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CAN CULTURE EVER CONSTRAIN THE ECONOMIC MODEL OF CORPORATE LAW?

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Can Culture Ever Constrain the Economic Model of Corporate Law?

Mark J. Roe*

ABSTRACT

With a few simple "moves," we can see where the economic model of corporate law could bump up against cultural limits. Or, better put, the economic model works well in the United States because little until now impedes Coasian re-bargaining among shareholders and managers. Begin with the economic model without limit: Takeovers persisted in the face of anti-takeover law in the 1990s, one can argue, because many managers were paid to stop from strongly opposing most takeovers. But managers' pay cannot be varied everywhere in the world as easily as it was raised in the Untied States. (The recent scandals show how wide that latitude has been here.). Where it cannot be so easily varied, re-splitting the corporate pie in managers' favor is harder. More generally, culture could affect the economic model if it affects the relative cost of institutional substitutes, by, say, degrading one form of organization but not others. Basic structures of corporate law—indeed, one could imagine even the public firm with diffuse ownership—could be affected by the degree to which local culture allows parties to vary their deals smoothly. When local norms make key variations costly, boundaries to the economic model of a type seldom thus far confining the American corporation appear. I sketch out, with the help of a Symposium's papers, where those boundaries can be glimpsed.

* Mark Roe is the Berg Professor of Law at Harvard Law School and wishes to thank the John M. Olin Center for Law, Economics, and Business for their support.

April 20, 2002

Can Culture Ever Constrain the Economic Model of Corporate Law?

Mark J. Roe[*]

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INTRODUCTION

Are there boundaries to the economic model of the structure of corporate law? If so, where do they begin?

Much scholarship in this Symposium deepens the model of corporate law as a three-player contract among shareholders, managers and the board. It's a model that Frank Easterbrook and Daniel Fischel used ten years ago here at The University of Chicago Law School in their book *The Economic Structure of Corporate Law*, which culminated and accumulated their work on the contractarian model of the corporate law.[1] Corporate law is or in its normative version should be a contractarian arrangement between and among managers, the board, and shareholders. Corporate law should be a set of default rules among these players, as the most likely rules the players would adapt, or the rules that would be the easiest to contract away from (if the parties did not want them). Fiduciary duties in this model represent the ex ante contract that managers and shareholders would have reached. Corporate law and corporate law judges referee, in this view, that three-party game. Corporate structure results from players adapting their corporate institutions and decisionmaking to the economic task at hand.[2]

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[1] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

[2] The *corporation* is, in this view, a *more* complicated contract, one that contracts with suppliers, employees, and so on; but corporate *law* focuses on the three-player contract. Here I show how culture

And in its positive form the contractarian perspective saw Delaware as coming close to the economic model, with most of Delaware corporate law (except probably for takeover barriers) conforming to the model.

The Symposium Articles fit this tradition. So, barriers to takeover tell some that the resulting increase in managerial agency costs would increase managerial compensation,[3] while it tells others that the increased agency costs would drive up the demand for other tools (such as more incentive-based compensation and more board independence), tools that would constrain these increased agency costs.[4] Or it could tell others that the economic model could be better applied if the board had less authority to decide on a takeover and shareholders more.[5] Or it could tell others that the three-party contract might be readjusted by giving the board yet more authority—via three–year terms—subject to a "campaign financing" law that would have the company pay the expenses for (some) shareholder-initiated proxy fights: more security for managers in the short-run, with lowered costs to shareholders who challenge managers in the medium-run.[6]

These views let us know that there's more to be said—and debated—on how best to implement the economic model of corporate law, a model that focuses on the three-party game of allocating decisionmaking authority among managers, the board, and shareholders. It is the model that has dominated corporate law scholarship and that continues to dominate it. And it is a good model for us, in the United States, because constraints that the Articles evince on the model are attenuated, weak, and unimportant here.

But to see why the model works so well, we should look for its boundaries; and the Articles show us where we should be exploring if we wanted to find those boundaries.

That is, can we trace the lines in the Articles to discern boundaries to that contractarian model? Is there a limit, where other factors outside of the three-player contractarian model kick in, factors that we would have to understand if we were to explain the corporation well?

There is, and if we look at the bigger picture that the Articles sketch out, we can catch glimmers of how culture could limit the economic model. So, here I use the

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could affect that three-party contract. American culture does not constrain it, but it is imaginable that culture could, and probably other cultures do.

[3] See Lucian Arye Bebchuk, Jess M. Fried, and David I. Walker, *Executive Compensation in America: Optimal Contracting or Extraction of Rents?*, 69 U. Chi. L. Rev. (2002).

[4] See Marcel Kahan and Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Strategic Responses to Takeover Law*, 69 U. Chi. L. Rev. (2002).

[5] See Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. Chi. L. Rev. (2002). Similarly, Victor Brudney and Allen Ferrell would apply an economic model to reallocate the power to make charitable gifts from managers to shareholders. Victor Brudney and Allen Ferrell, *Corporate Charitable Giving*, 69 U. Chi. L. Rev. (2002). And Fischel argues that the judges should resolve corporate disputes by using stock market prices, sometimes reconstructed, whenever possible. Daniel Fischel, *Market Evidence*, 69 U. Chi. L. Rev. (2002).

[6] See William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. Chi. L. Rev. (2002).

Articles from this Symposium to sketch out an outer limit, a boundary, to the economic model, where that model starts to do less well as a positive matter in explaining what institutions we see, and which ones are effective. (And where those of us who think the economic model in the end usually best maximizes welfare as a normative matter might seek to roll back these limits even farther.)

In Part I, I trace out the economic model, of how takeovers if impeded should induce substitute institutions that would keep the corporate pie from diminishing too much in size, but that would differently divide up that corporate pie. In Part II, I sketch out how culture, such as attitudes toward wealth, can facilitate or retard that Coasian restructuring: almost automatic in the United States, that new division of the pie would encounter stiff resistance elsewhere. Culture can vary the costliness of substitutes in the economic model. And, by varying costs, culture can vary the efficacy of the substitutes. Culture could limit this Coasian re-structuring, but in the United States it does not.

Then, in Part III, I expand this notion of cultural boundaries: even basic corporate law characteristics, such the efficacy of controls on interested party transactions, could be a function not just of finance, economic rationality, and institutional capacity, but cultural background. Identical institutions could produce widely varying results if we just vary one cultural consideration: varying attitudes toward wealth can vastly vary the efficacy of these institutions, the ease of ownership separation, and whether the Berle-Means firm will dominate an economy or be a minor, secondary business institution.

In Part IV, I look at the interaction between culture and economics, how and when economics dominates culture, and how and when each is independent. In Part V, I trace out two political limits to the economic model—one known and one revealed in the seminar—of how legislative politics and judicial sympathies can cap and limit the economic model, and then I conclude.

I. THE ECONOMIC MODEL WITHOUT LIMIT

A. Antitakeover Law Pressure on the Three-Party Bargain

Let us start with the perspective that takeovers reduce managerial agency costs to shareholders. It is the usual perspective, but not a unanimous one. But let us pass that debate here. And let us posit that we operate in the "space" where product, capital, and labor market competition do not fully constrain the managers to work for shareholders. (No need to sketch out limits to these markets: We all know those limits exist, although opinions differ as to where the line is.) In that "space," we posit, takeovers make managers work for shareholders.

But then antitakeover structures (such as poison pills), legislation, and court decisions (which the legislature does not overturn) impede takeovers. (One limit to an economic model might be right here. Why do courts constrain takeovers, and why do

legislatures let those decisions stand or add to the barriers?[7] Three-party efficiency might be an answer. But the shape of the corporation is partly determined by why the polity validates antitakeover mechanisms, such as the pill. It is not economically foreordained.[8] More on that below.)

So, antitakeover structures make managers less loyal to shareholders. Managerial agency costs rise, so the demand for takeovers persists, and indeed increases. If managerial agency costs rise, players would then pay "more" for takeovers.

B. The Coasian Bargain Redone

And, in Marcel Kahan and Edward Rock's model, with the gates open for high compensation, we see an institution that "buys" managers off from opposing takeovers. True, managers can now "just say no" (most of the time). But money can change their minds. It would be awkward—and visibly in violation of corporate law duties—if the offering company directly presented managers a check for twenty million dollars, on condition that those managers drop their opposition to a hostile bid, and managers cashed that check. But if there are preexisting options in place with a value of twenty million dollars that the takeover vests, then the managers see the personal value to them of the bid going forward. And they then often acquiesce.

The economic model, in a first cut at the issue, is vindicated. Managers have a "property" right to resist takeovers, but in a Coasian bargain—indirect, to be sure, and perhaps not the perfect way for the three parties to do these things—the managers get paid to give up their property right. If the value and efficiency of the transaction is large enough, it goes forward, as it would have before the antitakeover laws, devices, and decisions arose, but managers get a bigger piece of the pie than they did before.

One need not here evaluate whether the increased managerial compensation is "incentive" compensation or "rent-extraction."[9] The check could be seen as tribute to

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[7] Compare *Moran v Household International, Inc* 500 A2d 1346 (Del 1985) (holding that directors' poison pill defense mechanism was within the business judgment rule) with *Smith v Van Gorkom*, 488 A2d 858 (Del 1985) (holding that business judgment rule did not protect decisions by directors who were not reasonably informed). The first validated the poison pill and stood. The second lambasted directors and was effectively repealed. See 8 Del Code Ann §102(b)(7) (1991) (permitting corporations to eliminate personal liability of directors for breach of fiduciary duty).

[8] So it is logically possible that the Bebchuk article, 69 U. Chi. L. Rev. at __ (arguing that it is preferable to give board's less veto power over takeovers), sketches out the appropriate economic model, but that politics trumps it. Or, via Coase, there are *several* possible models and the political muscle of managers determines *which* one of the plausible models wins out. Indeed this might constitute one of the boundaries to economic analysis: The political muscle of managers has implications here. And managers may win if they have political allies. Is the result wealth-maximizing or do managers win because they "have the votes": Legislatures listen to managers, especially when the bystanders (employees, consumers, average citizens) are wary of hostile takeovers.

Let us put this potential limit aside for now, although it potentially cabins the pure economic model.

[9] Compare Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power vs. The Perceived Cost of Stock Options,* 69 U. Chi. L. Rev. (2002) (arguing that increased managerial

powerful managers, who extract value from the firm; or it could be seen as a payment contingent on a takeover, thereby aligning managerial incentives with shareholder value. All we need to know at first is that it is high enough to induce managers to accede to what would otherwise be a hostile takeover.[10] The takeover-induced pie is, we can believe, about the same in size, but it's division changes. (We pass over how much this Coasian rebargain re-creates the incentives ex ante: Some takeovers do not go forward even with the option-vesting "pay-off" because managers resist or the offeror withdraws a takover offer that the increased compensation made more costly.[11] And takeovers' incentive effects on managers are reduced by the antitakeover institutional structure, because managers know that a takeover will put them out of a job, yes, but will pay them handsomely, so there is less for them to fear ex ante, when running the firm. Yet they presumably compete more heavily for that big piece of the pie that the CEO can extract. How it all sorts out—more efficient overall, less efficient overall, or a change in orientation—is not fully clear in the model. The reequilibration possibly is not the best way for the players to handle corporate control transfers, but just a second or third best. But the point that we get some substitution effect, and possibly a large substitution effect—Kahan and Rock's basic point—is well-taken. We will stick with it.[12])

Thus sketched out, we see the economic model in action. The rule changes, and there's a Coasian reequilibration.[13] (The only "boundary" to the economic model thus far is the question of why managers win so often in getting antitakeover decisions and legislation, the question we have put aside. But once we take that political boundary as "given," as exogenous, the maximizing economic model is back in play.)[14]

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compensation is based on incentives), with Bebchuk, Fried, and Walker, 69 U. Chi. L. Rev. at (arguing that increased managerial compensation is due to rent-extraction by the managers).

[10] Or, managers *are* in fact getting incentive compensation. The incentive though is not day-to-day, compensation, but an incentive to sell the firm to the highest bidder.

[11] See Reinier Kraakman, *The Best of All Possible Worlds (Or Pretty Darn Close)*, 69 U. Chi. L. Rev. (2002)

[12] And for this parenthetical reason, Kahan and Rock's optimistic variation—with compensation *perfectly* offsetting the pill—seems possible but only if serendipity reigns. See 69 U. Chi. L. Rev. at __. The question would be how big a loss the three-players suffer—that is, how imperfect the compensation substitute is. A reservation here is that the new equilibrium, even one with and identical number of takeovers, could be—indeed, should be theoretically—at a lower level of shareholder welfare. But this reservation does not implicate their main claim: that there are substitutes, and they implicitly claim that the substitutes are (nearly) perfect substitutes, or at least good enough.

[13] This contractarian argument could partially explain the lull in takeovers at very end of 1980s, early 1990s. *Paramount's* approximation of a 'just say no' defense for boards maybe really did shut down takeovers. *Paramount Communications v. Time, Inc.*, 571 A.2d 1140 (Del. 1990). But then it took a few years for option mechanism to kick-in to weaken managers' determination to resist takeovers.

[14] Note the comparative effect: Indirect compensation buys managers off from opposing takeovers. As such, comparing takeover law among heterogeneous jurisdictions would thus not predict takeover incidence: That is, law could be the same across countries, or the same in a single country across time, but if compensatory side payments let managers get bought out, takeovers happen. If side payments don't work, takeovers don't happen. Rules could be the same, but if compensatory norms vary, takeover results differ.

If the substitute is close enough, Coase once again shows us how parties can contract around the rules to make the result efficient, conceivably as efficient as where we started.

That's enough. And we could stop there. But . . .

II. CULTURAL LIMITS TO THE ECONOMIC MODEL?

Not so fast.

Imagine that costs afflict the substitute. If the substitutes were highly costly—for some firms or in varying degrees for all firms—then a Coasian reequilibration would be harder. Large managerial-run firms would be less subject to takeovers, and probably run less well; some, maybe many, larger managerial-run firms would be less effective and in time out-competed by smaller ones.

The substitute here for the pure hostile takeover is the quasi-friendly offer with vesting of heavy stock options that buy off managers from their opposition. No other substitute, remember, works as well (we have assumed), and this substitute even if imperfect is pretty good.

But what if there were costs—big costs—to the substitute?

I am going to modulate the quality of this substitute with culture, with a preference extracted from the Symposium Articles. And when we do, everything changes.

Suppose that the new institutional arrangement induces organizational degradation in many firms (by, say, demoralizing enough employees in an important way), but the original arrangement did not. This is of course purely academic: According to the Kahan-Rock analysis—and this is plausible—Americans *are not* allergic to the substitute. CEOs get hyperpay, and the incidence of takeovers stays about the same, they suggest, without any other big cost to the economy.

But let us think about culture. And let us think about how cultural traits—or at least one trait—could differ from that which we have. That is, we know that in some general way culture affects what we do, but the usual perspective of culture is so wide, so general, and so thin that its analytic impact is correspondingly low. So let us take one cultural trait and only one—attitudes to wealth—vary it, and see how varying it could affect the micro-institutions of the public firm.

And when we do, as I said, everything changes.

A. As Affecting the Quality of Institutional Substitutes

Where is that one cultural assumption that makes the Coasian model work so nicely? Bebchuk, Fried, and Walker analyze CEO pay, concluding that the internal checks do not constrain CEO pay. Rather, they say, an "outrage" constraint caps pay. At

some point the press, or the directors' sense of what is right, kicks in and constrains pay from going higher.[15]

That outrage constraint is staggeringly high in the United States. Indeed, Kevin Murphy says that the American outrage constraint is so high that it probably hasn't yet been reached, and probably doesn't yet much constrain executive pay.[16] Lots of money can go into managerial hands before directors, or the press, are outraged. Hence, because it is staggeringly high, there is plenty of room for the Kahan-Rock Coasian buy-out mechanism to work their magic. The firm can reequilibrate. The only question is whether the new substitute arrangements are just about as good as the old ones, or not.

But where does that outrage come from? And what if the outrage constraint were not staggeringly high, but staggeringly low?

Consider the possibility that the board's directors could not possibly allow, say, more than five hundred thousand dollars in bonuses in any one year. No human being should make more money than that, they think. And further, imagine that the vesting of (a mere) five hundred thousand dollars in stock options is not enough to induce managers to take the takeover bid.

Then the target firm managers do not acquiesce in the bid, and since takeover law gave them the trump cards to resist a hostile bid, they defeat (most) hostile bids.

The consequence: higher managerial agency costs, fewer bids. The players might search for other substitutes (even better boards, say), but by hypothesis we do not have any other perfect or near-perfect substitutes. We will get an equilibrium eventually—maybe smaller firms, for example, with denser contracting relations among them—yes, but it would not be the same one we see here.

B. As Degrading the Organization

"Outrage" could link up to the firm's micro-structure. It might not just be the directors' internal sense of rightness and outrage, the mechanism that Bebchuk, Fried, and Walker posit. What if the firm's employees would be demoralized, or up-in-arms, if the CEO got twenty million dollars in a bonus or in exercisable stock options?

Then directors would have a problem: yes, they could buy off the CEO (into takeover acquiescence) via the high compensation and thereby restrain managerial agency costs (or reduce their negative consequences), *but* to do so would demean the organization.[17] Hence, some directors, because the firm's organizational structure was allergic to that new strain of compensation, would not take the substitute. Those firms would be immune from takeovers. And, hence, those firms' managers would be more entrenched, and managerial agency costs higher in that set of firms.

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[15] Bebchuk, Fried and Walker, supra note __, at __.

[16] Murphy, 60 U. Chi. L. Rev. at __.

[17] See Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. Pa. L. Rev. 1901, 1917, 1919 (2001).

And, hence, we have just traced out a cultural limit to the economic model. Yes, we get a new equilibrium in the division of authority among the three-players as takeover law becomes pro-manager and validates (nearly) a "just say no" defense, *but the quality of that equilibrium is determined in important part by culture*: The size of the internal outrage and organizational degradation that high executive pay induces is the cultural variable. And if culture made high pay highly costly to the organization, then the recalibration of authority would yield a less productive firm.

In the U.S. that cultural cost is nil, or nearly so. But in other *imaginable* cultures, the result would differ. The American reequilibration is plausible in the Kahan and Rock model *because* any American cultural constraint on pay is far out, hardly constraining at all.

And, hence, far off in the horizon we glimpse a potential cultural constraint to the economic model.

C. As Reconfiguring a Persisting Economic Model

We could absorb this cultural limit into the economic model by saying that culture is just an exogenous constraint. This move works logically, but the model is uninteresting if every time a maneuver worked badly for maximization we just dubbed the constraint an exogenous limit.

It would be better to look at culture here as primarily outside the American corporate model. Part of that boundary of outrage is demarcated by where compensation (in size and type) demeans the quality of the organization. At some point it is not just a general outrage—in, say, the press, the boardroom, public opinion, or the CEO's own conscience—but outrage among the employees on the shop-floor or in middle managers looking at their computer screens that is in play. If enough people in the organization are outraged, that outrage can demean organizational cohesiveness and, eventually, the firm's performance and its stock price. One might understand the beginning of outrage to be coterminous with the beginning of organizational degradation.

1. Just a different trade-off?

In one sense, perhaps boards (and senior managers) would operate in the stockholders' interests even here, eventually. Managers—to the extent unconstrained—end up with the highest compensation possible, until the level and type of compensation degrades the firm. (One might see this as putting an outside board-based boundary on managerial acquisitiveness, or one might see this as solely limited by the senior managers' own calculations: At some point they cannot get more because for them to take more would kill that golden goose.)

As compensation approaches that boundary, the organization begins to degrade. That degradation feeds back into the value of the stock the senior managers have, thereby limiting managers. It also diminishes managers' utility otherwise: they would preside over a deteriorating organization, which would diminish their sense of self, their happiness, and so forth. In the United States that boundary is so *very* far out in the compensation spectrum that the trade-off hardly happens; in other nations it is much closer in. Hence, a high level of pay, and pay highly sensitive to general stock market

performance, induces *less* outrage in the U.S. than one could imagine, and less outrage than it would create elsewhere.

If these cultural restraints were in play, that would not end economic adaptation. The players would seek to upgrade other substitutes (such as better boards) or fight harder for different rules. But by hypothesis these are highly imperfect (actually in the simple model we started with, nonexistent.) Shareholders might try even harder to roll-back antitakeover rules, overturn Paramount Communications v Time, Inc,[18] and so forth. They might win, they might lose, but whether they do would depend as much on their political power as the efficiency of the three-party bargain. As Kahan and Rock tell us, the shareholders tried to roll back the rules, but they failed. They might have succeeded if they tried again and harder. But they still might have failed.

Or—and this could be important—the nature of the firm might change in a way Coase described long ago, not in the social cost article but in the nature of the firm inquiry:[19] If cultural constraints impeded takeovers, and if substitutes were unavailable, managerial agency costs—a type of transaction cost—would rise. And, as Coase told us, if the transaction costs inside the large firm rose, and that rise made the large firm more costly relative to smaller firms, we would get a new firm vs. market trade-off. We would get more small firms, perhaps with denser relational contracts among them, and fewer very large firms.

And thus the economic model—of a three-party bargain that's easy to remake as rules change—works as long as culture does not seriously constrain the substitute. That is, as long as the "outrage constraint" is high enough to allow stock-based compensation that changes CEO resistance to a hostile takeover. But culture might constrain the substitute. If it does, all bets are off.

If it does, and if the other substitutes are functionally imperfect, we have just mapped out a cultural boundary to the economic model.

D. As Distant in the United States, and Closer-In Abroad

We can make this more real. I once was looking for the mechanics of incentive compensation in Europe, looking in part at tax rules that constrain heavy use of incentive compensation in French public companies. In conversation with a Paris-based compensation consultant, I asked how the French tax rules worked. Indeed, the tax rules were not generally as favorable as the American rules to the firm and the incentivized managers.

But then the consultant went on. He next complained about Americans (such as myself) who looked at the rules and the numbers, trying to find the incentive effects from

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[18] 571 A.2d 1140 (Del 1989).

[19] Ronald H. Coase, The Nature of the Firm (1937), in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 18, 23 (Oliver E. Williamson and Sidney Winter, eds,, 1991) (arguing that firms get larger until the costs of organizing the next transaction within the firm equals the costs of using the open market).

the tax rules, an effort revealing, he said, that we did not really understand the French company. A more basic reason explained why high incentive compensation had not yet, as of then, worked well for many French firms. The average French person, he said, hates the rich. Hate, he said. Not envy, as I might say would be the dominant American parallel trait. Not admiration, as might lace some of American culture.

Analogous sentiments are there in those other cultures: A legendary European manager (Percy Barnevik) just retired, as I am writing, with a multimillion dollar retirement benefit, a benefit that induced widespread disgust, with the "Swedish prime minister . . . saying he was 'distressed' over the size of [the] pension" and with a Swedish economist (not a sociologist) saying: "He has fallen from grace[.] . . . Sweden is unforgiving when it comes to greed."[20]

And the reaction has historically been a general one, not one tied to a specific person or a single financial event:

> Some countries—notably Germany, Spain, Belgium and Sweden—simply haven't caught on to the stock-options trends yet [in 1998], either because tax laws penalize them, *or options aren't considered entirely ethical* . . . . The idea of a corporate official having access to millions of dollars of his group's stock appeared antithetical to Sweden's egalitarian tradition.[21]

That lack of "ethics" could be manifold: Because the incentive pay demeaned the managers, who should be professionals, people who should not be explicitly motivated by money, but rather should do a professional job and then receive an honorarium; or because the incentive pay "unethically" made managers into "mere" agents of shareholders instead of professionals who stood above the fray in running the corporation. Whatever the reason, the price of the Coasian rebargain is made that much higher by the cultural constraint.

And one might imagine a mirror cultural image for the rich there: more ashamed, not self-justifying ("I provided value, hence I got rich," might be a common American reflection; or "I was lucky"), and more interested in hiding the result.

These are not American-style sentiments here. Or at least the American sentiment even if substantively similar here, is much, *much* paler. Surely these are not *dominant* American sentiments. And, hence, compensation can be constrained by culture (but isn't here). Even a shareholder-oriented board would think twice about rewarding senior managers if it would degrade the organization, demotivate middle management, or even induce work stoppages.

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[20] David Woodruff and Almar Latour, *Barnevik Gets Harsh Verdict In Court of Public Opinion*, WALL ST J EUROPE, Feb 18, 2002. The company was said to have sought to get much of that pension back, and Barnevik is said to have acceded to returning more than half. *ABB: Percy Barnevik et Goeran Lindahl restituent une part de leurs indemnités*, LES ECHOS, March 11 2002, at 18. And although Barnevik had to resign from several prestigious *European* board positions, id, he seemed likely to hold on to his *American* board seat at General Motors. Danny Hakim, *G.M. Keeps Options Open On Director*, N.Y. TIMES, Feb. 19, 2002, at C8.

[21] Peter Goldstein, *Managers and Managing: Compensation Packages Aren't All Alike – Base Pay Converges in Europe, but Bonuses and Stock Options Vary*, WALL ST J EUROPE, Dec 22, 1998 (emphasis added).

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An American economics-oriented analyst might then think that this imagined alternative culture, exemplified perhaps by the French possibility,[22] was inefficient. And, true, *inside* that three-person game, the three-players in America would have fewer options to reequilibrate than they now do. But that does not necessarily make the other cultures poorer, less efficient, or less fair. People's preferences are paid attention to, and the resulting equilibrium might yield a dollar or two less in GNP, as conventionally measured, but if the cultural preference differs, aggregate utility would be higher there if structures bend to the preference.[23]

But the key point is not that one society or another is better off, but that culture would affect how the three-player contractarian corporate model played out. The Coasian rebargain would not work the same for them, in the alternative culture, as it works here and now, in the real America's culture. And the Coasian "Nature of the Firm" organizational adjustment could dominate the Coasian "Social Cost" contractarian adjustment.

III. CAN CULTURE EVER AFFECT CORPORATE LAW AND INTERESTED PARTY TRANSACTIONS?

Why stop there?

Couldn't the apparent efficiency of corporate law's core—constraining interested party transactions—be affected, indeed couldn't it be determined, *by this one single cultural constraint*?

Consider two countries that constrain interested-party transactions well but imperfectly: Most interested-party transactions do not get through. But, Swiss-cheese-like, the institutions—primarily legal and judicial—impede most but are not impermeable. More could get through if the self-interested players persisted.

So, posit that American law is pretty good overall on this score, but—Swiss-cheese-like—has holes. And, of course we have one of the economic model's basic insights in play here: The *best* corporate law for shareholders does not constrain managers completely but does so ("only") optimally. Constraints have costs: Some worthwhile transactions would be deterred if the constraints were too tight; and constraints have costs as the organization becomes more bureaucratic and less supple. Hence, even a purely shareholder-oriented system would have some bad transactions getting through the "Swiss cheese" now and then. Enron might tell us that the holes in the

[22] This French possibility is from a conversation a few years ago. If real then, it probably is less real now for France, as compensation in more firms there creeps up toward American-style pay. ETUDE PROXINVEST, LA REMUNERATION DES DIRIGEANTS DU CAC 40, at 5 (2002); Sophie Fay, *Les patrons français autant payés que les Américains—Les 473 dirigeants des principales sociétés ont vu leur rémunération augmenter de 36 % en 2000*, LE MONDE, Feb 6, 2002.

[23] Consider GARY S. BECKER & KEVIN M. MURPHY, SOCIAL ECONOMICS: MARKET BEHAVIOR IN A SOCIAL ENVIRONMENT (2000).

Swiss cheese have become too big here,[24] but if the system self-corrects well and does not over-correct, holes would persist because costs to perfection would persist.

Imagine then a country with a clone of American corporate law: quite good but without purporting or succeeding in constraining all interested-party transactions. Some get through. But the one difference is culture, and again we focus on only one cultural trait and its potential effect on corporate structure. We stick with the same difference we have been focusing on: the "outrage" constraint on executive compensation is much, much lower in this clone country. Directors could not pay senior managers more than, say, a few hundred thousand dollars per year in total compensation. "No one," one could imagine the players in this alternative culture thinking, "is worth more than $500,000 in annual pay."

Compare these two countries in managerial propensity to push the firm into interested-party transactions. Managers have less to gain from self-dealing transactions in a country like the United States because high executive compensation (whether of the rent-extraction or the incentive variety) already makes them super-rich. But in a country where the "outrage constraint" is much lower—where the rich are hated, where culture is different, where the insider-managers have to (a) hide their wealth, and (b) engineer opaque transactions to put more money in their pockets, then the managers have a higher demand to hide insider trades, to obscure related-party transaction via corporate selling to a controlled entity, and to get more out of the firm in high perqs—those company-paid benefits that can make their lives comfortable.

Corporate law might be equally stable, efficacious, and so forth in these two nations—the real United States and the culturally differing clone—but there would be more "bad" (but mostly hidden) transactions in the culture where the outrage constraint was lower.

Or, stated differently, we could see an equal number of "bad" transactions in *both* cultures. But in the cultures where the outrage-constraint is inconsequential (for example, the United States) we see these transactions in the form of excess CEO compensation. And in the outrage-constrained culture (think: France, Germany, Italy, Scandinavia), we see these transactions in the form of corporate manipulations (insider trading, related party sales, and so forth).

This—the American result—may be the cheapest managerial pursuit of self-interest. Once the manager is paid his or her expected potential in diverting value away from outside shareholders, the managers would not (in this model) engage much further in interested-party transactions.

Why? Not necessarily because they think more money can not be had, but because of a diminishing marginal utility of money. After the, say, twenty million dollars in compensation is had, the manager is less interested in the two million dollars interested-party transaction: His sense of self-worth would be demeaned in any case by

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[24] Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. Chi. L. Rev. __ (arguing that Enron's problems are "symptomatic of troubling if not egregious behavior elsewhere").

having to stoop to engineer such a deal, and, with twenty million dollars already in the bank account, the utility of the transaction to the manager is less. And with that "Swiss cheese" corporate law in place, the manager engineering that kind of a transaction puts the twenty million dollars at risk, in two ways: One, he or she might get caught and lose that good job (and the twenty million dollars too). And, two, secret interested party transactions often distort the firm's operations. That distortion can lower firm value and, if the twenty million dollars comes in an equity interest—a stream of stock options, say—the manager who pursues a two million dollar interested-party transaction that demeans firm value by more than 10 percent would not make money by engineering that deal.

So he or she retreats from pushing the transaction. And overall that country might be thought to have better corporate law than the one where the manager—paid a "mere" five hundred thousand dollars—goes ahead with the insider trading or the interested-party transaction or the very high perqs. But it is culture that is making the difference here, not the base-line quality of corporate law or its enforcement.[25]

IV. Cultural Endogeneity: How Economics Constrains Culture

The world is surely more complicated than the three characteristics we have focused on thus far: of takeovers as the only constraint on managers, of compensation as the only way of making takeovers work, and of cultural attitudes toward wealth as the only constraint on compensation.

One complexity is endogeneity. Cultures are a mix of traits: envy and jealousy; admiration for those who succeed and resentment of those same people; respect for wealth and hatred of the rich, and so on. Mechanisms that succeed economically can reinforce the supporting cultural traits and suppress those that hinder the successful mechanisms.

So culture could change as corporate structures change, and there is evidence that this has been happening in Europe.[26] But endogeneity has its own limits. Some cultural traits are so embedded that they do not change. Those that would be most susceptible to change are those that are only implicated by one, new modern institution. But if the trait fits many institutions, only one of which is changing and only one of which is impeded by the constraint, that constraint will tend to endure more than the constraint that is only implicated by one changing institution. In a sense, cultural traits can be part of networks,

[25] I am here working through one cultural constraint and its effect on when outrage at managerial compensation kicks in. But one could work through a slew of such cultural constraints and see how they could affect corporate law and corporate structure. Not just: When does outrage kick in? But also: When does managerial self-restraint kick in? Why and when do players act professionally? Why and when do they act in self-interested fashion? Or, how does one build "unit cohesion" both at the top and throughout the organization, of loyalty beyond that which law requires?

[26] See, for example, Etude Proxinvest, at 5 (concluding that executive pay in France is approaching that in the United States).

and if only one part of the network is pressing on economically the constraint, while the others do not press (or in fact support) then the trait can, and will, persist.

V. POLITICAL AND SOCIAL LIMITS?

Managers and shareholders have been at odds in takeover contests. The rules of the game now favor managers, with takeover rules coming close now to the "just say no" defense that managers and their lawyers have long favored.[27]

Economically-oriented analysis usually sees this as inefficient or—even in a friendly analysis of the pill, such as Kahan and Rock's—efficient but only after players adjust and reequilibrate (with higher managerial compensation inducing protected managers to accept takeover bids).

As such, the economic model in its positive form needs to explain the usual antitakeover results. Here I will trace what might be a plausible economic story for a brief moment, sketching a possible basis for this antitakeover result to be efficient or at least not wildly costly in that three-party bargain. Then I shall return to our search for boundaries to the economic model.

The economic model might try to explain antitakeover results with an implicit contracts perspective. That is, one might imagine that stockholders would want to give managers discretion and authority, that they would believe that managers would work best if giving free reign. One could certainly imagine employment systems that did so—academic tenure comes to mind. And the new literature on IPO charter terms might support a yet-to-be developed implicit contract theory. That is, the new IPO charter literature shows that despite the presence of dominant stockholders, the newly-public firms *use* antitakeover terms in the charters, terms that the dominant stockholders have the means and, as usually thought, the incentives, to eliminate.[28] While an agency cost failure could explain this result,[29] it is at least possible that there is some efficiency effect that has yet to be well understood, probably one in which autonomy yields better (or at least equal) results.

Let us put aside the potential efficiency story for takeover protection—one that is not yet convincing to us, because most of the benefits seem available by other, cheaper means. Let us look at how other boundaries limit the three-party bargain.

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[27] See Martin Lipton, *Pills, Polls and Professors Redux*, 69 U. Chi. L. Rev. __ (2002) (arguing that to be effective in negotiations boards need to have the power to resist a takever).

[28] See Laura Casares Field and Jonathan M. Karpoff, *Takeover Defenses at IPO Firms*, 57 J. Fin. (forthcoming Oct. 2002) (finding that 53 percent of industrial firms going public from 1988 to 1992 had at least one takeover/defense at the time of their IPO); Robert Daines and Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L. ECON. & ORG. 83, 110 (2001) (finding that nearly 50 percent of firms going public adopt strong antitakeover provisions); John Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 Cal. L. Rev. 1301 (2001).

[29] Field and Karpoff, 57 J Fin at __ (pointing out that the separation of ownership and management is present at the IPO stage between manager and non-managerial shareholders).

Managers usually win in making takeover law. And their positional advantage in the firm gives them leverage on how firms throw their weight around in the political arena.[30]

One can, and should, see managers' takeover wins as partly due to their positional advantage in the firm being writ large into the polity. Corporate governance conflicts inside the firm—between managers and the board on one hand and shareholders on the other—can spill over into the polity. And who wins there can depend on authority inside the firm and how alliances play out in the polity.

Once those internal conflicts spill over, agency costs could be projected onto the polity, as managers try to use corporate resources to pay for political influence. True, that kind of *direct* influence has long been illegal, and managers' use of corporate resources must be more indirect.[31]

But, the polity can still determine some division of the spoils. This too places a limit on the economic model of corporate law. Antitakeover law was that much easier for managers to get in Ohio, Illinois, and Pennsylvania because players outside the three-party bargain—labor and "innocent" bystanders—were skeptical of takeovers. Incumbent labor, after all, has votes; those votes gave legislatures a reason to favor antitakeover rules and they gave legislatures a reason to hesitate when considering whether to overturn judge-made antitakeover rules. (Incumbent employees have votes, and since takeover law has to survive in the political arena before it gets to the economic arena, takeover law is less pro-shareholder than it would be otherwise.) These Ohio, Illinois, and Pennsylvania results left "space" for Delaware to go where it wanted to.[32]

And the judges' Article in this Symposium introduces another political/social element in Delaware into the equation, one that reaches the antitakeover result more directly, *and one that goes outside the three-player economic model*. Chancellor William Allen and Vice Chancellors Jack Jacobs and Leo Stine[33] tell us that in the back of the Delaware judges' minds sometimes are those stakeholder interests, interests that can not be—or should not be— slighted. Could this be tracing out one more boundary for the pure economic model? In one form, it could be this: There are differing allocations of

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[30] The mechanism is similar to how Victor Brudney and Allen Ferrell argue corporate charitable contributions represent managerial goals, not shareholder goals. Brudney and Ferrell, 69 U. Chi. L. Rev. at __.

[31] Robert H. Sitkoff, *Corporate Political Speech and the Competition for Corporate Charters*, 69 U. Chi. L. Rev. __ (2002).

[32] It is not obvious that if one wanted to bring employees/stakeholders to the table, the best way to do it would be to give managers *more* discretion, with that discretion reviewable primarily by the chancery court. Neither the managers nor the judges are primarily attuned to stakeholder interests. Hence, a political claim would be of an implicit "deal": Incumbent employees couldn't get what they would want (job protection?), but could only get an implicit alliance with managers to slow down the takeover machine. Or, more cynically, managers had to adopt an employee-oriented rhetoric to stabilize antitakeover law in a way that benefited themselves.

[33] The first is emeritus, the second two sitting.

authority among the three-economic players at the top. More board authority in one,[34] less in another.[35] But unless one model or another is convincing to chancellors, maybe convincing beyond all reasonable doubt, other considerations come into play, such as the chancellors' sympathy for the employees at the target (or at least at some targets). And hence corporate law is made with considerations beyond the economic coming into play, considerations that tip the balance between one economic model and another. And, hence, we have one more boundary to the economic model of the public firm.

CONCLUSION: GLIMPSES OF BOUNDARIES TO THE ECONOMIC MODEL OF THE CORPORATION

The economic model works well in explaining American corporate law and American corporate structures. It explains well much that we see because cultural constraints that could kick in early, do not.

Explaining this or that feature by pointing to culture generally is too easy. To get a better handle than we have so far on how culture can affect corporate law, law's efficacy, or the corporate structures that we do see, we should begin small, or at least narrow, and examine how one cultural constraint can affect the micro-structure of corporate governance in the firm.

The Articles give us one possibility, the "outrage" that is said to constrain executive pay from going even higher. If the internal outrage constraint to executive pay were low, not high (that is, if it were not as high as it is in the United States), the boundary for the economic model would be drawn differently. The Coasian bargain that keeps takeovers going in the face of hostile laws, structures, and court decisions would be less easily reversed, or not reversed at all. Takeovers would be less frequent. If other tools of making managers loyal to shareholders were much more imperfect, then performance in the large public firm would degrade, and presumably ownership structures change: There would be a comparative advantage for closely-held corporations over public firms. Firms would be smaller and more closely-held, with denser relational contracts among them. The adjustment would be more akin to the Coasian firm vs. market adjustment of "The Nature of the Firm" than the internal contractarian adjustment of "The Problem of Social Cost."

More could be said about how varying just this single cultural constraint could affect corporate results. Corporate law could be the same in two nations, but cultural differences could determine *how* managers extract rents (visibly via excess compensation or veiled via interested party transactions). If managerial compensation is very high, managers could rationally decline to pursue interested party transactions that they have a

[34] See Lipton, 69 U. Chi. L. Rev. at __ (arguing that boards need strong defensive powers to be strong negotiators for target shareholders).

[35] Bebchuk, 69 U. Chi. L. Rev. at __ (arguing that for target shareholders it is undesirable for boards to have a veto over outside offers to buy those shares).

high chance of "getting away with." But if culture constrained compensation, then managers' "demand" for these transactions would be higher.

And that is just culture. Think about the Coasian possibility that several allocations of authority among shareholders, managers, and boards are (roughly) equally efficient. Most of the time, the three players decide what to do. But when they dispute results, they usually turn to other authorities to resolve their disputes: the judges or the legislators, who can invoke principles and sentiments outside of the three-party bargain. Voters' skepticism about takeovers has been noted before,[36] as has legislators' susceptibility to labor influence.[37] And the Articles tell us even more: The simple sympathy of the chancellors for the employees can influence some results, presumably when the direction that other considerations point to is uncertain, unclear, or moot.

And, hence, out in the haze of the corporate horizon we can catch glimmers of boundaries to the economic model of the firm.

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[36] Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cin. L. Rev. 457, 491 (1998)) (noting that a plurality of the public "has a negative opinion of takeovers".

[37] See Mark J. Roe, *Takeover Politics*, in THE DEAL DECADE 321, 339-40 (Margaret Blair ed., 1993).