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Comment – Corporate governance and Coase's legacy: a reply to Henry Manne

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Professor Manne makes a fundamental statement, which he articulates in the domain of three major items of corporate governance. The statement is that 'there is no aspect of corporate governance that is not better left to private contracting and the play of market forces' (p. 190 of this volume).[1] This is applied to boards of directors, the market for corporate control, and insider trading. I do not think that Professor Manne would maintain his fundamental statement even in those circumstances that most evidently call for regulatory intervention. That he admits, implicitly, when he supports the 'need for courts to deal with real acts of misbehavior by directors' (p. 197 of this volume). By speculating on the limits of contracting and the meaning of misbehavior, I will try to illustrate why – maybe unfortunately – there is more need for regulation in corporate governance than Professor Manne suggests. Incidentally, my considerations are based on a framework not very different from his. While I am honored to be cited by the very pioneer of corporate law and economics, I am afraid I do not fully share his trust in the unfettered functioning of markets and private contracting for efficient corporate governance.

1. It is in the tradition of law and economics that regulation must be justified by market or contracting failures. This goes back to Ronald Coase (1960), whose views – as he also made clear in his Nobel Prize Lecture (Coase 1992) – tend to be misinterpreted in various formulations of a theorem that he has never enunciated. Coase did point to the virtues of the contracting process in resolving the misallocation of resources, but he

[1] In stating this, Manne refers to Macey (2008) who, however, articulates his reasoning through a more comprehensive set of institutions of corporate governance. For reasons of space, I am not in a position to comment upon Professor Macey's work, and on how it compares with the arguments developed by Manne. I briefly discuss Macey's contention that corporate law is made exclusively of default rules at the end of this comment.

also showed a number of limits to this process. Short of being unimportant, law can (but does not necessarily do so) support and correct private contracting in two ways: (1) by providing the entitlements to be contracted upon; (2) by regulating those entitlements whenever private contracting fails to do that efficiently because of high transaction costs.

When applied to corporate governance, this framework generates two basic grounds for regulatory intervention (Becht et al. 2007). The first is that some of the people affected by the deal might be missing from the bargaining table. The second is that the terms of the original agreement might be altered via renegotiation at a later stage. Both arguments reflect a problem known as contractual incompleteness. Contracts are imperfectly state-contingent, and as a result, unforeseen circumstances confer upon some of the parties to a so-called 'nexus of contracts' unanticipated power over the division of the firm's surplus. Those who may be adversely affected by these dynamics are naturally reluctant to invest in a long-term relationship. This is most unfortunate in corporate governance, whose major goal is maximizing the flow of investments committed to welfare-increasing production.

2. The first reason for regulatory intervention (third-party effects) is more often characterized as externalities of the corporate contract on other stakeholders' contracts. I doubt whether Ronald Coase would share this view. Put as externality, the argument is not powerful enough to support any further protection of shareholders or stakeholders than private ordering would grant. Both categories of players have a wonderful opportunity to contract for their rights in corporate governance when the firm goes public. High transaction costs would not give them a second chance when – as Professor Manne nicely puts it – public corporations evolve as entities in the market context. But then, more than about externalities, the real question is whether the property rights system confers upon these players a sufficiently broad range of entitlements to contract upon in the corporate governance set-up.

I believe that corporate law does this by complementing the property rights system with entitlements to control power that are not necessarily confined to ownership (Pacces 2007). This is the case when voting rights can be separated from ownership (for example, different classes of shares), or control rights are generated independently of voting rights (for example, management's privileged access to the proxy machinery). Although the issue of enabling rules is dismissed as one of secondary importance by Professor Manne, I consider this the most powerful argument for relying upon the market mechanism. When shareholders and stakeholder can effectively choose the entitlements necessary for protecting their investments, we may infer their preferences from this choice and its impact on stock prices. Under the same condition, we can conclude that those who contract for control powers need to protect their firm-specific investment from unforeseen contingencies, whereas those who don't simply refrain from putting that at stake.

I share Professor Manne's concern that corporate laws may, and most often do, fail to support that freedom of contract, although I see at least one way in which law may do too little, instead of too much, in addressing corporate governance from this angle. Following Berle and Means (1933), American scholars tend to take transition to managerial capitalism for granted. The reason why this may not happen – as is still the case in most countries of continental Europe – is not just that regulation interferes too much with the market mechanism, but also that it fails to provide the players with a sufficient range of entitlements to bargain over. When we take a quick look at comparative corporate governance, we see that managers are in charge when corporate law effectively allows management-controlled directors to be empowered against shareholders. When it does not allow that, control powers need to be *legally* supported by ownership, and this is how corporate governance gets stuck in controlling shareholding structures, regardless of whether this is efficient (Cools 2005).

Professor Manne correctly connects this part of my work with Bainbridge's (2002) advocacy of 'director primacy' (including the argument that stakeholders would contract for board representation when this is needed for them to invest). But he overlooks an important difference. I do not consider directors as monitors, unless the contract or regulation specifically entrusts *some* of them with this task, exactly because I share Professor Manne's view that (most) directors are part of the management team. Boards of directors are mainly (albeit not exclusively, as I am going to illustrate in a moment) an instrument for the exercise of control powers. When corporate law makes them powerful enough relative to shareholders, we observe management-controlled companies. When corporate law does not allow directors' empowerment, boards will still be the center of managerial discretion, but they will have to defer to a controlling shareholder. What these two outcomes have in common is that corporate governance, like any form of firm governance, needs to feature a unique line of command in order to protect firm-specific investments. Again, based on the work by Ronald Coase (1937), authority is no less important than market exchange in a capitalist economy. A prominent consequence of separation of ownership and control is that authority cannot just be supported by property rights (Zingales 2000).[2]

[2] For a theoretical discussion of this problem, see Chapter 6 by Pagano and van Oosterhout's Comment on it in this volume.

3. The second ground for legal intervention in corporate governance (opportunistic renegotiation) is related to the previous illustration of corporate law's support for private contracting. The corporate contract may well reflect efficient choices when the firm goes public. However, on the one hand, what is efficient today may no longer be efficient tomorrow. Indeed, this is the reason why law needs to support discretionary control powers (be they vested in the management or in controlling shareholders). On the other hand, unfettered discretion includes the power to alter the terms of the original agreement in the face of changed circumstances, and this may too easily result in expropriation of other constituencies. Leaving stakeholders aside, I agree with Professor Manne's argument that non-controlling shareholders would not invest if they were not confident that this arrangement still protects them well enough. But I disagree that the market mechanism is sufficient for this purpose. However control powers are allocated, the market can no longer support long-term commitments when it is 'superseded' by authority (Coase 1937).

For investor protection, Professor Manne especially relies on a market for corporate control operated by hostile takeovers. We would not need much else to prevent controllers from misbehaving – he argues – if a raider were always in a position to take control away from a disloyal or under-performing management. As highlighted by Lucian Bebchuk (1987, 1999), there are two reasons why this is not necessarily true. To start with, in a regulation-free environment, there is no guarantee that a new controller will enhance shareholder value instead of profiting from expropriation of non-controlling shareholders. Indeed, unconstrained opportunities for expropriation are a sufficient condition for shareholders to be under pressure to tender at any price. Secondly, hostile takeovers are ruled out whenever those in control are in a position to extract private benefits by diverting resources from minority shareholders into their own pockets. Since the only way for incumbents to be compensated for these benefits is selling control at a premium, they are committed to keeping control uncontestable.

Corporate controllers are therefore not in a position to commit to a no-expropriation policy by exposing themselves to the (threat of) hostile takeover. Quite to the contrary, that commitment must already be in place for hostile takeovers to be viable. Would the corporate contract be enough to support it? I believe not, and the reason is that controllers cannot credibly restrain their discretion through a contract whereby all control powers (including that of adapting the contract to unforeseen circumstances) are allocated to them in order to promote firm-specific investments. This is how regulation enters the picture. In order to support credible commitments that non-controlling shareholder will still be dealt with fairly, restraints on the corporate controller's discretion must be mandatory – that is, they cannot be opted out of by the corporate contract or any of its amendments.

Professor Manne seems to concede that this may be a good reason for courts to perform a residual check on the corporate controller's misbehavior. I think that we might agree that the domain of this check should be diversion of corporate resources – that is, theft in broad terms – and little else. However, the implications of this contention for the regulation of corporate governance are more far-reaching than they may appear.

4. When managers or controlling shareholders are vested with unfettered discretion, the opportunities for turning this into stealing are ubiquitous. They range from daily operations to corporate control transactions. The problem is that value diversion is not easily distinguished from the legitimate exercise of business judgment. In order to make sense of the Business Judgment Rule – a norm that preserves outside shareholders' commitment to delegating discretionary management regardless of how badly it turns out in hindsight – courts rely on the procedural fairness of corporate decision-making. Even in the presence of conflicts of interest, courts rely more on validation by directors who are independent of those in control than on their own ability to second-guess business judgment. However, independent directors – whatever that means – are not there to interfere with the management, but only to make sure that investor protection does not come at the price of over-regulating managerial discretion. I believe this is a major challenge for regulation today, rather than just an option (which could be reneged upon at anytime) for the corporate contract.

A similar reasoning applies to takeovers. Hostile takeovers are at odds with the (economically justified) concern of managers and controlling shareholders over the stability of their control powers. This may be why we have only experienced this phenomenon in specific spatial and temporal circumstances. Takeovers can also induce corporate controllers to do their best when they are friendly (incidentally, it is worth noting that this used to be Professor Manne's contention in 1965). However, once again this requires regulation to cope with problems of credible commitment (or, in Coasian terms, transaction costs). Non-controlling shareholders can become suddenly powerful in the face of a tender offer, when they are allowed a free ride on the insurgent's profits. Little do they know that, by short-circuiting the takeover mechanism, their opportunism just results in more shirking by the incumbents. As Professor Manne contends, there are a number of free-market ways out of this. However, they all result in a situation in which shareholders are induced to tender at any rate (thereby reopening the door to shareholder expropriation). Regulation must find the right balance between the bidder's commitment to enhance the company's value, shareholders' commitment to let him/her appropriate takeover gains, and the incumbent's commitment to part with control when he/she is compensated for its current value. I believe that it can (thereby restoring the virtues of Coasian bargain), although I concede to Professor Manne that it can better do so by weakening, instead of strengthening, minority shareholders.

Let me discuss very briefly the third topic analyzed by Manne, insider trading. I note that Professor Manne's argument in favor of insider trading is twofold. On the one hand, it improves the speed with which information is impounded in stock prices. On the other hand, it rewards the originators of information. I believe that the two arguments are related, so I will just explain why I am not entirely convinced about the latter. The rewards at issue are connected with profits on the stock market. While it is true that high-powered incentives to information acquisition, processing, and verification enhance stock market efficiency (Gilson and Kraakman 1984), I see two reasons why insiders should be prevented from profiting from their advantage in this.

First, insider trading reduces the incentives of outsiders to engage in the same activity, and accordingly, their returns from investing and willingness to invest in the stock market. Insiders may earn more from selling non-controlling stock when they are (legally) committed to letting only outsiders trade on information advantages. Secondly, prohibition of insider trading does not mean that insiders are prevented from otherwise reaping the gains of their information collection (another way of looking at their firm-specific investments). They can, indeed, to the extent that they manage to keep information about the firm's potential secret and to share it only with bidders who know better how to turn this potential into stock returns. This will allow two separate bargains on control and ownership: the first, rewarding the incumbent via a control premium; the second, making sure that insurgents take over if and only if they can enhance stock returns more than the market already anticipates.

5. My disagreement with Professor Manne on the unlimited virtues of private contracting generated a lively discussion at the conference[3] where our opposing views were aired. Based on that discussion, I need to clarify an important issue. My contention that mandatory rules are needed for investor protection could apparently be falsified by the observation that, even in those jurisdictions where this protection is considered high, the

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[3] See my introduction to this volume (at p. 11).

so-called 'mandatory rules' are not effectively binding. This seems to hold especially in the US, where traditionally corporate law has been considered to be mainly a collection of default rules (Easterbrook and Fischel 1991). The argument becomes particularly powerful when it is related to the choice of legal form and, even more so, of the corporate jurisdiction. Regardless of whether the law governing business corporations features mandatory rules in any given jurisdiction, these cannot be regarded as effectively mandatory when they can be opted out of either by choosing another legal form or by incorporating in another jurisdiction. This situation characterizes all American corporate jurisdictions, and particularly, the one governing the vast majority of US publicly held companies – Delaware. Within the limits of freedom of incorporation under European company law, the same argument would apply to Europe (Kraakman et al. 2009). It is therefore highly questionable whether investor protection in corporate governance is owing to the mandatory character of fiduciary duties – especially in the celebrated version administered by Delaware courts (Coffee 1989). Even in Delaware, 'fiduciary duties exist unless the parties have explicitly contracted them away' (Macey 2008: 23).

The argument that fiduciary duties are no exception to the enabling character of corporate law has a long-standing tradition in the US. Advocates of this position (for example, Romano 1989) contend that rational shareholders of a publicly held company would neither invest in a company offering insufficient protections against expropriation nor rubber-stamp a charter amendment aimed at removing those protections. The corporate contract thus protects investors well enough, and the question whether fiduciary duties need to be mandatory is the wrong question. Investors would only opt out of them in exchange for equivalent or stronger protections, for they would be fools to confer upon the management an explicit license to steal. The argument has been rejuvenated in a most interesting fashion by Hansmann (2006), who likewise contends that corporate contracts are very hard to amend due to the hold-out powers of minority shareholders. For this reason, companies choose not to depart from the statutory defaults and rely on the legislator to adapt the contract to changed circumstances. De facto, this makes default rules nearly as binding as mandatory rules. Both the companies and their investors, however, could take a different course of action. They could depart from the statutory defaults and opt out of any mandatory rules by incorporating in legal forms or jurisdictions that do not impose them. The fact that the vast majority of publicly held companies in the US do not do so does not change the circumstance that corporate law is exclusively made up of default rules.

In both the traditional and the most recent configuration, the argument is extremely formalistic. It revolves around the hypothetical propositions that: (a) shareholders *could* opt out of the protection supplied by fiduciary duties; (b) shareholders *would not* opt out of their contractual protections altogether unless they were irrational. Both propositions are true in a static setting, but they cease to hold in a dynamic context. The reason is that, unlike what both Romano and Hansmann assume, US investors are no longer in control of the corporate contract after the corporation has been established and, more importantly, floated on the stock market. A number of legal institutions, originally subscribed to by the investing public (for example, the proxy machinery and the limitations on outside shareholders' initiative), allow the corporate contract to be adapted to changed circumstances without the investors' effective consent. Non-controlling shareholders are normally asked to vote on these fundamental changes, but their vote doesn't mean much. On the one hand, it can only be solicited by those in control of the corporation. On the other hand, it is cast in situations of asymmetric information and collective action problems that could not lead to efficient bargaining. As a result, fundamental changes occur without non-controlling shareholders being involved in the bargaining. In the absence of alternatives, the latter simply rubber-stamp the decisions made by those whom they entrusted with the powers to deal with unforeseen circumstances in the first place.

These powers are very broad, as is shown by the significant incompleteness of the corporate contract (Rock and Wachter 2001). There is a void at the heart of the corporate contract, and intentionally so. Borrowing from the law and economics of contract law, Macey (2008) contends that one prominent way for shareholders to opt out of fiduciary duties is to stipulate in the corporate charter how certain contingencies should be dealt with. But this is done no more often than a choice of legal form other than the business corporation, or incorporation in jurisdictions more liberal than Delaware. Normally, publicly held companies *choose* to be subject to a set of mandatory rules for this is the only way to guarantee outside shareholders against expropriation without having to give up the flexibility of the corporate contract in the face of unforeseen circumstances. The business corporation provides a better balance of flexibility and commitment than the more contract-intensive legal forms available in Delaware or anywhere else in the US. In setting up the governance structure of a soon-to-be publicly held company, the founders *could not* afford to opt out of fiduciary duties because otherwise, the management *would* too easily renege on any other contractual promise that investors be dealt with fairly after the company has gone public.[4] That outside shareholders *could* opt out of fiduciary duties, but they *would not* do so in the absence of equivalent contractual protections, thus becomes irrelevant. The natural incompleteness of the corporate contract leaves them with no real choice.

It is telling that the importance of mandatory rules to support credible commitments is recognized by the same legal scholars who otherwise question whether corporate law has any real mandatory character (Kraakman et al. 2009: 22–3). In fact, much in the vein of the economists in the law and finance strand of literature (Djankov et al. 2008), they argue that 'there may be often little practical difference between mandatory and default rules' (Kraakman et al. 2009: 25). I find this unconvincing. A brief comparison between the US and the UK on a key issue – removal of directors – shows that the distinction between default and mandatory rules does matter in corporate law.

Both the Delaware General Corporation Law (§ 141) and the British Companies Act (§ 168 and § 303) stipulate that directors may be removed by a shareholder vote without cause. However, while the former is a default rule, the latter is mandatory. The outcome for publicly held companies is exactly the opposite in the two situations. The majority of Delaware companies going public in the US opt out of the default rule, mainly through the establishment of staggered boards (Bebchuk et al. 2002).

Conversely, the non-waivable right to remove directors without cause lays down the very foundation of institutional investors' power in UK corporate governance (Armour, Chapter 5 in this volume). To be sure, this example differs substantially from fiduciary duties, since removal of directors protects investors by taking powers away from the management instead of by regulating their exercise. I have explained earlier in this comment why a more enabling approach to distribution of powers would be preferable. The point I am making here is that, no matter how investor protection is devised, it needs to be supported by mandatory rules. Commitments that non-controlling shareholders be dealt with fairly could not be taken credibly when they can be opted out of by the corporate contract and its successive amendments.

6. To conclude, it is worth stressing that there is a strong argument in favor of mandatory rules the protection of investors against expropriation

[4] It could be argued that one alternative is to make the corporate contract more difficult to amend, for example by setting super-majority requirements. The disadvantages of this solution, which explain why it is hardly ever chosen by publicly held companies, are the same as for making the corporate contract more detailed to deal with future contingencies.

of the share of firm surplus they have originally contracted for. It becomes far shakier, if not untenable, when it is applied to ex-post bargaining over a surplus (or loss) generated by circumstances not fully anticipated by contract (for example, a takeover or a radical change in market conditions). Here I fully agree with Professor Manne that private contracting should be entirely relied upon. However, in the economics of incomplete contracts, this means that parties should have unlimited freedom to allocate entitlements to control powers ex ante. On the one hand, as I have said, this requires a bit more than freedom of contract in corporate governance. The available entitlements should be defined in the first place, and this is a major task for (enabling) corporate law. On the other hand, how can the control powers of managers and/or controlling shareholders be reconciled with the previous statement that outside shareholders should keep the share of surplus they have originally contracted for?

To this purpose, mandatory rules need to operate beyond corporate law and intervene also in the functioning of securities markets. What we can leave for the corporate contract to define are, for instance, the conditions for takeovers to be effected and for insiders to extract rewards from trading their shares. But in order for these conditions to hold throughout the company's lifecycle, a binding takeover and securities regulation must protect non-controlling shareholders from dilution through freeze-outs and withholding of key information on trading the company's stock. The metaphor of 'Securities Regulation as Lobster Trap' (Rock 2002) illustrates efficaciously how these protections complement corporate law's fiduciary duties in supporting credible commitments towards investors.

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