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William T. Allen

Modern Corporate Governance and the Erosion of the Business Judgment Rule in Delaware Corporate Law

2008 Davies Fund Lecture in Business Law, Osgoode Hall Law School, York University, 22 January 2008

EDITORS: Peer Zumbansen (Osgoode Hall Law School, Toronto, Director, Comparative Research in Law and Political Economy, York University), John W. Cioffi (University of California at Riverside), Lindsay Krauss (Osgoode Hall Law School, Toronto, Production Editor)

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LAW**

Abstract:

This essay addresses the relationship between the forces shaping modern corporate governance and wisdom of a liability rule to enforce the fiduciary duty of care against corporate directors.

Keywords: corporate governance, business judgment rule, liability rule, Delaware

JEL classification: G34, K20, K22

Author Contact:

William T. Allen
Nusbaum Professor of Law & Business
Director, NYU Pollack Center for Law & Business
New York University
Email: wallen@stern.nyu.edu

MODERN CORPORATE GOVERNANCE AND THE EROSION OF THE BUSINESS JUDGMENT RULE IN DELAWARE CORPORATE LAW

William T. Allen *

I.

This essay represents a slightly modified version of the January 2008 Davies Fund for Business Law Lecture that I delivered at Osgoode Hall Law School in Toronto. It addresses the relationship between the forces shaping modern corporate governance and wisdom of a liability rule to enforce the fiduciary duty of care against corporate directors.

This subject, and the topic of corporate governance more generally, are topics of public importance. The modern business corporation is the instrumentality within which the greatest part of our economic activity occurs, in which jobs and wealth are created and through which, to a great extent, our national competitiveness is maintained. It is largely within the corporate form that all of the great scientific discoveries from the time of the second industrial revolution forward have been shaped into useful products or services and brought to markets to improve human lives. From railroads to automobiles and airplanes, from aspirin to immuno-suppressants, from electricity, telephony, and computers, to the internet, WiFi and almost everything else that makes our lives safer, healthier, easier and more pleasant—all are produced and distributed by people organized within the publicly financed corporate form. The legal rules and practices and the economic techniques we deploy to incent and control the various individuals playing roles within these institutions matters to

* William Allen is the Director of the New York University Center for Law & Business, which is a joint venture of the Leonard N. Stern School of Business and the NYU School of Law. Allen is also a Professor of Law on the law faculty and a Professor of Business in the Department of Finance at the Stern School.

their efficiency and thus matters to our wealth production. And while the production of wealth is not our ultimate value, still the production of wealth is very important to us. With greater wealth we can dedicate more resources to study, to research and to the improvement of the human condition. Certainly a great deal else matters vitally to our public welfare, but the productivity and innovation that occurs within the business corporations is essential for our welfare. What business lawyers do – and I hope those who study corporation law also do -- is therefore imbued with the public interest.

My perspective on the subject of corporation law and governance may not be entirely conventional. For twelve years I sat on the Court of Chancery of Delaware in the United States. The judges of that court spend most of their time adjudicating cases of alleged breaches of fiduciary duty by corporate officer or directors. For the beginning lawyer such cases may seem to require complex technical legal analysis. But my years thinking about these cases lead me to see the core or heart of this area of law as not really legally technical at all. Rather I came to see that, beyond an understanding of technical black letter law, appreciation of three types of knowledge was essential to understand the law governing the obligations of corporate directors.

The first is an understanding of the economic function of the corporate form, of the respective economic roles of the corporate CEO and of corporate directors in effectively managing that form and the likely economic consequences to the operation of the form in future of particular judicial decisions.

The second element of understanding of the role and requisites of the corporate director, in my opinion, is an understanding of the opened-ended nature of the directors' legal obligation to the corporation and its shareholders. The essence of that obligation, while supervisory, is nevertheless to act as a faithful agent would act in the same or similar circumstances, --- we call this core obligation the fiduciary duty of loyalty. It of course is an obligation of great generality and it is so for the simple reason that the corporate form is, at its creation, intended to operate over an indefinite period in which unforeseen changes perhaps radical changes will inevitably occur. Thus the tasks appropriate to try to met the profit making goal of the corporation in these various unknown future states

cannot be specified. In lieu of detailed instructions to directors, the law provides, and investors rely upon, the vague generalities of the fiduciary duty of loyalty. In giving content to this general obligation in particular cases even judges with a sensitive understanding of the economics of the corporation's business may sometimes be required to resort to ideas of fairness in the relevant community. Thus, sometimes, ill-defined notions of fairness play an important part in shaping directors duties and in understanding the requirements of corporate governance.

The third source of understanding of the content of fiduciary obligations can be found in the judges appreciation of the history of the corporate institution. Of course, a most powerful part of that history is captured in judicial precedents, which when applicable a judge will be bound to respect and apply. But beyond that particular source of history, the best judges will also have a sound understanding of the evolution of the legal and business environment within which directors are required to function. Law is not the only force shaping director action and those enforcing the legal systems obligations on corporate directors should be mindful of the interactive quality of the various social forces that create that environment. My talk tonight will to a large extent be about these non-legal social forces that affect director behavior and thus should be taken into consideration, in my opinion, by judges shaping the fiduciary obligations of those directors. The title I have chosen for this talk is Modern Corporate Governance and the Erosion of the Business Judgment Rule.

When I use the term corporate governance I mean the complex of legal rules and social practices that allocate and constraint power over the internal affairs of a business corporation. The main function of these rules are two: first to provide for the efficient management of firms by professional managers and thus improve the ability of the firm to effectively engage in commercial activity and, second, to provide sufficient protections to providers of capital to induce them to commit their savings to the corporate enterprise without any legal right to a return. We legal academics in our writing virtually ignore the first of these purposes while focusing exclusively on the second.

From a legal point of view it is the corporate board of directors, elected by the equity investors, that serves as the lynchpin of corporate governance. It designates the powerful central managers and is charged to

monitor their performance. It is upon the corporate directors that I focus this afternoon.

For the men and women who serve on a corporate board today, perhaps Charles Dickens best captured the present situation: these are the best of times and the worst of times.

It is the best of times for board service in the sense that the corporate board is daily becoming a more significant player in our business culture. Thus, the opportunity to do useful and important work through membership on a corporate board has never been so great. For those men and women who joined a corporate board in order to further extend and deploy their talents, and to use their energy and experience in a positive way, this may indeed be the best of times.

But this may also seem the worst of times for corporate directors. Never has it been less clear exactly what is required to meet one's responsibilities in this role fully. Never has board service seemed to expose a director to greater risk of public criticism or embarrassment, deservedly or undeservedly and, in the event that on one's watch a great financial loss befalls the corporation, never have the risks of personal liability seemed greater.

II.

It was not ever thus. For much of the last century corporate boards were typically composed of senior managers of the firm, and outsiders related by business to the company – bankers, lawyers or suppliers. Independence, the value that modern commentators and regulators prize so highly was not very prominent. In this world, corporate directors acted chiefly as advisors to the corporation's chief executive officer. Certainly boards had a formal role in selecting and compensating the CEO, overseeing his succession plans, and reviewing his strategic planning, but in the ideology of board service of the time, boards were not seen as primarily responsible for these things. From the time of the rise of large capital markets until rather recently, at least in the U.S., public company

boards have been largely passive, reactive instrumentalities. Many at the time thought this was inevitable given the directors tiny ownership stakes and the part time involvement with the company.

We might call this model of a limited board, the Advisory Board Model of the corporate board. From the period when family control of large enterprise was replaced by professional managers until, lets say, 1985, the Advisory Board conception provided the normative model for how we thought boards did and should work. This was not seen as problematic. The success of the modern economy made questions of corporate governance seem largely irrelevant. This was especially true for the decades following the conclusion of World War II. The 1950s and 60s were halcyon days in economic terms at least. That period was marked by high growth rates, moderate unemployment and stable prices. At the center of this economy were the large, powerful and seemingly permanent U.S. business corporations which dominated global markets.

These large corporations – General Motors, AT&T, U.S. Steel, etc -- seemed such a permanent feature of the social landscape that in 1966 the Canadian-born economist John Kenneth Galbraith claimed in a popular book, *The New Industrial State*, that they represented a new and dangerous challenge to democratic government. He asserted that these business corporations had succeeded in freeing themselves from the constraints of competitive product markets largely through manipulative advertising; were free of capital markets constraints through their internal generation of capital; were largely free of unwanted government interference through revolving door employment practices and were free of Shareholder constraint because shareholders had been dispersed by capital markets and were passive and powerless too. Controlling these powerful institutions Galbraith saw not a system of corporate governance but only self-perpetuating senior managers who selected and dominated the corporate boards that nominally supervised them. Thus the leadership of these monster firms was seen as responsible to virtually no one.

This 1966 vision of an emerging corporatist society was plausible to many at the time, but, in fact, events were to prove this vision badly incorrect. For even as *The New Industrial State* was being written deep social forces were at work that over the next 25 years would transform what Professor

Galbraith had seen as an impregnable permanent economic power structure.

The first of these was emergence by the 1970s of powerful global competition in product markets. Two facts drove this heightened product market competition. The first is the primal driver of so much change in our times: technological innovation. Technology has the capacity while creating great new opportunities to rapidly if not instantly to render whole product lines irrelevant. Silicon chips, the computer, miniaturization and bio technology were perhaps the greatest drivers of this more competitive world. The transformations that they occasioned changed existing business structures because they changed every part of our lives.

The second factor creating more competitive product markets was the arrival on the scene circa 1975 of powerful new national economies. World War II had resulted in the destruction of the industrial infrastructure of the axis nations. We in North America, by contrast, came out of the war not only intact, but muscular with wartime growth. Thus we possessed the most highly productive economies in the decades following 1945. American firms dominated international markets by default.

But by the mid 1970s Japan and Germany had largely rebuilt their industrial capacity with state of the art technology and were seeking global markets. Thus the close of the 1970s foreign produced goods were challenging the dominance of American corporations not only in foreign markets, but in a variety of important U.S. product markets —cars and electronics being early and notable examples. We were no longer king of the hill; henceforth we would have to fight for the even the ground we needed to stand on, and not always successfully.

General Motors was the paradigm . In the 1950s and 60s GM had been the proud prototype of the power and control that caused Galbraith to raise an alarm.. But by the mid 1980s General Motors was becoming the most public of object lessons in failure to meet product market competition. It lost massive market share – going from about 43% of the U.S. domestic auto market to about 36% share over six or seven years. And this product market disaster generated, albeit not very promptly, a governance response. Finally the G.M. board of directors did what was almost unthinkable at the time: it fired the CEO. Today, in a time when

CEOs have a greatly reduced expected tenure, the shock of the CEO of America's paragon company being fired by "his board" may be hard to imagine. Cars and electronics were of course only the first product markets in which global competition pushed U.S. firms into patterns of change, including ultimately changed relationship between the CEO, the directors and the company's shareholders

The second foundational change that contributed to the evolution of a new corporate governance model was an historic shift in the dominant political ideology of business regulation. Students today may not fully appreciate just how regulated large parts of the American economy were in the 1950s and 60s. But over a relatively short period from say 1970 to 1990 the U.S. moved from a approach to business and economic regulation that placed heavy emphasis on government administration of price and entry and terms of service for a large part of the economy to a model that placed principle reliance upon market competition. This evolution too can be first noticed in the 1970s.

Criticism of the post-war regulatory state originated in the 1960s as a left of center critique that claimed that the regulatory state had been captured by the regulated industries themselves and was used by them as a technique to dampen price competition. These critics proposed a de-regulatory solution as a way to encourage consumer-friendly price competition. The earliest success of these critics was the U.S. Securities Acts Amendments of 1975. That act de-regulated the fixed brokerage fees that had existed for 183 years on Wall Street. Almost at a stroke the brokerage business was transformed from one of fixed prices in which the most important feature of a broker was his social connection, into a business in which the most important feature of a broker was the speed and price of execution of a trade. Everyone thought this was a big improvement, except of course the affable but dull witted sons of the well-to-do who had found comfortable sinecures employment in the non-competitive regime, thought this was a big improvement. This change was followed by the highly successful U.S. Airline Deregulation Act of 1978. That act byr introducing ide-ranging deregulation of the airline industry. It thus made price competition and thus cheap flights available to the traveling public. Both of these acts were judged notably successful in lowering prices and won converts to the de-regulatory approach. After the 1980 election of Ronald Reagan as the U.S. President , the political

right joined in with de-regulatory fervor. The Reagan administration lead a broad attack on regulation of business that, in the end, transformed the U.S. market economy. Air, truck and rail transportation were deregulated; Oil and gas prices, electricity, telecommunications and of course banking and finance. Suddenly – or not so suddenly actually—markets were a whole lot freer and lot more competitive.

The zeitgeist must have been reading Milton Friedman, not J.K. Galbarith. The attraction of using greater market competition as a technique of organizing economies seemed to be in the air. About the same time that President Reagan lead the assault on regulation in the US, Margaret Thatcher began her enormously beneficial privatization of the British economy; and most remarkably, only a bit later Deng Xiao Ping started moving the People’s Republic of China away from a pure planned and administered economy and towards greater market centered forms of economic activities. Later even the European social democratic and socialist parties were reluctantly introducing privatization programs in their domestic economies, albeit with a certain scorn for what then and now they refer to as the Anglo-Saxon model.

In all events, this rise in less regulatory, more “market” centered political ideology was an important contributor to the increasingly competitive environment for U.S. businesses both domestically and globally and thus pressed powerfully on status quo management and governance techniques.

The last fundamental force of change acting on corporate governance was the emergence of institutional investors. As the great Chicago economist Frank Knight noted early in the 20th century, and as Professors Berle and Means later documented, the disaggregation of investors that was a natural consequence of the rise of large public equity markets, had had the effect of freeing managers of the supervising presence of “owners”. In the absence of monitoring owners, management became free, to the extent product markets permitted, to be less efficient, particularly to build enterprises that were uneconomically large. The tendency for managers if left alone to act in ways that may benefit themselves rather than the residual owners of the firm is of course what economists and we corporate law academics too call the agency problem of management and it is the focus of most corporate law scholarship,

But by the 1970s the environment that gave birth to the agency problem in corporate governance too began to change. The way in which the United States elected to provide pension benefits to workers – using these great business corporations as the channel for providing for private pension savings – stimulated the growth of great private pension funds and large institutional investors to manage these assets. Pension funds and mutual funds grew enormously especially in the post World War period. By the late 1970s these institutions owned great chunks of securities in virtually all publicly traded firms. For these huge investors –and the agents for them that evolved such as Institutional Shareholders Services – collective action problems became less a powerful impediment to rational monitoring of corporate managers. Moreover during the hostile takeover movement of the 1980s these investors began to get used to the fat premia that were paid in takeovers. When these premia disappeared with the recession of the hostile takeover movement in 1990, these investors began to turn their eyes to the board of directors and corporate governance as a means to try to increase returns.

It seems hardly an exaggeration to say that together change in these primal forces –the intensity of global product market competition, the application of scientific and technological discovery to new products and product improvements, the emergence of a market centered political ideology, and the growth and organization of institutional investors -- have driven change in corporate governance as in much else in our social life . For corporate governance specifically I might mention one of the remarkable effects of this interaction of forces was the great growth in importance and scale of capital markets. The computer and all that it made possible, de-regulation and innovative in banking and finance and growth in the global economy together changed the scope, richness and scale of capital markets and the players in that market became larger and more specialized.

These deep sources of change, have massively changed corporate governance – for the better I think— but notice please that I have not yet mentioned law or liability rules in particular in talking about forces that have driven change in corporate governance. I point this out because one of the points I wish to emphasize in this talk is the secondary nature of the

law of directors duties and liability rules especially in regulating corporate governance. But changes in law did play a part in the evolution of modern corporate governance.

Among the secondary effects of the changes in the product and capital markets was the massive hostile takeovers phenomenon in the U.S. in the 1980s to which I just referred.. These leveraged transactions in turn created massive pressure on corporate law and governance. In 1985 – in the famous Van Gorkom, Revlon and Unocal cases – the Delaware courts in responding to these enormously significant transactions began a process of modification of their interpretation of corporate directors’ fiduciary duties. The focus of these legal changes were two ideas. First, in these cases the Delaware Supreme Court made it very clear that it took very seriously the formal allocation of ultimate corporate power to the board of directors. It did not adopt the “realistic,” view of the academic community at that time which saw boards as inevitably passive. In these change of corporate control cases, the Delaware Supreme Court demanded to see board engagement, not the CEO domination that Professor Galbraith had noted.

The second thrust of these opinions was the willingness of the Delaware Supreme Court to push the business judgment rule aside in order more actively to review board engagement in these cases. These judicial expressions of changing expectations of corporate directors were among the earliest changes in contemporary corporate governance standards.

III.

Now let us put this large scale historical framework aside and focus on corporation law itself. I wish to focus on advisory board model of corporate governance and specifically on the legal obligation of directors, then and now, to exercise reasonable care and attention and on the business judgment rule.

During the period in which the Advisory Board conception of governance dominated popular thinking, it is only a slight exaggeration to say that Delaware courts, and U.S. courts more generally, announced but did not enforce the duty of care. Except for a few 19th century and depression era examples of bank directors who failed to detect a fraud that caused bank failure, there were essentially no cases that imposed liability on directors absent self-dealing or suspected fraud. If directors were charged in a shareholder suit with carelessness that proximately caused a corporate loss, absent a conflicting interest or some unusual circumstance, it would be expected that such suit would be dismissed on motion under the business judgment rule. As you know, the business judgment rule is the doctrinal technique used by courts to protect directors from the risks they would face were juries permitted to answer the question: “did this director when he approved this loss making transaction act as a reasonable person in the same or similar circumstances would have acted?”

Of course, everyday the law requires judicial fact finders to answer the question whether a driver of an automobile acted reasonably or not in particular circumstances. Why then should the law evolve the business judgment rule to protect corporate directors from a similar review? While alternative stories may be possible, I suggest that the rule used to prevent easy re-examination of compliance with the director’s duty of care represents not an effort not to help directors, but to help shareholders. To understand how it tends to do so we must look at the operation of this legal rule in its full context – that is as part of a system of rules and practices that are aimed at making it attractive for individual savers to invest capital in equity securities on capital markets. Such investors willingly accept some estimated degree of risk in return in order to achieve some hoped-for return. The law tries to facilitate this acceptance of risk in several ways. First not only does it proscribe fraud but it also by mandating full and fair disclosure of information relevant to the likely risk and returns of the security. But beyond the investment decision itself, in order for the equity investors actually to earn the return they hope for, the corporation must accept risky investment projects.

It is however the nature of risky projects that some of them will fail. And it is the nature of some people who suffer a loss to wish to shift it to others. The device to try to shift such losses, when the transaction is wholly at arms length, may be a shareholder law suit against directors

alleging breach of the fiduciary duty of care. L Naturally, those approving risking investments know at the time that they make the decision that there will be an attempt to second-guess it, if the decision itself proves to be incorrect. Two final facts complete the environment that makes the business judgment rule a rule that benefits equity investors. The first is the obvious fact that in any subsequent shareholder attack on the attentiveness of the board, the judicial system cannot perfectly distinguish after the fact between business decisions that were negligent and those that were prudent but mistaken or unlucky. The second fact is that given the scale of modern business corporations losses from investment decisions may be very large while directors individual proportion of gains from a wise decision will be comparatively small (the directors owning only a small percentage of the company's stock in most public companies).

Putting these facts together we see that while equity investors ex ante wish directors prudently to accept risk, given both the fallibility of the judicial system in distinguishing negligence from bad luck and the disproportion between directors upside and downside risks, absent protection from later liability, we might expect directors to be disinclined to accept much risk in new projects. In other words the prospects of ex post liability to shareholders for breach of the duty of care will ex ante defeat the shareholders desire for the acceptance of risky projects by the corporation. Thus strong protection against the risk of judicial second guessing reasonableness of board decisions – such as the business judgment rule -- is in the economic best interests of shareholders ex ante.

Nor does a system that effectively denies to investors a right of action for breach of the duty of care does not leave investors unprotected. The effective and low costs systematic protection against director inattention has little to do with the legal regulation of directors duties. That protection resides in investors' ability cheaply to diversify their risks of loss in the stock market. That protection extends to risks of bad judgments that arise from all sources --- from director decisions that are ill-advised or even negligent to decisions that are prudent but risky and prove to be losers in the end perhaps because of macro-economic factors.

So in providing directors with strong protection against liability for breach of the duty of care, the business judgment rule would appear to be

beneficial to investors. But undeniably this strong protection appears to have a its dark side. Public company directors, having neither substantial investment risk nor liability risk, might well tend to become passive. Indeed it is to try to assure director engagement or attentiveness that the law imposes a fiduciary duty of care in the first place. Thus, the business judgment rule deals with one of the core problems of corporate governance: how can we offer to directors protection from liability for claims of insufficient attention (and thus encourage them to authorize risky transaction), while still offering sufficient incentives to assure investors that directors act in an engaged, monitoring role.

Over the last twenty years we can observe in Delaware corporation law some tendency of courts to be willing to review the reasonableness of director decisions at least in some settings. This first occurred in cases in the mid 1980s that I mentioned involving a change in corporate control and later a willingness to closely review the reasonableness of board processes and decisions was seen in the famous Disney case in which high executive compensation was challenged. This tendency for courts to be willing to second guess board decisions or processes when there is no financial conflicting interest, which is sometimes encouraged by corporate governance commentators, is I think worrying and likely in the end not to be beneficial to investor interests. Once we take account of the deep changes in the environment of corporate governance that have evolved over the last 30 years , I would urge that we can see that investor interests have more effective and lower costs techniques available to assure reasonable director attentiveness than the imposition of ex post liability for breach of a duty of care.

Often when we lawyers think of controlling behavior we think only or mainly in terms of liability rules. This is a mistake. There are other forces that shape or control director conduct that we need to recognize. I mention three: the moral beliefs of members of the groups from which directors are drawn and their concern for reputation among peers. Second economic incentives and third shareholder voice.

The most general of these supra-legal forces is, I suppose, group based norms of appropriate behavior. Whether one is a a corporate director, a member of a sports team or a school child at recess, well socialized persons hold developed ideas of right conduct that at least absent financial

self-interest tend more or less powerfully to induce conduct consistent with those ideals. Social control that operates through a commitment to a shared, belief system and its informal enforcement, is a very powerful if highly imperfect form of social control. Given the unspecified nature of the core fiduciary duty of loyalty, one of the important roles of the Delaware Court of Chancery, for example, is through the use of its rhetoric to try to teach corporate directors what constitutes conduct consistent with duty in the that office. In doing so it exploits for a good purpose some directors' natural tendency to prefer to do the right thing.

Group moral codes – the ideology of board service -- are “enforced” through a variety of social techniques, but perhaps most salient for corporate directors is reputation among fellows and in with the public. Certainly the willingness of the business press to publicize directors who appear to have badly minimized their board engagement has had an effect on director attitudes. No one successful enough to be invited onto a public company board wants his or her photograph in *Business Week* or the *Financial Times* as the stooge that slept through board service while the enterprise was destroyed. Admittedly this form of discipline is sometimes unfair. Nevertheless it can be and indeed has been a powerful force for positive change in governance.

There has been a marked change in the in dominant board ideology over the last twenty years. Board ideology always appropriately emphasized collegiality but today the public ideology of board service also emphasizes independent monitoring of corporate performance and risk management. In part this may be a response to greater emphasis on the board independence, especially of the nomination or governance committee, mandated by the 2002 amendment of the NYSE listing standards. But more deeply it reflects, I think, the combined effect of business journalism, active shareholder lobbying and judicial exhortation.

A second non-liability force for shaping director conduct arises from the deployment of economic incentives established through property right or by contract. Incentives are not intended to inhibit conduct, as a liability rule does, but to elicit it. Incentives arrangements, such as director share ownership or stock based compensation, when well designed, have the advantage of being prospective in operation and capable of detailed customization. Thus for example at Berkshire Hathaway, Warren Buffett

only nominates for the board individuals with very substantial stock investments in the company. These investments offer greater assurance of appropriate attentiveness than any liability rule is apt to provide. Moreover these incentives are self-enforcing.

A third range of non-liability techniques for inducing heightened director attentiveness has come from efforts to make shareholder voting more effective. These efforts include organizational or coordination efforts by shareholder advocates and legal change. Several legal system changes, having nothing to do with liability rules have had the effect of inducing greater director attentiveness. I will mention three. The first was the U.S. S.E.C.'s important 1992 amendment of its rules which enabled institutional investors to communicate with each other respecting forthcoming corporate votes, without costly SEC filings. The second rule change involved the 2002 change in NYSE listing standards that mandated that board nominations be in the hands of a wholly independent board committee. And third and most significant is the current effort in the U.S. to enhance shareholder voting power by changing the director election standard from plurality of those voting to a majority of those voting. This change has been facilitated by an amendment to Delaware corporate law that makes enforceable director agreements calling for any director who is reelected by a plurality of votes, but not a majority of shares voting, to submit a resignation to the board. Lobbying action by institutional investors has caused increasing numbers of large corporations to put such arrangements in place. Thus the power of active shareholders to influence board decisions wholly apart from liability rules has dramatically increased.

These efforts to enhance shareholder voice have had a notable effect. No longer does one find directors or CEOs publicly defending the view – as they once thought right to do -- that shareholders are just one of several corporate constituencies – all of which are to be treated fairly by senior management. Now directors and senior officers as well, appear to believe that shareholder welfare is the metric of success, even if the board has discretion about how and over what period to do that.

IV.

Let me try to relate these observations concerning the various non-liability forces acting on directors to the business judgment rule. I suggest that once we raise our gaze from the lawyer's tool box of positive and negative incentives that can be judicially enforced, we will see a social environment that can assist us – and has been used by the Delaware courts – to help to move corporate boards to a more active engagement, but which can do so without creating the tension that the liability rule creates.

Once you take notice of the myriad ways in which modern corporate governance constrains and incents corporate directors, and you acknowledge both the protections available to investors through diversification of their investments and their need to encourage risk taking activity, and finally once we recognize the deleterious effects on risk assumption that a liability rule creates, you may begin to believe, as I do believe, that the systematic risks to investors interests from possible director liability for breach of the duty of care, uncomplicated by financial conflict or improper motivation, likely far outweighs the systematic benefits that may accrue from deploying a liability rule, even if quite rarely. Thus I suggest that that any erosion of the protections of the business judgment rule such as the Delaware courts have on occasion flirted over the last twenty years would be profoundly unwise for investors.

Let me conclude this perhaps too widely ranging commentary, with some additional thoughts on modern corporate governance.

We have changed much and are changing much in corporate governance. Power over the great institutions of our productive economy is in fact being reallocated. Not only have product markets become more competitive, but within firms CEOs are to some extent losing power to boards. Even more strikingly corporate management and boards are losing power to shareholder representatives. Legal changes such as the failed movement to change shareholder access to the proxy and successful ones such as the ongoing effort to change the voting standard for corporate elections are part of this. Equally significant are political efforts by institutional agents of ultimate owners of stock. These representatives of

investors are forcing the gradual reduction in staggered boards for example and the rescission of poison pill rights plans. Perhaps even more importantly event-driven investors are growing in size and importance. The line between hedge funds, who invest in financial instruments and seek short term returns, and private equity funds, who seek to invest in control positions and seek longer horizon gains, is growing obscure. Eddie Lambert who moved from Goldman Sachs to his own hedge fund to now controlling both Sears and K Mart is perhaps a prototype. The growth in market discipline that started to with air line deregulation in 1978 and Mrs. Thatcher, continues to grow.

But we academics, who in thinking about corporate governance focus exclusively on the agency problem of centralized management and ways to reduce it, must recall that the heroes of our account (the residual risk bearers) are imperfectly represented by those who announce themselves as the voice of shareholders. The human actors who pull the strings of the institutional investors and the governance entrepreneurs are agents too. We have not thought enough about how the actual incentives of those who act for these institutions may differ from the social interest in long-term wealth creation. We all know that ISS is a for profit business that has its own conflicts. We understand that hedge funds, who claim to be owners, may sometimes have hedged away the true economic risk of their position. We know that the average mutual fund has an annual turnover rate in its portfolio of more than 100% -- which seems consistent with excessive trading driven by an internal agency problem. But what do we corporate law academics make of these facts? They do not fit well into the theory that structures the conventional academic view.

One way to look at the current corporate governance scene is as reflecting a contest for the trust of the men and women of the country who have accumulated savings, often to fund their retirements. On the one hand are agents of the real economy – decentralized senior management teams and boards who control the institutions of the real private economy. On the other hand are certain agents of financial economy – particularly hedge fund entrepreneurs, portfolio managers, investment banks and governance entrepreneurs. So the question is who do you trust?

I suppose it is obvious that sensible corporate governance public policy lies in some balance of power between the agents of the real economy and

agents of the financial economy. There is no science to discover or to deduce that balance point. But when matters of great importance to the welfare of the people are concerned and uncertainty is present I suggest modesty and caution in making changes to facilitate one group or the other. At the very least I suggest that the agents of shareholders who have gathered a great deal of influence and power into their hands do not appear to require a liability lever against corporate boards, when those boards act without a conflicting interest. Thus at the very least I commend to courts and commentators a continuation of a strong business judgment rule.