From Corporate Law to Corporate Governance

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1. Introduction

In 1962, Bayless Manning, the Yale Law School corporate law scholar and later Stanford Law School dean, announced the death of corporate law. Writing evocatively about a subject that was at the time deadly boring, Manning wrote:

"[C]orporation law, as a field of intellectual effort, is dead in the United States. When American law ceased to take the "corporation" seriously, the entire body of law that had been built upon that intellectual construct slowly perforated and rotted away. We have nothing left but our great empty corporation statutes—towering skyscrapers of rusted girders, internally welded together and containing nothing but wind." [1]

Manning bemoaned that the corporate statute—the rusted girders of his metaphor that provided the formal structure of the enterprise—no longer was enough to understand what really mattered: how the corporation performed. Once the formalism of the statute was recognized as insufficient itself to explain the true matter of concern, the conclusion followed: nothing was left but wind.

Manning's lament could be written off as just a law professor's realization that his discipline no longer explained enough about actual corporation behavior. But the concern was not limited to legal scholars; the same realization was coming to the surface in financial economics. In 1976, Jensen and Meckling provided what became the canonical account of the corporation in *Theory of the Firm: Managerial Behavior, Agency Costs and the Theory of the Firm.*[2] Addressing a different literature, Jensen and Meckling educed a metaphor similar to Manning's: the theory of the firm in economics was an "empty box:"[3]

"While the literature of economics is replete with references to the 'theory of the firm,' the material generally subsumed under that heading is not a theory of the firm but actually a theory of markets in which firms are important actors. The firm is a "black box" operated so as to meet the relevant marginal conditions … Except for a few recent and tentative steps, however, we have no theory which explains how the conflicting objectives of the individual participants are brought into equilibrium so as to yield this result." [4]

Jensen and Meckling focused centrally on the concept of agency costs—the cost of techniques to align the incentives of the different participants necessary to conducting the corporation's business. From their perspective, the corporation was a "form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals."[5] Reframed in current Silicon Valley terminology, the corporation is a multi-sided platform that integrates inputs on the one hand and customers on the other.

The intellectual impact of the agency cost characterization is hard to overstate: for the last 40 years, the mission of American corporate law, and of corporate scholarship more broadly, has taken the form of a search for the organizational Holy Grail, a technique that bridges the separation of ownership and control by aligning the interests of shareholders and managers through a series of techniques, over time highlighting the role of independent directors, hostile takeovers, and activist shareholders in this effort.[6] This coalescence around corporate law as a vehicle to produce shareholder profits hit its high point when Henry Hansmann and Reinier Kraakman, in an article confidently titled "The End of History for Corporate Law," concluded that "in key commercial jurisdictions … there is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."[7]

The result of Jensen and Meckling's seminal reframing of corporate law into something far broader than disputes over statutory language was that both Manning's empty skyscrapers and Jensen and Meckling's empty box began to be filled. And it was no coincidence that the term "corporate governance" appeared at about this time.[8] Over a reasonably short period, corporate governance codes appeared, like that of the OECD,[9] which ranged much more broadly than the limited coverage of a particular national (or state) corporate statute. Perhaps most aggressively, in 1997 during the East Asian financial crisis the International Monetary Fund and the World Bank included corporate governance reform as a condition to assistance alongside traditional macroeconomic restraints such as deficit reduction.[10] Academic attention followed the same growth pattern. For example, more than a quarter of all articles published in the *Journal of Financial Economics*, one of the two leading finance journals, from 1995 through August 29, 2013 were related to corporate governance.[11]

But with what have the empty skyscrapers and boxes been filled? The short answer is that the new content has addressed the variety and interaction of contracts—formal contracts, implicit contracts,[12] and the braiding of the two[13]—that Jensen and Meckling's treatment of the corporation as a nexus of platforms invites. In the remainder of this chapter, I will address three somewhat idiosyncratically chosen but nonetheless related examples of the implications of the shift from corporate law to corporate governance, from legal rules standing alone to legal rules interacting with non-legal corporate processes and institutions. Of course, the point is not to be exhaustive, nor even to provide a taxonomy covering the categories of the new content that is filling empty skyscrapers and boxes; the number and breadth of the chapters in this book make obvious that either effort necessarily exceeds my ambition here. Rather, my more limited goal is to provide examples of how this shift from corporate law to corporate governance—from a largely legal focus to one that focuses on the corporation's inputs, outputs and how they are managed and, ultimately, the manner in which governance interfaces with other institutional elements that make up a capitalist system—complicates the problem corporate scholars, of whatever mix of disciplines, have to confront.[14]

The chapter proceeds by tracking how corporate law became corporate governance through three examples of how we have come to usefully complicate the inquiry into the structures that bear on corporate decision making and performance. Section 2 frames the first level of complication in moving from law to governance by defining governance broadly as the company's operating system, a braided framework encompassing legal and non-legal elements. Section 3 then adds a second level of complication by treating corporate governance dynamically: corporate governance becomes a path-dependent outcome of the tools available when a national governance system begins taking shape, and the process by which elements are added to the governance system going forward—driven by what Paul Milgrom and John Roberts call "supermodularity."[15] That characteristic reads importantly on both the difficulty of corporate governance, as opposed to corporate law, reform, and the non-intuitive pattern of the results of reform: significant reform leads to things getting worse before they get better. Section 3 then further complicates corporate governance by expanding it beyond the boundaries of the corporation, treating particular governance regimes as complementary to other social structures—for example, the labor market, the capital market and the political structure—that together define different varieties of capitalism.

Section 4 then considers commonplace, but I will suggest misguided, efforts to take a different tack from sections 2 and 3: to simplify rather than complicate corporate governance analysis by recourse to now familiar single-factor analytic models in academic corporate law and governance: stakeholder theory, team production, director primacy, and shareholder primacy. Section 4 suggests that these reductions are neither models nor particularly helpful; they neither bridge the contextual specificity of most corporate governance analysis nor address the necessary interaction in allocating responsibilities among shareholders, teams, and directors. In addition, these "models" are static rather than dynamic, a serious failing in an era in which the second derivative of change is positive in many business environments and Schumpeter seems to be getting the better of Burke. Section 5 concludes by examining the importance of a corporate governance system's capacity to respond to changes in the business environment: the greater the rate of change, the more important is a governance system's capacity to adapt and the less important its ability to support long-term, firm-specific investment.

2. Corporate Governance as the Corporation's Operating System

In teaching corporations, I ask at the beginning of the first class a seemingly simple question: what is a corporation? After a predictable series of ever more complicated and sophisticated responses from very smart students, I dramatically display[16] a copy of a California corporation's articles of incorporation together with the Secretary of State's certifying cover page, on which appear attractive pictures of the California state animal (the grizzly bear) and state flower (the California poppy).[17] The corporation is nothing but a few pieces of paper I say, leading up to a point similar to that made by Jensen and Meckling: corporations are best understood not as a single thing but as the intersection of different things—recall that Jensen and Meckling describe then as "legal fictions."[18] To be sure, the formalities are thin and incomplete, but they are nonetheless important. For example, the corporate statute gives the entity limited liability and unlimited life, features that caused the *Economist* in 1926 to equate the corporation's invention with the industrial revolution's most important technological innovations.[19] But these are passive characteristics. Something more is necessary to bring the golem to life.

This sets the stage for my real point. A corporation should be defined functionally by reference to the structure that allows a legal fiction to operate a business and makes it possible for third parties to confidently do business with it. Some of these structures are legal rules that, in specified circumstances, allow the corporation to be treated, like Pinocchio, as if a real boy. However, the mass of the business operation, both in importance and in bulk, is not legal at all. It is processes of information flow, decision making, decision implementation, and decision monitoring: how people operating the corporation (1) obtain the information they need to make, implement, and monitor the results of business decisions (including information relevant to regulatory compliance); (2) distributes information from information originators to managers with sufficient expertise and experience to evaluate it; and (3) makes decisions, communicate decisions to the employees who implement them, and then gather information about the consequences, for the next round.

It is obvious that the formal corporate legal skeleton covers only a very small part of how the corporation actually operates to carry out its business and continually adapts to its business environment. In Bernard Black's terms, most of the legal rules concerning the corporation's operations are "trivial,"[20] in the sense that the rules are important only if they are ignored despite how easily they are to satisfy. The rest and obviously most important part of the governance structure—the dark matter of corporate governance—is the realm of reporting relationships, organizational charts, compensation arrangements, information gathering, and internal controls and monitoring, all largely non-legally dictated policies, practices, and procedures that do not appear in the corporate statute or the corporation's charter or bylaws. To be sure, non-legal governance processes can morph into the "legal" when legislatures conclude that self-generated governance is less effective than social welfare demands. A familiar example: after the Enron/WorldCom accounting scandals, Sarbanes–Oxley imposed a set of governance requirements over financial reporting, which included external monitoring of internal controls, a specified board committee structure and composition, and mandatory officer responsibilities. But, in general, even where the board has compliance responsibilities, the implementation is for the firm to work out.

Put differently, corporate governance is the corporation's operating system. This characterization of governance in operational terms is reflected in the description of corporate governance offered by the Business Roundtable, an organization composed of the CEOs of many of the largest US corporations:

"A good corporate governance structure is a working system for principled goal setting, effective decision making, and appropriate monitoring of compliance and performance. Through this vibrant and responsive structure, the CEO, the senior management team and the board of directors can interact effectively and respond quickly and appropriately to changing circumstances, within a framework of solid corporate values, to provide enduring value to the shareholders who invest in the enterprise."[21]

The end of the odd journey from corporate law to a more complex corporate governance system would give Dean Manning solace. His skyscrapers have been filled to overflowing, but formal law—the corporate statute and cases interpreting it—occupy far fewer floors in the building. The outcome of this integration of law and managerial mechanisms puts law in an important but plainly subordinate role in the corporation's operating system:

"Investors provide to a corporation the funds with which it acquires real assets. The investors receive in return financial claims (securities) on the corporation's future cash flows. The size of these future cash flows then depends importantly on management's choice of what real assets to acquire and how well these assets are managed over time. The capital market's pricing of the financial claims acquired by investors is in effect a valuation of these future cash flows. Corporate law provides a framework within which a firm's managers make these investment and operating decisions. Properly designed, this legal framework helps spur management to choose and deploy assets in ways that maximize the value of the firm's expected future cash flows … The better corporate and securities law perform these tasks, the more valuable the corporation's underlying business and correspondingly, the financial claims that the corporation issues."[22]

3. Path Dependence: Corporate Governance, Complementarity, and Supermodularity

The second effort to complicate corporate governance adds a dynamic dimension. Corporate governance is path dependent—history matters significantly.[23] In a path dependent environment with factors such as increasing returns and network externalities, an observed equilibrium may be inefficient compared to arrangements possible at the time of the comparison that were not available when the arrangements arose. Initial conditions, determined by fortuitous events or non-economic factors such as culture, politics, or geography, can start the system down a specific path. For example, Silicon Valley's development near to the San Francisco Bay next to Stanford University, as opposed to the shores of Lake Michigan where Northwestern and the University of Chicago are about the same distance from each other as Stanford and the University of California at Berkeley, depended importantly on initial conditions. These included, importantly, Stanford's hiring Frederick Terman as dean of the engineering school shortly after World War II. Terman had directed one of the Cambridge, Massachusetts, wartime labs that sought to bring cutting-edge science to bear in support of the war effort and so recognized the value of translational research, that is, the link between university research and its practical application.[24] Put simply, "history matters."[25]

That history matters influences the dynamics of the system to be understood. In particular, history's shadow can make it difficult to reform existing institutions or adjust to changes in a company's product market even if current alternatives exist that, absent transition costs, would be more efficient. In the context of corporate governance as defined here, the role of complementarities drives the system down a path from which it is difficult later to depart. By "complementarities" I have in mind governance elements that create value because they make the existing system work better as a whole, and the fact that the "efficiency" of an element cannot be separated from the question of "fit."

One of the major corporate governance questions to which path dependence and complementarity gives rise can be usefully framed in terms of the operating system metaphor: in a world of increasingly global product and capital markets, is there room for multiple corporate operating systems? Do particular corporate governance systems give rise to sustainable competitive advantage in particular product markets? What happens if a particular governance system is efficient until a change in the market renders it less efficient than that of new competitors and path dependency slows adjustment?[26]

3.1 The Japanese Example

The development of Japanese corporate governance exemplifies the influence of complementarities on the persistence of corporate governance structure as broadly defined in section 2. Suppose one begins with an initial condition of a commitment to lifetime employment for a large number of employees, as was the case in the development of post-war Japanese corporate governance.[27] The next question relates to the influence of that initial condition on a corporation's production process. Because the norm of lifetime employment makes human capital a long-term asset, the company will sensibly make substantial firm-specific human capital investments in its employees, thus developing a work force that supports team and horizontal coordination.[28]

In turn, the need to protect this long-term investment in human capital fits best with bank, as opposed to stock market-based, financing, to prevent the stock market from upsetting the company's implicit commitments to labor. Bank-based finance elevates the role of the bank as the monitor of managerial performance, rather than the public shareholders; this means suppressing public shareholders' rights and expectations relative to those of the bank. The need to monitor the performance of a management freed from stock market oversight thus led to the post-World War II Japanese main bank system. A single bank (typically leading a syndicate of banks) directly monitored a company's investment choice through the company's need to borrow to fund new projects, and through the information about the company's cash flow and performance that came to the bank through its provision of the company's general banking services.[29] Commonly, the main bank and the other banks that participated in providing loans to the company also held significant amounts of the company's equity, again out of a concern that a hostile takeover might upset the company's labor and financing arrangements.

Should the company fall on hard times, the main bank was expected to bail it out, through the provision of additional funds, but at the price of displacement of management with bank employees. The main bank bailout expectation was understood to be "an institutional arrangement complementary to the system of permanent employment." Bailout "helps to preserve the firm-specific human assets accumulated in the framework of the lifetime employment system and hence provides incentives for them to be generated in the first place."[30] In turn, this package of attributes and the related internal production methods are complementary to particular kinds of activity. The Japanese governance system, with its large investment in firm-specific employee human capital, is very effective when innovation is linear, and depends importantly on team work, but it is much less effective when innovation is discontinuous—the Japanese structure does not lend itself to Schumpetarian (or Christensen-like[31]) disruption.[32] The overall result has been a tightly integrated system of production that has been difficult to change in response to changing business conditions and opportunities for innovation.

In Milgrom and Robert's terms, the relationship between these governance and associated organizational characteristics is supermodular. By that term they mean that at each decision node where a new governance or characteristics must be added to the existing system, the corporation will choose from among the alternatives that which best "fits" with the already present elements. That fit, in turn, is a function not just of the efficiency of the new element standing alone—the increased productivity that results simply from its addition—but also of the new element's capacity to improve the performance of the existing elements—the extent to which it is supermodular.[33]

The complementarity among elements of the system, then, is a barrier to reform of the system because changing one element in the system results in degrading the performance of all other system elements to which that element was complementary. Just as adding a complementary element increased system performance by more than its own contribution, removing an element, by regulatory design or voluntarily in response to changed economic conditions, reduces performance of all elements. Like financial leverage, supermodularity steepens the performance curve both on the upside and on the downside: short of changing all elements of the system at once, reform will result in reduced system performance until enough of the system changes to recreate complementarities among the new and remaining elements.

Continuing the Japanese example, the combination of allowing Japanese companies to access non-Japanese sources of capital through the Eurodollar market and the enormous success of Japanese companies such that projects could be financed through cash flow rather than bank-provided project finance, eroded the role of the main bank. The contemporaneous drop in the value of the Nikkei reduced the value of the banks' cross-holdings in its customer companies, which necessitated sales of significant amounts of those holdings to maintain bank compliance with capital requirements.[34] At the same time, conditions in many product markets came to favor discontinuous innovation rather than linear innovation. Reduced performance of any part of a governance system built on complementarities reduced the performance of the entire Japanese governance system, yet the previously efficient complementarities create a barrier to reform.

This analysis provides background to understanding why the recent corporate governance reform proposals of Prime Minister Shinzo Abe represent more than tinkering with the formal relationships between shareholders and managers. The main bank system has not functioned for years, cross-shareholdings are of lesser significance, and Companies' Act revisions provide a better framework for activist investors and reflect a conscious effort to use government intervention to overcome path dependencies that sustain a no longer advantageous system of governance and production. Nonetheless, there has been little change in the labor market, including especially the continued absence of an external market for managerial talent and the actual operation of Japanese corporate governance—the Japanese corporation's operating system—remains familiar.

3.2 Expanding the Complementarity Concept: Varieties of Capitalism

The transformation of corporate law into corporate governance discussed in section 2 and the recognition of the impact of complementarities within a single country's governance system were importantly expanded through a literature that has been styled "the varieties of capitalism."[35] A governance system experiences path-dependent complementarities, not only internally among a company's factors of production, but also among a country's corporate governance system and other social and economic institutions including, importantly, the state. Simplifying the more complex yet elegant structure of the literature, different countries have different varieties of capitalism. A capitalist system necessarily has more or less coordination among labor markets, corporate governance arrangements, capital markets, and the educational system that provides worker training both outside and inside the firm consistent with the skill sets associated with firm organization and production. The state's political and social system—for example, the government's role in the economy both directly through state ownership and also more indirectly through the regulatory structure—must fit with the overall structure dictated by the interaction of the other elements. In turn, the institutions through which government and social influences operate are both forged through the relationships among the various inputs to the particular form of capitalism, and serve as the field on which those controlling the input strategically interact.[36]

The result is a stylized typology of two general forms of economic and political organization. Each displays, although the term is not used, supermodularity—the pieces evolve to facilitate the variety's functioning and to reinforce each of its elements. In this account, the two rough forms of political economy are called "liberal market economies" (LME) and "coordinated market economies" (CME). In LMEs, firms coordinate their activities largely through hierarchies within the firm and through competitive markets outside the firm.[37] The basic tools are said to be contracts and arm's-length arrangements.[38] In CMEs, firm activities operate importantly through non-market arrangements, relying on relational arrangements supported by reputation and, more generally, through incomplete contracting supported by public and private regulatory institutions. Firms and markets are organized through strategic interaction among firms and other institutions. "In some nations, for instance, firms rely primarily on formal contracts and highly competitive markets to organize relationships with their employees and suppliers of finance, while, in others, firms coordinate these endeavors differently."[39] It will be obvious, for example, into which category the Japanese main bank system falls.

The last element in the analysis is dynamic: each system's political, social, and corporate governance institutions evolve in a path-dependent fashion from an initial condition to a coordinated structure of complementary institutions driven by choices based on supermodularity and complementarities: "nations with a particular kind of coordination in one sphere of the economy should tend to develop complementary practices in other spheres as well."[40] For example, a stock-market-based capital market implies market-based institutions in the financial sector consistent with the development of a vibrant venture capital market not generally present in countries with a bank-centered capital market[41] and a labor market characterized by employment at will, while extensive employment protection is associated with non-market coordination of industrial relations.[42] Similarly, stock-market-based capital markets are associated with market monitoring of company performance through control contests, while bank-centered capital markets are associated with bank-mediated monitoring and the absence of stockholder-driven control contests. On this account, the United States and the United Kingdom exemplify LME nations while Germany and Japan are CME nations.

My goal in this section was to further complicate our understanding of corporate law and corporate governance by embedding governance in a broader framework whose components are complementary and by highlighting the dynamics of that broader system. The "varieties of capitalism" approach takes us part of the way. On the one hand, it stresses how different systems came to their present form. On the other, however, it does not fully address the tension between path dependency and the need for a particular variety to respond to changes in markets and products. For example, the capacity of globalization and technology to disrupt existing industry and employment patterns highlights the importance of the extent to which particular varieties (and sub-varieties) of capitalism are adaptively efficient.[43] The US system is said to be adaptively efficient but at the same time criticized for being too "short-term" oriented, while the Japanese system was praised for its capacity to credibly commit to long-term investment horizons, but appears to be slow in adapting to significant changes in markets and technologies.[44]

This poses what now may be the most interesting question—can a single system be both adaptive and committed? To close with a speculation, corporate governance serves to support risk transfer. As capital markets become more complete, additional mechanisms of transfer become available. The ability to transfer risk in slices through derivatives, in contrast to a broadband risk bearing instrument like common stock, creates the option of a company remaining privately held as a commitment device to a particular investment horizon that matches its markets and skills.[45] From this perspective, adaption takes place through self-selection at the company level, rather than at the system level.

A final qualification remains. The “varieties of capitalism” approach dates from the turn of the millennium. We now observe new governance patterns evolving from scratch where there is no prior path. Chinese state capitalism offers a form of coordinated system, but one in which the resolution of tensions among stakeholders more directly flows through the state and party apparatus rather than through the interaction between the company and other relational institutions, and where a question remains whether corporate governance and its formal components serve the same function in the Chinese system that they do in other varieties of capitalism.[46]

4. Analytic Models in Corporate Governance

To this point, I have broadly summarized the evolution of corporate law into corporate governance and then from corporate governance as a stand-alone concept into a component of a particular capitalist system made up of complementary subsystems and whose path dependency defines the characteristics of the broader system’s adaptive dynamics. Like evolutionary systems more generally, the movement was towards greater complexity. Section 4 now further emphasizes complexity by critically assessing recent efforts to simplify, rather than complicate, our understanding of corporate governance through single-factor governance models. As can be predicted by my account in sections 2 and 3, I view these models as interesting and intriguing, but inevitably partial, the equivalent of a painter’s studies for a larger work. For the kind of analytic non-formal models used by legal academics, the right methodological move is to complicate, not simplify. Perhaps most important, these single-factor models are largely static, immune in their positive and normative analysis to the influence of the broader concept of governance addressed in section 3.

4.1 Models in Corporate Law

Some 40 years after economics began making important inroads into corporate law scholarship, a significant amount of academic, but not judicial, attention is still directed at devising the right “model” of corporate law and governance.[47] The “shareholder primacy” model contests with the “stakeholders” model, which in turn confronts the “team production” model and the “director primacy” model. In section 4 I argue that this debate, as engaging, interesting, and extended as it has been, is ultimately a blind alley, both theoretically and practically. The reasons are not complicated, although as I have suggested in sections 2 and 3, we have come to understand that the behavior that this dialogue has sought to explain is quite complicated. Indeed, it is the very complexity of the phenomenon to be explained that allows a simple critique of singular static explanations.

Each of these “models” seeks to explain the structure and performance of complex business organizations—law is relevant only to the extent that it interacts with other factors in shaping the corporation’s operating system—by reference to a single explanatory variable. The single variable character of the contending accounts has resulted in an oddly driven circular debate that is prolonged because those proffering each model defend it by emphasizing the limits of the others—something like an academic perpetual motion machine. In fact, each of the models is part of a more complicated description of a very complex phenomenon.

Stephen Bainbridge, whose entry into the[1] single factor horse race I will address later in this section, invokes the fable of the blind men and the elephant in arguing that an overarching concept of the corporation is needed.[48] An account of corporate organization that does not feature prominently each of the contending model's central features—shareholders, managers, and employees, stakeholders and directors—is limited to explaining only part of the phenomenon. Elephants have trunks, tails, ears, and legs; corporations have shareholders, managers, and employees, stakeholders and directors. Making the elephant walk and the corporation function effectively requires that all of these parts work together—the task is organizational intelligent design or, as I have called the exercise more generally, transaction cost engineering.[49] And that requires an explanation that focuses on more than one factor, however overarching. The problem of understanding corporate organization is interesting and hard because it requires explaining the interaction of multiple inputs in a dynamic setting, a problem that vexes both formal and informal modelers.

I should pause for a moment to clarify what I mean by a model. Of course, none of the accounts I address here involves a formal mathematical model of the sort familiar from the economic and finance literatures. They are more in the style of an informal analytic narrative,[50] which persuades because its explanation rings true rather than because the equations balance.[51] This technique is a kind of verbal regression that restricts the degrees of freedom in explaining a phenomenon by complicating rather than simplifying. A real regression first simplifies the problem as the interaction of two variables, and then measures the power of the explanation by the closeness of the data point—the dots—to the least squares line.[52] An analytic regression operates in exactly the opposite fashion: by increasing the number of dots that must be connected, but now by a narrative rather than by a regression line. A workshop question that asks "what about" a particular fact challenges the verbal regression with a dot the presenter's explanation of a phenomenon cannot explain, and so limits the degrees of freedom in constructing a narrative explanation.

In the remainder of this section I will briefly survey the contending models—stakeholders, team production, director primacy, and shareholder primacy—highlighting both why each model's animating factor is important and why it is partial. In doing so I will not do justice either to the extensive literature associated with each model or the sophistication of some of the debate.[53] My point is simply that, standing alone, none of the single-factor models explain the complex phenomenon of the governance of corporations in a dynamic context.

4.1.1 Stakeholder Model

A stakeholde*r* model of corporation law or governance recognizes that the corporation is a major social institution that is at the core of a capitalist system. In the United States, large public corporations produce the bulk of GDP, employ vast numbers of workers and so support the stability of families and communities, and pay taxes at every level of the nation—local, state, and federal. It has become commonplace to credit the corporate form with a significant role in economic productivity. For example, writing in 1926, the *Economist* magazine trumpeted this role:

"Economic historians of the future may assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honor with Watt and Stephenson, and other pioneers of the industrial revolution. The genius of these men

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produced the means by which man's command of natural resources has multiplied many times over; the limited liability company the means by which huger aggregations of capital required to give effect to their discoveries were collected, organized and efficiently administered."[54]

It then follows simply enough that all those affected by the performance of the corporation have an interest in its operation, which leads in turn to an economic measure of social welfare against which a corporation's performance can be measured: as framed by economists Patrick Bolton, Marco Becht, and Alicia Roell, the net gain to all those doing business with the company, thereby requiring a netting of gains and losses among, for example, customers, suppliers, employees and shareholders.[55]

Intertwined with this measure of overall productivity, however, is a distributional concern. If the gains arising from the corporation's activity are not shared among stakeholders in a fashion perceived as equitable, the social legitimacy necessary to support efficient production breaks down, a framing that resonates with the current income equality debate and the populist themes now current in US politics across both the Democratic and Republican parties.[56] In the more recent governance debate, the stakeholder model is situated as a response to the position Hansmann and Kraakman describe as now dominant: that the corporation should be run to maximize shareholder value.[57]

What is missing in the stakeholder account, however, is the link between the stakeholder model and production. While production may depend on a broad perception that the fruits of production are equitably distributed, in the absence of efficient production, that task is made more difficult because there is less to distribute. A fair criticism is that too little attention is given to the governance mechanisms through which stakeholder interests can be taken into account consistent with efficient production. To be sure, stakeholder board representation has been a matter of debate but hardly implementation in the United States, and co-determination is a familiar but narrow European phenomenon.[58] And as Henry Hansmann pointed out some years ago, there is no legal reason why large corporations are capital rather than labor cooperatives.[59]

Yet the problem with a stakeholder model remains: it a one-factor model, largely concerned with distributional issues as a counterpoint but not as an alternative to shareholder primacy. To be sure, behavioral economics provides evidence that perceptions of fairness may in some circumstances be complementry to, rather than in tension with, maximizing production[60] and that framing the corporate purpose only in terms of shareholder value may dissuade boards of directors from taking action that increases the size of the pie if it reduces the piece shareholders receive. However, what remains largely unaddressed in the stakeholder discussion is how to hold accountable the corporate decision makers, composed largely of white, older men and, almost without exception, wealthy people, whatever their ethnicity or gender, for the size of the pie the corporation creates or for its distribution.

4.1.2 Team Production

A team production theory of corporate governance, energetically advanced by Margaret Blair and Lynn Stout, seeks to fill the gap in stakeholder theory by directly linking a concern with non-shareholder constituencies, especially employees, to firm productivity.[61] The model, stated simply, is that efficient production is a function of firm specific investment by a wide range of stakeholders—a team, rather than a hierarchy. However, if the stakeholder's firm-specific investment is subject to opportunistic grabbing by a different stakeholder—for example, the shareholders—the stakeholder will be less willing to make the efficient level of investment. For example, employees may be reluctant to make firm specific human capital investments if shareholders can subsequently renege on the firm's promise to pay the employee a return on that investment.[62]

The need to protect all stakeholders' firm specific investments gives rise to the team production model's governance implications. The model calls for a decision maker who will coordinate the contributions of different stakeholders to protect their expectations of a return on their investments, i.e., to see that the stakeholders play well together and so increase the size of the pie rather than squabbling over the efforts of one stakeholder group to expropriate a different group's piece. Blair and Stout assign this function to the board of directors who operate, in their somewhat awkward term, as "mediating hierarchs," balancing the various stakeholders' interaction, and so facilitating the right ex ante level of specific investment by all parties.

The reader will recognize that the team production model closely tracks the efficiency analysis of the Japanese main bank governance model considered in section 3; Japanese horizontal organization of production is framed, as is the team production model, in contrast to US vertical organization. In the Japanese governance model, lifetime employment, protected by limited reliance on equity financing and main bank monitoring, encourages employees to make firm-specific human capital investment by protecting them from opportunistic behavior by shareholders, and so provides a foundation for a very efficient manufacturing system that is built around horizontal planning, decision making, and production processes. But the reader will also recall that the advantage of Japanese horizontal organization of production is contextual. First, it is more effective than US-style hierarchical organization when innovation is linear, as in precision manufacturing, but inferior to the US style when innovation is discontinuous. Second, team production's stability depends on conditions in the capital and product markets—increasing alternative sources of capital, for example, degraded the critical role of the main bank, as did the success of the companies themselves, who then could avoid main bank monitoring by financing projects through internally generated funds.

Unlike Aoki's development of "J form governance,"[63] Blair and Stout's claim for team production is largely a-contextual. The problem is that, as analysis of Japanese governance shows, team production is a strategy, not the "right" way to organize governance or production; it fits some industries, some production techniques, and some clusters of complementary elements of one variety of capitalism at particular times, but not others. Indeed, in some contexts, horizontal teams and vertical non-teams both may work. The difference in strategies between Costco and Sam's Club, both US big-box-membership grocery and sundries stores is a good example. They are direct competitors but they treat their workers quite differently. Costco pays higher wages, provides healthcare, etc. Costco's position is that company profits are higher if their workers like their jobs and want to keep them (a business person's account of an efficiency wage story). Sam's Club (owned by Walmart) treats its workers materially worse than Costco, but nonetheless performs adequately.[64]

A second problem is more directly governance related: who polices the behavior of the mediating hierarchs even in a team production context? In the US governance model, the only formal source of constraint is the right of only one stakeholder—the shareholders—to vote. However, as Blair and Stout stress, so long as the corporation resembles the Berle and Means pattern of widely distributed ownership, the right to vote and so the power to monitor the hierarchs, is dramatically diluted by coordination costs: proxy contests are expensive and while their costs are borne by the proponent of the fight, the gains are shared by all shareholders. This leaves the hierarchs on a very long leash indeed.

The problem with hierarchs, then, is that strategy and governance follow changes in the capital market rather than lead it.[65] The wide discretion Blair and Stout claim for the hierarchs was first challenged by the development of junk bonds in the 1980s.[66] The availability of financing to corporate outsiders allowed a large increase in hostile takeovers that were used to take apart the residue of the failure of the 1970s conglomerate experiment. The result was to significantly shorten management's leash. Non-statutory monitoring techniques, like tender offers, provided a short cut around the coordination costs associated with widely distributed shareholdings: Even small shareholders could recognize a large premium when one was offered, although the need to secure financing to purchase the target limited the size of the companies that were potential targets. The debate over efforts to constrain capital market monitoring though target company defensive tactics—the extent to which mediating hierarchs could prevent shareholders from accepting a hostile bid—then raged on for 30 years.

More recently, the capital market fault line shifted again—ownership of equity became increasingly intermediated through institutional investors holding stock as record owners for widely dispersed beneficial owners. Shareholdings in US public corporations are now quite concentrated as a result of equity intermediation—a number of institutions whose representatives could be seated around a large board room table collectively hold voting rights that effectively control most corporations—ushering in what Jeff Gordon and I have called "Agency Capitalism."[67] At this point, activist hedge funds and other specialized shareholder activists entered the fray as complements to the new ownership concentration. Rather than buying targets themselves, such activists tee up strategic business choices for decision by "reticent" rather than passive institutional shareholders and in that way serve as a catalyst for the expression of institutional shareholder voice. This further erodes the coordination costs barrier to monitoring mediating hierarchs. Because an activist's own stock purchase need be only large enough to credibly signal its conviction in its proposals, even the largest public corporations are potentially "in play." Put differently, the activist shareholders differ from the raiders of the 1980s in that instead of leveraging the target's balance sheet to finance a takeover, they leverage the equity holdings of institutional investors to win a proxy contest conditional on convincing the institutional investors that the activist's proposal is sound.[68] And here context is again central. If the mediating hierarchs are largely walled off from capital market monitoring, now through proxy fights rather than takeovers, companies' response to changes in the business environment are slowed down, a very undesirable result if, as appears to be the case, the rate of change in the business environment is increasing. Bad governance then leads to bad strategy.

4.1.3 Director Primacy

Stephen Bainbridge proffers a director primacy model as a counterpoint to both the stakeholder and the team production models on the one hand, and as an element of a shareholder primacy model on the other.[69] The differences among those models are nicely organized around two simple concepts proffered by Bainbridge: the corporation's ends and the means by which those ends are achieved. Director primacy differs sharply from the stakeholder model and somewhat more obliquely from team production on the ends sought. It includes an undiluted commitment to "shareholder wealth maximization"[70] as the measuring rod of a corporation's performance. The significant difference between director primacy and team production, conceptually but not necessarily operationally, concerns the means by which shareholder wealth maximization is achieved. Both team production and director primacy share a commitment to a very long leash for boards of directors, relegating shareholders to a limited role as a vehicle for constrained capital market intervention. The shareholders' cameo role is expected to be limited to those unusual circumstances when the shortfall in corporate performance, whether in its use of existing assets or in its failure to reach out for new opportunities, exceeds the coordination costs of energizing shareholders either directly through a takeover or indirectly through elections. In this important respect, team production and director primacy share a central feature of Aoki's description of Japanese corporate governance discussed in section 3:[71] capital market intervention, in Japan through main bank intercession and in the US through the stock market, should be triggered only by very poor performance.[72]

Thus, central to both models is the limited role of shareholders; under both team production and director primacy, management and directors are on a very long leash. Team production and director primacy differ, however, not only in the intellectual foundation of their respective models—Blair and Stout channeling Alchian and Demsetz[73] and Holstrom[74], and Bainbridge building on Coase[75] and Arrow[76]—but also in the breadth of their claim. Fairly assessed, team production is a particular production strategy, not a governance model for all seasons. Director primacy makes the broader claim: it purports to be a generally applicable governance structure. In striking the governance balance between, in Arrow's terms, "authority" and "responsibility," it plainly favors authority—management over shareholders. But this broader claim founders on the same rock that scuppered team production's broader claim.

Japan's main bank primacy model, like director primacy protecting management save in dire circumstances, no longer worked when the structure of the Japanese economy changed as a result of Japanese corporations' success and the contemporaneous opening of the Japanese capital market. Director primacy's stability and its normative appeal depend on circumstances in the capital market: the cost of shareholder coordination sets the limit on director discretion, in Arrow's terms again, setting the efficient tradeoff between authority and responsibility. The reconcentrated ownership of large public US corporations as catalyzed by activist investors dramatically reduced the shareholder coordination costs in challenging managements and boards; this shortened the leash. But the critical new feature of "coordination" was the activists' role as credible information intermediaries. Insofar as the board's claim to "authority" rested on both a purported informational advantage and the cost of informing widely dispersed shareholders, the activists' information-based counterview shifted the balance, as evidenced by the voting behavior of sophisticated institutional investors. Arrow himself anticipated that if smaller groups could assess specific claims of error on the part of those in authority, responsibility could be achieved without so general a scope of review that authority was dissipated and information costs multiplied.[77]

Stated most simply, the "right" governance model is contextual. It depends on what the particular company does and on conditions in the capital market; in other words, a governance model must be dynamic. One-factor models that cannot accommodate changes in either the product market or the capita market are too simple to accommodate the complexity of the business environment in which corporations function.[78]

4.1.4 Shareholder Primacy

Setting out the shareholder primacy model is somewhat more complicated than the description of the stakeholder, team production, and director primacy models. In Bainbridge's nice dichotomy, shareholder primacy is used as a label for both an end and a means; it is at once the corporation's goal but also how that goal should be achieved. Thus, there is a need to be precise about the subject under examination. With respect to the end of corporate governance, I start with a broad definition of social welfare in the organization of public corporations: the net impact on all those effected by the company, thereby requiring a netting of gains and losses among, for example, customers, suppliers, employees, communities, and shareholders, in effect Kaldor–Hicks efficiency with a broad reach of whose utility counts.[79]

With respect to means, my focus in this section is the role assigned to shareholders. For this purpose, we have to bring in another literature, beginning in the early 1980s and continued to date by the energy of Lucian Bebchuk among others, who argues for a much broader role for shareholders than contemplated by either Blair and Stout or Bainbridge.

In important but unfortunate respects, the debate over shareholder primacy was clouded by some of its early framing. Two characterizations are particularly regrettable: that the allocation of authority through the corporate governance system turns on shareholder ownership or, alternatively, on the specificity of different stakeholders' contribution to the corporation. The ownership claim—that the corporation should maximize shareholder wealth because shareholders "owned" the corporation—was straightforward but far too simple. In fact, we have known better than that from the beginning of the debate. Ownership is a bundle of rights; which elements of the bundle we give to a particular party depends on what we want to accomplish; the inquiry is instrumental not normative. That distinction was drawn sharply in the corporate governance context as early as 1981. The shareholder's governance role depends on the organizational design needed to give residual claimants the power to assess management and the board's performance. "[I]ndeed, if the statute did not provide for shareholders we would have to invent them."[80] Debates about the specificity of different stakeholders' contributions to the corporation were also little help; the relative character of those contributions depended on the particular and changing character of the corporation's business environment, so it was difficult to generalize based on this characteristic.

Once we recognize that the problem with the firm specificity branch of the shareholder primacy argument is that all stakeholders make contributions and the character of those contributions, and hence the various stakeholders' investment in the corporation, depend on the firm's strategy, the second characterization problem appears: it follows that the right governance structure is also going to depend on context. Sometimes the contributions, driven by the nature of the business and the corporation's strategic response support horizontal team production; sometimes they support vertical hierarchical organization and sometimes a mix. This appears from Table 1 below, a stylized income statement. The figure illustrates that each line item in an income statement reflects the participation of a different category of stakeholders. And it requires little imagination to think of how all but the shareholders' interests are conditional on circumstances. Different events will differentially affect the value of different stakeholders' inputs. Only the shareholders have an incentive to adjust the returns other shareholders receive for their inputs, because the residual returns will depend on the success of that adjustment. Put differently, one could substitute for the term "shareholder primacy” that of “Kaldor–Hicks efficiency” as a description of the operative governance model, and so match the label to the measure of social welfare.[81]

Table 1 A Stakeholder Income Statement

Line item	Amount	Stakeholder
Sales	XXXXXX	Customers
Wages	XXXXXX	Employees
Cost of goods sold	XXXXXX	Suppliers
Taxes	XXXXXX	Community
Net Income	XXXXXX	Shareholders

It is apparent that, as the reference to the blind men and the elephant fable reveals, corporate performance depends on the complex coordination of all stakeholders groups, taking into account the particular context of the company's business. We return to where we started this part: the corporate elephant needs customers, employees, suppliers, communities and shareholders to perform. That implies a basic structure of management monitored by directors, with shareholders in the position of residual owners and having the vote—the right to disrupt existing management through their influence on the identity of the directors. It is at this point that the issue around shareholder primacy takes form. The team production and director primacy models, for different reasons, share the view that shareholders' role in changing management should be formally limited—management's leash must always be long. As we've seen, the two positions as so framed share a more than passing relation to Aoki's description of Japanese management. The main bank in Japan (during its prominence) and shareholders in the US can replace management, but only when things get very bad.

But the Japanese experience also teaches that the efficient length of the leash depends on history, strategy, and conditions in the capital market. The evolution of complexity in our understanding of corporate governance highlights that the role of shareholders and so the length of management's leash depends on the circumstances. In the 1970s, management and directors experimented with conglomerate strategies. Consistent with the team production and director primacy models, management and directors had the autonomy to carry out the experiment. In the end, the experiment failed and changes in the capital market—Michael Milken and Drexel Burnham's development of junk bonds—shortened management's leash by facilitating shareholder-dependent bust-up hostile takeovers. The length of management's leash was shortened again in the new century by the growing intermediation of equities and the rise of activist shareholders who levered institutional investors' equity holdings to extend capital market oversight to firms that were too big to take over in the 1980s.

The lesson of this section is that one-factor corporate governance models are too simple to explain the real-world dynamics we observe. Hansmann and Kraakman are descriptively correct that there seems to be convergence around a governance structure that generally contemplates shareholders as the residual owner. In equilibrium, directors oversee management's efforts to coordinate the inputs of all stakeholders and their competing claims on corporate revenues, with the particular resolution depending on the corporation's product market and strategy; shareholders have a limited function. When performance is lacking, management's leash shortens based on the techniques available to shareholders through the capital market. Corporate governance matters when the leash shortening is triggered by changes in the product market in which the company participates, in the instruments the capital market provides, and in the pattern of shareholdings that results from conditions in the capital market.

5. Conclusion

In the end, governance is messy, complicated, and contextual because that is the character of dynamic markets. And that is the point of this chapter. The move from corporate law to corporate governance reflects a move from a simple legal view of the corporation to one that became increasingly complex and dynamic, hand in hand with the increased complexity and dynamics of the capital market, input markets, and product markets that corporations inhabit. And therein lies the problem with corporate governance models: at best they are snapshots, stills of a moment a in motion picture. Corporate governance is part of the structure of an economy whose behavior, and hence whose architecture, is dictated by the interaction among all of the markets in which the corporation operates, each of which is itself in motion. In a sense we are confronted with a corporate governance version of the physicist three-body problem: the interaction of the bodies that influence the structure of corporate governance are too complex to allow a prediction of the optimal governance structure going forward.[82]

Is there a lesson from recognizing the complexity of real world corporate governance? I think so. It is the centrality of change. As discussed in section 2, there is a tradeoff between a governance system that encourages long-term firm specific investment and one that is mutable, quickly adapting to changes in the business environment.[83] This tension between stability and change is baked into a capitalist system. Change is a source of progress, but it is always risky since the established order more or less works, sometimes seemingly well.[84] Reinier Kraakman and I characterized the tension as a debate across the years between Burke and Schumpeter:[85] should we preserve what is working against a potentially disruptive innovation?

Burke cast this tension in terms that anticipate today's tendentious long-term versus short-term debate. Remarking on the leaders of the French revolution, Burke stressed their short-term orientation: "Their attachment to their country itself is only so far as it agrees with some of their fleeting projects; it begins and ends with that scheme of polity which falls in with their momentary opinion."[86] In contrast, Burke has a great respect for the French aristocracy who were threatened by the purported short-termists: "Of my best observation, compared with my best inquiries, I found [the French] nobility for the greater part composed of men of high spirit, and of a delicate sense of honor, both with regard to themselves individually, and with regard to their whole corps, over who they kept, beyond what is common in other countries, a censorial eye."[87]

Schumpeter's riposte to the Burkean fear of chaos has become familiar:

"The opening up of new markets—and the organizational development from the craft shop to such concerns as U.S. Steel illustrate the same process of industrial mutation— … that incessantly revolutionalizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism."[88]

From this perspective, the governance tradeoff—between stability and mobility—depends on the predicted range of future change in a particular industry and company. If the second derivative of change is positive but whose direction is difficult to predict, then a governance system that priviliges mutuability over stability will outperform. And here path dependency raises its head a final, pessimistic time. In a governance system characterized by supermodularity, shifts from a commitment-based governance system to one that facilitates adaptation to changing conditions will be hard to accomplish. Again, Japan's slow progress at reforming the operation of its corporation governance system despite dramatic changes in its formal corporate law stands witness to the problem.

This is an appropriate point to conclude. The move from corporate law to corporate governance, and the resulting increase in complexity, allows us both to understand the problems we need to solve and the difficulty of doing so.

Notes

[1] Bayless Manning, The Shareholders' Appraisal Remedy: An Essay for Frank Coker, 72 Yale L. J. 223, 245 n. 37 (1962). Manning's dirge for corporate law was hardly limited to the US. Speaking in broader geographic terms, Manning expanded his point. "Those of us in academic life who have specialized in corporation law face technological unemployment, or at least substantial retooling. There is still a good bit of work to be done to persuade someone to give a decent burial to the shivering skeletons. And there will be plenty of work overseas for a long time to come, for in Latin America, and to a lesser extent on the Continent, the 'corporation' yet thrives and breeds as it did in this country eighty years ago" (ibid.).

[2] Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and the Theory of the Firm, 3 J. Fin. Econ. 305 (1976).

[3] Ibid. at 306.

[4] Ibid. at 306–307.

[5] Ibid. at 311 (emphasis omitted).

[6] Ronald J. Gilson, Corporate Governance and Economic Efficiency: When do Institutions Matter?, 74 Wash. U. L. Q. 327, 330 (1996). The literature and the courts are now beginning to address what happens to this theory and the case law derived from it when corporations have increasingly concentrated ownership, albeit in the form of institutions as record holders for their beneficiaries, what Jeffrey Gordon and I have called "Agency Capitalism." See Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Col. L. Rev. 883 (2013); Ronald J. Gilson & Jeffrey N. Gordon, Agency Capitalism: Further Implications of Equity Intermediation, in Research Handbook on Shareholder Power 32 (Jennifer Hill & Randall Thomas, eds., 2015).

[7] Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 Geo. L. J. 745 (2001).

[8] Brian R. Cheffins, The History of Corporate Governance, in The Oxford Handbook of Corporate Governance (2013), nicely tracks the emergence of the term corporate governance. He notes that the term only came into vogue in the 1970s in a single country—the United States. One outcome of this shift was that the "technological unemployment" that Manning feared did not arise. Hostile takeovers, a response to agency costs made broadly possible by the development of junk bonds, generated enormous amounts of work and profits for fancy law firms. Lincoln Caplan, Skadden: Power, Money, and the Rise of a Legal Empire chap. 5 (1993) captures the phenomenon.

[9] A current compilation of current country and NGO corporate governance codes can be found at the European Corporate Governance Institute website: http://www.ecgi.org/codes/index.php. For examples of the governance codes of large public and private institutional investors, see, e.g., Cal. Pub. Employees' Ret. Sys., Global Principles of Accountable Corporate Governance (2015), https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf; BlackRock, Proxy Voting Guidelines for U.S. Securities, available at http://www.blackrock.com/corporate/en-no/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf.

[10] See, e.g., Timothy Lane, et al., "IMF- Supported Programs in Indonesia, Korea, and Thailand," 72–73 (Int'l Monetary Fund Occasional Paper No. 178, 1999); "Asia Pacific Talks Vow Tough Action on Economic Crisis," N.Y. Times, Nov. 26, 1997, at A1.

[11] Out of a total of 1,533 articles published by the Journal of Financial Economics between January 1, 1995 and August 29, 2013, 414 (27%) dealt with corporate governance. Author's calculation.

[12] The term "implicit contract" comes out of the labor economics literature. The critical point is that, from a legal perspective, an implicit contract is not a contract at all: it has neither formal terms nor formal enforcement. Rather, it is a description of patterns of behavior that are enforced by reputation markets. See Sherwin T. Rosen, Implicit Contracts: A Survey, 23 J. Econ. Lit. 1144 (1985)

[13] Ronald J. Gilson, Charles Sabel, & Robert E. Scott, Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine, 110 Col. L. Rev. 1377 (2010). The term "braiding" reflects the potential for complementarity between formal law and explicit contracts on the one hand, and implicit contracts on the other. In this account formal law and explicit contracts facilitate the development and maintenance of implicit contracts; in effect, the formal components of the braid endogenize trust, the foundation for sustainable implicit contracts. Ibid. at 1384.

[14] Like Manning, I have a personal concern about the role of corporate law academics. On this front, the shift from corporate law to corporate governance and to the role of corporate governance in the larger structure of a capitalist economy, has had the desirable result of forcing corporate law academics to become interdisciplinary.

[15] Paul Milgrom & John Roberts, Complementarities and Systems: Understanding Japanese Economic Organization, 9 Estudios Economicos 3 (1994).

[16] At least I imagine that the students have that assessment of the gesture rather than a variety of less flattering characterizations ranging from showboating to simply strange.

[17] This was how the document looked at the time my class exemplar was issued. California, as of 2014 the world's 8th largest economy (Samanta Masunaga, We're Number 8: California Near the Top of World's Largest Economies, Los Angeles Times, July 25, 2015), has statutorily designated not only a state animal and state flower, but also a state bird, a state amphibian, a state fossil, a state insect, and 28 other categories of designated state symbols. See California Governance Code Sections 420–429.8.

[18] Jensen & Meckling, *supra* note 2, at 310.

[19] Economist, December 18, 1926.

[20] Bernard Black, Is Corporate Law Trivial? A Political and Economic Analysis, 24 Nw. U. L. Rev. 542 (1990).

[21] "Principles of Corporate Governance 2005," Business Roundtable, November 2005, at 6.

[22] Edward G. Fox, Merritt B. Fox, & Ronald J. Gilson, Economic Crisis and the Integration of Law and Finance, 116 Col. L. Rev. 325, 327–328 (2016).

[23] Among the efforts to apply path dependency to corporate governance, see Lucian A. Bebchuk & Mark J. Roe, A Theory of Path Dependence in Corporate Governance and Ownership, 52 Stan. L. Rev. 127 (1999); Marcel Kahan & Michael Klausner, Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases, 74 Wash. U. L. Q. 347 (1996); See Ronald J. Gilson, Corporate Governance and Economic Efficiency: When do Institutions Matter?, 74 Wash. U. L. Q. 327 (1996).

[24] "[I]ndustrial districts are path dependent—an industrial district's location may result not from the invisible hand of efficiency, but from 'the details of the seemingly transient and adventitious circumstance'." Ronald J. Gilson, The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128 and Covenants not to Compete, 74 N. Y. U. L. Rev. 575, 577 (1999), quoting Paul A. David & Joshua L. Rosenboom, Marshallian Factor Market Externalities and the Dynamics of Industrial Localization, 28 J. Urban Econ. 349, 368 (1990).

[25] Masahisa Fujita & Jacques-Frangois Thisse, Economics of Agglomeration, 10 J. Japanese & Int'l Econ. 339, 341 (1996); Paul Krugman, Space: The Final Frontier, 12 J. Econ. Persp. 161 (1998).

[26] An early article, Rebecca M. Henderson & Kim M. Clark, The Reorganization of Existing Product Technologies and the Failure of Established firms, 35 Admin. Sci. Qtly. 9 (1990), illustrates this point by demonstrating that the market leader in one generation of product architecture loses out in the next, weighed down by having to unlearn all of the capabilities that made it succeed in the prior generation. For more recent analysis, see Steven Blader, Claudine Gartenberg, Rebecca Henderson & Andrea Prat, The Real Effects of Relational Contracts, 105 Am. Econ. Rev. 452 (2015, Papers and Proceedings).

The same analysis applies when the question is posed with respect to competition between national governance systems. For the application of this analysis to the effect of changes in product markets on competition between national governance systems, see Gilson, *supra* note 23, at 329–334.

[27] A commitment to lifetime employment was itself a response to labor conditions in post-World War II occupied Japan manifested by labor occupation of factories and the belief that

it was needed to constrain the communist movement in Japan. See Ronald J. Gilson & Mark Roe, Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance, 99 Col. L. Rev. 508 (1999).

[28] See Masahiko Aoki, Toward an Economic Model of the Japanese Firm, 28 J. Econ. Lit. 1 (1990).

[29] The collection of articles in The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies (M. Aoki & H. Patrick, eds., 1995) depicts the main bank system at its apogee.

[30] Masahiko Aoki, Hugh Patrick, & Paul Sheard, The Japanese Main Bank System: An Introductory Overview 3, 18, in Aoki & Patrick, *supra* note 29.

[31] See Clayton M. Christensen, The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail (1997).

[32] See Peter A. Hall & David Soskice, An Introduction to Varieties of Capitalism, in Varieties Of Capitalism: The Institutional Foundations of Comparative Advantage 35 (Peter A. Hall & David Soskice eds. 2001); Aoki & Patrick, *supra* note 29.

[33] Milgrom & Roberts, *supra* note 15.

[34] See Hideaki Miyajima & Fumiaki Kuroki, The Unwinding of Cross-Shareholding in Japan: Causes, Effects, and Implications, in Corporate Governance in Japan: Institutional Change and Organizational Diversity 79 (Masahiko Aoki, Gregory Jackson, and Hideaki Miyajima eds., 2007).

[35] See generally, Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (Peter A. Hall & David Soskice, eds., 2001).

[36] Peter A. Hall & David Soskice, An Introduction to Varieties of Capitalism 3, in Hall & Soskice, *supra* note 35.

[37] Ibid. at 8.

[38] Later developments in contract theory complicate this formulation somewhat. In LMEs, formal and informal contracts can be complementary, supporting relational arrangements. See Gilson, Sabel, & Scott, *supra* note 13.

[39] Hall & Soskice, *supra* note 35, at 9.

[40] Ibid. at 18. Mark Roe, for example, explores in detail the interaction between a country's political institutions and its corporate governance practices. See Mark J. Roe, Political Determinants of Corporate Governance (2006).

[41] See Ronald J. Gilson & Bernard Black, Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets, 47 J. Fin. Econ. 243 (1998).

[42] Hall & Soskice, Introduction, *supra* note 36.

[43] See Douglas C. North, Institutions, Institutional Change and Economic Performance 36 (1990).

[44] This is a debate that goes back at least 25 years. See Gilson & Gordon, *supra* note 6, at 332–333.

[45] Ronald J. Gilson & Charles Whitehead, Deconstructing Equity, discusses the potential for this method of adaptive efficiency. See Ronald J. Gilson & Charles Whitehead, Deconstructing Equity: Public Ownership, Agency Costs and Complete Capital Markets, 108 Col. L. Rev. 231 (2008).

[46] Curtis Milhaupt raises the question of whether corporate governance in China serves the same function as in other systems, and so whether familiar comparative analysis is helpful. Curtis J. Milhaupt, Chinese Corporate Capitalism in Comparative Context (October 13, 2015). Columbia Law and Economics Working Paper No. 522. Available at SSRN: http://ssrn.com/abstract=2673797. Elsewhere, Milhaupt helpfully describes the existing pattern and structures of Chinese government ownership of large companies, posing the question of whether the challenge is not the particular elements of Chinese corporate governance, but whether there is a span of control problem that suggests a conglomerate on steroids. See Li-Wen Lin & Curtis J. Milhaupt, We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, 67 Stan. L. Rev. 697 (2013).

[47] It is interesting that the Delaware judiciary appears to be more sensitive to the dynamics of corporate governance. While the broad claim of the adaptive character of Delaware corporate law dates to the Supreme Court's approval of an early variety of the poison pill in Unocal Corp. v. Mesa Petroleum, 493 A.2d 946 (Del. 1985), the Delaware courts appear to recognize the impact on governance of the intermediation of equity. See Gilson & Gordon, *supra* note 6.

[48] Stephan M. Bainbridge, Competing Concepts of the Corporation (a.k.a. Criteria—Just Say No), 2 Berkeley Bus. L. J. 79, 83 (2005). Lynn Stout, whose competing model is also addressed in section 4, invokes the parable as well. Lynn A. Stout, On the Nature of Corporations, 9 Deakin L. Rev. 775 (2004).

[49] See Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 93 Yale L. J. 239 (1984).

[50] See Robert H. Bates, Avner Grief, Margaret Levi, Jean-Laurent Rosenthal, & Barry R. Weingast, Analytic Narratives 3–23 (1998). Robert H. Bates, Beyond the Miracle of the Market: The Political Economy of Agrarian Development in Kenya (2005), provides an excellent example of this approach.

[51] This genre characterizes most of my own work as well, with the exception of occasional efforts with more formally oriented colleagues. See, e.g., Ronald J. Gilson & Alan Schwartz, Corporate Control and Credible Commitment, 43 Int'l. Rev. L & Econ. 115 (2015).

[52] For present purposes, I do not address multiple variable analysis.

[53] In particular, I will keep the number of references in the footnotes limited to illustrative examples. Otherwise, I fear, the references will get in the way of the argument.

[54] Economist, *supra* note 19.

[55] Patrick Bolton, Marco Becht, & Alicia Roell, Corporate Governance and Control, Handbook of the Economics of Finance, vol. 1, 1–109 (2003). See Michael Magill, Martine Quinzil, & Jean-Charles Rochet, A Theory of the Stakeholder Corporation, 83 Econometrica 1685 (2015). Roberta Romano traces recognition in the United States of corporations' need to orchestrate the competing demands of suppliers, customers, employees, and the community to Adolf Berle in Power Without Property (1959). Roberta Romano, Metapolitics and Corporate Law Reform, 36 Stan. L. Rev. 923 (1984).

[56] Mark J. Roe, Backlash, 98 Col. L. Rev. 222 (1998), provides an interesting account of the intersection of these forces in early twentieth-century Argentina.

[57] Hansmann & Kraakman, *supra* note 7. To be fair, Hansmann and Kraakman are typically used as a trope for a position—all that matters is shareholders—that they explicitly do not take. See *infra* note 62.

[58] See, e.g., Romano, *supra* note 55 at 963–971. A flurry of US state statutes that allowed or obligated boards of directors to take stakeholders into account have been largely without substance. Most important, these statutes, as well as corporate charter provisions that mirrored the statutes, were not enforceable by their putative beneficiaries.

[59] Henry Hansmann, The Ownership of Enterprise (1996).

[60] The empirical evidence is collected in Gilson, Sabel, & Scott, *supra* note 13, at 1384–1386.

[61] The original statement of the model is found in Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1990).

[62] The converse will also be true. While shareholders can sell their shares if they are treated poorly, the sale price will reflect that treatment, in effect capitalizing the expected reduced returns associated with other stakeholders' opportunism. The drop in share price then will reflect the stakeholders' opportunism. The usual reference for the argument to how shareholders can opportunistically shift returns from other stakeholders to themselves is Andrei Shleifer & Lawrence Summers, Breach of Trust in Hostile Takeovers, in Hostile Takeovers: Causes and Consequences 33 (A. Auerbach ed. 1988). For present purposes I note only that the analysis does not parse. In short form, Shleifer & Summers use post-airline deregulation as an examination of shareholder opportunism. The effect of deregulation was to allow entry of low-cost airlines with the result that the loss of the regulatory rents that had accrued to capital and labor resulted in losses to both. From this perspective, the takeovers that hit the industry was a process of allocating that loss between labor and capital. While Shleifer and Summers argue that the resulting allocation violated an implicit contract between airline and management, they do not explain how one would identify the terms of an implicit contract concerning an event—deregulation—that was not anticipated. They do suggest that the reallocation was only possible because post-takeover management did not value the prior management's reputation and the resulting ability to enter into implicit contracts. However, they do not explain why an asset that is valuable to prior management is not equally valuable to post-takeover management. See Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 620–622 (1995).

[63] Aoki, *supra* note 28.

[64] This assessment is examined in Liza Featherstone, Wage Against the Machine, Slate (June 27, 2008), http://www.slate.com/articles/business/moneybox/2008/06/wage_against_the_machine.html.

[65] Gilson & Gordon, *supra* note 6.

[66] See Ronald J. Gilson, Catalyzing Corporate Governance: The Evolution of the United States' System in the 1980s and 1990s, 24 Corp. & Sec. L. J. 143 (2006).

[67] Gilson & Gordon, *supra* note 6.

[68] Ronald J. Gilson & Jeffrey N. Gordon, Agency Capitalism: Further Implications of Equity Intermediation, in Research Handbook on Shareholder Power 32 (Jennifer Hill & Randall Thomas eds., 2015).

[69] Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547 (2002).

[70] Ibid. at 580.

[71] Japan may actually illustrate how the stakeholder model, team production, and director primacy can all co-exist in one system (suggesting that they need not be distinct "models" at all). That is, the Japanese firm in its heyday favored employees over shareholders. Those employees engaged in a tournament to become directors, whereupon they would reap the largest rewards (partly through tenure) and play the role of Blair & Stout's (*supra* note 61) mediating hierarchs. Because these senior managers were largely insulated from capital market pressures, and due to the absence of a lateral market for managerial talent, the system was one of director primacy in the extreme. I am grateful to Curtis Milhaupt for making this connection.

[72] In the 1980s, when hostile takeovers were dismantling the failed conglomerate experiment, firms representing 1–3% of total stock market value underwent leveraged buyouts each year from 1985 to 1988. Bengt Holstrom & Steven Kaplan, Corporate Governance and Merger Activity in the U.S.: Making Sense of the 1980s and 1990s, 15 J. Econ. Persp. 121 (2001). This volume of takeovers led to a report by the Council on Competiveness, headed by Harvard Business School strategy professor Michael Porter, extolling the Japanese governance system: "In general, the U.S. system is geared to optimize short-term returns, the Japanese and German systems optimize long-term returns." Michael E. Porter, Capital Choices: Changing the Way American Invests in Industry, 5 J. Appl. Corp. Fin. 4 (1992). The phenomenon generalizes: However long management and the board's leash, when the capital market begins to tug on it, those being tugged don't like it. See section 4.1.4.

[73] See Armen Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 67 Am. Econ. Rev. 777 (1972), discussed in Blair & Stout, supra note 61, at 266–268.

[74] See Bengt Holstrom, Moral Hazard in Teams, 13 Bell J. Econ. 324 (1982), discussed in Blair and Scott, supra note 61, at 268–269.

[75] See Ronald Coase, The Nature of the Firm, 386 (1937), discussed in Bainbridge, supra note 69, at 547.

[76] Kenneth J. Arrow, The Limits of Organization (1974), discussed in Bainbridge, supra note 69, at 57–59.

[77] Arrow, *supra* note 76, at 78–79.

[78] As a style of proof that their model is right (and that others are wrong), both Blair & Stout and Bainbridge offer extended arguments that current and historical corporate law is consistent with their respective models. I do not discuss these efforts here for two reasons. First, they necessarily depend on some version of an older argument that the common law, in this case corporate law, is efficient; without needing to rely on Alchian & Demsetz, Holstrom, Coase and Arrow, the process of case selection (and the structure of other lawmaking institutions) will result in efficient rules. This claim, whose intuition was understandable when first made, has not fared well. Absent a mechanism that leads to efficient outcomes based on distributed incentives, the claim is devolves into a belief that judges can be expected to get the answer right. My task here is instrumental, intelligent design rather than a blind belief in the operation of the judicial system. Put differently, a claim of survivorship in favor of an observable structure is a weak proof of efficiency. Second, invocation of the consistency of statutory rules and judicial decisions with the proffered models is an “inside baseball” argument. The authors discussed in the text (and I) are, with the exception of one economist whose appointment is in a law school, lawyers. Thus, tying a claim for a particular model back to legal arguments is understandable but backwards: In an intelligent design context, existing legal institutions and rules are a tool, not evidence of efficiency.

[79] See Bolton et al., *supra* note 55. Henry Hansmann and Reinier Kraakman point out that even this broad measure of social welfare is contestable. “For many individuals, increasing social stability may be worth sacrificing a meaningful amount of productivity as measured—as it conventionally is—in terms of the net value of market transactions … It is not crazy to feel that a leisurely daily walk to a dependable workplace in the well-preserved medieval city of one’s birth is preferable to lower prices on smartphones.” Henry Hansmann & Reinier Kraakman, Reflections on the End of History for Corporate Law, in Convergence of Corporate Governance: Promise and Prospects (Abdul Rasheed & Toru Yoshikawa, eds., 2012). Of course, this tradeoff is hardly limited to corporate governance, as a moment’s reflection on the current debate over the desirability of lowering trade barriers reminds. Addressing the broader issue is beyond my ambitions here other than to note that there is nothing in a Kaldor–Hicks analysis that counsels against redistribution of gains and losses.

[80] Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 834 n. 56 (1981). Easterbrook and Fischel made the same point in Voting in Corporate Law, 26 J. L. & Econ. 395 (1983).

[81] I recognize the difficulty of specifying and then operationalizing a fully developed measure of Kaldor–Hicks efficiency. However, I am concerned here with a real corporation’s operating system, where the measure is pragmatic: does it work to manage the stakeholders competing for the corporation’s revenues.

[82] I understand the standard reference is to Henri Poincaire, New Methods of Celestial Mechanics (1892).

[83] Ronald J. Gilson, The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment, 61 Ford. L. Rev. 161 (1992), emphasizes the importance of a corporation's mutability—its capacity to respond quickly to changes in its business environment.

[84] Clayton Christensen, The Innovator's Dilemma (2002), focuses on the dangers to market leaders from staying with what seems to work and what they are good at: why industry leaders fail to anticipate an innovation that devalues their skills and products, and as a result dilutes their dominant position—in Christensen's terms, a "disruptive" technology. The problem is not that the leaders are poorly managed; rather they are attentive to their customers, continually improve the quality and reduce the prices for their product, and usually anticipate what their customers will want before their customers know it themselves. Instead of merely extending the existing product architecture, a disruptive technology reflects so sharp a break with existing strategies that neither a market leader nor its customers initially see the new technology's potential. When the disruptive technology develops so that it is generalized to the industry core, the dominant firms are then displaced because they cannot respond quickly enough to the change in the architecture of production. More recently, the concept has been extended to any change in technology that severely degrades market leaders' capabilities and opens the door to new entrants. See Rebecca Henderson: The Innovator's Dilemma as a Problem of Organizational Competence, 23 J. Prod. Innovat. Manag. 5 (2016).

[85] Ronald J. Gilson & Reinier Kraakman, Takeovers in the Target Boardroom: Burke versus Schumpeter, 50 Bus. Law. 1419 (2005).

[86] Edmund Burke, Reflections on the Revolution in France 75 (Frank M. Turner ed. 2003)(originally published in 1790).

[87] Id. at 115.

[88] Joseph Schumpeter, Capitalism, Socialism and Democracy 82–83 (1942).