearly, there is no consensus on the need for responsibility and certainly not on its scope or on the mechanisms for its achievement. But the unthinking acceptance of authority based on echoes from religion and kingship is, I believe, gone.... Authority is undoubtedly a necessity for successful achievement of an organization's goals, but it will have to be responsible either to some form of constitutionally planned review and exposure or to irregular and fluctuating tides of disobedience.\textsuperscript{219}

\textsuperscript{219} ARROW, \textit{supra} note 9, at 79.