

VIRGINIA LAW & BUSINESS REVIEW

VOLUME 5

FALL 2010

NUMBER 2

THE CULT OF EFFICIENCY IN CORPORATE LAW

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ABSTRACT

This paper challenges a fundamental assumption of corporate law scholarship. Corporate law is heavily influenced by economics, and by normative economics in particular. Economic efficiency, for example, is seen as the primary goal of good corporate governance. But this dependence on standard notions of economic efficiency is unfortunate, as those notions are highly problematic. In economic theory, efficiency is spelled out in terms of individual preference satisfaction, which is an inadequate foundation for any sort of normative analysis. We argue that on any account of the good, people will sometimes prefer things that aren't good for them *on that account*. Giving people what they want, then, isn't necessarily an accomplishment, and thus the normative assessment of economic outcomes is much more complicated than economists recognize. This fact is something that should be reflected in corporate law scholarship, and would greatly expand the range of possible considerations when restructuring corporate law.

INTRODUCTION

THE standard view in corporate law holds that corporations are organized to maximize shareholder wealth. This focus is supposed to be economically efficient in the sense that no alternative arrangement can better satisfy any corporate stakeholder without satisfying another stakeholder to a lesser extent. This efficiency claim has both a descriptive and a normative dimension: focus on shareholder wealth maximization (subject to the business judgment rule) is the corporate standard because of pressures to satisfy stakeholder wishes; it is also supposed to be a good thing precisely because it improves the satisfaction of some stakeholders' desires without diminishing the satisfaction of others.

The normative argument here is problematic. Economic efficiency is ultimately a matter of how preference satisfaction is distributed. Preference satisfaction, however, is a deficient foundation for moral claims: giving people what they want isn't necessarily a good thing. This is not merely the result of particular judgments based on traditional moral views. On any account of the good, people will sometimes want things that aren't good for them *on that account*. Economic efficiency looks at the wrong sort of thing for a normative view. Given this problem, the moral foundation of corporate law is undermined.

This Article proceeds in three stages. The first Part reviews some of the basic notions of economic efficiency, from Pareto optimality to the more forgiving Kaldor-Hicks version. The second Part examines how corporate

scholars of almost every variety have reflexively relied upon standard notions of efficiency to provide the normative underpinnings for their particular visions of corporate governance. The third Part, comprising the bulk of the essay, argues that efficiency is normatively irrelevant and, as such, is not a proper basis for evaluating the structures of corporate governance. This conclusion undercuts many of the arguments against corporate reform, opening the debate over corporate governance to a much wider, and ultimately more illuminating, array of considerations.

I. ECONOMIC EFFICIENCY – A QUICK REVIEW

When economists discuss efficiency, they are typically referring to *Pareto optimality*, also known as *Pareto efficiency* or *allocative efficiency*. To understand Pareto optimality, one must first understand the notion of a *Pareto improvement*. A situation x is a Pareto improvement over a situation y just in case no one (strictly) prefers y to x and at least one person (strictly) prefers x to y .¹ The definition of a Pareto improvement is sometimes put in terms of utility: x is a Pareto improvement over y just in case the utility of x is at least as great as the utility of y for everyone and the utility of x is greater than the utility of y for at least one person.² Since utility, in the sense intended, is simply a numerical index of individual preference satisfaction, the two accounts are equivalent³—either way, Pareto improvements are defined in terms of preference satisfaction. A situation is Pareto optimal just in case no other situation is a Pareto improvement over it.⁴ If, for example, z is a Pareto optimal situation, and someone (strictly) prefers x to z then there must be someone else who prefers z to x . In other words, if a situation is Pareto optimal and someone wants to change it, then either someone else opposes the change or you weren't at a Pareto optimal situation to begin with. A Pareto optimal situation is often thought to be desirable because it is the end result of a series of Pareto improvements, which are thought to be good. In other words, Pareto optimality is valued because it implies that as much uncontested (and thus

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1. See, e.g., DANIEL M. HAUSMAN & MICHAEL MCPHERSON, *ECONOMIC ANALYSIS, MORAL PHILOSOPHY, AND PUBLIC POLICY* 65 (2d ed. 2006). On the standard terminology, this is a *weak* Pareto improvement; x is a *strong* Pareto improvement over y if and only if everyone (strictly) prefers x to y . We frame the discussion in terms of weak Pareto improvements, but the arguments apply to strong Pareto improvements too, *mutatis mutandis*.
 2. See, e.g., YEW-KWANG NG, *WELFARE ECONOMICS: INTRODUCTION AND DEVELOPMENT OF BASIC CONCEPTS* 30 (1979).
 3. See HAUSMAN & MCPHERSON, *supra* note 1, at 53–54.
 4. *Id.* at 65.

uncontroversial) preference satisfaction has been achieved as possible from a given starting point.

The uncontested nature of Pareto improvements is what makes them so appealing to economists. So long as a given situation is a Pareto improvement over what preceded it, one never has to balance one person's gains in satisfaction with another's losses (since, by definition, nobody prefers the former situation and hence nobody loses satisfaction). This allows economists to avoid making interpersonal utility comparisons, which are thought to be fraught with difficulties.⁵ The main difficulty with such comparisons is that there is no objective scale upon which to compare the level of preference satisfaction of two different people.⁶ As Lionel Robbins recognized in the early 1930s:

*There is no means of testing the magnitude of A's satisfaction as compared with B's. If we tested the state of their blood-streams, that would be a test of blood, not satisfaction. Introspection does not enable A to measure what is going on in B's mind, nor B to measure what is going on in A's. There is no way of comparing the satisfactions of different people.*⁷

Economists, seeking to ground their claims on neutral empirical evidence, thus limited themselves to measuring the desirability of various situations in terms of Pareto improvements and Pareto optimality.⁸

Dodging the problem of interpersonal utility comparisons, however, comes at a price—economists are left with a relatively stripped-down metric. People and institutions are rarely in situations where, all things considered, they are in position to make a decision that produces a Pareto improvement—more frequently, there are winners and losers. It is also far from clear that anyone would want to limit policymakers to decisions that produced Pareto improvements. As Amartya Sen pointed out:

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5. See JAMES GRIFFIN, WELL-BEING: ITS MEANING, MEASUREMENT, AND MORAL IMPORTANCE 113–20 (1986); Daniel M. Hausman, *The Impossibility of Interpersonal Utility Comparisons*, 104 MIND 473, 475–77 (1995); Grant M. Hayden, *The False Promise of One Person, One Vote*, 102 MICH. L. REV. 213, 236–47 (2003). A brief discussion of the concept of utility and its relationship to welfare may be found in Alfred F. MacKay, *Extended Sympathy and Interpersonal Utility Comparisons*, 83 J. PHIL. 305, 305–07 (1986).
 6. See Hayden, *supra* note 5, at 244–47.
 7. LIONEL ROBBINS, AN ESSAY ON THE NATURE & SIGNIFICANCE OF ECONOMIC SCIENCE 139–40 (2d ed. 1937).
 8. See Hayden, *supra* note 5, at 238; Peter J. Hammond, *Interpersonal Comparisons of Utility: Why and How They Are and Should Be Made*, in INTERPERSONAL COMPARISONS OF WELL-BEING 200, 206 (Jon Elster & John E. Roemer eds., 1991).

An economy can be optimal in this sense even when some people are rolling in luxury and others are near starvation as long as the starvers cannot be made better off without cutting into the pleasures of the rich. If preventing the burning of Rome would have made Emperor Nero feel worse off, then letting him burn Rome would have been Pareto-optimal. In short, a society or an economy can be Pareto-optimal and still be perfectly disgusting.⁹

Thus, Pareto measures, at best, incompletely capture most decision-making situations and may even counsel against some very good options (extinguishing the fires of Rome, for example). They have, in other words, both descriptive and normative shortcomings.

Economists have responded to these shortcomings by relying upon another, related measure of efficiency—Kaldor-Hicks efficiency.¹⁰ A situation x is a Kaldor-Hicks improvement over situation y just in case the winners under x could compensate the losers such that, after compensation, nobody would prefer y to x and at least one person would prefer x to y .¹¹ In other words, states of affairs are Kaldor-Hicks efficient just in case they *would* be Pareto improvements if compensation were actually paid.¹² For this reason, some have called Kaldor-Hicks efficiency a “potential Pareto” criterion.¹³

Using Kaldor-Hicks efficiency has helped economists get around the fact that the Pareto criterion has little to offer in analyzing most situations, where the realistic options produce both winners and losers. This enables them to get some work done while maintaining the fiction that they are doing so in a “neutral” way. It is a fiction, of course, because the Kaldor-Hicks criterion is useful only because it reintroduces interpersonal utility comparisons and their messy, unfounded value judgments.¹⁴ That said, many economists, and the corporate law theorists who follow them, spin their theories praying for Pareto efficiency and settling for Kaldor-Hicks. At any rate, Kaldor-Hicks efficiency is concerned with utility, which is to say preference satisfaction. If we are right about the inadequacy of preference satisfaction based normative claims, Kaldor-Hicks efficiency falls along with Pareto efficiency.

9. AMARTYA K. SEN, *COLLECTIVE CHOICE AND SOCIAL WELFARE* 22 (1970).

10. See Jules L. Coleman, *The Grounds of Welfare*, 112 *YALE L.J.* 1511, 1517 (2003). For more on Kaldor-Hicks efficiency, see generally JULES L. COLEMAN, *MARKETS, MORALS, AND THE LAW* 81–86, 98–100, 104–05, 116–17 (1988).

11. See Coleman (2003), *supra* note 10, at 1517.

12. See, COLEMAN (1988), *supra* note 10, at 84. Of course, actual compensation need not be paid. See *id.*

13. See GUIDO CALABRESI & PHILIP BOBBITT, *TRAGIC CHOICES* 85–86 (1978); see also HAUSMAN & MCPHERSON, *supra* note 1, at 65.

14. See Coleman (2003), *supra* note 10, at 1517.

Preference-based claims of efficiency play both a descriptive and normative role in economic theory. Economists appeal to Pareto optimality in order to describe the outcomes that result from (or are at least approached by) certain economic interactions; they also see such efficient outcomes as desirable. Economists focus on these outcomes precisely because they see them as good.¹⁵ The descriptive account that features efficiency claims holds that, absent constraints, people will engage in voluntary trading in order to achieve their goals. Under certain (not-wholly-improbable) conditions, voluntary transactions are Pareto improvements. In order for a trade to happen, for example, at least one participant must (strictly) prefer it and no participant will prefer that it not happen; further, most third parties are likely to be indifferent.¹⁶ Voluntary transactions will proceed until no one wants to trade anymore, resulting in a Pareto optimal situation. This is the core of the argument that perfectly competitive markets are efficient.¹⁷

The normative role of Pareto efficiency is even easier to see. Almost all economists accept some version of the Pareto principle, which holds, roughly, that if a situation x is a Pareto improvement over a situation y then x is better than y .¹⁸ The argument for the Pareto principle involves two key principles.

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15. Paul T. Heyne, *Moral Misunderstanding and the Justification of Markets*, THE REGION (Dec. 1998), available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3583.
 16. This assumes that the preferences of people who aren't part of the transaction aren't "entangled" with those of traders. While this is generally false (for example, repugnant markets, envy, altruism, etc.), it is at least plausible for many interactions among strangers.
 17. Perfect competition involves a set of conditions that are sufficient to guarantee that voluntary transactions are Pareto improvements.
 18. See, e.g., HAUSMAN & MCPHERSON, *supra* note 1, at 136; AMARTYA K. SEN, ETHICS & ECONOMICS: THE MORAL STANDING OF THE MARKET 10 (Ellen Frankel Paul et al. eds., 1985); Bertil Tungodden, *The Value of Equality*, 19 ECON. & PHIL. 1, 19 (2003); Howard F. Chang, *A Liberal Theory of Social Welfare: Fairness, Utility, and the Pareto Principle*, 110 YALE L.J. 173, 175–80 (2000); Martin Feldstein, *Reducing Poverty, Not Inequality*, 139 PUB. INTEREST 33, 34 (1999); Nicolas Gravel, *On the Difficulty of Combining Actual and Potential Criteria for an Increase in Social Welfare*, 17 ECON. THEORY 163, 164 (2001); Nicholas Rescher, *Economics vs. Moral Philosophy: The Pareto Principle as a Case Study of their Divergent Orientation*, 10 (Ellen Frankel Paul et al. eds., 1985); THEORY & DECISION 169, 170 (1979); Amartya K. Sen, *Liberty, Unanimity and Rights*, 43 *Economica* 217, 217 (1976); Amartya K. Sen, *Personal Utilities and Public Judgments: Or What's Wrong with Welfare Economics*, 89 ECON. J. 537, 537 (1979); Robert Sugden & Albert Weale, *A Contractual Reformulation of Certain Aspects of Welfare Economics*, 46 *ECONOMICA* 111, 111 (1979). On the standard terminology, this is a version of the *strong* Pareto principle since it appeals to *weak* Pareto improvements. The strong Pareto principles involves weak Pareto improvements; the *weak* Pareto principle involves strong Pareto improvements, i.e., if everyone prefers x to y then x is better than y . See, e.g., Nicolas Gravel, *On the Difficulty of Combining Actual and Potential Criteria for an Increase in Social Welfare*. 17 *ECON. THEORY* 163, 164 (2001).

Unambiguous Welfare Gain (“UWG”): The existence of a Pareto improvement implies that there is welfare gain for someone without a decrease in anyone’s welfare.

Minimal Benevolence (“MB”): It is (morally) good to increase welfare, other things equal.¹⁹

UWG holds that preference satisfaction is connected with well-being; MB ties well-being to morality. If both principles hold true, then Pareto improvements increase welfare and increasing welfare is good, *ceteris paribus*.²⁰ This argument involves a dual appeal to dominance reasoning—that if something is better along one set of dimensions and no worse along any other, then it must be better with respect to those dimensions all together. If x is a Pareto improvement over y , x is supposed to be better than y with respect to one facet of the good—welfare—because it improves the well-being of at least one person and leaves no one worse off. Further, if other non-welfare values are the same, then x is better than y *simpliciter*. A number of thinkers are leery of the Pareto principle on the grounds that moral analysis goes beyond issues of well-being. They allow, for example, that x might be a Pareto improvement over y and still be worse than y because well-being is not the only morally relevant issue in evaluating x and y .²¹ They usually conclude that Pareto improvements are still morally appealing because, even if particular Pareto improvements are not, on balance, good, Pareto improvements are moral improvements, other things equal.²² Even on this account, every inefficient outcome is worse with respect to welfare than any Pareto improvement over it. The maximum amount of welfare obtainable is reached by some Pareto optimal outcome. This allows, of course, for non-welfare distinctions among Pareto efficient outcomes, but it is often thought that being Pareto optimal is a necessary condition for something to be a best outcome.

19. See HAUSMAN & MCPHERSON, *supra* note 1, at 65.

20. See, e.g., HAUSMAN & MCPHERSON, *supra* note 1, at 64–65; Botond Koszegi & Matthew Rabin, *Choices, Situations, and Happiness*, 92 J. PUB. ECON. 1821, 1821–23 (2008); S. Gloria-Palermo & G. Palermo, *Austrian Economics and Value Judgments: A Critical Comparison with Neoclassical Economics*, 17 REV. POL. ECON. 63, 66–67 (2005); Anne E. Cudd, *Is Pareto Optimality a Criterion for Justice?*, 22 SOC. THEORY & PRACTICE 1, 1, 28–29 (1996).

21. See, e.g., HAUSMAN & MCPHERSON, *supra* note 1, at 65–67; SEN (1985), *supra* note 18; Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 579 (2006); Sen (1976), *supra* note 18, at 220, 226, 235; Robert Sugden, *Is Fairness Good? A Critique of Varian’s Theory of Fairness*, 18 NOUS 505, 505 (1984).

22. See HAUSMAN & MCPHERSON, *supra* note 1, at 138; SEN (1985), *supra* note 18, at 10; Chang, *supra* note 18, at 177, 196.

II. EFFICIENCY IS CENTRAL TO CORPORATE LAW

The study of corporate governance is concerned with control over corporate decision-making: it investigates who has such control, the extent of that control, and the purpose that the control serves. These questions raise important issues about both the ontology and teleology of corporations. There seems to be considerable debate, for example, about what corporations actually *are*: artificial persons, entities (partially abstract) that can be owned, or sets of interconnected contracts.²³ There is, however, general agreement about certain features of corporate control. Virtually everyone agrees that shareholders have relatively little direct control over corporate policy.²⁴ Shareholders do, however, have the right to receive residual profits as well as the right to elect the board of directors. The directors are, in turn, the locus of authority within the corporation—they are the representatives of the firm when human counterparts to the fictional form are required.²⁵ The board, however, does not generally run the business—directors generally delegate this power to the officers of the corporation, who have day-to-day control over a firm’s decision-making. It is one of the stylized facts about corporate governance that this corporate structure separates ownership from control.²⁶ And it seems to be a condition on the adequacy of any theory of the corporation that it accounts for these principal features of corporate governance.²⁷

There is also considerable agreement about not only the proximate goal at which corporate decision-making aims—shareholder wealth maximization—but also the further end served by focusing on this goal—allocative

23. See, e.g., STEPHEN BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 17, 23–30 (2008); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 11–12, 37, 67–68 (1991); Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32–33, 122–26.

24. See BAINBRIDGE, *supra* note 23, at 4–6, 19–20; EASTERBROOK & FISCHEL, *supra* note 23, at 1, 4–6.

25. ROBERT CHARLES CLARK, *CORPORATE LAW* 21 (1986).

26. See BAINBRIDGE, *supra* note 23, at 4. See generally, ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 277 (1932), whose discussion of the separation of ownership and control has arguably led to much of the later work in the field. Cf. Edward B. Rock & Michael Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1624 (2001) (“It was as if everyone already knew (from Berle and Means) that the master problem of corporate law was agency costs, and along came an economic model and a vocabulary to elaborate that view.”).

27. See BAINBRIDGE, *supra* note 23, at 3; EASTERBROOK & FISCHEL, *supra* note 23, at vii.

efficiency.²⁸ As we will see, while theorists disagree about *how* the relationships among corporate stakeholders lead to Pareto improvements, they generally agree that they do lead to such improvements. As is usually the case where economic reasoning is involved, this kind of appeal to efficiency plays both descriptive and normative roles: the focus on shareholder wealth is both explained and justified as the result of Pareto improving transactions.²⁹

On the traditional account of the corporation, shareholders own the firm.³⁰ Managing operations through anything like ownership consensus, however, is exceedingly difficult because shareholders have different perspectives, degrees of interest, and levels of expertise. Given this difficulty, shareholders find it advantageous to their interests to hire a manager, and often to set up a management hierarchy. Such a course achieves both the lower transaction costs of unified decision-making and the higher outputs of having the firm controlled by someone with special expertise.³¹ The (expected) increased profits make it at least *possible* for the corporation to offer more attractive deals to other stakeholders, so no one should lose utility.³²

The shareholder-ownership/management-control account involves a classical principle-agent situation—the owners relinquish control for the benefits of expertise and unitary decision-making. As an employee of the shareholders, a manager has a duty to look out for their interests.³³ There are no advantages to be gained, however, unless the shareholders actually relinquish control and the managers actually exercise it. This relationship is set forth in the business judgment rule.³⁴

There are drawbacks to any such arrangement, of course. A manager/agent will not have exactly the same incentives as her shareholders/principals. She might, therefore, be tempted to cheat, or at least give less than her full effort.³⁵ The oversight provided by assigning her a fiduciary duty tends to ameliorate such problems, as does the market for

28. See, e.g., BAINBRIDGE, *supra* note 23, at 32–33, 35, 57–59, 65–72; EASTERBROOK & FISCHEL, *supra* note 23, at vii, 67–68, 93; Lee, *supra* note 21, at 535–39.

29. See BAINBRIDGE, *supra* note 23, at ix–xii; EASTERBROOK AND FISCHEL, *supra* note 23, at vii–viii.

30. See BAINBRIDGE, *supra* note 23, at 6–7, 32–33; Friedman, *supra* note 23, at 33.

31. See BAINBRIDGE, *supra* note 23, at 4–6, 37–45; EASTERBROOK & FISCHEL, *supra* note 23, at 8–10; Friedman, *supra* note 23, at 122.

32. See Lee, *supra* note 21, at 537–38.

33. See Friedman, *supra* note 23, at 33.

34. See BAINBRIDGE, *supra* note 23, at 106–14; EASTERBROOK & FISCHEL, *supra* note 23, at 93–100; Lee, *supra* note 21, at 551–52.

35. See BAINBRIDGE, *supra* note 23, at 73–74; EASTERBROOK & FISCHEL, *supra* note 23, at 91.

corporate control and her concern for her own reputation, but too much direct monitoring undermines the point of the arrangement.³⁶

Does this imply that there is an inefficiency built into the usual corporate structure? No, or at least not an allocative inefficiency. A corporation would achieve greater profits if managers had the same interests as shareholders; in that sense, the corporation isn't achieving as much as it could. Allocative efficiency is concerned, however, with the preferences of agents: in general, a manager won't want to act exactly as shareholders would have her; to incentivize her to do so, shareholders would need to monitor her in a way they would rather not. Dividing ownership from control is a compromise from the perspective of both shareholders and managers, but it is also a Pareto improvement over shareholder control.

A more recent account of corporate governance holds that a corporation is best understood as set of voluntary, intersecting agreements, i.e., as a nexus of contracts.³⁷ Given that this model is based on a series of contracts, and each of those contracts is posited to involve a Pareto improvement (for all parties consenting to a contract prefer the state of affairs under the contract), it should come as no surprise that the resulting corporation is viewed to have a strong basis in efficiency. Once this underlying story is in place, the details take care of themselves. On this account, corporations have unified control for exactly the same reasons as on the more traditional view: all contracting parties prefer unified decision-making by experts. The distribution of corporate proceeds to various stakeholders is also supposed to be efficient. Shareholders, in particular, as the residual claimants, are assigned what is left after all fixed claims on corporate proceeds have been paid.³⁸ Managers and directors are assigned, by contract or statute, a fiduciary duty to shareholders in order to make the residual attractive.³⁹ Total proceeds are supposed to be higher if the residual claims are assigned to one group.⁴⁰ Shareholders get the nod over other stakeholders in lieu of contractual claims because that is the best way to induce them to put their money at risk while also relinquishing any real control over how it is used.⁴¹ Again, the result is a combination of

36. See BAINBRIDGE, *supra* note 23, at 75, 100–04, 112–13; EASTERBROOK & FISCHEL, *supra* note 23, at 91–93, 217–18.

37. See BAINBRIDGE, *supra* note 23, at 17, 23–24, 28–30, 33–37, 43–47; EASTERBROOK & FISCHEL, *supra* note 23, at 12, 14, 90–91.

38. See BAINBRIDGE, *supra* note 22, at 57–59, 65–72; EASTERBROOK & FISCHEL, *supra* note 22, at 30, 67–68.

39. See BAINBRIDGE, *supra* note 22, at 68, 71–72; EASTERBROOK & FISCHEL, *supra* note 22, at 90–93.

40. See BAINBRIDGE, *supra* note 22, at 66–67; EASTERBROOK & FISCHEL, *supra* note 22, at 38.

41. See BAINBRIDGE, *supra* note 22, at 67–72; EASTERBROOK & FISCHEL, *supra* note 22, at 36–37.

managerial control (as expressed by the business judgment rule) and shareholder interest (expressed by charging the managers with maximizing shareholder wealth) that is supposed to be a Pareto improvement over both shareholder control and a system that tries to promote all stakeholder interests.

Not all legal scholars are advocates of shareholder wealth maximization. Most, however, seem to accept that it is, as a descriptive matter, the primary goal of most corporations.⁴² Some who argue that shareholder wealth maximization isn't an appropriate goal do so on efficiency grounds.⁴³ Margaret Blair and Lynn Stout, for example, believe that the board should directly advance the interests of all corporate constituents, and needs to be somewhat insulated in order to do that (as to avoid domination, at a minimum, by shareholder interests).⁴⁴ The interests of the corporation, in their view, "can be understood as a joint welfare function of all the individuals who make firm-specific investments and agree to participate in the extracontractual, internal mediation process within the firm."⁴⁵ The directors, as mediating hierarchs in this system, make decisions in order to maximize preference satisfaction of all stakeholders (according to the joint "welfare" function) and so to increase allocative efficiency (at least in the Kaldor-Hicks sense).

Indeed, efficiency is regarded with such reverence that even those who criticize shareholder wealth maximization for non-efficiency (e.g., moral) reasons still allow that efficiency is an important consideration. Susan Stabile, for example, believes that the economic interests of a corporation should be subordinated to the promotion of human dignity.⁴⁶ Her particular vision is grounded Catholic social thought, which "emphatically rejects the idea that social welfare is merely a question of giving people what they want without regard to what it is that people want."⁴⁷ That said, Stabile doesn't wholly abandon economic efficiency as a normative goal; instead she limits her criticism to the "exclusive" focus on shareholder wealth maximization, noting that profit remains a "legitimate" corporate pursuit.⁴⁸

42. See Lee, *supra* note 21, at 535, 537–39 (2006).

43. See generally Lee, *supra* note 21, for a discussion of Blair's and Stout's team production account for and Elhauge's argument for profit-sacrificing discretion.

44. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 288–89 (1999).

45. *Id.* at 288.

46. See Susan J. Stabile, *The Catholic Vision of the Corporation*, 4 SEATTLE J. SOC. JUST. 181, 186 (2005).

47. *Id.* at 189.

48. See *id.* at 190–91.

III. EFFICIENCY AND ITS SHORTCOMINGS

A. Some Existing Criticisms of Efficiency

Over the years, this single-minded focus on efficiency has attracted a fair amount of criticism. Scholars have taken aim at everything from its cramped view of the content of peoples' preferences to its overreliance on revealed preferences to its disdainful exclusion of other considerations (such as fairness). We briefly catalogue some of the main criticisms in order to distinguish the argument made in this paper.

One set of criticisms is that standard economics, and hence corporate law scholarship, paints an incomplete picture of the content of people's interests and preferences. Standard economics imagines people as self-interested utility maximizers and sometimes, more specifically, wealth maximizers.⁴⁹ This certainly underpins much of the economic reasoning in corporate law—many scholars, for example, assume that shareholders have a single-minded interest in profit maximization and build their theories of corporate governance accordingly.⁵⁰ There is little room in standard economics for people who are concerned about fairness, justice, and similar “other-regarding” outcomes.

But real people, the critics maintain, are not and should not be like this. Real people want all sorts of things, including outcomes that appeal to their conceptions of fairness or justice.⁵¹ Even the archetypes of *Homo economicus*—shareholders—are interested in more than just increasing the monetary value of their shares.⁵² The economics underlying corporate theory, to the extent it says differently, is both descriptively inaccurate and normatively bankrupt.

Economists have a ready answer to this criticism. Utility is just a mathematical representation of preferences, and it ultimately reflects a person's desires.⁵³ To the extent people desire states of affairs that promote something beyond their narrow, financial self-interest, those desires get built

49. See Lawrence E. Mitchell, *The Cult of Efficiency*, 71 TEX. L. REV. 217, 228 (1992).

50. The assumption that shareholders have relatively homogeneous preferences with respect to wealth maximization is important to many theories of corporate governance. See Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 448 (2008); Grant M. Hayden & Matthew T. Bodie, *Shareholder Democracy and the Curious Turn Toward Board Primacy*, WM. & MARY L. REV. 2071, 2085 (2010); Mitchell, *supra* note 49, at 229.

51. See Grant Hayden & Stephen Ellis, *Law and Economics After Behavioral Economics*, 55 KAN. L. REV. 629, 640 (2007); Mitchell, *supra* note 49, at 229.

52. See Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 578 (2006) (cataloguing the ways in which shareholder interests diverge); Hayden & Bodie, *One Share, One Vote*, *supra* note 50, at 500 (same).

53. See Hayden & Ellis, *supra* note 51, at 640.

back into their utility functions.⁵⁴ (As Louis Kaplow and Steven Shavell put it, people may have a “taste” for fairness that is reflected in their preferences.)⁵⁵ This response, while no doubt true, does undercut some of the claims made by corporate theorists on the basis of shareholder preference homogeneity. More importantly for our purposes, though, this move by economists to capture a broader range of human desires does little to take them outside of people’s preferences. If anything, it solidifies the role of preference satisfaction in descriptive accounts and, indirectly, the sanctity of preference satisfaction in normative accounts.

A second set of criticisms of efficiency take aim at the source of information about people’s preferences. In order to discern the content of preferences, most economists rely exclusively upon people’s actual choices. Indeed, the choices themselves are identified as “revealed” preferences.⁵⁶ This reliance upon observable behavior, much like the use of Pareto efficiency to begin with, is supposed to take the guesswork out of preference assessment.⁵⁷ The claim that people choose what they prefer is treated as a virtual tautology, so choice gives us all of the information we could want about preferences.

This account has been questioned in a number of ways. Initially, economists are criticized for ignoring other sources of information about preferences. One may deduce preferences from actual choices, but one may also come across preference information through introspection (for one’s own preferences) or communication (asking others about their desires).⁵⁸ A second criticism is that reliance upon actual choices may be especially problematic where it is used most—in market contexts—where choices are often constrained by the ability to pay.⁵⁹ For example, an economist would be hard pressed, in analyzing our purchase decisions, to come up with much

54. See *id.* at 640–41; Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1553–55, 1557–58 (1998).

55. See LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 21, 431 (2002).

56. See Herbert Hovenkamp, *The Limits of Preference-Based Legal Policy*, 89 NW. U. L. REV. 4, 4–5 (1994).

57. See *id.* at 4–6. Hovenkamp argues that discovering preferences is so problematic that it can never be correctly described as objective. *Id.* at 6.

58. See Lee, *supra* note 21, at 580–82; Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 339–40 (1977).

59. Willingness to pay, as measured by actual choices, is a function of both utility and budget constraint. Steve isn’t willing to pay a million dollars to see his children thrive, not because he wouldn’t pay anything to see them do well but because he does not have the million dollars to spend. See Hovenkamp, *supra* note 56, at 13; Thomas F. Cotter, *Legal Pragmatism and the Law and Economics Movement*, 84 GEO. L.J. 2071, 2127 (1996).

information about our very real desires for front-row seats to all Kansas basketball games.⁶⁰

These criticisms of revealed preference undermine any analytic link between choice and preference, and have been subject to discussion elsewhere.⁶¹ Our critique, however, is more fundamental. Regardless of the source of our information about the preferences that sustain efficiency claims, we maintain that those preferences are ill-suited to fill the normative role assigned to the Pareto principle. No pattern of actual preference satisfaction is sufficient to establish any welfare claim.

B. Efficiency is Normatively Irrelevant

The problem with the Pareto principle is that it relies on the controversial UWG claim.⁶² Economists routinely identify welfare with utility (and so ultimately with preference satisfaction).⁶³ This is especially true of law and economics scholars and their corporate law disciples. Louis Kaplow and Steven Shavell, for example, have touted the superiority of a welfare or well-being approach in evaluating the effect of legal rules.⁶⁴ They explicitly define welfare in terms of utility and expected utility, which incorporates everything that one may find valuable (or distasteful).⁶⁵ They straightforwardly rely on preferences as revealed by behavior to identify those wants (and aversions).⁶⁶ Their central thesis is that their welfare-based approach is superior to one in which notions of fairness drive our assessment of legal rules.⁶⁷

60. See Gary Bedore, *KU Sells Courtside Basketball Seats for \$15,000 Each*, LAWRENCE JOURNAL-WORLD, Aug. 21, 2009, at 1.

61. See, e.g., Daniel M. Hausman, *Revealed Preference, Belief, and Game Theory*, 16 ECON. & PHIL. 99 (2000).

62. Recall that the Unambiguous Welfare Gain claim is that the existence of a Pareto improvement implies that there is welfare gain for someone without a decrease in anyone's welfare. The accompanying claim of Minimal Benevolence is comparatively weak: it asserts only that well-being is one dimension of value. This is generally recognized as a reasonable view, so we won't discuss it here.

63. See, e.g., Koszegi & Rabin, *supra* note 20, at 1821, 1823–24; Julianne Nelson, *Business Ethics in a Competitive Market*, 13 J. BUS. ETHICS 663, 663–64 (1994); Sugden, *supra* note 21, at 507. There is a Libertarian argument for market exchange, but it isn't based on the value of facilitating preference satisfaction. Voluntary trades are supposed to be good because they respect freedom, whether or not they enhance welfare. See Walter E. Williams, *The Argument for Free Markets: Morality vs. Efficiency*, 15 CATO J. 179, 182 (1996).

64. See Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 967 (2001), reprinted in KAPLOW & SHAVELL, *supra* note 55, at 3.

65. See KAPLOW & SHAVELL, *supra* note 55, at 18.

66. See *id.* at 409.

67. See *id.* at 3–4.

Although Kaplow and Shavell define welfare by way of preference satisfaction, they acknowledge that there are “possible differences” between individual preference and “true well-being.”⁶⁸ This gap is, of course, important, and the success of their normative claim rides on their ability to bridge it. But when it comes to so-called “objectionable” preferences, they end up admitting that, under their approach, there is no basis for ignoring them or, indeed, even defining them.⁶⁹ Instead, they tend to limit the category of such preferences, spending a fair amount of time on the preferences of rapists, bigots, and sadists, which allows them to dodge the issue by arguing that such preferences are rare enough that they will most often be outweighed in the utility calculus and thus will not lead to laws that allow their satisfaction.⁷⁰ When it comes to cognitive shortcomings, they make a similar fudge, explaining that when individuals do not fully understand what is good for them, one may use their “actual well-being”—what they would prefer if they correctly understood how they were affected.⁷¹ Of course, there is little explanation how one, relying upon revealed preferences, is to get this information.⁷²

Corporate law scholars further muddle up this issue. Stephen Bainbridge, for example, just skips preferences and defines Pareto improvements in terms of well-being. He holds that x is a Pareto improvement over some y just in case x makes at least one person better off than she would be at y without making anyone worse off than they would be at y .⁷³ He leaves out preferences, however, not because he thinks there is reason to doubt that satisfying a person’s preferences will make her better off. Instead, he seems to so closely identify preference satisfaction with well-being that he feels comfortable conflating the two. As a result, Bainbridge’s “better off” formulation isn’t a version of the economic notion of Pareto improvement at all.⁷⁴

Economists and corporate law scholars, then, regularly equate well-being with preference satisfaction. We should be unwilling to follow suit. The clearest illustrations of how preference and well-being come apart involve appeal to moral and prudential intuitions. Rachel, for example, lost everything she ever loved to her methamphetamine addiction. To hold that she was better off in some way for fulfilling her desire for meth doesn’t make sense—preferring a pleasant stupor to a (quite satisfactory) family life was an

68. *See id.* at 4 n.4, 12–13.

69. *See id.* at 421–26.

70. *See id.* at 427.

71. *See id.* at 23.

72. *See id.* at 410–13.

73. *See* BAINBRIDGE, *supra* note 23, at 58.

74. *See* HAUSMAN & MCPHERSON, *supra* note 1, at 64–65.

error for Rachel. A moment's reflection suggests that people often want things that are not good for them: inexperienced drivers want vehicles they can't handle; the overconfident want to avoid correction; the self-loathing want to be inappropriately punished; the bigot desires to avoid those she sees as inferior. When someone gets what she wants in such cases it doesn't count as any sort of welfare gain because the desires satisfied are just inappropriate or mistaken.⁷⁵

At a practical level, it is inevitable that people will want things that don't enhance their welfare. People make mistakes in forming preferences, even when they reason from their own views about welfare. And, importantly, satisfying mistaken preferences won't be conducive to an agent's well-being *even by her own lights*.

In the most prosaic (and common) cases, people have false beliefs that lead them to want one thing when it would make sense for them to want another. Steve might, for example, desire money and so come to want shares in CompuGlobalHyperMegaNet (CGHMN) because he believes (erroneously, it turns out) that an investment in CGHMN will make money.⁷⁶ Steve's proximate desire for shares of CGHMN does not track his more basic desire for money and so satisfying his desire for shares doesn't make him better off by his own view.⁷⁷ It follows, then, that erroneous beliefs can give rise to Pareto improvements where at least one person will actually be worse off by her own lights. Someone must be selling shares of CGHMN if Steve is able to buy them. A transaction between them might well be a Pareto improvement: Steve wants to buy, the seller wants to sell, and no one else really cares. In general (e.g., special circumstances and portfolio effects aside), people prefer to buy shares when they think their value will go up and sell when they think their value will go down. No matter what happens to CGHMN stock, one of the parties will fail to achieve their ends: if the price goes down, Steve will regret his purchase; if the price goes up, the seller will regret the sale. Both want to make the transaction but one will fail to get what he or she really wants.⁷⁸ This sort of possibility shows that Pareto improvements wouldn't guarantee welfare gains even if what people sought were actually good.

False beliefs aren't the only source of mistaken preferences. Psychology tells us that people have other trouble bridging the gap between their

75. See Chang, *supra* note 18, at 179; Sen (1976), *supra* note 18, at 220–23, 225–26, 229–32; Thomas Scanlon, *Preferences and Urgency*, 72 J. PHIL. 655–65 (1975).

76. Most of our desires are derived from more basic desires and beliefs in this way.

77. Actually getting money might not be what it is cracked up to be either. It is possible for someone to end up where she ought to be by failing to get what she wants.

78. See HAUSMAN & MCPHERSON, *supra* note 1, at 124, 137–38; Amartya Sen, *Minimal Liberty*, 59 ECONOMICSA, 139, 143–44 (1992).

overarching goals and the situation-specific preferences that guide their behavior: they have a hard time resisting nearer but lesser goods, overweight the influence of small probabilities, are too risk-averse for possible gains, and are too willing to gamble in order to avoid even trivial losses.⁷⁹ People are sometimes attracted to things in an irrational way: they find forbidden fruit more appealing, suffer from sour-grapes reasoning, or fall prey to group-think.⁸⁰ People often form beliefs, desires, and preferences without attending to all of the elements of the situations they consider important.⁸¹ Reasoning goes awry in many ways, so on any account of the good it is practically certain that people will desire things that are not beneficial on their own view of the good.⁸² These sorts of possibilities show that Pareto improvements would not guarantee welfare gains even if people were ultimately motivated to achieve what is actually good.⁸³ Given the many ways in which actual preferences can be based on mistakes, it is a poor idea to read welfare conclusions off of the mere existence of Pareto improvements.

The point of the preference-versus-welfare criticism is not merely that utility is imperfectly correlated with well being. The real lesson, rather, is that every account of the good must distinguish what *someone thinks is* good from what *is* good. A person's preferences capture what she thinks is good, or at least what she thinks is worth doing.⁸⁴ Welfare, on the other hand, is

79. For an overview, see Colin Camerer, *Behavioral Economics: Reunifying Psychology and Economics*, 96:19 PROCEEDINGS FROM THE NATIONAL ACADEMY OF SCIENCES OF THE UNITED STATES OF AMERICA 10575–77 (1999); Philip E. Tetlock & Barbara A. Mellers, The Great Rationality Debate, 13 PSYCH. SCI. 94, 94–97 (2002).

80. See HAUSMAN & MCPHERSON, *supra* note 1, at 128–29.

81. See FREDERIC SCHICK, UNDERSTANDING ACTION 55–88 (1991); Stephen Ellis, *Market Hegemony and Economic Theory*, 38 PHIL. SOC. SCI. 513, 522–29 (2008); Hayden & Ellis, *supra* note 51, at 629, 661–75. I might, for example, form the intention to go for a cup of coffee with a colleague without attending to either a previously scheduled engagement or my recently diagnosed ulcer. Even important values will not influence a person's action-guiding preferences where those values aren't activated.

82. See Sen (1976), *supra* note 18, at 220–26, 232. This is why there is a standard distinction between manifest (revealed) preferences and true (normative) preferences. See John Beshears et al., *How Are Preferences Revealed?*, 92 J. PUB. ECON. 1787, 1787 (2008); Chang, *supra* note 18, at 193; Rescher, *supra* note 18, at 176–77. A person is motivated to act by her manifest preferences, but those preferences may not track what she ultimately wants. This also explains the appeal of laundered or amended preferences in normative analyses. See HAUSMAN & MCPHERSON, *supra* note 1, at 128–29; Chang, *supra* note 18, at 183.

83. This is one reason why Kaplow and Shavell's appeal to what people would prefer under full information, see KAPLOW & SHAVELL, *supra* note 55, at 16, doesn't help their view. Even when people can formulate a view of the good (e.g., they can see what they would prefer if they knew more), they can't ensure that their proximate preferences track that view.

84. This shows that preference satisfaction and welfare are connected after a fashion, albeit not in a way that helps the Pareto principle. This is also why (even though they are not

concerned with what is actually good, or at least part of the good. No one who reflects on the difference between *thought to be good* and *good* can understand satisfying even her own preferences (i.e., doing what she thinks is good) as simply equivalent to doing what is good because people are prone to mistakes—there is always a conceptual gap. Investigating what people want is simply distinct from investigating well-being. Appealing to the Pareto principle to make welfare assessments is sort of like taking a poll to find the answer to a math problem. In both cases you learn what people think, but the method itself can't determine whether they have the correct answer. The conceptual distance between *good* and *thought to be good* implies that preference satisfaction isn't even a satisfactory indicator of welfare. We can't reach welfare conclusions from on preference-satisfaction evidence where a person is wrong about what is good or worthy of choice. Intuitions may diverge about exactly how likely such cases are, but we must have an independent examination of what is good for people, and so what they should want, to determine which intuitions are more accurate. If we had information about what was good for someone, of course, we wouldn't care about the status of her proximate preferences in the first place. As with the math problem analogue, there isn't much point in taking a poll once you've done the calculations carefully.⁸⁵ Mere preference, then, has no real role to play in normative assessment.

The foregoing criticism of UWG, that preference satisfaction is not well-being, is quite persuasive. Despite this fact, most economists still rely on the Pareto principle and most philosophers seem willing to let them. Defenders of the Pareto principle respond to the critique in two different ways. The first attacks the argument itself as depending on controversial premises. The second response holds that while UWG is, strictly speaking, false, it is approximately true: the existence of a Pareto improvement is *prima facie* evidence that someone has experienced a welfare gain without anyone's welfare being decreased.⁸⁶

With regard to the first response, some defenders of the Pareto principle hold that any distinction between welfare and preference satisfaction must depend on a controversial view of the good.⁸⁷ A critic, it seems, must go outside of an agent's view of the good to argue that she desires something

interdefinable) utility is connected to choice in descriptive economics—it captures what people see as worthy of choice on the whole.

85. This is not to say that there is no reason to have people check your reasoning, especially if it is complex. The point, rather, is that the reasoning is the focus, not simply the end result.

86. As we saw before, some supporters of the Pareto principle overlook its dependence on UWG and so they fail to even register the criticism.

87. See SEN (1985), *supra* note 18, at 10; Rescher, *supra* note 18, at 175–77.

that is not beneficial for her: after all, she sees what she wants as worth pursuing. Arguments across conceptions of the good, however, are notoriously intractable. There is no agreement about what is good, so criticisms of preferences are inevitably tendentious.⁸⁸ Given disagreements about morality, it seems best to leave welfare (and other facets of the good) in the eye of the beholder.⁸⁹ This view is usually amplified by the claim that it is not an economist's job to work on moral truths anyway.⁹⁰ As an initial matter, this defense of UWG based on controversial views of the good involves some questionable burden shifting. The fact that people disagree about the nature of the good does not show that a given view about the good is not the right one. At a minimum, philosophical argument seems to rule out some conceptions of the good as inadequate (for example, divine command theories of ethics). And while figuring out ethics may not be a job for economists, this doesn't imply that economists can ignore philosophical insights.⁹¹

A number of popular views of the good, some of them quite defensible, imply that people often want the wrong things. Many religious views of the good, for instance, hold that people do not generally want good things. Buddhists have a problem with desire in general—as the Second Noble Truth has it, suffering is caused by attachment.⁹² Many Christians think that Original Sin leads to depraved desires—people pursue things that are actually bad for themselves.⁹³ Deontological views of ethics, such as Kantian views, rule out certain desires as inappropriate.⁹⁴ Even views that tie the good

88. See KAPLOW & SHAVELL, *supra* note 55, at 426; Rescher, *supra* note 18, at 175–76.

89. See HAUSMAN & MCPHERSON, *supra* note 1, at 119; Gravel, *supra* note 18, at 164; Sugden, *supra* note 21, at 507. There is a more positive case for UWG that involves a contractarian argument. Contractarians hold that rules are justified if they can command unanimous consent. Everyone can agree to a Pareto improvement—some (those who prefer it) will advocate for it, no one will block it (since no one prefers the alternative). See Cudd, *supra* note 20, at 7; Sugden, *supra* note 21, at 507. Everyone would agree to Pareto principle (and a bit more) behind a veil of ignorance. See Sugden & Weale, *supra* note 18, at 113. In this sense, at least, rationality endorses Pareto improvements—they are what rational people can achieve.

90. See HAUSMAN & MCPHERSON, *supra* note 1, at 119–20; Anthony B. Atkinson, *The Strange Disappearance of Welfare Economics*, 54 *KYKLOS* 193, 194–95 (2001).

91. Arguably, economists have already committed to a philosophical position by holding UWG.

92. See JOEL KUPPERMAN, *CLASSIC ASIAN PHILOSOPHY* 26, 31–35, 40–41 (2d ed. 2007).

93. See MICHAEL C. REA, *THE METAPHYSICS OF ORIGINAL SIN*, in *PERSONS HUMAN AND DIVINE* 319, 323 (Peter van Inwagen & Dean Zimmerman eds., 2007). A less radical take holds that Original Sin has merely disordered human desires, making right desires impossible to achieve without divine aid. See *id.* at 323–24.

94. IMMANUEL KANT, *GROUNDWORK OF THE METAPHYSICS OF MORALS* 33–36; 4:424–28 (Mary Gregor ed., 1997). According to Kant, “philosophy is to manifest its purity as

closely to human nature generally hold that it is difficult to determine what actions and attitudes are appropriate under various circumstances.⁹⁵ UWG is inconsistent with these common views of the good. Economists can defend their usual approach to welfare economics, then, only if they are willing to enter the debate about the good. They remain unwilling, however, to even address such philosophical issues.⁹⁶

Burden of proof issues aside, the controversial-views-of-the-good defense of UWG is misdirected. As it is drawn above, the distinction between preference satisfaction and welfare doesn't depend on any particular view of the good. The criticism of UWG is not that there is one true view of the good such that people want things that are not in fact good. Rather, it holds that for any (remotely plausible) conception of the good, even someone who holds it will prefer some things that are inconsistent with that conception.⁹⁷ There are a number of reasons why a person's preferences might come apart not only from what is objectively valuable (if there is such a thing) but also from her own deepest subjective values.

As we saw before, perfectly normal reasoning can lead people to actually want things they wouldn't want if they knew the facts. People have false beliefs, sometimes due to poor information and sometimes due to poor (for example, non-Bayesian) information processing.⁹⁸ Likewise, the psychological evidence tells us that there will always be a gap between agents' values and their behavior-guiding preferences. People don't, and as a practical matter can't, evaluate specific situations in a way that is fully consistent with even their own considered views of the good. The preference-satisfaction-is-not-well-being criticism of UWG doesn't depend on *any* particular view of the good, much less a controversial one.

sustainer of its own laws . . . that they expect nothing from the inclination of human beings but everything from the supremacy of the law and the respect owed it or, failing this, condemn the human being to contempt for himself and inner abhorrence." *Id.* at 35; 4:425–26.

95. *See, e.g.*, ARISTOTLE, NICHOMACHEAN ETHICS 64–65; 1113a15–1113b2 (Terence Irwin ed., 1985); JOHN STUART MILL, UTILITARIANISM 14–15 (13th ed. 1906).

96. *See* HAUSMAN & MCPHERSON, *supra* note 1, at 67, 119–20; Rescher, *supra* note 18, at 176.

97. To some, this might evoke the debate between objective and subjective views of the good. Our argument, however, doesn't hinge on that discussion. It probably would be easier to make the case that people sometimes want harmful things if "there [were] things that are good in themselves for an individual independently of her desires and attitudes toward them[.]" Richard J. Arneson, *Perfectionism and Politics*, 111 ETHICS 37, 37 (2000). Still, it is possible to reason poorly about the good and so have misguided preferences even if "the things that are intrinsically good for an agent . . . acquire this status only in virtue of how she happens to regard them[.]" *Id.*

98. *See* Koszegi & Rabin, *supra* note 20, at 1827–28.

The mitigation response to the criticism that preference satisfaction isn't the same as well-being maintains that although the connections among choices, preferences, and welfare aren't certain, they are close enough to validate most economic claims. UWG, then, is approximately true: the existence of a Pareto improvement is *prima facie* evidence that someone has experienced a welfare gain without anyone's welfare being decreased. Koszegi and Rabin's recent paper, "Choices, Situations, and Happiness," is a prime example of this approach.⁹⁹ Koszegi and Rabin note that on the traditional economic approach, "observed behavior is assumed to reflect fully rational maximization of utility, and . . . welfare is higher in one situation than another if it lets a person attain the outcome she seems most inclined to choose."¹⁰⁰ They acknowledge, however, that this account has conceptual deficiencies.

Preferences, for instance, are more complicated than is usually assumed. Someone might prefer to have help quitting smoking, other things being equal, but prefer to pass up an opportunity to receive aid because she hates to ask for it.¹⁰¹ Koszegi and Rabin are primarily interested in drawing a methodological lesson here: choice behavior alone cannot isolate complex preferences of this sort.¹⁰² A pattern of choices can't, for example, exclude the possibility that someone would get more utility from a painful, unavoidable death than anything she actually chooses over death—she chooses only with respect to avoidable deaths and so we have no basis for assessing her preference for unavoidable ones.¹⁰³ Common sense suggests, of course, that people don't want to suffer a painful, unavoidable death and this is good enough to exclude a preference for such outcomes. In order to fix preferences, then, choice evidence must be supplemented with some ancillary assumptions. Koszegi and Rabin admit that economics always relies on such choice-unobservable principles.¹⁰⁴

Like the critics of UWG, Koszegi and Rabin also allow that people make mistakes in the pursuit of their ends: for example, they misunderstand the stock market, commit the gambler's fallacy, or make other cognitive errors.¹⁰⁵ They are focused on a methodological lesson here as well: choices aren't

99. *Id.*

100. *Id.* at 1821.

101. *See id.* at 1821–24. Preferences of this sort violate what Koszegi and Rabin call "Menu Independence of Welfare." *Id.* at 1824.

102. *See id.* at 1823–27. Different sets of preferences lead to the same sorts of choices (for example, people continue to smoke for different reasons) so no set of behavioral observations can, by itself, tease out which preferences are operative.

103. *See id.* at 1823.

104. *See id.* at 1821, 1823. They see a role for psychology in uncovering new, perhaps less common sense, assumptions of this sort. *See id.* at 1827, 1830–31.

105. *See id.* at 1827–28.

always good evidence for a person's preferences because her actions might express her mistakes rather than her desires.¹⁰⁶ The take-home message, again, is that we can't just read a person's utility off her behavior without consulting psychological evidence and assumptions.¹⁰⁷

Despite its problems, Koszegi and Rabin think the standard economic approach to welfare is on the right track: "[w]hen doing so with sensible ancillary assumptions, inferring people's well-being based on the presumption that observed choices are rational is in our view the best scientific program for studying well-being yet formulated."¹⁰⁸ In particular, they stand by the substantive conclusions of standard welfare economics:

Despite conceptual problems . . . in many cases it seems clear that both rationality and choice-set independence of preferences are good enough approximations that in fact familiar approaches are quite sufficient. . . . [R]evealed preference is too powerful a tool for studying well-being, and the ancillary assumptions needed to render the tool effective are often too minimal and reasonable, to fret much about the conclusions economists are reaching except in cases where there are specific reasons to doubt these assumptions.¹⁰⁹

Despite their shortcomings, then, the connection between choices and preferences is good enough to support the normative conclusions of economic reasoning.

Even critics of the Pareto principle accept something like the foregoing mitigation line. Hausman and McPherson, for example, make the case that "[t]here are problems with endorsing all Pareto improvements (as the Pareto principle does)"¹¹⁰ Still, they hold that "[t]he Pareto principle has some real ethical appeal because satisfying preferences surely has something to do with promoting well-being."¹¹¹ Sen, likewise, emphasizes "the unacceptability of the Pareto principle as a universal rule."¹¹² Nonetheless, he holds that "there is something very central in the idea that preferences unanimously held

106. *See id.* at 1828–29.

107. Investigating mistakes provides another potential role for psychology within the general economic framework.

108. Koszegi & Rabin, *supra* note 20, at 1821. While Koszegi and Rabin "make the case for supplementing and combining" the traditional approach with psychological research, they are primarily interested in patching conceptual cracks. *Id.* at 1821.

109. *Id.* at 1823.

110. HAUSMAN & MCPHERSON, *supra* note 1, at 137.

111. *Id.* at 138.

112. Sen (1976), *supra* note 18, at 235.

by members of a community cannot be rejected by that community. As Blau . . . puts it, “I can see no case for an outside observer denying a unanimous choice.”¹¹³

Standard welfare economics treats choices (or at least the instrumentally rational ones) as welfare maximizing.¹¹⁴ The mitigation response to the criticism of the Pareto principle, while it allows that choice and welfare can come apart, argues that the connection is still good enough to be useful. It is important to recognize, however, that the Pareto principle relies upon the connection between choice and *welfare*. Under the standard view, that connection involves two steps: the first equates choice with preference satisfaction and the second preference satisfaction with welfare. The mitigation response is primarily concerned with examining and ultimately defending the first step, but such moves shed little light on the validity of the second, which is crucial to the Pareto principle (and the focus of this essay).

Mitigationists such as Koszegi and Rabin are a perfect, recent example of this. While they reject “the debilitating tautology that everything people do maximizes their utility,”¹¹⁵ they still accept the even more problematic view that well-being is a matter of utility maximization. Koszegi and Rabin, for example, only *argue* for the claim that behavior, supplemented by psychological assumptions, allows us to characterize preferences. The view that “rationality and choice-set independence of preferences are good enough approximations” only supports the claim that we can read preferences off behavior, yet they *conclude* that looking at preferences “is too powerful a tool for studying well-being.”¹¹⁶ They just take it for granted that there is a close connection between utility and welfare. Much the same point holds for Hausman and McPherson, as well as for Sen. While they recognize that they are concerned specifically with preferences on the one hand and welfare on the other, they simply appeal to their intuitions that there must be *something* that connects preference satisfaction and well-being.

Appeal to the popular views of the good canvassed above should be enough to cast at least some doubt on any intuition linking welfare and preference satisfaction. If the Second Noble Truth (or a Christian account of

113. *Id.* at 235–36. Sen rejects the Pareto principle in favor of “a *conditional* version If everyone in a community prefers x to y and wants that preference to count, then x must be socially preferred to y (conditional weak Pareto principle)] . . .” *Id.* at 236. Sen also discusses a conditional version of the strong Pareto principle. *Id.* at 243. Conditionalizing the Pareto principle in this way doesn’t help with the objection we are pressing. Sen wants to salvage the intuition that no outside observers can question a unanimous choice; this is exactly the intuition we argue is unsupported.

114. Koszegi & Rabin, *supra* note 20, at 1821.

115. *Id.* at 1822.

116. *Id.* at 1823.

original sin or Kant's categorical imperative, etc.) were correct then the "ancillary assumptions" to which Koszegi and Rabin appeal, "minimal and reasonable" though they might be, wouldn't be enough to vouchsafe "the conclusions economists are reaching" about the welfare properties of Pareto improvements.¹¹⁷ The intuition that preference satisfaction has something to do with welfare must be sensitive to the debate about the good. Mere appeal to the existence of Pareto improvements cannot answer any normative questions.

More importantly, any intuition that actual, situation-specific preferences (as opposed to broader value commitments) at least approximate the good must yield when we recall the way in which welfare and utility come apart. As we saw before, poor reasoning (in its many forms) will lead everyone to have desires that don't make sense given their more fundamental values. Whatever conception of the good someone might hold, she can (and, as a practical matter, will) want something inconsistent with that conception. In order to separate mistaken from value-congruent preferences, we need to be explicit about the value standard at issue and use it to evaluate preferences. This, however, is exactly what standard normative economics tries to avoid—the Pareto principle is supposed to allow us to determine when we have a welfare gain without any need to look at the value judgments that preferences are based upon. Once the value standards are required, there isn't much point in consulting preference satisfaction—we can look directly at whether behavior advances the relevant values. Again, taking a poll might provide correct answers to a math problem, but maybe not. The only way to tell is to either know the answer independently or to closely follow and evaluate the reasoning process of those polled. Once you have done or are doing the math, however, the existence of the poll isn't helping you find the answer. Likewise with the Pareto principle: the mere existence of a Pareto improvement doesn't tell us about welfare; we need to look at the appropriate values for that.¹¹⁸

117. *Id.*

118. The contractarian case for UWG is undermined by the same point. Contractarianism assumes that people will agree to what they should. Even contractual views allow that people can misunderstand or misforecast value assessments. See Cudd, *supra* note 20, at 26; Sugden & Weale, *supra* note 18, at 119. The normative force of a social contract depends on avoiding such errors. Even contractarians, then, must distinguish between deals that people would actually make and deals they should make (by way of constraints such as the original position). See Sugden & Weale, *supra* note 18, at 111, 113. Absent such a distinction, a contract is, at best, a *modus vivendi*. Political sustainability is important, of course, but it is a different issue than morality. See Atkinson, *supra* note 90, at 197, 199.

IV. WHITHER CORPORATE GOVERNANCE?

The Pareto principle is false because the existence of a Pareto improvement does not imply a welfare gain for anyone. The problem isn't merely that Pareto improvements do not guarantee well-being on many views of the good. Rather, no view of the good allows someone to draw conclusions about welfare (or any other facet of the good) from the existence of a Pareto improvement (or any other pattern of preference satisfaction). As a normative claim, the Pareto principle is worthless because it looks at the wrong thing.

There are some obvious practical benefits to unanimous consent, especially in the political realm.¹¹⁹ Politics is the art of the possible so it is important to identify a consensus-based starting point for normative assessment. We are willing to allow, then, that trying to achieve Pareto improvements might generally be a wise policy, despite the fact that the Pareto principle isn't true. Still, getting agreement is, at most, a *modus vivendi*, not a stopping point. Economists are therefore mistaken when they assert that "economic research and teaching does *now* (via our various notions of efficiency and welfare) reach strong conclusions about well-being."¹²⁰ What, then, is the appropriate role for economics in the study of welfare?

Economists, as such, have no particular insight about what makes people better or worse off. Even without its own characterization of well-being, however, economic analysis can still help us understand features of the world that have been independently identified as relevant to well-being.¹²¹ Economics, for example, is the primary tool we have for studying the distribution of food, shelter, security, and comfort items in a given society. While the connection is not straightforward, the distribution of such goods is (quite plausibly) a crucial determinant of human welfare. Economics has an important role to play in the study of well-being but it is no part of that role to determine what counts as welfare.

Arguments based on economic efficiency, however, are often used to counter proposals for restructuring corporate law. Kent Greenfield, for example, has long championed a variety of progressive corporate reforms.¹²² He generally advocates moving away from the model of shareholder primacy by allowing firms to straightforwardly account for the effect of their decisions

119. It might even be that agreement on a course of action has some evidentiary value—there may be something to folk beliefs about the "wisdom of the crowd" and "crowdsourcing."

120. Koszegi & Rabin, *supra* note 20, at 1831.

121. See HAUSMAN & MCPHERSON, *supra* note 1, at 129–33.

122. See, e.g., KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 123–24 (2007); Kent Greenfield & D. Gordon Smith, *Debate: Saving the World with Corporate Law?*, 57 EMORY L.J. 947, 952, 975 (2008).

on society at large.¹²³ More specifically, he argues in favor of changing the composition of the board of directors to include representatives of other corporate stakeholders such as employees, customers, creditors, and the community.¹²⁴ In Greenfield's view, these reform proposals would shift the focus of corporations away from the aggregation of shareholder profit in favor of promoting other social values.

These proposals are often countered with simple appeals to their purported inefficiency. D. Gordon Smith, for example, recently argued against many of Greenfield's proposals by noting that they might come at the expense of shareholder utility.¹²⁵ Any move toward Greenfield's goals that materially changed the content of corporate decisions would "sacrifice potential shareholder value in favor of value for non-shareholder constituencies" and thus "destroy much of the good that corporations have done."¹²⁶ While Smith allows that corporations might "enhance employee welfare, make the environment cleaner, or improve human rights throughout the world," they should do so only when they can act "without impairing shareholder value."¹²⁷

Importantly, Smith doesn't counter these proposals on their own terms. Instead, he is content to point out, "[l]ike other would-be reformers, Professor Greenfield runs smack into Adam Smith's invisible hand."¹²⁸ To be fair, Greenfield, like Blair and Stout discussed above, also structures his arguments largely on the basis of preference-based efficiency claims—he views his reform proposals to be superior because they take more direct account of the preferences of all stakeholders rather than just the shareholders. (Indeed, he is complimented for "cleverly" turning economic analysis against its practitioners.)¹²⁹ Smith then counters those proposals with a claim that shareholders may not prefer them—any move away from status quo is viewed with suspicion because it could not be a Pareto improvement.¹³⁰ These simple appeals to the descriptive efficiency (or inefficiency) of corporate law masquerade as normative argument and, in the end, mean that neither side fully engages with the real issues.

A quick survey of the scholarship turns up many similar arguments with respect to current and proposed changes in corporate law. The Sarbanes-

123. See Greenfield & Smith, *supra* note 122, at 965.

124. See *id.* at 980.

125. See D. Gordon Smith, *Response: The Dystopian Potential of Corporate Law*, 57 EMORY L.J. 985, 1009–10 (2008).

126. *Id.* at 1010.

127. *Id.* at 1008.

128. *Id.* at 995.

129. *Id.* at 995 n.64.

130. See *id.* at 1008–10.

Oxley Act and its provision of independent audit committees is criticized for failing to improve corporate financial performance.¹³¹ Proposed reforms that target excessive executive compensation are defended on the grounds that no corporate constituents, including shareholders, have anything to complain about because they all received the benefit of their real or “hypothetical” bargains.¹³² This species of argumentation really thrives against the background view of the corporation as a nexus of contracts. If the proposal were an improvement, then people would have already agreed to it; they haven’t, therefore it’s a bad proposal. Whether applied to the Sarbanes-Oxley Act, Say-on-Pay, or other broader corporate reforms of the sort advocated by Greenfield, the debates assume a Panglossian view of corporate affairs in which the mere existence of a particular feature of corporate governance is the ultimate argument for its continuation.

CONCLUSION

The primary upshot of this paper is methodological. Debate about corporate structure has been effectively short circuited by appeals to considerations of allocative efficiency. There is nothing wrong with treating the standard structures of corporate governance as a descriptive base-line. But the (purported) efficiency of such structures provides them with no normative presumption whatsoever. If someone were to give a compelling moral argument that corporate decision-makers should abide by certain rules or take into account certain interests that they currently don’t, it adds nothing to the debate to merely point to inefficiencies that would be introduced. It is important to know the results of any changes in corporate governance, of course, and such results may well affect the argument that supports such changes. It is important to note, however, that the consequences of interfering with even voluntary transactions are not self-evaluating: we need to appeal to normative arguments before we can draw any conclusions. Even if corporations as currently structured are efficient in a descriptive sense, that is no barrier at all to any normative argument for altering corporate governance.

131. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529–33 (2005).

132. JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 9–10 (2008).